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GLOBAL COST OF CAPITAL: THE CASE OF GLOBAL COMPUTER SYSTEMS
Rathin S. Rathinasamy, Ball State University
Les Livingstone, University of Maryland
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CASE DESCRIPTION

Global Computer Systems (GCS) is a hypothetical multinational company in the IT industry. The company is a major player in the industry catering to clients from a variety of industries. GCS has different segments specializing in major areas of its operation. The case provides an opportunity to examine various issues that need consideration while making capital budgeting decisions. One of the significant issues is that of determining the cost of capital on the basis of which the hurdle rate is calculated in deciding whether a project is worth accepting. This forms the central issue around which the case is structured. This case is suitable for use in a core Finance courses of MBA programs, and for use in MBA and under-graduate senior level international finance courses. Ideally, the case should be distributed well before the session so that students have adequate preparation time to go through the case and visit relevant internet sources mentioned therein. The case discussion may take up anywhere between 60 minutes to 90 minutes depending on the depth to which the students are intellectually stimulated to delve into.

Gordon Crown, Chief Financial Officer of GCS, would like you to help him develop a company-wide cost of capital policy that is consistent with modern finance theoretical constructs. He would also like you to provide your recommendation on the acceptability of the projects. He also feels that since stock prices often fluctuate, it would be advisable to use book value weights in computing the component capital costs and the cost of capital.

However, his young deputy, Helen Chang who is a recent MBA graduate, feels that market prices are very important indicators of the health of the company and they provide very good signals to the corporation in terms of the future directions. As such, she feels that the market value weights approach would be the best approach.

She is also of the opinion that the Required Rate of Return on any given project, in addition to the WACC, should also include various risk premiums like stand-alone or project specific risk which can be further broken down into political risk, repatriation risk, exchange rate risk etc. Further, she believes that the required rate of return should be increased by about 1% to allow for capital investment projects that have no cash inflows, such as pollution control equipment and safety equipment.

KEYWORDS: Cost of capital, computer systems, finance education, case study

JEL: A23, D24, I22

CASE INFORMATION

Global Computer Systems (GCS) is an IT company that develops and manufactures IT products and services worldwide. Its major operating segments include Global Technology Services, Global Business Services, Software, Systems and Technology, and Global Financing. The majority of the company's enterprise business, which excludes the company's original equipment manufacturer (OEM) technology business, occurs in industries that are broadly grouped into six sectors –
financial services, public, industrial, distribution and communications as well as small and medium sized businesses.

In spite of the current global financial crisis, GCS appears to be doing very well. In January of 2009, it announced better than expected fourth quarter earnings with net income of US$4.4 billion, up from US$4 billion the previous year. According to its CEO, GCS “performed well in an extremely difficult economic environment” in year N+4 and that the company will “enter the year in a very strong position”. Table 1 summarizes the recent trend across some of the popular parameters.

Table 1: GCS’s Summary Financial Data (N+2–N+4)

<table>
<thead>
<tr>
<th>Consolidated results (US$, in millions)</th>
<th>Year N+4</th>
<th>Year N+3</th>
<th>Year N+2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Sales</td>
<td>$103,630.0</td>
<td>$ 98,786.0</td>
<td>$ 91,423.0</td>
</tr>
<tr>
<td>Net Sales Growth</td>
<td>4.91%</td>
<td>8.1%</td>
<td>0.31%</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>$15,938.0</td>
<td>$13,516.0</td>
<td>$11,928.0</td>
</tr>
<tr>
<td>Operating Profit Growth</td>
<td>17.91%</td>
<td>13.31%</td>
<td>27.21%</td>
</tr>
<tr>
<td>Diluted EPS Excluding Extraordinary Items</td>
<td>8.93</td>
<td>7.18</td>
<td>6.06</td>
</tr>
<tr>
<td>Growth Rate</td>
<td>24.37%</td>
<td>18.48%</td>
<td>23.42%</td>
</tr>
</tbody>
</table>

The table presents a summary of consolidated results of GCS’s financial data from N+2 to N+4 years.

The Consolidated Income Statement of GCS is presented in Table 2 pertaining to the years, Year N through Year N+3.

Table 2: GCS Income Statement (N–N+3) Values in Millions (Except for per share items)

<table>
<thead>
<tr>
<th>Period End Date</th>
<th>Year N+3</th>
<th>Year N+2</th>
<th>Year N+1</th>
<th>Year N</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stmt Source Date</td>
<td>12/31/N+3</td>
<td>12/31/N+2</td>
<td>12/31/N+1</td>
<td>12/31/N</td>
</tr>
<tr>
<td>Stmt Length</td>
<td>12 Months</td>
<td>12 Months</td>
<td>12 Months</td>
<td>12 Months</td>
</tr>
<tr>
<td>Stmt Source</td>
<td>10-K</td>
<td>10-K</td>
<td>10-K</td>
<td>10-K</td>
</tr>
<tr>
<td>Stmt Update Type</td>
<td>02/26/N+4</td>
<td>02/26/N+4</td>
<td>02/26/N+4</td>
<td>02/27/N+3</td>
</tr>
<tr>
<td>Revenue</td>
<td>98,785.0</td>
<td>91,423.0</td>
<td>91,134.0</td>
<td>96,293.0</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>98,786.0</td>
<td>91,423.0</td>
<td>91,134.0</td>
<td>96,293.0</td>
</tr>
<tr>
<td>Cost of Revenue, Total</td>
<td>57,057.0</td>
<td>53,129.0</td>
<td>54,602.0</td>
<td>60,724.0</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>41,728.0</td>
<td>38,294.0</td>
<td>36,532.0</td>
<td>35,569.0</td>
</tr>
<tr>
<td>Selling/General/Administrative Expenses, Total</td>
<td>22,060.0</td>
<td>20,259.0</td>
<td>21,134.0</td>
<td>20,079.0</td>
</tr>
<tr>
<td>Research &amp; Development</td>
<td>6,153.0</td>
<td>6,107.0</td>
<td>5,842.0</td>
<td>5,874.0</td>
</tr>
<tr>
<td>Depreciation/Amortisation</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Interest Expense (Income), Net Operating</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Unusual Expense (Income)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Other Operating Expenses, Total</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Operating Income</td>
<td>13,516.0</td>
<td>11,928.0</td>
<td>9,376.0</td>
<td>9,616.0</td>
</tr>
<tr>
<td>Interest Income (Expense), Net Non-Operating</td>
<td>217.0</td>
<td>293.0</td>
<td>-220.0</td>
<td>-139.0</td>
</tr>
<tr>
<td>Gain (Loss) on Sale of Assets</td>
<td>18.0</td>
<td>41.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Other, Net</td>
<td>1,172.0</td>
<td>1,054.0</td>
<td>3,070.0</td>
<td>1,192.0</td>
</tr>
<tr>
<td>Income Before Tax</td>
<td>14,489.0</td>
<td>13,316.0</td>
<td>12,226.0</td>
<td>10,669.0</td>
</tr>
<tr>
<td>Income Tax - Total</td>
<td>4,071.0</td>
<td>3,901.0</td>
<td>4,232.0</td>
<td>3,172.0</td>
</tr>
<tr>
<td>Income After Tax</td>
<td>10,418.0</td>
<td>9,415.0</td>
<td>7,994.0</td>
<td>7,497.0</td>
</tr>
<tr>
<td>Tax rate</td>
<td>28.10%</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Minority Interest</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Equity In Affiliates</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>U.S. GAAP Adjustment</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>
This table presents the consolidated income statement of GCS from N to N+3 years.

The consolidated Balance Sheet of GCS is presented in Table 3 pertaining to the years, Year N through Year N+3.

Table 3: GCS Consolidated Balance Sheet (in millions) (N–N+3) Financial data in US$ Values in Millions (Except for per share items)
Other Current Liabilities, Total  |  13,475.0  |  13,257.0  |  12,029.0  |  11,903.0
Total Current Liabilities     |  44,310.0  |  40,090.0  |  35,152.0  |  39,786.0

Total Long Term Debt          |  23,039.0  |  13,780.0  |  15,425.0  |  14,828.0
Deferred Income Tax           |  1,064.0   |  665.0     |  1,616.0   |  1,770.0
Minority Interest             |  0.0       |  0.0       |  0.0       |  0.0
Other Liabilities, Total      |  23,549.0  |  20,192.0  |  20,457.0  |  22,931.0
Total Liabilities             |  91,962.0  |  74,727.0  |  72,650.0  |  79,315.0

Redeemable Preferred Stock   |  0.0       |  0.0       |  0.0       |  0.0
Preferred Stock - Non Redeemable, Net | 0.0 | 0.0 | 0.0 | 0.0
Common Stock                 |  35,188.0  |  31,271.0  |  28,926.0  |  26,673.0
Retained Earnings (Accumulated Deficit) | 60,640.0 | 52,432.0 | 44,734.0 | 38,148.0
Treasury Stock - Common       | -63,945.0  | -46,296.0  | -38,546.0  | -31,072.0
Other Equity, Total           | -3,414.0   | -8,901.0   | -2,016.0   | -2,061.0
Total Equity                  |  28,469.0  |  28,506.0  |  33,098.0  |  31,688.0

Total Liabilities & Shareholders’ Equity | 120,431.0 | 103,233.0 | 105,748.0 | 111,003.0

Total Common Shares Outstanding | 1,385.23 | 1,506.48 | 1,573.98 | 1,645.59
Total Preferred Shares Outstanding | 0.0 | 0.0 | 0.0 | 0.0

This table presents the consolidated balance sheet of GCS from N to N+3 years.

The detailed composition of total long term debt of US$ 23,039 million reported on the consolidated Balance Sheet for the year N+3 is presented in Table 4. The table provides details for debt securities of various maturities along with the coupon rates payable on them.

Table 4: Details of Long-Term Debt (US$, in millions)

<table>
<thead>
<tr>
<th>Coupon Interest Rate</th>
<th>Maturities</th>
<th>Balance on N+3</th>
<th>Annual Interest Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.48%</td>
<td>N+4-N+7</td>
<td>$12,295***</td>
<td>$551</td>
</tr>
<tr>
<td>5.34%</td>
<td>N+8-N+9</td>
<td>3,545</td>
<td>189</td>
</tr>
<tr>
<td>5.69%</td>
<td>N+10-N+14</td>
<td>3,026</td>
<td>172</td>
</tr>
<tr>
<td>8.375%</td>
<td>N+15</td>
<td>750</td>
<td>63</td>
</tr>
<tr>
<td>7.00%</td>
<td>N+21</td>
<td>600</td>
<td>42</td>
</tr>
<tr>
<td>6.22%</td>
<td>N+23</td>
<td>469</td>
<td>29</td>
</tr>
<tr>
<td>6.50%</td>
<td>N+24</td>
<td>313</td>
<td>20</td>
</tr>
<tr>
<td>5.875%</td>
<td>N+28</td>
<td>600</td>
<td>35</td>
</tr>
<tr>
<td>7.00%</td>
<td>N+41</td>
<td>150</td>
<td>11</td>
</tr>
<tr>
<td>7.125%</td>
<td>N+92</td>
<td>850</td>
<td>61</td>
</tr>
</tbody>
</table>

Other currencies (average interest rate at December 31, N+3, in parentheses)

| Euros (3.4%)         | N+4-N+9    | 2,466         | 84                     |
| Yen (2.2%)           | N+6-N+10   | 767           | 17                     |
| Swiss francs (1.5%)  | N+4        | 442           | 7                      |
| Other (2.7%)         | N+4-N+9    | 89            | 2                      |

Weighted average interest rate = $1,283/$26,362 = 4.87%

Less: Net unamortized discount 65
Add: SFAS No. 133 fair value 432
'  26,729
Less: Current maturities 3,690
Total 23,039

This table provides a detailed break-down of the composition of Long-term debt of GCS reported on its consolidated Balance Sheet for the year N+3.

All GCS bonds are rated Aaa by Moody’s and AAA by Standard & Poor’s. Interpretation of bond rating categories normally assigned by both the credit rating agencies are summarized in Table 5.
Table 5: Credit Rating Categories

<table>
<thead>
<tr>
<th>Rating Description</th>
<th>Moody’s Ratings</th>
<th>Standard &amp; Poor’s Ratings</th>
<th>Rating Grades</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highest Quality</td>
<td>Aaa</td>
<td>AAA</td>
<td>Investment Grade</td>
</tr>
<tr>
<td>High Quality</td>
<td>Aa</td>
<td>AA</td>
<td></td>
</tr>
<tr>
<td>Upper Medium</td>
<td>A-1, A</td>
<td>A</td>
<td></td>
</tr>
<tr>
<td>Medium</td>
<td>Baa-1, Baa</td>
<td>BBB</td>
<td></td>
</tr>
<tr>
<td>Speculative</td>
<td>Ba</td>
<td>BB</td>
<td></td>
</tr>
<tr>
<td>Highly Speculative</td>
<td>B, Caa</td>
<td>B, CCC, CC</td>
<td></td>
</tr>
<tr>
<td>Default</td>
<td>Ca, C</td>
<td>D</td>
<td></td>
</tr>
</tbody>
</table>

The table describes the interpretation of various categories assigned by two credit rating agencies.

Currently, in the capital budgeting arena, each GCS division has its own method of calculating the cost of capital resulting in different hurdle rates; thus, it leads to non-uniformity with regard to accept/reject decisions on capital investments. GCS feels that in order to maximize shareholder value, it has to come up with company-wide guidelines for calculating its cost of capital and standardize the hurdle rates and accept/reject decisions throughout the company. For the year N+6, GCS is considering the following capital budgeting projects with these projects spread around the globe:

Table 6: GCS’s N+6 New Projects Under Consideration

<table>
<thead>
<tr>
<th>Project</th>
<th>Net Investment Cost (US$, in millions)</th>
<th>Proposed Location</th>
<th>Estimated IRR</th>
<th>Type of Project</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$500</td>
<td>Europe</td>
<td>26.3%</td>
<td>Existing product, new market</td>
</tr>
<tr>
<td>2</td>
<td>$400</td>
<td>USA</td>
<td>13.5%</td>
<td>New product, new market</td>
</tr>
<tr>
<td>3</td>
<td>$650</td>
<td>Asia</td>
<td>8.6%</td>
<td>Expand existing product in existing market</td>
</tr>
<tr>
<td>4</td>
<td>$1,500</td>
<td>Asia</td>
<td>23.4%</td>
<td>New product, existing market</td>
</tr>
<tr>
<td>5</td>
<td>$350</td>
<td>USA</td>
<td>24.6%</td>
<td>Replace Equipment</td>
</tr>
<tr>
<td>6</td>
<td>$750</td>
<td>Europe</td>
<td>10.2%</td>
<td>Expand existing product in existing market</td>
</tr>
<tr>
<td>7</td>
<td>$250</td>
<td>Asia</td>
<td>26.7%</td>
<td>Existing product, new market</td>
</tr>
<tr>
<td>8</td>
<td>$325</td>
<td>Asia</td>
<td>18.8%</td>
<td>New product, existing market</td>
</tr>
</tbody>
</table>

This table provides details of new projects under consideration by GCS in year N+6

Further, GCS has a total budget allocation (capital constraint) of US$4.2 billion for the N+6 capital investment budget. Project risk tends to vary with project type, as described in table 7.

Table 7: Type of project and degree of risk

<table>
<thead>
<tr>
<th>Type of Project</th>
<th>Degree of Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Routine replacement of equipment</td>
<td>Minimal</td>
</tr>
<tr>
<td>Cost reduction</td>
<td>Low</td>
</tr>
<tr>
<td>Expand existing products in existing markets</td>
<td>Moderate</td>
</tr>
<tr>
<td>Add new products in existing markets</td>
<td>Moderate-High</td>
</tr>
<tr>
<td>Expand existing products in new markets</td>
<td>Moderate-High</td>
</tr>
<tr>
<td>Add new products in new markets</td>
<td>High</td>
</tr>
</tbody>
</table>

This table describes the risk profiles of different kinds of projects normally undertaken by businesses.

You have been provided with an excellent opportunity to assist Gordon Crown and Helen Chang in your first exposure to a real world scenario. Having recently completed MBA Finance from a leading University, this is your best chance to launch your career in corporate finance by applying relevant concepts that you may have come across in the class room discussions at your University. A further
challenge is to justify the basis of your analysis in the most convincing manner to address Helen Chang’s concerns, being an MBA herself. Gordon Crown is now eagerly awaiting your recommendations.

QUESTIONS

After a quick glance at the available information and the decision making requirements of the Gordon Crown, you have decided that at the minimum you have to do the following:

**Question 1:** For component costs:
A. Compute the before- and after-tax costs of GCS debt.
B. Compute the cost of equity (assuming all funds come from internal sources):
   i. Using the constant growth Gordon Dividend Valuation Model
   ii. Using the Security Market Line Equation (SML) from the Capital Asset Pricing Model (CAPM)

**Question 2:** Compute the Weighted Average Cost of Capital (WACC) based on cost of equity estimated under the Gordon's Constant Growth Dividend Valuation Model:
A. Using book value weights for debt and equity
B. Using market value weights for debt and equity

**Question 3:** Compute the WACC based on cost of equity estimated under the CAPM:
A. Using book value weights for debt and equity
B. Using market value weights for debt and equity

**Question 4:** Address the pros and cons of using market value weights versus book value weights and reconcile the divergent views of Crown and Chang.

**Question 5:** Compute the Required Rate of Return for the project(s), adding appropriate risk premiums subjectively to the WACC’s in questions 2 and 3. These risk premiums can differ depending on the nature and continental location of the projects.

**Question 6:** Make a recommendation as to which, if any, of the investments identified in Table 6 should be accepted taking into account the capital constraint.

**APPENDIX**

i. GCS is part of several stock market indices such as the Dow Jones Composite Average, S&P 100, S&P 500 and S&P Composite 1500.

ii. The long-run average return on the S&P 500 Index is 12.4%.


iv. The beta of GCS is 0.91. Use 5% for the equity premium (sometimes called the market risk premium) which is the market-wide premium demanded by investors for investing in stocks rather than in virtually risk-free U.S. Treasury securities. GCS common stock is presently trading at $95 per share.

v. You can find daily interest rates for Moody’s Aaa bonds at the following website http://www.federalreserve.gov/releases/h15/Update/. Essentially, you can find the current market value for the bonds listed in Table 4 by using these daily interest rates. For the foreign currency bonds listed in
Table 4, you have to use the book values in place of market values. You may want to recall that corporate bonds have a face value of $1,000 unless otherwise stated. Bond interest is normally paid twice yearly on June 30 and December 31. Assume that all bonds mature on December 31.

vi. Include charts and tables, where appropriate. Clearly state your assumptions and provide detailed calculations, where necessary.

BIOGRAPHY

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GLOBAL COST OF CAPITAL: THE CASE OF GLOBAL COMPUTER SYSTEMS

TEACHING NOTES
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She is also of the opinion that the Required Rate of Return on any given project, in addition to the WACC, should also include various risk premiums like stand-alone or project specific risk which can be further broken down into political risk, repatriation risk, exchange rate risk etc. Further, she believes that the required rate of return should be increased by about 1% to allow for capital investment projects that have no cash inflows, such as pollution control equipment and safety equipment.

QUESTIONS

Having recently completed MBA Finance at Ball State University, you feel that you are up to the task. At the minimum, you have decided that you have to do the following:

**Question 1:** For component costs:
A. Compute the before- and after-tax costs of GCS debt.
B. Compute the cost of equity (assuming all funds come from internal sources):
   i. Using the constant growth Gordon Dividend Valuation Model

Solution 1

In our ultimate quest of estimating the weighted average cost of capital, we need to first estimate the cost of each component in the capital structure of GCS. Debt and equity are the two most popular sources of financing used by most firms. As can be observed from the consolidated balance sheet presented in table 3 of the case, GCS too uses debt and equity in its capital structure. Let us therefore, begin by estimating the cost of debt for GCS. One of the significant advantages of using debt as a source of financing is the tax deductibility of interest expense. It is to be noted that the case requires us to compute the weighted average cost of capital using market and book value weights. We will hence need to arrive at the after-tax cost of debt using these two different methods. We will discuss the relative merits and appropriateness of following both these approaches a little later in this note. Let us therefore proceed to discuss the computation of cost of debt using both the weights as required by the case.

For component costs:
A. Compute the before- and after-tax cost of GCS debt.

<table>
<thead>
<tr>
<th>Component</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>GCS Debt at Book Value (from Table 4)</td>
<td>$26,362 million</td>
</tr>
<tr>
<td>Interest on Debt (from Table 4)</td>
<td>$1,283 million</td>
</tr>
<tr>
<td>Pretax Interest Cost (from Table 4)</td>
<td>4.87%</td>
</tr>
<tr>
<td>Tax Rate (from Table 2, Year N+3)</td>
<td>28.10%</td>
</tr>
<tr>
<td>After-tax Interest Cost on book value of all</td>
<td>3.50%</td>
</tr>
</tbody>
</table>

Note that 4.87% is the before-tax cost of debt. In order to arrive at the after-tax rate cost of debt, we need to find the tax rate applicable to GCS. Table 2 of the case which presents the Income statement of GCS states the tax rate as 28.1%. Using this rate we can convert before-tax cost of debt that we just computed to an after-tax basis by simply multiplying it with “1-tax rate”. As can be seen from the above computations, the after tax cost of debt is 1.37%, much lower than the before-tax cost of debt.

Discovering the market value weighted cost of debt is a more challenging task than the book value weighted cost that we just arrived at. The challenge is primarily to find the market value of debt holdings of GCS which is not readily available in the case. Thus, students would be forced to apply Yield-to-Maturity (YTM) concepts in valuing bonds. YTM is a very important and fundamental concept in finance to which students need to be exposed thoroughly. Note (V) at the end of the case provides an important clue regarding the starting point for YTM application in the case. When market value of bonds are not readily available, we can find the market rate of interest for similar bonds instead and then apply YTM concepts to arrive at the present value (market value) of the bonds. Applying YTM concept, the value (future value) of the bonds is simply discounted at the market rate of interest to arrive at the market value (present value) of bonds. In order to ensure that the students are on the same page, at this stage, the facilitator may pick up a simple illustration to refresh YTM concepts before proceeding further. The basic premise of YTM is that when there is a difference between the coupon rate of interest and market rate of interest, the market value of bonds would adjust accordingly to make the yield on such bonds equivalent to the market interest rate. Let us now apply YTM principle to find the market value of various bonds listed in table 4 of the case. To start with, students may refer market interest rate on Moody’s Aaa bonds at federal reserve’s website, the link to which is provided in note (V) at the end of the case. Since GCS bonds are also rated Aaa, the market rate on Moody’s Aaa bonds provides us a comparable rate to work with. On the date the authors accessed the link, the market interest rate for Moody’s Aaa bonds appeared at 5.48%. Table TN1 illustrates computation of market value of bonds for GCS, based on the market rate of 5.48%.
Table TN1: Details of Long-Term Debt (US$, in millions)

<table>
<thead>
<tr>
<th>US Dollar Notes and Debentures</th>
<th>Present Value Principal</th>
<th>Present Value Interest</th>
<th>Total Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>12/31/N+3 Present Value at 5.48%*</td>
<td>12/31/N+3 Present Value at 5.48%*</td>
<td>12/31/N+3 Present Value at 5.48%*</td>
</tr>
<tr>
<td><strong>Coupon Interest Rate</strong></td>
<td><strong>Maturities</strong></td>
<td><strong>Balance on N+3</strong></td>
<td><strong>Annual Interest Expense</strong></td>
</tr>
<tr>
<td>4.48%</td>
<td>N+4-N+7</td>
<td>12,295</td>
<td>551</td>
</tr>
<tr>
<td>5.34%</td>
<td>N+8-N+9</td>
<td>3,545</td>
<td>189</td>
</tr>
<tr>
<td>5.69%</td>
<td>N+10-N+14</td>
<td>3,026</td>
<td>172</td>
</tr>
<tr>
<td>8.38%</td>
<td>N+15</td>
<td>750</td>
<td>63</td>
</tr>
<tr>
<td>7.00%</td>
<td>N+21</td>
<td>600</td>
<td>42</td>
</tr>
<tr>
<td>6.22%</td>
<td>N+23</td>
<td>469</td>
<td>29</td>
</tr>
<tr>
<td>6.50%</td>
<td>N+24</td>
<td>313</td>
<td>20</td>
</tr>
<tr>
<td>5.88%</td>
<td>N+28</td>
<td>600</td>
<td>35</td>
</tr>
<tr>
<td>7.00%</td>
<td>N+41</td>
<td>150</td>
<td>11</td>
</tr>
<tr>
<td>7.13%</td>
<td>N+92</td>
<td>850</td>
<td>61</td>
</tr>
<tr>
<td><strong>Subtotal U.S. Bonds</strong></td>
<td></td>
<td>22,598</td>
<td>$1,173</td>
</tr>
</tbody>
</table>

Foreign Currency Bonds in $U.S.

- Euros: 2,466 84
- Yen: 767 17
- Swiss Fr: 442 7
- Other: 89 2

**Book Value of All Bonds**: $26,362 $1,283

**Market Value of All Bonds**
(Foreign Currency Bonds taken at book value): 27,907

The table presents all possible information required to compute the book value and market value of debts held by GCS. While the book value estimates have been obtained from table 4 of the case, the market value estimates have been built using YTM principle using current market rate of interest on similarly rated bonds. *Current market rate of interest on AAA bonds.

The first four columns of table TN1 have simply been reproduced from Table 4 of the case. It is assumed that the maturities are in equal installments over the periods mentioned in column 2. It is also assumed that interest payment on GCS bonds are made semi-annually, as is the common practice in the real world. This assumption necessitates column 5. As a result, the present value of the principal and interest components of the bonds have been separately calculated in column 6 and 7. Column 8 is simply the summation of columns 6 and 7. For simplicity sake, we are assuming that the market value of foreign currency bonds is the same as their book value. Since the value of these bonds is a tiny proportion of total bonds, this assumption would not make a significant impact to total market value of all GCS bonds. Had the amount of foreign currency bonds been significantly higher (which is anyway quite rare to find even in the real world), an attempt could have been made to obtain the relevant market interest rates for each of the foreign currency denominations and then proceed with present value computations similar to what has been done for USD bonds. Table TN1 presents all the relevant information that we may need to compute the before- and after-tax cost of debt based on market value as well book value estimates. The final computations can be summarized as under.

Before-tax cost of debt (based on book value) = Total Interest / Book value of all Bonds

Before-tax cost of debt (based on book value) = $1,283/$26,362 = 4.87%

After-tax cost of debt (based on book value) = Before-tax cost of debt * (1 - tax rate)

After-tax cost of debt (based on book value) = 4.87% * (1 – 28.10%) = 3.50%

Before-tax cost of debt (based on market value) = Total Interest / Market value of all Bonds
Before-tax cost of debt (based on market value) = $1,283/$27,907 = 4.60%
After-tax cost of debt (based on market value) = Before-tax cost of debt * (1 - tax rate)
After-tax cost of debt (based on market value) = 4.60% * (1 – 28.10%) = 3.31%

B. Compute the cost of equity (assuming all funds come from internal sources):
In order students do not lose sight of the big picture, they may be reminded at this stage to note that our ultimate objective is to arrive at weighted average cost of capital. We have already computed the after-tax cost of debt in the previous step. The next logical step in determining the weighted average cost of capital is the computation of cost of equity. There are various approaches to determine cost of equity. However, as suggested by the requirements of the case, we would be using two approaches to estimate the cost of equity, namely:

(a) Gordon's Constant Growth Dividend Valuation Model, and (b) Security Market Line Equation (SML) from the Capital Asset Pricing Model (CAPM).

i. Using the Constant Growth Gordon's Dividend Valuation Model

The Gordon dividend valuation model is based on the premise that the intrinsic (current market) value of equity is the present value of future dividends which grow at a constant rate. The model can be quantitatively stated as follows:

\[ P_0 = \frac{D_1}{(k_s - g)} \]  

where,

\( P_0 = \) Current market value of equity
\( D_1 = \) Expected dividend one year hence
\( k_s = \) Cost of equity
\( g = \) Constant growth rate of dividends

As with any model, we can solve equation (1) to find any unknown variable if all remaining variables are given. Obviously, the application of the model in the current context is to solve for ‘\( k_s \)’ or cost of equity. The model can be expressed as follows:

\[ k_s = \frac{D_1}{P_0} + g \]  

In note (iv) at the end of the case, the current market price of GCS common stock is stated as $95 per share. The current dividend per share is $1.5 as provided in table 2 of the case. Previous years’ dividend per share is also given in the same table, which can be used to arrive at a growth rate of 20.99%. The current dividend can then be multiplied with the growth rate to arrive at dividend per share for the next year. To summarize, we have the following known variables:

\( P_0 = $95 \)
\( D_i = D_0 x (1 + g)^i = $1.5 \times (1 + 0.2099)^1 = $1.81 \)

Solving equation (2) with the help of known variables, we arrive at cost of equity of 22.90% as explained below.

\[ k_s = \frac{$1.81}{$95} + 0.2099 = 0.229 = 22.90\% \]

A point worth noting here is that the Gordon model applies only to companies whose dividends reflect a virtually constant growth rate. GCS seems to fit the constant growth case quite closely.

ii. Using the Security Market Line Equation (SML) from the Capital Asset Pricing Model (CAPM)
The CAPM estimates the required rate of return (cost of equity), based on firm’s beta, the risk free rate of return, and the market return and can be expressed as follows:

\[ k_s = r_f + (r_m - r_f) \times \beta_s \]  

(3)

Where, 
- \( k_s \) = Cost of equity
- \( r_f \) = Risk free return
- \( r_m \) = Market return
- \( \beta_s \) = Beta of the stock GCS (i.e., stock’s sensitivity to market movements)

We can estimate of cost of equity by solving equation (3) with the help of information made available in the case as follows:

Beta (as given in note-iv at the end of case) = 0.91
Risk free return (10-year U.S treasury from link provided in note-v at the end of case) = 2.76%
\( r_m - r_f \) or market risk premium (as given in note-iv at the end of case) = 5.00%
Cost of Equity, \( k_s \) = 2.76 %+( 5%*0.91) = 7.31%

A point worth noting at this stage is the large difference between the estimates of cost of equity under CAPM and Gordon model. One of the reasons for the lower estimate under CAPM could be attributed to the low beta of GCS. The other reasons could be attributed to the fact that Gordon’s model ignores risk free rate and market return while giving more weight to the rate of growth in dividends.

**Question 2:** Compute the Weighted Average Cost of Capital (WACC) based on cost of equity estimated under the Gordon Dividend Valuation Model.

A. Using book value weights for debt and equity

B. Using market value weights for debt and equity

**Solution 2:** Computing the Weighted Average Cost of Capital (WACC) based on cost of equity estimated under the Gordon Dividend Valuation Model.

A. Using book value weights for debt and equity

The cost of equity estimated using Gordon’s model would now have to be integrated with cost of debt to arrive at WACC using book value weights for debt and equity.

<table>
<thead>
<tr>
<th>Components</th>
<th>$ millions</th>
<th>Weight</th>
<th>Cost</th>
<th>WACC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>26,362</td>
<td>48.08%</td>
<td>3.50%</td>
<td>1.68%</td>
</tr>
<tr>
<td>Equity</td>
<td>28,469</td>
<td>51.92%</td>
<td>22.90%</td>
<td>11.89%</td>
</tr>
<tr>
<td>Total</td>
<td>54,831</td>
<td>100.00%</td>
<td></td>
<td>13.57%</td>
</tr>
</tbody>
</table>

Thus, WACC using book value weights is 13.57%.

B. Using market value weights for debt and equity

The market value of equity can be computed as follows.

Total Common Shares Outstanding (table 3 of case) = 1,385.23 million
Current price per share (given in case) = $95
Market value of common equity (1,385.23 million x $95) = $131,597 million
WACC using market value weights for debt and equity can then be arrived as follows.

<table>
<thead>
<tr>
<th>Components</th>
<th>$ millions</th>
<th>Weight</th>
<th>Cost</th>
<th>WACC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>27,907</td>
<td>17.50%</td>
<td>3.31%</td>
<td>0.58%</td>
</tr>
<tr>
<td>Equity</td>
<td>131,597</td>
<td>82.50%</td>
<td>22.90%</td>
<td>18.89%</td>
</tr>
<tr>
<td>Total</td>
<td>159,504</td>
<td>100.00%</td>
<td></td>
<td>19.47%</td>
</tr>
</tbody>
</table>

Thus, the WACC using market value weights is 19.47%.

**Question 3:** Compute the WACC based on cost of equity estimated under the CAPM.
   A. Using book value weights for debt and equity
   B. Using market value weights for debt and equity

**Solution 3:** Compute the WACC based on cost of equity estimated under the CAPM.
   A. Using book value weights for debt and equity

The cost of equity estimated under CAPM would now have to be integrated with cost of debt to arrive at weighted average cost of capital using, book value weights for debt and equity.

<table>
<thead>
<tr>
<th>Components</th>
<th>$ millions</th>
<th>Weight</th>
<th>Cost</th>
<th>WACC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>26,362</td>
<td>48.08%</td>
<td>3.50%</td>
<td>1.68%</td>
</tr>
<tr>
<td>Equity</td>
<td>28,469</td>
<td>51.92%</td>
<td>7.31%</td>
<td>3.80%</td>
</tr>
<tr>
<td>Total</td>
<td>54,831</td>
<td>100.00%</td>
<td></td>
<td>5.48%</td>
</tr>
</tbody>
</table>

Thus, WACC using book value weights is 5.48%.

   B. Using market value weights for debt and equity

Similarly, the cost of equity estimated under CAPM would now have to be integrated with cost of debt to arrive at weighted average cost of capital using, market value weights for debt and equity.

<table>
<thead>
<tr>
<th>Components</th>
<th>$ millions</th>
<th>Weight</th>
<th>Cost</th>
<th>WACC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>27,907</td>
<td>17.50%</td>
<td>3.31%</td>
<td>0.58%</td>
</tr>
<tr>
<td>Equity</td>
<td>131,597</td>
<td>82.50%</td>
<td>7.31%</td>
<td>6.03%</td>
</tr>
<tr>
<td>Total</td>
<td>159,504</td>
<td>100.00%</td>
<td></td>
<td>6.61%</td>
</tr>
</tbody>
</table>

Thus, the WACC using market value weights is 6.61%.

As expected, due to lower cost of debt, the effect of higher cost of equity is moderated downward in the WACC. The Gordon model applies only to companies whose dividends reflect a virtually constant growth rate. If this is not the case, using the CAPM model might be appropriate. GCS seems to fit the constant growth case.

**Question 4:** Address the pros and cons of using market value weights versus book value weights and reconcile the divergent views of Crown and Chang.
Solution 4:

The case presents divergent views of Crown and Chang regarding the weights to be used for the company-wide cost of capital policy. Crown is in favor of book value weights since market values fluctuate too often. Chang on the other hand prefers market values as they are forward looking.

For convenience, the views of Crown and Chang are restated below. Gordon Crown, Chief Financial Officer of GCS, would like you to help him develop a company-wide cost of capital policy that is consistent with modern finance theoretical constructs. He would also like you to provide your recommendation on the acceptability of the projects. He also feels that since stock prices often fluctuate, it would be advisable to use book value weights in computing the component capital costs and the cost of capital.

One simple argument is to use book value weights if existing funds are likely to be used for financing selected projects. Similarly, market value weights might be appropriate in the case of projects that are to be financed using fresh financing. WACC must obviously form the basis for the company wide cost of capital policy that Crown wants to put in place. As stated earlier, GCS might use the Gordon constant growth model since its dividend growth is reasonably constant. A firm is likely to use only one WACC applicable to the entire entity since most capital projects of the firm are assumed to use the approximate corporate average debt-equity mix given the fungible nature of cash flows. Hence, the corporate WACC may suffice while evaluating most capital projects. However, the WACC may need to be adjusted appropriately if certain projects of the firm are expected to utilize significantly different debt-equity mix from the corporate average debt-equity mix. Crown may have to incorporate this realization while attempting to develop a company-wide WACC.

A company-wide cost of capital policy that is consistent with modern finance theoretical constructs would be as follows:

- Start with WACC.
- Use book values if existing funds will be used for the selected projects, but use market values in the case of projects that will use newly raised funds.
- Use Gordon constant growth model if dividend growth is reasonably constant – which is the case for GCS.

Question 5: Compute the Required Rate of Return for the project(s), adding appropriate risk premiums subjectively. These risk premiums can differ depending on the nature and continental location of the projects.

Solution 5:

The required rate of return is supposed to be a project specific version of WACC. Depending on the riskiness of a project’s forecasted cash flows, the WACC is normally revised upward to arrive at the relevant required rate of return. For instance, new projects may involve new customers, new processes or new products. Therefore, such projects may be perceived as more risky than existing time-tested operations of the firm. Moreover, certain unprofitable projects may have to be undertaken for strategic reasons. Thus, other projects may be required to generate sufficiently higher rate of return in order to subsidize such ‘strategic’ projects. Similarly, foreign projects may demand an even higher required rate of return considering the additional risks involved in terms of repatriation, political, and exchange rate risks. The above reasons tend to justify the required rate of return to always exceed the WACC.

In the context of GCS, assuming that existing funds are to be used, the relevant WACC is 13.57% as per Gordon’s model. To this, as suggested by Chang, we may add 1% as an allowance for projects without
cash inflows. These capital expenditure projects are required by law, but earn no cash inflows. The required rate of return is therefore 14.57%. To this rate, a premium for projects according to risk type needs to be added. The risk type of various projects are provided in Table 7 of the case. One approach to assign the risk premium to these risk types is exhibited in Table TN2.

Gordon Model

If existing funds are to be used, then the book value of WACC is 13.57%
Add an allowance for projects without cash inflows 1.00%
Additionally, projects in foreign countries generally have an added risk premium of 2% to 4% depending on the country and the degree of political risk, repatriation risk, exchange rate risk, etc.

Add a premium for projects according to risk type (Table 7)

Table TN2: Risk type of projects (ROR Based on Book-Value weights)

<table>
<thead>
<tr>
<th>Type of Project</th>
<th>Degree of Risk</th>
<th>Suggested Risk Premium</th>
<th>Required Rate of Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Routine replacement of equipment</td>
<td>Minimal</td>
<td>0.00%</td>
<td>14.57%</td>
</tr>
<tr>
<td>Cost reduction</td>
<td>Low</td>
<td>1.00%</td>
<td>15.57%</td>
</tr>
<tr>
<td>Expand existing products in existing markets</td>
<td>Moderate</td>
<td>2.00%</td>
<td>16.57%</td>
</tr>
<tr>
<td>Add new products in existing markets</td>
<td>Moderate-High</td>
<td>3.00%</td>
<td>17.57%</td>
</tr>
<tr>
<td>Expand existing products in new markets</td>
<td>Moderate-High</td>
<td>5.00%</td>
<td>19.57%</td>
</tr>
<tr>
<td>Add new products in new markets</td>
<td>High</td>
<td>6.00%</td>
<td>20.57%</td>
</tr>
</tbody>
</table>

The table presents one possible approach to assign risk premium to projects of varying risk profile. The impact of risk adjusted required rate of return can be observed from the table, in line with the basic relationship between risk and return suggested in financial theory.

Gordon Model

If existing funds are to be used, then the market value of WACC is 19.47%
Add an allowance for projects without cash inflows 1.00%
Additionally, projects in foreign countries generally have an added risk premium of 2% to 4% depending on the country and the degree of political risk, repatriation risk, exchange rate risk, etc.

Add a premium for projects according to risk type (Table 7)

Table TN3: Risk types of projects (ROR Based on Market-Value weights)

<table>
<thead>
<tr>
<th>Type of Project</th>
<th>Degree of Risk</th>
<th>Suggested Risk Premium</th>
<th>Required Rate of Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Routine replacement of equipment</td>
<td>Minimal</td>
<td>0.00%</td>
<td>20.47%</td>
</tr>
<tr>
<td>Cost reduction</td>
<td>Low</td>
<td>1.00%</td>
<td>21.47%</td>
</tr>
<tr>
<td>Expand existing products in existing markets</td>
<td>Moderate</td>
<td>2.00%</td>
<td>22.47%</td>
</tr>
<tr>
<td>Add new products in existing markets</td>
<td>Moderate-High</td>
<td>3.00%</td>
<td>23.47%</td>
</tr>
<tr>
<td>Expand existing products in new markets</td>
<td>Moderate-High</td>
<td>5.00%</td>
<td>25.47%</td>
</tr>
<tr>
<td>Add new products in new markets</td>
<td>High</td>
<td>6.00%</td>
<td>26.47%</td>
</tr>
</tbody>
</table>

This table presents one possible approach in assigning risk premium to the ROR based on Market-Value weights. The impact of the risk adjusted required rate of return can be observed from the table, in correspondence with the risk and return relationship suggested in financial theory.

Question 6: Make a recommendation as to which, if any, of the investments identified in Table 6 should be accepted taking into account the capital constraint.
**Solution 6:**
Table 6 of the case lists various projects under consideration along with their IRRs. Based on the nature of these projects, their IRR, and the required rate of return that we determined in table TN2 earlier, we are now well equipped to decide which of those projects should be accepted. Table TN4 summarizes the decision criteria.

### Table TN4: GCS’s N+6 New Projects Under Consideration (ROR Based on Book-Value weights)

<table>
<thead>
<tr>
<th>Project</th>
<th>Net Investment Cost (US$, in millions)</th>
<th>Proposed Location</th>
<th>Estimated IRR</th>
<th>Type of Project</th>
<th>International Risk Premium</th>
<th>Required Rate of Return (RRR)</th>
<th>DECISION</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$500</td>
<td>Europe</td>
<td>26.30%</td>
<td>Existing product, new market</td>
<td>2%</td>
<td>21.57%</td>
<td>ACCEPT</td>
</tr>
<tr>
<td>2</td>
<td>$400</td>
<td>USA</td>
<td>13.50%</td>
<td>New product, new market</td>
<td>0%</td>
<td>20.57%</td>
<td>REJECT</td>
</tr>
<tr>
<td>3</td>
<td>$650</td>
<td>Asia</td>
<td>8.60%</td>
<td>Expand existing product in existing market</td>
<td>3%</td>
<td>22.57%</td>
<td>REJECT</td>
</tr>
<tr>
<td>4</td>
<td>$1,500</td>
<td>Asia</td>
<td>23.40%</td>
<td>New product, existing market</td>
<td>3%</td>
<td>20.57%</td>
<td>ACCEPT</td>
</tr>
<tr>
<td>5</td>
<td>$350</td>
<td>USA</td>
<td>24.60%</td>
<td>Replace Equipment</td>
<td>0%</td>
<td>14.57%</td>
<td>ACCEPT</td>
</tr>
<tr>
<td>6</td>
<td>$750</td>
<td>Europe</td>
<td>10.20%</td>
<td>Expand existing product in existing market</td>
<td>2%</td>
<td>18.57%</td>
<td>REJECT</td>
</tr>
<tr>
<td>7</td>
<td>$250</td>
<td>Asia</td>
<td>26.70%</td>
<td>Existing product, new market</td>
<td>3%</td>
<td>22.57%</td>
<td>ACCEPT</td>
</tr>
<tr>
<td>8</td>
<td>$325</td>
<td>Asia</td>
<td>18.80%</td>
<td>New product, existing market</td>
<td>3%</td>
<td>20.57%</td>
<td>REJECT</td>
</tr>
</tbody>
</table>

The table compares the estimated IRR and RRR to arrive at accept-reject decisions for projects of different risk profiles. The IRR must exceed RRR for the project to be accepted, else it has to be rejected.

Note that the capital constraint for all projects is US$4.2 billion. If we total the net investment for all the projects which have been accepted in TN4, these amount to only US$2.6 billion. Therefore, there is no need for capital rationing.

Also note that table TN4 is a result of using WACC under Gordon’s model with book value weights. Students may find it interesting to analyze the outcome when market value weights are used instead, as shown in table TN3 and TN5. When market value weight is used under Gordon’s model, the required rate of return would work out to be higher by 5.90%. This is the differential between 13.57% and 19.47% as presented earlier. When the market value weight is used instead of book value, all projects listed in TN5, except for project 5 would stand rejected. IRR of project 5 alone would exceed its required rate of return and hence would be accepted. The net investment required in that case works out to be $350 million. The current year balance sheet lists cash and equivalents at more than $6 billion. Therefore it is most unlikely that new capital funds will have to be raised in the market in order to finance this project.

Since book-value weights are based on historical data while market-value weights are based on more current data, an argument can be made for the superiority of the market-value weights based on results and outcomes.
Table TN5: GCS’s N+6 New Projects Under Consideration (ROR Based on Market-Value weights)

<table>
<thead>
<tr>
<th>Project</th>
<th>Net Investment Cost (US$, in millions)</th>
<th>Proposed Location</th>
<th>Estimated IRR</th>
<th>Type of Project</th>
<th>International Risk Premium</th>
<th>Required Rate of Return (RRR)</th>
<th>DECISION</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$500</td>
<td>Europe</td>
<td>26.30%</td>
<td>Existing product, new market</td>
<td>2%</td>
<td>27.47%</td>
<td>REJECT</td>
</tr>
<tr>
<td>2</td>
<td>$400</td>
<td>USA</td>
<td>13.50%</td>
<td>New product, new market</td>
<td>0%</td>
<td>26.47%</td>
<td>REJECT</td>
</tr>
<tr>
<td>3</td>
<td>$650</td>
<td>Asia</td>
<td>8.60%</td>
<td>Expand existing product in existing market</td>
<td>3%</td>
<td>25.47%</td>
<td>REJECT</td>
</tr>
<tr>
<td>4</td>
<td>$1,500</td>
<td>Asia</td>
<td>23.40%</td>
<td>New product, existing market</td>
<td>3%</td>
<td>26.47%</td>
<td>REJECT</td>
</tr>
<tr>
<td>5</td>
<td>$350</td>
<td>USA</td>
<td>24.60%</td>
<td>Replace Equipment</td>
<td>0%</td>
<td>20.47%</td>
<td>ACCEPT</td>
</tr>
<tr>
<td>6</td>
<td>$750</td>
<td>Europe</td>
<td>10.20%</td>
<td>Expand existing product in existing market</td>
<td>2%</td>
<td>24.47%</td>
<td>REJECT</td>
</tr>
<tr>
<td>7</td>
<td>$250</td>
<td>Asia</td>
<td>26.70%</td>
<td>Existing product, new market</td>
<td>3%</td>
<td>28.47%</td>
<td>REJECT</td>
</tr>
<tr>
<td>8</td>
<td>$325</td>
<td>Asia</td>
<td>18.80%</td>
<td>New product, existing market</td>
<td>3%</td>
<td>26.47%</td>
<td>REJECT</td>
</tr>
</tbody>
</table>

*The table compares the estimated IRR and RRR to arrive at accept-reject decisions for projects of different risk profiles. The IRR must exceed RRR for the project to be accepted, else it has to be rejected.*

**CONCLUSIONS**

The case provides an excellent opportunity to students to apply Gordon’s dividend valuation and Capital Asset Pricing Models in estimating the cost of equity. They are led to appreciate the significance of WACC in determining the criteria for acceptance of capital investment projects. Moreover, students get insights into the appropriateness of book value and market value weights while determining WACC. The case also builds an international context for capital investment projects and discusses various considerations that include incorporation of various risk premiums in calculation the required rate of return.
AN ETHICAL AND EMPLOYMENT QUAGMIRE:  
THE CASE OF JBS  
Michael Martin, University of Northern Colorado  
Joseph J. French, University of Northern Colorado  

ABSTRACT  
This case describes a hypothetical ethical dilemma involving labor relations at JBS Swift in Greeley, Colorado. The case describes the employment decisions faced by a hypothetical manager working at JBS Swift during the 2008 labor dispute over working conditions for Somali workers during Ramadan. The case provides detailed background information on JBS Swift, current labor relationships in the meat packing industry, applicable labor laws and ethical frameworks. At the end of the narrative the reader is asked to formulate ethically and legally sound recommendations. The suggested audiences for this case study are upper level undergraduate students and graduate students.  

JEL: D63; J50; J40; J80  

KEYWORDS: Business Ethics, Labor relations, Case Study  

INTRODUCTION  
Matt Lander sits in front of his computer and reads with alarm the continuing news stories reporting on the recent walk out, and subsequent lawsuit of a large portion of JBS’s workforce. The report indicates that the employees are disgruntled about working conditions during their religious holiday, Ramadan.  

Matt works for the world’s largest meat packing firms, headquartered in Brazil. Matt is currently assigned to JBS Swift’s, Greeley, Colorado branch. The news reports that most of the Somali workers walked out in protest over the rigid working conditions imposed during Ramadan. In particular, the workers appear to be disgruntled over the difficulties in fulfilling the religious requirements for prayer during the Muslim holy month.  

As Matt investigates, he realizes the seriousness of the accusations levied against JBS by several of their Somali and Muslim employees. Accusations include harassment during Ramadan, a pattern of discrimination since 2008, a hostile work environment, failure to accommodate, and retaliatory discharge (http://www.eeoc.gov/eeoc/newsroom/release/8-31-10.cfm). After Matt reviews all press releases, he obtains a copy of the claim filed by the Equal Employment Opportunity Commission (EEOC) on behalf of the disgruntled JBS Swift employees (see Exhibit 1 in appendix A). After visiting the EEOC website Matt discovers that religious discrimination claims increased by 100% between 1992 and 2007 (http://www.eeoc.gov).  

Matt is relatively new to the position of special ethics and legal advisor to the board of directors. He was hired to help investigate, review, modify (if needed), and implement an organizational code of ethics. JBS’s board of directors has requested a report outlining recommendations on how to handle the recent labor dispute. As their website and mission statement clearly state, JBS is concerned about treating the community and all employees fairly and ethically. Further, as with any business, the board wants to ensure that they are able to adhere to their values while still maintaining high levels of efficiency in their production capacities (See Exhibit 3 in appendix C).
The board wants Matt to outline how they should handle this dispute both legally and ethically. Further, they want to Matt to ensure that corrective measures will have minimal impact on productivity. The board is concerned that if they give into the demands of the disgruntled employees, production will decrease. Further, the board is concerned that the non-Muslim employees will feel as if the Muslim employees are being given preferential treatment. They want Matt to outline how they should proceed.

In order to properly prepare his report, Matt must educate himself on the background of JBS, the background of the Somali workers, the applicable legal issues and appropriate ethical frameworks. He begins his research with the company background. The remainder of this case is structured as follows, first the company background is presented, next the history of JBS in Greeley and the history of protein production described, followed by a brief introduction to Somalia and Somali workers in Greeley. With the background the case proceeds to describe Ramadan and the ethical and legal frameworks applicable to the presented ethical quagmire at JBS.

COMPANY BACKGROUND

JBS Swift is a protein production multinational giant with 140 production facilities worldwide and over 120,000 employees, JBS is the largest animal protein processor in the world. JBS is a globally diversified company producing a variety of products including food, leather, pet products and biodiesel. An international industry leader, JBS has production and processing plants in Brazil, Argentina, Italy, Australia, USA, Uruguay, Paraguay, Mexico, China and Russia (www.jbssa.com). The story of JBS Swift is one of hard work, aggressive expansion and industry knowhow. The founder of the world’s largest protein producer is Jose Batista Sonbrinho (aka Ze Mineiro) from the state of Goias in Brazil. Jose Batista Sobrinho opened his first butcher shop (Casa de Carne Mineira) in 1953 and quickly acquired a deep knowledge of the market for cattle. Within a month of opening his first butcher shop, his products became known in the Anapolis region for their superior quality. Within four years, Sonbrinho saw the opportunity to supply beef to the construction workers who were building the new capital of Brazil (Brasilia). He established a slaughterhouse in the new capital with the aid of five key employees (www.jbssa.com).

Building on the success of the slaughterhouse in Brasilia, Sonbrinho leased a slaughterhouse in nearby Luziania in 1962. This allowed production capacity to double to approximately 55 animals per day. Expansion continued in Brazil with the acquisition of Formosa Industrial Slaughter house, this investment allowed Sonbrinho to further increase production capacity. In the same year, following the advice of a friend, Sonbrinho renamed the company Friboi with a view to leave the slaughterhouse plant and transition the firm into the meat packing industry (www.jbssa.com).

Growth continued to be strong for Sonbrinho’s company and in 1997; the firm began to export fresh beef. In a significant expansion, Friboi finalized acquisition of Barra do Garcias Plant near Brazil’s largest city (Sao Paulo, Population approximately 19 million). This expansion greatly increased the size and visibility of Friboi. The expansion created a need to develop a better transportation system for cattle. Friboi responded with an innovative truck fleet with a capacity to carry up to 42 animals per truck. This truck fleet allowed the company to increase its production while maintaining the quality people had come to expect from Friboi. By 2003, the Andradina Transportation Company was created under the Group’s transportation system (www.jbssa.com). With much of the domestic market consolidated, Friboi began turn its attention toward international expansion. Friboi did not have to look far, in 2005, the firm acquired Swift in neighboring Argentina. The acquisition turned Friboi (renamed to The Group) into Brazil’s first multinational company in the meat industry. Shortly after the acquisition of Swift, The Group changed its corporate structure from a limited liability company to a corporation. The newly formed corporation was renamed JBS, taking the initials of its founder--Jose Batista Sobrinho. In March 2007, JBS became the first company in the meat-packing sector to go public on the Brazilian Stock
Listing on the Brazilian stock exchange allowed for more efficient methods to raise capital and allowed JBS to continue its international expansion. In July of the same year JBS acquired a 100% ownership stake in the American Swift Foods and Companies (plants in the US and Australia). With this expansion, JBS became the largest Brazilian multinational company in the food-processing sector (www.jbssa.com).

**JBS in Greeley, Colorado USA**

JBS started operations in the United States in 2007. At the time of acquisition, JBS’s president made the following quote: "With this acquisition, we become the largest beef company in the world," With the acquisition, JBS estimated that for the year following the acquisition that it would have pro forma total revenue of $13.2 billion, earnings before interest, taxes depreciation and amortization, of $730 million and a net debt of $2.3 billion. At the time of the deal Brazilian investors applauded the acquisition and shares rose 1.5% on announcement of the deal. Prior to the acquisition Swift and Company was the third-largest meatpacker in the U.S. The company sells primarily meat cuts to the U.S. market under the Swift Angus beef brand name and Swift Premium pork. With the purchase, JBS acquired a known global brand name with sales and operations in markets that were relatively new to the company, including Hong Kong, Japan, Mexico, South Korea, mainland China and Taiwan. (http://www.marketwatch.com/story/brazils-jbs-buys-swift-foods-for-14-bln).

One of the primary meat packing facilities of the former Swift (now JBS) is in the town of Greeley, Colorado. The following is a brief history of one of America’s most interesting western townships.

Greeley began as a joint-stock colonization company in 1869 in New York City. The original name was ‘Union Colony’ to reflect the vision of the founder Nathan Meeker for people to unite for the purpose of sharing common goals. The first colonists were required to have money for the first year and agree to obey the rules of the colony requiring temperance, cooperation, agriculture, irrigation, education, faith and home and family. In 1870, the first 480 settlers arrived in northern Colorado. The town began investment in infrastructure including wells, irrigation ditches with a readily available supply of coal from the nearby coalmines. By 1886, Greeley had sewer lines, an electric plant and manufactured gas (www.greeleygov.com).

Greeley benefited from the expansion of the west as railroads brought more settlers, livestock and consumer items. Residents of Greeley built canneries, stockyards, warehouses, tanneries and icehouses. By 1890, over 90,000 acres of land was irrigated and the State Normal School opened. The populations of Greeley had grown to over 8,000 and the local newspaper referred to Greeley as “The Athens of the West”. Growth continued in Greeley with the first radio station developed in 1921 (the nation’s 5th oldest). One of the leading families in Greeley, the Monforts, expanded their family farm into an international, multi-billion dollar feeding, processing and shipping corporation. By 1964, Monfort of Colorado had the most technologically advanced cattle and lamb slaughtering facility in the nations (www.greeleygov.com).

Greeley was designated an ‘All American City’ in 1987. The current population of Greeley is 89,000. An article from the neighboring city of Fort Collins highlights some of the challenges that Greeley is currently facing, much of which is attributed to the meat packing industry. “Greeley didn't always have a 30 percent Latino population. It didn't always have an elementary education system where more than half of the children are Latino. And Greeley didn't always have a slaughterhouse.” (http://www.greeleytribune.com/article/20061226/NEWS/112230087)

As this quote indicates much of the recent development of Greeley has been due to the employment practices of its largest employer—Swift and after 2007 JBS, the world’s largest protein producer. The composition of the workforce at JBS Swift is due to the nature of the industry.
A BRIEF HISTORY OF PROTEIN PRODUCTION

The slaughterhouse has always been a challenging place to earn a living in the USA. At the beginning of the 19th century, most of the production was localized due to lack of industrialized refrigeration. During the period of when production was localized, butchers were considered to be skilled labor and earning a good living. Following the innovations in transportation and refrigeration in the 1860’s the meat packing industry grew and plants developed in major cities and Americans consumed more beer. Major centers in the late 1800’s were in Chicago, Kansas City and Omaha (http://www.greeleytribune.com/article/20061226/NEWS/112230087).

Since the advent of large slaughterhouses the industry relied on immigrant workers. The first immigrants to make up the workforce in America’s early slaughterhouses were primarily from Lithuania and Poland. In the 1960’s an innovative company called the Iowa Beef Processor (now Tyson Foods) changed the way Americans produce beef. The company was founded on a simple idea: that the way meat was processed at the time was antiquated. Their goal was equally simple: to revolutionize the industry by creating "meat factories" that could process meat more efficiently and economically (www.fundinguniverse.com/companyhistories/IBP-Inc-Company-History.html). One of the key components to this strategy was to move meatpacking away from urban centers and to more rural areas like Greeley. This strategy made sense for several reasons, first it reduced transportation costs by locating production closer to the raw materials and second it reduced the reliance on unionize labor and therefore cut production costs. The industry shift from urban production to rural production also changed the composition of the labor force utilized in meatpacking. Many communities offered tax breaks and other incentives to attract a meatpacking plant in their city. The problem is that many of the townships which were successful in attracting production facilities did not have a large enough labor force. As a result, the companies had to find workers to staff the facility. This often resulted in a largely immigrant, largely Hispanic workforce and in some instances a large illegal workforce.

Currently, the meatpacking industry is considered a "point of entry" job for new immigrants to the United States (http://www.greeleytribune.com/article/20061226/NEWS/112230087). Another issue Matt must consider is the public perception that meat packing plants don’t pay or treat their employees fairly. As can be seen in the above figures, meat processing plants often provide a substantial economic stimulus for the local community (see Figures 1 & 2).

Figure 1: Iowa Employee Average Earnings

![Figure 1: This chart displays the relative income levels of traditional entry level jobs as compared to those of a meat processing plant. As can be seen a meat processing position has a comparatively strong salary. Employees in meat processing plants on average earn more than $29,000 per year plus benefits, and employees in meat packing plants earn $26,400 per year plus benefits, for jobs in rural areas with a low cost of living. Source: MeatAMI.com](image1)

Figure 2: Colorado Comparative Salaries
Figure 2, in contrast to Figure 1, depicts the relative weakness of meat packing salaries when compared to local Colorado professional salaries. It is this distinct lack of salary growth which ensures this industry will remain a high turnover profession.

BACKGROUND ON SOMALIA

In recent years, a large portion of the meatpacking workforce has come from migrant workers from a little known country located in the ‘Horn of Africa’, Somalia. Matt was unaware about the details of this country and looked up some relevant information about the current economic and political aspects of Somalia. Below is a summary of Matt’s research, beginning with a map of the nation.

Figure 3: Map of Somalia
Figure 3, shows a detailed map of the nation of Somalia (US State Department). The capital of the nation is Muqdisho. Somalia’s land area is slightly smaller than Texas (637,657 sq. km). Somalia is located in ‘horn’ of Africa near along one of the busiest corridors of marine international trade. However, given its location Somalia is a tragic story of government corruption and civil strife. According to the US State Department, more than the half the population is illiterate, infant mortality rates are greater than 10% and life expectancy is below 50 years. On almost all quality of life indicators, Somalia ranks at or near the bottom globally. Despite having large untapped reserves of iron ore, tin, gypsum, bauxite, uranium, copper, salt; likely petroleum and natural gas reserves, Somalis GDP per capita was only $600 in 2008 (US State Department). Somalia’s economy is pastoral and agricultural, with livestock--principally camels, cattle, sheep and goats--representing the main form of wealth (US State department). Somalis are recognized throughout the world for their superior ability in raising and slaughtering livestock.

The following quote from the U.S. state department illustrates the lack of control the central government has over its territory in Somalia: “U.S. citizens considering travel by sea near the Horn of Africa or in the southern Red Sea should exercise extreme caution, as there has been a notable increase in armed attacks, robberies and kidnappings for ransom at sea by pirates. Merchant vessels continue to be hijacked in Somali territorial waters, while others have been hijacked as far as 1,000 nautical miles off the coast of Somalia, Yemen, and Kenya in international waters.”

Somalia has been without an effective central government since President Siad Barre was overthrown in 1991(British Broadcasting Corporation). The absence of functioning central government in Somalia allowed outside forces to become more influential by supporting various groups and persons in Somalia, particularly Djibouti, Eritrea, Ethiopia, Egypt, Yemen, and Libya, all of which have supported various Somali factions and transitional governments. In January 2009, Ethiopian forces completely withdrew from Somalia. Near the same time the Untied States designated one of the leading power brokers in the nation as a terrorist organization. The name of the organization is al-Shabaab. Al-Shabaab and other extremist forces garnered power in subsequent years through their effective fighting of the Ethiopians, intimidation and harsh implementation of Shari'a law.

Insurgent forces now control most of south-central Somalia and parts of Mogadishu, significantly hampering the transitional federal governments’ ability to provide public services as well as affecting the delivery of humanitarian aid to vulnerable Somali populations. The lack of rule of law in Somalia has lead to mass killings and significant migration of Somalis to refugee camps in neighboring countries. The turmoil in Somalia has a lead to many Somali families relocating to Western Europe and the United States.

Somalis in Greeley, Colorado USA

The United States has a long history of accepting refuges from war torn countries. In fact, the US is one of only ten countries in the world that accepts unrestricted refugees. The vast majority of Somali population in Greeley are refugees. Very few (if any) of the Somalis currently residing Greeley arrived directly from refugee camps, but rather they arrived in major US cities, such as Denver or New York. After arrival in the US, refugees are allowed free movement across the US. The initial waves of Somalis to move to Greeley were single men following job opportunities at JBS Swift. According to a representative from the East African Community of Colorado, in 2007-2008 there were less than 40 Somali families living in Greeley. However, after this initial wave of immigrants to Greeley, the second wave of Somali immigration has been a combination of families and single men. In 2010, East African Community of Colorado estimated the number of Somali families in Greeley to be in excess of 400 and growing very rapidly. Current estimates approximate that JBS Swift employs 50% of Somalis currently working in Greeley.
The majority of Somali refugees residing in Greeley have spent in excess of a decade living in Kenyan refugee camps. Some Kenyan refugee camps have in excess of 80,000 people in them. Approximately ten percent of Somalis in refugee camps are resettled annually. Prior to arrival in the US, Somali refugees are required to take 8 hours of cultural orientation and are given comprehensive health and background screenings. Upon arrival, they receive food stamps and Medicaid for a limited time. Refugees are required to reimburse the US government for the cost of their air ticket to the US. The majority of Somalis in Greeley are from the majority culture of Somali. Most Somalis are pious Muslims with strong family values. (Source-Lutheran Family Services of Colorado)

Background on Ramadan

In order to better understand their point of view and why so many of JBS’s Somali workers walked out during the holy month of Ramadan, Matt investigated the origins and customs of this religious holiday. Below is a brief summary of his research. The ninth month of the Islamic calendar is known as Saum, or fasting and is considered the fourth pillar of Islam (Emerick, 2004). During this month (Ramadan), Muslims seek forgiveness for sins, pray for guidance and learn spirituality, compassion, patience and modesty via fasting. Ramadan is a time of religious devotion and a time of self-denial. The form of self-denial is evidenced from the denial of food, drink, profanity, lying, sex and fighting between sunrise and sunset. Typically Muslims eat a meal prior to sunrise and after sunset (Emerick, 2004).

The purpose of Ramadan for Muslims is to master one’s body. The Qur’an explains the purpose of fasting: “You who believe! Fasting is prescribed for you, as it was prescribed for those before you, so you can gain more spiritual awareness.” (Qur’an 2:183) According to the Qur’an, fasting is the status of a religious duty. The desire to eat is one of the most powerful motivations anyone must face. Emerick suggests that when people forget God’s good laws and the advice of the prophets, they can easily fall prey to any self-destructive impulses. Therefore, strengthening the soul and bringing the body along in step are crucial to spirituality. According to Emerick, people can become better enlightened only when they rise above the flesh and recognize the force of their spirit. All Muslims over the age of puberty must observe Ramadan. Those who are exempted include the very young, the sick and the elderly who are too weak. Women in their menses or in labor or after childbirth are given temporary exemptions (Emerick, 2004).

ETHICAL FRAMEWORK AND IMPLICATIONS

Prior to making recommendations to the board of directors at JBS, Matt decides to review the pertinent ethical and legal frameworks beginning with the responsibility of a multinational corporation as an ethical agent. Increasingly, corporations are viewed not merely as profit-making entities but also as moral agents that are accountable for their conduct to their employees, investors, suppliers, and customers. Companies are more than the sum of their parts or participants. Because corporations are chartered as citizens of a state and/or nation, they generally have the same rights and responsibilities as individuals.

Through legislation and court precedents, society holds companies accountable for the conduct of their employees as well as for their decisions and the consequences of those decisions. Viewed as moral agents, companies are required to obey the laws and regulations that define acceptable business conduct. Laws and regulations are necessary to provide formal structural restraints and guidance on ethical issues. However, as Matt knows, simply complying with the law is not enough.
Organizational Ethics

One reason ethics programs are important for an organization is to help make employees aware of the potential legal and ethical issues within their work environments. The headlines are replete with daily scandals. Companies such as Enron or Tyco have thrust the need for organizational codes of conduct into the forefront of the collective corporate mindset. New legislation, such as the Sarbanes-Oxley Act of 2002 (107 P.L. 204), the Dodd-Frank Wall Street Reform, and the Consumer Protection Act (Pub.L. 111-203) have significantly increased oversight for organizational behavior. Understanding the factors that influence the ethical decision making process can help companies encourage ethical behavior and discourage undesirable conduct. An organization needs to realize that personal decision making and ethical behavior does not exist in a vacuum. As one commentator highlights, “decision making within a firm will be influenced, limited, shaped, and in some cases virtually determined by the corporate culture of the firm.” (DesJardins, 2009, pg. 83) In fact, it is this realization that led to the hiring of Mr. Lelander.

To promote legal and ethical conduct, industry analysts suggest an organization such as JBS develop an organizational ethics program by establishing, communicating, and monitoring ethical values and legal requirements that characterize its history, culture, industry, and operating environment (Ferrell, 2011). Without uniform standards and policies of conduct, it is difficult for employees to determine what behaviors are acceptable within a company. As Matt reviews the laundry list of accusations (see Exhibit 2 in appendix B) he begins to see the effects of lax controls. If these accusations are true, how was this cultural mindset created?

Matt wonders if he should revise his company’s ethics program. Matt ponders what frameworks should be used as the foundation any ethics program. What are JBS’s primary goals and values? Matt realizes a strong ethics program includes a written code of conduct, an ethics officer to oversee the program, care in the delegation of authority, formal ethics training, and auditing, monitoring, enforcement, and revision of program standards. He begins to wonder if JBS should hire an ethics officer, to assist in the governance and implementation of any ethics program. Further, he wonders what changes should be implemented to fairly and ethically treat all members of such a diverse workforce. Matt clearly has a lot of work ahead of him!

Legal Frameworks

After several hours of research, Matt realized that he had overlooked several of the very important legal aspects of JBS’s labor issue, which will need to be included (or at least contemplated) prior to making his recommendations. The labyrinth of legal regulations a human resource manager must be able to navigate in order to avoid potential liability certainly is daunting. However, while this area of law is still evolving, there are a few well established legal principles that need to be reviewed prior to Matt making his recommendations to the board of directors. Matt dusts off his Equal Employment Opportunity Commission guidelines to review the myriad of relevant federal statutes. He compiles the following list presented in Figure 4.

With regard to the filed claim, Title VII of the Equal Employment Act (42 USC § 2000e et seq (2000)), is the most concerning regulation in Matt’s view. Traditionally, employees bring discrimination suits alleging that they have been discriminated against on the basis of a few legally protected categories. Liability is assigned when a plaintiff can prove they were intentionally discriminated against (this is referred to as disparate treatment). Further, liability will be assigned if the plaintiff can prove employer policies have had an adverse impact (even if unintentional) on members of a protected group (this is disparate impact). These suits are generally based on state or federal legislation which specifically prohibits discrimination (whether disparate treatment or impact) based on certain protected classifications. Most of the claims in the filed suit involve disparate treatment.
Figure 4: Listing of Federal Laws Which Prohibit Employment Discrimination

- Title VII of the Civil Rights Act of 1964 (Title VII), which prohibits employment discrimination based on race, color, religion, sex, or national origin;
- The Equal Pay Act of 1963 (EPA), which protects men and women who perform substantially equal work in the same establishment from sex-based wage discrimination;
- The Age Discrimination in Employment Act of 1967 (ADEA), which protects individuals who are 40 years of age or older;
- Title I and Title V of the Americans with Disabilities Act of 1990, as amended (ADA), which prohibit employment discrimination against qualified individuals with disabilities in the private sector, and in state and local governments;
- Sections 501 and 505 of the Rehabilitation Act of 1973, which prohibit discrimination against qualified individuals with disabilities who work in the federal government;
- Title II of the Genetic Information Nondiscrimination Act of 2008 (GINA), which prohibits employment discrimination based on genetic information about an applicant, employee, or former employee; and
- The Civil Rights Act of 1991, which, among other things, provides monetary damages in cases of intentional employment discrimination.

This Figure lists the main U.S. Federal legislation which is aimed at preventing or limiting employment discrimination. This list does not include state specific legislation, which may include additional protections. *compiled from www.eeoc.gov and other sources.

The main piece of federal legislation used to combat employment discrimination or protect against potential liability is Title VII of the Civil Rights Act of 1964. Title VII theoretically only prohibits employer (defined as employers who have 15 or more employees) discrimination on the very limited categories of sex, race, religion, color or national ancestry. Employees, who believe they have been discriminated against on a basis which does not fall under the umbrella of Title VII or one of the above listed statutes, are essentially left unprotected.

However, creative uses of Title VII or some unique state protections for employees have expanded employee protections, especially for failure to accommodate sincerely held religious beliefs. These claims are often easy to bring against an employer because the courts only require that the religious beliefs be strongly or sincerely held as opposed to nationally recognized. In most cases, a history of religious practices, or a history of behavior based on religious beliefs is sufficient to raise a claim. Typically, the employer has to attempt to accommodate the employee’s religious based request, but is not required to hire additional workers, inconvenience other workers, or pay only a minimal (de minimis) cost of accommodation. Trans World Airlines v. Hardinson, 432 U.S. 63, 81 (1977).

As mentioned, Title VII of the Civil Rights Act of 1964 (“Title VII”) prohibits employers from discriminating against individuals because of their religion in hiring, firing, and other terms and conditions of employment. Specifically, Title VII also requires employers to reasonably accommodate the religious practices of an employee or prospective employee, unless to do so would create an undue hardship upon the employer (see Exhibit 2 in appendix B). This essentially means that employers may not treat employees more or less favorably because of their religion; employees cannot be required to participate, or refrain from participating, in a religious activity as a condition of employment; employers must reasonably accommodate employees’ sincerely held religious practices unless doing so would impose an undue hardship on the employer; employers must take steps to prevent religious harassment of their employees; and finally, employers may not retaliate against employees for asserting rights under Title VII. Hardinson, 432 U.S. 63, 82.

However, an employer is not obligated to provide the specific or requested accommodation. If the employer reasonably accommodates the employee’s religious needs (such as a change in schedule for religious observance), the employer need not consider the employee’s preferred accommodation even if this preferred accommodation does not cause an undue hardship. Ansonia Board of Education v. Philbrook, 479 U.S. 60, 70 (1986).

The preventative measures aspect (as mention in the Hardinson case) catches Matt’s attention. Title VII places an affirmative responsibility on employers to maintain a work environment free of harassment, intimidation, and repeated insults. The concept of a hostile work environment traditionally applies to
sexual discrimination claims; however, the same concepts apply to religious discrimination claims as well. The Supreme Court in *Harris v. Forklift Systems*, 510 U.S. 17, 21 (1993), defined a hostile or abusive work environment as one in which the “challenged conduct must be severe or pervasive enough "to create an objectively hostile or abusive work environment -- an environment that a reasonable person would find hostile or abusive.” Matt distinctly remembers from his previous HR courses that an employer can be liable if fellow employees create a hostile work environment and the employer knew or should have known of this environment and failed to correct the situation. Matt wonders if this is indeed the case with JBS.

Religious employees often confront conflicts between their employment obligations and their religious obligations; federal law (and many state and local laws for that matter) require employers to try to accommodate those obligations. Title VII provides that an employer must *reasonably accommodate* an employee's religious beliefs and practices unless doing so would cause “undue hardship on the conduct of the employer's business.” (Prenkert, 2006) However as Chief Justice Rehnquist has noted, what constitutes a reasonable accommodation or an undue hardship is not clearly articulated in the statute. (Ansonia Board of Education v. Philbrook), 479 U.S. 60, 63 (1986). To date the generally accepted definition is still the *de minimis* standard as set by the Supreme Court in the Hardinson case.

A reasonable accommodation is one that eliminates the employee’s conflict between his religious practices and work requirements and that does not cause an undue hardship for the employer (Civil Rights Act). Requested accommodations obviously will vary; an employee may need a particular day off each year for a religious holiday, to refrain from work every week on his or her Sabbath, to wear religious garb, or to have a place to pray to name a few accommodations. An employer must try to allow the employee to meet these religious obligations so long as the accommodation does not create an undue business hardship.

Matt has considered several potential accommodations including shift swaps between employees, shorter but more frequent breaks, voluntary assignment substitutions, flexible scheduling (allowing an employee to work on Sundays, Christmas or other national holiday in place of the day he or she needs off), lateral transfers to other positions in the company, and use of lunch time in exchange for early departure. Matt could allow an employee who needs to observe a religious holiday to work longer hours on Monday through Thursday to enable the employee to leave early. An employer may require an employee to use their paid time off, such as personal or vacation days, to meet an employee’s required accommodation.

Courts employ a two-step framework to analyze claims of religious discrimination under Title VII of the Civil Rights Act of 1964, 42 U.S.C.S. § 2000e et seq. Initially, a plaintiff must establish a prima facie case by demonstrating (1) she had a bona fide religious belief, the practice of which conflicted with an employment duty; (2) she informed her employer of the belief and conflict; and (3) the employer threatened her or subjected her to discriminatory treatment, including discharge, because of her inability to fulfill the job requirements (Pruszynski citing, E.E.O.C. v. Alamo Rent-A-Car, 432 F. Supp. 2d 1006, 1011 (D. Ariz. 2006)) If the plaintiff establishes her prima facie case, the burden shifts to the employer to show one of two things: (1) that it initiated good faith efforts to accommodate reasonably the employee's religious practices; or (2) that it could not reasonably accommodate the employee without undue hardship. If negotiations between employee and employer do not produce a proposal by the employer that would eliminate the religious conflict, the employer must either accept the employee's proposal or demonstrate that it would cause undue hardship were it to do so (Alamo, at 1012-1013). Consider the Hardinson case in which the Court held that an employer need not adapt to an employee's special worship schedule as a reasonable accommodation where doing so would conflict with the seniority rights of other employees. It should be noted, however, that the ultimate responsibility for proving that any reason (or claimed occupational qualification) is a pretext for discrimination lies with the employee. *McDonnell Douglas v Green*, 411 U.S. 792, 802 (1973).
Despite the volumes nature of employee initiated religious discrimination claims, there are several examples of employers successfully fighting a religious discrimination claims. An example is the Second Circuit’s ruling in favor of the employer who refused an employee’s request to wear a beard for religious reasons. The individual came to work unannounced with a beard and had never previously indicated to his employer that he held such religious beliefs. The court did not believe he had substantiated the existence of a strongly held belief, (Rosenberg J 2002). Similarly a court upheld the company’s attempt to have an employee cover up a tattoo depicting a hooded figure and a burning cross which the employee alleges resulted from his religious beliefs in the KKK, Swartzentruber v. Gunite Corporation, 99 F.Supp. 2d 976, (D.C. 2000). In another highly publicized case, Cloutier v CostCo., 390 F. 3d 126, 128. (1st Cir. 2004) an employee who belonged to the Church of Body Modification refused to remove an eyebrow ring during work to comply with the employer’s jewelry prohibition. The court held that the employer had a valid interest in its work forces appearance and public image, and allowing the employee to wear the eyebrow ring could be considered an undue hardship. As a result, the stores policy prohibiting facial jewelry did not violate the employee’s freedom of expression or religion.

As mentioned above, an employer is not required to provide an accommodation that causes it an undue hardship. The U.S. Supreme Court has ruled that this means that an employer need not incur more than minimal costs in order to accommodate an employee’s religious practices. Matt begins to contemplate whether shift swaps and his other suggestions would create an undue hardship. The EEOC has interpreted this to mean that an employer can show that a requested accommodation causes it an undue hardship if accommodating an employee’s religious practices requires anything more than ordinary administrative costs, diminishes efficiency in other jobs, infringes on other employees’ job rights or benefits, impairs workplace safety, causes coworkers to carry the accommodated employee’s share of potentially hazardous or burdensome work, or if the proposed accommodation conflicts with another law or regulation. For example, an employer probably does not have to train a part-time employee at substantial cost in order to cover for another employee who is unable to work on Saturdays (see http://www.adl.org/religious_freedom/resource_kit/religion_workplace.asp).

Matt looks at this requirement and ponders if special schedules for Islamic employees would meet this threshold. He is aware that although Islam is certainly a sincerely held belief by his employees, the undue hardship standard creates quite a loophole. In fact, legal commentators often note that this standard may be overused in favor of employers (Prenkert and Magid 2006).

CONCLUSIONS

Still sitting at his computer, Matt considered the long successful history of JBS Swift and the partnership between the largest meatpacking firm and the city of Greeley. Matt has several questions to ponder over the next three days prior to making his recommendations. First, how can a labor policy be designed to satisfy all existing stakeholders in a fair and legal manner? Second, what accommodations, if any should be given to the Somali workers? Third, how will other employees respond if special treatment is provided to just this segment of the workforce? Finally, what items should an ethics policy/program contain at JBS to help avoid future problems? Matt went out to the lobby to get a refill on his coffee as he pondered the answers to these toughquestions.

REFERENCES


Cloutier v CostCo, 390 F. 3d 126, 128. (1st Cir. 2004).


APPENDICES

Appendix A: Exhibit 1-General Allegations as detailed in EEOC v. JBS USA, LLC d/b/a JBS Swift & Company, 10-CV-02103 PAB-KUM (D. Colo.) This is only a portion of the allegations and complaint as filed by the EEOC. For a complete copy, please reference the filed complaint as listed above.

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According to the Muslim religion, Muslims must pray five (5) times a day according to the Muslim prayer calendar.

1. Throughout their employment, the Charging Parties and other aggrieved Muslim, Somali and Black employees were subjected to a hostile work environment because of their race, national origin, and/or religion.

2. Throughout their employment, the Charging Parties and other aggrieved Muslim individuals were denied and continue to be denied the ability to pray.

3. Muslim employees at the Facility were harassed and continue to be harassed when they attempted to pray during scheduled breaks.

4. Muslim employees at the Facility were harassed and continue to be harassed when they attempted to pray during their bathroom breaks.

5. Muslim employees' requests to pray during bathroom break were denied.

6. Charging Parties, other immigrants from Somalia (“Somali employees”), and Muslim, employees were subjected to harassing comments on the basis of their race (Black), national origin (Somali), and/or religion (Muslim).

7. Managers, supervisors, and other employees regularly threw blood, meat, and bones at the Somali and Muslim employees. Somali employees were regularly called names such as [names have been redacted]

8. There was offensive anti-Somali, anti-Muslim and anti-Black graffiti present in the restrooms. For example, employees saw graffiti such as “Somalis are ______,” “_______Somalians, redacted, redacted, redacted, and “redacted.”

9. The Somali and Muslim employees were offended by the above comments and actions.

10. Somali and Muslim employees were discriminatorily denied bathroom breaks.

11. Some of the Charging Parties complained about harassment based on religion, race and national origin, but Defendant failed to correct the hostile work environment.

12. Somali and Muslim employees were disciplined and continue to be disciplined more harshly than non-Somali and non-Muslim employees, or were disciplined for conduct that others were not.
The Events Relating to Ramadan 2008

13. The requirement stated in the Qur’an that Muslims pray five (5) times a day is especially important during the holy month of Ramadan, when Muslims also fast during the day and only break their fast at sundown during their fourth prayer of the day.

14. Fasting during Ramadan requires no intake of either food or water before sunset.

15. The first day of the 2008 Ramadan holiday on which the charging parties reported to work was Tuesday, September 2, 2008.

16. On September 2, 2008, at the conclusion of the B shift, at 11:45 p.m., between 40 and 100 Muslim employees went to the Superintendent’s office (Juan Palacios) to request that the meal break be moved from 9:15 p.m. to 7:30 p.m., so that the Muslim employees could pray in accordance with the requirements of their religion and break their fast within 15 minutes of sunset.

17. For the next two shifts, Wednesday and Thursday, September 3 and 4, 2008, Swift accommodated the Muslim employees and had the lunch break occur midway through the shift, at 7:30 p.m. From Friday, September 5, 2008 and thereafter, Swift refused to accommodate the Muslim employees and instead moved the break to 8:00 p.m. on Friday and to 8:30 p.m. thereafter. Muslim employees had suggested numerous ways their need to pray during the workday could be accommodated, but their suggestions were rejected.

18. On Friday, September 5, 2008, shortly before the Muslim employees believed their 7:30 p.m. break would occur, Swift decided to move the break to 8:00 p.m.

19. On September 5, 2008, at around 7:30 p.m., Swift stationed management employees at all of the exits and refused to allow the Muslim employees to leave the line and told them to return to their lines.

20. Swift shut off the water fountains and/or tagged them with red tags and yellow tape.

21. Red tags are usually used in the Swift facility to indicate rotten or spoiled meat.

22. Because the water fountains were unavailable for use, the Muslim employees were prevented from getting a drink of water, a drink they needed after fasting all day for Ramadan.

23. Because of Swift’s actions, the Muslim employees were also prevented from washing up, a religious requirement before prayers.

24. At 8:00 p.m., the employees were allowed to take their break.

25. During the break, Swift management told the Muslim employees to go outside the facility. When the Muslim employees attempted to re-enter the facility at the conclusion of the break, Swift told them they could not return to work.

26. On Monday, September 8, 2008, Swift informed the Union those employees who had left the plant Friday evening had engaged in an “unauthorized work stoppage” and would be placed on an indefinite suspension.

27. On Tuesday, September 9, 2008, Swift decided that employees who had left the facility Friday evening would be allowed to return to work and given a final written warning with Friday and Monday being treated as unpaid suspensions, provided they returned to work that day.

28. Swift did not contact each of the affected Muslim employees to tell them they were expected to return to work that day.

29. On Wednesday, September 10, 2008, Swift terminated all of the Muslim employees who had not returned to work on Tuesday, including employees who attempted to return to work on Wednesday and who told Swift that they did not know they were to return the previous day.

Pattern or Practice Of Discriminatory Treatment Because of Race, National Origin, Religion, and/or Retaliation

30. Plaintiff re-alleges all of the foregoing paragraphs.

31. Since at least December 22, 2007, Defendant has engaged and continues to engage in a pattern or practice of unlawful discriminatory employment practices at its facility in Greeley, Colorado, in violation of Section 703(a) of Title VII, 42 U.S.C. § 2000e-2(a) by discriminating against Charging Parties and other aggrieved individuals with respect to the terms and conditions of their employment because of their race, Black, national origin, Somali, religion, Muslim, and/or retaliating against employees who requested a reasonable accommodation for their religion.

32. The pattern or practice of discriminatory treatment includes, without limitation, harassment, disparate treatment, denial of religious accommodation, retaliation against individuals who seek religious accommodation, and disciplining and discharging Somali Muslim employees because of their religion, national origin, and in retaliation for requesting religious accommodation or having religious accommodation requested on their behalf.

33. The effect of the practices complained of above has been to deprive the Charging Parties and other aggrieved individuals of equal employment opportunities and otherwise adversely affect their employment status because of their race, national origin, religion, and/or because they sought religious accommodation.

34. The unlawful employment practices complained of above were and are intentional.

35. The unlawful employment practices complained of above were done with malice or with reckless indifference to the federally protected rights of Charging Parties and other aggrieved employees.
Second Claim: Failure to Accommodate Religion

36. Plaintiff re-alleges all of the foregoing paragraphs.

37. Since at least December 22, 2007, Defendant has engaged and continues to engage in unlawful employment practices at its facilities in Greeley, Colorado, in violation of Section 703(a) of Title VII, 42 U.S.C. § 2000e-2(a) by failing to reasonably accommodate its Muslim employees’ religious practices and/or beliefs.

38. The unlawful employment practices complained of above were and are intentional.

39. The unlawful employment practices complained of above were done with malice or with reckless indifference to the federally protected rights of Charging Parties and other aggrieved Muslim and/or Somali employees.

Third Claim: Retaliation For Requesting Accommodation

40. Plaintiff re-alleges all of the foregoing paragraphs.

41. Since at least September 2008, Defendant has engaged and continues to engage in unlawful employment practices at its facilities in Greeley, Colorado, in violation of Section 704 of Title VII, 42 U.S.C. § 2000e-3 by disciplining and/or terminating Charging Parties and other Muslim employees in retaliation for their requests for religious accommodation.

42. The effect of the practices complained of above has been to deprive the Charging Parties and other aggrieved individuals of equal employment opportunities and otherwise adversely affect their employment status because of their requests for religious accommodation.

43. The unlawful employment practices complained of above were and are intentional.

44. The unlawful employment practices complained of above were done with malice or with reckless indifference to the federally protected rights of Charging Parties and other aggrieved Muslim and/or Somali employees.

Fourth Claim: Hostile Work Environment/Harassment

45. Plaintiff re-alleges all of the foregoing paragraphs.

46. Since at least December 22, 2007, Defendant has engaged and continues to engage in unlawful employment practices at its facility in Greeley, Colorado, in violation of Section 703(a) of Title VII, 42 U.S.C. § 2000e-2(a) by harassing Charging Parties and other aggrieved individuals, and/or because of their race, Black, national origin (Somali), and/or religion (Muslim).

47. The harassment of Black Somali and Muslim employees was sufficiently severe or pervasive as to alter the terms and conditions of their employment.

48. Management employees participated in the harassment of Black Somali and Muslim employees.

49. Management employees knew or should have known of the harassment of Black Somali and Muslim employees.

50. Management employees failed to take appropriate action to prevent or promptly correct the harassment of Black Somali and Muslim employees.

51. The effect of the practices complained of above has been to deprive the Charging Parties and other aggrieved individuals of equal employment opportunities and otherwise adversely affect their employment status because of their race, national origin, and/or religion.

52. The unlawful employment practices complained of above were and are intentional.

53. The unlawful employment practices complained of above were done with malice or with reckless indifference to the federally protected rights of Charging Parties and other aggrieved Muslim and/or Somali employees.

Sixth Claim: Discriminatory Discipline And Discharge

54. Plaintiff re-alleges all of the foregoing paragraphs.

55. Since at least September 2008, Defendant has violated and continues to violate Section 703(a) of Title VII, 42 U.S.C. § 2000e-2(a) by disciplining and discharging Charging Parties and other aggrieved individuals because of their national origin, religion and/or in retaliation for requesting religious accommodation.

56. Muslim and Somali employees were disciplined and discharged for allegedly engaging in a work stoppage, while non-Somali, non-Muslim employees were not disciplined for similar conduct.

57. Somali employees were directed not to come to work and/or were not allowed to return to their shift because of their religion, national origin, and/or because they had requested or needed a religious accommodation. Defendant disciplined and discharged Somali employees for allegedly engaging in an unauthorized work stoppage when they failed to report to work as directed. The effect of the practices complained of above has been to deprive the Charging Parties and other aggrieved individuals of equal employment opportunities and otherwise adversely affect their employment status because of their national origin, religion, and/or because they requested religious accommodation.
Sixth Claim: Discriminatory Discipline And Discharge

58. The unlawful employment practices complained of above were and are intentional.

59. The unlawful employment practices complained of above were done with malice or with reckless indifference to the federally protected rights of Charging Parties and other aggrieved employees.

Appendix B: Exhibit 2


Title VII makes it unlawful to "discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin." 42 U.S.C. § 2000e-2(a).

In certain instances, differential treatment is allowed for religion, sex, or national origin if it is a bona fide occupational qualification. Sexual harassment is also prohibited under this law as are all forms of harassment based on membership in a protected class.

Under Title VII an employer is required to reasonably accommodate the religious belief of an employee or prospective employee, unless doing so would impose an undue hardship.

§ 2000e. Definitions

(a) The term "person" includes one or more individuals, governments, governmental agencies, political subdivisions, labor unions, partnerships, associations, corporations, legal representatives, mutual companies, joint-stock companies, trusts, unincorporated organizations, trustees, trustees in cases under title 11, United States Code, or receivers.

(b) The term "employer" means a person engaged in an industry affecting commerce who has fifteen or more employees for each working day in each of twenty or more calendar weeks in the current or preceding calendar year, and any agent of such a person, but such term does not include (1) the United States, a corporation wholly owned by the Government of the United States, an Indian tribe, or any department or agency of the District of Columbia subject by statute to procedures of the competitive service (as defined in section 2102 of title 5 of the United States Code), or (2) a bona fide private membership club (other than a labor organization) which is exempt from taxation under section 501(c) of the Internal Revenue Code of 1954 [26 USCS § 501(c)] except that during the first year after the date of enactment of the Equal Employment Opportunity Act of 1972 [enacted March 24, 1972], persons having fewer than twenty-five employees (and their agents) shall not be considered employers.

(j) The term "religion" includes all aspects of religious observance and practice, as well as belief, unless an employer demonstrates that he is unable to reasonably accommodate to an employee's or prospective employee's religious observance or practice without undue hardship on the conduct of the employer's business.


§ 2000e-2. Unlawful employment practices

(a) Employer practices. It shall be an unlawful employment practice for an employer—

(1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin; or

(2) to limit, segregate, or classify his employees or applicants for employment in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's race, color, religion, sex, or national origin.

(e) Businesses or enterprises with personnel qualified on basis of religion, sex, or national origin; educational institutions with personnel of particular religions. Notwithstanding any other provision of this title [42 USC §§ 2000e et seq.], (1) it shall not be an unlawful employment practice for an employer to hire and employ employees, for an employment agency to classify, or refer for employment any individual, for a labor organization to classify its membership or to certify or refer for employment any individual, or for an employer, labor organization, or joint labor-management committee controlling apprenticeship or other training or retraining programs to admit or employ any individual in any such program, on the basis of his religion, sex, or national origin in those certain instances where religion, sex, or national origin is a bona fide occupational qualification reasonably necessary to the normal operation of that particular business or enterprise, and (2) it shall not be an unlawful employment practice for a school, college, university, or other educational institution or institution of learning to hire and employ employees of a particular religion if such school, college, university, or other educational institution or institution of learning is, in whole or in substantial part, owned, supported, controlled, or managed by a particular religion or by a particular religious corporation, association, or society, or if the curriculum of such school, college, university, or other educational institution or institution of learning is directed toward the propagation of a particular religion.

(m) Impermissible consideration of race, color, religion, sex, or national origin in employment practices. Except as otherwise provided in this title [42 USC §§ 2000e et seq.], an unlawful employment practice is established when the complaining party demonstrates that race, color, religion, sex, or national origin was a motivating factor for any employment practice, even though other factors also motivated the practice.
APPENDIX C: Exhibit 3

JBS Greely Mission Statement/Values

Mission: “To be the best at what we set out to do, totally focused on our business, ensuring the best products and services for our customers, solidity for our suppliers, satisfactory profitability for our shareholders and the certainty of a better future for all our employees.”

VALUES
Planning: Think before you act. Look to the future. Always be prepared.
Determination: Never give up. Be involved. Drive to meet your goals and objectives.
Discipline: Each day, be organized and prompt. Focus on details.
Availability: Be supportive and accessible. Take initiative.
Sincerity: Be true. Disagree when necessary. Recognize when to say no; however, be positive and offer solutions.
AN ETHICAL AND EMPLOYMENT QUAGMIRE: 
THE CASE OF JBS
TEACHING NOTE
Michael Martin, University of Northern Colorado
Joseph J. French, University of Northern Colorado

CASE DESCRIPTION

The setting for this case is the JBS Swift Corporation in Greeley, Colorado. Specifically, this case describes the hypothetical employment decisions Matt Lelander, a fictional manager, must confront as the result of a labor dispute over working conditions for Somali workers during Ramadan. Mr. Lelander is presented several ethical, legal, and employment dilemmas. The board of directors for JBS has requested that Mr. Lelander evaluate these dilemmas and present a report with recommendations on how to proceed. The claims involve a series of accusations levied against JBS by several of their Somali and Muslim employees. These claims include assertions of harassment during Ramadan, a pattern of discrimination since 2008, a hostile work environment, failure to accommodate, and retaliatory discharge. The dispute and allegations can be found in Appendix A. The case provides detailed background information on JBS Swift, current labor relationships in the meat packing industry, applicable labor laws and an ethical discussion. Students are asked to formulate ethically and legally sound recommendations to the board of directors. The suggested audiences for this case study are upper level undergraduate students and graduate students.

Learning and Teaching Objectives

This case has several learning objectives;
1. Identify and evaluate any potential ethical lapses in the treatment of JBS employees.
2. Analyzes the potential issues (both legal and ethical) presented by treating employees differently based on their religious beliefs.
3. Explore the various potential responses available for an HR manager presented with these allegations.
4. Contemplate what provisions an organizational code of conduct and corporate governance plan should contain for this organization.
5. Discuss what procedures and policies an organization could or should implement to avoid these types of issues.

CLASS USE

An effective method for teaching this case involves allowing students to read the actual EEOC compliant filed by the JBS workers. Combining this reading with a video clip (such as a clip investigating the meat processing industry); will help set the stage as to what the working environment and conditions are like in the meat processing industry. There are several clips available on publicly web broadcast systems such as YouTube. Generally, this case should be presented towards the end of a semester at the culmination of a business ethics course or legal environment course. Conversely, this case can also serve as an introduction to the topic of business ethics or employment discrimination. If this is the preferred use, the professor may which to avoid the suggested assignment described above as the students may not yet be equipped to complete it.

The overall discussion of this exercise usually takes about 50-75 minutes in a class of 35-40 students. This discussion can be structured in three parts; brainstorming and listing all the ethical and legal issues,
narrowing the list, and constructing a feasible proposal to be presented in front of the class (hypothetical board of directors).

An alternative approach is to discuss and narrow all the potential legal and ethical issues and then assign the students (as groups or individuals) the task of preparing and turning in a well written report (usually by the next class period). You can also assign several groups to present their proposals. If they are to present proposals, we stress that they assume they are actually presenting to JBS’ board of directors and advise instructing them to act accordingly.

As there are a multitude of business ethics course books and approaches, this case is designed so it can accompany any business ethics text. We cite an ethical framework, published in the Ferrell et al. text, (Ferrell, O.C., Friedrich,J, and Ferrell, L, 2011, Business Ethics, Ethical Decision Making and Cases, Mason, OH, Cengage), however, the case can be completed using any established business ethics framework.

Time permitting, and to further encourage a robust discussion, a role play scenario can be used. Divide the students into groups to represent various stakeholders including the Somali employees, the Greeley JBS management, the non-Muslim employees, the board of directors, etc. Have the students in groups discuss the business, legal, and ethical issues facing their assigned stakeholder and devise negotiating positions. Then have the entire class engage in discussion in which the professor moderates. If time does not permit simply divide the class into two groups. One group should represent the Somali employees and the other JBS’ management.

DISCUSSION QUESTIONS

Before any meaningful class discussion is attempted it is imperative that the class read the entire case study including Appendixes. Appendix A: Exhibit 1 lays out the actual claims and complaints as filed by the EEOC in the District of Colorado. This exhibit describes several instances of alleged harassment and failure to accommodate such as those described in allegations 3, 4, 5, and 10, as listed below:

3. Muslim employees at the Facility were harassed and continue to be harassed when they attempted to pray during scheduled breaks.
4. Muslim employees at the Facility were harassed and continue to be harassed when they attempted to pray during their bathroom breaks.
5. Muslim employees’ requests to pray during bathroom break were denied.
10. Somali and Muslim employees were discriminatorily denied bathroom breaks.

The allegations in Appendix A, Exhibit 1, lay out in detail the alleged treatment which is the crux of this case. It should be noted that these are only allegations and not established facts. However, whether or not these claims have merit, they do provide an excellent foundation for discussing the imperative for organizational codes of conduct and well as corporate governance programs. Further, this case sets up the fundamental business ethics principle that the laws and regulations established by our government set minimum standards for responsible behavior. These laws do not delineate what is ethical nor do they establish organizational values.
RECOGNIZING ETHICAL ISSUES

Students will need to identify the ethical issues present in this case. An ethical issue is a situation, a problem, or even an opportunity that requires thought, discussion, or investigation to determine the moral impact of the decision. Stakeholders, who include employees, define a business’s ethical issues.

Further, it is important for students to understand that new ethical issues are emerging all the time. As presented, JBS seems to have an optimization issue (see Ferrell text, pg 63) which is the tradeoff between equity (equality or fairness) and efficiency (that is, maximum productivity). Allowing some employees to take more frequent breaks to pray may affect overall meat processing capacity. Further, if JBS grants the Muslim employees special prayer breaks, they may get backlash from the non-Muslim employees who are not allowed such breaks and feel they are not being treated fairly.

Abusive behavior, whether perpetrated by the employer of fellow employees, is another potential ethical issue. The claims filed by the EEOC suggest that abusive and intimidating behavior is a common ethical problem. Abusive and intimidating behavior includes anything from physical threats, false accusations, annoying, profanity, insults, yelling, harshness, ignoring someone, or unreasonableness in accommodations. If the students read Appendix A Exhibit 1, they should be able to identify several instances of alleged abusive behavior. Some examples include allegations 7, 8, and 10, as listed below:

7. Managers, supervisors, and other employees regularly threw blood, meat, and bones at the Somali and Muslim employees. Somali employees were regularly called names such as {names have been redacted}

8. There was offensive anti-Somali, anti-Muslim and anti-Black graffiti present in the restrooms. For example, employees saw graffiti such as “Somalis are _____,” “_____ Somalians, redacted, redacted, redacted, and “redacted.”

10. Somali and Muslim employees were discriminatorily denied bathroom breaks.

Laws regulating business conduct are passed because certain stakeholders believe that business cannot be trusted to do what is right in certain areas, such as consumer safety and environmental protection. Civil law defines the rights and duties of individuals and organizations. Criminal law not only prohibits specific actions, such as fraud or theft but also imposes fines or imprisonment as punishment for breaking the law.

Violations of Title VII generally constitute a civil law violation (although based on the allegations, criminal charges also may be present). Title VII of the Equal Employment Act was designed to ensure that all employees are treated fairly and equally. Specifically, employees should not suffer adverse employment actions as a result of their sincerely held religious beliefs. Clearly, based on the allegations by the EEOC, Muslim employees suffered detrimental effects as a result of their religious beliefs. If the court accepts these allegations as true, JBS could face severe penalties and several of the fired employees will be entitled to damages.

SUGGESTED ASSIGNMENT QUESTIONS

1. What are the ethical and legal problems described in the article? Using one page, delineate the three most troubling ethical concerns as well as the three most concerning legal issues.
2. Who are the stakeholders? Who is affected by this issue and how? How is each stakeholder harmed or benefited by the proposed actions?
3. What are the most important values of each stakeholder?
4. How did this problem develop and what are the underlying causes? Do you believe there are cultural conflicts at issue?
5. How could JBS have avoided these issues?
6. If you were Matt Lelander, how would you advise the Board? Write a three page memo detailing your suggestions.

If students are having trouble when identifying issues or developing their suggestions, the professor can suggest students consult the U.S. Sentencing Commission Guidelines for Organizations (available at http://ftp.ussc.gov/corp/Murphy1.pdf), as well as the EEOC’s Best Practices for Eradicating Religious Discrimination in the Workplace (available at http://www.eeoc.gov/policy/docs/best_practices_religion.html) (last visited May 12th, 2011).

The U.S. Sentencing Commission Guidelines for Organizations (FSGO) create incentives for firms to aim at ethical performances rather than simply maintain legal compliance. Taking the high road can be both cost efficient and important for satisfying basic objectives of the firm. Federal Sentencing Guidelines for Organizations mandate that top management and board members are responsible for maintaining an ethical organizational culture. Given these guidelines, organizations such as JBS need to define an organizational culture, relate it to their risk areas and establish mechanisms, program and policies to manage their risks and define their culture.

Further, the EEOC’s Best Practices for Eradicating Religious Discrimination in the Workplace, clearly articulates some simple and pragmatic recommendations for employers when dealing with potential religious discrimination claims. A few of the suggested accommodation and tips are listed below:

- Employers should inform employees that they will make reasonable efforts to accommodate the employees’ religious practices.
- Employers should train managers and supervisors on how to recognize religious accommodation requests from employees.
- Employers should train managers to gauge the actual disruption posed by religious expression in the workplace, rather than merely speculating that disruption may result. Employers should also train managers to identify alternative accommodations that might be offered to avoid actual disruption (e.g., designating an unused or private location in the workplace where a prayer session or Bible study meeting can occur if it is disrupting other workers).
- Employers should incorporate a discussion of religious expression, and the need for all employees to be sensitive to the beliefs or non-beliefs of others, into any anti-harassment training provided to managers and employees.
- Employers should consider developing internal procedures for processing religious accommodation requests.
- Employers should individually assess each request and avoid assumptions or stereotypes about what constitutes a religious belief or practice or what type of accommodation is appropriate.
- Employers and employees should confer fully and promptly to the extent needed to share any necessary information about the employee’s religious needs and the available accommodation options.
- An employer is not required to provide an employee’s preferred accommodation if there is more than one effective alternative to choose from. An employer should, however, consider the employee’s proposed method of accommodation, and if it is denied, explain to the employee why his proposed accommodation is not being granted.
- Managers and supervisors should be trained to consider alternative available accommodations if the particular accommodation requested would pose an undue hardship.
- When faced with a request for a religious accommodation which cannot be promptly implemented, an employer should consider offering alternative methods of accommodation on a temporary basis, while a permanent accommodation is being explored. In this situation, an
employer should also keep the employee apprised of the status of the employer’s efforts to implement a permanent accommodation.

ETHICAL FRAMEWORK

To appropriately evaluate and respond to potential ethical issues, it is often helpful for a manager (or students) to adopt an ethical decision making framework. A framework for ethical decision making is a set of questions that managers can use to clarify the relevant business issues. The chart below provides one such popular framework. As previously suggested, there are several other such frameworks used in various texts which will work equally as well.

<table>
<thead>
<tr>
<th>One potential framework for ethical decision making suggests the evaluating of several organizational elements including ethical issue intensity, individual factors, and organizational factors, such as corporate culture and opportunity.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. <strong>Ethical Issue Intensity:</strong> The intensity of an ethical issue relates to its perceived importance to the decision maker.</td>
</tr>
<tr>
<td>2. <strong>Individual Factors:</strong> Although a personal moral compass is important, it is not sufficient to prevent ethical misconduct in an organizational context.</td>
</tr>
<tr>
<td>3. <strong>Corporate Culture:</strong> Corporate culture as a set of values, beliefs, goals, norms, and ways of solving problems shared by the members (employees) of an organization of any size (for profit or nonprofit).</td>
</tr>
<tr>
<td>4. <strong>Recognizing an Ethical Issue:</strong> An ethical issue is a situation, a problem, or even an opportunity that requires thought, discussion, or investigation to determine the moral impact of the decision.</td>
</tr>
</tbody>
</table>


BIOGRAPHY

Michael W. Martin is an Assistant Professor of Business Law at the University of Northern Colorado. He received his LL.M, taxation from the University of Washington. Prior to receiving his LL.M., he earned his MBA and J.D. from the University of Creighton. His research interests involve Business Law, Ethics, Real Estate, Federal Policy, Estate Planning, and Taxation. His work has been published and presented at several leading journals and conferences including the Academy of Legal Studies in Business and the Rocky Mountain Academy of Legal Studies. He teaches Ethics, Business Law, and Real Estate courses at University of Northern Colorado’s Monfort College of Business.

Joseph French holds a PhD in Financial Economics from the University of New Orleans. French’s primary research interests are in the areas of international finance, corporate finance and developmental economics. Joe’s research appears in several peer reviewed journals including: Studies in Economics and Finance, International Journal of Banking and Finance, Journal of Developing Areas, Journal of the Academy of Marketing Sciences and Economics of Emerging Markets. Currently Dr. French is an Assistant Professor of Finance at the Monfort College of Business of the University of Northern Colorado.
A PARTNERSHIP, A SHAM, OR A LOAN?
Paul J. Brennan, Minnesota State University, Mankato

CASE DESCRIPTION

This case was an adapted version of a tax case heard in U.S. Federal District Court and the US Court of Appeals. The case involved a partnership set-up by a large US corporation with its own subsidiaries as managing partners and foreign partners as outside investors. The formation of the partnership resulted from a stated objective of finding an alternative to debt financing, but provided far more significant tax savings benefits. The case was intended for use in an undergraduate taxation class focusing on business entities or an undergraduate accounting capstone or special topics course. The case and its attendant exercises were designed as applied vehicles for exploring the dimensions of the debt vs. equity classification and the nature of economic substance doctrine. The case and exercises require little knowledge of partnership taxation, but some research of the economic substance doctrine, the concept of what constitutes a partnership, and the arguments for debt vs. equity classification are required. The case may be used as a writing assignment or for class discussion. Estimated time for completion of the assignments, including research, is about four hours. Estimated time for class discussion of answers is less than one hour.

JEL: K34, H26

KEYWORDS: Tax Law, Tax Evasion

CASE INFORMATION

Janet Dolan, had just celebrated her sixth year as an attorney with the US Department of Justice Tax Division. During her time with the division she acquired substantial trial experience involving civil cases between the US government and taxpayers in the US Tax and District Courts. Her career had developed nicely and she enjoyed the progressive expertise and responsibility that came with her job, but she felt a bit apprehensive as she approached a new case assigned to her. This case involved a purported partnership tax shelter and the largest monetary stakes of her career, about 62 million dollars, were riding on the outcome.

The new case involved a partnership called Tolkin Holding set up by a large US corporation with a couple of its subsidiaries as managing partners. The IRS disallowed the partnership arrangement as a sham transaction with no real business purpose other than tax avoidance and assessed back taxes, interest, and penalties in excess of 60 million dollars. The corporation paid the tax but sued in US District Court for a refund. Janet was anxious about handling the new case. Not only was the claim large but she had never prosecuted a tax shelter case of this size or nature before and she wasn’t all that confident of her expertise in the issues involved.

The case had been assigned to her while she was on a two week vacation. She asked her assistant, Dan Fowler, to review the case and brief her on the important details when she returned from vacation. Today was her first day back and she heard a knock on her door at 10:00 AM. Dan was punctual as usual.

Janet: Hey, Dan. I enjoyed my time off, but I’m sure relieved you were here when this case arrived. Great to see you!

Dan: You, too! Hope you feel rejuvenated because we have some challenges with this one. Let me tell you a little about the new case. After reviewing this case, the words of two authors come to mind. One
described a tax shelter as an investment that is worth more after taxes than it was before taxes (Johnson, 1995). Another suggested that the partnership form of business was motivated more by tax avoidance than by business goals (Johnston, 2003). I won’t go that far, but this arrangement sure seemed to be worth more to the organizers after considering the potential tax savings. This arrangement shifted many millions of dollars of taxes away from a major US corporation to foreign investors who were not subject to US tax.

Janet: Who were the partners involved in this partnership?

Dan: The majority partners were two wholly owned subsidiaries of ABL Corporation. They controlled about 82% of the beginning capital and their shares increased during the life of the partnership. The ABL partners ran the partnership operations with the assistance of other outside ABL subsidiaries that were paid for operational services on a contract basis. The minority partners were two foreign banks. They owned about 18% of the capital at formation of the partnership but those shares decreased as their interest was liquidated through installment payments over six years.

Janet: So the banks were limited partners?

Dan: I guess you might call them that, but the IRS called them creditors using the criteria of IRS Notice 94-47. That’s part of the reason we are here today.

Janet: What business did the partnership operate?

Dan: The Tolkin Holdings Partnership leased sixty-three older aircraft to various airlines. The primary operating activities involved collecting and monitoring lease payments, negotiating with airlines over lease issues and/or aircraft sales, locating new lessees or purchasers of aircraft after the expiration of lease terms, and maintenance and refitting of the older aircraft to bring them into compliance with noise regulations. As you may know, ABL Corporation was a very large finance company operating extensively in the airline leasing business for decades. The ABL subsidiary partners contributed sixty-three older airplanes and the attendant leases along with $240 million of cash to the partnership. These leases continued to operate throughout the six year life of the partnership. Some of the aircraft exited leases and some were sold or transferred to outside ABL entities during this time.

Janet: What did the foreign banks contribute for their partnership interest?

Dan: The foreign partners established their partnership accounts with an investment of approximately $117 million. Based on contributions to the initial capital accounts, the two ABL subsidiary partners owned slightly more than 82% of capital and the foreign banks each owned about 9%. Again, the capital ownership of the banks decreased with scheduled installment liquidations over the six year period.

Janet: How was this partnership arrangement initiated?

Dan: This partnership was a device masterminded by the investment banking firm of Lars & Mullen. Lars & Mullen was active in the airline investment and consulting industry and was identified by the IRS as the developer of a number of tax sheltering vehicles for multiple corporations. ABL Corporation retained Lars & Mullen in 1993 and this partnership arrangement was completed by the end of the year and operated for six years under its initial arrangement before winding up business and dissolving the partnership.
Janet: Yes, I remember the name Lars & Mullen. The Tax Division was acquainted with their work. You said that the partnership shifted millions of dollars of taxes away from the US corporate family and toward foreign exempt investors. How did the tax shifting arrangement operate?

Dan: Well, I had a hard time figuring it out at first but after analyzing the essential facts more completely, the arrangement was actually fairly simple. I drafted a simplified example showing how this arrangement operated (See Table 1). Essentially, what Tolkin Holdings did here wasn’t much more complicated than my example. You just have to add a whole bunch of zeros to the numbers.

Table 1: Hypothetical Example of Partnership Tax Shifting

<table>
<thead>
<tr>
<th></th>
<th>Accounting Income</th>
<th>Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental Revenues</td>
<td>$40,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Expenses w/o Depreciation</td>
<td>-$10,000</td>
<td>-$10,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>-$20,000</td>
<td>$0</td>
</tr>
<tr>
<td>Rental Income</td>
<td>$10,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Interest Revenue</td>
<td>$6,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>Net Income</td>
<td>$16,000</td>
<td>$36,000</td>
</tr>
<tr>
<td></td>
<td><strong>Allocations to Partners (50% to each)</strong></td>
<td><strong>Allocations to Partners (50% to each)</strong></td>
</tr>
<tr>
<td>Accounting Income</td>
<td>Partner A $8,000</td>
<td>Partner B $8,000</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$18,000</td>
<td>$18,000</td>
</tr>
<tr>
<td>Capital Accounts</td>
<td>Partner A $100,000</td>
<td>Partner B $100,000</td>
</tr>
<tr>
<td>Beginning Capital Accounts</td>
<td>$8,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>Accounting Income Allocation</td>
<td>$108,000</td>
<td>$108,000</td>
</tr>
<tr>
<td>Changes in Benefits from Partnership Arrangement</td>
<td>Partner A $-2,000</td>
<td>Partner B $2,000</td>
</tr>
<tr>
<td>Increase (Decrease) in Accounting Return</td>
<td>$-2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Decrease (Increase) in Tax Liability**</td>
<td>$-3,600</td>
<td>$3,600</td>
</tr>
<tr>
<td>Net Increase (Decrease) in Benefits</td>
<td>$-1,600</td>
<td>$1,600</td>
</tr>
</tbody>
</table>

Facts: Assume the AB Partnership forms with a building contributed by Partner A worth $100,000 and cash of $100,000 contributed by Partner B. For tax purposes, A’s building is completely depreciated (and cannot be depreciated further) but the property will be depreciated at $20,000 per year for the next five years for partnership accounting purposes. A’s property generates rental revenues of $40,000 per year and incurs expenses other than depreciation of $10,000. After deducting all expenses from rental revenues, A’s property generates $10,000 of accounting income or a 10% return ($10,000/$100,000) on the beginning book value of the investment. B’s cash generates a 6% return. Both accounting and taxable income are allocated 50% to each partner. Assume each partner has a 30% tax rate on income from the partnership. The results are summarized in the numerical example below.

** If A did not enter into this partnership arrangement, A would be taxed on $30,000 of rental income instead of $18,000 of partnership taxable income. If B did not enter the partnership, B would be taxed on $6,000 of interest income instead of $18,000 of partnership taxable income. The changes in tax liabilities are determined from multiplying the differentials in taxable income by the assumed 30% tax rate. Explanation of Table 1: The numerical example provides a simplified illustration of how a partnership allowed one partner contributing heavily depreciated property to shift significant amounts of taxable income to another partner. A received a lower accounting return from this arrangement but that was more than compensated by higher tax savings due to taxable income shifting. B received a higher accounting return by this investment but the benefits were more than offset by the detriments of increased tax liability.

Janet: They managed to shift taxable income because of large differences between partnership accounting and taxable income due to fully depreciated property being contributed by one group of partners?

Dan: Yes.

Janet: I thought there were regulations requiring taxable income to be shifted back to the contributing partners under these circumstances.

Dan: Well, there are some rules requiring that now but this partnership was formed just before the effective date of those rules (See IRC § 1.704-3).

Janet: You don’t suppose that was a coincidence, do you?
Dan: No. The large differences between accounting and taxable income were due mostly to the fact that the older aircraft contributed to the partnership by the ABL partners were fully depreciated for tax purposes using accelerated methods prior to their contribution but still had significant value and produced large depreciation deductions for partnership accounting purposes.

Janet: How big was the difference between the accounting and taxable income?

Dan: Well, look at Table 2. The banks’ initial investments were increased by slightly less than 28 million of accounting income over the life of the partnership but the taxable income allocated to them was just over 310 million.

Table 2: Tolkin Holdings’ Accounting and Taxable Operating Income and Respective Allocations to Foreign Bank Partners (1993-1998)

<table>
<thead>
<tr>
<th>Year/Period</th>
<th>Tolkin Holdings’ Accounting Income</th>
<th>Allocation to Banks</th>
<th>Tolkin Holdings’ Taxable income</th>
<th>Allocation to Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/6/1993-12/31/93</td>
<td>$339,000</td>
<td>$332,000</td>
<td>16,491,481</td>
<td>16,073,453</td>
</tr>
<tr>
<td>1994</td>
<td>$9,857,000</td>
<td>$9,660,000</td>
<td>76,593,747</td>
<td>75,061,872</td>
</tr>
<tr>
<td>1995</td>
<td>$6,682,000</td>
<td>$6,548,000</td>
<td>63,680,135</td>
<td>62,406,532</td>
</tr>
<tr>
<td>1996</td>
<td>$1,368,000</td>
<td>$1,340,000</td>
<td>50,892,829</td>
<td>49,874,972</td>
</tr>
<tr>
<td>1997</td>
<td>$2,304,000</td>
<td>$2,258,000</td>
<td>51,812,412</td>
<td>50,776,164</td>
</tr>
<tr>
<td>1998</td>
<td>$7,736,000</td>
<td>$7,560,000</td>
<td>57,244,395</td>
<td>55,945,807</td>
</tr>
<tr>
<td>Totals</td>
<td>$28,286,000</td>
<td>$27,698,000</td>
<td>$316,624,999</td>
<td>$310,138,800</td>
</tr>
</tbody>
</table>

Table 2 reports the accounting and taxable operating income of the Tolkin Holdings Partnership throughout its existence and the amount of that income that was allocated to the foreign partners. The reader can see that the overwhelming majority of this income was allocated to the foreign partners despite their minority capital position. The operating income does not include guaranteed payments to the controlling ABL partners for their management services.

Janet: Wow! Those differences were striking. The banks received most of the accounting income but the benefits of getting the lion’s share of accounting income would have been more than offset by the additional tax burden from having such a large amount of taxable income shifted to them. Where the banks protected from the increased tax burden by tax treaty?

Dan: Correct. The treaty between the USA and their home country exempted this partnership income from US taxation under the geographical circumstances of the partnership. Had their partnership interest been classified as loans, the US government could have taxed the banks on the interest payments. More importantly, the interest payments would have provided the same deduction for both accounting and tax and the ABL partners would have been responsible for the remaining taxable income.

Janet: That treaty was convenient! The banks were truly tax indifferent. Lars & Mullen probably started with that condition as the centerpiece of their strategy.

Dan: Supposedly Lars & Mullen was paid somewhere in the neighborhood of nine million dollars for consulting and setting up this partnership.

Janet: Good help isn’t cheap these days. We’re in the wrong business, Dan! Tell me a little more about how income was determined and allocated under the partnership agreement.

Dan: The partnership was set up with the capital contributions I mentioned before. At any given time, the partners’ investments in the partnership were calculated by the value assigned to their initial contributions, plus the accounting income allocated and added to their investments, minus any withdrawals by the partners. Because the investments of the foreign bank partners were liquidated by installment payments over six years, their shares of partnership capital declined continuously over time.
However, their shares of partnership accounting and taxable income stayed the same throughout their time in the partnership.

The partnership operating agreement did not allocate income according to ownership of capital. The agreement called for special allocations of accounting and taxable income. If positive, the operating income (both for accounting and tax purposes) was allocated 98% to the foreign banks (49% each) and 1% each to the ABL entity partners. The 98% accounting income allocation was structured, based on forecasts of income and liquidating balances of the foreign banks’ investments, to allow the banks to receive a target return on their investment of approximately 9.036% during their membership in Tolkin Holdings. Under the partnership agreement, the banks were given a guaranteed minimum return of between 8% and 8.5% and a cap on any significant returns in excess of the target returns.

Janet: How did this target rate of return of somewhere around 9% for the banks’ investment compare with the normal borrowing rate of ABL and subsidiaries?

Dan: According to ABL financial documents produced, the corporate family’s normal borrowing rate on loans during the period ranged between 3% and 6%.

I should also mention that the partnership agreement called for different types of allocations for different types of income. The normal operating income was the type that was overwhelmingly allocated to the foreign banks. Other more volatile income was overwhelmingly allocated to the managing ABL partners.

The normal operating income from leases was simple and relatively stable. Revenues consisted of aircraft lease rental payments and interest on investments. Expenses consisted primarily of the administrative expenses (paid mostly to overseas ABL Corporation entities for technical and management services), interest expense on loans used to finance the aircraft, and depreciation on the leased aircraft. For both book and tax purposes, the ABL entity partners received guaranteed payments as managing partners and these reduced normal operating income.

The other type of income – gains and losses from disposals of leases and aircraft – was mostly allocated to the ABL partners. Some of the airplanes and leases were transferred to other ABL entities outside of the partnership. This type of income had the potential to be more volatile than the operating income and might have caused too much deviation from the target returns promised the banks if it had been allocated to them. The ABL managing partners could tweak the operating income by transferring planes and leases in and out of the partnership while also influencing operating income by controlling the amount paid to ABL entities outside the partnership for contract services.

Janet: Looks like the managing ABL partners had a great deal of control over the amount of accounting income allocated to the banks and the increases to their investment accounts. The ABL partners gave the minority bank partners a good accounting return on their investment but shifted a much larger amount of taxable income to them while being consistent with the 98% of operating income allocation.

OK, the partnership made a special allocation of partnership accounting and taxable income to the foreign partners. Although those partners never held more than 18% of the partnership capital they were allocated approximately 98% of the accounting and taxable operating income. That’s usually acceptable for partnership tax purposes as long as those allocations are made for both partnership accounting and tax purposes. Technically, these income allocations to the foreign partners, although odd, didn’t violate the letter of the law at the time. Challenging the income allocations may be problematic.
Dan: Yes, the other IRS claims for disallowing this arrangement: lack of economic substance apart from tax avoidance and re-characterizing the partnership as a debtor/creditor relationship may be more promising.

Janet: The economic substance doctrine was often how we attacked tax avoidance arrangements that may not have violated technical rules of the tax law but violated the spirit of the law. The doctrine required a taxpayer to demonstrate some non-tax business or investment purpose for setting up an investment arrangement. What business purpose did ABL Corporation claim motivated this transaction?

Dan: ABL claimed that this partnership was a proactive response to possible difficulties in selling or borrowing funds against its older aircraft portfolio which were the type contributed to this partnership. The company stated that this financing vehicle was just one of a number of alternatives considered for raising money from its older aircraft portfolio while keeping additional debt off its books. The company wished to raise funds for traditional cash and leverage purposes but did not wish to sell the aircraft because they were performing profitably under existing leases and their marketability was less favorable than newer aircraft that were more up-to-date in technology and compliance features.

ABL claimed that this partnership was a preferred financing vehicle over borrowing because of its existing leverage situation. The aircraft portfolio already was encumbered heavily by liabilities as many of its leases were leveraged leases where the lessor borrowed to finance the property and the loans were secured by the property. Also, much of ABL’s unsecured debt contained negative pledges against incurring further secured debt on its aircraft portfolio. Finally, ABL Corporation claimed that it wished to maintain its AAA credit rating and had committed to keeping its debt to common equity ratio at or below 8 to 1. By 1993, the debt to common equity ratio stood at 7.96 to 1. Since ABL Corporation controlled the partnership, the corporation consolidated its assets and showed the interests of the foreign banks as minority interests in equity on its balance sheets.

Janet: They wanted to raise money by leveraging their older aircraft portfolio so their response was to contribute this aircraft and dump 240 million of their own money into a partnership for the purpose of obtaining 117 million from outside investors that was repaid over less than ten years with a cost of capital far exceeding their normal borrowing rate?

Dan: Apparently.

Janet: You described previously how this partnership operated existing leases contributed by the managing partners who ran the business assisted by other related corporate parties. Did this partnership have any employees of its own?

Dan: Tolkin Holdings had only one part-time employee who handled a small amount of administrative functions from an office in Bermuda. The ABL entities were the managing partners of the partnership and most other administrative functions were outsourced to outside entities controlled by ABL.

Janet: How much did the foreign banks participate in the management of Tolkin Holdings?

Dan: The banks did not participate in managing the partnership other than participating as non-voting partners in annual meetings and signing some consent documents. The ABL partners maintained that Federal Aviation Administration regulations limited the ability of foreign entities to have direct voting rights in Tolkin Holdings. For internal and government regulatory purposes of their home country, the foreign banks referred to their investments in Tolkin as loans.
Janet: The banks' internal characterizations of their investments were interesting in that they indicated a preference for creditor classification. However, not participating in the management of a partnership isn’t fatal to partner classification. Lack of management participation is typical of limited partners. Often a critical distinction between debt and equity concerns the possibilities of an upside return and a downside risk. What were the potentials of large gain or investment loss for the foreign banks?

Dan: The banks had negligible downside risk and the partnership arrangement contained a number of features to protect their investments. Their interests were intended to be liquidated by the end of the decade through a series of installment distributions. Other protection features were a guarantee by the partnership to hold liquid investments (which could include commercial paper of ABL) equal to 110% of the remaining value of the banks’ investments, provisions enabling the banks to liquidate their investments in case of default (in which case there would be sufficient liquid assets to cover their remaining investments), and a separate guarantee of a minimum return by ABL Corporation. Finally, a tax indemnification agreement was given to the banks to compensate the banks for any U.S. tax liability in the event the IRS determined that the banks were subject to U.S. tax. As nonresident corporate partners, the banks were not subject to U.S. taxation under their tax treaty, but were subject to U.S. taxation on interest received if they were regarded as nonresident banks making commercial loans to U.S. companies (See IRC Sec. 881).

Janet: They were allocated 98% of the partnership operating income. What if the partnership operated at a loss? Potentially, that could have eroded part of their investment.

Dan: Under the partnership agreement, the foreign bank partners had some exposure to allocations of operating losses, but operating income was fairly predictable and operating losses never occurred. Even if losses had occurred, the agreement capped the banks’ exposure to a maximum amount through the feasible range of operating results. Theoretically the bank partners could have received the benefits of higher than expected operating income, but the relatively predictable operating income could also be manipulated by guaranteed payments to the managing ABL partners and payments to related, outside entity contractors. The banks’ shares of operating profit upside could be limited to a predictable stream. More unpredictable was non-operating income primarily from sales of aircraft to outsiders or transfers to outside ABL entities, but these types of gains or losses were mostly allocated to the ABL subsidiary partners.

Essentially the allocation formulas coupled with the installment distributions were designed to provide the foreign banks with a target return of approximately 9.036% on the average balance of their investments and those investors earned a return virtually identical to the target return over the period of their membership. The partnership maintained separate tracking investment accounts only for the bank investors. The overall increases to the bank investors’ accounts were actually adjusted periodically in order to meet this target return.

Janet: Table 3 looks like a schedule of distributions to the banks.

Dan: Yes. The banks’ minority interests were liquidated over a six year period with more than half of the value of their investment accounts returned within the first two and a half years. The agreement even provided for a premium in case of early redemption of the banks’ partnership interests. Although the original agreement called for installment liquidations over eight years, the partnership was terminated effectively at the end of 1998 because of a change in the tax law for the treatment of partnerships under tax treaties that had the potential of making a material change in the taxability of the partnership arrangement.
Table 3: Investment Accounts of Foreign Bank Partners and Scheduled Distributions

<table>
<thead>
<tr>
<th>Year</th>
<th>Adjustments at 9.036%</th>
<th>Scheduled Distributions</th>
<th>Account Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>$3,494,000</td>
<td>$5,856,000</td>
<td>$114,924,000</td>
</tr>
<tr>
<td>1994</td>
<td>$10,374,000</td>
<td>$39,128,000</td>
<td>$86,170,000</td>
</tr>
<tr>
<td>1995</td>
<td>$7,776,000</td>
<td>$42,846,000</td>
<td>$51,100,000</td>
</tr>
<tr>
<td>1996</td>
<td>$4,518,000</td>
<td>$19,620,000</td>
<td>$36,098,000</td>
</tr>
<tr>
<td>1997</td>
<td>$3,260,000</td>
<td>$10,992,000</td>
<td>$28,366,000</td>
</tr>
<tr>
<td>1998</td>
<td>$2,654,000</td>
<td>$30,930,000</td>
<td>0</td>
</tr>
</tbody>
</table>

This table illustrates the investment accounts set up by the partnership for the foreign partners and the periodic adjustments made to them at the agreed upon target rate of return. The 1998 scheduled cash distribution represented the buyout of the banks interests. The 1998 payment was actually made in two installments during 1999 and 2000 and interest was added to those amounts. The final payments made in 1999 ($6,770,862) and 2000 ($26,032,067) brought the total of the cash payments to the banks to $151,246,151 which amounted to a return of their investment plus an effective rate of return approximating 9.036%.

Janet: Seems like the partnership was both created and dissolved for tax reasons. Well, thanks for the great overview of the case! You really did a lot of work here sorting this out.

Dan: What’s your verdict so far?

Janet: Well, this arrangement contained many similarities to a limited partnerships but your description of the arrangement seems to fit the traditional debtor/creditor relationship, too. The installment payment schedule with a virtually fixed return doesn’t seem substantially different from a car loan, albeit a very expensive one! If this was a debtor/creditor relationship, the foreign bank partners would have been subject to tax for the interest received on the loans and the interest deductions for the ABL partners would have been the same amount for both accounting and tax purposes. The differences in collective tax liabilities would have been huge.

Let’s do a little preliminary research and application aimed at challenging this arrangement due to lack of economic substance. Let’s also take a look at legal concepts of equity versus debt classification and the applied criteria of IRS Notice 94-47. Let’s meet again a week from today, same time, to discuss our initial strategies after doing a little further research on these topics.

QUESTIONS

1) What is the tax doctrine of economic substance (sometimes called substantial business purpose or sham transaction doctrine) and what is its purpose? Briefly describe this doctrine and some of the normal concepts associated with it. Provide arguments that would both favor and refute the claim that this venture was formed with a business purpose other than tax avoidance.

2) After many years of discussion over codification and some failed attempts to accomplish that, a codification of the economic substance doctrine was added to the Internal Revenue Code in 2010 as part of that year’s health care act. The codification was referred to as a clarification. Refer to IRC § 7701 (o) and review the language of the statute. What specific provisions of this amendment might have helped the government defeat this tax sheltering arrangement?

3) Were the foreign banks truly partners or were their interests more appropriately categorized as installment debt holders? What attributes of the arrangement made their investment seem like equity and what attributes pointed to a debt classification? In formulating your answer, apply the criteria of IRS Notice 94-47 to the facts of the case. You may also want to consult the Uniform Partnership Act.
A PARTNERSHIP, A SHAM, OR A LOAN?

TEACHING NOTES
Paul J. Brennan, Minnesota State University, Mankato

CASE DESCRIPTION

This case was an adapted version of a tax case heard in U.S. Federal District Court and the US Court of Appeals. The case involved a partnership set-up by a large US corporation with its own subsidiaries as managing partners and foreign partners as outside investors. The formation of the partnership resulted from a stated objective of finding an alternative to debt financing, but the arrangement provided far more significant tax benefits for controlling entity. The case was intended for use in an undergraduate taxation class focusing on business entities or an undergraduate accounting capstone or special topics course. The case and its attendant exercises were designed as applied vehicles for exploring the dimensions of the debt vs. equity classification and the nature of economic substance doctrine. The case and exercises require little knowledge of partnership taxation, but some research of the economic substance doctrine, the concept of what constitutes a partnership, and the arguments for debt vs. equity classification are required. The case may be used as a writing assignment or for class discussion. Estimated time for completion of the assignments, including research, is about four hours. Estimated time for class discussion of answers is less than one hour.

INSTRUCTOR'S OVERVIEW AND BACKGROUND INFORMATION

This case was an adapted version of a tax case heard in U.S. Federal District Court and the US Court of Appeals (TIFD III-E v. U.S., 2004/2006). The case was prepared from the published opinions and from trial materials submitted by counsels to the District Court. The essential facts are as represented in those documents but the names of the partnership and its partners have been disguised. The case uses a conversation between fictional attorneys representing the U.S. government as a device to transmit the facts and essential issues.

The case involved a partnership set-up by General Electric Capital Corporation (ABL Corporation of this case) with its own subsidiaries as managing partners and foreign banks as outside partner/investors. The formation of the partnership resulted from a stated objective of finding a financing vehicle to leverage a portion of the older aircraft used in its aircraft leasing operations while keeping debt off consolidated balance sheets. The resulting partnership, Castle Harbour (Tolkin Holdings of this case), accomplished the financial objective, but, more significantly, provided substantial tax shifting benefits.

A number of general partnership rules and specific financial and legal circumstances allowed this tax shelter to operate. The first was the general allowance of special allocations to partnerships. Special allocations have been defined by Congress as allocations of income, gain, loss, deduction, or credit (or items thereof) among partners in a manner that is disproportionate to the capital contributions of the partners (Staff of the Joint Committee, 1976). The foreign banks were allocated almost all of the accounting and taxable operating income despite having a decidedly minority portion of the partnership capital. Other forms of gain and loss that might have made the returns to the foreign banks deviate too much from the target returns were specially allocated to the majority controlling partners. The foreign investors were unaffected by the large allocations of taxable income to them because they were exempt from U.S. taxation by treaty provisions on income from this partnership. Had their investments been classified as loans, the interest payments would have been subject to U.S. taxation, and the tax savings to the domestic corporate partners would have been much smaller.
The tax savings to the ABL entity partners came at the expense of much smaller economic cost because the economic returns to the foreign bank partners were determined by allocations of partnership accounting income that were far smaller than the allocations of taxable income. Accounting income was much smaller than taxable income because the property contributed by the ABL partners was fully depreciated for tax purposes (and could not be depreciated further for that purpose) but still resulted in substantial depreciation deductions for partnership accounting purposes. Finally, regulations that would have required curative tax allocations (special allocations of deductions away from, or income toward, the ABL partners) to reduce or eliminate this accounting/tax discrepancy did not take effect until after the formation of this partnership.

Eventually the arrangement was challenged and disallowed by the Internal Revenue Service. The partnership paid the IRS assessment of 62 million dollars but challenged the IRS determination and sued for a refund in U.S. District Court. The U.S. attorneys advanced multiple arguments against the partnership arrangement including the claims that the arrangement lacked a bona fide business purpose other than tax avoidance and that the entity was not a true partnership in that its minority outside partners were virtually identical to debt holders. The District Court ruled for the partnership in finding a valid partnership arrangement and a sufficient business purpose other than tax avoidance. The government appealed and the District Court decision was reversed by the U.S. Court of Appeals for the Second Circuit.

The case was designed for use in an undergraduate business taxation class or an undergraduate accounting capstone or special topics course. The case does present some reasonably complex issues of partnership and international tax law but these are not emphasized here. The technical points of these issues were included in the litigation presentations of the partnership and the government but they are not particularly necessary or appropriate topics for discussion outside of an advanced (perhaps graduate level) class in taxation.

QUESTIONS

1) What is the tax doctrine of economic substance (sometimes called substantial business purpose or sham transaction doctrine) and what is its purpose? Briefly describe this doctrine and some of the normal concepts associated with it. Provide arguments that would both favor and refute the claim that this venture was formed with a business purpose other than tax avoidance.

Donald Korb (2005), Chief Counsel for the Internal Revenue Service, described the Economic Substance Doctrine as a tool for judicial interpretation of Congressional intent when transactions may not violate certain mechanics of the Code and Regulations but appear to violate the intent of the tax law. Harvard Law Professor Bernie Wolfman characterized the doctrine as a safeguard against excessively literal readings of narrow portions of the tax law that would fail to uphold the intent of the statutory scheme (Korb, 2005).

Tax sheltering devices often were designed to achieve desired tax benefits without violating the literal wording of the Internal Revenue Code and Regulations while violating the intention of the tax law. Provisions of the tax law may be employed (and often combined) for purposes not envisioned by the creators of the tax law in order to derive tax benefits. The government used to Economic Substance Doctrine to thwart these devices when it could not rely on the expressed wording of the Code or Regulations.

Economic Substance was a judicially developed doctrine that was used to set aside a transaction when it was considered to lack economic substance apart from the realization of tax benefits. If the taxpayer’s treatment of a transaction was set-aside, the government could reclassify the transaction according to its
view of the transaction’s substantive form. Judicial interpretations of common law doctrines usually were subject to considerable variation, and lack of uniformity was problematic in the historical application of the doctrine. Under a traditional two-factor test, a transaction had economic substance if 1) taken as a whole and viewed objectively, the transaction has economic substance and 2) the taxpayer had a subjective business purpose (other than tax avoidance) for the transaction. The degree to which courts demanded evidence to satisfy these factors was not uniform and neither was the weight given to each of these factors. Some decisions required proof of both while others required satisfaction of only one factor (Beavers, 2009).

The government argued that the Tolkin Holdings arrangement lacked economic substance because the arrangement did not make sense from a pre-tax economic perspective and was not a bona fide joint venture between partners to operate an enterprise. ABL did not need the foreign banks’ funds and could have borrowed at a lower pre-tax rate than they gave the foreign partners; the liquid asset balance requirement froze funds in the partnership anyway; the banks provided nothing in term of expertise, management, or other needed services to the aircraft leasing operation; ABL essentially ran the business in the same way that it would have without the partnership; and significant transaction costs (for example, fees to the consultants designing and forming the venture) did not make sense from a non-tax economic perspective. If the partnership lacked economic purpose other than tax shifting, the partnership was a sham, should be disregarded for tax purposes, and the income allocated as if no partnership existed. Following this line of reasoning, the minority interests would have been classified as debt and ABL would have had a tax deduction only for the lower amount of actual payments (the target returns on investment distributed to the banks). The banks’ interest income would have been subject to U.S. taxation.

The trial judge ruled that the partnership did have a valid business purpose and economic reality – not just in the fact that it operated a legitimate business – but also because a valid business reason existed for its formation. ABL sought financing solutions for its older leased aircraft without incurring additional debt and risking violating debt covenants. The partnership proposal met its need for off-balancing financing and this business objective probably could not have been accomplished without this type of entity. An interesting, although not particularly surprising, conclusion to be drawn from the trial judge’s decision is that a form-over-substance transaction used for financial reporting purposes could provide legitimate business cover to avoid a sham characterization for tax purposes.

2) After many years of discussion over codification and some failed attempts to accomplish that, a codification of the economic substance doctrine was added to the Internal Revenue Code in 2010 as part of that year’s health care act. The codification was referred to as a clarification. Refer to IRC § 7701 (o) and review the language of the statute. What specific provisions of this amendment might have helped the government defeat this tax sheltering arrangement?

The enacted provision has been included with this Teaching Note (See Appendix entitled Codification of the Economic Substance Doctrine) for the instructor’s reference. An instructor assigning this question may choose to provide the appendix as a handout or to have the students look up the statute themselves.

The Codification of the Economic Substance Doctrine was one of the revenue raising provisions included in the administration’s budget proposals. The provision was projected to raise approximately four and a half billion dollars but this was well below earlier estimates due to the government’s success in battling tax shelters earlier in the century (Lipton, 2010). Attempts toward codification of the doctrine have come and gone over the last ten years. For example, a proposal enacted by Senator Levin of Michigan had been attached to a 2005 spending bill but pulled immediately before passage of the bill at year end. Supporters of codification argued that codification was necessary for guidance, uniform application, and enforcement. Critics of codification efforts (and they had been numerous) argued that legitimate planning
transactions may be penalized or, from a pro-government standpoint, that more specific codification of factors may hamper the flexibility of tax authorities and courts (Beaver, 2009).

The codification was called a “clarification” and primarily clarified that economic substance required satisfaction of both 1) a meaningful change in the taxpayer’s economic position (apart from Federal income tax effects) and 2) substantial business purpose for the arrangement (apart from Federal income tax effects). Perhaps the most significant addition by the bill was an additional penalty for understatement of tax when a transaction was found to lack economic substance and the taxpayer failed to disclose the transaction. When this situation applied, the taxpayer could face a 40% penalty on the tax deficiency due to the tax sheltering arrangement.

The required two-pronged test provided by the codification probably wouldn’t have changed the arguments made by the government in this controversy (See response to Question 1 above for a description of those). The inclusion of the adjectives “meaningful” and “substantial” may have enabled the government to insist that the taxpayer was required to present a stronger case to satisfy these conditions than the one accepted by the trial court judge.

§ 7701 (o)(2) required that when profit potential was considered in satisfying the two-pronged test, a taxpayer must show that any expected or potential pre-tax profit from a venture must be substantial in relation to the present value of expected net tax benefits and that transaction fees and foreign taxes must be considered to reduce any potential profits. State and local tax benefits were also to be considered as part of tax benefits. No quantitative guidance was provided for interpreting the meaning of “substantial.”

The controlling corporate family of this partnership gave the foreign banks a significantly higher return on their funds than the corporation’s normal borrowing rate and the pretax cash flow for the controlling corporation was smaller than it would have been if the leasing operations were not included in this partnership arrangement. In terms of partnership accounting income, the ABL partners kept little of this operating income for themselves after their guaranteed payments were subtracted. Conversely, the tax shifting benefits (See Table 2 of the case) were substantial. The economic benefits from the partnership clearly may have failed the substantiality test in comparison to the expected tax benefits. Under this language, the government could have argued that the meaningful change in ABL’s economic position from this arrangement was negative without considering the tax benefits.

§ 7701 (o)(2)(B)(4) dismissed the presence of a financial accounting benefit as a substantial subjective business purpose if the origin of the benefit was a reduction of federal income tax. The shifting of income taxes to the foreign bank partners undoubtedly provided a tax savings financial accounting benefit in the form of reduced deferred tax liabilities, but Tolkin Holdings didn’t tout this objective. Instead, the partnership advocated off-balance sheet financing as the primary financial accounting benefit of forming this partnership. The government may have been able to argue that both of these benefits had to be considered and the reduction of federal income taxes was the more significant financial accounting benefit. The fact that ABL deposited a considerable sum of its own money into this partnership (much larger than the amounts deposited by the outside bank investors) and the arrangement may have made very little difference in ABL’s debt ratios may have refuted the argument that the off-balance sheet benefit was a substantial business purpose.

3) Were the foreign banks truly partners or were their interests more appropriately categorized as installment debt holders? What attributes of the arrangement made their investment seem like equity and what attributes pointed to a debt classification? In formulating your answer, apply the criteria of IRS Notice 94-47 to the facts of the case. You may also want to consult the Uniform Partnership Act of 1997.
Most state partnership laws have been based on the Uniform Partnership Act (current revision 1997). Section 202 (a) of the Act defines a partnership as an association of two or more persons to carry on as co-owners a business for profit. That general definition would seem broad enough for any unincorporated entity with two or more owners operating a commercial enterprise. However, Section 202(c)(3) of the Act provides that receipt of a share of partnership business profits is prima facie evidence that the person is a partner but that inference shall not be drawn if such profits were received in payment of debt in installments or otherwise or as interest on a loan though the amount of payment may vary with the profits of the business. Those provisions provided a standard to argue that the foreign banks’ partnership interests should have been reclassified as debt.

Sections 7701(a)(2) of the Internal Revenue Code provides a general description of a partnership but that definition is very broad and almost any joint arrangement that isn’t properly classified as another type of taxable entity (e.g., trust or estate or a corporation) would seem to qualify. Section 761(a) of the Code describes the taxability and reporting status of a partnership as being distinct from other named entities. These Code sections don’t offer much guidance in making a distinction between a bona fide partner and a creditor.

A useful and simple framework for examining the debt vs. equity characteristic of the partnership arrangement is IRS Notice 94-47 (1994). The Notice provides a multi-factor test of considerations for distinguishing between debt and equity interests. The general considerations are listed in Table 4.

Table 4: Factors for Distinguishing Debt and Equity under IRS Notice 94-47

<p>| | |</p>
<table>
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<tbody>
<tr>
<td>1</td>
<td>Whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;</td>
</tr>
<tr>
<td>2</td>
<td>whether owners of the interest have the right to enforce payment of principal and interest;</td>
</tr>
<tr>
<td>3</td>
<td>whether the rights of owners are subordinate to the rights of general creditors;</td>
</tr>
<tr>
<td>4</td>
<td>whether the owner/holders have rights to participate in management;</td>
</tr>
<tr>
<td>5</td>
<td>whether the issuer is thinly capitalized;</td>
</tr>
<tr>
<td>6</td>
<td>whether there is identity between the holders of the instrument in question and the stockholders of issue;</td>
</tr>
<tr>
<td>7</td>
<td>the label placed in the instruments by the parties; and</td>
</tr>
<tr>
<td>8</td>
<td>whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agencies, or financial accounting purposes.</td>
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The eight factors listed in Table 4 are the prescribed issues for distinguishing debt from equity interests under IRS Notice 94-47. No one factor is conclusive, there is no prescribed formula for weighting the factors, and no particular majority or supermajority of them is required for a definitive classification.

The U.S. attorneys argued strongly at trial that the minority foreign partners’ interest should have been classified as debt. The trial judge’s opinion discussed the factors of the Notice but dismissed the significance of the document for resolving the issue. The appellate court’s reversal depended heavily on applying the factors of the document.

Factors five and six did not apply to the Tolkin Holdings situation. These factors would apply generally to a corporation where shareholders held both stock and debt of the corporation. If a corporation had mostly debt and relatively little stock in its capital structure, and most of the debt holders were also stockholders, there may be an appearance that the shareholders were attempting to avoid the double taxation of the corporate form by self-classifying much of their equity interest as debt so the corporation could deduct the interest payments to them. Tolkin Holdings was taxed under federal law as a partnership so the double taxation issue did not apply to them and none of the Tolkin partners held more than one type of interest in the partnership.

Counsels for ABL partners argued that repeated classification by ABL of Tolkin Holdings as an equity investment in its financial statements and in its filings with the FAA were clear evidence of the equity classification under Factors seven and eight. The minority partner banks were less committed to the
equity classification. Representatives from both banks testified that for internal book purposes and for home country tax purposes, the investments were treated as loans and one representative testified that his office made only loan investments. ABL’s counsels argued that the banks’ classifications were incomplete representations of how they viewed their interests and the trial court. The trial court judge apparently gave more weight to the ABL presentations, but the appellate judge found that the minority partner representation of the investments as debt should have been given greater weight than the self-serving representations of the ABL partners.

The government pointed to the trivial role of the banks in the management of Tolkin Holdings. They really had no role in the actual management of the enterprise. The ABL partners’ counsels argued that the banks had to be kept out of management for FAA purposes and that the banks actually did participate in some annual meetings and did provide some consent forms. The trial court judge dismissed this factor as having little importance and said that many stockholders do not participate in management. The appellate judge differed by stating that the foreign banks were distinguishable from diffuse stockholders of a very large corporation, and while this factor was not conclusive in a debt or equity classification, the lack of management involvement by a significant investor weighed against viewing the investment as an equity interest.

The terms of the operating agreement carefully subordinated the rights of the foreign banks to general creditors. In addition, the banks did not have the traditional creditor rights to enforce repayment of interest and principal through judgment and collection or foreclosure proceedings. On the other hand, the banks specifically were entitled to require liquidation of Tolkin Holdings (and distribution of their capital accounts) if the scheduled payments were not made. The trial judge noted that the ability to force partnership liquidation was often given to partners and didn’t infer a creditor interest. The appellate judge found that the banks’ interest had even better collateral than most creditors because they could force liquidation where their investment was covered by the requirement that the partnership maintain liquid assets equal to 110% of the banks’ remaining investment accounts and by ABL’s separate guarantee of the payment schedule and the banks’ returns.

The government argued that the minority partners’ investments essentially were rights to receive a sum certain, with a relatively stable interest rate, and had a fixed maturity date indicated by the repayment schedule. The government stated that the agreement was “no more complicated than a car loan (TIFD-III, United States Trial Brief, 2004).” The last payment was scheduled for year 2000 either by a liquidating payment or the purchase of the banks’ remaining interest by one of the ABL partners. The agreement also provided for a premium to be paid in case of early buyout much like a premium paid for early redemption of bonds or a penalty for prepayment provided for certain loan arrangements. The government also noted that the actual final return on investment was almost identical to the target return of the agreement and varied less than many consumer loans. The government argued that both the structure and return of the banks’ investment gave them far less exposure to risk than would be experienced by a bona fide equity holder.

ABL’s counsels likened the banks’ investment to preferred stock with a potential upside, perhaps similar to the nature of participating preferred stock. The partnership attorneys’ analogy of the foreign partners’ interest to participating preferred stock contained some irony. Taking the characterization one step further, the partnership interest actually may have resembled mandatorily redeemable preferred stock which, since the enactment of Statement of Financial Accounting Standards 150 (FASB, 2003), should be treated as a liability.

The trial judge was persuaded by the upside potential and the plaintiff’s characterization of the investment. The judge found that while the banks were more or less guaranteed a minimum return they were not guaranteed a maximum return so they could not have been characterized as an owner of a fixed
return. The trial judge argued that the potential upside, even if slight, makes the holder of such an interest concerned with the profitability instead of just solvency. The appellate court stated that the trial judge was too persuaded by the formalities of the partnership documents and erred by ignoring the operational realities of the venture where the managing partners could control any potential upside by tweaking the amount of partnership operating income and transferring leased assets to a controlled subsidiary of the partnership.

Although the trial court judge addressed the factors in IRS Notice 94-47, he gave them little weight in his decision. He felt that the factors were intended to reclassify purported stockholder debt as equity in cases where corporations were thinly capitalized and were not intended to reclassify the equity interest of a partner as debt. He noted that the government could not cite a single case where they were so used and apparently wasn’t enthusiastic about breaking new ground. The appellate court found error in this asymmetrical interpretation and ruled that the factors were applicable across situations.

**APPENDIX**

<table>
<thead>
<tr>
<th>Codification of Economic Substance Doctrine</th>
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<tr>
<td>§ 7701 (o) Clarification of economic substance doctrine</td>
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<tr>
<td>(1) Application of doctrine. In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—</td>
</tr>
<tr>
<td>(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and</td>
</tr>
<tr>
<td>(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.</td>
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<tr>
<td>(2) Special rule where taxpayer relies on profit potential.</td>
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<tr>
<td>(A) In general. The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.</td>
</tr>
<tr>
<td>(B) Treatment of fees and foreign taxes. Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.</td>
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<tr>
<td>(3) State and local tax benefits. For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.</td>
</tr>
<tr>
<td>(4) Financial accounting benefits. For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.</td>
</tr>
<tr>
<td>(5) Definitions and special rules. For purposes of this subsection—</td>
</tr>
<tr>
<td>(A) Economic substance doctrine. The term &quot;economic substance doctrine&quot; means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.</td>
</tr>
<tr>
<td>(B) Exception for personal transactions of individuals. In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.</td>
</tr>
<tr>
<td>(C) Determination of application of doctrine not affected. The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.</td>
</tr>
<tr>
<td>(D) Transaction. The term &quot;transaction&quot; includes a series of transactions.</td>
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</table>

**REFERENCES**


IRS Notice 94-47, 1994-1 *Cumulative Bulletin* 357


**BIOGRAPHY**

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CORPORATE CODES OF CONDUCT AND BUSINESS PRINCIPLES IN LIGHT OF THE GOLDMAN SACHS LAWSUIT SETTLEMENT
Marion S. Mogielnicki, Montclair State University

ABSTRACT

The Securities and Exchange Commission recently settled a monumental lawsuit against the investment firm of Goldman Sachs, Inc. The settlement mandated that the Wall Street titan agree to strengthen its ethical policies and procedures. This paper will discuss Goldman Sachs as a complicated corporate entity and examine its relationship to its own Code of Conduct and Ethics in light of the lawsuit. It will present an historical perspective and a summary of the research and efficacy of Codes. This review postulates that business should implement their Codes and ethical programs by way of thorough and effective analysis of new investment products such as mortgage-backed securities. It explains how Goldman should have better utilized ethical mechanisms to examine these products. The paper condenses the more relevant recommendations of the Report of the Business Standards Committee of Goldman Sachs. Finally, this review evaluates the definition of waivers contained in Codes and concludes that businesses should eliminate this exception.

JEL: K19; K22; K42

KEYWORDS: Ethics, Implementation, Code of Conduct or Ethics, Business Principles, Business Standards Committee, Waiver, Conflict of Interest, SEC, Abacus, Mortgage Backed Securities

INTRODUCTION

Goldman Sachs, Inc., arguably the most successful firm in the history of Wall Street suffered a serious setback this year when it settled an ignominious lawsuit brought by the SEC for fraud and misrepresentation in the structuring and selling of mortgage backed securities to its own clients. The gravamen of the legal complaint was that Goldman did so with full knowledge that the investments presented a serious negative credit risk. (Securities and Exchange Commission v. Goldman, Sachs & Co. and Fabrice Tourre, 2010). Despite settlement of the suit for $550 million dollars, the largest in the history of Wall Street (Goldman Sachs & Co. Settlement with SEC, 2010), the financial services titan has tarnished its own reputation for unfailing client loyalty and brilliant business decision making. Goldman, in its dealings with respect to this lawsuit, may have breached conflicts of interest, placed its own profits well above those of its clients, and added to a breakdown of fairness and efficacy in the financial markets. (Jeffers and Mogielnicki, 2010). Goldman’s activities of misrepresentation and infractions of the anti-fraud statutes governing the finance sector leading to this lawsuit are troubling in light of its adoption of a Code of Conduct and a set of Business Principles. (Jeffers and Mogielnicki, 2010). These documents contain a policy that seeks to provide an ethical path for its employee’s behavior, encourage elevated moral principles, and establish a standard of fairness and equity in its dealings with and treatment of its clients.

This inquiry examines the nature of Codes of Conduct or Codes of Ethics, and postulates that codes must undergo meaningful and constant review and revision, provide guidance in the investment field for novel products, and be properly and thoroughly implemented with a view towards conflict of interest principles. This paper takes the view that financial sector businesses should test investment vehicles such as mortgage-backed securities within the confines of the ethical rubric before they utilize them. Goldman
failed to implement the values and priorities established in their Code and in their Business Principles and thus may not have behaved ethically with respect to selling and packaging of mortgage-backed securities. Included in this analysis is a discussion of Waivers of Codes of Conduct, which is a part of the Goldman document. The conclusion is that the term itself is inappropriate to and axiomatic of the symbol and purpose for which institutions need Codes of Ethics. Thus, businesses should unilaterally excise them from the language of Codes.

The paper reviews codes in their historical context and provides a brief summation of the status of empirical research. It further discusses optimal standards for ongoing code re-evaluation, implementation of codes and guiding principles, and corporate governance with respect to conflicts of interest issues. In relation thereto, the inquiry discusses Goldman’s response to the lawsuit and ensuing public relations morass.

Finally, this review evaluates some of the recommendations contained in the Goldman Sachs Report of the Business Standards Committee of January 2011 and touches upon the philosophical intent and pragmatic steps that Goldman intends to take to restore client confidence.

THE LAWSUIT: SECURITIES AND EXCHANGE COMMISSION V GOLDMAN SACHS & CO. AND FABRICE TOURRE

On April 16, 2010 the Securities and Exchange Commission, in a scathing civil lawsuit, alleged that Goldman, Sachs & Co. as well as its employee, Fabrice Tourre made materially misleading statements and omissions in connection with a synthetic collateralized debt obligation (CDO), called Abacus 2007-AC1 that it sold to its investor clients in early 2007. Because the transaction occurred at a time when the U.S. housing market was beginning to show signs of weakness, the SEC believed that certain activities and misrepresentations of Goldman and Tourre constituted misconduct in violation of Section 17(a) of the Securities Act of 1933, Section 10(b) of the SEC Act of 1934, and Exchange Act Rule 10b-5. (Securities and Exchange Commission v. Goldman, Sachs & Co. and Fabrice Tourre, 2010). Collectively, these federal anti-fraud statutes make transactions that constitute “a scheme or artifice to defraud”, and other untrue statements or omissions a clear violation for which liability would attach. (U.S.C. Sec. 77q (a) (“The Securities Act”); 15 U.S.C. Sec. 77j (b) (Authority: Sec. 10; 48 Stat. 891); 15 U.S.C. 78 (j)).

Goldman had structured Abacus 2007-AC1 with Paulson & Co. Inc, a hedge fund notable for winning huge profits by taking short positions. (Zuckerman, 2010; Teather, 2010). The marketing materials that Goldman provided to its foreign institutional investors stated that ACA management, an independent third party whose role it was to analyze credit risk in mortgage-backed securities, selected the underlying mortgages contained in the Abacus investment. Goldman represented that these were sound investments but at the same time the marketing materials presented did not disclose that Paulson & Co. Inc. with economic interests directly opposite to Goldman’s clients played a significant role in the selection of the underlying portfolio mortgages. Paulson was bearish on the housing market and helped to choose mortgage backed securities that were expected to experience a negative credit event and subsequently default. After the Abacus portfolio selection, Paulson entered into Credit Default Swaps (CDS) and shorted these securities, essentially betting that the mortgages contained in the Abacus deal would fail. The government alleged that Goldman might not have disclosed any of these facts in the marketing materials provided to its clients, and that this omission was a statutory violation. (Securities and Exchange Commission v Goldman Sachs & Co. and Fabrice Tourre, 2010).

Furthermore, the SEC claimed that Fabrice Tourre, who was the Goldman representative on the deal worked directly with Paulson, personally devised, and marketed the transaction, and misled ACA into believing that Paulson’s interest in Abacus was long and that his interests in the collateral selection were
aligned with ACA’s. In fact, nothing could have been further from the truth. (Goldman Sachs & Co. Settlement with the SEC, 2010; SEC. gov 2010, New York Times DealBook, 2010). By January 29, 2008, just 9 months after inception, 99 percent of the portfolio had been downgraded. According to the litigation, Paulson profited by 1 billion dollars while deal investors lost a commensurate amount. Goldman’s response in opposition to the suit was that they were merely mitigating business risk and operating within a legal zone of business ‘as usual’ and filed an Answer denying such accusations. ( Jeffers and Mogielnicki, 2010). Nevertheless, in April 2010, The SEC announced a settlement and Goldman agreed to pay a total of 550 million dollars to defrauded clients and the SEC as well as to review and revise its ethical policies and procedures. Goldman, in its settlement only admitted to making a “mistake” in not disclosing the role of Paulson in the marketing materials. ( Goldman Sachs & Co. Settlement with the SEC, 2010).

Goldman’s Response to the Lawsuit Settlement

Indeed, Goldman has been well known for its client-centered emphasis and at the same time for its aggressive stance on Wall Street. It includes a conglomerate with some of the largest hedge and equity funds in history resulting in monumental profits. It is a global investment bank, and an investment management company that operates in trading and securities services. ( New York Times Goldman Sachs Group Inc. News, 2010). Goldman has prided itself on the well-healed image of a firm that elevates its clients. This has now been shattered, though, because of duplicitous conflict of interest dealings in the sub-prime mess. Rolling Stones Magazine, in a scathing turn of phrase has characterized the Wall Street firm as “a great vampire squid wrapped around the face of humanity relentlessly jamming its blood funnel into anything that smells like money.” (Taibbi, 2010). Because it has operated a private equity business, and allowed proprietary traders to flourish, the opportunity for self-dealing flowing from an unbridled path of information from one entity to another has helped to contribute to improper ethical behavior at the expense of valuable clients. Goldman traders can access information that affords them great advantage over competitors, and the business, through its powerful and omnipresent corporate persona can move the market in its favor as a result. (New York Times Goldman-Sachs Group Inc. Online 2010).

To its credit, Goldman apparently recognizes that changes must be made from the inside out. In May 2010, it convened a Business Standards Committee (“BSC”) to strengthen its client-centered focus and review and improve upon its transparency as a business entity. In January 2011, Goldman Sachs, after a six-month review, issued a 39 page Report of the Business Standards Committee, which are hereafter discussed (Goldman Sachs Report of Business Standards Committee, 2011).

Goldman Sachs Code of Conduct and Business Principals

Goldman has created an ethical policy for its workers that include a Code of Business Conduct and Ethics, (“the Code”), and a statement of Business Principles that represent the company’s view of expected ethical standards on the job. (Goldman Sachs Code of Business Conduct and Ethics, 2009). According to the Code, the institution “embodies the commitment …to conduct our business in accordance with all applicable laws, rules and regulations and the highest ethical standards.”

Section B of the Code mandates that “Any employee or director who is aware of a material transaction or relationship that could reasonably be expected to give rise to a conflict of interest or perceived conflict of interest should discuss the matter promptly with an Appropriate Ethics Contact.” Furthermore, the Company includes a Compendium of laws, rules and regulations as a part of the Code that is pertinent to firm business and provide further guidance for its employees.
In Section 2C of the Code the Company asserts that it only succeeds through “honest business competition” and will not engage in “illegal or unethical business practices”. Its ethical posture also includes fair dealing with clients, and other contractors. Finally, unfair advantage in the manner of “manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or unfair dealing practice” is disallowed under the policy.

The Goldman Sachs official website makes the Code available to its employees and the company further urges that employees and others read the Code in conjunction with the online-published statement of Business Principles. At the top of this document is the tenet: “Our clients’ interests always come first.” In addition, the last statement reads “Integrity and honesty are at the heart of our business”. (Goldman Sachs Code of Business Conduct and Ethics, 2009). Clearly, Goldman has set forth a policy embedded in their Code that alleges that high ethical standards are paramount in its business operation and that it values a client focused approach based on integrity and disclosure.

Waiver of the Code

The Goldman code does include a waiver and devotes two paragraphs to describing how employees and board members can obtain a waiver.

It states,

“From time to time, the firm may waive certain provisions of this code. Any employee or director who believes that a waiver may be called for should discuss the matter with the Appropriate Ethics contact. Only the Board of Directors or a committee of the Board may make waivers for executive officers (including Senior Financial Officers) or directors of the firm. An employee or director who is aware of a material transaction or relationship that could reasonably be expected to give rise to a conflict of interest should discuss the matter promptly with the Appropriate Ethics Contact.”

Waiver of Codes: Misleading Misnomer


The first problem with the use of the term is that only the person receiving the benefit may grant the waiver and then only after full disclosure. It is therefore not correct to say that the firm under the auspices of the Board of Directors can waive a right that would typically belong to a client, customer, provider or contractor, etc. Are we to think that before a Goldman employee seeks to commit, let us say a conflict of interest, that he or she would give advance notice to their client?

Apart from the inappropriate use of the word, the entire idea of granting a “waiver” smacks of hypocrisy and self-dealing whenever the ethics embodied in the code is inconvenient for the company. It does not suggest to the corporate body that ethics values are meaningful to any serious degree. It also can have dire consequences, as it did for Enron, the giant energy corporation that committed gross infractions by allowing individuals to create off the book entities that were presumably doing business with the company. Enron upper management was able to waive the requirements under the wording of the waiver if the CEO believed it would not affect the company. (Elson and Gyves, 2003). Enron ultimately failed because of mismanagement and corrupt dealings.
Finally, in light of the BSC report Waivers no longer seem to fit in with its recommendations, and may even be inconsistent with the report’s intent and proposed new procedures.

AN HISTORICAL PERSPECTIVE OF ETHICAL CODES OF CONDUCT IN BUSINESS

Commercial crime and business misconduct is certainly not a phenomenon of recent history. Businesses, in an effort to stem improper behavior and provide ethical guidelines for employee behavior began to set forth statements that reflected ethical “codes” or “creeds” as early as the middle of the last century. In the 1970’s and 1980’s the use of codes became more fashionable, especially in the wake of the domestic and foreign bribery scandals of the time, resulting in the Foreign Corrupt Practices Control Act of 1977. (Benson, 1989). In the 80’s quality of life issues involving pollution, smoking, lead poisoning, acid rain and radiation, amongst others, led corporate officers to seize upon Corporate Codes as a way to stress better corporate values. (Brooks, 1989). Corporate giants such as Tyco, WorldCom, Enron, AIG and Adelphia outraged the public by engaging in corruption, excessive risk taking, self-dealing, conflict of interest, and criminal activity. (Sims and Brinkman, 2003). The Sarbanes-Oxley Act, a federal law passed in 2002, required that financial officers of certain large corporations publish their Codes of Ethics and any subsequent changes thereto. (Sarbanes-Oxley, 5 U.S.C. §§ 7201 et.seq.). In 2004, the United States Sentencing Commission amended its guidelines and set forth criteria for effective corporate ethics programs, which would ameliorate punishment for white-collar crimes if implemented. (US Sentencing Commission, 2005). This further spurred absorption with Codes as a means to diminish corporate criminal liability.

In the past twenty years there has been a trend towards an increased use of Codes in large part due to globalization, increased internet and media attention on a Company’s corporate ethical culture, and a business’ willingness to use Codes as “marketing instruments of legitimization” (Stohl, Stohl and Popova, 2009).

In 2004 Kaptein conducted a landmark empirical phone survey of 200 of the largest multi-national corporations in the world and found that 52% of them had a Code referred to either as the Stakeholder Statute (75%), the Values statement (49%), or the Code of Conduct (46%), thus establishing the high prevalence of a Company Code of some sort. (Kapstein, 2004). Recent studies have focused on whether multinationals have taken a global perspective towards the contents of Codes of Ethics, and indeed one recent study conducted by Stohl, et. al, looked at Codes established by global companies across sectors. The researchers asked whether the contents of Codes of multinational organizations are converging; in effect, do the Codes reflect standards of the global community that identify more desired ethical, and humane practices throughout the world? This “third generation of ethics” is marked by heightened awareness of the “larger connected environment”. The results of the study of 157 Corporations on the Global 500 found that while convergence is seen in communication features that only the companies based in the European Union demonstrated real reflexivity and universal consciousness in the language of their Codes to any significant degree. However, it was noted that there is progress amongst other companies as more than three quarters of businesses did associate with third generation thinking in some manner. (Stohl, Stohl, and Popova, 2009).

Studying Codes of Ethics

There is a sharp difference of opinion amongst scholars as to whether Codes of Conduct are good, bad or neutral for the company itself or simply not effective to stem the tide of unethical behavior. (Kapstein and Schwartz, 2008). Some view codes as contributing to the company’s overall reputation, morality and business success. (Bowie and Duska, 1992). Other researchers believe codes to be beneficial to
employee’s attitudes and behaviors when the corporate culture takes ethical programs seriously. (Trevino and Weaver, 1991). They also may help to avoid legal liability or ameliorate criminal sanctions. (Pitt and Groskaufmanis, 1990). On the other hand, some scholars believe that they are mere “window dressing” (White and Montgomery, 1980), are costly when compared to what they presumably add to the organization (Hess, McWhorter and Fort, 2006), and possibly counter-productive. (Grundstein-Amado, 2001).

Nevertheless, because ethics is widely viewed as an essential component of business success by shareholders and corporate governance, and especially in light of the recent scandals in the financial industry, firms believe ethical codes are highly necessary. (Svensson, Wood, et. al., 2009).

The scientific research on the effectiveness of codes is clearly a mixed bag. While admittedly difficult to assess, no fewer than 79 studies have attempted to examine the empirical efficacy of codes. (Kaptein and Schwartz, 2008). The development of a generally accepted terminology for doing so is still in its infancy. (Gaumnitz and Lere, 2004). However in 2008 Kaptein and Schwartz formulated an integrated research model for the effectiveness of business codes and they submit that future research should rely upon the following control variables for analysis; expectations of stakeholders, environmental and organizational characteristics, objectives of the organization, development process, content, sub-codes, implementation, personal characteristics, internal context, and conduct and consequences. Kaptein, in subsequent research, has further defined eight organizational virtues when, if improved by an ethics program, could result in multidimensional relationships that have practical relevance that adds to an understanding of how codes work. While analyzing components of ethics programs, and the dimensions of ethical culture, Kaptein found that ‘clarity’ was most highly related to codes of ethics, ethics officers, ethics communication and training but that other dimensions had negative relationships with components of ethics programs. (Kaptein, 2008). As a practical matter, organizations might be able to improve programs based on this information.

Codes Must Be Effectively Implemented Through Product Analysis

Following the disclosure that Goldman had helped to foist upon its clients investments that it had reason to believe would fail, and the ensuing admission that it had made a “mistake”, presumably on both a legal and ethical level, the obvious question that remained was how could these investments pass ethical muster in the first place? Should companies have subjected them to an analysis of what is considered unethical conduct pursuant to and embodied in the Code of Ethics and its ethical culture? Was there a mechanism for such a review? Did companies use internal controls for such activities that are comprehended within the ethical rubric of the firm? Should, in fact, there be an ethical audit of new products with company committee’s that have strict oversight?

Corporate management should be results oriented in the use of codes. CEO’s should demonstrate a high commitment to the values they espouse, and should in effect be their “champion”. They must not only organize and develop codes, but also implement programs developed around them. (Murphy, 1998). The codes need to have a prophylactic function. (Brenner, 1969). A question that large multi-dimensional firms such as Goldman need to ask is how can the ethics program be utilized to forestall and prevent problems of conflict of interest due to what may be at first a novel situation employing new and untried investment products? Before the company allows widespread use, they should subject products to a rigorous ethical audit.

Codes can be effectively implemented as long as the strong message they send cascades down within the organization through tangible programs, training and overview. While real life situations will erupt that may not be foreseeable that compel businesses to call upon the ethics of their culture, these messages
should more importantly prevent ethical conduct from happening in the first place. According to Svensson, there must be tangible implementation, communication and benefits that enable the ethos of the code to come to life in all that the organization does” (Svensson, Wood, et.al, 2009).

Goldman May Not Have Implemented Values Contained in its Codes

Businesses should intertwine product development with ethics. Companies would do well to avoid ignoring potential troubling practices because they were technically legal. The 1999 repeal of the Glass-Steagall Act took down the barriers between investment banking and retail banking and increased fluidity in the information flow between consumer and investment departments. (Gramm-Leach-Bliley Act, 1999). In view of the lack of barriers, re-packaging of loans may not have been scrutinized enough in light of the ethical “ethos” of the company in the Goldman scenario and probably for many other banks. (Story, L., Morgenson, G., 2011). Questionable practices and products may have been utilized in an effort to remain competitive and retain market share. If committees within Goldman Sachs had subjected these products to a more comprehensive ethical review, and if senior management eliminated or modified products that could have potentially created serious ethical breaches under the codes, negative repercussions for Goldman, and, to some extent, for the broader economy, might have been mitigated. Goldman may have fared much better with successful implementation of its Code through well-regulated corporate analytical structures of new products. This confirms a well-settled ethical principle that companies who rush headlong towards the nirvana of short-term profits might be heading in the wrong direction. (Jennings, M., 2006)

Report of the Goldman Sachs Business Standards Committee

It is interesting that Goldman initially states in the January, 2011 Report of the Goldman Sachs Business Standards Committee that the Business Principles were codified 30 years ago, that the world is more complicated now and that the Codes need to be re-visited. (Report of the Goldman Sachs Business Standards Committee, 2011). Many of the acknowledgements and resolutions in the report are promising.

Clearly, it is appropriate that Goldman’s purpose for taking a long look at itself centers on re-establishing the client focus for which they are so famously known and which has now been so infamously tarnished. Towards that end, they have put forth in this report some encouraging philosophical goals that have been missing as well as defined some new structures and organizations for preventing ethical problems.

They are dedicating their future approach, according to the report, to a decision of “should we” undertake a certain activity, rather than “can we”. This future oriented thinking is a step in the right direction toward identification of ethical problems and possibly better ethics program implementation under the business principles of the firm. Other philosophical underpinnings of the document include a “re-commitment to transparency”, and to the strong resolution of conflict of interest issues.

The firm, perhaps more importantly, is proposing to develop and implement processes and structures that resolve some of these important concerns. First, the firm is re-committed to “strong accountability processes”, “risk management practices”, and methods for strengthening conflict of interest procedures. The Report gives focus to the subject of structured products and emphasizes the need to undertake heightened review including evaluation, and suitability of products. Goldman proposes to reinvigorate identification, review, approval and documentation of structured products within this framework. Accordingly, a Firm wide New Activity Committee and a Firm wide Suitability Committee, under the auspices of the Board of Directors will be established to approve new products, and oversee standard setting for products.
Finally, Goldman apparently recognizes that the free flow of information between businesses has presented serious conflict of interest matters. Thus, they are targeting wall crossing and informational barriers throughout the corporate system. It is recommended that some asset backed and mortgage-backed securitization activities should be removed to the Financing Group rather than remain with the Securities Division as a result.

**IMPLICATIONS**

The implications for Goldman Sachs and, indeed, many of the major banks that engaged in unethical and possibly illegal practices within the context of Abacus-like deals could be massive. According to the recently released United States Senate Subcommittee Financial Crisis Report, Goldman Sachs “securitized high risk mortgages” from 2004-2007 for “lucrative fees”, “magnified the impact of toxic mortgages on financial markets”, “took a short position on the mortgage market”, “created a conflict between the firm’s proprietary interests and the interests of its clients,”, did not disclose “taking a short position” in the Abacus deal, and “used Credit Default Swaps… to bet against the mortgage market”. (United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, 2011). The Committee report states “during the course of its investigation into the Goldman Sachs case study, the Subcommittee issued 13 document subpoenas as well as multiple document request letters to financial institutions, government agencies, hedge funds, due diligence firms, insurance companies, individuals, and others. The Subcommittee obtained tens of millions of pages of documents, including internal reports, memoranda, correspondence, spreadsheets, and email. The Subcommittee conducted over 55 interviews and one deposition, including interviews with a variety of senior executives and Mortgage Department personnel at Goldman Sachs.” The thrust of the complaint against Goldman is its “failing to manage conflicts of interest”. Because of this, the Committee is recommending “strong implementation of the new restrictions on proprietary trading and conflicts of interest”…

The Committee referred the Senate Report to the United States Department of Justice and the Securities and Exchange Commission for investigation. In addition, the Manhattan district attorney’s office recently sent a broad subpoena to Goldman for documents concerning mortgage-related transactions that led to the 2008 financial crisis. (Hennings, 2011). Authorities could find that Goldman is criminally liable for activities associated with the previous charges and indict top Executives for criminal wrongdoing.

The negative ramifications for a society in which the financial markets do not operate in a fair and efficient way are staggering if judged by the recent economic collapse. The lack of ethical conduct therefore has broad implications within the business world and the real world, and a more rigorous ethical analysis of financial products could go far to right this wrong.

**CONCLUSION**

This inquiry asks the question whether Code of Ethics should be a real and meaningful stricture on unethical practices within the financial sector, especially during the review of investments products that are not tried and true.

The paper reviews the case of SEC v. Goldman Sachs and Fabrice Tourre and examines the relationship of Goldman Sachs to its Code of Ethics in light of its role in the Abacus deal and the settlement of the lawsuit. The suit alleged that the company had committed securities fraud by not disclosing to its clients material information about a third party’s short position vis à vis the Abacus deal. Ultimately, Goldman Sachs admitted making a ‘mistake’ and paid 550 million dollars and made other promises to settle the matter. Thereafter, it issued a Report of the Business Standards Committee presumably in an attempt to
ameliorate behaviors that could lead to future conflicts of interest. Nevertheless, the United States Senate conducted an investigation, and the SEC, the Manhattan District Attorney’s Office, and the U.S. Department of Justice have continue to conduct additional investigations into Goldman’s activities that could result in the identification of criminal activity.

This paper describes Goldman’s current Code of Conduct and Business Principles, and the Waiver of the Code. Companies should eliminate Waivers from Codes because only those who are entitled to the benefit can “waive”, not the corporation, and they give the business an opportunity to side-step ethics. It then outlines an historical perspective of Ethical Codes of Conduct in Business. This paper sets forth a brief review of the study of Codes of Ethics and finds that the research on the effectiveness of Codes is not entirely consistent. Nevertheless, businesses continue to formulate and include Codes of Ethics into their corporate culture even as the world becomes more inter-connected.

This paper postulates that Goldman did not follow its own Code of Ethics with respect to the Abacus case and possibly other deals and committed unethical conflict of interest. Had it done so, and further, had it subjected the Credit Default Swaps and other similar or novel products to a more serious and rigorous ethical analysis under the rubric of the Code, this may have forestalled the troublesome lawsuit and avalanche of scrutiny by governmental enforcement agencies. Indeed, these activities may have also added to the wider economic societal meltdown to a significant degree and a true adherence to ethical codes may have ameliorated such consequences to some extent.

Going forward it is necessary to continue to ask how business should implement Codes in morally correct ways when postulating and instituting new and complicated investment products. What quality control structures and mechanisms should top executives put into place that give Codes meaning and attempt to avoid conflict of interest? These methods, once advanced, should be tested against ethical expectations, and the words and meaning of the Code. Obviously, the sky can no longer be the limit, as huge negative consequences ensue, not just for Wall Street, but also for Main Street when ethics are merely “empty words”. Studies on the value and efficacy of codes must continue so that businesses do not lose focus of them as necessary and effective tools for good and morally correct behavior. As governmental agencies pursue proof of criminal activity and evince a desire to see accountability for the dire nature of the economy researchers must continue to attempt to understand the role that business ethics plays in such a scenario.

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Hart Engineering Co. v. FMC Corp., 593 F. Supp. 1471, 1478 (D.R.I. 1984) (“A waiver in its classic sense is a voluntary and intentional relinquishment of a known right, benefit, claim or privilege which, except for such waiver, the party would have enjoyed.”) (quoting Richland County v. State, 180 N.W.2d 649, 657 (N.D. 1970))


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BIOGRAPHY

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JOHN RAWLS’ DIFFERENCE PRINCIPLE: EVIDENCE FROM GUATEMALA
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ABSTRACT

While literature indicates that strong intellectual property (IP) protection is needed to attract foreign direct investment (FDI) in developing countries like Guatemala, the literature fails to address adequately the economic, social, and political considerations facing developing nations in the reformation of their IP laws. This article addresses those considerations by applying John Rawls’ Difference Principle. Rawls’ Difference Principle depicts justice as an issue of fairness, which focuses on the distribution of resources and permits an unequal distribution only to the extent that the weakest members of society benefit from that inequality. This article finds that Rawls would reject the findings from the literature and support a weak IP regime in Guatemala for three key reasons. First, economically, Guatemala’s weakest members would have immediate access to otherwise price-prohibitive products. Second, socially, Guatemala could reallocate resources to service Guatemala’s weakest members more pressing needs. Third, politically, Guatemala’s IP weak regime would be entirely consistent with the letter of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) and improve relations with its trading partners. According to Rawls, Guatemala’s approach to maintain a weak IP regime would be ethically sound.

JEL: F12, O34, O38

KEYWORDS: John Rawls, Difference Principle, Guatemala

INTRODUCTION

The role of intellectual property (as embodied in patents, copyrights, or trademarks) in the production of goods and services has resulted in intellectual property rights (IPR) becoming an important cornerstone of international economic policy. The optimal level of strength of these protections (e.g. weak or strong) has been vigorously debated. Proponents of strong IPR protections argue that such protections are necessary to provide a wide variety of economic benefits to developing nations, including attracting foreign direct investment (Sherwood, 1997). By contrast, opponents contend that the benefits of strong IPR protections are grossly exaggerated. For example, they argue that empirical studies have not decided conclusively that a positive relationship exists between IPR protection and FDI (Maskus and Reichman, 2004).

In the present article, I argue that commentators favoring the use of strong IPR protections in developing countries’ economic strategies fail to address adequately the economic, social, and political considerations facing developing nations, like Guatemala, in reforming their IP laws. The focus of the literature has been on promoting FDI, not on these critical considerations that deeply impact a developing nation’s decision in selecting the optimal level of strength of its IPR protections. Further, in contrast to previous studies, this article examines Guatemala’s approach to reformation of IPR protections by applying John Rawls’ Difference Principle, which focuses on the distribution of resources and permits an unequal distribution only to the extent that the weakest members of society benefit from that inequality (Rawls, 1971). Empirical evidence supports that maintaining an IP regime that is either too strong or too weak will harm any nation’s economic well-being (Greenbaum, 2009). Accordingly, this article discusses weak and strong IP regimes, not in absolute terms, but to describe whether Guatemala should maintain an IP regime similar in strength relative to those that exist in developed nations.
This article is organized as follows: Section II reviews the literature and previous findings. Section III examines the development and progression of Guatemala’s intellectual property regime. Section IV addresses the economic, social, and political considerations of a strong IP regime in Guatemala by applying John Rawls’ Difference Principle. Section IV summarizes and offers some conclusions.

REVIEW OF THE LITERATURE

Previous studies, including Ferrantino (1993), Maskus and Konan (1994), and Lee and Mansfield (1996), have explored the impact of IPR protections on FDI. However, the results of these empirical studies have not been conclusive. Some studies have found no statistically significant relationship between IPR and FDI. For example, Ferrantino (1993) found no statistically significant relationship between the extent of U.S. affiliate sales in a foreign country and that country’s membership in an international patent or copyright convention. Further, employing the Rapp and Rozek (1990) index of IPR protection, Maskus and Konan (1994) did not obtain statistically significant results between IPR protection and FDI. Similarly, using Ginarte and Park (1997) index, Primo Braga and Fink (2000) found no impact of IPR protection on FDI.

By contrast, Lee and Mansfield (1996) found that the strength of a country’s IPR protection was positively correlated with the volume of U.S. FDI inflows into a host country. Maskus (1998) found that IPR protection had a significant and positive impact on FDI in industries with considerable intellectual property-related ownership advantages than for FDI in services as well as low-tech and standardized manufacturing. Similarly, Smith (2001) also found a positive correlation between sales of U.S. affiliates and the strength of IPR protection in a host country.

Further, Maskus (1998) found that intellectual property protection is more likely to attract FDI if two additional conditions are met. First, the country needs to have a strong capacity to imitate foreign products and technologies (Maskus, 1998). For example, if local competitors are unable to copy these products and technologies, foreign firms are unlikely to be threatened, and intellectual property protection will be unnecessary (Yu, 2007). Second, the country needs to have a sufficiently large market to enable foreign firms to capture economies of scale or scope (Maskus, 1998). Put simply, if a country lacks a sufficiently large market, foreign firms are unlikely to find it advantageous to move its productions abroad.

Finally, Primo Braga and Fink (2000) found intellectual property protection can affect foreign investment in two negative ways:

First, stronger IPR protection provides title holders with increased market power and could, at least theoretically, cause firms to actually divest and reduce their service to foreign countries. Second, higher levels of protection may cause [transnational corporations] to switch their preferred mode of delivery from foreign production to licensing.

In sum, the results of these empirical studies exploring the impact of IPR protection on FDI have led to mixed conclusions. The ambiguity of these findings may result for several reasons: measurement problems related to IPR protection, the use of highly aggregated FDI data, and substitution effects between FDI and other forms of using intellectual property beyond national borders (Nunnenkamp and Spatz, 2004). Further, none of these studies examined the impact of economic, social, and political considerations facing developing nations in reforming their IP regime. Moreover, as Rapp and Rozek (1990) point out, their index is based solely on the laws on a nation’s books, not on the ways these laws are enforced.

The studies do support, however, that countries that lack a strong imitative capacity and a sufficiently large market are unlikely to benefit from stronger intellectual property protection. As Yu explained:
even if countries meet these two prerequisites, stronger intellectual property protection may be unnecessary for attracting FDI. It depends on the complex interactions between the different location advantages, especially when some of these advantages are significant enough to compensate for the lack or ineffectiveness of strong intellectual property protection. Thus, the relationship between the strength of intellectual property protection and FDI remains theoretically ambiguous (Yu, 2007).

Guatemala’s Intellectual Property Regime

Historically, in Guatemala, there were no general requirements for local participation or any restrictions on repatriation of capital (Encyclopedia of the Nations, 2010). Guatemala's major diplomatic interests were regional security and regional development (Encyclopedia of the Nations, 2010). Though Guatemala participated in several regional groups, particularly those related to trade and environment, foreign investor interest in Guatemala was minimal. However, in 1996 after 36 years of a bloody civil war, the Peace Accords were signed and removed a major obstacle to foreign investment, and Guatemala has pursued important reforms and macroeconomic stabilization. (The World Factbook, Central Intelligence Agency, 2010).

In 1998, Guatemala sought to improve global competitiveness with the passage of The Foreign Investment Law (The Law) (Ley de Inversión Extranjera, Legislative Decree 9/98) of March 1998, which consolidated foreign-investment regulations and reduced the barriers to foreign investment (The Foreign Investment Law, 1998). The Law aimed to increase protection for foreign investment and remove many restrictions on types of foreign investment (Economist Intelligence Unit, 2010). The Law provided for eight free trade zones and offered incentives in the sectors of forestry, mining, tourism, and petroleum sectors. However, foreign investment was still restricted to minority ownership of domestic airlines and ground transport. (The World Factbook, Central Intelligence Agency, 2010).

Guatemala further sought to increase economic growth when the Guatemalan Congress (Congress) passed The Industrial Property Law in August 2000, to bring the country's intellectual property rights laws into compliance with the World Trade Organization's (WTO) Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), which requires that members satisfy minimum standards for IP regulations (The Industrial Property Law, 2000). For example, pursuant to Article 61 of the TRIPS Agreement, trademark laws govern “any sign or combination of signs, capable of distinguishing the goods or services of one undertaking from those of another undertaking” (TRIPS Article 61, 2009). Similarly, The Industrial Property Law sought to satisfy the same aims as TRIPS, namely to protect the unwary consumer from being misled as to the nature and origin of the good. The Industrial Property Law affords protection for the right of exclusive use of a trademark for a period of 10 years. This right of exclusive use may be renewed indefinitely for 10-year-periods. (OTEXA Market Reports/Tariffs, 2010). In most cases, the Industrial Property Law aimed to provide the foreign investor with the same rights and enforcement mechanisms as a Guatemalan national (OTEXA Market Reports/Tariffs, 2010).

As required by the TRIPS Agreement, The Industrial Property Law affords protection for a patent for 20 years from the date of filing the patent application (OTEXA Market Reports/Tariffs, 2010). Licensing agreements for patents have effect against third parties only if they are registered (OTEXA Market Reports/Tariffs, 2010). Finally, in the area of copyrights, the Law on Copyright and Neighboring Rights provides protection to the authors and right holders of artistic works (OTEXA Market Reports/Tariffs, 2010). Regardless of nationality, protection is given throughout the lifetime of the author and for 75 years after the author’s death (OTEXA Market Reports/Tariffs, 2010). The owner of copyright and any persons specifically authorized by him have the right to prohibit the import or export of legally manufactured copies of the owner’s works and the import or export of copies manufactured without the owner’s consent (OTEXA Market Reports/Tariffs, 2010).
TRIPS contains enforcement system provisions that require a series of minimum measures the WTO Members must undertake to ensure the enforcement of IPRs (TRIPS, 2009). The Industrial Property Law includes and determines a series of general rules or provisions applicable to the enforcement procedures. Pursuant to the criminal penalty schedule, the Guatemalan Penal Code has a series of offenses related to intellectual property with prison terms between 1 and 4 years and fines between Q. 1,000.00 and Q. 500,000.00 (at an exchange rate of Q. 8.00 for 1 U.S. Dollar, these fines will be between U.S. $125 and U.S. $62,500) (Guide to Doing Business in Guatemala, 2005). This penalty schedule is consistent with Guatemala’s obligation pursuant to the TRIPS Agreement. Article 61 of the TRIPS Agreement obliges contracting parties to “…provide for criminal procedures and penalties to be applied at least in cases of willful trademark counterfeiting or copyright piracy on a commercial scale” (TRIPS Article 61, 2009).

Despite the adoption of the TRIPS Agreement and the passage of stronger protections for IPR, Guatemala’s enforcement of intellectual property laws has been ineffective (U.S. Department of State Investment Climate Statement -Guatemala, 2009). A number of raids, cases, and prosecutions have been pursued against violators of IPRs; however, resource constraints and lack of coordinated government action impede efficient enforcement efforts (OTEXA Market Reports/Tariffs, 2010). Furthermore, Guatemala was listed on the United States Trade Representative (USTR) Watch List in the 2009 Special 301 report (USTR Special Report, 2009). The Special 301 Report is prepared annually by the USTR under Section 182 as amended of the Trade Act of 1974. The Act provides that the USTR must on an annual basis “identify those foreign countries that deny adequate and effective protection of intellectual property rights, or deny fair and equitable markets access to United States persons that rely upon intellectual property protection…” (The Trade Act of 1974).

Placement on the USTR Watch List creates a perception of surveillance by the USTR and may lead to U.S. bilateral trade sanctions. Key concerns cited in the 301 Report included: a) the need to provide higher priority to, and greater resources for, combating piracy and counterfeiting; and b) to enhance enforcement efforts by pursuing raids and prosecutions against small scale sellers and manufacturers of pirated and counterfeit goods (USTR Special Report, 2009).

The Industrial Property Law was modified in 2003 to provide pharmaceutical test data protection consistent with international practice, and in 2005 the law was again amended to comply with IPR protection requirements in The Central American Free Trade Agreement (CAFTA) (OTEXA Market Reports/Tariffs, 2010). In May 2006, Guatemala strengthened its legal framework for the protection of IPR with the passage of laws in preparation for the entry into force of the CAFTA-DR and spurred increased investment and diversification of exports. (The World Factbook, Central Intelligence Agency, 2010). The CAFTA-DR provides for improved standards for the protection and enforcement of a broad range of IPR, which are consistent with U.S. and international standards of protection and enforcement as well as with emerging international standards. Finally, in April 2010, the Congress passed the Law of Partnerships for Economic Infrastructure Development (Ley de Alianzas para el Desarrollo de Infraestructura Económica, Legislative Decree 16/2010), which aimed to increase foreign investment in infrastructure and public works by regulating the relationship between government and the private sector in public-private partnerships (PPPs) (Economist Intelligence Unit, 2010).

John Rawls’ Difference Principle

One of the most widely discussed theories of distributive justice in recent years has been proposed by John Rawls. The system of intellectual property rights falls under what Rawls (1971) considers the subject of justice:

For us the primary subject of justice is the basic structure of society, or more exactly, the
Rawls asserts that rational individuals in specially constructed, imaginary circumstances called the *original position* would select the principles that should govern the basic structure of a just or well-ordered society (Rawls, 1971). Persons in an original position will or should agree that all social primary goods (e.g., basic liberties such as opportunity, income, and wealth) are to be distributed equally unless an unequal distribution of any or all of these goods is to the advantage of the least favored (Younkins, 2000). In this position, behind what Rawls calls a *veil of ignorance*, Rawls thinks rational individuals would agree to two primary principles (the second of which has two parts). Rawls thinks that individuals would agree to: one, a system of equal liberty for all; and two, if there are to be differences, those differences will be in the interest of the least well-off, and attached to positions under conditions of fair equality of opportunity (Rawls, 1971).

According to the difference principle, the rational individual will choose a system of justice that adequately provides for those who are least well-off because the rational individual may end up in such a disadvantaged position. Rawls concludes that such a social contract will guarantee a just society without sacrificing the happiness or liberty of any one individual (Favor and Lamont, 2007). In other words, Rawls depicts justice as an issue of fairness, focusing on the distribution of resources, and permitting an unequal distribution only to the extent that the weakest members of society benefit from that inequality. As a result, Rawls’ conception of justice puts the least well-off in the position that they would have been in except for some undeserved and unfortunate circumstances (Favor and Lamont, 2007).

Before explaining why Rawls would support a weak regime, Rawls would reject a strong IP regime because a grant of strong IPR protections would not favor Guatemala or its weakest members. Strong IPR protection allows foreign firms to enjoy greater market power over the availability, quality, and pricing of the items owned (Maskus and Konan, 1994). A strong IP regime provides protection for exporting firms against local copying of the product, suggesting that they would increase the market size facing exporters and induce them to sell more. Consequently, these protections would allow the exporting firms to enjoy greater market power and charge higher prices. Further, strong IPR protection would not be accepted by rational individuals in the original position as just because, in trying to increase the well-being of the least well-off, the fact that Guatemala’s least well-off would have no access to price-prohibited items (pharmaceuticals), via higher prices, harms them. Moreover, the lack of competition resulting from strong IPR protections harms Guatemala. That is, IPRs grant foreign firms monopoly power over their innovations. Monopolies do not help Guatemala’s least well off; therefore, Rawls would reject a strong IP regime under these circumstances.

**RESULTS**

**Economic Considerations**

Strong IPR protection comes with economic, social, and political considerations for developing nations that developed nations do not face. Guatemala is one of the poorest countries in Central America (The World Factbook, Central Intelligence Agency, 2010). The majority of Guatemalans live in poverty and 15 percent live in extreme poverty (The World Factbook, Central Intelligence Agency, 2010). Guatemala faces enormous economic costs to efficiently reform, maintain, and monitor its intellectual property regime. For example, the regime requires qualified personnel to manage and enforce the system including examiners, administrative personnel, civil and criminal law enforcement personnel, and judges. Though
any nation faces costs associated with reformation, Guatemala faces economic challenges in reforming and maintaining an IP regime that disproportionately impacts it because Guatemala is one of the poorest countries in the world (The World Factbook, Central Intelligence Agency, 2010). Further, Guatemala’s enforcement of IPRs has been essentially ineffective because of resource constraints (OTEXA Market Reports/Tariffs, 2010). Guatemala City is one of the largest markets in Central America for name-brand goods (Brosnan, 2000). The issues facing infringement of IPRs in Guatemala are widespread, and the downtown streets are filled with local businesses selling imitation apparel from sneakers to jeans (Brosnan, 2000). A number of raids, cases, and prosecutions have been pursued against the sellers of counterfeit merchandise; however, resource constraints impede efficient enforcement efforts (OTEXA Market Reports/Tariffs, 2010). The effectiveness of Guatemala’s intellectual property regime is inextricably intertwined with its legal and enforcement systems. Consequently, a lack of effective enforcement of IPRs results in essentially meaningless reforms of Guatemala’s IP regime.

Moreover, Rawls would favor a weak IP regime because Guatemala’s weakest members would have immediate access to otherwise price-prohibitive products. Guatemalans face a high risk for contracting major infectious diseases (The World Factbook, Central Intelligence Agency, 2010). Empirical evidence supports that an increase in the protection of IPRs in developing countries raises the prices for goods (e.g. pharmaceuticals) that citizens in developing countries could not otherwise afford (Maskus and Konan, 1994). Access to pharmaceutical drugs would represent increases in consumer welfare when compared to the prohibitive prices that would prevail with strong IPR protection (UNCTAD, 2005). A strong IP regime provides protection for exporting firms against local copying of the product, suggesting that they would increase the market size facing exporters and induce them to sell more. Further, strong IP protections allow firms more power over the pricing and availability (and quality) of the items owned. Consequently, these protections would allow the exporting firms to enjoy greater market power and charge higher prices. A weak intellectual property regime would be accepted by rational individuals in the original position as just because, in trying to increase the well-being of the least well-off, the fact that the least well-off would have access to otherwise unavailable products benefits them.

Social Considerations

The costs of maintaining a strong IP regime denies servicing the weakest members more pressing needs and causes them to feel further disenfranchised. Moreover, public perception that the Government has failed to prioritize properly the needs of its citizens often fuels protests and civil unrest in developing nations. For example, business owners protested vehemently in the streets in opposition to the passage of The Industrial Property Law passed in 2000 (Brosnan, 2000). More than half of Guatemala’s population lives on less than $2 a day and 15 percent on less than $1 a day (United States State Department Report, 2010). Guatemala's social development indicators, such as infant mortality, chronic child malnutrition, and illiteracy, are among the worst in the hemisphere (United States State Department Report, 2010). It is difficult for Guatemala’s Government to justify the expenditures necessary to maintain a strong IP regime in the public eye when Guatemala faces public health concerns.

Further, Rawls would favor a weak IP regime because Guatemala could reallocate resources to service Guatemala’s weakest members more pressing needs. Rational individuals in the original position would not view a strong IP regime as just because it diverts needed funds from addressing Guatemala’s weakest members more pressing needs such as public health. Therefore, Rawls would argue that a regime in which resources are distributed unequally to the advantage of Guatemala’s least favored could stifle social unrest and improve public health.

Moreover, a weak IP regime should not be considered a safety net for Guatemala who cannot strongly compete against larger exporting firms, but instead a system, which does not reward undeserved entitlements. Rawls maintains that the job of distributive justice is to limit the influence of one's place of
birth, social status, and family influences so that undeserved entitlements do not unduly influence the amount of benefits we receive in life (Rawls, 1971). The deep disparity between Guatemala and developed trading partners in the areas of wealth, education and familiarity with the frontiers of technological knowledge, in particular, means that these underserved inequalities call for redress in order to produce genuine (e.g., fair) equality of opportunity instead of procedural (e.g., formal) equality of opportunity. Rawls believes there is no more good reason to allow the distribution of wealth and income to be determined by the possession of natural endowments than by social and historical factors.

Political Considerations

Elected leaders in developing countries are often faced with the challenges of two diametrically opposed positions: anti-IP protection public interest groups and pro-IP protection multinational firms. For example, Guatemala’s former President Alfonso Portillo received considerable backlash from the citizenry when he introduced IP reforms in 2000 (Brosnan, 2000). Many local business owners protested vehemently in the streets in opposition to the passage of the Industrial Property Law passed in 2000 (Brosnan, 2000). Leaders of developing nations may threaten their political viability by endorsing a strong IP regime or satisfying its obligations under an agreement when many local businesses benefit from a weak IP regime. In addition, Guatemala faces international political pressure from multinational firms to spur local economic growth by becoming a signatory to international trading agreements. To address these international pressures, developing nations overestimate the ability of their infrastructure to support the necessary enforcement of their IP regime. For example, Guatemala was listed on the Watch List in the 2009 Special 301 Report (USTR Report, 2009). Key concerns cited in the Report included the need to provide higher priority to combating piracy and counterfeiting (USTR Report, 2009). Consequently, Guatemala’s placement on the list threatens its political perception within the global community and foreign aid from the United States.

Guatemala’s approach of a weak IP regime would be entirely consistent with the letter of the TRIPS Agreement and improve relations with its trading partners. The preamble of the TRIPS Agreement recognizes “the special needs of the least-developed country Members in respect of maximum flexibility in the domestic implementation of laws and regulations in order to enable them to create a sound and viable technological base” (TRIPS, 2009). More specifically, Article 8 of the agreement states:

Members may, in formulating or amending their laws and regulations, adopt measures necessary to protect public health and nutrition, and to promote the public interest in sectors of vital importance to their socio-economic and technological development, provided that such measures are consistent with the provisions of this Agreement (TRIPS, 2009).

TRIPS permits all members, including those with great sectoral disparities, to “carefully tailor the country’s protection to local needs” (TRIPS, 2009). Because the TRIPS Agreement covers only minimum standards of protection offered by each WTO member, it does not dictate the scope of protection beyond what the agreement requires. Therefore, consistent with TRIPS, Guatemala may decide to protect more urgent needs such as public health.

Further, Guatemala would not be the first developing country to successfully tailor its intellectual property system to the needs of local industries. For example, in China copying rates vary considerably across types of goods, with business applications software experiencing the highest rates and entertainment software and music recordings and motion pictures having lower copying rates (Yu, 2007). Thus, China decided to strengthen the protection for business software applications more than that for music recordings and motion pictures.

Finally, a weak intellectual property regime would be accepted by rational individuals in the original
position as just because, in trying to increase the well-being of the least well-off, the least well-off would have access to an improved trading position with their more developed trade partners. Developing nations traditionally have weak negotiating power with developed trading partners. (Lo, 2004). Under pressure internationally to spur economic growth, developing nations become signatories to international IP treaties (Greenbaum, 2009). However, Guatemala’s resource constraints make it ill-equipped to satisfy its obligations under its agreements with the United States because Guatemala has overestimated the ability of its infrastructure to support the necessary IP regime. A weak regime promotes a more realistic evaluation of Guatemala’s IP regime. Consequently, this would lead to higher levels of compliance and ameliorate relations with trading partners.

SUMMARY AND CONCLUSIONS

This article aims at addressing economic, social, and political considerations Guatemala faces in reforming its IP laws that previous empirical studies failed to examine on the relationship between IPR protection and FDI. Previous studies emphasized the importance of developing nations, like Guatemala, to provide strong IPR protection in order to attract foreign direct investment. None of the studies examined the impact of economic, social, and political considerations facing developing nations in the reformation of their IP regime. This article examines Guatemala’s approach to reformation of IPR protections by applying John Rawls’ Difference Principle, which focuses on the distribution of resources and permits an unequal distribution only to the extent that the weakest members of society benefit from that inequality.

This article finds the application of John Rawls’ Difference Principle would reject the findings from the literature that strong IPR protection is needed to attract FDI in developing countries like Guatemala and support a weak IP regime in Guatemala for three key reasons. First, economically, Guatemala’s weakest members would have immediate access to otherwise price-prohibitive products. Second, socially, Guatemala could reallocate resources to service Guatemala’s weakest members more pressing needs. Third, politically, Guatemala’s IP weak regime would be entirely consistent with the TRIPS Agreement and improve relations with its trading partners. Consequently, if Rawls is correct that behind a veil of ignorance, rational individuals would choose a system of equal liberty for all, but, if there are to be differences, they are to favor the least well off, then it is easy to conclude that Rawls favors Guatemala employing a weak IP regime.

Guatemala’s response to IPRs might be very different than the response from developed countries that do not face the same pressing economic, social, and political challenges that Guatemala faces. Guatemala is one of the poorest countries in the world with the majority of Guatemalans living in poverty and 15 percent living in extreme poverty. Although Guatemala may endorse an economic strategy that may create more robust IPR protections in order to improve its relationship with the United States so that Guatemala is removed from the 301 watch list, such a strategy may come at the expense of Guatemalans’ access to otherwise price-prohibitive pharmaceuticals. The reality is that there is no one-size-fits-all solution. Instead, Guatemala should tailor its IP regime to its own needs and strengths. Further research will be necessary to measure the success of Guatemala’s approach to protection of IPRs and its impact on attracting FDI.

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**BIOGRAPHY**

Dr. Quarles is a former Assistant United States Attorney for the United States Justice Department where he prosecuted violations of intellectual property laws and other economic crimes. He has served as an International Coordinator for the Department of Justice handling extraditions and representing the interests of foreign governments pursuant to Mutual Legal Assistance Treaties. Dr. Quarles currently lectures domestically and internationally regarding international business transactions. Dr. Quarles can be contacted at 877 W. Vaughn Avenue, Gilbert, Arizona 85233, bjquarles@yahoo.com, (602) 367-7099
DID CONFIDENCE KILL THE TRIFFIN PLAN?
Carol M Connell, City University of New York

ABSTRACT

I examine two competing proposals for reforming and reviving confidence in the international monetary regime. Robert Triffin introduced and championed the proposal for centralized reserves. Fritz Machlup championed the proposal for flexible rates originally introduced by Milton Friedman. Triffin claimed that Fritz Machlup did more than anyone to ensure that floating exchange rates won the policy debate because of his influence on academic economists and policy makers. I examine Machlup’s influence on these opinion molders through his leadership of the Bellagio Group conferences.

JEL: B22, B23, B31, E42

KEYWORDS: Triffin Plan; world monetary regime reform; confidence, liquidity and adjustment

INTRODUCTION

Long before the financial crisis of 2008, reforming the world monetary regime was on everyone’s lips. In this paper, I examine two competing proposals for reform. Robert Triffin introduced and championed centralized reserves. Fritz Machlup championed and popularized flexible exchange rates, first introduced by Friedman (1953). We know in the end that flexible exchange rates prevailed and there was no overall reform. Triffin credited adoption of flexible exchange rates to Fritz Machlup influence on policy markers and academics through his leadership of the Bellagio Group conferences (Triffin 1960, p. 8). If Triffin is right, how did Fritz Machlup come to exert so much influence on the move from the gold-exchange standard to flexible exchange rates?

This paper begins with a review of the literature on confidence and framing, and then turns to the critical balance of payments problems facing the world after World War II. An exploration of the Triffin and Machlup arguments follows. I then examine Fritz Machlup’s leadership role in the Bellagio Group conferences and the clash of ideas in the conferences and journals of the day. In the final section, I return to the question posed in the introduction and draw conclusions.

LITERATURE REVIEW

Dow (2008) explains that framing refers to the way in which presentation influences how we understand ideas. Different disciplines frame subject matter in their own characteristic ways (economics versus sociology, for example). Even within disciplines there can be framing differences, ranging from differences in the meaning of terms to differences in the underlying theory, resulting in different policy recommendations. Framing follows from logical positivism, which demands that scientific statements be testable against facts. For example, confidence is a term that has long been important to framing capital markets; we hear about investor confidence all the time. Confidence was outside the frame of the Bureau of International Settlements (BIS), an organization capturing data on international monetary flows. Nor was confidence part of the analysis of the International Monetary Fund (IMF), responsible for capturing data on money supply and interest rates. Nelson, Oxley and Clawson (1997) examine how framing influences political attitudes and finds that framing effects are stronger among respondents with a sophisticated understanding of the issues. For them, framing reinforces existing beliefs and arguments. The authors suggest framing as well as social interaction are critical to mobilization and collective action. In public policy, Mintz and Redd (2003, p. 195) identify framing with manipulation. They distinguish two subtypes that are relevant here. In evaluative framing, the frame anchors assessment of the
environment. In productive framing, the frame guides thinking toward an intended result. In this paper, Machlup emerges as the principal actor. Through the Bellagio Group conferences, he created an opportunity for evaluative and productive framing. Machlup manipulated the discussion to focus on three results --- adjustment, liquidity and confidence.

DATA AND METHODOLOGY

The paper takes an historico-biographical approach, drawing on the personal and published papers of Robert Triffin and Fritz Machlup.

RESULTS

A Crisis in Confidence

From 1946 to 1973, the Bretton Woods Agreement of 1944 was in force. Bretton Woods established gold as the universally accepted reserve asset for international payments and effectively fixed exchange rates. Supplies of gold were limited and new gold stores were under the control of gold-mining countries like Russia and South Africa. US dollars and British pounds sterling substituted for gold in all international payments, although they were convertible to gold on demand. Convertibility ended in Britain in 1947 and did not resume until 1958, leaving the US dollar the sole reserve currency backed by gold. Foreign trade depended on dollars available through the Eurocurrency market. The Eurocurrency market was heavily dependent on monetary policies in the US, as concerns spread about the War in Vietnam and Johnson’s Great Society program. Nevertheless, by the late 1960s, the size of this market was huge (Toniolo 2005, p. 461). From 1958 to 1968, the Bretton Woods financial system needed a whole series of agreements, regimes rules, and institutions to ensure it worked (Gavin, 2004). Nevertheless, the imbalance in international payments and flows of short-term capital that emerged in the mid to late 1960s became increasingly hard to resolve (De Vries 1976, p. 3). US and European policy-makers feared that loss of confidence in the dollar might trigger a run on the US Treasury gold window. Both saw loss of confidence as a threat to national and economic security.

Robert Triffin – Liquidity and Adjustment Problems Trigger Loss of Confidence

Robert Triffin was born in Belgium and educated at the Catholic University of Louvain and later Harvard University. He was a Yale economist (1951-1977) and a former member of the Federal Reserve Board, serving as chief of the Latin American section from 1942 to 1946. From 1946 to 1949, Triffin played various roles at the International Monetary Fund. Triffin committed his efforts to the reform of the Bretton Woods system. At the same time, he was also a member of Jean Monnet’s Action Committee for the United States of Europe.

Like the architects of Bretton Woods, Triffin shared distrust for free capital markets and flexible exchange rates. Nevertheless, his experience of the pre-1914 gold standard led him to decide that, in practice, gold was neither self-managing with central bankers as passive facilitators nor self-correcting. Triffin believed a single key currency to be fundamentally unstable. Key currency countries will therefore fall from grace and will not provide the basis for a sound international financial order. In Europe and the Money Muddle, Robert Triffin argued the growth of foreign countries’ reserves had depended on a vast redistribution of net reserves from the United States to the rest of the world. He said further that such a movement could not continue without eventually undermining confidence in the dollar itself. (Triffin 1957, p. 296-297). Triffin expanded on this argument in his statement to the Joint Economic Committee of Congress in October 1959. If the United States ever stopped running balance of payments shortfalls and supplying reserves, the resulting shortage of liquidity would cause the global
economy to contract. Nevertheless, if the deficits continued, inflation and loss of confidence would result (Triffin 1959). This diagnosis is known as “Triffin’s Dilemma” or “Triffin’s Paradox.”

Triffin’s 1959 prescription was to replace gold and foreign currency reserves by gold-guaranteed deposit accounts at the IMF. Triffin’s later writings placed increasing stress on the inflationary potential of continuing US deficits and the threat of a gold and dollar crisis. He admitted that he had underestimated the US deficits that foreign central bankers would be willing to absorb (Triffin 1978, p. 5).

Fritz Machlup – A Failure of Confidence Triggers Adjustment and Liquidity Problems

Fritz Machlup (1966a) was the first economist to credit adjustment and liquidity to a failure of confidence. He was also the first to argue that a restoration of confidence would make adjustment and liquidity moot. For Machlup, the French (and German) focus on payments adjustment had a simple explanation. For many years, the United States had spent, lent and invested money abroad. The US had paid largely in dollars which the monetary authorities of many nations now held in their monetary reserves. The French government disapproved of some of this spending and investing, for example the war in Vietnam and foreign direct investment in French firms. The French regarded adjustment as the most urgent need (Machlup 1966a, p. 2). The growing wealth of the Bank of France made it hard for the French to understand a present or imminent shortage of reserves in the world (Machlup 1966a, p. 2). To the American argument for a new reserve asset, the French reply was the deficit must end first. While Machlup argued that the French position was understandable, he saw the problem differently. The American difficulties in achieving balance had nothing to do with an absence of safeguards. “[Future] contingencies, as I see them (or fear them) are less likely to arise from inadequate liquidity than from inadequate confidence.” (Machlup 1966a, p. 2)

According to Machlup, the American position rested on two optimistic assumptions. First, the US assumed that it could eliminate its payments deficits in short order. Second, the US believed that its dollar would remain as good as gold despite its deficits. To provide liquidity was the first order of business (Machlup 1966a, p. 2-3). Foreign trade liberalization and convertibility were critical to the growth of world trade and prosperity. Both depended on ample liquidity. Without US deficits, more countries would suffer shortfalls in their international payments. To stop losses in their reserves, countries might adopt restrictive commercial policies and place new limits on convertibility, halting or reversing world trade and finance. Nations must agree on a method of creating satisfactory annual increments in world liquidity with no time to lose. (Machlup 1966a, p. 3)

Machlup saw the weakness of the American position in its assumptions. The American attitude about the problem of confidence reflected a debtor position. One can hardly expect a debtor to propose measures to safeguard against loss of confidence in his ability to pay. Machlup argued that the balance of payments of the United States and confidence in the dollar were not separate problems. “[A] weakening of the confidence – private, not official – in the dollar has for the past few years caused the deficit in the balance of payments. To seek adjustment without confidence is probably hopeless.” (Machlup 1966a, p. 3) Changes in the flow of private short-term capital often reflect changes in confidence in the convertibility of the gold and foreign exchange value of a currency. Given that short-term capital also moves in response to interest rate differences, it is sometimes difficult to untangle the two. From 1951 to 1959, private short-term capital had moved into the United States every year except 1954. Beginning in 1960, large outflows followed for five years. (Machlup 1966a, p. 4-5) The cause of the outflows was loss of confidence in convertibility of the dollar (Machlup 1966a, p. 5).

Machlup argued, “I submit that a system of securing confidence would all of itself restore balance in the payments position of the United States (Machlup 1966a, p. 6). To what extent did the world surplus of reserves add to confidence? Machlup argued it was not a final amount but annual additions to reserves that had a positive impact on confidence. In countries suffering losses in foreign reserves, the authorities would eventually restrict international trade and capital movements. Annual additions to reserves were essential to reduce or avoid deficits (Machlup 1966b, p. 30).
The Confidence Issue at the Bellagio Group Conferences

On October 2, 1963, US Secretary of the Treasury and Governor of the International Monetary Fund Douglas Dillon announced he was launching two studies of the international monetary regime. Three academic economists (Fritz Machlup, William Fellner and Robert Triffin) heard Dillon’s announcement and decided to embark on an independent study. They prepared to invite economists with widely divergent views with no problem or proposal considered “out of bounds” (Machlup 1964, p. 8).

Table 1: Attending Bellagio Group Members, Their Institutional Affiliations and Public Policy Experience

<table>
<thead>
<tr>
<th>Member</th>
<th>Institution (University)</th>
<th>Former Public Policy Role</th>
<th>Country of Citizenship (birth)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prof. Arthur L. Bloomfield.</td>
<td>Pennsylvania</td>
<td>Federal Reserve</td>
<td>US (Canada)</td>
</tr>
<tr>
<td>Prof. Lester Chandler</td>
<td>Princeton</td>
<td>Federal Reserve</td>
<td>US</td>
</tr>
<tr>
<td>Prof. Alan C. L. Day</td>
<td>London</td>
<td>Radcliffe Committee</td>
<td>UK</td>
</tr>
<tr>
<td>Prof. Pierre Dieterlen</td>
<td>National Center of Scientific Research</td>
<td>European Monetary Union</td>
<td>France</td>
</tr>
<tr>
<td>Prof. Leon Dupriez</td>
<td>Louvain</td>
<td>National Bank of Belgium</td>
<td>Belgium</td>
</tr>
<tr>
<td>Prof. William J. Fellner</td>
<td>Yale</td>
<td>Council of Economic Advisors</td>
<td>US (Hungary)</td>
</tr>
<tr>
<td>Prof. Alberto Ferrari</td>
<td>Rome</td>
<td>Bureau of International Settlements</td>
<td>Italy</td>
</tr>
<tr>
<td>Prof. Gottfried Haberler</td>
<td>Harvard</td>
<td>Federal Reserve, National Bureau of Economic Research</td>
<td>US (Austria)</td>
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<tr>
<td>Prof. Albert Hahn</td>
<td>Frankfurt</td>
<td>Banker, Bankhaus L. Albert Hahn</td>
<td>Switzerland (Germany)</td>
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<tr>
<td>Prof. George Halm</td>
<td>Fletcher School of Law and Diplomacy</td>
<td></td>
<td>US (Germany)</td>
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<tr>
<td>Sir Roy Harrod</td>
<td>Oxford</td>
<td>Advisor to Harold Macmillan; International Monetary Fund</td>
<td>UK</td>
</tr>
<tr>
<td>Prof. Michael Heilperin</td>
<td>Institut Universitaire de Hautes Etudes Internationales</td>
<td></td>
<td>US (Poland)</td>
</tr>
<tr>
<td>Mr. Fred Hirsch</td>
<td>The Economist</td>
<td>International Monetary Fund</td>
<td>UK (Austria)</td>
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<tr>
<td>Prof. Harry G. Johnson</td>
<td>Chicago</td>
<td></td>
<td>Canada</td>
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<tr>
<td>Prof. Fritz de Jong</td>
<td>Groningen</td>
<td>Labor Party of Groningen</td>
<td>Netherlands</td>
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<tr>
<td>Prof. Peter B. Kenen</td>
<td>Columbia</td>
<td>Federal Reserve</td>
<td>US</td>
</tr>
<tr>
<td>Prof. Charles Kindleberger</td>
<td>MIT</td>
<td>Federal Reserve, Bureau of International Settlements</td>
<td>US</td>
</tr>
<tr>
<td>Prof. Kioshi Kojima</td>
<td>Hitotsubashi</td>
<td>Pacific Free Trade Agreement</td>
<td>Japan</td>
</tr>
<tr>
<td>Dr. Alexandre Lamfalussy</td>
<td>Banque de Bruxelles</td>
<td>Banker, Banque de Bruxelles; Bureau of International Settlements</td>
<td>Belgium (Hungary)</td>
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<tr>
<td>Prof. Friedrich Lutz</td>
<td>Zurich</td>
<td>International Monetary Fund</td>
<td>Germany</td>
</tr>
<tr>
<td>Prof. Fritz Machlup</td>
<td>Princeton</td>
<td>Consultant, US Treasury</td>
<td>US (Austria)</td>
</tr>
<tr>
<td>Prof. Burton Malkiel</td>
<td>Princeton</td>
<td>Council of Economic Advisors</td>
<td>US</td>
</tr>
<tr>
<td>Prof. Hans Moller</td>
<td>Munich</td>
<td>Banker, Bank Deutscher lander;</td>
<td>Germany</td>
</tr>
<tr>
<td>Prof. Robert Mundell</td>
<td>McGill</td>
<td>United Nations, International Monetary Fund, World Bank, Federal Reserve</td>
<td>Canada</td>
</tr>
<tr>
<td>Prof. Jurg Niehans</td>
<td>Zurich</td>
<td>Swiss Diplomatic Corps</td>
<td>Switzerland</td>
</tr>
<tr>
<td>Prof. Bertil Ohlin</td>
<td>Handelshogskolan</td>
<td>Swedish Minister of commerce (1944-45); member, Riksdag from 1938 to 1970</td>
<td>Sweden</td>
</tr>
<tr>
<td>Prof Jacques Rueff</td>
<td>Consul for Economic and Social Affairs</td>
<td>Advisor to French President Charles de Gaulle</td>
<td>France</td>
</tr>
<tr>
<td>Dr. Walter Salant</td>
<td>Brookings</td>
<td>Treasury Department, Securities and Exchange Commission, Commerce Department, NATO</td>
<td>US</td>
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<tr>
<td>Prof. Tibor Scitovsky</td>
<td>California</td>
<td>Organization for Economic Cooperation and Development</td>
<td>US (Hungary)</td>
</tr>
<tr>
<td>Prof. Egon Sohmen</td>
<td>Saar</td>
<td>European Monetary Union</td>
<td>Austria</td>
</tr>
<tr>
<td><strong>Prof. Robert Triffin</strong></td>
<td><strong>Yale</strong></td>
<td>Federal Reserve, International Monetary Fund, European Monetary Union</td>
<td>US (Belgium)</td>
</tr>
<tr>
<td>Dr. Pierre Uri</td>
<td>Atlantic Institution</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This table identifies the members of the Bellagio Group, their university or organizational affiliation, former public policy role, and country of citizenship and birth. Note that country of birth is in parentheses. Source: Machlup, F. International Monetary Arrangements: The Problem of Choice (1964a) and author’s research into former public policy roles.

Most economists invited to join the Bellagio Group conferences had played an active public policy role before moving into academe. See Table 1 Attending Bellagio Group Members, Their Institutional...
Affiliations and Public Policy Experience. The selection was deliberate, since political judgments would play an important role in discussions of policy alternatives. Some members continued to be active in efforts toward European integration.

Machlup’s invitation suggested the conferences were an experiment to understand sources of disagreement by examining the assumptions underlying major policy approaches. Fritz Machlup set the preconditions for discussion. Assumptions betraying political attitudes were especially important to Machlup. He saw that judgments about what is politically “unacceptable” or “impossible” might be responsible for wide disagreement among economists. Machlup warned against confusing political assumptions with value judgments (Fritz Machlup Papers, box 282, folder 6).

Participants agreed to evaluate reform policies based on improved payments adjustment, liquidity and confidence. At Machlup’s urging, conference participants agreed to a definition of terms (Machlup 1964, p. 43-45). For example, conferees sorted payments imbalances into three types depending on frequency and cause. They agreed that each reform policy should include a solution to the provision of currency reserves (Machlup 1964, p. 53-58). Conferees agreed that problems of confidence in reserve currencies arise for two reasons. First, monetary authorities may want to change the composition of their reserves by substituting one reserve asset for another. Second, they may not wish to accept more of a particular asset they already hold and to convert additional amounts acquired into gold. In either case, the presentation of a large dollar or sterling claim for conversion into gold might lead other holders to run down their dollar or sterling balances as well. This could trigger drastic action by the US or UK in defense of its gold reserves (Machlup 1964, p. 58-65).

Table 2 summarizes the differences in fundamental assumptions underlying four major policy approaches. Many members of the Bellagio Group had preferred policy approaches. Some, like Harrod and Lutz, had several preferred approaches. As well as differences, the Bellagio Group discussions threw some likenesses into relief. For example, supporters of centralized reserves and multiple currency reserves policies faulted the current gold-exchange standard and proposed semi-automatic gold standard for the same haphazard approach to gold production and failure to ensure against liquidity problems.

They also shared the assumption that payments adjustment would fail to work fast enough to enable countries to finance their shortfalls with available reserves and borrowing. Therefore, gold-based policies could meet neither liquidity nor adjustment tests. Supporters of flexible rates agreed, adding that delayed payments adjustment would lead to tariffs to limit imports or foreign aid tied to military purchases.

Bellagio Group members carried the debate on policy options into their own publications. Burton Malkiel saw Triffin walking a tightrope between two irreconcilable goals: a central bank and emancipation from gold and distrust of big government institutions (Malkiel 1963, p. 515). Charles Kindleberger argued that many economists saw the Triffin solution “the first-best solution economically,” but “most of them think that it is politically out of the question” (Kindleberger 1970, p. 216). Outside the Bellagio Group, Oscar Altman of the IMF attacked Triffin’s assessment of the liquidity needs of growing international trade. He argued an expanded IMF would find itself intervening in the money markets of the US and UK. He argued further that the composition of IMF assets would need to change from currency and short term loans to long-term investment (Altman 1961, p. 187). Leland Yeager faulted the Triffin plan for focusing on the liquidity problem with its high potential for inflation with no mechanism to resolve balance of payments problems (Yeager 1961, p. 312).
Table 2: Exchange Rate Policies and Their Advocates

<table>
<thead>
<tr>
<th>Policy</th>
<th>Fundamental Assumptions</th>
<th>Desired Impact</th>
<th>Bellagio Group Advocates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Semi-automatic gold</td>
<td>Raise the price of gold to allow the removal (redemption) of all reserve-currencies from</td>
<td>Eliminate payments imbalances.</td>
<td>Pierre Dieterlen, Albert Hahn, Sir Roy Harrod, Michael Heilperin,</td>
</tr>
<tr>
<td>standard</td>
<td>the system. Leave gold as sole reserve asset. Fix exchange rates.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Centralized Reserves</td>
<td>Major reserve holders agree to keep fixed proportion of gross reserves as gold -</td>
<td>Removal of reserve currencies and increase in gold price raise.</td>
<td>Jacques Rueff</td>
</tr>
<tr>
<td></td>
<td>guaranteed deposits, with IMF authorized to adjust quantity of reserves through open</td>
<td>Addresses liquidity.</td>
<td>Robert Triffin, ACL Day, Sir Roy Harrod (alternative plan),</td>
</tr>
<tr>
<td></td>
<td>market operations, overdrafts, or bonds.</td>
<td>Confidence in system depends on confidence in IMF.</td>
<td>Alexandre Lamfalussy, Pierre Uri</td>
</tr>
<tr>
<td>Multiple Currencies</td>
<td>Monetary authorities of reserve currency countries agree to diversify foreign exchange</td>
<td>Permits growth of reserves for payments adjustment under conditions of full</td>
<td>Friedrich Lutz, Burton Malkiel, Sir Roy Harrod (alternative plan)</td>
</tr>
<tr>
<td></td>
<td>holdings to include mixed currencies (not only US and UK) and gold as reserves, ensure</td>
<td>employment, stable prices, and fixed exchange rates.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>no abrupt and destabilizing changes.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flexible Exchange Rates</td>
<td>Market forces increase export revenues for deficit countries decrease import expenses</td>
<td>Payments balance achieved through adjustment of the exchange rate to market</td>
<td>Milton Friedman, Fritz Machlup, Gottfried Haeberler, Albert Hahn,</td>
</tr>
<tr>
<td></td>
<td>for surplus countries.</td>
<td>supply and demand.</td>
<td>George Halm, Harry G. Johnson, Friedrich Lutz (alternative plan),</td>
</tr>
<tr>
<td></td>
<td>International agreements restrict monetary authorities from intervening in market.</td>
<td></td>
<td>Egon Sohmen</td>
</tr>
</tbody>
</table>

Table 2 summarizes the fundamental assumptions and desired outcomes of the four major policy approaches explored by the Bellagio Group. Many members had preferred policy approaches; see “Advocates” column. Some members, like Harrod and Lutz, had several preferred approaches. Source: Report on International Monetary Arrangements: The Problem of Choice (1964) and author’s own research.

The semiautomatic gold standard and flexible exchange rates shared an appealing feature. Both substituted fixed rules and automatic mechanisms for governmental discretion (Machlup 1965, p.168). Indeed, distrust for government intervention (big government or government institutions) was the reason the Monetary Committee of the European Economic Community disapproved the Triffin Plan (Robert Triffin Papers, MS 874, Box 1, folder 1). Disapproval did not end the Triffin Plan.

The publications of the Bellagio Group and media attention created by the conferences gave the Bellagio Group a high profile. We learn from Triffin’s notes that Group of Ten members saw the usefulness of the Bellagio Group as a non-governmental, independent think tank. Otmar Emminger, in his role as chair of the deputies of the Group of Ten, found the Bellagio Group conferences invaluable to policy deliberations. Members of the Group of Ten would become close working partners with the Bellagio Group, joining them for seminars some 15 times through 1974. (Robert Triffin Papers, MS 874, box 12, folder 2)

In November 1965, Otmar Emminger asked the Bellagio Group to devise adjustment policies for countries in payments imbalance and to investigate the use of special reserve assets. They were to assume no change to fixed exchange rates. Fritz Machlup asked the Bellagio conferees to consider and rank order their preferred exchange rate solutions to liquidity, adjustment and confidence problems.

Table 3 reflects the Bellagio Group members’ preferred solutions to the liquidity, adjustment and confidence problems, based on Robert Triffin’s calculations at the fourth conference. Ignoring the request to consider fixed exchange rate solutions only, the Bellagio Group voted the Triffin plan with flexible exchange rates their number 1 choice. The Bellagio Group recommended to the Group of Ten the
hybrid solution of flexible rates and Triffin’s plan for increased credit reserves under the control of the IMF.

Table 3: Adjustment, Liquidity and Confidence Preferences

<table>
<thead>
<tr>
<th>Goal</th>
<th>Mechanism</th>
<th>Member Votes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjustment</td>
<td>Adjustable pegs/wider margins (Managed flexibility) outvote unlimited flexibility</td>
<td>14/17</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Credit Reserves</td>
<td>14/17</td>
</tr>
<tr>
<td>Confidence</td>
<td>Consolidate into IMF deposits</td>
<td>14/17</td>
</tr>
</tbody>
</table>

This table shows the Bellagio Group members’ preferred solutions to the liquidity, adjustment and confidence problems. The results are based on a survey made by Fritz Machlup at the end of the fourth Bellagio Group conference. Robert Triffin calculated the survey results, based on 17 attendees. The data are available in Triffin’s hand-written notes in Robert Triffin Papers, MS 874, Box 12 folder 2.

CONCLUSION

The goal of this paper was to examine Triffin’s claim that Fritz Machlup turned the tide of opinion toward exchange rates as an instrument to correct balance of payments adjustment problems and restore confidence in the international monetary regime. Of particular importance to this interpretation are the archival records of Fritz Machlup at the Hoover Institution and Robert Triffin’s papers at Yale University. Because of Triffin’s involvement with both European integration and the Bellagio Group, the Triffin papers reveal the many points of tangency between the two efforts.

The findings support Triffin’s claim. The current paper attributes Machlup’s influence to his selection of economists to join the Bellagio Group; his close working relationship with the deputies of the Group of Ten; his creation of a broad platform of joint conferences, papers and books to promote their work, and his framing of the problem of world monetary system reform.

While Fritz Machlup was a powerful advocate for flexible exchange rates, the archives show us that his leadership of the Bellagio Group conferences gave him incomparable reach and influence. Beginning with his choice of invitees, Machlup selected academic economists who were associated in print with a specific exchange rate policy, most of whom had had prior public policy experience. He built a close relationship with Otmar Emminger and the deputies of the Group of Ten. Robert Solomon, American representative on the Ossola Committee of the Group of Ten, distinguished the Bellagio Group’s work from that of the IMF or Group of Ten. “More stress was placed on the desirability of changing exchange rates as a means of balance of payments adjustment…. more concern was expressed about the instability that could arise from the ‘overhang’ of foreign exchange reserves. (In general the report of the Bellagio Group holds up well in the light of subsequent developments)” (Solomon 1977, p. 71).

Machlup continued to extend invitations to academics and former policy-makers with very different policy approaches to co-lead future Bellagio Group. New leaders extended the policy and intellectual reach of the conferences. Machlup’s continued involvement ensured that policy rivals had the opportunity to put their arguments through the same rigorous methodological analysis. Machlup also had access to conferences like the American Economic Association, the American Banking Association and the American Enterprise Institute, that sought to give the Bellagio Group members access to larger and more international audiences. As senior editor of the Princeton University Finance Section, Machlup published many dozens of papers on international monetary reform written by Bellagio Group members and officials who had attended extended group meetings.

Finally, it was in Machlup’s framing of the issues in terms of adjustment, liquidity and confidence that he had a distinctive advantage. The (potential) shortage of liquidity and its devastating effect on confidence and stability, originally exposed by Triffin, had an important influence on the plan to create Special
Drawing Rights. The hybrid solution recommended by the Bellagio Group (and finally adopted) put the primary focus on flexible rates to moderate confidence in reserve media. Special Drawing Rights relieved a shortage of international reserves while convertibility of the dollar was still an issue (IMF 1987, p. 12). With the growth of international credit markets and elimination of gold convertibility and par values in the 1970s, other attributes of the SDR have become important. The SDR is a source of cost free, lower-risk, supplemental owned reserves (Clark and Polak 2004). The SDR is also a potential alternative to credit markets when confidence in the system is in crisis. Not actual currency, the SDR might serve as the basis for a universal currency, similar to Keynes’ bancor (Alessandrini and Fratianni 2009).

A limitation of this paper is the narrowness of its focus. The collapse of the Bretton Woods Agreement and the integration of Europe is a complicated story with many interrelationships. My continuing research into the Bellagio Group focuses on the group’s contribution to public policy and international trade and finance scholarship.

ACKNOWLEDGEMENTS

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BIOGRAPHY

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BIBLIOGRAPHY


ENTREPRENEURSHIP UNDER SEVERE ADVERSE CONDITIONS: THE NORTHWEST MEXICAN CASE
José Gabriel Aguilar Barceló, Universidad Autónoma de Baja California
Alejandro Mungaray Lagarda, Universidad Autónoma de Baja California
Martín Ramírez Urquidy, Universidad Autónoma de Baja California
Natanael Ramírez Angulo, Universidad Autónoma de Baja California

ABSTRACT

We analyzed the performance of marginalized subsistence microenterprises, through dichotomous logistic regressions by maximum likelihood. We tested 52,224 hypotheses, trying to find behavior patterns on microenterprises. The results show that performance is the result of a combination of factors related to the owners and the decisions made by them on their entrepreneurial environment, if measured as an approximation of the success/failure ratio. It is possible to know many of these variables before the business starts. In addition, some variables did not show the expected relation; this suggests that these projects deserve a different treatment than the formal micro and small enterprise. These factors may well influence the design of microenterprises’ assistance programs, micro loans and the establishment of commercial areas that allow an “enhanced” micro entrepreneur profile.

JEL: C35, D12, D13, D14

KEYWORDS: Small business, marginalization, performance, logit, maximum likelihood.

INTRODUCTION

Microenterprises are of significant potential contribution to local economies (Iduarte & Zarza, 2005). However, many of these are not as active in regional development as expected, mostly because they were not created under a formal entrepreneurship vision; instead, they are more focused on personal or family economic survival (Del Cid, 2006) operating in a steady loss of capital and therefore being considered as subsistence microenterprises (Cohen, 2006). Part of the origin of this phenomenon in Latin American countries, is the contraction of labor markets that, in the absence of unemployment insurance, makes individuals turn to unregistered -and in that sense parallel and informal- economic activities in order to get the funds to meet their basic living needs (Mungaray, Ramírez, Aguilar & Beltrán, 2007).

Within this group, those who stand out are householders who opt to set up in their homes a local craft business with just the right value added to its products, to stay afloat. Severe restrictions stemming from lack of support and social and economic marginalization affect these social base small businesses. Nevertheless, these microenterprises can place themselves above the rest in some cases, when measured by sales volume or consumer preference, and against all odds, they have a long and profitable life (Alcalá, Mungaray & Ramírez, 2004). This is likely due to the inherent talent of the owners, and the search to meet their needs for economic self-sufficiency.

In this paper, we study the performance attributes of subsistence microenterprises that help to rise above social and economic marginalization in Mexico’s northwest border region, through the determination of individual and interrelated impacts from variables of different nature. It was found that some variables concerning the organization of the microenterprise, but also some related to the proprietors –which in many cases are known even before the start of operations- are an accurate forecast of the microenterprise performance in terms of success/failure ratio. This constitutes a certainty factor that can help in setting
the appropriate conditions for an efficient regulation, including a potential future formalization and a more effective assistance and financial support.

We structure the paper as follows: first, we argue about the importance of entrepreneurs’ behavior on microenterprise performance, especially when they are close to self-employment; this serves as a base to present the hypothesis and the objectives of the study. Then, we further detail the work model. After that, we describe the specific data treatment. The next to last section describes the main results and their interpretation. Last section shows the conclusions and final remarks.

LITERATURE REVIEW

The study of entrepreneurship originated several decades ago. The dualist school subscribed to the notion that the informal sector is comprised of marginal activities, distinct from and not related to the formal sector; these actions provide income for the poor and a safety net for them in times of crisis (ILO-PREALC-ILO, 1981). In accordance with this vision, the objective of an informal enterprise is to assure the survival of the workers and their families, in a clearly inferior sector than formality (Tokman, 1989; Harris & Todaro, 1970).

Later on, the structuralism school argued that in the informal sector, subordinated workers serve to reduce labor costs and, thereby, increasing the competitiveness of large firms that are part of a modern sector that is underdeveloped. This line of thought suggest that the productive structure is segmented, allowing the coexistence of highly productive activities with those that are not as technical (Castells & Portes, 1989); the result of these actions are low wages and the worst labor conditions. According to this theory, the informal sector is a structural surplus of the employment market, caused by an implacable capitalist system. On the other hand, legalists’ theories subscribes to the notion that the informal sector is comprised of brave micro entrepreneurs who choose to operate informally in order to avoid the costs, time and effort of formal registration. Under this view, government regulations are stifling private enterprise, especially micro and small enterprises (De Soto, Gherzi & Ghibellini, 1986). In a sense, it emphasizes transactions costs as a reasoned and voluntary element of decision to stay in informality (Bosch & Maloney, 2007).

The illegality school of thought made a similar postulation but with a persecutory slant. According with them, informal entrepreneurs choose deliberately to operate illegally in order to avoiding taxation, commercial regulations and other fees and costs of operating formally, even committing criminal acts (Maloney, 2004). These last two lines of thought are associated with neoliberal ideas. Finally, in recent years, a new theory has emerged in which all others are integrated, and consider that institutions are to blame for labor mobility and wage differences, thus causing multiple segments within labor markets (Piore, 1980; Fields, 2005).

This paper defines subsistence and informal microenterprise as unregistered household activities, owned and operated by own-account workers that may employ contributing family workers and unregistered employees on an occasional basis that creates scarce income for immediate consumption rarely used for reinvestment purposes (Del Cid, 2006). Though is not the one of the direct causes, global recessions like the ones experienced during 2008 and 2009, tend to accelerate the creation of subsistence microenterprises in marginal urban areas of the developing countries (Aguilar, Mungray & Ramirez, 2009). This provides an opportunity to understand its scope and influence, focusing towards the differentiation between developing a real anti crisis resources and throwing money in low impact and populist aid programs. Parallel to theoretical approaches, it is common to identify two different types of micro entrepreneur’s profiles when doing fieldwork in unregulated micro and small enterprises.
First, there are those who are not interested in modifying their operation methods. Second, those who are willing to deal with organizational restructuration that leads to the formalization of their operations and, as a result, to fulfill tax obligations to the Internal Revenue Service, however, they do not possess the knowledge or means to achieve it (Mungaray, Ramírez-Urquidy, Texis, Ramírez & Ledezma, 2008). In an imperfect sense, we associate the first group with the involuntary entrepreneurship that has no other purpose than to supplement the inadequate family income (Maloney, 2004). On the other hand, we relate the voluntary entrepreneurship with the second group because its members are willing to sacrifice current profits for higher future profits (regardless of the formalization or not of the microenterprise).

Moreover, there are also two types of starting up subsistence microenterprises: those who appear to have growing potential and those who do not (Bosch & Maloney, 2007). Although it is easy to recognize the bad projects, end up being difficult to identify and support the good ones when they exist. The problem arises by the fact that there is no agreement on the definition of “success” for most of these projects, in the sense that they could be considered as technically apt to invest in the formalization process. Given that there are grounds to reduce the informality phenomenon, Is it possible to contribute to the identification of entrepreneurs that want to and have the technical means to do so?

According to the objectives, there are many ways to measure the microenterprise performance using proxies for business success (Mungaray et al., 2008). Among the monetary ones is usual to consider the evolution of financial criteria such as profitability, costs, sales or profits (Marroquín, 2008). Some authors (Robles, Saavedra, Torero, Valdivia & Chacaltana, 2001), stated that the main factors for determining small businesses health are utilities over sales, average work product and the rate of growth in the number of employees. Measuring the performance based on short-term economic and financial criteria usually provides suitable indicators of both present businesses aspects and growth potential. This is because, first, it is expected that a subsistence microenterprise operation must cease once the level of earnings has allowed it to reach its immediate goals, revealing an inefficient procedure in terms of microeconomic theory; and second, high profits are basic supports -though not necessarily sufficient- for the short term planning activities of the microenterprise.

Many factors can affect (either enhance or inhibit) the micro business development; much of them are related to the proprietor figure (Marroquín, 2008). More so, micro entrepreneur personality defines the business management style (Stokes & Fitchew, 1997). When a micro business is created by a few members of the same family -like in 50% of the time in Mexico (Mungaray et al., 2008)- seems indisputable that economic, social, cultural and family decisions around the day by day of the owners will have a direct impact on the business development level. The main conjecture of this paper is that good financial performance of subsistence microenterprises that begin and develop under marginal conditions, without assistance programs, with poor market tactics and offering low value added, are the result of factors related to the individual characteristics and the simple decisions taken by the micro entrepreneur about his project.

**DATA AND METHODOLOGY**

The input data correspond to socioeconomic information of 962 informal microenterprises surveyed by the Assistance and Teaching for Micro and Small Enterprises Investigation Center of the Universidad Autónoma de Baja California during 2006-2008. The collected data classified by convenience sampling method due to the logistical difficulties in trying to locate subsistence microenterprises. This caused an unavoidable slant towards the opinion of the micro entrepreneurs that actually cooperated, who are part of those with active micro companies at the time when the survey was conducted (it was difficult to obtain information of the extremely poor performance cases because they disappear very quickly). Finally, we treat the data as a cross section.
Table 1: Elements of the Dependent Variable

<table>
<thead>
<tr>
<th>Variable</th>
<th>d Type</th>
<th>d Type</th>
<th>Dichotomous Criterion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Monthly Utilities ($x$)</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Average Monthly Sales ($y$)</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Return on Sales = ($x/y$)*100</td>
<td>Below the first quartile ($Q_1$)</td>
<td>Above the third quartile ($Q_3$)</td>
<td>Mean: 8.74%, $Q_1 = .47%$, $Q_3 = 9.34%$</td>
</tr>
</tbody>
</table>

Dependent variable is structured by the ratio of frequencies between low performance businesses ($d$ type) and high performance businesses ($\bar{d}$ type) based on return on sales.

Table 1 shows the formation of the dependent variable, finally structured by the ratio of frequencies between low performance businesses ($d$) and high performance businesses ($\bar{d}$) based on return on sales ($ROS$). Looking for a higher differentiation between groups, the low performance ones include those sample cases smaller in value than the first quartile, and the high performance microenterprises include all observations higher in value than the third quartile, thus, both groups have the same data size (but not necessarily the same range size).

Table 2: Categorization of Independent Variables Related to the Owners

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Owners’ Variables</th>
<th>$a$, $b$ or $c$ Types</th>
<th>$\bar{a}$, $\bar{b}$ or $\bar{c}$ Types</th>
<th>Dichotomous Criterion</th>
</tr>
</thead>
<tbody>
<tr>
<td>S</td>
<td>Sex</td>
<td>Male</td>
<td>Female</td>
<td>-</td>
</tr>
<tr>
<td>A</td>
<td>Age</td>
<td>Lower than or equal to the criterion</td>
<td>Higher than the criterion</td>
<td>Median: 39 years old</td>
</tr>
<tr>
<td>MS</td>
<td>Marital status</td>
<td>Single (including widowed and divorced)</td>
<td>Married or cohabiting couples</td>
<td>-</td>
</tr>
<tr>
<td>NE</td>
<td>Number of economic dependents</td>
<td>Lower than the criterion</td>
<td>Equal or higher than the criterion</td>
<td>Median: 3 people</td>
</tr>
<tr>
<td>PB</td>
<td>Place of birth</td>
<td>South of Mexico</td>
<td>North of Mexico*</td>
<td>-</td>
</tr>
<tr>
<td>HE</td>
<td>Highest educational level</td>
<td>Middle school completed</td>
<td>Above middle school</td>
<td>-</td>
</tr>
<tr>
<td>SE</td>
<td>Source of experience related to microenterprise management</td>
<td>Self learning</td>
<td>Guided through school, previous jobs or friends</td>
<td>-</td>
</tr>
</tbody>
</table>

The northern states are Nayarit, Sinaloa, Chihuahua, Baja California, Baja California Sur, Coahuila, San Luis Potosí, Nuevo León, Aguascalientes, Tamaulipas, Durango and Zacatecas. The rest of the Mexican states as South.

A list with the definition of the independent variables is in Table 2; data relevance and previous work determines the main selection of variables (Aguilar, Ramírez & Barrón, 2007). When dealing with grouped data no specification problems arise for an adequate sample size. We eliminated all highly correlated variables at a disaggregated level in advance. Since the calculation requires dichotomous data, if the variables are metric (continuous or discrete) in nature, the median is used to divide it.

Nominal qualitative variables of $n$ (>2) categories are differentiated in a way that they provide balanced groups while also maintaining economic sense. About 56% of micro entrepreneurs interviewed were women, 51% had at most 39 years old and 69% were married or cohabiting couples. Concerning microenterprises, 62% are engaged in food production and retail food sales.

Through logit models, Goodman (1972) calculates individual and grouping multiplicative influence impacts of a pool of variables related to the occurrence or not of an event measured as observed proportions. Mamon and Marshall (1977) found and explained that certain agent behaviors are the result of a system of variables of both personal and environmental nature, from which it is possible to determine unilateral, bilateral and multilateral relations. This seminal work laid the foundations for recent literature but in any case explain the performance of microenterprises in Mexico.
Table 3: Categorization of Independent Variables Related to the Microenterprises

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Microenterprises’ Variables</th>
<th>( a, b ) or ( c ) Types</th>
<th>( \bar{a}, \bar{b} ) or ( \bar{c} ) Types</th>
<th>Dichotomous Criterion</th>
</tr>
</thead>
<tbody>
<tr>
<td>MA</td>
<td>Main activity</td>
<td>Food production and retail food sales</td>
<td>Other retail sales</td>
<td>-</td>
</tr>
<tr>
<td>IC</td>
<td>Initial capital</td>
<td>Lower than or equal to the criterion</td>
<td>Higher than the criterion</td>
<td>Median: 180 USD</td>
</tr>
<tr>
<td>ST</td>
<td>Sales tactics</td>
<td>Aspect related to pricing or service provision</td>
<td>Aspects related to quality of products</td>
<td>-</td>
</tr>
<tr>
<td>PM</td>
<td>Pricing mechanism</td>
<td>Market based</td>
<td>Cost based</td>
<td>-</td>
</tr>
<tr>
<td>CF</td>
<td>Credit facilities to clients</td>
<td>No</td>
<td>Yes</td>
<td>-</td>
</tr>
<tr>
<td>RPAP</td>
<td>Reinvestment as a percentage of annual profits</td>
<td>Not consistent with ROS*</td>
<td>Consistent with ROS</td>
<td>Median: 50%</td>
</tr>
<tr>
<td>AD</td>
<td>Advertising</td>
<td>No</td>
<td>Yes</td>
<td>-</td>
</tr>
<tr>
<td>AE</td>
<td>Average age of employees</td>
<td>Lower than or equal to the criterion</td>
<td>Higher than the criterion</td>
<td>Mean: 31 years old</td>
</tr>
<tr>
<td>PF</td>
<td>Percentage of profits used for family purposes</td>
<td>Lower than or equal to the criterion</td>
<td>Higher than the criterion</td>
<td>Mean: 51%</td>
</tr>
<tr>
<td>TO</td>
<td>Time since opening</td>
<td>Lower than the criterion</td>
<td>Equal or higher than the criterion</td>
<td>Median: 2 years</td>
</tr>
<tr>
<td>HW</td>
<td>Hours worked by day (operating hours)</td>
<td>Eight hours or less</td>
<td>More than eight hours</td>
<td>-</td>
</tr>
</tbody>
</table>

Not being consistent with ROS for the microenterprise \( i \) occurs when \( ROS_i > \) mean and \( RPAP_i \leq \) median or when \( ROS_i \leq \) mean and \( RPAP_i > \) median. Consistent with ROS occurs when \( ROS_i > \) mean and \( RPAP_i > \) median or \( ROS_i \leq \) mean and \( RPAP_i \leq \) median. In the above calculation, we use the metrical version (non-dichotomous) of the ROS and RPAP variables.

Based on Goodman (1972), we use an unsaturated model of dichotomous variables \( A, B, C \) and \( D \) whose types are \( \{a, \bar{a}\}, \{b, \bar{b}\}, \{c, \bar{c}\} \) and \( \{d, \bar{d}\} \) respectively and with a sample size of \( n \) observations. A “case” will be one of the eight possible combinations for the three independent variables \( A, B \) and \( C \). The observed frequency for the case \((i,j,k)\) with \( D \) as a dependent variable is noted by \( f_{ijkl} \), where subscripts \( i = a \) or \( \bar{a} \), \( j = b \) or \( \bar{b} \), \( k = c \) or \( \bar{c} \) and \( l = d \) or \( \bar{d} \), indicate, respectively, the type taken by the variables \( A, B, C \) and \( D \). We introduce the proportion of frequencies of a type \( d \) over a type \( \bar{d} \) of the dependent variable

\[
\omega_{ijk} = \frac{f_{ijkl}}{f_{ij\bar{k}\bar{d}}} \tag{1}
\]

which is named as the observed frequency ratio and will be considered as the functional form of the dependent variable (Goodman, 1972). The estimated frequency for the case \((i,j,k)\) is called \( F_{ijkl} \) when \( D \) takes on the type \( l \). So,

\[
\Omega_{ijk} = \frac{F_{ijkl}}{F_{ij\bar{k}\bar{d}}} \tag{2}
\]

will be the estimated frequency ratio for the case \((i,j,k)\). The model that combines, in the form of multiplicative form, all the impacts is:

\[
\Omega_{ijk}^D = \gamma^{AD}_i \gamma^{BD}_j \gamma^{CD}_k \gamma^{ABD}_{ij} \gamma^{ACD}_{ik} \gamma^{BCD}_{jk}, \tag{3}
\]

where \( \gamma^{AD}_i, \gamma^{BD}_j \) and \( \gamma^{CD}_k \) represent the individual impacts on \( \Omega_{ijk}^D \), associated to the variables \( A, B \) and \( C \) when their types are respectively \( i, j \) and \( k \); whereas \( \gamma^{ABD}_{ij}, \gamma^{ACD}_{ik} \) and \( \gamma^{BCD}_{jk} \) show the related impact associated to the joint variables \( AB, AC \) and \( BC \) when their types are respectively \( ij, ik \) and \( jk \). We set the term \( D \) at the end of the superscript to emphasize the dependent variable. Expression (3) is the more complex model but there are other \( 2^6 - 1 = 63 \) possible representations for individual and related
impacts in the three variable model that imply that at least one of the impacts is assumed with neutral
effect, i.e., a value of one. In sum, all 64 variants will represent “the family” of hypothesis tests for the
three variables model, which rotate to reach all possible combinations on the set of variables considered
in the analysis. We can advise that (3), is in itself an equations system with as many equations as
combinations without repetition exist in the triplet $(i, j, k)$.

The maximum likelihood method leads to an appropriate solution of (3) because of the structure of the
dependent variable (Powers & Xie, 2008), for which we express the formula as an exponential function as follows:

$$\ln \left( \frac{p_{ijk}}{1-p_{ijk}} \right) = \beta^{AD} + \beta^{BD}_i + \beta^{CD}_j + \beta^{ABD}_{ij} + \beta^{ACD}_{ik} + \beta^{BCD}_{jk}$$  \hspace{1cm} (4)

where the observed frequency ratio is now expressed in an “odds ratio form”, considering that the relative
frequencies for types $d$ and $\bar{d}$, respectively, in the $(i, j, k)$ case, are

$$p_{ijk} = \frac{f_{ijkd}}{f_{ijkd} + f_{ijk\bar{d}}}$$ \hspace{1cm} (5a)

$$q_{ijk} = \frac{f_{ijk\bar{d}}}{f_{ijkd} + f_{ijk\bar{d}}}$$ \hspace{1cm} (5b)

and that $p_{ijk} + q_{ijk} = 1$. Also, the following equivalences has been taken into account to obtain the
expression (4),

$$e^{\beta^{AD}} = y^{AD},$$
$$e^{\beta^{BD}_i} = y^{BD}_i,$$
$$e^{\beta^{CD}_j} = y^{CD}_j,$$
$$e^{\beta^{ABD}_{ij}} = y^{ABD}_{ij},$$
$$e^{\beta^{ACD}_{ik}} = y^{ACD}_{ik},$$
$$e^{\beta^{BCD}_{jk}} = y^{BCD}_{jk},$$

To explore the adequacy of the model and the statistical significance of the parameters, we use the chi-
square test based on the likelihood ratio,

$$\chi^2 RV = 2 \sum_{i=1}^{2} \sum_{j=1}^{2} \sum_{k=1}^{2} \sum_{l=1}^{2} f_{ijkl} \ln \frac{f_{ijkl}}{f_{ijkl}}$$ \hspace{1cm} (6)

that is used as a goodness of fit test (and not as a dependency test) allowing to realize the following left
tailed hypothesis test

$H_0$: There are moderate similarities between observed and estimated distribution

$H_1$: There are high similarities between observed and estimated distribution \hspace{1cm} (7)

The statistical value of (6) together with the degrees of freedom, are used to calculate the $p$ value of the
hypothesis, interpreted as the probability of obtaining a result as extreme as the one observed, when the
alternative hypothesis is true. We compare the $p$ value with the critical value used for significance
testing, i.e., $\alpha = .05$. 

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EMPIRICAL IMPLICATIONS

The exploratory econometric exercise evaluate complete “families” (64 variants) for all combinations of three independent variables (816 combinations for a set of 18 independent variables according to the combinatorial formula), resulting 52,224 estimates. In search of the most relevant variables we segregate those families with at least 20% of its variants satisfying the condition of $p$ value $\geq .95$ and that 50% of them also complied with $p$ value $\geq .75$. The filter allows the selection of 30 families on which we based the following analysis.

In a broad sense, there is a close relation of highest educational level to sex, marital status and origin of experience, in the case of variables directly linked to the owner and to sales tactics and pricing mechanism when referring to microenterprise decisions. In addition to previous relations, there is a strong connection between marital status and the source of experience but also to the microenterprises’ main activity, sales tactics, time since opening and the percentage of profits used for family purposes. In addition, the origin of experience has close relation with the gender of the entrepreneur, and finds expression in the main activity of microenterprises and the way proprietors set prices. Below, we explain the type, sign and magnitude of the variables included according to econometrics tests.

Figure 1: The Most Significant Test on Sex / Educational Level / Source of Experience

Sex has a frequent and direct impact on the performance of the microenterprises. Specifically, women have higher success/failure ratio probability (Figure 1). Owners’ age appears rarely in tests, but when evident, it always shows a direct impact on performance; having less than 39 years old when managing a business contributes to success. Marital status is one of the most frequent variables according to evidence; not often has a direct effect, but when it does, shows that single micro entrepreneurs are slightly more successful (Figures 2, 3, and 4).

Typically, when the proprietor is married, the best alternative to ensure business continuity is to work beyond a typical workday. Equally, being single facilitate a good microenterprise results by not having the family commitments; therefore, owners may be able to focus more on the business performance without working overtime looking for short-term liquidity. Although it might seem paradoxical, the women entrepreneurs have a higher success rate when they had to play both mother and father roles (single women with three or more economic dependents).
Figure 2: The Most Significant Test on Main Activity / Marital Status / Source of Experience

Additionally, the test yielded the following results: $\gamma^{ab} = 1.0004$, $p$ value = .9705**. Shocks above the horizontal line increase success/failure ratio. Shocks below the horizontal line decrease success/failure ratio. The first three potential bars refer to individual shocks. The three last potential bars are interrelated shocks.

Figure 3: The Most Significant Test on Marital Status / Educational Level / Source of Experience

Additionally, the test yielded the following results: $\gamma^{ab} = 1.0122$, $p$ value = .9784**. Shocks above the horizontal line increase success/failure ratio. Shocks below the horizontal line decrease success/failure ratio. The first three potential bars refer to individual shocks. The three last potential bars are interrelated shocks.

The educational level is the most often presented variable in the results; nevertheless, it rarely displays a direct impact; when displayed, is not entirely clear that the lack of basic education could be a barrier to success. In addition, it is uncommon that subsistence micro business with a minimum performance threshold are being led by someone with high school or higher education, maybe because those promoters would be looking to get higher revenues in others jobs (Figures 1, 3, and 5). The means in which an owner learned the production process and business management normally has no direct impact on performance but it is associated with the highest study degree and pricing mechanisms; nevertheless, having been driven, slightly increases the success probabilities over failure ratio (Figures 1, 2, and 5). Neither the number of economic dependents nor the place of birth have significantly alters the odd ratio.

The microenterprise’s main activity is not a variable that predisposes success or failure in a direct manner but may be essential for others like sex or marital status to appear, reinforcing its individual effects (Figures 2, 3, and 4). Sales tactics has low incidence in the selected tests, but it shows a direct impact stating that -although these businesses serve markets with low purchasing power- product quality rather than pricing or credit facilities, will bring higher profits to microenterprises (Figures 3 and 6). The fact that 62% of the sample is food retailers probably have to do with this order of priorities. Provide credit facilities to clients directly affect the micro business performance (Table 4); it is simple, if subsistence microenterprises want to stay afloat in the market, they should not give credit to their clients. This may
Seem counterintuitive, but in countries with high poverty and inflation rates, and many people with unmet basic needs, the emergence of opportunistic behavior in interpersonal relationships is latent.

**Figure 4: The Most Significant Test on Marital Status / Profits For Family Purposes / Time Since Opening**

<table>
<thead>
<tr>
<th>Marital status (A)</th>
<th>Utilities for family purposes (B)</th>
<th>Time since opening (c)</th>
<th>AB</th>
<th>AC</th>
<th>BC</th>
</tr>
</thead>
<tbody>
<tr>
<td>≤ 51.2 %, 7.85 %</td>
<td>≥ 2 years 8.97 %</td>
<td>≥ 2 years 8.97 %</td>
<td>0.00 %</td>
<td>0.00 %</td>
<td>0.00 %</td>
</tr>
<tr>
<td>&gt; 51.2 %, -7.28 %</td>
<td>&lt; 2 years -8.23 %</td>
<td>≤ 2 years 7.85 %</td>
<td>0.00 %</td>
<td>0.00 %</td>
<td>0.00 %</td>
</tr>
</tbody>
</table>

Additionally, the test yielded the following results: $\gamma_{AB} = .9739$, p value $= .9802**$. Shocks above the horizontal line increase success/failure ratio. Shocks below the horizontal line decrease success/failure ratio. The first three potential bars refer to individual shocks. The three last potential bars are interrelated shocks.

**Figure 5: The Most Significant Test on Educational Level / Source Of Experience / Pricing Mechanism**

<table>
<thead>
<tr>
<th>Educational level (A)</th>
<th>Source of experience (B)</th>
<th>Pricing mechanism (C)</th>
<th>AB</th>
<th>AC</th>
<th>BC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market 5.30 %</td>
<td>Cost -5.03 %</td>
<td>Market -5.03 %</td>
<td>0.00 %</td>
<td>0.00 %</td>
<td>0.00 %</td>
</tr>
<tr>
<td>14.50 %</td>
<td>3.77 %</td>
<td>14.50 %</td>
<td>-3.63 %</td>
<td>0.00 %</td>
<td>0.00 %</td>
</tr>
</tbody>
</table>

Additionally, the test yielded the following results: $\gamma_{AB} = 1.0029$, p value $= .9650**$. Shocks above the horizontal line increase success/failure ratio. Shocks below the horizontal line decrease success/failure ratio. The first three potential bars refer to individual shocks. The three last potential bars are interrelated shocks.

The average age of employees is either a low incidence variable that somehow affects, directly or indirectly the success/failure ratio; when there is a direct influence, the variable acts in the sense that not so young workers have a slightly better opportunity to generate higher profits (Figure 6). *Reinvestment as a percentage of annual profits* is a variable of average importance in terms of its frequency (Table 4); however, as expected, this variable has close relation with the dependent variable through profit level. Those who use most of their income to cover family needs take the risk of having future financial problems or lack of capital. By investing less than 51% of utilities to cover family expenses, the success/failure relationship are increased (Figure 6). Therefore promoters face a critical trade off (the home-microenterprise dilemma) perhaps unwittingly; on any case, it has low relevance as a solely predictor of the microenterprise performance.

*Use of advertising* is a low frequency variable but usually it has a direct effect that reveals that in this kind of business, paid advertising does not always have a significant impact on income. Possibly a cheaper word-of-mouth advertising and a warm and personal customer service have replaced the lack of formal marketing activities, resulting in an implicit behavior towards benefit maximization (Table 4).
Figure 6: The Most Significant Test on Sales Tactics / Average Age of Employees / Daily Operating Hours

Additionally, the test yielded the following results: $\nu_{ad} = 1.0106$, $p$ value $= .9648**$. Shocks above the horizontal line increase success/failure ratio. Shocks below the horizontal line decrease success/failure ratio. The first three potential bars refer to individual shocks. The three last potential bars are interrelated shocks.

Table 4: Summarizing Results of the 30 Families Selected

<table>
<thead>
<tr>
<th>Variables included in test</th>
<th>Impacts (hypothesis)</th>
<th>Goodness of fit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Individual</td>
<td>Interrelated</td>
</tr>
<tr>
<td></td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>S, MA, MS</td>
<td>0.9933</td>
<td>-7.61</td>
</tr>
<tr>
<td>S, MA, HE</td>
<td>0.9862</td>
<td>-6.31</td>
</tr>
<tr>
<td>S, MA, AE</td>
<td>0.9875</td>
<td>-4.92</td>
</tr>
<tr>
<td>S, HE, SE</td>
<td>0.9904</td>
<td>-6.19</td>
</tr>
<tr>
<td>S, HE, ST</td>
<td>0.9996</td>
<td>-6.37</td>
</tr>
<tr>
<td>S, HE, CF</td>
<td>0.9816</td>
<td>-6.62</td>
</tr>
<tr>
<td>MA, A, HE</td>
<td>0.9882</td>
<td>0</td>
</tr>
<tr>
<td>MA, A, SE</td>
<td>0.9853</td>
<td>0</td>
</tr>
<tr>
<td>MA, MS, SE</td>
<td>1.0004</td>
<td>0</td>
</tr>
<tr>
<td>MA, MS, AD</td>
<td>0.9765</td>
<td>-5.34</td>
</tr>
<tr>
<td>MA, MS, PF</td>
<td>0.9870</td>
<td>0</td>
</tr>
<tr>
<td>MA, HE, PF</td>
<td>0.9870</td>
<td>0</td>
</tr>
<tr>
<td>A, HE, SE</td>
<td>0.9953</td>
<td>9.52</td>
</tr>
<tr>
<td>A, SE, PM</td>
<td>0.9874</td>
<td>11.11</td>
</tr>
<tr>
<td>MS, HE, SE</td>
<td>1.0002</td>
<td>0</td>
</tr>
<tr>
<td>MS, HE, ST</td>
<td>1.0122</td>
<td>0</td>
</tr>
<tr>
<td>MS, HE, RPAP</td>
<td>0.9992</td>
<td>0</td>
</tr>
<tr>
<td>MS, HE, TO</td>
<td>0.9894</td>
<td>0</td>
</tr>
<tr>
<td>MS, SE, AD</td>
<td>0.9626</td>
<td>0</td>
</tr>
<tr>
<td>MS, SE, TO</td>
<td>0.9766</td>
<td>0</td>
</tr>
<tr>
<td>MS, ST, CF</td>
<td>1.0006</td>
<td>0</td>
</tr>
<tr>
<td>MS, CF, AD</td>
<td>0.9694</td>
<td>4.46</td>
</tr>
<tr>
<td>MS, RPAP, AD</td>
<td>0.9559</td>
<td>0</td>
</tr>
<tr>
<td>MS, PF, TO</td>
<td>0.9739</td>
<td>0</td>
</tr>
<tr>
<td>HE, SE, PM</td>
<td>1.0029</td>
<td>0</td>
</tr>
<tr>
<td>HE, SE, AE</td>
<td>1.0022</td>
<td>0</td>
</tr>
<tr>
<td>SE, ST, HW</td>
<td>1.0021</td>
<td>0</td>
</tr>
<tr>
<td>SE, PM, RPAP</td>
<td>0.9883</td>
<td>0</td>
</tr>
<tr>
<td>SE, PM, TO</td>
<td>0.9770</td>
<td>0</td>
</tr>
<tr>
<td>ST, AE, HW</td>
<td>1.0106</td>
<td>-10.00</td>
</tr>
</tbody>
</table>

$\chi^2 - LR$: likelihood ratio; df: degrees of freedom. Impacts shown are only of type a, b or c and its interrelations.

Microenterprise’s age acts usually as a complement for other variables; when acts directly, occurs that in the short time since opening microenterprises are more susceptible to disappear. Having survived the second year of operations increases the possibility of staying alive in the market near future (Figure 4). Pricing mechanisms are a necessary support for others variables, but is not clear how it could be favorable for a microenterprise, whether to fix prices based on competition or on costs plus methods (Figure 5).

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Surprisingly, the initial capital was not decisive for the microenterprises performance. Figure 7 summarizes the main statistical results of the 30 families selected.

CONCLUSIONS

This paper analyzes the factors that influence microenterprise performance when they emerge from socially and economically marginalized environments through logit models estimated by maximum likelihood. The study aims at determining the nature of the factors that occur with greater frequency and strength in entrepreneurship that emerges despite of and because of disadvantaged conditions in Mexico. We use socioeconomic data of 962 informal retail units provided by the Teaching and Assistance Center for the Investigation of the Micro and Small Enterprises (Baja California) for the years 2006 to 2008. We treat the data as a cross section allowing testing a wide range of hypotheses through unsaturated models of dichotomous variables. Results show that the profits of subsistence microenterprises could be partially determined by factors related to their owners and by the decisions made from them on a personal and entrepreneurial environment. We must highlight that it is possible to know many of these variables even before the project starts operating. The most common variables found are endogenous (usually although not always- controlled), e.g., educational level, marital status, source of experience and main activity; most of them intrinsic characteristics of the proprietor and some own decisions. Subsistence microenterprise does not seem to depend crucially on external factors to find a guaranteed minimum niche market. In addition, other variables that do not fit like previous ones, but provide a direct impact on performance when they are present like sex, owners’ age, sales tactics, advertising management and credit facilities to customers.

These findings are important to consider during the design of entrepreneurship support programs, micro credits and territorial distribution planning. The perception of subject of assistance, training and how the subsistence microenterprise are important because the initial capital, by itself, does not guarantee a good performance or that spend on advertising could be critical in this kind of microenterprises. Definitively, not all entrepreneurs are the same. This shows that there is an important opportunity to launch an industrial policy that considers success factors of subsistence microenterprises and raises awareness of their importance, especially for micro entrepreneurs. Perhaps they, individually, do not contribute to local development and economic expansion but ignoring them may be more costly in terms of national stability. It could also be possible focus limited resources on those projects that have a specific entrepreneurship profile thus ensuring that they can be able to consolidate themselves as an answer to a better lifestyle for their families (Aguilar et al., 2009).

The lack of relevance of the data and of the robustness in some definitions are the main limitations of the paper, explained by an incomplete universe of variables because we use a secondary source of information and the questionable measure for microenterprise success considering the marginalization environment on which they operate. Further investigation on this matter will focus on alternative success measurements, not necessarily financial; and to the practical differentiation of an involuntary and a voluntary micro entrepreneur.

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GREY MARKETING A CAUSE FOR ANALYSIS OF PRICE AND DISTRIBUTION CHAIN DEFICIENCIES

Igor Pustylnick, SMC University, Zug, Switzerland

ABSTRACT

The vast majority of grey marketing cases are not discovered until the matter is brought before courts of law or arbitrage tribunal. Because of this, it is hard to build the dynamics of an average case and draw conclusions on the phenomenon in general. This paper observes a real life grey marketing case from its inception to the eventual winding down. This case shows the effects of the grey marketing do not only inflict damage to the bottom line of the original manufacture. They also set consumer expectations for lower product prices. Grey marketing pricing strategy appears to serve as a guideline for pricing policies of makers of competing products entering the market.

JEL: M16, M19, M31

KEYWORD: Grey Marketing, Pricing, Distribution Chain, Price Strategy, Competitive Pricing

INTRODUCTION

Grey marketing refers to the process of selling legitimate trademarked goods through the non-authorized channels. According to (Pikard, 1996) “Grey marketing occurs when one party possesses the exclusive right to sell a certain product designated by a trademark in a certain area, and another party sells similar products in the same area under the same trade name.” This definition requires the presence of two conditions: (1) The existence of the agreement of exclusive rights to sell a certain product in the territory, (2) The existence of a strong registered trademark, which is recognized in a territory where a potential grey marketing activity may occur.

Despite the relative ease with which they may develop, the appearance of grey marketing is not frequent. For grey marketing to exist the product must be superior to others in the category, like Porsche cars or Rolex watches. (Schuster, 2010) describes a recent case of grey market sales of Omega watches. The product is perceived as significantly overpriced by a relatively large group of consumers.

Grey marketing usually appears because of the combination of aforementioned conditions. In many cases, grey market goods appear in the retailer’s hands through a maze of semi-legal operations, which can generate a legitimate interest from the authorities. The progress of international trade and increases in the number of multinational and global organizations around the world have spurred the creation of a large number of distribution channels and equally large number of entities. The purpose of these entities in the trade cycle is to act as an intermediary between the source, which is not necessarily a manufacturer, and the destination, which is not always a retailer or a consumer. These organizations have formed a rather impenetrable supply chain for each element of a non-productive entity generating its own profit. Through this chain, the price of goods can increase three or even fourfold without any measurable changes in a product itself. It is possible for small entrepreneurial companies to purchase the goods legitimately in one part of the world, move them to the other part of the world, sell them at a markup generally acceptable in the destination country. They are able to do this by setting the price well below the same product price in the legitimate distribution chain. The combination of these four conditions forms a viable opportunity for the creation of a grey market for any product.

This paper starts with a literature review that describes the state of today’s research on grey marketing and related topics. It follows with a description of grey marketing. The next section discusses the finding
and shows the methods of fighting grey marketing strategies. The last section of the paper draws conclusions and presents further research suggestions.

LITERATURE REVIEW

Grey marketing is regulated by the country of import. Each country has its own process of settling grey marketing cases. In the USA the definition and clauses of grey marketing are regulated by the Lanham Act, which accordingly to (Curley & Ferry, 2006) and (Schonfeld, 2010) gives the trademark owner full rights to decide who will sell the goods in the USA. However, with the advent of the Internet and e-commerce the definition of sale became even more blurred. The retailer of goods may reside in one part of the world and the buyer can potentially reside anywhere else. The Internet sale transaction may be executed in the country where Lanham Act or similar legal norms are not applied. The delivery of the product to the customer appears from the legal standpoint as the sending of a simple legal mail parcel from one country to another. In the case of grey marketing, the importer of goods does not break any import laws of the country they reside in. The surface legality of grey marketing allows them to persist over a long period since it takes time for the manufacturer to detect the illegal sales (Mendelsohn & Stanton, 2009).

(Chen, 2002) argues that persecuting grey marketing efforts of importation and selling goods yields an unfair advantage to legal distributors of goods thus creating a monopoly for selling the products. Entrepreneurs see grey marketing as an opportunity to sell goods at a lower price based lower costs during the acquisition and importation process (Brooks, 2010). Grey marketing largely constitutes a response by the market to the creation of a rigid distribution structure by the manufacturer of the goods or the trademark. Clarke 3rd and Owens (2000) and Beard, Kaserman & Stern, 2009 discuss dependency between the efficiency of the organization itself and efficiency of the underlying price structure.

As stated earlier grey marketing is only possible if the product is of excellent quality, it is sought by consumers and is perceived as overpriced. Grey marketers would endeavor to import and sell the product in the target country only if the product cost of delivery to the market would be significantly lower. Hence, the grey marketer still makes a profit by selling the product at a lower price. (Mathur, 1995) (Carrigan, 1999) explore the relationship between older (50+) consumers and retailers and shows that poor treatment of customers can also pave way to the appearance of the grey market for a certain product.

The main cause of a grey market is the division of responsibilities inside the product distribution chain. When the product first appears and is sold locally the product manufacturer undertook marketing and distribution efforts in order to deliver the product to the retailers. As the enterprise of making the product grows, the manufacturer attempts to segregate them from the distribution process and concentrate all efforts on R&D and manufacturing. At this stage of product development, the manufacturer seeks the alliances with companies, which would take over distribution of the product in a certain territory (Lee, 2006).

According to (Huang, Lee, & Hsiao, 2008) the distribution company does not strive to improve the product or fit it to the needs of the consumer. It simply owns the trademark for the territory of distribution, which gives it exclusive rights to deliver the products to retailers. In some cases, the manufacturer retains the right to influence price policies. However, in the vast majority of instances the distributor has exclusive rights to set the product price for the territory it operates. When the market is perfectly competitive, the distribution company has no other choice but to compete on price with distributors of similar products. In this case, the distribution operates by installing a market acceptable markup over the overall product cost. When the market is monopolistically competitive, distributors may apply a higher markup to a high quality product, which in the perception of the consumer has no analogs to the market (Argenton, 2010).
Monopolistically competitive markets usually create perfect conditions for product overpricing. If the product is mass-produced and sold in many places around the world, this approach to pricing can create conditions for the emergence of a grey market. (Frentzen & Nakamoto, 1993) underscore the importance of information flows in any market. Consumers make purchasing decisions based on the options presented to them by the operators of the market. (Gal-Or, 1988) states that incomplete information may seriously hurt the ability of market players to make a correct decision. (Livnat, 1986) shows that market equilibrium can shift based on the appearance of information to buyers and sellers. Grey markets appear in part because consumers lack information on the proper value of the illegally sold product and on the availability of substitutes of equal quality.

(Felten, 2010) notes that the appearance of grey marketing shows the possibility for price arbitrage similar to that observed in currency trading. However, it can be argued that in the market for tangible goods the ability to extract gains from alternative routes of product delivery is much smaller than in foreign currency trades. Despite the fact that financial damage to the company might not be large, (Eagle, Kitchen, Rose, & Moyle, 2003) argue that the value of brand equity can be seriously diminished by grey market activities.

CASE DESCRIPTION

The market for knitting needles has always been a two-tier market. The first tier contains needles of premium quality, which are coveted by consumers. These needles are made out of chrome plated aluminum tubes, high quality bamboo, wood such as birch or beech, bones and dairy byproducts. The price of these needles rarely reflects the costs of manufacturing and is set based on the estimation of the price consumers are willing to pay. Customers buying these products are aware of their superior qualities.

The second market tier is comprised of low quality bamboo needles as well as needles made of inexpensive steel and plastic. These needles are often made in countries with less expensive labor and sold all over the world under different brand names. Inexperienced knitters buy these products mainly because they are not sure if they would want to practice the craft or move on to other endeavors. Knitters must make a significant investment into good quality premium-tier needles in order to satisfy their needs. It is customary for an average knitter to have 8-10 sets of needles of different diameters. Professional knitters usually have multiple sets of needles of the same diameter which they use on a knitting project or multiple knitting projects simultaneously. Many cases of grey marketing are reported when the process of illegal import and sales of goods is detected by the owner of the trademark. Because of this, many cases lack both continuity and dynamics when reported in the mass media and are examined in scholarly papers. The case described in this paper was a staged experiment, which was observed from its inception to the time the grey marketing efforts were shut down.

The case under review is a real world example of grey marketing, which happened in Canada in 2004-2009. The owners of the company involved favor Russian Style (Vilensky & Pustylnick, 2009) of knitting, which have a very smooth surface. One of the owners acquired this habit while using Russian manufactured steel needles with chrome-plated surface. After serious consideration, the Russian needles were deemed not suitable for import because Russians do not produce needles thicker than 5 mm.

Taking into consideration the requirements of the Canadian knitting market, which has a demand for needles of 2 mm -12.5 mm and sometimes even thicker, the company decided on using similar chrome plated needles produced in Germany, (called Product A in this paper). However in North America the same needles were distributed by another company which was not a division of the manufacturer, and was granted an exclusive right to distribute and sell these needles anywhere in North America including Canada.
The distributor struck the agreement with a distribution partner in Canada, which had a right to represent itself as a Canadian affiliate of the major North American distributor. Information on the real cost of Product A for both distribution entities is private and confidential. This paper uses the estimated price based on certain assumptions for illustration. Table 1 represents the transformation of price as the needles are passed through the distribution channels. It is assumed that the Canadian distributor used Canada Post services to deliver the needles. If they use a courier, the retail price might have differed.

Table 1: Distribution of Price in Supply Chain

<table>
<thead>
<tr>
<th>Step</th>
<th>Price of the Product</th>
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<tbody>
<tr>
<td>Main Distributor</td>
<td>$8.00 USD</td>
</tr>
<tr>
<td>Canadian Distributor</td>
<td>$12.00 USD</td>
</tr>
<tr>
<td>Transportation Cost</td>
<td>$2.00 USD</td>
</tr>
<tr>
<td>MSRP (Ontario)</td>
<td>$24.00-26.00 USD</td>
</tr>
</tbody>
</table>

This table displays a gradual accumulation of price value of a pair of Product A as the product moved along the supply chain.

The price of the products consists of the cost of manufacturing, delivery to the consumers and an acceptable profit margin. The manufacturer can use a marginal cost model as they are in control of the manufacturing process. Distributors are more used to the cost-plus or full-cost models which gives them control over the fluctuation of currency rates and manufacturer costs. It is also common in North America to use the “double cost MSRP”, which suggests that MSRP (or DSRP in the case of a distributor being a price setter) should be set as double the wholesale product price. This formula would cover all costs incurred by the buyer as well as the collateral costs of advertisement and stale stock. This pricing scheme also takes into consideration that no more than a half of all products would be sold at the suggested price and that the retailer would conduct dump sales of stale stock at significantly lower prices.

Product A, Bamboo and Dairy needles presented in Table 2 represent a premium product segment, whereas the rest of the competition represent low-end needle brands. Product A clearly dominated the premium market segment because of product versatility and superior quality. Besides the excellent quality chrome-plated surface, its circular variety also had a very flexible non-cringing cord, which is extremely useful in knitting socks using the Magic Loop technique.

Table 2: Needle Product Market Shares

<table>
<thead>
<tr>
<th>Type/Brand</th>
<th>Percent of Market Share</th>
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<tr>
<td>Product A</td>
<td>13%</td>
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<tr>
<td>Competitor A</td>
<td>20%</td>
</tr>
<tr>
<td>Competitor B</td>
<td>40%</td>
</tr>
<tr>
<td>Competitor C</td>
<td>20%</td>
</tr>
<tr>
<td>Bamboo (All Brands)</td>
<td>6%</td>
</tr>
<tr>
<td>Dairy (All Brands)</td>
<td>1%</td>
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</tbody>
</table>

This table displays percentage of market shares for various types/brands of needles at the time when grey marketing case started.

The product sold as a grey market product usually causes changes in the structure of the market. The consequences of grey market differ based on the extent to which the grey market retailer has access to the product consumers. In order to keep a low profile as well as to keep prices as low as possible, a grey market retailer does not advertise the product on the same scale as the original manufacturer or distributor. The most common marketing approach for grey market goods is viral marketing (Dasari & Anandakrishnan, 2010). Knitting is a social hobby and many knitters assemble into guilds or collectives in order to spend few evenings a month indulging in their hobby.

These groups usually discuss the product prices and share information about bargains and below market prices for yarns and needles. At the same time, the grey market retailer has to assume full responsibility for faulty products including the costs of replacement or repair of faulty products into their price model.
The market for the premium product exists as long as the product remains relatively expensive and relatively unaffordable to large numbers of consumers. Grey markets for the same product may decrease the longevity of the original market. In this case, grey market retailers would not be able to sustain the level of sales they enjoyed originally thus decreasing the viability of the grey market for a product. In the knitting needles market there are two trends which play role in the original appearance of the grey market: (1) The buyers and the potential buyers of the premium product see the opportunity to buy a premium product for lower price; (2) The buyers of the second tier products can be convinced that the difference in price is much lower and that the premium quality product yields other tangible benefits to the user. As a result, the initial acceptance of the grey market price scheme was high and the grey marketer reaped tangible benefits causing the legitimate distributor a significant loss in revenue. In time, the grey market retailer saturates the segment of the market most susceptible to bargains and the amount of sales naturally drops. Hence, this market appeared relatively short lived. Table 3 illustrates this trend by using the sales of Product A of the grey marketer.

Table 3: Sales of Product A per Year

<table>
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<tr>
<th>Year</th>
<th>Quantity Sold (100s)</th>
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<tr>
<td>2004</td>
<td>627</td>
</tr>
<tr>
<td>2005</td>
<td>950</td>
</tr>
<tr>
<td>2006</td>
<td>930</td>
</tr>
<tr>
<td>2007</td>
<td>615</td>
</tr>
<tr>
<td>2008</td>
<td>497</td>
</tr>
<tr>
<td>2009</td>
<td>176</td>
</tr>
</tbody>
</table>

This table displays distribution of sales of Product A (in 100s) per each year of the grey marketing case.

As Table 2 shows peak sales are reached soon after the company made a decision to import the goods through the alternative channel. Despite relying only on the viral marketing the grey marketer reached the peak sales in the second year. During the third year of grey market operations, the primary distributor and manufacturer, who made every attempt to stop grey market sales, detected the company’s efforts. These efforts together with the relative market saturation caused drops in sales with subsequent decision to exit the market by the grey marketer. This case clearly suggests that grey markets even if they are not targeted legally with “cease and desist” orders are not sustainable in the long run because they target only those consumers who are willing to find the lower priced goods and are not interested in the potentially illegal character of the sales.

DISCUSSION

A small entrepreneurial company would consider involvement in the grey market based on the perceived possibility of the price arbitrage. For the arbitrage to exist there should be a glaring discrepancy between the costs of the products in different parts of the world. This inconsistency in costs must offset the costs of delivery, the costs of sales and the costs of upholding the warranty and replacements by a grey marketer in order to create a consideration for the price arbitrage. The grey marketer must also take into consideration the short life span of the grey market and the possibility of both injunctions and barriers created by the owners of the legal distribution channels. (Champion, 1998) admits that simulations of grey marketing schemes indicate that these schemes are bound to be short-lived which is supported by the findings of this case.

While considering the possibility of arbitrage, potential grey marketers must also consider that involvement in the grey market of any substantive size would require a large initial investment. Regular distribution in North America uses a net 30 price model for the distribution of goods to retailers. By using this model, any retailer has 30 days of sales of the merchandise before they are required to make a
payment to the distributors. The relationship between the paying distributor and the manufacturer is even more relaxed and net 60 or 90 models are often used.

Grey market distribution requires the company to buy the goods outright by paying the full price at the time of purchase. One of the reasons for this lies in the fact that the grey market retailer and the catering distributor want to stay under the radar and reduce interactions to the absolute minimum in order to maintain a business relationship for an extended period. On the other hand, the channels of goods acquisitions for a grey market are often located in parts of the world that do not accept any form of payment other than cash on purchase. The company considering grey market retail must include the cost of capital invested in the purchase of goods in order to create a full arbitrage picture.

For consistency we consider the manufacturer of the good is the owner of the original trademark. Although a distribution company can own a trademark on the certain territory, the overall ownership of the trademark belongs to the manufacturers. Quite often independent distributors of the product attempt to secure the distribution rights for a long period. This policy is based on the consideration that introduction of the product to the market of a significant size such as North America may take a fairly long time and will be met with sizable resistance by the consumer community.

This existing order of things locks a manufacturer out of the price setting process. The distributor becomes the only influential price setter on a certain territory. Agreements between the manufacturer and distributor often dictate only the volume of product which distributor must purchase or order from manufacturer in order to continue the relationship. Quite often, the distributor decides to set the price artificially high in order to maintain the status of the product as a premium purchase.

E-commerce creates significantly more transparency in any market of consumer goods including the market for knitting needles. The manufacturing company attempts to use the same price scheme for all its distributors in order to avoid conflicts which can potentially result in a legal action especially in the USA. In the USA unjustified price discrepancy is explicitly forbidden based on the Robinson - Patman act (Beard, Blair, Kaserman, & Stern, 2009). In this case, it is the responsibility of the distributors of the product to set the prices in a manner to exclude the possibility of an arbitrage within their distribution territory. In the described case of Product A, there were several attempts other than the one by the grey marketer discussed here to sell the needles in North America via Internet at prices significantly lower than the price set by the major distributor.

Hence, the manufacturer of the products has only two viable options. One possibility is to set a price which would deny the possibility of the arbitrage. A second possibility is to fight the grey marketing of its products through injunctions. The deficiency in price strategy can be attributed to the excessive independence given to the distributor over setting the price in a certain distribution territory. It can also be attributed to the improper positioning of the product. Pricing a luxurious and premium product would attract grey marketers much faster than when the product is priced to sell. Hence, in the case of positioning the product as a luxury item the product manufacturer must have more control over the product distribution (ex: luxury cars).

(Lin & Lin, 2010) state the appearance of substitutes in monopolistically competitive markets is highly probable. The feature differentiating a leading brand of products is always a target of copy by white labels and competition. In the case of grey market products, we consider products as substitutes which have similar features, comparable quality and the price, which rivals the price set by the grey market retailers. There is no visible connection between the appearance of a grey market for a certain brand and the appearance of substitutes. However, in some cases the price setting strategy of grey market retailers can spur the creations of equally priced substitutes of comparable quality. Unlike grey market goods, the
substitutes are legal. The manufacturer of the product can change its features in order to differentiate from the substitutes or reduce the price in order to make substitutes less viable.

After the grey marketer in this case entered into the market for Product A, several substitutes of comparable price and quality appeared on the knitting needle market. All these needles are made out of chrome plated aluminum tubes. They all sport flexible non-tangling cords, which make them as versatile as Product A. Company X made the first entrance. The original retail price of their needles was set at $10-15 but have since been lowered. Since 2008, two companies: Distributor A from China and Distributor B from Germany entered the North American market. The MSRP of the needles vary from $10 to $15. In 2010 despite being considered, the best in the industry, Product A was priced out of the competition. Table 4 shows the pricing by the competitors.

Table 4: Comparative Sales Prices of Premium Needle Products

<table>
<thead>
<tr>
<th>Company</th>
<th>Price</th>
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</thead>
<tbody>
<tr>
<td>Company X</td>
<td>$7.00 USD</td>
</tr>
<tr>
<td>Distributor A</td>
<td>$11.00 USD</td>
</tr>
<tr>
<td>Distributor B</td>
<td>$7.00 USD</td>
</tr>
<tr>
<td>Product A</td>
<td>$15.00 USD</td>
</tr>
</tbody>
</table>

The table shows Manufacturer Suggested Retail Prices for each of the products in the Product A-like needle market.

Out of three competitors, Company X does not wholesale the needles. Because of its size, the company manufactures its own needles and has an obvious advantage on the internet market. On the retail market both Distributor A and Distributor B, have products with prices lower than Product A. The quality of the needles become virtually identical and the customers are switching to the more affordable product.

Manufacturers of premium products must always consider the product may be out-priced or even outright replaced by substitutes. The manufacturer cannot control the quality of substitutes as compared to their own products. A grey market sets the new acceptable price for the products. Elimination or reduction of the grey market can give a manufacturer temporary relief from the onslaught of the grey market retailers. However, the price set by the grey market is the price that will be targeted by the manufacturers of substitutes entering the market. By the time substitute products enter the market the manufacturer of the original product being targeted must be ready to come out with a product containing new features to differentiate the product while maintaining the price.

This paper does not consider distribution channels, which are fully dependent on the manufacturer for its price setting policies. However, it is important to discuss the channels which have a large degree of autonomy over price setting in their territory. According to (Myers & Griffith, 1999) tightening control over the distribution channels’ policies is one of the most effective ways of fighting grey market attempts. Grey market retailers use legal channels in order to deliver goods to the consumer. They pay the applicable tariffs and duties and charge all applicable taxes as well. In many countries, these activities are considered legally entrepreneurial. The laws of the USA allow the owner of a trademark to get a court injunction related to the sales goods, considered part of a grey marketing scheme. However, the onus lies on the trademark owner to prove that the trademark infringement indeed occurred.

In the case of Product A, the North American distributor marketed the needles under a different trademark. They used a different color scheme for packaging in an attempt to distance itself from the manufacturer thus concealing its identity. In the attempt to fight grey market sales, the North American distributor had to change the packaging to resemble the original used in Europe. They also had to display the original trademark to make sure that the infringement is easily traceable. It is the goal of the grey marketer to piggyback on the name and the reputation of the product sold. Hence, the distributor owning
the trademark has to abandon the attempt to re-brand the product and stay as close as possible to the original product trademark to be successful in fighting grey marketing efforts.

Grey marketing is an indication of deficiency in the price policy of a manufacturer or distributor of a product. There is no single set of rules applicable to all products anywhere in the world. However when, as in the case of Product A, the price of the product sold by the distributor is almost double the grey market price, there is early indication that the price of the product is not justified by market conditions. The owner must realize that customers, spoiled by grey market prices will not be willing to return to the original pricing even if the grey market retailer ceases to exist. Another reason for price adjustment is potential saturation of the market at a lower price through grey market sales. If the distributor is not willing to adjust prices they may face reduced product demand by the time they finished fighting the grey market retailer in court. It would be much more efficient to fight the grey market using the market mechanisms of price adjustment. As stated earlier any grey market retailer must make a substantial upfront investment into the potential grey market goods. They must see a clear potential for an arbitrage, which would allow them to return their initial investment and earn a profit. Reducing the price of the product sold over legal channels may stop the grey marketing scheme at its inception and protect the legal distributor of the goods.

In many cases a distributor attempts to secure the largest possible territory for their distribution efforts in order to achieve maximum gains from their endeavor. Sometimes the distribution mechanisms are not properly aligned with the transportation mechanisms available in the territory of distribution. This causes larger transportation costs which are inevitably used in forming the retail price. The appearance of the grey market indicates that the overall retail price is too high and that the transportation factor may be to blame for the price escalation. In the case of Product A, both North American and Canadian distributors are located on the Pacific Coast. While both companies enjoy ease of communication with each other in the same time zone, the price of transportation through the territory of Canada, especially to the large Eastern markets of Ontario, Quebec and to the lesser extent the Maritime Provinces, is extremely high. To fight grey marketing in the East, it would be more prudent for the primary distributor to set up a distribution centre in Eastern Canada, which would cater to the aforementioned regions. The reduced retail price of the original product would offset the damage done in the East by the grey marketing efforts.

CONCLUSION

The main goal of this paper was to observe a real life grey marketing case from its inception to winding down. The observations are valid only for the case under review. The case shows that grey marketing indicates deficiency in the price strategy (the grey marketed product was significantly overpriced). The paper suggests two potential causes for overpricing: (1) overestimation of positioning of the product, correlating with (Thompson, 2009) and (2) potential poor structure of the distribution chain (Lim, Lee, & Tan, 2001). However, it is important to underscore that although grey marketing has a damaging effect for the company price strategy and especially the bottom line, the company can use it to its own advantage. Long and well-established businesses sometimes become oblivious to changes appearing in the market for a certain product. It is important for the manufacturer to have a good feel for how their distribution chain performs. Even without tracing the full chain of delivery of goods forming a grey market, the manufacturer can detect and potentially correct the pricing strategy of the original product. This correction would eliminate or reduce the threat of grey marketing.

Price setting schemes set by grey marketers are dangerous to the original product manufacturer’s bottom line. By employing reduced prices, grey market retailers prompt consumers to expect lower pricing. The makers of substitutes use the price set by grey marketers as a benchmark for entry prices of their products. As a result, the manufacturer of the original product faces a threat from new entries to the market in addition to the one they face from grey marketing. Any market is based on the market laws set by
microeconomics. Grey marketing is a manifestation of these laws showing the price setting strategies of a product have to be corrected. The outcome of this study is consistent with the findings of (Lee, 2006), (Thompson, 2009) and (Antia, Bergen, & Dutta, 2004). The owner of the price strategy must treat grey marketing as an indicator of existing faults in their own price strategy rather than an illegal menace (Berman, 2004).

Further research on the subject should include the comparison of multiple grey marketing cases. We could observe in the described case the short lifespan of the grey marketing suggested by using the market simulations (Champion, 1998). Comparison of the dynamics of several cases may yield proof of the quick deterioration of sales by the grey marketer. This practical observation would add solid support to the conclusions made in the research.

REFERENCES


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BIOGRAPHY

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