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Editors

Stephen J.J. McGuire, California State University, Los Angeles  
and  
Deborah Walker, Fort Lewis College

## *Journal of Case Research and Inquiry*

California State University, Los Angeles  
5151 State University Drive, STF 709  
Los Angeles, CA 90032 U.S.A.

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## **Western Casewriters Association**

The Western Casewriters Association (WCA) is the Western regional association of business casewriters. Its purpose is to train, develop and support business case writing for research and pedagogical purposes. WCA organizes an annual conference for experienced and new case-writers and academics using cases for teaching, and publishes the *Journal of Case Research and Inquiry*. [www.westerncasewriters.org](http://www.westerncasewriters.org)

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### ***JCRI Webmaster***

**Ludwig Slusky**, California State University, Los Angeles, [lslusky@calstatela.edu](mailto:lslusky@calstatela.edu)

## JCRI Editorial Policy

### ***Aim and goals***

The *Journal of Case Research and Inquiry* (JCRI) is a publication of the Western Casewriters Association ([www.westerncasewriters.org](http://www.westerncasewriters.org)). The *Journal of Case Research and Inquiry* publishes peer-reviewed teaching case studies (cases) prepared from primary and secondary research, as well as pedagogical notes and scholarly articles concerned with case research and teaching with cases. The journal publishes one issue per year, and if submissions so merit, may publish additional issues with editorial board approval. Cases, notes, and articles published in the journal are available online, full text, and free of charge at [www.jcri.org](http://www.jcri.org).

### ***Scope***

The journal publishes cases that address significant contemporary and perennial issues faced by organizations and managers in the areas of business and public administration, nonprofit management, social entrepreneurship, and public policy. All cases are necessarily accompanied by instructor manuals (IMs) that are not published but may be provided to the instructors upon request. All cases and IMs are double blind peer-reviewed by at least two reviewers. Cases may be derived from primary field research, secondary research, or a combination of both. JCRI does not accept fictional cases, nor cases, notes, or articles previously published elsewhere. Case authors are required to obtain release forms, when necessary, from the organizations studied.

Pedagogical notes that accompany a given case may also be published; notes may be summaries of industry characteristics and trends, or theoretical or legal analyses useful in the understanding of a case. All notes are blind peer-reviewed by at least two reviewers.

Finally, the journal publishes scholarly articles addressing significant issues related to case research, case writing, and teaching with cases. All articles are blind peer-reviewed by at least two reviewers.

### ***JCRI open source availability policy***

Cases, notes, and articles are available online at [www.jcri.org](http://www.jcri.org) at no cost to instructors and students at state and nonprofit educational institutions, who shall be granted the right to reproduce them for educational purposes. The journal shall encourage instructors to include in their course syllabi links to the JCRI website so that students can easily access cases, notes, and articles. For reproductions for commercial purposes in textbooks or elsewhere, authors shall retain all rights.

### ***Submission of manuscripts***

Authors should submit manuscripts electronically to [editor@jcri.org](mailto:editor@jcri.org). All submissions must follow the JCRI submission guidelines available in detail at [www.jcri.org](http://www.jcri.org). The minimum requirements for submission shall be:

When submitting manuscripts, authors should submit two WORD files, attached to a single email to [editor@jcri.org](mailto:editor@jcri.org). Each file sent to the journal should be saved with a name that clearly identifies the manuscript short title, type of manuscript, and date. At no place in any document except the Submission Form should authors be identified.

The first WORD file should contain the SUBMISSION FORM and the CASE SYNOPSIS (for cases) or ABSTRACT (for notes or articles). (See submission guidelines). This document contains the information required for contacting the author(s). It is used only by the editor and authorship is not revealed to reviewers. Please do not send PDF files to the journal.

The second WORD file should contain the CASE and INSTRUCTOR'S MANUAL (IM) for cases, or the NOTE or ARTICLE. (See submission guidelines).

In all documents submitted, use a size 12 Calibri font, 1 ½ spaced for text. Use a size 10 Calibri font, single spaced, for Exhibits, Tables, Appendices, Footnotes, Endnotes, Financial Statements, and References. Leave a one-inch margin on the top, bottom, and sides of all pages. Align text with the left except for major titles, and do not "justify" the text. Number (starting with 1) all pages of each document. Do not submit more than two files. Include any charts, graphs, figures, images, or photographs in the manuscript in the approximate place where it should be included. While IMs, notes, and articles may be written in the present tense, by convention all cases should be written in the past tense (e.g., "In 2015, Widgets-R-Us was the global leader in widget manufacturing.")

JCRI is an online publication. Case authors are encouraged to include photos, maps, links to websites, embedded videos and other features that take advantage of the internet.

#### ***Review policy***

At the editor's discretion, a submission to the journal may be rejected without a full review, particularly if the manuscript does not align well with the aim and scope of the journal.

Otherwise, all submissions shall be blind peer reviewed by at least two qualified reviewers. Authors shall receive the two reviewer's comments, together with a decision (reject, revise and re-submit, accept) by the editor. Unless approved by the editorial board, no cases or papers shall be invited and none published without undergoing the peer review process.

#### ***WCA Membership requirement for authors***

There shall be no fees to publish in the journal, however the policy of the journal is that at least one author must be a WCA member for the year in which the case is published. To join WCA, please visit [www.westerncasewriters.org](http://www.westerncasewriters.org)

#### ***WCA conference cases***

Authors of cases presented at the WCA conference will be invited and encouraged to submit their work to the journal. However, all submissions (whether presented at a NACRA, WCA, or other conference) will undergo the peer review process. No paper - even a WCA award-winning case - shall be guaranteed publication in the journal.

#### ***Content of the journal***

Published manuscripts may include CASE STUDIES, NOTES, and ARTICLES, which will be duly identified in different parts of the journal

- ***Case studies*** - The main part of the journal shall contain peer reviewed teaching case studies (cases) by authors who conducted primary research, secondary research, or a combination of both. Cases shall be about real organizations or managers facing issues in business administration, public administration, nonprofit management, or social entrepreneurship.

Cases must be submitted together with complete instructor manuals (IMs). IMs shall not be published in the journal, but shall be peer reviewed together with the case.

- **Notes and exercises** - A second part of the journal shall contain peer reviewed Notes, which can be summaries of literature, theory, or industry descriptions designed to be assigned to students together with cases. Peer reviewed Exercises may be short case-like assignments that provide less context about the organization and its environment than do cases studies but permit some of the learning associated with the case method.
- **Articles** - A third part of the journal may contain peer reviewed scholarly articles which may address issues related to case research, teaching with cases, publishing case studies, and other topics related to case research.

### **Release forms**

The journal shall require signed release forms from organizations, which must be collected by case authors for any case to be published that was carried out using primary research. The journal shall not publish a case based on primary research without a signed release form.

### **Ownership and distribution of Instructor Manuals**

Instructor manuals (IMs) shall be archived by the journal for a period of at least three years after publication of a given case. IMs will only be provided to educators who so request them when such instructors are formally affiliated with a College or University.

No fees shall be charged to instructors who receive IMs, nor is membership in the WCA required to receive an IM. Educators seeking an IM should complete a request form on the JCRI website. IMs will then be sent by the journal editor to the requesting instructor with a cc to the case author, who may wish to know who is using his or her case and for what purpose. After the three-year period, inquiries for IMs should be made to the case author.



## JCRI Publication Ethics Policy

Approved by the JCRI Editorial Board, March 9, 2017

1. **Board Accountability.** The JCRI Editorial Board shall be responsible for establishing and updating, as needed, the Publication Ethics Policy of the *Journal of Case Research and Inquiry*.
2. **Editor Responsibilities.** The JCRI Editor shall be responsible for the content of the cases, notes, articles, and letters published in the journal. In consultation with the Editorial Board, the Editor shall endeavor to ensure that the content of the journal meets the standards of quality expected by the Western Casewriters Association (WCA) through the application of the blind peer-review process. The Editor shall also be responsible for ensuring that any non-peer reviewed content of the journal is clearly identifiable.
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5. **Retractions and Corrections.** The JCRI Editor shall be responsible for the publication of retractions, corrections, or clarification as needed, and shall keep the Editorial Board aware of any issues that might necessitate a retraction, correction, clarification or apology.
6. **Volunteer Basis.** The JCRI Editor, Editorial Board members, and reviewers shall carry out their duties on a volunteer basis, and under no circumstances accept any payment for such duties. Under no circumstances shall potential authors be required to make any payments to the JCRI or its Editor, Editorial Board, or reviewers, nor shall any such payment be accepted.
7. **Quality of the Review Process.** The Editor, in consultation with Editorial Board, shall review and as needed update the journal's editorial policy and guidelines for reviewers in order to ensure that thorough and timely reviews are prepared. The Editor shall also endeavor to ensure that the reviewers selected are qualified to review the submissions sent to them. The Editor shall apply the same review policies, procedures, and standards to submissions by WCA members, JCRI Editorial Board members, and non-WCA members. In addition, the JCRI Editor shall encourage reviewers to comment on the originality of submissions and be attentive to redundant publications or plagiarism. JCRI shall not accept fictional cases, nor cases, notes, or articles previously published elsewhere.

8. **Decisions and Appeals.** Decisions to accept or reject cases, notes, and articles shall be based on each paper's importance, originality, clarity, and pedagogical relevance as well as adherence to the submission requirements provided at [www.jcri.org](http://www.jcri.org). Editorial decisions shall not be affected by the origins of the manuscript, including the institutional affiliation, nationality, ethnicity, political beliefs, race, gender, religion, or sexual orientation of authors. Authors whose submissions to JCRI have been rejected may appeal to the President of the Western Casewriters Association at [www.westerncasewriters.org](http://www.westerncasewriters.org).
9. **Support of the Scholarly Process.** As appropriate, the Editor shall provide information to authors, reviewers, and institutions in order to support recognition of scholarly contributions.
10. **Support for author rights.** As per JCRI editorial policy, authors shall maintain full ownership and copyright for all papers published in the journal, with all the associated rights and obligations.
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### Case Research

**NEGLIGENT ADMISSION: WAS IT UNETHICAL TO RECRUIT MARCUS JOHNSON?**, p. 12

By Michael Conklin

In 1978 Marcus Johnson was recruited to play basketball at Quandary University despite being illiterate. He expressed concern about the academic rigor of Quandary but was assured he would receive a "meaningful education." During his four years at Quandary, the athletic department enrolled him in classes such as ceramics, marksmanship, and theory of basketball, which didn't contribute toward a degree. Despite having special tutors who would sometimes complete assignments for him, he performed poorly. After four years he was far from finishing a degree.

*Key words: Negligent admission, university, illiteracy, ethics, athletics, college sports*

**HOMEBOY INDUSTRIES: REDEFINING SOCIAL RESPONSIBILITY**, p. 17

By R. Duncan M. Pelly, Yang Zhang and Stephen J.J. McGuire

This case addresses two major problems facing contemporary managers – defining industry boundaries for a firm with multiple strategic business units and generating meaningful intra-organizational collaboration in the face of potentially conflicting goals. The case uses an innovative non-profit, Homeboy Industries, to illustrate these dilemmas. Homeboy Industries is affiliated with the Jesuit order of the Catholic Church and conducts rehabilitative training, education, and job placement for former prison inmates.

Homeboy Industries comprises a wide variety of social enterprises, including bakeries, catering, silk screening, tattoo removal, development classes, and a café. Some of these social enterprises are profitable, others are not, but in theory each is designed to provide benefit to members of the program first, and then to the community. Within Homeboy, there are conflicting definitions of success, which adds to the complexity of strategic choice for the business units. Professional managers at Homeboy, including the CEO, emphasize financial sustainability, while the founder and executive director, Father Boyle, emphasizes non-economic benefits to the community and to the clients of Homeboy.

*Key words: Homeboy Industries, social responsibility, social entrepreneurship*

***KPMG CANADA'S ISLE OF MAN OFFSHORE COMPANY TAX STRATEGY***, p. 48

By Gretchen Lawrie and Yang Zhang

The Canada Revenue Agency (C.R.A.) first learned from auditing Canadian couple, Peter and Irene Coopers' tax returns in 2012 that during the late 1990s and early 2000s, the accounting firm, KPMG LLP of Canada (KPMG Canada or the Firm) had developed and sold an offshore Isle of Man company tax strategy (IOM Strategy or Strategy) to the Coopers and other wealthy Canadian individuals, which provided them the means to receive millions of dollars of offshore companies' earnings and profits purportedly as tax-exempt gifts. In 2012, the C.R.A. determined that KPMG Canada's IOM Strategy was a "sham," because the intention of the Strategy was for the Coopers to receive, under the guise of tax-exempt gifts, taxable foreign investment income from an IOM company. Therefore, the Coopers were assessed taxes, interest, and penalties on more than \$3.5 million they had received by participating in the strategy but had not reported as income on their tax returns from 2003 to 2010.

*Key words: Tax, Canada, Isle of Man, tax shelter*

***DOES ELON MUSK RANK? LEADERSHIP, CREATIVITY, AND STAKEHOLDER IMPACT***, p. 65

By Benjamin N. Alexander, Jean-François Coget and Patricia C. Dahm

Elon Musk is a study in contrasts. Some consider him an extraordinary leader, while others revile him as an autocratic egomaniac. He is alternately hailed as an inventor commensurate to Thomas Edison or a potential fraud incapable of meeting production deadlines who is perpetually one step away from bankruptcy. His ethics are a matter of intense debate: some see him as a visionary, working to solve the biggest problems humanity faces, such as the depletion of our energy resources and the potential for the extinction of our species, while others emphasize his inhuman treatment of others close to him, his workers, and even his (ex-) wives.

The case asks students to evaluate whether or not Elon Musk deserves a spot on Business Insider's "Top 100 Creators" list, and provides information to evaluate his approach to leadership as well as his impact on stakeholders. The award is evaluated on the "bold moves to create value for four constituencies: shareholders, employees, consumers, and society," which relates to leadership. The case may yield passionate discussions and strong, conflicting points of view. The case allows students to apply various theories of leadership, creative leadership, and stakeholder impact.

*Key words: Leadership, creativity, stakeholder impact*

***PEPSICO: WILL THE COMPANY SPIN OFF CARBONATED BEVERAGES***, p. 83

By Issam Ghazzawi

As soda contributed less than 25% of its global sales in the past few years, PepsiCo was no longer a soda company. The company was witnessing a new era as it started emphasizing healthier products. With the continual growth of its snacks division and non-carbonated drinks-especially in North America and Russia, its two largest markets -PepsiCo had a sound 2016. With a portfolio including \$22 billion worth of brands, the company built a world-class go-to-market system, strong retail and foodservice partnerships, and its core instant currency earnings per share grew 9%, exceeding its goal of 6% growth. Its organic revenue grew 3.7%. Equally important, the company has increased its investment in research and development by 45% since 2011 to \$3.5 billion.

PepsiCo's snack division, Frito-Lay North America, was the most valuable and profitable division, making almost 40% of the company's valuation. The company's North America Beverages division continued to be a strong performer despite having a drinks portfolio weighted heavily toward the slow-growth carbonated drinks category. North America Beverages' success was primarily due to the steady growth of PepsiCo's non-carbonated drinks. Carbonated beverages have been weighing down the company over the years, causing major contention with activist investors. Health concerns and obesity had become key challenges for the giant company. PepsiCo had created a plan to reduce sodium, fats, and sugar in its products and had introduced more whole grain foods to its line-up. Additionally, the company was able to offer a new line of 100-calorie-per-portion products repackaged as Mini Bites and a variety of real fruit and vegetable crisps called Flat Earth. PepsiCo was faced with a major challenge: To further accelerate and transform a successful model that profited from the sales of carbonated beverages and unhealthy snacks to a new model that could benefit from the sales of healthy beverages and other food. The major dilemma has been whether PepsiCo would agree with its activist investors to spin off its beverages division. If so, what would PepsiCo do with such a spun-off company?

*Key words: PepsiCo, Pepsi-Cola, strategy, diversified companies, divestiture, mergers and acquisitions, spinoffs.*

***RISING FROM THE ASHES***, p. 116

By Douglas Lyon and Stephanie Owings

The El Moro Tavern was a thriving part of Durango's restaurant scene until a fire in the fall of 2016 closed the business for several months. Business interruption and fire insurance helped the restaurant weather the financial turmoil associated with the smoke and fire damage, as well as the loss of revenue from the closure. El Moro continued to pay its employees during the closure, thus reinforcing El Moro's close-knit organizational culture. Management asked the employees to volunteer at the non-profit organization of their choice while they were on paid leave. That innovative commitment to Durango's well-being garnered glowing press and positive feelings among the employees and in the community. El Moro reopened to great community fanfare in early 2017, and the tavern won the Spirit of Durango award at the annual Durango Chamber of Commerce Award Ceremony in January 2018.

*Key words: Restaurant, employees, business interruption*

***LOS ANGELES FIRE DEPARTMENT: DIVERSITY IGNITES DISCRIMINATION***, p. 129

By Stephen J.J. McGuire, Jeewhan Yoon, Patricia Robbins, Oshin Babaian, Fernando Iniguez, Vardui Koshkaryan, Maribel Pelayo and Taguhi Sogomonyan

Located in a “salad bowl” of ethnic communities, the Los Angeles Fire Department (LAFD) was the second largest municipal firefighting force in the United States protecting over four million people. The Department’s Engine Company No. 1 was established in 1887. In 1972, the federal government filed a lawsuit against Los Angeles claiming that the city discriminated against Blacks, Latinos, and Asians. As a result, the LAFD adopted an Affirmative Action Program and created a Minority Recruitment Unit to improve the recruitment of members of underrepresented demographic groups.

Although the Department in recent years had members representing every ethnic group in the city, the LAFD faced many internal issues regarding recruitment of women, harassment, gender discrimination, and changing its male-dominated culture to embrace diversity. A series of events, including numerous lawsuits that took a toll on the City’s taxpayers, hindered the growth of minorities in the LAFD program, and resulted in very few women passing the qualifying examinations. In 2018, Fire Chief Ralph Terrazas unveiled the departments’ 2018-2020 strategic plan, which included a firefighter recruitment plan.

How could LAFD optimize its recruiting efforts to women and ethnic minorities? What changes to human resources policies could the department make to increase diversity and to promote an organizational culture of inclusion? What else would Fire Chief Terrazas need to do?

*Key words: Fire department, discrimination, sexual harassment, consent decree, human resource management*

## Letter from the Editors

This is the fourth issue of the *Journal of Case Research and Inquiry*. So far, **JCRI** has published 28 peer-reviewed teaching case studies prepared from primary and secondary research. Each case has been thoroughly peer-reviewed and is accompanied by a peer-reviewed instructor's manual that is available to qualified instructors upon request. The cases published in **JCRI** address diverse issues in business and society. They include studies of for-profit, nonprofit, and governmental organizations in several countries around the world. Instructors will find cases that focus on everything from entrepreneurship and small business management to decisions made in multi-national organizations. The journal has also published five peer-reviewed scholarly articles or notes concerned with case research and teaching with cases. Cases, notes, exercises, and articles published in the journal are available online, full text, and free of charge at [www.jcri.org](http://www.jcri.org). The editors are available to write to authors' tenure and promotion committees, upon request.

In the volume, we publish seven new cases. Some are short, others are very detailed. Topics covered include ethics, tax law, social entrepreneurship, leadership, strategy, business interruptions, discrimination in employment, and more. These cases are ready for use in the classroom, and all have detailed, peer-reviewed instructor manuals to assist with their classroom use.

In 2019, **JCRI** intends to publish a special issue with short cases about issues in developing countries. We encourage you contact the editors for more information.

**JCRI** is the publication of the Western Casewriters Association (WCA). On the WCA website, <http://www.westerncasewriters.org/>, authors will find a call for cases for the next WCA conference to be held on March 7, 2019 in Rohnert Park, California (Sonoma Wine Country), at the DoubleTree Hilton. The WCA annual conference is a unique opportunity to engage with other case-writers in a small group format to exchange feedback and polish-up your case, learn about teaching with cases, and enjoy presentations from leading case authors and case educators. The WCA is held in association with the annual meeting of the Western Academy of Management.

We would like to thank our reviewers for their detailed, insightful comments on the case submissions this year. We look forward to receiving well-written cases, notes, and articles for 2019 and urge you to consider the journal for your case research.

Thank you,

Steve McGuire and Deborah Walker  
Editors, *Journal of Case Research and Inquiry*



## **NEGLIGENT ADMISSION: WAS IT UNETHICAL TO RECRUIT MARCUS JOHNSON?**

**MICHAEL CONKLIN**  
Angelo State University

It was 1978 when Jason started as the head of the athletic department for Quandary University, a private college in the U.S. Midwest that competed in Division I NCAA athletics. Jason had heard of a star high school athlete named Marcus Johnson from Kansas City, a 6'9" center who averaged 21 points and 20 rebounds a game. His dominance on the court, however, did not translate to the classroom. While his high school "C's" were below average for Quandary University, Jason was more concerned about his American College Testing (ACT) score. He scored a 9 out of 36. The average at Quandary University in 1978 was 23.2.

When Jason expressed concerns about Johnson's ability to handle the academic workload at Quandary University, the basketball head coach winked and said, "*Don't worry, we can give him 'special tutoring.'*" Jason had heard a rumor of special athletic department tutors who would do assignments and even take tests for student athletes. The coach's comment confirmed the rumor.

"*We'll just enroll him in classes like ceramics, marksmanship, and theory of basketball,*" said the head coach.

## Recruitment of College Athletes

College athletic directors and coaches faced incredible pressure to win from their institutions and the alumni of their institutions. Consequently, they recruited great players - players for whom there was intense competition. It should have been no surprise that such an environment led to recruitment violations. In the 1990s, four University of Michigan basketball players received a combined \$600,000 from one booster (Top 10 Infamous NCAA Sanctions 2010). In 1999, a University of Minnesota academic advisor admitted to accepting extra money from the coach to write over 400 papers for men's basketball players (Top 10 Infamous NCAA Sanctions 2010). The 2008 Memphis Tigers' men's basketball team was sanctioned for allegedly arranging another person to take Derrick Rose's SAT test (Top 10 Infamous NCAA Sanctions 2010). In 2013, A Southwestern Louisiana (now the University of Louisiana at Lafayette) assistant coach forged the signature of a high school principal to allow a recruit to attend (Carson 2013).

It was also no surprise that this intense competition for star recruits led to coaches making exaggerated claims. College basketball Coach Larry Brown said, *"Every kid I recruited for college felt that he had an opportunity to play in the NBA and I liked him to have those expectations"* (Sperber 2001).

In fact, the chance of an entering freshman NCAA basketball player going on to play in the NBA was smaller than 1%. The NCAA claimed that it was 1.3%. However, the NCAA's claim was based on NCAA seniors; many high school athletes who were recruited to play in the NCAA never made it to their senior year (NCAA.org).

### Admission of Marcus Johnson

In his discussion with the basketball coach, Jason expressed concern that the classes Marcus Johnson would take (ceramics, marksmanship, etc.) would not contribute toward a degree. The head coach replied, *“Hey, I was hired to win basketball games; I’ve never received a bonus based on graduation rates. Besides, Marcus Johnson is a poor black kid. This will be the best thing to ever happen to him.”*

Because of his high school GPA and ACT score, Johnson needed to be admitted as a *“special permission”* student. The head basketball coach said Johnson would play an integral role on the team and asked Jason to appeal to the academic vice president, so that Johnson could attend Quandary University.

Jason reluctantly went along with the head basketball coach and got Marcus Johnson admitted to Quandary University. Just as Jason had feared, Marcus Johnson did not perform well academically. Even with the *“special help”* on tests and homework, his freshman GPA was 1.6, and it only went downhill from there. After four years at Quandary University, Johnson’s overall language skills were those of a fourth grader. To make matters worse, he turned out to not be the basketball star that he was recruited to be. He started in only 9 games and averaged only 4 points per game.

One evening, while Jason was looking over the scouting reports for the upcoming year’s entering recruits, an angry, 6’9” man barged into his office. Jason immediately recognized him as Marcus Johnson. He was upset because after four years he was nowhere near earning a degree. *“When you guys recruited me, the deal was I play basketball for you and you educate me. I fulfilled my end of the bargain so now it’s time for you to do the same,”* he exclaimed. Should Quandary University have admitted Marcus Johnson? Given that Marcus Johnson was recruited and did not receive a degree, what, if anything, should Jason do now?





**Michael Conklin** currently serves as Assistant Professor of Business Law at Angelo State University. He received his JD from Washburn School of Law in 2007, MBA from Oklahoma City University in 2004, and completed postgraduate coursework at the University of London in 2010. Dr. Conklin is an active scholar primarily publishing in law reviews.

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## **HOMEBOY INDUSTRIES: REDEFINING SOCIAL RESPONSIBILITY**

**R. DUNCAN M. PELLY**  
McMurry University

**YANG ZHANG**  
University of Texas at El Paso

**STEPHEN J.J. MCGUIRE**  
California State University, Los Angeles

***“We don’t hire homies to bake bread. We bake bread to hire homies.”***  
Father Boyle

***“There's no question Greg Boyle is a saint, but even saints need good businessmen.”***  
Richard Riordan, former Mayor of Los Angeles

Established in 1988, Homeboy Industries was a non-profit organization that offered alternatives to gang activity and assisted former gang members and prisoners to reintegrate into society. Father Gregory Boyle, the Jesuit priest and founder of Homeboy Industries, had initially focused on job placement for ex-gang members. However, the growing number of “homies” quickly outpaced the number of available jobs, so in 1992 Homeboy Industries began to launch its own businesses in order to provide employment. Thomas (“Tom”) Vozzo joined as CEO in 2012 to manage and grow the portfolio of businesses and service programs. By 2018, Homeboy had 10 businesses – some profitable and some not – as well as several ongoing education, support, and job placement programs. Within Homeboy, there were conflicting definitions of success, which added to the complexity of strategic choice for the business units.

Homeboy Enterprises was a combination of social programs and business units. The business units, or social enterprises, in theory were to be self-sufficient; that is, make enough profit to keep going without additional assistance. Father Boyle tended to prefer social programs over social enterprises, reasoning that *“we don't want to balance our budget on the backs of the people we're trying to serve.”*

Homeboy's programs included: Tattoo Removal, Mental Health Services, Legal Services, Education, a specific training and certification program for Solar Panel Installation, Case Management of Trainees, Workforce Development and Job Placement services. Despite its entrepreneurial successes, Homeboy remained dependent on outside financial support for its social programs.

Homeboy's social enterprises were in four broad categories: Kitchen and Bakery, Grocery, Apparel and Merchandise, and Electronics Recycling. Some businesses were brick-and-mortar and others were online. The largest businesses in terms of revenue were the bakery and the then the silkscreen and embroidery business.

During the 2008-2010 recession – a period in which the number of homies served increased while Homeboy Industries received fewer donations – Father Boyle's model proved untenable. In April 2010, Homeboy Industries had a \$5-million deficit<sup>1</sup> and was forced to lay off more than 330 of its approximately 425 employees, including senior staff and administrators.<sup>2</sup>

Former KB Home CEO Bruce Karatz began volunteering at Homeboy Industries in April 2010 as an informal advisor to Homeboy's board of directors.<sup>3</sup> Homeboy Industries benefitted from Karatz' business acumen. He provided a much-needed infusion from his personal funds and from donations from his circle of wealthy friends.<sup>4</sup> The 2010 recession's impact on Homeboy Industries was alleviated thanks to Karatz' efforts. Tom Vozzo, Homeboy's first CEO in 2012, controlled costs aggressively and expanded Homeboy's business to the online market. By 2014,

Homeboy earned \$15 million in total revenue and social enterprises contributed to 34.7% of revenue.<sup>5</sup> The remaining funds were acquired from individuals, foundations, corporations, events, and the government. In 2017, total revenue topped \$18.3 million, and the portfolio of social enterprises contributed 31% of that, or \$5.6 million.

Vozzo was convinced that the organization could succeed in various different businesses *because of* – not in spite of – the hard work of the homies. He remarked:

*“I was struck by the fact that the rest of the business world needs to understand that these folks who’ve faced barriers and overcame them are good hard workers, and they should be employed. So it became our vision to not just have our nonprofit Homeboy businesses, but to push the frontier and have a set of for-profit enterprises that employ the same folks and prove to the world that this model can be successful.”*

### Divergent or Convergent Visions?

Despite Vozzo’s efforts, Homeboy Industries’ existence was precarious due to its dependence on donations, and its business model was not projected as financially sustainable. Both Father Boyle and Tom Vozzo wished to achieve the greatest good for the greatest number of potential clients, but the specific mix of business units and their respective strategies had not been agreed upon. Conventional wisdom indicated that a business that did not have a clear strategy was destined to fail. But was Homeboy Industries a *business*? If so, did it have to follow conventional business rules?

Father Boyle’s development of the different services at Homeboy Industries focused on personal and spiritual development of homies, with profit as a possible – but not necessary – outcome. Under Father Boyle’s model, Homeboy Industries resembled a charity. In contrast,

Vozzo's pragmatic approach had its roots in his corporate background. Vozzo believed altruism could not financially sustain the organization. His vision was to create a portfolio of strategic business units and encourage income-generating activities to subsidize Homeboy's social mission. Furthermore, the act of providing employment to clients and holding them accountable for the value they extracted from Homeboy was a form of social responsibility. Therefore, each homie should generate enough profit to finance a portion of his/ her rehabilitation.

Which strategy should Homeboy Industries pursue and what type of organization should it become? Should Homeboy Industries continue to follow Father Boyle's vision of a charitable organization? Should Homeboy follow Vozzo's vision of a social enterprise that used business practices to help the community? Or could the ideal strategy be a blend of the two?

#### **Exhibit 1. Homeboy Industries, Los Angeles, CA**

*Source: HubPages, Homeboy Industries*



### Hope Has an Address

During the 1970s, street gangs emerged across California, with 95% of California cities with populations of 100,000 or more reporting gang problems.<sup>6</sup> Father Boyle entered the order of the Society of Jesus (Jesuits) and was ordained a priest in 1984.<sup>7</sup> He began working at the Dolores Mission Church in Boyle Heights, a neighborhood of Los Angeles, in 1986.<sup>8</sup> Boyle Heights had at least seventeen gangs<sup>9</sup> and more than 10,000 gang members.<sup>10</sup> Father Boyle realized that most of the teenagers he met had either dropped out or were expelled from school with no place to go and few job opportunities.<sup>11</sup> He began a job training and employment referral center for at-risk youth at the church, called *Proyecto Pastoral*.<sup>12</sup>

In 1992, *Proyecto Pastoral* expanded and was re-named Homeboy Industries (HBI). The organization's primary program was, "*Jobs for a Future*," which used a multi-service approach to assist clients – including at-risk youth, ex-gang members, and former Los Angeles County jail inmates.<sup>13</sup> HBI provided vocational training, work experience, job referrals, and placement. HBI's motto was, "*Nothing Stops a Bullet like a Job*."<sup>14</sup>

Father Boyle was a positive change agent who confronted personal danger. He experienced drive-by shootings and other dangerous incidents in Boyle Heights, and in March 2003 he was diagnosed with leukemia, necessitating a medical leave of absence.<sup>15</sup> After a series of chemotherapy treatments, his leukemia was in remission.<sup>16</sup> Father Boyle's primary concern wasn't his health; instead, he wished to help as many people as possible in Boyle Heights for as long as he was able to do so.<sup>17</sup>

Father Boyle's efforts positively affected Boyle Heights. In 2014, Homeboy Industries provided programs and services to 9,033 homies, helping redirect their lives to become contributing members of society.<sup>18</sup> By September 2015, Homeboy Industries had assisted 120,000 former

gang members.<sup>19</sup> UCLA professor Jorja Leap, who studied gangs and intervention programs, spent nearly five years tracking 300 Homeboy clients. She found low levels of recidivism, reduced levels of traumatic stress disorder, and that the majority had found full- or part-time work and had rekindled family ties. Professor Leap described Homeboy Industries as follows: *“There is no one like them for one-stop shopping.”*<sup>20</sup>

### A Second Chance at Life

Rasheena was born and raised by her grandmother in Los Angeles. Her parents were drug addicts and career criminals. Rasheena was also sexually abused by one of her brothers. She joined a gang because it provided a sense of love and protection. Eventually, Rasheena was sentenced to 6 years and 8 months in prison, leaving her daughter alone – just as her mother had done to her. Despite realizing the error of her ways, Rasheena could not secure employment and needed guidance. During Homeboy’s 18-month training program, she gained life and employment skills. She believed Homeboy was a true safe-haven, and described her experience:

*“You’re not alone, your life is a precious gift. Never again will I allow the horrors of my past to define me. I’ve broken through my barriers victoriously and these victories define the woman I am today.”*<sup>21</sup>

Another Homeboy client, Ramon, described Homeboy Industries’ spiritual, professional, and personal support:

*“I decided to make my life better through Homeboy about half way through my prison sentence. Another convict owed me money for drugs I sold him, and he didn’t have it. I knew I would have to kill him, and I didn’t want to do it. I prayed for three days for God to give me a sign. Father Boyle came to the prison the next day and told me about how he could help me when my sentence was over. He was the sign. I decided not to kill my fellow inmate, and the next week he paid me my money. At this point, I decided to make the change.”*



*"Homeboy clients come in broken. Father Boyle lifts us up. Father Boyle recognized that gangs are a tool of Satan, and people were addicted to the gang lifestyle. He recognized that it's tough to break the continuous cycle of gangs and prison, when we have no references, no work history, and no education. Father Boyle gives us a safe place to work where we can get strong, and prove not only to ourselves, but also to employers, that we can contribute."*<sup>22</sup>

### Exhibit 2. Homeboy Clients

Source: Homeboy Industries 18-month model



### Social Enterprise Journey

The reason nonprofit organizations existed, according to some researchers, was because of a market or governmental failure to provide needed services, or because clients are unable to accurately evaluate certain kinds of services and thus required organizational forms in which they could place trust.<sup>23</sup> A social enterprise was normally explained as a rational and functional solution to public sector funding and philanthropic resource constraints.<sup>24</sup> Spanning both nonprofit and for profit fields, a social enterprise took social concerns into account and created value in innovative ways.

Homeboy's slogan changed from, *"Jobs for a Future"* in 1988 to, *"Jobs not Jails."*<sup>25</sup> Homeboy helped the formerly gang involved and the previously incarcerated by offering hope, training,

and job skills. Homeboy's goal was to help former gang members redirect their lives and become contributing members to their families and community.<sup>26</sup> Homeboy Industries did not expect perfect, but it did expect improvement. *"We expect people to work on themselves here,"* explained Father Boyle.<sup>27</sup>

*"Father G offered me a job and I said, 'I don't want a job.' He said, 'Yes, you do, you're hired,'"* recalled Stephanie Lane, who worked in the Homegirl Café for more than four years.

Homeboy young clients struggled with little education, an unhappy childhood, and poverty. To serve these troubled youths, Homeboy encouraged individuals under the age of 21 to attend Homeboy's Learning Works Charter High School. This school had an independent-study curriculum tailored to the needs of those who had dropped out or were expelled from traditional schools.<sup>28</sup>

### Homeboy Industries' Social Programs

Annually, Homeboy Industries provided programs and services to more than 5,500 community members. Most of those helped were formerly gang-involved and previously incarcerated men and women in Los Angeles County. Homeboy helped them to redirect their lives and become contributing members of the community. In 2018, Homeboy provided services in the following broad program areas:

- Tattoo Removal
- Mental Health Services
- Legal Services
- Education
- Solar Panel Training
- Case Management

- Workforce Development and Job Placement

### ***Tattoo Removal***

Tattoo removal was Homeboy's busiest program because it provided services to both homies and members of the community at large. The service was particularly important because tattoos in visible areas such as the face, neck, and hands were serious impediments to employment. Homeboy had two senior staff members operating the department/medical office; one manager and an assistant manager. Three Homeboy trainees and two rotating volunteers assisted in the medical office. There were 35 volunteer doctors, physician assistants, and nurses who provided the actual tattoo removal sessions. In 2017, Homeboy provided over 11,834 tattoo removal treatments.<sup>29</sup>

### ***Mental Health***

In 2017, 24 therapists at Homeboy Industries provided 3,670 therapy sessions.<sup>30</sup> Therapists met one-on-one with Homeboy clients to help them deal with events in their past as they transitioned toward work. Therapists also facilitated group support sessions for members of the community. Transcendental Meditation (TM) was introduced at Homeboy Industries in 2017 because of a gift of long-time supporter, Jim Carrey. Trainees learned a healthy, positive way to deal with life's stress by learning to practice TM.

There were also programs for substance abuse support, caring for babies and children, and domestic violence intervention services.

### ***Legal Services***

Ten volunteers – lawyers and paralegals – provided legal services to Homeboy Industries' clients, from basics such as payment of traffic tickets to more complicated matters, including family reunification.

### ***Education***

Homeboy Education offered 40 weekly classes for Homeboy trainees and community clients, most of which were free and open to the public. Academic, life skills, substance abuse, wellness, arts, and work readiness classes were offered, among many others.<sup>31</sup> Appendix C includes a schedule of classes offered by Homeboy. In 2017, 21, 451 class sessions were offered.<sup>32</sup>

Since 2010, Homeboy Industries had a partnership agreement with the Learning Works Charter High School. While the high school prepared youths academically and helped them to get their high school diploma, Homeboy Industries prepared the students for jobs. The high school had an annex office at the Homeboy Industries headquarters in Boyle Heights.

### ***Solar Panel Installation Training and Certification***

A specific type of education promoted by Homeboy Industries was solar panel installation, which prepared homies for an occupation with high demand in Southern California. Homeboy Industries placed clients in the 4-month Photovoltaic Training program at East Los Angeles Skills Center, and paid for clients' tuition and material costs. Homeboy also provided tutoring to help clients pass a national credentialing test to become certified installers. Homeboy Industries had served nearly 1,000 clients since the program began, and bragged of a 92% graduation rate with a 70% placement rate within 90 days of graduation.<sup>33</sup>

### **Case Management: The 18-month program**

Homeboy offered an 18-month trainee and placement program that started with training and ended with a job. About 300 clients per year benefitted from the program, and the organization spent more than \$3,000 per month for each trainee. Roughly one trainee entered the program per week, via a lottery system. All potential trainees underwent a screening process and drug testing. After the first several months, clients were funneled into one of the social enterprises. Each client worked with a case manager to develop individual goals for learning and development. From the start, trainees were paid slightly more than minimum wage.<sup>34</sup> There were many more potential clients for the 18-month program than there were slots available. *"There's twice and three times as much demand out there,"* CEO Thomas Vozzo said. *"We have the know-how, we just don't have the finances."*<sup>35</sup>

Vozzo, however, had faith in the quality of the training provided and in the abilities of homies, and he urged employers to give them a shot:

*"If I get on a soapbox, I just want businesses, especially small to midsize, [to realize that] our folks come through with the Good Housekeeping Seal of Homeboy. Give them a chance. They're good workers. Don't judge them by some of the tattoos they still have on their face ... Come be our partner."*

### **Workforce Development and Job Placement**

Homeboy's employment counselors helped clients uncover talents and aptitudes, get ready for jobs, look for jobs, and find work. Counselors were intermediaries between employers and Homeboy clients (both trainees and community clients). Homeboy offered a weekly series of workshops to help clients find jobs and get ready for them. And of course, Homeboy provided job placement services – it worked hard to help potential employers find homies, and Homeboy trainees to find employers who would take a chance on them.<sup>36</sup>

### Homeboy Industries' Business Portfolio

"We have a portfolio of businesses," Vozzo noted.

*"Some are pure job-training grounds, some provide jobs and opportunities and probably break even, and others make money that offsets the costs of the other businesses. We can triple our volume of bread out of this facility. There's a big business opportunity if we focus on restaurants that want artisanal bread. We're going to come up with a new menu soon to drive more people in for breakfast."<sup>37</sup>*

In 2015, Homeboy Industries ran a deficit. In 2016, it broke even and in 2017, through aggressive control of costs, its revenues exceeded its operating costs. Exhibit 3 shows the financial statements of Homeboy Industries from 2014 to 2017. Tom Vozzo focused on improving client retention, promoting homies to management positions, and creating a trauma-informed community.<sup>38</sup> He noted that,

*"We have a very expensive model. We pay people to come get themselves healthy. We pay them for eight hours [per day], and most of that time, in the early months of their tenure, they're working on themselves and then a few hours of work in the businesses. Our businesses probably carry three times as much labor as a for-profit business."*

A Homeboy Industries business was considered to be successful if it generated meaningful employment and allowed homies to learn skills that would help them get jobs. Nonetheless, Vozzo expected each business unit to make a profit – if one removed the cost of labor. Vozzo told homies that, "We're going to hold you accountable for the bottom line. If you take out labor, you need to be making money." In 2017, Social Enterprises at Homeboy Industries generated \$5.6 million, or 31% of all money brought in. (See Exhibit 3.)

**Exhibit 3. Homeboy Industries 2014-2017 Financial Statement***Source: Homeboy Industries' Annual Reports*

<b>Revenue (in \$Millions)</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
Social Enterprise	5.2	7	6.1	5.6
Foundations & Corps	4.5	2.8	2.3	3.5
Individuals	3.2	4.3	4.2	4.5
Events	1.6	1.9	2.3	2.6
Government	0.5	0.6	1.7	2.1
<b>Total Revenue</b>	<b>15</b>	<b>16.6</b>	<b>16.6</b>	<b>18.3</b>
<b>Expenses</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
Re-entry Programs	4.5	5.4	6.4	6
Social Enterprise	3.8	3.2	3.4	3.3
Trainee Compensation	3.5	4	3.3	3.1
Administrative	1.3	1.8	2.1	2.1
Fundraising	1.2	1.4	1.4	1.7
<b>Total Expense</b>	<b>14.3</b>	<b>15.8</b>	<b>16.6</b>	<b>16.2</b>

In 2018, the social enterprises run by Homeboy Industries were grouped in four broad categories: Kitchen and Bakery, Grocery, Apparel and Merchandise, and Electronics Recycling. The largest businesses in terms of revenue were the bakery and then the silkscreen and embroidery businesses.

***Kitchen and Bakery Businesses***

Kitchen and bakery provided the largest source of revenue, approximately \$3.1 million in 2017, and the most jobs. These social enterprises included the Homeboy Bakery, Homeboy Gluten-Free Bakery, Homegirl Café, Homegirl Catering, Homeboy Diner at City Hall, Homeboy Café and Bakery at LAX, Farmers Markets, and Homeboyfoods.com.

***Homeboy Bakery*** was Homeboy Industries first social enterprise, founded in 1992. The bakery produced fresh bread, cakes, pies and snacks every single day for sale to the public directly, as a wholesaler, and through the Homegirl Café.

**Homeboy Gluten-Free Bakery.** In February of 2017, Charles and Janice Lavine generously donated their business, Breakaway Bakery on W. Pico Blvd., to Homeboy Industries. The bakery, which was re-branded as the Homeboy Gluten-Free Bakery, served gluten-free, vegan, and kosher products made daily on-site.<sup>39</sup>

**Homegirl Café.** The café was in the ground floor of Homeboy Industries' headquarters. It served farm-to-table breakfast and lunch dishes with Latino flavors, as well as a brisk coffee and pastry business at the counter.

**Homegirl Catering** was a woman-run business that provided full-service catering for small (10 people) to large (1,000 or more people) events, with customized box lunches or a full menu served by the Homegirls.

**Homeboy Diner at City Hall.** Right in the City Hall of Los Angeles, The diner sold grab-and-go sandwiches, salads, desserts, coffee, tea and other items direct from Homegirl Café and Homeboy Bakery.

**Homeboy Café and Bakery at LAX.** The organization had an opportunity to open a café at Los Angeles International Airport (LAX). However, two reasons hindered the expansion. First were the security checks at the airport. LAX would not accept HBI employees with criminal records. Second, public transportation to and from the airport was inconvenient; homies would have to spend more than three hours getting to LAX.<sup>40</sup> Because of these issues, Homeboy Industries entered into a license agreement with Florida-based Areas USA in September 2010. Areas USA staffed and operated the café at the airport. (See Exhibit 6.)



**Exhibit 6. Homeboy Café & Bakery at LAX**

Source: [BackroadsTraveler.blogspot.com](http://BackroadsTraveler.blogspot.com)



**Homeboyfoods.com.** Homeboy Industries had an online market, where it sold freshly made cookies, cakes, pies, jams and preserves, coffee, granola, and other treats from the Homeboy Bakery.

**Farmers Markets.** Fresh baked bread, salads, and baked goods from Homeboy Bakery and the Homegirl Café were sold at several local farmers markets in Los Angeles and nearby cities by the Homeboy Farmers Market teams.

**Grocery Business**

Bruce Karatz' first action as a Homeboy volunteer was to broker a distribution deal for HBI's chips and salsa through Ralph's grocery stores.<sup>41</sup> Grocery items were made by Snak King, a snack food manufacturer who offered private label service.<sup>42</sup> Homeboy salsa, chips and Guacamole were sold at over 250 Ralph's locations in Southern California, as well as at some Walmarts, Gelson's Markets, and at the Homegirl Cafe. (See Exhibit 5).<sup>43</sup> Royalties from grocery sales exceeded \$1.1 million annually.

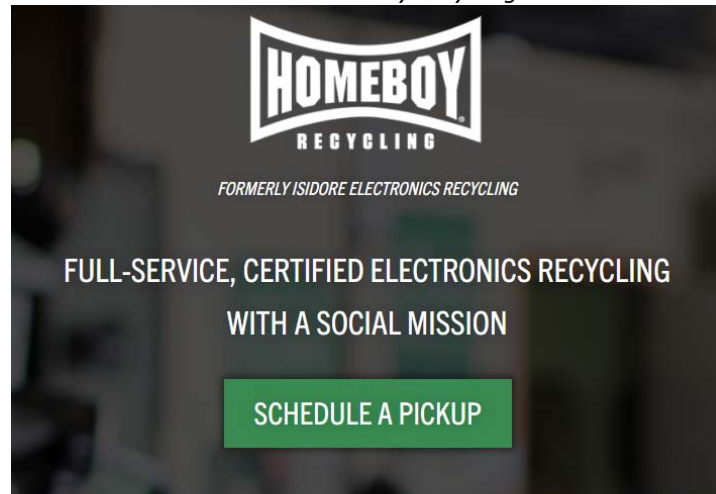


### ***Homeboy Electronics Recycling***

In 2017, Homeboy launched a new business venture related to recycling and repair of electronics, secure data destruction, IT asset recovery, and prop rental. Homeboy Industries purchased Isidore Electronics Recycling, located a few blocks away from the nonprofit's facilities (See Exhibit 7). Kabira Stokes, CEO of Isidore Electronics Recycling, imagined hiring people out of the Homeboy training program for entry-level jobs, like dismantling computers, then moving them up to more managerial roles. Stokes added that, *"It's very clear that the government cannot – and perhaps, in the case of this new administration, will not – do so, and the nonprofit sector can't do it alone."* The Homeboy Recycling model, Stokes says, *"is the future of capitalism."*<sup>44</sup>

#### **Exhibit 7. Homeboy Recycling**

*Source: Homeboy Recycling*



*For every 75,000 pounds of recyclables we collect, we create 1 job.*

## Homeboy Brand and Business Model

Clearly, Homeboy's brand was valuable. However, the brand value may not have originated from Homeboy's successful business model, but rather from its good deeds and Father Boyle's reputation. In a 2012 interview with *Entrepreneur*, Father Boyle admitted that a few years ago, ". . . there was no business plan at all. Zero."<sup>45</sup>

Homeboy's brand brought in charity donations and income to ensure current and future financial stability. The next necessary steps were brand building and expansion. In 2015, Homeboy's senior leadership included four former trainees and seven professional managers. Homeboy's brand value didn't ignite Father Boyle's interest, instead he wished to focus on the expansion of Homeboy's business model.

*"We decided, maybe five years ago, after fielding so many requests, that HBI would not franchise and become the 'McDonald's' of gang intervention programs (Over 5 billion gang members served!!). But we now have a Homeboy network of twenty-eight programs in the United States, born and modelled after HBI. From Spokane to Miami, we have offered technical assistance—we have gone there and they have come to us. Rather than airlift HBI into St. Paul or Wichita, programs have been 'born from below' and modelled on our approach. This allows more ownership on the part of each city and is more organic, sensible, and sustainable because of it."<sup>46</sup>*

### **Competition with Other Organizations**

There were some well-known organizations similar to Homeboy Industries, such as the Young Men's Christian Association (YMCA), the Salvation Army, Goodwill Industries, and D.C. Central Kitchen. These institutions competed with Homeboy for clients, donations, media attention, and business. In the United States, the YMCA had 2,700 local chapters in 2018. The USA YMCA's goal was,

*"To enhance its member associations' ability to effectively carry out the Y's mission in their communities and partner with all Y's to achieve the movement's collective goals and priorities."<sup>47</sup>*

The Salvation Army provided support for four groups: adults, children, families, and those who needed disaster relief.<sup>48</sup> Prison ministries was one of the sections under support for adults. In prison ministries, the Salvation Army played a growing role in prison rehabilitation and crime prevention. In some jurisdictions, prisoners were paroled to the direct custody of the Salvation Army. Services included Bible correspondence courses, pre-release job-training programs, and employment opportunities in cooperation with parole personnel, material aid, and spiritual guidance to prisoners and their families.<sup>49</sup> By the end of 2014, the Salvation Army was the only charity to offer services in every ZIP code in the United States and served more than 30 million Americans every year.<sup>50</sup>

Goodwill Industries offered job training and access services to former-inmates re-entering the community. The services were available to men, women and young adults committed to getting their lives back on track.<sup>51</sup> More than one in four people served by Goodwill through face-to-face services were youth or young adults 24 years of age or younger, and more than 101,000 of these were described as at-risk youth.<sup>52</sup> Goodwill provided job training in industries that included retail, banking, hospitality, food service, packing and assembly, manufacturing, and health care. Goodwill counselors worked one-on-one with individuals to identify training needs and provide the support services for every person to achieve the most from their abilities.<sup>53</sup> *“Every 23 seconds of every business day, a person served by a Goodwill agency earns a good job.”*<sup>54</sup>

D.C. Central Kitchen’s (DCKK’s) was a culinary training program founded by nightclub owner Robert Eger to fight hunger, strengthen bodies, empower minds, and build communities. Its motto was, *“Combating Hunger, Creating Opportunity.”*<sup>55</sup> Since 2008, ninety percent of DCKK graduates found jobs despite recessions. DCKK CEO Mike Curtin said, *“We are not just alleviating hunger. We are feeding the soul of the city.”*<sup>56</sup> In 2014, D.C. Central Kitchen recovered 807,534 pounds of food and purchased 200,100 pounds of produce from local farmers. This food was made into 1.7 million partner agency meals and 876,000 school meals.

DCKK also trained chronically unemployed, homeless, and previously incarcerated individuals for culinary careers. Instead of offering a hand-out, DCKK's 14-week program provided a hand-up through culinary training, social services, internships, and job placement assistance. In 2014, there were 89 graduates, with an 89% job placement rate. Over the course of a year, graduates earned a collective \$1.7 million in wages and paid approximately \$339,000 in payroll taxes. DCKK also provided on-going programs for its graduates. According to Mike Curtin, *"Our Culinary Job Training program didn't just help people find a job; we helped them keep those jobs by investing in long-term evaluation and follow-up services."*<sup>57</sup> In 2013, DCKK opened its first subsidiary in Los Angeles, L.A. Kitchen, which was 7 minutes away from Homeboy Industries. In 2014, D.C. Central Kitchen earned \$13.92 million. The social enterprises revenue compromised more than 60% of D.C. Central Kitchen's total revenue in 2014.

Homeboy Industries was a noble organization serving former gang members during their transition to community members. How should Homeboy execute its mission going forward? Should it pursue Father Boyle's charity model and help homies irrespective of cost? Alternatively, should Homeboy pursue a social enterprise model grounded in financial stability with a portfolio of profitable businesses, as advocated by Tom Vozzo? Or, should the ideal strategy be a combination of the two?



**R. Duncan M. Pelly**

is an Associate Professor of Entrepreneurship at the Johnson School of Business, McMurry University.



**Yang Zhang**

is a Ph.D. student in Human Resource Management and Organizational Behavior at the University of Texas, El Paso.

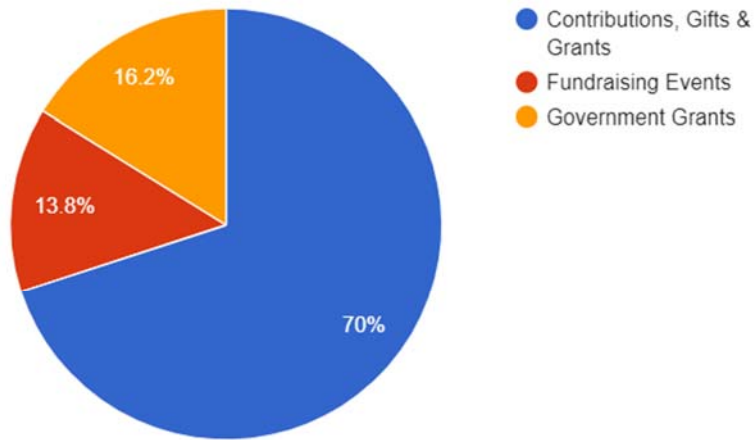


**Steve McGuire**

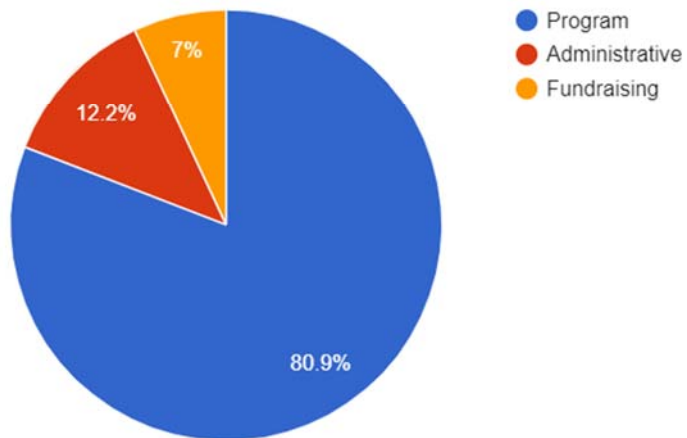
is Professor of Management and Director of Graduate Studies at the College of Business and Economics, California State University, Los Angeles.

**Appendix A**  
**Homeboy 2016 Revenue and Expense Breakdown**  
*Source: Charity Navigator*

**Contributions Breakdown (FYE 12/2016)**



**Expenses Breakdown (FYE 12/2016)**





**Appendix B**  
**Ralphs Chips and Salsas List**

*Source: Ralphs South Atlantic Blvd, Los Angeles*

Brand	Salsas		Chips	
	Size (oz.)	Price	Size (oz.)	Price
Homeboy Industries	16.0	\$ 3.99	14	\$ 2.99
Mission	15.5	\$ 2.49	20	\$ 2.99
Del Real	16.0	\$ 3.99	(-)	(-)
Tostitos Cantina	15.5	\$ 3.49	(-)	(-)
Calidad	(-)	(-)	12	\$ 1.79

**Appendix C**  
**Homeboy Industries Class Schedule**  
 Source: Homeboy Industries Education Office

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
9:00am-11:00am: Employment Services: Orientation (community clients) (Career Resource Center)	9:00am-10:30am: Employment Services: Job Search (community clients) (Career Resource Center)	9:00am-1:00pm: Employment Services: Computer Skills (community clients) (Career Resource Center)	9:00am-10:30am: Employment Services: Interview Prep (community clients) (Career Resource Center)	9:00am-12:00pm: Employment Services: Resume Building (community clients) (Career Resource Center)
9:00am-10:00am: Monday Morning Meditation (Classroom A)	9:15am-11:15am: 'La Classe' Art Academy** (Febian's Art Studio Downtown) (Classroom A)	9:00am-9:30am: Homeboy New-Hire Orientation (Classroom A)	9:15am-10:30am: enrollment required G.E.D. Prep: Math (Classrooms A & B & Group Therapy)	9:00am-10:00am: Solar Panel Orientation (Group Therapy)
9:00am-10:00am: enrollment required G.E.D. Prep: Language Arts (Writing) (Classroom B)	9:15am-10:30am: enrollment required G.E.D. Prep: Math (Classrooms A & B & Group Therapy)	10:00am-11:00am: **trainees only Homeboy 101** (Classroom A)	10:30am-12:00pm: enrollment required G.E.D. Prep: Language Arts (Classroom B & Lab & Group Therapy)	9:00am-11:00am: Baby & Me (Classroom A)
10:00am-11:00am: **trainees only Homeboy 101** (Classroom A)	10:30am-12:00pm: enrollment required G.E.D. Prep: Language Arts (Classroom B & Lab & Group Therapy)	10:00am-11:00am: Al-Anon 'Circle of Hope' (Classroom B)	10:30am-12:00pm: Narcotics Anonymous (Classroom A)	10:00am-11:00am: Griminals & Gang Members Anonymous (Classroom B)
10:00am-12:00pm: enrollment required D.V. Intervention for Men (Classroom B)	10:30am-11:30am: enrollment required Parenting (Classroom A)	11:00am-12:00pm: **trainees only Anger Management (trainees only) (Classroom B)	12:00pm-1:00pm: Yoga (Classroom B)	11:00am-12:00pm: Homeboy 12-Step Study (Classroom A)
11:00am-12:00pm: Pathways to College Workshop (Career Resource Center)	11:30am-12:30pm: Alcoholics Anonymous (Classroom A)	1:00pm-2:00pm: N.A. Women to Women (Classroom B)	1:00pm-2:00pm: enrollment required Parenting (Classroom B)	11:00am-12:00pm: Healing Circle (Classroom B)
11:30am-12:30pm: A.A. / N.A. (Classroom A)	12:00pm-1:30pm: enrollment required Project Fatherhood: Phase 1 (Classroom B)	1:00pm-3:00pm: Tutoring w/ Ms. June (drop-in) (Group Therapy)	1:00pm-2:30pm: Building Positive Relationships for Women (Peace Over Violence) (Classroom A)	12:00pm-2:00pm: enrollment required D.V. Intervention for Men (Classroom B)
1:00pm-3:00pm: Tutoring w/ Ms. June (drop-in) (Group Therapy)	12:30pm-1:30pm: enrollment required Anger Management (community clients only) (Classroom A)	1:30pm-3:00pm: enrollment required Project Fatherhood: Phase 2 (Classroom A)	1:00pm-3:00pm: GED Exam Prep Tutoring (drop-in) (Career Resource Center)	1:00pm-2:00pm: Men's Group (Classroom A)
1:30pm-2:30pm: enrollment required Substance Abuse: Phase 1 (Classroom A)	1:00pm-3:00pm GED Exam Prep Tutoring (drop-in) (Career Resource Center)	2:00pm-4:00pm: enrollment required D.V. Intervention for Women (Classroom B)	2:30pm-3:30pm: enrollment required Anger Management (community clients only) (Classroom A)	3:00pm-4:00pm: enrollment required Substance Abuse: Phase 2 (Classroom A)
2:30pm-3:30pm: enrollment required Relapse Prevention (Classroom A)	1:30pm-2:30pm: enrollment required Substance Abuse: Phase 2 (Classroom A)	3:00pm-4:00pm: enrollment required Substance Abuse: Phase 1 (Classroom A)	2:30pm-3:30pm: Four Agreements (Classroom B)	3:00pm-4:00pm: **trainees only Homeboy Tour Guide Prep (Classroom B)
2:30pm-4:30pm: New Opportunities Adult H.S. (Break Room)	2:30pm-4:00pm: A.V.P. Mini-Session (Alternatives to Violence Project) (Classroom A)	3:00pm-5:00pm: New Opportunities Adult H.S. (Group Therapy)	3:30pm-4:30pm: Odyssey Artists' Workshop (Classroom A)	7:30pm-9:00pm: Narcotics Anonymous (Classrooms A & B)
3:00pm-5:00pm: Street Poets Writing Workshop (Classroom B)	6:00pm-7:30pm Narcotics Anonymous (Classrooms A & B)	4:00pm-5:00pm: Typing (Career Resource Center)		
3:30pm-4:30pm: Odyssey Artists' Workshop (Classroom A)				

## Appendix D Home Industries Catering Review

Source: Yelp and Homeboy website

 11/30/2015

This review is for the catering portion of Homegirl, as we used them for our recent wedding a few weeks ago.

My husband and I chose them after reading about them on a wedding blog, and finalized our choice once we also understood the rehabilitation aspect of their organization. It was a big bonus for us, to know that the money we were spending on a wedding necessity was also going back into a pretty awesome program. From the start, their coordination staff was pleasant and consistent in their communication, often answering me within a few hours of an email or phone call. The menu was thoroughly vetted and combed over to ensure we had enough food, and all of our guests were accommodated (they have a bunch of veggie options).

On the day of, we couldn't have been more pleased. They were there on time and set up for our afternoon start. Our guests loved the food, and made it a point to tell us so. The ladies that were there from Homegirl to set up/look after the food were so sweet and nice as well. Again, many of our guests would go on to tell us how wonderful they were. And that's pretty much all you can ask for, really great quality food and service with a positive attitude.

Appendix D cont.  
Home Industries Catering Review

 8/21/2015

 2 check-ins

Restaurants are a dime a dozen. We find them everywhere on LA. And nonprofits are plentiful, but most do not accomplish direct results on their clients.

But this is not the case with Homeboy Industries and Homegirl Cafe. As a social worker, I have researched this place. I've also have talked to clients of the agency. Both of which give me such a great feeling about this place. Homeboy transforms lives every single day. I have bought their baked goods at my local farmers market and donate everytime I do so.

On my list was Homegirl Cafe. After coming here twice (breakfast and lunch), I could honestly say I will continue to come back every single time I am in the area (and maybe sometimes when I am far away). The quality of the food is superb. I have not tried anything that has been short of excellent. The fish, soups, salads, sandwiches, flavored waters, pastries everything is great.

Add to all this the fact that the individuals preparing your food, serving you and ringing you up are all Homeboy clients who are eager to make your day great is the cherry on the sundae. I love this place and I am sure you will as well.

## Appendix E Goodwill's Mission and Results

Source: Goodwill Industries

Goodwill strives to enhance the dignity and quality of life of individuals and families by helping people reach their full potential through education, skills training and the power of work.

Goodwill meets the needs of all job seekers, including programs for youth, seniors, veterans, and people with disabilities, criminal backgrounds and other specialized needs. Last year, Goodwill helped more than 26.4 million people train for careers in industries such as banking, IT and health care, to name a few — and get the supporting services they needed to be successful — such as English language training, additional education, or access to transportation and child care.

### Our Mission

Goodwill works to enhance the dignity and quality of life of individuals and families by strengthening communities, eliminating barriers to opportunity, and helping people in need reach their full potential through learning and the power of work.

### Our Results

Our Mission Results in 2014

- 89 million total employment and community services
- More than 318,000 people placed into employment
  - As a result of the educational credentials attained, these individuals increased their collective lifetime earnings by more than \$11 billion
- 26.4 million total persons served
  - More than 2 million people received job training and placement services through Goodwill agencies
  - More than 24 million people used Goodwill mobile and online learning to improve their skills or accessed virtual services, which constituted an increase of nearly three times the number from 2013

### How We Did It

- Total revenue generated by Goodwill organizations: \$5.37 billion
- Total revenue spent directly on programs: 83 percent
- Total number of donors (includes repeat donations): 90 million
- Total number of retail stores: More than 3,000 and an online auction site, [www.shopgoodwill.com](http://www.shopgoodwill.com)

### Revenue Sources Breakdown

- Retail sales: \$3.94 billion
- Industrial and service contract work: \$666 million
- Government grants: \$104 million
- Corporate and foundation grants: \$33 million
- Individual gifts/Endowments/Fees for services: \$48 million
- Government support for mission services: \$393 million

**Appendix F**  
**Goodwill Southern California Profit Statement 2016**

*Source: Goodwill Industries*

	Total
Revenues:	
Operating revenues	\$ 114,344,315
Sales from stores	3,622,852
Commodities sales	7,395,591
Contract services	12,511,489
Workforce development revenues	502,990
Other	138,377,237
Other revenues and support:	
Contributions	4,649, 249
Contributions to capital campaign	25,794
Interest and dividends	381,922
Contributed goods	75,829,516
Loss on sale of property, plant, and equipment	(18,540)
Net assets released from restriction	-
Total revenues and support	219,245,178
Expenses:	
Program services	207,988,107
Fundraising	1,493,472
General Administrative	10,855,987
Total operating expense	220,337,566
Changes in net assets from operations	1,092,388
Other changes in net assets:	
Realized and unrealized gains and losses	927,519
Changes in net assets	164,869
Net assets, beginning of the year	27,843,585
Net assets, end of year	\$27,678,716

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# ***KPMG CANADA'S ISLE OF MAN OFFSHORE COMPANY TAX STRATEGY***

**GRETCHEN LAWRIE**

California State University, Los Angeles

**YANG ZHANG**

University of Texas at El Paso

## **Introduction**

Although Peter Cooper was an experienced businessman, he did not consider himself to be a tax expert. So, over the years Peter and his wife Irene had relied on professional tax and legal advisors to organize their personal finances. In 2000, when the tax-exempt treatment of distributions from one of the Cooper's trusts was about to expire under Canadian tax law, Mr. Cooper asked his accountant, Derrold Norgaard, a partner of KPMG Canada, what alternatives the Coopers had to replace the trust.<sup>1</sup> Norgaard and another KPMG Canada partner, Barrie Phillip, recommended that the Coopers transfer their trust's assets to an Isle of Man company (IOM company), which would in return gift to them its profits and earnings from investing the trust's assets.<sup>2</sup> After thoughtful assessment of the partners' advice, Mr. Cooper in 2001 retained KPMG Canada to convert their trust into an IOM company.<sup>3</sup>

Following the 2012 audit of their tax returns by the Canada Revenue Agency (C.R.A), the Coopers were notified that the IOM strategy was a "sham." Because the intention of the strategy was for the Coopers to receive - purportedly as tax-exempt gifts - taxable foreign investment income, the C.R.A. had assessed them taxes, interest, and penalties on more than \$3.5 million.

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The authors developed the case for class discussion rather than to illustrate either effective or ineffective handling of the situation. The case and its accompanying instructor's manual were anonymously peer reviewed and accepted by the *Journal of Case Research and Inquiry, Vol. 4, 2018*, a publication of the Western Casewriters Association. The authors and the *Journal of Case Research and Inquiry* grant state and nonprofit institutions the right to access and reproduce this manuscript for educational purposes. For all other purposes, all rights are reserved to the author. Copyright © 2018 by Gretchen Lawrie. Contact: Gretchen Lawrie, California State University, Los Angeles, 5151 State University Drive, Los Angeles, CA 90032, (323) 343-3000, [Gretchen.Lawrie@calstatela.edu](mailto:Gretchen.Lawrie@calstatela.edu)

Why would KPMG Canada, one of the largest accounting firms in the world with a reputation of being a respected auditor and tax expert, recommend to individuals, like the Coopers, that they should participate in offshore tax sham that could result in paying significant back taxes, interest, and penalties?

### **Overview of KPMG Canada's IOM Strategy**

As part of the IOM Strategy, a KPMG Canada client would gift sums of money and/or property to an Isle of Man company, which held and/or invested the client's gifted amounts.<sup>4</sup> In return, the IOM company would gift to the client its earnings, profits, and/or the client's original purported gifts, which were treated as tax-exempt gifts for Canadian income tax purposes, and therefore not reported on the client's Canadian income tax returns.<sup>5</sup> To implement an IOM Strategy, KPMG Canada charged its clients either a fixed sum of \$100,000 or a percentage of the clients' annual tax savings. From 1999 to 2003 and in 2007, KPMG Canada earned approximately \$1.6 million in fees for implementing the IOM Strategy 16 times for 27 clients. Except for one time in 2007, KPMG Canada ceased implementing the IOM Strategy after 2003.<sup>6</sup>

### **Development of KPMG Canada's IOM Strategy**

Starting in the late 1990s, KPMG Canada began to develop its IOM Strategy in response to legislative changes to "a tax planning vehicle" that had allowed Canadian immigrants to receive (under Canadian tax law) tax-exempt distributions from foreign trusts for a period of five years.<sup>7</sup> According to KPMG Canada, individuals who used the IOM Strategy, could: 1) receive tax-

exempt distributions; 2) invest and accumulate assets free of tax; or 3) protect assets from wealth, estate, and inheritance taxes and creditors.<sup>8</sup>

At a 2016 hearing held by Canada's Standing Committee on Finance on Canada Revenue Agency's (C.R.A.) efforts to combat tax evasion and avoidance, KPMG Canada partner Gregory Wiebe testified that KPMG Canada had "...conducted extensive internal and external due diligence..." on the IOM Strategy and that it was "absolutely" legal under Canada's tax laws when it was developed in the 1990s.<sup>9</sup> Mr. Wiebe stated that during the development phase of the IOM Strategy, all tax aspects of the Strategy had been "fully vetted."<sup>10</sup> Specifically, two KPMG Canada partners had conducted "detailed technical review[s]" of the IOM Strategy.<sup>11</sup> After that, KPMG Canada's general anti-tax avoidance committee (Committee) reviewed the Strategy, and finally KPMG Canada's Managing Partner of the national tax practice approved it and signed off on it.<sup>12</sup>

During the Committee's review of the IOM Strategy, KPMG Canada partner Barrie Philip noted that "if the funds acquired by the [IOM company]" from the client were "ultimately to be reacquired" by the client, then "there would be a very heavy onus" on the client to demonstrate that he or she did not have a "valuable legal interest" in the IOM company and never intended to get the funds back from the IOM company.<sup>13</sup> If it could **not** be proven that the client had no interest in the IOM company, then Canada's anti-tax avoidance rules could apply. Also, if the client intended to reacquire the funds, it would be "hard to argue" that the IOM Strategy was not "a trust, agency, or nominee relationship, or even a 'sham...'"<sup>14</sup>

The Committee also concluded that the "right tax policy result would be for no Canadian tax to apply if there was no ultimate distribution back to Canada..." of the IOM company's assets.<sup>15</sup> But, if the client "from the outset intended to receive distributions" from the IOM company, then it would be plausible to argue that Canada's tax laws had been violated.<sup>16</sup> However, the Committee "noted in passing" that it would be difficult for the C.R.A. to criticize the IOM plan

without evidence of “*moneys coming back to (or intended to come back to)*” Canada. But even if such evidence became “... *fact (if it were to do so) many [of the client’s] taxation years*” could be statutorily barred from review by the C.R.A.<sup>17</sup>

In addition, during the development phase, a Canadian law firm and an Isle of Man law firm provided, at KPMG Canada’s request, written opinions on the consequences of the IOM Strategy under Canadian and the Isle of Man tax laws.<sup>18</sup> The Canadian law firm, Fraser Milner Casgrain LLP (now Dentons LLP), concluded that any income or earnings a client received from the property he or she transferred to the IOM company would not be attributable to the client, since the client would have given a “*true gift*” to the IOM company, because after the transaction the client would not control the company and its members would not be the client’s agents.<sup>19</sup>

For its IOM Strategy, KPMG Canada had “*developed a comprehensive implementation package*” and had arrangements with service providers, such as institutional shareholders, director and management service companies to support the Strategy.<sup>20</sup> The fees for the IOM Strategy were either about 15 percent of a client’s annual tax savings, one percent of the capital invested in the Strategy, or another appropriate basis depending on the application and the value to the client. The minimum fee was \$100,000 to \$125,000 plus retainer.<sup>21</sup>

### **Marketing and Selling KPMG Canada’s IOM Strategy**

By 1999, KPMG Canada was marketing and selling its IOM Strategy to current clients and other high net worth individuals, who had a minimum of \$10 million to invest in an offshore company.”<sup>22</sup> KPMG Canada’s National Product Champions, partners and other tax and financial

professionals were members of marketing and sales teams. KPMG Canada partners and tax professionals were to “*identify and pass along*” to their tax services advisors the names of individuals who might be interested in an IOM Strategy.<sup>23</sup>

The IOM Strategy was specifically marketed to: 1) individuals interested in restructuring their tax-exempt immigration trusts because of potential changes to the law; 2) individuals concerned about creditor protection, estate, wealth, and inheritance taxes; 3) individuals interested in philanthropic activities without the restraints of Canada’s charitable foundation rules; and 4) shareholders of Canadian private and public companies that had significant growth potential, who were interested in an offshore estate freeze.<sup>24</sup>

In initial meetings with potential clients, tax professionals were to discuss the “*primary benefits*” of the IOM Strategy, such as receiving tax-exempt income and protecting assets from creditors or former spouses. Other primary benefits for clients included avoiding: 1) estate fees, probate fees, succession duties and/or death taxes; 2) challenges to their wills; and 3) Canadian regulations on donations to charitable foundations. They were also to discuss with potential clients the risks of the IOM Strategy, such as the tax and penalty consequences if the C.R.A. were to determine that the Strategy violated Canada’s anti-tax avoidance rules.<sup>25</sup>

### KPMG Canada’s Clients, Peter and Irene Cooper

Prior to immigrating to Canada in the mid-1990s, the Coopers followed the recommendations of their advisors at the accounting firm of Ernst & Young LLP. The Coopers set up a Trust in November 1996 in Liechtenstein with them as the beneficiaries of the Trust. Under Canada’s Immigration Trust Rules (C.I.T. Rules) that were in effect when the Coopers immigrated, they could receive, as Canadian immigrants, tax-exempt distributions from their foreign Trust for a

five-year period. Upon expiration of the five-year period, distributions from their Trust would no longer be exempt from Canadian taxes.<sup>26</sup>

Because the five year tax-exempt period was set to expire in 2001 - as well as the possibility that the government of Canada was going to repeal the C.I.T. Rules - Mr. Cooper contacted his accountant Mr. Norgaard in 2000 for advice "*as to possible alternatives*" to their Trust.<sup>27</sup> On October 15, 2000, Messrs. Norgaard and Philip recommended that the Coopers transfer as tax-exempt gifts the Trust's assets to a company incorporated in the Isle of Man, which would subsequently transfer its income and earnings as tax-exempt gifts to the Coopers. In October 2001, the Coopers retained KPMG Canada to replace their Trust with an Isle of Man company.<sup>28</sup>

On December 19, 2001, Ogral Company Limited was incorporated in the Isle of Man. On January 1, 2003, the Coopers' Trust transferred purportedly as gifts over \$19 million to Ogral. Under Ogral's bylaws, the Board of Directors, by unanimous vote, could approve gifts to "*Eligible Persons,*" who were defined as the Coopers, their sons and their spouses, and their lineal descendants, of Ogral's income, earnings, assets and/or capital.<sup>29</sup> As per the Coopers' written requests, Ogral's board of directors approved, from 2003 to 2010, the transfer of more than \$5.8 million to the Coopers. Claiming that the transferred funds were tax-exempt gifts from Ogral, rather than taxable income, the Coopers did not report the funds on their tax returns prepared by KPMG Canada. Based on a percentage of the Coopers' annual tax savings, KPMG's fees from 2002 to 2008 were approximately \$300,000.<sup>30</sup>

### Consequences for the Coopers

Following the 2012 audit of their tax returns, the C.R.A. determined that the Coopers had received \$3.5 million of taxable foreign investment income from Ogral - not tax-exempt gifts - which they should have reported on their 2003 to 2010 income tax returns. In 2012, the Coopers were devastated to learn that the C.R.A. had assessed taxes and interest on the \$3.5 million and had added a \$1.38 million gross negligence penalty. They were fined \$4.8 million for not notifying the C.R.A. of the funds being held for them in Ogral's foreign bank accounts.<sup>31</sup>

### The Coopers Dispute the Assessment of Taxes on their Gifts from Ogral

Represented by KPMG Canada Law LLP, the Coopers in March 2015 filed an appeal with the Tax Court of Canada asking the court to reverse the C.R.A.'s tax, interest, and penalty assessments.<sup>32</sup> In their appeal, the Coopers stated that because Mr. Cooper was not a legal or tax expert, "*at various times in structuring [their] affairs, they had sought, considered and relied on the advice*" of respected professional tax and business law advisors to structure their financial affairs. Concerning the IOM Strategy, Mr. Cooper stated that he had "*sought and obtained sophisticated professional advice*" from KPMG Canada as to the possible alternatives to their Trust and had "*thoughtfully, deliberately, and carefully assessed*" the Firm's recommendation.<sup>33</sup>

In response, the C.R.A. stated that the IOM Strategy was created with the intention to deceive Canadian tax authorities, so that the Coopers could receive taxable income on a tax-free basis.<sup>34</sup> Further, the strategy was a "sham," because the Coopers and KPMG Canada had intentionally mischaracterized the transfer of their money to Ogral as a gift, despite knowing that the Coopers' overall objective was not to gift their money to Ogral, but to reacquire their initial investment in Ogral and to receive, under the guise of gifts, Ogral's earnings and profits.<sup>35</sup> Also, despite Ogral's corporate formation documents, as the *de facto* directors and shareholders of



Ogral, the Coopers controlled Ogral and had not relinquished control or ownership of the funds they had transferred to Ogral.<sup>36</sup>

### Consequences for KPMG Canada

The C.R.A. did not bring criminal charges against KPMG Canada, its partners and/or employees for encouraging and/or assisting clients, such as the Coopers, to willfully evade taxes by using the IOM Strategy to receive taxable income on tax-free basis. KPMG was also not assessed civil gross negligence penalties for advising and/or assisting clients to evade taxes and/or making false statements or omissions on their tax returns.

The union that represents accountants, auditors, and financial professionals employed by the Canadian government is the Association of Canadian Financial Officers (ACFO). In May 2016, ACFO filed two professional misconduct complaints against KPMG Canada for violating the Canadian Chartered Professional Accountants' code of conduct, bylaws, and regulations by developing, marketing, and selling its IOM Strategy.<sup>37</sup> The ACFO claimed that KPMG Canada had acted *"contrary to the profession's reputation for competence and integrity"* and affected the *"public perception of the accounting profession."*<sup>38</sup>

In response, KPMG Canada publicly stated that the ACFO's complaint was defamatory *"nonsense"* and that all of KPMG Canada's tax planning work had and will continue to meet Canadian federal and provincial tax laws. Further, any review of its tax planning work would conclusively demonstrate that KPMG Canada's partners, professionals, and other employees had acted with the *"highest integrity and respect"* for Canadian tax laws.<sup>39</sup>

### Consequences for Other KPMG Canada Clients

The C.R.A. assessed some of KPMG Canada's other IOM Strategy clients for taxes, interest, and/or penalties on their unreported income. Several other IOM Strategy clients were offered amnesty by the C.R.A. from future civil and criminal prosecutions, penalties, and fines in exchange for paying taxes and interest on their unreported income.<sup>40</sup>



**Gretchen Lawrie** is an Assistant Professor of Accounting at California State University, Los Angeles College of Business and Economics. She graduated in 1989 from Wheaton College in Illinois with a degree in political science and from Wayne State University Law School in 1992 with a J.D. and then in 1997 with an L.L.M. in taxation. Prior to teaching, Gretchen was a senior associate then a manager in the federal mergers and acquisition tax group at KPMG LLP. Her research interests include corporate, partnership, and individual federal taxation.



**Yang Zhang** is a Ph.D. student at the University of Texas at El Paso. Her research interest includes: firm innovation, high performance work systems, and teamwork. Prior to the doctoral program, she got her master degree in Business Administration at California State University, Los Angeles. She obtained her bachelor degree of accounting in China.

## Appendix A U.S. and Canadian Tax Law

### Tax Planning

Tax planning is the process of reviewing options for decreasing, deferring, and/or eliminating a taxpayer's tax liabilities. U.S. tax laws do not prohibit taxpayers from using tax planning to reduce their taxes to the least possible amounts, but taxpayers are prohibited from using tax planning to avoid or evade taxes.<sup>41</sup>

### U.S. Tax Laws: Tax Shelters

Although there is not one precise, agreed-on definition of the term tax shelter, a tax shelter is a law, a regulation, a transaction or series of transactions, a strategy or a scheme that shelters income from taxation. Some tax shelters represent lawful or legal tax avoidance and other ones represent unlawful or illegal tax evasion.<sup>42</sup>

In general, a tax shelter is legal because Congress concluded that the loss of tax revenues is an acceptable side-effect of tax laws that encourage certain types of investments or other activities.<sup>43</sup> For example, to encourage individuals to save for retirement, they can make pretax contributions to an individual retirement account (I.R.A.). Also, if certain requirements are met, they may be able to deduct their I.R.A. contribution from their income, thus reducing their tax liabilities.<sup>44</sup>

An illegal tax shelter can be a device, a strategy, a transaction, or a series of transactions that yield tax benefits, such as deductions, losses, or credits, that are used to reduce and eliminate taxpayers' tax liabilities without reducing their real economic income.<sup>45</sup> I.R.C. §6662(d) (2)(c)(ii) defines an illegal or abusive tax shelter as: 1) a partnership or other entity; 2) any investment plan or arrangement; or 3) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is to avoid or evade federal income tax.<sup>46</sup> The I.R.S. has stated that some tax shelters are considered illegal or abusive because the tax benefits attributable to the tax shelter, like losses or deductions, "...produce little or no benefit to society, or the tax benefits are exaggerated beyond..." the intended benefits.<sup>47</sup>

Besides identifying certain tax shelters as illegal, the I.R.S. also maintains a publicly available list of tax shelters it has identified as potentially abusive, but not *per se* illegal, which are referred to as listed transactions.<sup>48</sup> Under I.R.C. §6707, individuals must notify the I.R.S. that they aid, assist, or advise on the promotion, organization, or implementation of a listed transaction and maintain a list of their tax shelter clients that is available upon request by the I.R.S. I.R.C. §6707A provides that taxpayers must disclose to the I.R.S. participation in a listed transaction.

### U.S. Tax Laws: Abusive Offshore Tax Schemes

According to the I.R.S., taxpayers use abusive offshore tax schemes to evade taxes by hiding income in foreign bank accounts, brokerage accounts, trusts, companies, or partnerships. In general, abusive offshore tax schemes consist of multi-layered transactions used "...for the purpose of concealing the true nature and ownership" of a taxpayer's taxable income or assets.<sup>49</sup>

In an offshore tax scheme, generally, taxpayers transfer income and/or assets that would be subject to taxes to an offshore foreign bank account, trust, corporation, or other business entities located in countries with low- or no-income taxes. Taxpayers may directly transfer money and/or assets to an offshore bank account, trust, or business entity, or use methods to conceal transfers, such as fabricating the sale of their property to an offshore company.<sup>50</sup>

Subsequently, the taxpayers' income and/or assets are repatriated to the taxpayer with little or no U.S. taxes being paid.<sup>51</sup> The repatriation may be direct or concealed, such as the offshore company that may gift income, make a loan, or rent property to the taxpayer at zero or below market rates.<sup>52</sup>

### **U.S. Tax Laws: Consequences for Taxpayers**

Taxpayers can be assessed taxes and interest on unreported or underreported income, as well as applicable civil and criminal fines and penalties.

Under I.R.C. § 6662(a) and (b), taxpayers can be assessed a 20 percent accuracy-related penalty on an underpayment of tax liabilities attributable to: 1) negligence; 2) intentional disregard of rules or regulations; or 3) substantial understatement of income, unless they can show that they had acted in good faith and that there was a reasonable cause for the underpayment. If a tax understatement is due to fraud, under I.R.C. § 6663(a), taxpayers can be assessed a 75 percent penalty.

I.R.C. § 6707A provides that taxpayers who do not disclose on their tax returns participating in a listed transaction, can be assessed a 75 percent penalty on the amount of the reduction of their taxes resulting from the listed transaction. For individuals, the penalty cannot be less than \$5,000 or more than \$100,000 and for corporations, partnerships, and other entities, the penalty cannot be less than \$10,000 or more than \$200,000.<sup>53</sup> Taxpayers can also be assessed accuracy-related penalties of 20 percent or more on an understatement of tax resulting from a listed transaction.<sup>54</sup>

Taxpayers can be charged, convicted, and/or imprisoned for tax-related crimes. For example, I.R.C. § 7201 provides that a taxpayer, who is found guilty of willfully attempting to evade or defeat any tax or its payment can be fined up to \$100,000, or \$500,000 and/or imprisoned up to five years.

### **U.S. Tax Laws: Consequences for Tax Return Preparers**

Under I.R.C. § 6700, individuals that make or cause another person to make a false or fraudulent statement in connection with promoting, organizing, and/or selling an abusive tax shelter, can be assessed \$1,000 or, if the individual can establish that it is less, the penalty equals 100 percent of the gross income from their tax shelter related activities.<sup>55</sup>

Individuals, including entities, such as accounting firms, who aid, assist, and/or advise on a listed transaction, do not provide or provide false or incomplete information about their listed transaction activities to the I.R.S., the penalty is the greater of \$200,000 or 50 percent (or 75 percent if intentional) of the income resulting from their activities.<sup>56</sup> Also, if they do not provide a list of their advisees within 20 business days of the Service's request, the penalty is \$10,000 per day.<sup>57</sup>

Under I.R.C. §§ 6694(a) and (b), penalties can be assessed against paid tax return preparers, who take unreasonable tax return positions or engage in willful or reckless conduct that results in an understatement of a taxpayer's tax liabilities. I.R.C. § 6694(a) provides that a tax return preparer, who prepares a return resulting in an understatement of a taxpayer's tax liabilities due to an unreasonable tax return position, can be assessed a penalty equal to the greater of \$1,000 or 50 percent of the income derived from preparing the return. For tax shelters and listed transactions, a tax return position is unreasonable if there is no reasonable belief that the position would

more likely than not be sustained on its merits, meaning that there is less than a 50 percent likelihood of the position being upheld if challenged by the I.R.S.<sup>58</sup> The penalty may not be assessed, if a tax return preparer can show that there was reasonable cause for the understatement and he or she acted in good faith.<sup>59</sup> Under I.R.C. § 6694(b), the penalty for preparing a return resulting in an understatement due to a willful attempt to understate tax liabilities or reckless or intentional disregard of rules and regulations is the greater of \$5,000 or 75 percent of income derived by preparing the return.<sup>60</sup>

If a firm employs a tax return preparer, under I.R.C. § 6694, the firm can be assessed the same penalty if:

- 1) one or more members of the firm's principal management or officers or a branch office participated in or knew of the unreasonable position or willful or reckless conduct that caused the understatement;
- 2) the firm failed to follow or failed to provide appropriate procedures for review of the position for which the penalty is imposed; or
- 3) the firm disregarded its reasonable and appropriate review procedures through willfulness, recklessness, or gross indifference in the formulation of the advice, or the preparation of the return that included the position for which the penalty is imposed.<sup>61</sup>

Under I.R.C. § 6701, tax return preparers or anyone else that aids and abets in the understatement of tax liabilities can be assessed \$1,000 for each individual tax return or \$10,000 for each corporate tax return.

I.R.C. § 7201 provides that tax return preparers, who are convicted for willfully attempting to evade or defeat any tax or its payment, can be fined up to \$100,000 (\$500,000 in the case of a corporation) and/or imprisoned up to five years. Under I.R.C. § 7206, return preparers can be fined up to \$100,000 or up to \$500,000 in the case of a corporation and/or up to three years in prison, if they are convicted of willfully assisting or advising in the preparation of fraudulent or false statements. I.R.C. § 7207 states return preparers convicted of preparing fraudulent returns, statements, and/or documents, can be fined up to \$10,000 or up to \$50,000 in the case of a corporation and/or imprisoned up to one year.

### **U.S. Tax Laws: Taxation of Gifts**

The U.S. Supreme Court held, in *Commissioner v. Duberstein*, that a gift occurs when a donor gives something to a donee that proceeds from a detached and disinterested generosity and out of affection, respect, admiration, charity, or similar impulses of the donor.<sup>62</sup> Under I.R.C. § 102, the amount of cash and/or the value of property that individuals receive as a gift are not taxable.

### **Canada Tax Law: Tax Shelters and Abusive Tax Avoidance Transactions**

Under Canada's Income Tax Act (I.T.A.), a tax shelter is defined as a gifting arrangement or a purchase of property arrangement where tax shelter promoters and/or advisors represent to potential donors and property buyers that the arrangements will generate tax losses, deductions and/or other tax benefits equal to or in excess of their donation or purchase price, which can be used to reduce and/or eliminate taxes on their income and/or gains.<sup>63</sup> Also, if the main objective of other types of arrangements is to obtain tax benefits that can be used to reduce and/or eliminates taxes, the arrangement is considered a "tax shelter-like arrangement."<sup>64</sup>

Some tax shelters are legal under the I.T.A., such as registered pension plans and registered education savings plans. But other tax shelters are illegal, such as art-flipping schemes where taxpayers donate art to a charity organization in exchange for a receipt showing an inflated appraisal value of their donated art. Using the inflated appraisal value, the taxpayers claim a charitable tax credit that is higher than the actual appraisal value of the donated art.<sup>65</sup>

Under the I.T.A., a transaction (or a series of transactions) is considered to be “abusive tax avoidance” if the transaction’s sole purpose is to generate a tax benefit and the transaction is inconsistent with the “object, spirit, and purpose” of the tax rule used to generate the tax benefit.<sup>66</sup> If a transaction is determined to be abusive tax avoidance, the transaction can be invalidated, the tax benefits denied, and/or tax, interest, and/or penalties may be assessed against the taxpayer.<sup>67</sup>

Under the I.T.A., taxpayers can be assessed taxes and/or interest on their unreported and underreported income and penalties. One penalty is the civil negligence penalty under I.T.A. Subsection 163(2), which can be assessed against taxpayers, who knowingly, or under circumstances amounting to gross negligence, made a false statement or omission on their tax returns. I.T.A. Subsection 163.2(2) and 2(4) provide that civil penalties can be assessed against third-parties, such as tax preparers and advisors, who advised and/or assisted taxpayers in tax evasion. Under I.T.A. 239, criminal tax evasion charges can be brought against taxpayers and their tax advisors, preparers, planners, or promoters, who encouraged and/or assisted them in willfully evading taxes.<sup>68</sup>

### **Canada Tax Law: Taxation of Gifts**

Under Canadian laws, a gift is “... the voluntary transfer of property owned by a donor to a donee, in return for which no benefit or consideration flows to the donor.”<sup>69</sup> For tax purposes, a gift is valid and tax-exempt to the donee, the one receiving the gift, if the donor: 1) had the intention to give a gift to the donee; 2) voluntarily transferred money or property to the donee; 3) owned the transferred money or property; and 4) did not receive a benefit and/or valuable consideration in exchange for the gift.

## Endnotes

- <sup>1</sup> KPMG LLP of Canada (KPMG Canada) is a Canada limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative, a Swiss entity. KPMG Canada operates in over 35 locations in Canada with more than 700 partners and more than 6,000 employees (<https://home.kpmg.com/ca/en/home.html>).
- <sup>2</sup> The Isle of Man is a self-governing, British Crown dependency located in the Irish Sea between England and Ireland ([www.britannica.com/place/Isle-of-Man](http://www.britannica.com/place/Isle-of-Man)).
- <sup>3</sup> Between Peter Marshall Cooper and Her Majesty the Queen, Notice of Appeal, Tax Court of Canada, 2015-1070(IT)G, pp. 3, 4, and 13 (March 17, 2015) (Cooper Notice); Between Peter Marshall Cooper and Her Majesty the Queen, Deputy Attorney General of Canada, Solicitor for Her Majesty the Queen, Amended Reply to Peter Marshall Cooper Notice of Appeal, pp. 11 and 15, Tax Court of Canada, 2015-1070(IT)G (July 13, 2015) (C.R.A. Reply).
- <sup>4</sup> Canada, House of Commons, The Canada Revenue Agency, Tax Avoidance and Tax Evasion: Recommended Actions, Report of the Standing Committee in Finance, 42d Parl., 1st Sess., p. 22 (Oct. 2016) (2016 Report); KPMG LLP of Canada Offshore Company Tax Product Alert (Oct. 14, 1999); KPMG LLP of Canada Offshore Tax Product Alert (Nov. 2, 2000) (together Tax Product Alerts); KPMG LLP of Canada Potential Client Script (circa 1999); C.R.A. Reply, pp. 2 and 23.
- <sup>5</sup> 2016 Report, p. 22; C.R.A. Reply, pp. 2 and 23.
- <sup>6</sup> Canada, House of Commons, Evidence, the Standing Committee in Finance, 42d Parl., 1st Sess., FINA -17, p. 32 (May 3, 2016) (Wiebe Testimony).
- <sup>7</sup> Tax Product Alerts.
- <sup>8</sup> *Id.*
- <sup>9</sup> Wiebe Testimony, pp. 1 and 5.
- <sup>10</sup> *Id.*
- <sup>11</sup> *Id.*
- <sup>12</sup> *Id.*
- <sup>13</sup> KPMG Canada General Anti-Avoidance Committee Offshore Tax Strategy Memo (Jan. 2, 2001) (Committee Memo).
- <sup>14</sup> Wiebe Testimony, p. 5.
- <sup>15</sup> *Id.*
- <sup>16</sup> *Id.*
- <sup>17</sup> *Id.*
- <sup>18</sup> Tax Product Alerts.
- <sup>19</sup> Fraser Milner LLP Opinion Letter to KPMG LLP of Canada, Joel A. Nitikman, pp. 16 and 17 (Oct. 25, 1999).
- <sup>20</sup> Tax Product Alerts.
- <sup>21</sup> *Id.*
- <sup>22</sup> *Id.*
- <sup>23</sup> *Id.*



<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> Cooper Notice, p. 3; C.R.A. Reply, p. 15; Income Tax Act, R.S.C. 1985, c. 1 (5<sup>th</sup> Supp.) s 94 (I.T.A.).

<sup>27</sup> Cooper Notice, pp. 3 and 4; C.R.A. Reply, pp. 3, 14, and 15.

<sup>28</sup> C.R.A. Reply, pp. 14 and 15.

<sup>29</sup> Cooper Notice, p. 5.

<sup>30</sup> C.R.A. Reply, pp. 15-18, 25, and 33; Cooper Notice, pp. 5 and 7; Isle of Man Companies Act of 1931.

<sup>31</sup> C.R.A. Reply, pp. 1-2, 8-9, and 31-33; Cooper Notice, pp. 1 and 2; I.T.A. ss 162(7); 163(2); 162(7) and 233.3(3); Form T1135, Foreign Income Verification Statement.

<sup>32</sup> Cooper Notice, p. 17.

<sup>33</sup> Cooper Notice, pp. 2, 4, 13, and 16.

<sup>34</sup> C.R.A. Reply, pp. 29 and 36.

<sup>35</sup> C.R.A. Reply, pp. 27 - 30; Cooper Notice, p. 9.

<sup>36</sup> C.R.A. Reply, pp. 5, 17-18, 27 – 30, and 32-33; Cooper Notice, p. 9.

<sup>37</sup> “Financial officers union files complaint against KPMG over tax work on Isle of Man,” Bruce Cheadle, The Globe and Mail (May 13, 2016).

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> Harvey Cashore, David Sglins, Frederic Zalac, and Kimberly Ivany, “Canada Revenue Offered Amnesty to Wealthy KPMG Clients in Offshore ‘Tax Sham,’” CBCNews, March 8, 2016 ([www.cbc.ca/news/business/canada-revenue-kpmg-secret-amnesty-1.3479594](http://www.cbc.ca/news/business/canada-revenue-kpmg-secret-amnesty-1.3479594)); 2016 Report, pp. 22 and 42.

<sup>41</sup> Gregory v. Helvering, 293 U.S. 465, 469 (1935), *aff’g* 69 F.2d 809 (2d Cir. 1934); Yosha v. Comm. 861 F2d 494, 497 (7<sup>th</sup> Cir. 1988), *aff’g* 87 T.C. No. 1087 (1986).

<sup>42</sup> “The New Market in Corporate Tax Shelters,” Joseph Bankman, 83 Tax Notes 1775-1777 (June 21, 1999).

<sup>43</sup> I.R.S. Pub. 550; Treas. Reg. § 1.6662-4(g)(2)(ii); Abusive Offshore Tax Avoidance Schemes – Talking Points, An Abusive Scheme Toolkit for External Stakeholders, I.R.S. (Oct. 2, 2017) p. 666 (<https://www.irs.gov/businesses/small-businesses-self-employed/abusive-offshore-tax-avoidance-schemes-talking-points>) (Abusive Tax Schemes) (Abusive Tax Schemes). [DELETE 2<sup>ND</sup> ONE]

<sup>44</sup> I.R.C. §§ 408 and 219.

<sup>45</sup> I.R.S. Pub. 550; “Tax Planning and ‘Tax Sheltering’: Is It More Than a Word Game?” Peter L. Faber, The State and Local Tax Lawyers, Symposium Edition (2006), pp. 25 and 28.

<sup>46</sup> Treas. Reg. § 1.6662-4(g)(2)(i).

<sup>47</sup> I.R.S. Pub. 550; Treas. Reg. § 1.6662-4(g)(2)(ii); Abusive Tax Schemes, p. 666

<sup>48</sup> I.R.S. Notice 2009-59, 2009-31 I.R.B. 170.

- <sup>49</sup> Abusive Tax Schemes; IRS: Offshore tax cheating remains on ‘Dirty Dozen’ list of tax scams, I.R.-2018-64 (March 20, 2018) (Tax Scams List).
- <sup>50</sup> 2005 Report, p. 16.
- <sup>51</sup> *Id.*
- <sup>52</sup> *Id.*
- <sup>53</sup> *Id.*
- <sup>53</sup> I.R.C. § 6707A; Treas. Reg. § 301.6707A-1.
- <sup>54</sup> I.R.C. § 6662A.
- <sup>55</sup> I.R.C. §§ 6700(a) and 7701(a)(1).
- <sup>56</sup> I.R.C. § 6707; Treas. Reg. § 301.6707-1.
- <sup>57</sup> I.R.C. § 6708; Treas. Reg. § 301.6708-1.
- <sup>58</sup> I.R.C. § 6694(a); Treas. Reg. § 1.6694-2.
- <sup>59</sup> I.R.C. § 6694(a)(3).
- <sup>60</sup> I.R.C. § 6694(b); Treas. Reg. § 1.6694-3.
- <sup>61</sup> Treas. Reg. §§ 1.6694-2(a)(2) and 1.6694-3(a)(2).
- <sup>62</sup> *Comm. v. Duberstein*, 363 U.S. 278 (1960).
- <sup>63</sup> I.T.A. s 237.1(1).
- <sup>64</sup> Third-Party Civil Penalties, Canada Revenue Agency, IC 01-1 (Sept. 18, 2004) pp. 2 and 6.
- <sup>65</sup> Fact Sheet: Art-donation schemes or Art Flipping, C.R.A. (Nov. 2002); Shane D. Onufrechuk, “Tax Traps & Tips for Shelter from the Storm: Current Tax Shelter Issues beyond Numbers,” *British Columbia CPA* (Sept. 2005).
- <sup>66</sup> I.T.A. s 245(1) to 245(3); *Trustco Mortgage Co. v. Canada*, 2005 S.C.C. 54, para. 17; Alan W. Schwartz and Kevin H. Yip, *Policy Forum*, “Defending Against a GAAR Reassessment,” *Canadian Tax Journal* (2014) 62:1, p. 130.
- <sup>67</sup> I.T.A. s 245(2).
- <sup>68</sup> C.R.A. Information Circular 01-1 (Sept. 18, 2001); Peter Aprile, “Tax Advisors & Accountants Third-Party Penalties: Civil or Criminal?” *Tax Section of the Ontario Bar Association* (March 2013).
- <sup>69</sup> *The Queen v. Littler* 1978, 6181; *Re Bayoff Estate* 2000.

# ***DOES ELON MUSK RANK? LEADERSHIP, CREATIVITY, AND STAKEHOLDER IMPACT***

**BENJAMIN N. ALEXANDER  
JEAN-FRANÇOIS COGET  
PATRICIA C. DAHM**

California Polytechnic State University

Elon Musk, the dynamic leader of Tesla and SpaceX, appeared on *Business Insider's* 2016 "Top 100 Creators" list, a prestigious account of the most important people in the world (Martin, Loudenback & Pipia 2016). As the magazine prepared to update the list in early 2019, Gwen Botts, a new staff writer, wondered if Musk was truly worthy of the distinction. To be a *Business Insider* Creator, a leader had to make "bold moves to create value for four constituencies: shareholders, employees, consumers, and society." While praised for his boldness and vision, Musk had also been criticized for his "domineering style," and the sometimes-shaky performance of his different companies.

Gwen breezed into the newsroom, eager to get to work. With potential awardees' faces projected on the wall, the Editor-in-Chief read the names out loud. Knowing that each of the staff writers would be assigned a few potential "Creators" to evaluate, Gwen anxiously glanced around the room. When the Editor-in-Chief paused to take a breath, she quickly declared, "I'd like to evaluate Elon Musk." Taken a bit aback, the Editor-in-Chief simply responded, "Great."

Gwen smiled nervously and turned her mind to the task at hand: "Considering his leadership style and stakeholder impact, should Musk be on the list?"

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The authors are listed alphabetically; they contributed equally to the development of the case. The authors developed the case for class discussion rather than to illustrate either effective or ineffective handling of the situation. The case relies on publically available data. The depiction of Business Insider's editorial process is meant to stimulate student engagement and any similarity to actual editorial practices is purely coincidental. The case and its accompanying instructor's manual were anonymously peer reviewed and accepted by the *Journal of Case Research and Inquiry*, Vol. 4, 2018, a publication of the Western Casewriters Association. The authors and the *Journal of Case Research and Inquiry* grant state and nonprofit institutions the right to access and reproduce this manuscript for educational purposes. For all other purposes, all rights are reserved to the authors. Copyright © 2018 by Benjamin N. Alexander, Patricia C. Dahm and J.F. Coget. Contact: Benjamin N. Alexander, Orfalea College of Business, California Polytechnic State University, San Luis Obispo, CA 93407, (805) 756-5305, [balexa02@calpoly.edu](mailto:balexa02@calpoly.edu)

## Launching Musk

### *Early Life and Personal Relationships*

Musk had achieved rock star CEO status through his various ventures and his vision for society, a level of celebrity perhaps matched only by Steve Jobs among business leaders in previous decades. Actor Robert Downey Jr. had even shadowed Musk to develop his interpretation of Marvel Comics' character Tony Stark, inventor of the Iron Man suit (Favreau 2010). However, Musk's life had not been a linear ascension to global stardom, influence, and wealth. Born in 1971 in South Africa, he was very introverted and fascinated with how things worked as a child. He would often be immersed in contemplation, unable to hear others calling out to him. Bullies targeted Musk at school, once brutally pushing him down a staircase and, another time, punching him in the face so ferociously that he had to be hospitalized. His parents divorced when he was a young child. Though Musk was close with his mother, he chose to live with his father because he saw him as "*sad and lonely*" (Vance 2015). However, this choice led to further pain; Musk would later recount that his father was very hard on him and his brother, Kimbal. In his adult life, Musk cut all ties with his father.

In 1988, Musk left South Africa for Canada and began college there before moving to the United States. Higher education shaped Musk both intellectually and personally. While he famously dropped out of Stanford's Ph.D. program in Applied Physics after just a few days, Musk's undergraduate experience helped him focus on several big areas that he believed would change the world, areas in which he would later start companies: the internet, the transition to solar energy, and space exploration (Vance 2015).

In Canada, he met Justine Wilson, who would in due course join him in Silicon Valley and become his first wife in 2000. The couple suffered the tragedy of losing their first child to Sudden Infant Death Syndrome (SIDS) and eventually divorced in 2008 after having five children together. Musk was deeply involved in his entrepreneurial ventures at the time of the divorce.

Justine wrote that he was “*obsessed with his career,*” while she was merely “*a sideline player in the multimillion-dollar spectacle of [his] life*” (Musk 2010).

### ***First Ventures: Zip2, X.Com***

Musk weathered the crash of the dot.com bubble in the early 2000s and leveraged gains from his internet firms’ exits into bigger ventures in energy and space (see Exhibit 1). His first venture in 1995 was originally named Global Link Information Network and later renamed Zip2. Zip2 developed city guide software that connected users and local businesses. The firm enabled direct communication between users and local businesses through URL-initiated fax years before Google maps launched in 2005. Early on, however, Zip2 shifted from targeting individual businesses to newspapers and entered into contracts with newspaper publishers including The New York Times Company, Knight Ridder, and the Hearst Corporation (Vance 2015). In 1999, Musk sold the company to Compaq for \$307 million, netting \$16 million personally after taxes (Chafkin 2007).

Still shy of 30 years old and seemingly disinterested in leisurely enjoying his wealth, Musk wasted no time in investing in his second venture, X.com, an online banking platform. After merging with Peter Thiel’s Confinity, the combined firm became PayPal. After Musk took over as CEO, the company faced significant challenges with the platform’s stability and fraudulent use. In a coup, Musk was replaced as CEO while he was traveling outside the United States, and he was forced to accept an advisory role. Later, he commented that “*It’s not a good idea to leave the office when there are a lot of major things underway which are causing people a great deal of stress*” (Elon Musk best videos 2015). After contracting malaria, Musk became even more distanced from the company’s leadership. While PayPal would eventually become the industry leader in online payments, Musk’s original vision for X.com as a full online banking alternative did not come to fruition. Nonetheless, PayPal was lucratively sold to eBay.com for more than \$1.5 billion in 2002 (Urban 2015a; Vance 2015).

### Exhibit 1. Musk's Ventures

Sources: Chafkin 2007, 2017; Dobush 2018; Higgins 2016; Huddleston 2018; Kharpal 2017; Urban 2015a; Vance 2015, 2017; Winkler 2017

Venture	Musk's Role (dates of involvement)	Current State
Zip2 (city guide)	Founder, Chairman (1995-1999)	Sold to Compaq in 1999
X.com/PayPal (online banking)	Founder, CEO (replaced before sale) (1999-2002)	Sold to eBay in 2002
SpaceX (space)	Founder, CEO, CTO (2002-)	Privately held, valued at \$21.5 billion in 2017
Tesla (electric vehicles, solar energy)	Early investor, CEO (2008-) and Chairman (2004-2018)	Publicly traded, acquired SolarCity in 2016, Musk replaced as Chairman in 2018
Stripe (online payments)	Investor	Privately held, valued at \$9.2 billion
The Boring Company (Infrastructure and Tunnel development)	Founder (2016-)	Early Stage
OpenAI (AI research)	Founder, Supporter (left board in 2018)	Active
Neuralink	Founder, CEO (2016-)	Early stage

Already, though, Musk's attention had shifted. With a fortune of \$165 million after PayPal's sale (Urban 2015a; Vance 2015), Musk had enough capital to pursue his other interests in space exploration and solar energy (Rhodes 2009).

### Current Ventures

#### *SpaceX*

SpaceX was a privately-owned company that designed, manufactured, and launched rockets and spacecraft, founded in 2002 by Elon Musk (Vance 2015). Musk's preoccupation with space travel originated in his childhood with science fiction classics such as Isaac Asimov's *Foundation*

novels (Vance 2015). His interest in space was not purely or even primarily market-oriented. Rather, Musk viewed multi-planetary colonization as essential to ensuring the survival of humankind and Mars as the only realistic alternative to Earth. In 2017, he wrote that there were two paths for humanity: *“One path is we stay on Earth forever, and then there will be some eventual extinction event... The alternative is to become a space-bearing civilization and a multi-planetary species, which I hope you will agree is the right way to go”* (Musk 2017). Yet any colony must overcome challenges with terraforming, infrastructure building, and perhaps most importantly, the cost of space launch vehicles. Under President George W. Bush, NASA estimated that a human-crewed mission to Mars would cost \$50 billion, or \$10 billion per astronaut. Musk estimated that a viable colony would require a critical mass of one million colonists which, without any economies of scale, would cost \$10 quadrillion dollars, more than 500 times the United States’ gross domestic product in 2016.

After failing to buy an economical launch vehicle from Russian sellers for the nonprofit Mars Oasis project in 2001 (Vance 2015), Musk founded SpaceX just prior to selling PayPal. His goal was to produce launch vehicles that were better and cheaper than the antiquated and inefficient launch vehicles then available. He observed that since the moon landing in the 1960s, no significant advances had been achieved in space flight (Urban 2015b). Compared to advances in other high-tech industries such as telecommunications, space exploration had stalled. By 2015, Musk had invested more than \$100 million into SpaceX and aimed to reduce the cost of transporting a human to Mars by a factor of 20,000, down to \$500,000 per person (Urban 2015b).

From its founding to early 2018, SpaceX had made several important advances. It had developed its own *“Merlin”* rocket engine and a succession of increasingly higher capacity rockets: the Falcon 1 (in reference to Star Wars’ millennium falcon), the Falcon 9, and the Falcon heavy which, consisting of three Falcon 9 rockets put together, was the world’s most

powerful operational rocket in 2018. SpaceX's rockets were affordable in comparison to those of competitors. According to a 7-year contract with NASA, SpaceX charged \$133 million per launch whereas Orbital, a competitor, charged \$237.5 million in 2008 (Yembrick 2008). For private clients with less stringent requirements, SpaceX charged only \$60 million, making it the most cost-efficient space launch company in the world by far (Chaikin 2012). SpaceX planned to further reduce the cost of launches by reusing rockets after landing them safely on earth and by achieving economies of scale through mass production, among other factors.

However, in 2018, SpaceX's financial viability remained uncertain, and it had suffered several setbacks with its rockets. In addition to losing several rockets at launch to explosions, two Department of Defense reports had found large numbers of "*major nonconformities*" relative to competitors' rockets (Thompson 2018). While SpaceX's finances were not publicly available, the *Wall Street Journal* had gained access to recent data and reported that the company lost \$250 million in 2015 (Winkler & Pasztor 2017; see Exhibit 2). Moreover, SpaceX's projected revenue relied on a yet-to-be-initiated satellite internet service. While the company seemed to have recovered from the 2018 accidents and lost revenue, it faced steep competition in the development of manned and unmanned rockets from several other reputable organizations including Orbital ATK, a public company with a long history in aerospace and defense, United Launch Alliance, a joint venture of Lockheed Martin and Boeing, Arianespace SA, a joint venture backed by several European governments, Blue Origin, a company controlled by Amazon founder Jeff Bezos, and Rocket Lab, a private firm focused on cost-effective satellite launches.

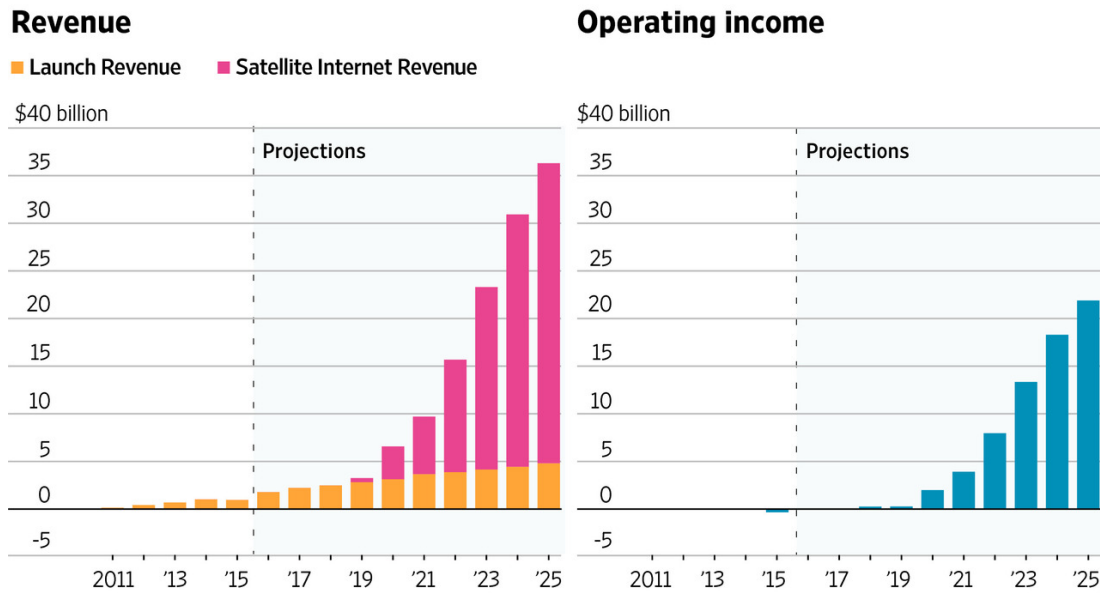


**Exhibit 2. Revenue and Launch Projections at SpaceX**

Source: The Wall Street Journal, Jan. 13, 2017

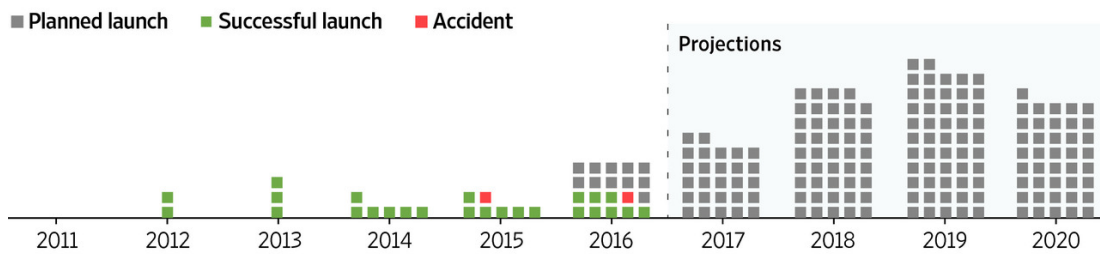
## Reaching for the Stars

SpaceX projects that soaring revenue from its planned satellite-internet business will dwarf its launch revenue.



### On the Launchpad

The company forecasts a dramatic increase in launches in coming years. Accidents in 2015 and 2016 caused planned launches to be delayed.



Note: specific launch targets for 2011-15 not available  
Source: the company, early 2016 documents

THE WALL STREET JOURNAL.

## Tesla

Musk was perhaps best known for Tesla, the iconic electric car company that had disrupted the automobile industry by jumpstarting the development of electric vehicles. Founded in 2003,

Tesla initially received \$6.5 million from Musk who was one of the firm's first investors (Vance 2015). According to Musk, *"the overarching purpose of Tesla Motors (and the reason I [funded] the company) [was] to help expedite the move from a mine-and-burn hydrocarbon economy towards a solar electric economy, which I believe to be the primary, but not exclusive, sustainable solution"* (Musk 2006, paragraph 2). After learning that the company was losing money on each \$92,000 Roadster it sold, Musk fired the CEO and eventually took over the position himself in 2008 (Davis 2010). He was credited with redesigning many of the Roadster 2's systems as well as Tesla's supply chain. Tesla's next car, the Model S, was widely acclaimed, but considered too expensive and produced in insufficient numbers to dent the new car market. More models would soon follow. Tesla began delivering the Model X, an SUV, in 2015 and, in late 2017, started fulfilling orders for a midrange car with a \$35,000 starting price, the Model 3 (Hawkins 2017). By 2018 Tesla had also publicized plans to develop a minibus, a pickup truck, and a semi-truck.

Innovation was at Tesla's core, and the location of its headquarters in Silicon Valley was no accident. The technology to produce high-capacity batteries at low cost was a cornerstone of Tesla's ability to deliver affordable electric cars for the masses. To this end, Tesla invested billions in the development and production of lithium-ion batteries, including the construction of a Gigafactory that was 30% complete in November 2017 (Gertner 2017). Efficient lithium-ion batteries had applications beyond automobiles, such as the storage of solar energy for homes. Tesla also invested in autonomous driving technology, which was first incorporated into the Model S in October 2015 (Urban 2015c). With regard to its business model, Tesla dismissed the traditional dealership model that was standard in the United States and pursued direct sales (Ohnsman & Niquette 2014). Finally, Tesla invested in the electric vehicle infrastructure through the development of a network of superchargers, where its vehicles could be rapidly charged.

**Exhibit 3. Selected Tesla Financial and Operational Data (2015-2018)**

Sources: CNBC staff 2017; DeBord 2017; Ferris 2018; Statista 2018;  
Tesla Inc. 2018a, 2018b; Y-charts 2019; Wattles 2016

	2015	2016	2017	2018
Tesla Revenue	\$4.05 billion	\$7 billion	\$11.76 billion	\$14.24 billion (through Q3)
Tesla Net Loss	\$888.66 million	\$674.91 million	\$1.96 billion	\$1.12 billion (through Q3)
Tesla Market Cap	\$31.84 billion	\$33.13 billion	\$52.4 billion	\$57.15 billion
Tesla Deliveries (U.S.)	50,580	76,230	101,312	500,000* production target, unlikely to be met
New Car Sales (Worldwide)	72.61 million	77.25 million	79.02 million	81.6 million** forecast

Musk's efforts to stimulate an energy revolution through Tesla were furthered by its 2016 acquisition of Solar City, a solar panel installation and leasing company started by Musk's cousins, in which he had invested and served as chairman (Higgins 2016; Urban 2015a; Vance 2015). Solar City had become the largest installer of solar panels in the United States and claimed to have developed the world's most efficient solar panel in 2015 (Worland 2015). While SolarCity had numerous potential synergies with Tesla, its acquisition exacerbated Tesla's already precarious financial situation.

In 2018, despite being well more than a decade old and having completed an IPO in 2010, Tesla had not yet matured to the point of stability. It had had few profitable quarters, losing \$100s of millions in most years, and some analysts predicted it was on the verge of running out of cash

despite its creative system of taking deposits on future sales (Shen 2017). Moreover, Tesla had repeatedly failed to hit production targets, missing projections time and again. In announcing the Model 3 in July 2017, Musk had projected that Tesla would produce 20,000 vehicles a month by the end of the year. Pre-orders flooded in, but by early 2018 it was still struggling to produce 2,500 cars per week (Ferris 2018). As a result, customers who had placed deposits faced long, uncertain delays and many canceled their orders (Logan 2017). Still, Tesla's share price soared, and while volatile, Tesla's market capitalization exceeded that of other U.S. automobile manufacturers in stretches of 2017 and 2018 despite their vastly larger outputs. Musk's bombast seemed a double-edged sword, both driving excitement and leading to unmet expectations. After Musk tweeted that he had secured financing to take Tesla private at a significant premium, statements deemed fraudulent, Tesla, Musk, and the SEC reached a settlement of \$40 million in fines (Ohnsman 2018). The settlement further required Musk to relinquish his position as chairman, though he remained Tesla's CEO.

But Tesla's challenges did not end there. Other automobile manufacturers across the world, and particularly in China, followed Tesla's lead in developing new vehicles (e.g., McHugh 2018, Thompson 2017). In addition to the pure electric vehicles that Tesla produced, firms generated models that were plug-in hybrids and others that were powered by biofuels, natural gas, or hydrogen. Pure electric vehicles appeared to be gaining momentum, but no standard had emerged among alternatives to traditional internal combustion engines. Separately, while environmental groups acknowledged the benefits of electric cars, some asserted that more gains could be made by encouraging public transportation or cycling than with private vehicles (Casson 2018; Lynskey 2019). Though Musk announced Tesla's intent to develop an electric bus, this niche was far more crowded than electric cars (Yvkoff 2016).

### ***Other Ventures***

While SpaceX and Tesla appeared to occupy most of Musk's professional energy, he was also attached to numerous other startups and technologies (Calderone 2016). In addition to stimulating R&D in the hyperloop - a transportation concept he had articulated in a public white

paper - investing in Stripe - an online payment firm - and founding a tunneling company, The Boring Company, Musk was a cautionary voice in the development of artificial intelligence (AI). Looking beyond its application in autonomous driving, Musk viewed AI as an existential threat to humanity (Urban 2015d) and was a sponsor of OpenAI, a “*non-profit AI research company, discovering and enacting the path to safe artificial general intelligence*” and a co-founder of Neuralink, a firm which sought to develop brain-computer implants (Winkler 2017).

### Musk’s Leadership

Elon Musk was a genius according to many, such as writer and futurist Alex Lightman (Lightman 2015). He was reported to have a photographic memory and was able to recall intricate details from textbooks on aerospace engineering, for instance, and conversations he had with experts on the subject. He educated himself to become an aerospace expert within months of founding SpaceX. Employees at each of Musk’s companies feared encounters with him because they knew he would drill them with extremely detailed questions covering all possible angles of the problems they were working on (Urban 2015a; Vance 2015). Regardless of their own level of expertise, many felt that Musk outsmarted them.

Furthermore, Musk worked hard. He was demanding of his employees, but more of himself. Julie Ankenbrandt, one of his collaborators at X.com said: “*We all worked 20 hours a day, and he worked 23 hours*” (Vance 2015). He devoured information relevant to all of his ventures and would send emails and work on problems regarding his companies at all hours, including in the middle of the night (Vance 2015). A telling story was of him reading an obscure Soviet rocket manual at an outing in Las Vegas meant to celebrate PayPal’s success with his co-founders.

Albert Einstein attributed a large part of his genius to the ability to solve problems at a different level of analysis from the one at which the problem was generated (Dass 2011: 38). Musk appeared to likewise balance attention to detail with a sense for the bigger picture. He was reportedly involved in the most intimate details of each product. For instance, he worked closely with Franz von Holzhausen to design the look of Tesla's Model S, focusing on design minutia such as sun visors and insisting on retracting door handles which preserved the purity of lines (Dyer, Gregersen & Furr 2015). At SpaceX, Musk claimed to remember all of the details of his Falcon rockets down to the smallest component and how they fit into the whole architecture of the rocket (Urban 2015b; Vance 2015). But Musk also grounded his work in a vision of ensuring the survival of the human species (Urban 2015b; Vance 2015). And between the details and the overarching vision, Musk was adept at identifying commercial opportunities although the long-term viability of his various ventures remained unclear.

Though his commitment to some matters had been questioned, Musk appeared to possess an unshakeable, if selective, determination. Despite being ignored or turned down numerous times while courting his first wife, he never stopped pursuing her until she relented. Likewise, after SpaceX's third launch failure, Musk and his employees knew that they only had enough money to fund one more attempt. If they failed, SpaceX would likely die. After the rocket exploded in the sky, Musk reportedly gave SpaceX employees one of the company's most memorable and rousing speeches. He announced, "*I will never give up, and I mean never*" (Hsu 2008), and went on to explain calmly what went right about the launch and what went wrong, outlining a detailed plan for how to address the issues (Vance 2015). The fourth launch was successful and led NASA to award SpaceX a major contract.

Musk's ability to inspire employees helped him hire the very best people. For instance, one of SpaceX's first recruits was Tom Mueller (Vance 2015), an aerospace engineer who built amateur rockets in his garage and enjoyed a strong reputation among other rocket amateurs. Mueller went on to design SpaceX's in-house rocket engine, the Merlin, and was often regarded as

SpaceX's smartest employee, other than Musk. Even after the initial growth of his companies, Musk maintained a commitment to hiring the best of the best. Typically, this involved asking the relevant engineering departments at elite universities to identify their best students. However, credentials were not sufficient and occasionally not necessary; more important were the candidate's passion and actual abilities. The typical candidate fit a profile similar to Musk himself: a hard-core engineer with the ability to understand basic science, a passion for actually building stuff, a relentless work ethic and motivation, and the ability to collaborate with others. If such a candidate lacked a prestigious diploma, it did not matter to Musk. Until 2014, Musk was reputed to interview every potential employee, even interns, for SpaceX (Stevenson 2014).

Much as Steve Jobs used to recruit talent with the phrase "*Come down here and make a dent in the universe*" (Isaacson 2011: 94), Musk attracted candidates with lofty goals, such as colonizing Mars, and the perception that his firms were the most innovative in their respective fields. While technicians were paid well, Musk's ventures cut costs by paying employees less than competitors and expecting employees to work harder, to the tune of 60 to 80 hours per week, weekends often included (Boyle 2016). Recruiters were upfront with job candidates. They considered it a privilege to work at one of Musk's ventures, a crusade undertaken for the glory and the adventure rather than the money and comfort.

While often inspiring, Musk's interpersonal style could cause consternation and led some to characterize him as callous. For instance, he was once reported to reprimand a Tesla employee for choosing to attend his child's birth rather than a Tesla event (Vance 2015). Musk seemed to expect others to sacrifice their personal lives as he did in the name of lofty goals. He was also criticized as heartless for letting go of his long-time personal assistant, Mary Beth Brown. After she asked for a raise, Musk asked her to take a leave for a few weeks so that he could evaluate how replaceable she was. Upon Brown's return, he fired her.

While some of Musk's collaborators described him as humble, his self-confident style, even if predicated on ability and performance, grated on others. He assessed Facebook CEO's Mark Zuckerberg's knowledge of AI as limited and, in response to a critical news story, called the reporter "*a huge douchebag and an idiot*" (Elon Musk best videos 2015). He was described as frightening when he drilled his collaborators. If engineers were unable to answer his detailed questions about a problem or to go about solving it as thoroughly as Musk himself would, he would verbally tear the engineers to pieces or even fire them. If an employee told Musk that something was difficult or impossible to deliver, he'd say, "*Fine. You're off the project, and I am now the CEO of the project. I will do your job and be CEO of two companies at the same time. I will deliver it.*" (Vance 2015: 20-241).

### Gwen's Decision: Is Musk a Creator?

After doing her research, Gwen was not yet ready to make her decision. Should Musk be on the list? Before making her recommendation, she needed to return to her notes on Musk's leadership and stakeholder impact.





**Benjamin N. Alexander** ([balex02@calpoly.edu](mailto:balex02@calpoly.edu)) is an Assistant Professor of Management at the Orfalea College of Business, California Polytechnic State University, San Luis Obispo. Ben received his Ph.D. from the A.B. Freeman School of Business at Tulane University. His research examines social entrepreneurship, collective action, research methods, and stakeholder management.



**J.F. (Jean-Francois) Coget** ([jcoget@calpoly.edu](mailto:jcoget@calpoly.edu)) is Associate Dean for Academic Programs and Professor of Management at the Orfalea College of Business at Cal Poly, San Luis Obispo. He earned his Ph.D. from the Anderson School at UCLA, and was previously a faculty member at HEC Paris. His research interests include creativity, intuition, emotions, and leadership.



**Patricia C. Dahm** ([pdahm@calpoly.edu](mailto:pdahm@calpoly.edu)) is an Assistant Professor of Management and Human Resources at the Orfalea College of Business, California Polytechnic State University, San Luis Obispo. She received her Ph.D. in Business Administration (Concentration: Organizational Behavior/Human Resource Management) from the Carlson School of Management, University of Minnesota. Her research focuses on work-life integration, gender differences in career success, and leadership.



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## **PEPSICO: WILL THE COMPANY SPIN OFF CARBONATED BEVERAGES?**

**ISSAM GHAZZAWI**  
University of La Verne

*"I am so pleased to report that 2016 marked another exceptional year for PepsiCo. Across the company, we delivered top-tier financial performance, the kind of performance that's commensurate with the confidence you've placed in us to steward this iconic corporation."*

- Indra K. Nooyi

Indra K. Nooyi, PepsiCo's Chair of the Board of Directors and Chief Executive Officer, was very confident that the planned annual shareholders meeting would be as successful as the company's strategic direction. It was in mid-February 2017, when Nooyi was sipping a cup of tea in her office located in Purchase, New York, watching the falling snow behind her window and reflecting on the state of the company. She recalled the statement she had made to the company shareholders in 2015 during PepsiCo's 50th anniversary celebration, which focused on how carbonated beverages were *"a thing of the past,"* and emphasized how healthier products would *"future-proof"* Pepsi's portfolio (Forbes n.d.). As soda had contributed less than 25% of its global sales in the past few years, PepsiCo was no longer a soda company (Forbes n.d.). It was a new era as PepsiCo started moving toward healthier product offerings.

Under Nooyi's leadership, 2016 marked another exceptional year for PepsiCo because of its continuing growth in snacks and non-carbonated drinks, especially in North America, as well as its growth in Russia—the company's second-largest market after the United States (Forbes 2017a). PepsiCo's portfolio included \$22 billion of brands. Exhibit 1 shows PepsiCo's brands.

The company had built a world-class go-to-market system and strong retail and foodservice partnerships. Its core instant currency earnings per share grew 9%, exceeding the goal of 6% growth (PepsiCo 2017). The company's organic revenue grew 3.7% in 2017, in line with a goal of approximately 4%. Importantly, PepsiCo's operating margins increased 80 basis points compared to 2015, yielding approximately \$1 billion in annual savings since 2012 (PepsiCo 2017). Through its thorough capital allocation and sound capital management, PepsiCo improved its net return on invested capital by 190 basis points to 21.5% and generated \$7.8 billion in free cash flow, exceeding its goal of returning approximately \$7 billion in cash to shareholders through dividends and share repurchase. Equally important to its growth, the company increased its investment in research and development by 45% since 2011—equivalent to \$3.5 billion over the past 5 years (PepsiCo 2017).

#### Exhibit 1. Images of PepsiCo 22 billion-dollar brands

Source: NoTricksZone.com



Leveraging the company's massive market share of the U.S. savory snacks market, its snack division, Frito-Lay North America, was PepsiCo's most valuable and profitable division, making up almost 40% of the company's valuation (Forbes 2017a). The company's North America

Beverages division continued to be a strong second, despite having a drinks portfolio heavily weighted with the slow-growing carbonated drinks category. The North America Beverages division's success was primarily due to the steady growth of non-carbonated drinks.

For many years, the soft drink industry has been one of the most profitable industries, with an estimated gross margin of approximately 83% and net margin of about 35%, with Coke taking the dominant market share (Carpenter & Sanders 2009). While the two giants defined the soft drink industry and fought what became known as the "*Cola Wars*," the battleground was changing. Nooyi recalled that "*after years of investing aggressively, too aggressively in retrospect, our international beverage business suffered dramatic losses*" (cited in Carpenter & Sanders 2009: 104).

Carbonated beverages had weighed down the company over the past few years. Activist investors asked to spin off the beverages division. As a result of this contention and as a part of the company's strategic vision for the future, PepsiCo had been focusing its efforts on strengthening and further growing its fast-growing beverages' segments, including sports and energy drinks, ready-to-drink tea, and bottled water (Forbes 2017a). With an above-average dividend yield of 3.0%, PepsiCo had grown its revenues-per-share to 9.7% a year over the last decade; its success was attributed to its continued growth and stability (Forbes 2017a).

## PepsiCo Overview

### *PepsiCo, Inc.*

One of the largest food and beverage companies in the world, PepsiCo took its name in 1965 when the Pepsi-Cola Company merged with Frito-Lay, Inc. (Forbes 2017b). Located in Purchase, New York, the company operated in over 200 countries. Pepsi-Cola was founded in the late 1890s by Caleb Bradham, a pharmacist in New Burn, North Carolina. Frito-Lay emerged in 1961 through the merger of the Frito Company founded by Elmer Doolin in 1932 and the H.W. Lay company founded by Herman W. Lay also in 1932 (PepsiCo 1965).

### *The Early History*

The company's history and success evolved around certain individuals and dates. It was the year 1893 when Caleb Bradham, like other pharmacists at the turn of the century, served customers refreshing drinks at the soda fountain of his drugstore. At the time, his most popular beverage was a drink that he made through a mix of sugar, water, caramel, lemon oil, kola nuts, nutmeg, and other additives. Known as "Brad's drink," the beverage became an overnight sensation (Bellis 2017). The original Brad's drink was created in the summer of 1893 and was renamed in 1898 after Caleb bought the trade name "Pep Cola" for \$100 from a competitor who had gone broke. According to Bellis (2017), *"Although some reports claim the original drink contained pepsin—which would go a long way to explaining the drinks' subsequent name change—the use of the digestive enzyme is now regarded as the stuff of pure legend."*

The popularity of the Pep Cola drink led Bradham to focus his energy and resources on developing a full-fledged business. He applied for a trademark with the U.S. Patent Office in Washington, D.C., started the Pepsi-Cola Company with 97 shares of stock, and placed the very first Pepsi-Cola newspaper advertisement in the *New Bern Weekly Journal* (Pepsistore n.d.). A Pepsi-Cola logo was designed by one of Mr. Bradham's neighbors, an artist.



Leveraging the theme of “*Exhilarating, Invigorating, Aids Digestion,*” Bradham moved bottling operations from his drugstore in 1903 into a rented warehouse, from which he sold 7,968 gallons of syrup in the first year of operation (Pepsistore n.d.; Stoddard 2013). A year later, Pepsi-Cola moved all its bottling and syrup operations into a new purchased building in New Bern, known as the “*Bishop Factory,*” and started its first bottling franchises one year later in 1905 in Charlotte and Durham, North Carolina. The company registered its trademark in Canada in 1906 (Pepsistore n.d.; Stoddard 2013). The year 1907 witnessed Pepsi-Cola’s success as it grew to 40 franchises and sold more than 100,000 gallons of syrup and registered its trademark in Mexico. In 1908, Pepsi-Cola became one of the first companies to modernize its delivery from horse drawn carts to motor vehicles (Pepsistore n.d.; Stoddard 2013). By 1909, there were 250 Pepsi-Cola bottlers in 24 states (Stoddard 2013). Exhibit 2 shows vintage images of the Pepsi-Cola logo.

#### Exhibit 2. Vintage images of Pepsi-Cola logo

Source: Google Images



### *The Fall and Rise of Pepsi-Cola*

World War I left a devastating impact on people, countries, and organizations, and Pepsi-Cola was no exception. One consequence of the war was the high price of the sugar and its rationing. The rationing of sugar made it difficult for Pepsi-Cola to produce enough syrup to meet its customers' demands. The company attempted to use substitutes for sugar, including molasses, which resulted in both inferior taste and lower acceptance by customers (PepsiCo n.d.; Solarnavigator n.d.). During that era, sugar prices soared from 3 cents to 28 cents per pound as demand skyrocketed. Caleb Bradham gambled on the fluctuations in sugar prices believing that sugar prices would continue to rise—they fell instead, leaving him a massive overpriced sugar inventory that contributed to Pepsi-Cola's downfall. On May 31st, 1923, the company officially filed for bankruptcy, its assets were purchased by Craven Holding Corporation for \$30,000, and Caleb went back to his pharmacy (PepsiCo n.d.; Pepsistore n.d.).

In 1923, soon after its bankruptcy, the Pepsi-Cola trademark was purchased by a New York stockbroker, Roy C. Megargel, who moved the company's operations from New Bern to Richmond, Virginia. The company was still struggling and Megargel used his own funds to make up for the deficits the company incurred annually. According to Stoddard (2013: 8), *"By 1929, there was a glimmer of hope within the Pepsi-Cola Company. That ended in October of 1929 when the stock market crashed and the country plunged into the Great Depression."*

Despite his best efforts, Roy Megargel failed to save the company. Pepsi-Cola declared bankruptcy for the second time in 1931 (PepsiCo n.d.; Solarnavigator n.d.). That same year, Charles G. Guth, a successful entrepreneur and candy manufacturer, purchased the company's trademark and the syrup recipe. As president of Loft Incorporated, a large chain of candy stores and soda fountains, Guth saw Pepsi-Cola as an alternative to his unsatisfactory business relationship with the Coca-Cola Company for Loft's soda fountains (PepsiCo n.d.; Solarnavigator n.d.). Under Guth's leadership and with a \$1 million in earnings for its new owner within 2

years of its purchase, Pepsi-Cola became a national icon, especially during the Great Depression (PepsiCo n.d.).

Throughout the 1930s, the company's sales and revenues soured, as Pepsi-Cola set up bottling franchises across the country and expanded internationally. The company's trademark was also registered in Latin America and the Soviet Union. Additionally, Pepsi-Cola awarded bottling franchises to bottlers in Canada (PepsiCo n.d.; Solarnavigator n.d.). In 1934, the company moved to a new headquarters in Long Island City, New York, and got its new president Walter S. Mack in 1938 (Stoddard 2013).

Despite competition and low profit margins compared to its competitors, Pepsi retained its market leadership through increased sales volume. Its catchy song about its low price, with *"twice as much for a nickel"* for lyrics, was also a big hit. Its tune, *"Nickel, Nickel,"* became the first advertising jingle to be played and heard coast-to-coast on network radio, making broadcast and advertising history (Zetaboards n.d.). Armed with its advertising team, the company's soft drink business grew larger than the candy company that owned it. Accordingly, the company changed its name from Loft Incorporated to the Pepsi-Cola Company (PepsiCo n.d.).

During World War II, Pepsi advertising was patriotic and uplifting. The company adopted a new red, white, and a blue color scheme for its bottles. Additionally, the era of aerial advertising and the writing of *"Pepsi-Cola"* in the sky at air shows and other events had begun.

Mack, a believer in progressive causes, realized that African Americans were an untapped market. Pepsi thus gained market share by targeting its advertising toward this African American *"niche market"* (Capparell 2007; Martin 2007; Stewart 2007). Pepsi-Cola started a series of advertisements *"showing African-Americans as fun-loving middle-class consumers*

living the American dream. In one ad, the small boy shown shopping for Pepsi with his mother was Ron Brown, who would become secretary of commerce" (Martin 2007).

### ***A New Era, a New Challenge!***

After World War II, Pepsi-Cola moved its headquarters to Manhattan, New York and continued its worldwide expansion into Latin America, the Philippines, and the Middle East. At the same time, the company started experimenting with new bottle sizes and began using its first cans. The post-war marketplace brought with it a new phenomenon, the emergence of supermarkets, along with changing economics of soft drink production and distribution. Responding to these changes, Pepsi-Cola was forced to abandon its half price strategy relevant to its arch rival, Coca-Cola, and soon after, the popular and long-running "*Nickel, Nickel*" advertising was replaced with "*More Bounce to the Ounce*" as the company became more focused on positioning and de-emphasized price as its advantage point. Marketing Pepsi as the "*bargain drink*" was less desirable as the country was growing increasingly prosperous in the post-war era (Stoddard 2002).

Customers reacted negatively. A new cycle started at Pepsi-Cola: decreased revenue translated into less money for advertising. In return, less money going toward advertising resulted in decreased sales, ultimately resulting in decreased profit for the company. The results were not encouraging. The company made almost \$7 million in 1947 and only a little over \$3 million in 1948. Moreover, Pepsi had stayed out of the vending machine market while its competitors were adding machines across the country. By the time Pepsi reacted, it was late; the delay cost the company many prime locations (Zetaboards n.d.).

Although Mack was a big force in leading the Pepsi-Cola Company during its tough time, he was known as a very hands-on manager who rarely delegated responsibilities to others. By 1950, Pepsi's board of directors decided that the company needed a change in management style as Mack had made strategic errors in judgment during the last couple of years of his leadership.

The board thus brought in Alfred N. Steele in 1950 to become Pepsi-Cola's president. An experienced executive, Steele had been vice president at Coca-Cola (Zetaboard n.d.).

With vast marketing and sales experience at Coca-Cola, Steele transformed Pepsi-Cola into a modern soft drink company. Out of the belief that the Pepsi drink was too sweet for the modern customer, he reformulated Pepsi-Cola and updated its trademark. In 1953, Steele introduced the new slogan "*The Light Refreshment*," referring to the newly adopted formula that contained less sugar. He had hoped that this new branding would elevate Pepsi's image from a "*bargain-basement*" drink. As Pepsi lacked the funds for a nationwide advertising campaign, Steele invested heavily in regional advertising. Once one region had recovered, he started concentrating on another region (Zetaboard n.d.). Under Steele's strategic leadership, Pepsi began to lose its reputation around 1958 as a bargain soda and started to become a fashionable young adult favorite. Steele also moved the company aggressively into supermarkets, vending machines, and overseas markets, more than tripling Pepsi's earnings in less than a decade (Zetaboard n.d.). In 1959, the company introduced Team, a lemon lime drink to diversify its offerings; unfortunately, Steele passed away that same year (Stoddard 2013).

### ***The 60s***

In 1963, Don Kendall, an executive in Pepsi's fountain sales department since 1947, became the company's president. It was during the mid-1960s that the United States witnessed a boom in its teenage population. This segment of the population – born shortly after World War II – was generally known as the "*Baby Boomers*," but it was also referred to as the "*Pepsi Generation*" by PepsiCo (Stoddard 2013; Zetaboard n.d.). Pepsi advertising had shifted from the product itself to the people who consumed it. This new strategy inspired the "*Come Alive! You're in the Pepsi Generation*" advertisements in 1964 that were well received by many (Stoddard 2013; Zetaboard n.d.).

In 1963, Pepsi introduced Diet Patio Cola, a sugar-free drink to accommodate some customers' needs. However, its sales results were disappointing, due to inadequate funding and the fact that diet drinks were considered the drink for those with medical conditions (Stoddard 2013). As Pepsi focused more on its branding, the company introduced the drink again under the brand name of "Diet Pepsi" in 1964. Through the name change, Pepsi was able to promote both Pepsi and Diet Pepsi together (Stoddard 2013). In 1964, Pepsi purchased Mountain Dew, a drink created by Tip Corporation, a move that helped Pepsi bottlers compete with Sun Drop (Stoddard 2013).

### ***The Merger of Pepsi-Cola with Frito Lay: The Emergence of PepsiCo, Inc.***

In 1965, Pepsi-Cola merged with Frito Lay, a major snack company. Wall Street labeled the merger "a marriage made in snack food heaven" (Stoddard 2013: 22). The company's name became PepsiCo, Inc., and its two predecessors became divisions of PepsiCo, Inc. (Company-Histories n.d.). Throughout the next few decades, PepsiCo continued its success by expanding its presence around the globe and challenging soda industry leader Coca-Cola for market share with aggressive marketing campaigns and promotion. These campaigns included its famous "Pepsi Generation," "Pepsi Challenge," "Join the Pepsi People Feelin' Free," and "Puppies" (Stoddard 2013; Zetaboard n.d.).

The company's success in the 1960s and 1970s was attributed to five distinct policies, all of which Kendall and his crew pursued diligently: (a) Advertising on a massive scale, (b) introducing new soft drink brands, (c) leading the industry in innovative packaging, (d) global outreach, and (e) diversification through acquisitions and various product lines (Company-Histories n.d.). During the "Cola Wars," Pepsi invested in the fast food restaurant business—buying Pizza Hut in 1997, Taco Bell in 1978, and Kentucky Fried Chicken in 1982—with the sole purpose of blocking Coke from further dominating the fountain market. Its arch-rival Coke has created a strategic partnership with McDonald's, which accounted for 75-100 million gallons of Coke annually in the U.S. alone (Carpenter & Sanders 2009).

In 1983, Roger Enrico became the chief executive of PepsiCo, Inc. USA (Ivory 2016; Smith 2016). Under Enrico's leadership, the company moved further in the advertising arena and almost immediately signed a multimillion-dollar sponsorship deal with pop singer Michael Jackson. Jackson sang "*You're the Pepsi Generation*," and moonwalked with a young Alfonso Ribeiro, who would later gain stardom as Carlton Banks on the sitcom "*The Fresh Prince of Bel-Air*" (Ivory 2016). Building on that success, other celebrities were recruited, including the likes of Lionel Richie and Madonna (Ivory 2016).

In 1986, PepsiCo president Don Kendall selected D. Wayne Calloway as his successor. Calloway, who held numerous executive positions within PepsiCo and had been instrumental in the success of Frito-Lay, decided to restrict PepsiCo's business to three business segments: (a) beverages, (b) snack foods and (c) restaurants (Applegate, Schlesinger & Votroubek 1994).

Due to Roger Enrico's successful marketing and operations for U.S. beverages, Pepsi had increased its market share significantly and was within a percentage point of the leader Coca-Cola by 1987. Enrico was promoted to CEO of PepsiCo Worldwide Beverages, a position he held from 1987 to 1991 (Encyclopedia of World Biography 2017). Craig Weatherup took charge of the U.S. beverages division after Enrico's promotion, and his biggest challenge was to meet the increasing customer demand for more choices of refreshment beverages. Accordingly, he expanded Pepsi's portfolio to include over 188 different beverages (Stoddard 2013).

By 1994 PepsiCo had eight businesses within its core segments: (a) Pepsi-Cola North America, (b) Pepsi-Cola International, (c) Frito-Lay, Inc., (d) PepsiCo Foods International, (e) Pizza Hut Worldwide, (f) Taco Bell Worldwide, (g) Kentucky Fried Chicken Corporation, and (h) PepsiCo Food Systems Worldwide. The heads of these businesses reported directly to Calloway.

In 1996, Roger Enrico was named chief executive and chairman of PepsiCo. A year later, he spun off the struggling company's restaurant division composed of Taco Bell, Kentucky Fried Chicken, and Pizza Hut chains into an independent public company, Yum! Brands (Ivory 2016; Smith 2016). Enrico also emphasized snack foods over beverages. Enrico oversaw PepsiCo's acquisition of Tropicana from Seagram for \$3.3 billion in 1998.

In 2001, Steven S. Reinemund became PepsiCo's Chair and CEO, an executive who had spent 22 years working for PepsiCo in various capacities. During his CEO tenure at PepsiCo, revenues grew by \$9 billion, net income rose 70%, earnings per share were up 80%, and PepsiCo's market cap exceeded \$100 billion (WayBack Machine 2006). Reinemund led the acquisitions of several PepsiCo food and beverage companies, including Quaker Oats, Naked Juice, Izze and Stacy's Chips.

Upon Reinemund's retirement in 2006, PepsiCo named Indra Nooyi, who had joined the company in 1994, as its fifth CEO in PepsiCo's 44-year history (Marketwired 2009; Useem 2008). Nooyi had directed the company's global strategy for more than a decade and had led PepsiCo's restructuring, including the divestiture of its assets into Yum! Brands under Roger Enrico (Levine 2006). In 1998, Nooyi took the lead in the acquisition of Tropicana and the merger with Quaker Oats, which brought Gatorade to PepsiCo (Levine 2006; Marketwired 2009). She was named third on the *Forbes* 100 Most Powerful Women list in 2009 (Forbes, 2009) and second Most Powerful Woman in *Fortune's* 2017 list (Fortune 2017). Useem (2008) asserted:

*"As CEO, she has continued to pursue her unusual, and tremendously ambitious, vision for reinventing PepsiCo. She is trying to take the company from snack food to health food, from caffeine colas to fruit juices, and from shareholder value to sustainable enterprise."*

Appendix A provides a timeline of PepsiCo's important milestones.



### PepsiCo, Inc. Business Portfolio in 2016

At the turn of the 21st century, PepsiCo was a leading global conglomerate food and beverage company with a massive brands portfolio, including Frito-Lay, Pepsi-Cola, Gatorade, Tropicana, and Quaker Oats. Through its own facilities, its authorized bottlers, its contracted manufacturers, and other third parties, PepsiCo produced, marketed, distributed, and sold a wide variety of beverages, foods, and snacks in over 200 countries and territories (PepsiCo 2017). Exhibits 3 and 4 display images of Frito Lay products and PepsiCo beverages. Throughout the years, PepsiCo had streamlined its operations. In 2016, the company was organized into six divisions that brought in over \$62 billion in revenue. These divisions were:

**1) Frito-Lay North America.** This division included food and snack business in the United States and Canada. Frito-Lay made some of the bestselling savory snacks in the United States and around the world, including Cheetos, Doritos, Fritos, Lay's, Ruffles, SunChips, and Tostitos (Hoovers 2017a). In addition, the company made Grandma's cookies, Funyuns, Cracker Jack candy-coated popcorn, and Smartfood popcorn. Adding to the list, the company introduced a line of chips made with the fat substitute Olestra under the brand name "Light" (Hoovers 2017a). Frito-Lay made its healthier snacks and dips through its 50–50 joint venture with the Strauss Group. Finally, its Sabra Dipping joint venture enabled Frito Lay to make fresh hummus, spreads, Mediterranean salsas, and other vegetarian foods (Hoovers 2017a).

## Exhibit 3. Images of Frito Lay Products

Source: Bing Images



## Exhibit 4. Image of PepsiCo Beverages

Source: Bing Images



**2) Quaker Foods North America.** This division included cereal, rice, pasta, and other branded food in the United States and Canada.

**3) North America Beverages.** This division included beverages in the United States and Canada.

**4) Latin America.** This division included all PepsiCo beverage, food, and snacks in Latin America.

**5) Europe and Sub-Saharan Africa.** This division included all PepsiCo beverage, food, and snack business in Europe and Sub-Saharan Africa.

**6) Asia, Middle East, and North Africa.** This segment included all PepsiCo beverage, food, and snack business in Asia, Middle East, and North Africa.

Through mergers and acquisitions, PepsiCo built a \$22 billion brand that consisted of \$14 billion worth of beverage brands, eight carbonated (i.e., sparkling) and six non-carbonated (i.e., still), and \$8 billion in food brands. See Exhibit 5 for PepsiCo's billion-dollar brands.

#### Exhibit 5. PepsiCo's 22 Billion Dollar Brands

Source: Sure Dividend

<b>Sparkling Brands</b>	<b>"Still" Beverages Brands*</b>	<b>Food Brands**</b>
<i>Pepsi</i>	<i>Gatorade</i>	<i>Lay's</i>
<i>Diet Pepsi</i>	<i>Tropicana</i>	<i>Walkers</i>
<i>Pepsi Max</i>	<i>Aquafina</i>	<i>Doritos</i>
<i>Mountain Dew</i>	<i>Lipton**</i>	<i>Ruffles</i>
<i>Diet Mountain Dew</i>	<i>Brisk</i>	<i>Fritos</i>
<i>7 Up**</i>	<i>Starbucks RTD Beverages**</i>	<i>Cheetos</i>
<i>Sierra Mist</i>		<i>Tostitos</i>
<i>Miranda</i>		<i>Quaker</i>

\* A still beverage was a non-alcoholic drink without carbonation.

\*\*Lipton and Starbucks RTD Beverages had partnerships with Unilever (UL) and Starbucks (SBUX), respectively. Dr. Pepper/Snapple (DPS) owned the United States rights to 7 Up while PepsiCo owned the international rights.

Each division's net revenue (in \$ millions) and contributions to PepsiCo's consolidated net revenue for fiscal years 2014, 2015, and 2016 are shown in Exhibits 6-10.

### Exhibit 6. PepsiCo Segment Net Revenue (in \$ million) and Percentage Contributions to Consolidated Net Revenue

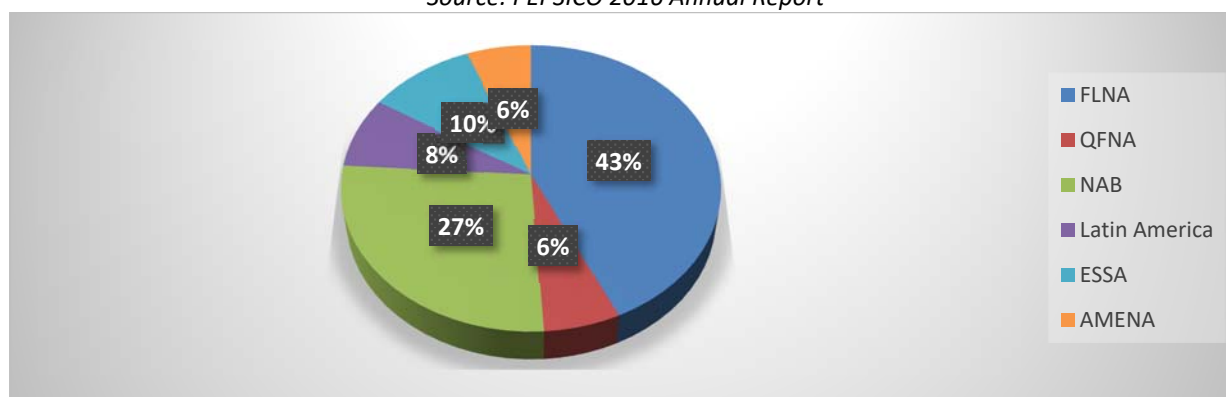
Source: PEPSICO 2016 Annual Report

	Net Revenue			% of Net Revenue		
	2016*	2015	2014	2016	2015	2014
FLNA	\$ 15,549	\$ 14,782	\$ 14,502	25	23	22
QFNA	2,564	2,543	2,568	4	4	4
NAB	21,312	20,618	20,171	34	33	30
Latin America	6,820	8,228	9,425	11	13	14
ESSA	10,216	10,510	13,399	16	17	20
AMENA	6,338	6,378	6,618	10	10	10
	<b>\$ 62,799</b>	<b>\$ 63,056</b>	<b>\$ 66,683</b>	<b>100</b>	<b>100</b>	<b>100</b>

\*PepsiCo fiscal 2016 results included an extra week of results (53<sup>rd</sup> reporting week). The 53<sup>rd</sup> reporting week increased 2016 net revenue by \$657 million, including \$294 million in FLNA segment, \$43 million in QFNA segment, \$300 million in NAB segment, and \$20 million in ESSA segment.

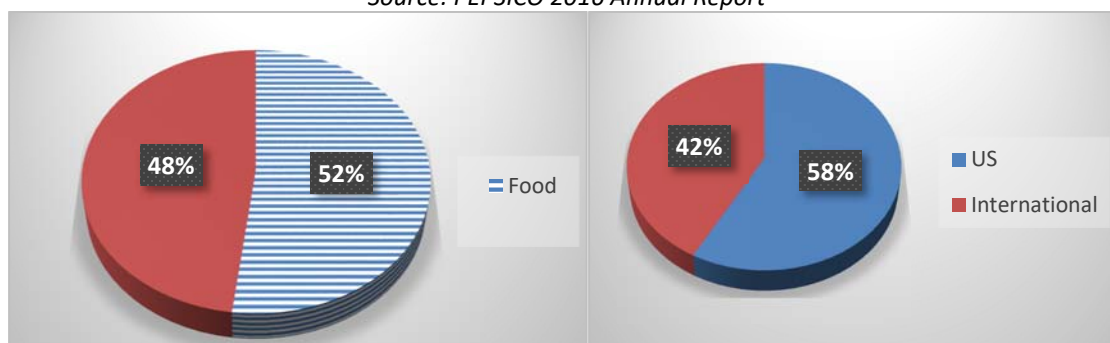
### Exhibit 7. PepsiCo 2016 Operating Profit per Division

Source: PEPSICO 2016 Annual Report



## Exhibit 8. PepsiCo 2016 Net Revenue Mix (Food vs. Beverage and US vs. International)

Source: PEPSICO 2016 Annual Report



## Exhibit 9. PepsiCo Consolidated Income Statements, 2012-2016

Source: Amigobulls.com

Fiscal year is January-December	2016	2015	2014	2013	2012
<b>PepsiCo Revenues</b>	<b>62.8B</b>	<b>63.06B</b>	<b>66.68B</b>	<b>66.42B</b>	<b>65.49B</b>
Cost of Goods Sold (COGS)	28.21B	28.38B	30.88B	31.24B	31.29B
<b>PepsiCo Gross Profit</b>	<b>34.59B</b>	<b>34.67B</b>	<b>35.8B</b>	<b>35.17B</b>	<b>34.2B</b>
Research & Development Expense	-	-	-	-	-
Selling General & Admin Expense	24.74B	26.24B	26.13B	25.36B	24.97B
Income Before Depreciation Depletion Amortization	9.86B	8.43B	9.67B	9.82B	9.23B
Depreciation Depletion Amortization	70M	75M	92M	110M	119M
Non-Operating Income	110M	59M	85M	97M	91M
Interest Expense	1.34B	970M	909M	911M	899M
PepsiCo Pretax Income	8.55B	7.44B	8.76B	8.89B	8.3B
Provision for Income Taxes	2.17B	1.94B	2.2B	2.1B	2.09B
Minority Interest	50M	49M	45M	47M	36M
Investment Gains Losses	-	-	-	-	-
Other Income	-	-	-	-	-
Income Before Extraordinaries & Disc Operations	6.38B	5.5B	6.56B	6.79B	6.21B
Extraordinary Items & Discontinued Operations	-	-	-	-	-
<b>PepsiCo Profit/ Loss (Net Income)</b>	<b>6.33B</b>	<b>5.45B</b>	<b>6.51B</b>	<b>6.74B</b>	<b>6.18B</b>
Average Shares used to compute Diluted EPS	1.45B	1.49B	1.53B	1.56B	1.58B
Average Shares used to compute Basic EPS	1.44B	1.47B	1.51B	1.56B	1.58B
Income Before Nonrecurring Items	7.04B	6.79B	7.07B	6.82B	6.45B
Income from Nonrecurring Items	-711M	-1.34B	-553M	-83M	-276M
PepsiCo Earnings Per Share Basic Net	4.40	3.71	4.27	4.32	3.92
PepsiCo Earnings Per Share Diluted Net	4.36	3.67	4.27	4.32	3.92
EPS Diluted Before Nonrecurring Items	4.85	4.57	4.63	4.37	4.10
Preferred Dividends Accounting Paid	-	-	-	-	-
Dividends Common	-	-	-	-	-
Dividend Per Share Common	2.96	2.76	2.53	2.24	2.13

## Exhibit 10. PepsiCo Consolidated Balance Sheet Statements, 2012-2016

Source: Amigobulls.com

Fiscal year is January-December	2016	2015	2014	2013	2012
Cash	9.16B	9.1B	6.13B	9.38B	6.3B
Marketable Securities	6.97B	2.91B	2.59B	303M	322M
Receivables	6.69B	6.44B	6.65B	6.95B	7.04B
Inventory	2.72B	2.72B	3.14B	3.41B	3.58B
Raw Materials	1.32B	-	1.59B	1.73B	1.88B
Work in Progress	150M	-	173M	168M	173M
Finished Goods	1.26B	-	1.38B	1.51B	1.53B
Other Current Assets	1.55B	1.87B	2.14B	2.16B	1.48B
<b>PepsiCo Total Current Assets</b>	<b>27.09B</b>	<b>23.03B</b>	<b>20.66B</b>	<b>22.2B</b>	<b>18.72B</b>
Property Plant & Equipment	36.82B	35.75B	36.3B	36.96B	36.16B
Accumulated Depreciation	20.23B	19.43B	19.06B	18.39B	17.03B
<b>PepsiCo Net Property Plant &amp; Equipment</b>	<b>16.59B</b>	<b>16.32B</b>	<b>17.24B</b>	<b>18.58B</b>	<b>19.14B</b>
Investment & Advances	1.95B	2.31B	2.69B	1.84B	1.63B
Other Non-Current Assets	-	-	-	-	-
Deferred Charges	-	-	-	-	-
Intangibles	27.86B	27.26B	29.05B	32.65B	33.5B
Deposits & Other Assets	636M	750M	860M	2.21B	1.65B
<b>PepsiCo Total Assets</b>	<b>74.13B</b>	<b>69.67B</b>	<b>70.51B</b>	<b>77.48B</b>	<b>74.64B</b>
Notes Payable	6.89B	4.07B	5.08B	5.31B	4.82B
Accounts Payable	14.24B	13.51B	13.02B	12.53B	11.9B
Current Portion Long-Term Debt	-	-	-	-	-
Current Portion Capital Leases	-	-	-	-	-
Accrued Expenses	-	-	-	-	-
Income Taxes Payable	-	-	-	-	371M
Other Current Liabilities	-	-	-	-	-
<b>PepsiCo Total Current Liabilities</b>	<b>21.14B</b>	<b>17.58B</b>	<b>18.09B</b>	<b>17.84B</b>	<b>17.09B</b>
Mortgages	-	-	-	-	-
Deferred Taxes/Income	5.07B	4.96B	5.3B	5.99B	5.06B
Convertible Debt	-	-	-	-	-
Long-Term Debt	30.05B	29.21B	23.82B	24.33B	23.54B
Non-Current Capital Leases	-	-	-	-	-
Other Long-Term Liabilities	6.67B	5.89B	5.74B	4.93B	6.54B
<b>PepsiCo Total Liabilities</b>	<b>62.93B</b>	<b>57.64B</b>	<b>52.96B</b>	<b>53.09B</b>	<b>52.24B</b>
Minority Interest	-	-	-	-	-
Preferred Stock	-151M	-145M	-140M	-130M	-123M
Common Stock Net	24M	24M	25M	25M	26M
Capital Surplus	4.09B	4.08B	4.12B	4.1B	4.18B
Retained Earnings	52.52B	50.47B	49.09B	46.42B	43.16B
Treasury Stock	31.47B	29.19B	24.99B	21B	19.46B
Other Liabilities	-13.82B	-13.21B	-10.56B	-5.02B	-5.38B
<b>PepsiCo Shareholders Equity</b>	<b>11.2B</b>	<b>12.03B</b>	<b>17.55B</b>	<b>24.39B</b>	<b>22.4B</b>
<b>PepsiCo Total Liabilities &amp; Shareholders' Equity</b>	<b>74.13B</b>	<b>69.67B</b>	<b>70.51B</b>	<b>77.48B</b>	<b>74.64B</b>

**Exhibit 11. PepsiCo Consolidated Cash-flow Statements, 2012-2016***Source: Amigobulls.com*

Fiscal year is January - December	2016	2015	2014	2013	2012
<b>PepsiCo Net Income Cash Flow</b>	<b>6.38B</b>	<b>5.5B</b>	<b>6.56B</b>	<b>6.79B</b>	<b>6.21B</b>
Depreciation Depletion Amortization Cash-Flow	2.37B	2.42B	2.63B	2.66B	2.69B
Net Increase (Decrease) in Assets Liabilities	912M	992M	1.16B	958M	434M
Cash From (used in) Discontinued Operations	-	-	-	-	-
Other Adjustments Net	745M	1.67B	164M	-720M	-858M
<b>PepsiCo Net Cash from (used by) Operating Activities</b>	<b>10.4B</b>	<b>10.58B</b>	<b>10.51B</b>	<b>9.69B</b>	<b>8.48B</b>
Increase (Decrease) in Prop Plant And Equipment	-2.94B	-2.67B	-2.74B	-2.69B	-2.62B
Acquisition Disposition of Subsidiaries	-127M	-10M	115M	21M	-459M
Increase (Decrease) in Investments	-4.09B	-314M	-2.3B	61M	61M
Other Cash Inflow (Outflow) from Investment Activities	9M	-573M	-10M	-21M	12M
<b>PepsiCo Net Cash from (used by) Investment Activities</b>	<b>-7.15B</b>	<b>-3.57B</b>	<b>-4.94B</b>	<b>-2.63B</b>	<b>-3.01B</b>
Issuance (Purchase) of Equity Shares	-2.54B	-4.5B	-4.27B	-1.89B	-2.1B
Issuance (Repayment) of Debt Securities	2.21B	4.61B	1.67B	301M	3.55B
Increase (Decrease) in Bank & Other Borrowings	1.54B	25M	-2B	1.17B	-1.46B
Payment of Dividends & Other Cash Distributions	-4.23B	-4.04B	-3.73B	-3.43B	-3.31B
Other Cash from (used by) Financing Activities	81M	81M	64M	64M	14M
<b>PepsiCo Net Cash from (used by) Financing Activities</b>	<b>-2.94B</b>	<b>-3.83B</b>	<b>-8.26B</b>	<b>-3.79B</b>	<b>-3.31B</b>
Effect of Exchange Rate Changes on Cash	-252M	-221M	-546M	-196M	62M
<b>PepsiCo Net Change in Cash &amp; Cash Equivalents</b>	<b>62M</b>	<b>2.96B</b>	<b>-3.24B</b>	<b>3.08B</b>	<b>2.23B</b>
Cash & Equivalents at Beginning of Year	9.1B	6.13B	9.38B	6.3B	4.07B
Cash & Equivalents at Year End	9.16B	9.1B	6.13B	9.38B	6.3B

**PepsiCo's Industries**

As a conglomerate, PepsiCo could be categorized under five industry classifications: (a) non-alcoholic beverage manufacturing, (b) soft drink manufacturing, (c) water and ice manufacturing, (d) breakfast cereal manufacturing, and (e) snack food manufacturing.

### **The Non-Alcoholic Beverage and Water Manufacturing Industry**

According to the *New York Times* (2017), the “non-alcoholic industry consists of companies engaged in manufacturing non-alcoholic beverages, such as water, fruit drinks, soft drinks, iced coffee and tea, as well as other flavored beverages.” Per Hoovers (2017b), the industry was dominated by major companies including Coca-Cola, Dr. Pepper, Snapple, and PepsiCo (all based in the United States), along with Britvic (United Kingdom), Cott (Canada), Danone (France), Nestlé (Switzerland), Red Bull (Austria), and Suntory (Japan). In this industry and as a result of the global demand for lighter, healthier, and replenishing drinks, “bottled water is expected to be the fastest growing category in global packaged beverages over the next five years” (Euromonitor 2017). Global sales of nonalcoholic beverages totaled more than \$850 billion per year, and the worldwide market was growing despite weak carbonated soft drink sales (Hoovers 2017b). The leading regional markets for soft drinks were Latin America, North America, and Western Europe (Hoovers, 2017b). The U.S. nonalcoholic beverage manufacturing industry included about 1,200 establishments and had a combined annual revenue of about \$50 billion. Refer to Exhibit 12 for the top coffee companies in the world and to Appendix B for the world’s leading soft drink companies.

#### **Exhibit 12. The Top Coffee Companies Worldwide in 2015 by Market Share**

Source: Adbrands.net

1. Nestlé	6. Starbucks
2. Jacobs Douwe Egberts	7. Tchibo
3. Kraft Heinz	8. Lavazza
4. JM Smucker	9. Strauss Group
5. Keurig Green Mountain	10. 3 Corações (Strauss/Sao Miguel)

As of 2014, the U.S. beverage market significantly grew after having been essentially flat in 2013. According to the Beverage Marketing Corporation, 2014 had the strongest growth in several years (PR Newswire 2015). “The vibrancy of the already-large bottled water segment, as well as more general ones, such as the continuing economic recovery, contributed to the overall increase in liquid refreshment beverage volume, which reached 30.9 billion gallons in



2014” (PR Newswire 2015). Refer to Exhibit 13 for the top 10 liquid refreshment brands in the United States.

### Exhibit 13. The Top 10 Liquid Refreshment Brands in the US

Source: Adbrands.net

1. Coke Family	6. Nestlé Pure Life (Nestlé Waters)
2. Pepsi Family	7. Sprite (Coca-Cola)
3. Mountain Dew (PepsiCo)	8. Dasani (Coca-Cola)
4. Dr. Pepper (Dr. Pepper Snapple)	9. Poland Spring (Nestlé Waters)
5. Gatorade (PepsiCo)	10. Arizona

In 2014 alone, bottled water was the U.S. consumer choice of a healthy, natural, zero-calorie refreshment beverage. Bottled water pricing also played a major factor in its upward growth by 7.3% (PR Newswire 2015). Energy drinks and ready-to-drink coffee outperformed the traditional categories of carbonated soft drinks and fruit beverages (PR Newswire 2015). Carbonated soft drinks remained by far the biggest liquid refreshment beverage category but continued to shrink in both volume and market share. According to the Beverage Marketing Corporation, soda volume had slipped by 1% from 12.9 billion gallons in 2013 to fewer than 12.8 billion gallons in 2014. That, in turn, has lowered soda’s market share from slightly less than 43% to just above 41% (PR Newswire 2015). Although carbonated beverages had declined more slowly than it had done in previous years, some soda brands, such as Sprite and Mountain Dew, did achieve growth. In fact, carbonated soft drinks accounted for five of the 10 most valuable beverage trademarks in 2014, with Coca-Cola and Pepsi-Cola retaining their first and second positions respectively (PR Newswire 2015).

The sports beverage segment exceeded 1 billion gallons for the first time in 2011 and surpassed 1.4 billion gallons in 2014 with Gatorade (including all brand variations) becoming the sixth largest beverage trademark. In the same year, bottled water had four entries among the leading brands, up from three the year before. All four brands outperformed the liquid

refreshment beverage category as a whole (PR Newswire 2015). According to Michael C. Bellas of the Beverage Marketing Corporation, “*Products that connect with what contemporary consumers want, like bottled water and functional offerings, added buoyancy to the ever-changing market*” (PR Newswire 2015).

In the U.S. market, the top 10 carbonated soft drinks manufacturers in 2014 were: (a) Coca-Cola, (b) PepsiCo, (c) Dr. Pepper Snapple, (d) Cott Corp., (e) National Beverage, (f) Monster Beverage Co., (g) Red Bull, (h) Rockstar, (i) Big Red Soda, and (j) private label and other (Beverage Digest as quoted in adbrands.net n.d.).

### ***The Snack Foods and Breakfast Cereal Manufacturing Industries***

The snack foods industry included companies who made items such as nuts, chips, popcorn, and peanut butter. Worldwide competition in the global snack food industry was fierce as a small number of multinational snack food companies controlled about half of the world’s snack food market. Top makers of snack foods companies included Frito-Lay, Mondelez International, Snyder’s-Lance, and Utz Quality Foods (all based in the United States), as well as Calbee Foods (Japan), Nongshim (South Korea), and United Biscuits located in the United Kingdom (Hoovers 2017c). According to Global Industry Analysts (Hoovers 2017c), the worldwide snack foods market was expected to exceed \$630 billion in revenue by 2020 with Europe and the United States leading the way as the largest markets for snack foods. The industry witnessed double-digit sales growth in China and Brazil (Hoovers 2017c). The Asia/Pacific region was the world’s fastest-growing snack foods market and had a projected compound annual growth rate of 7.2% through 2020. There were growth opportunities in Latin America, the Middle East, and Africa (Hoovers 2017c).

The breakfast cereal manufacturing industry included companies making ready-to-serve packaged cereals, as well as cereals that needed to be cooked such as oatmeal and farina. Major companies include General Mills, Kellogg, Post, Quaker (owned by PepsiCo), and

TreeHouse Foods, all based in the United States, along with The Jordans & Ryvita Company (United Kingdom), and Cereal Partners Worldwide, a joint venture between General Mills and Nestlé (Hoovers 2017d).

Although the snack foods industry did not include makers of cookies and candy, if one added candy and cookies to breakfast cereal and snack foods, the largest companies would be Nestlé, PepsiCo, Unilever, Coca-Cola, Mars, Mondelez, Danone, General Mills, Associated British Foods, and Kellogg's. Exhibit 14 shows the 10 largest food and beverage companies in the world in 2016.

These large companies had advantages in raw material purchasing, manufacturing efficiencies, distribution, and marketing budgets. Small manufacturers struggled when competing with these giant multinational corporations, but were able to compete effectively by using different distribution methods such as self-distributing products, selling online, or marketing snacks as gift items (Hoovers 2017c).

As changing consumer tastes drove snack and other food sales, manufacturers were usually aware of trends in different markets. Multinational companies often created new flavors to match regional taste preferences. For example, the snack food market in the Western hemisphere was driven by healthy, low-calorie snacks. On the other hand, Frito-Lay promoted sweet snacks in Shanghai and meat-flavored snacks in Beijing. Snacks and other foods items that were generally considered to be less healthy were becoming more popular in Asia, as more people incorporated Western-style convenience foods into their diets (Hoovers 2017c).

The U.S. snack foods manufacturing industry included about 650 establishments with a combined annual revenue of about \$35 billion (Hoovers 2017c). Europe was the largest snack

food region in the world, with strongholds in markets such as the United Kingdom, Germany, France, Spain, Italy, and Russia.

The United States was the second largest snack food market, with exports accounting for 4% of total U.S. snack food production and imports totaling less than 2% (Hoovers 2017c). The U.S. industry was highly concentrated with the top 50 companies accounting for about 90% of industry revenue. Of the world's 10 largest companies, six were headquartered in the United States (see Exhibit 19).

In the United States, consumers demanded convenient breakfast foods, and cereal manufacturers responded by producing/acquiring product lines such as toaster pastries and snack bars. These same companies were leveraging their cereal brands by extending them to snack mixes, cereal bars, and other co-branded desserts (Hoovers 2017d).

**Exhibit 14. The Top 10 Largest Food and Beverage Companies in the World in 2016***Source: Businessinsider.com*

<b>Company</b>	<b>Major Brands</b>	<b>2015 Revenue</b>	<b>Headquarters</b>
1. Nestlé	Nestlé brands included: Gerber baby food, Perrier, DiGiorno, and Hot Pockets. Its famous candy brands were: Butterfinger and KitKat.	\$87 billion	Switzerland
2. PepsiCo	In addition to its non-alcoholic beverages, PepsiCo owned Frito-Lay and Quaker Oats, which produced an enormous variety of snack foods, including Ruffles, Lay's, Tostitos and Fritos brands. PepsiCo also owned healthier products including: Tropicana, some lines of the TAZO juice and tea brand, oatmeal, Mother's cereal and puffed wheat.	\$63 billion	USA
3. Unilever	Unilever's diverse list of brands included Lipton tea, Magnum ice cream, and Hellmann's mayonnaise.	\$59.1 billion	United Kingdom
4. Coca-Cola	Coca-Cola moved beyond soda, with beverage brands including Dasani, Fuze, and Honest Tea.	\$44.3 billion	USA
5. Mars, Inc.	While Mars was best known for its chocolate brands, such as M&Ms, it also owned Uncle Ben's rice, Starburst, and Orbit gum.	\$33 billion	USA
6. Mondelez	Mondelez, a snack-centric company owned famous brands such as Oreo, Trident gum, and Sour Patch Kids.	\$29.6 billion	USA
7. Danone	The company was best known for the yogurts Activa, Yocrunch, and Oikos. Danone also sold medical nutrition products and bottled water.	\$24.9 billion	France
8. General Mills	General Mills was best known for cereals like Cheerios and Chex. The company also owned brands such as Yoplait, Hamburger Helper, Haagen-Dazs, and Betty Crocker.	\$17.6 billion	USA
9. Associated British Foods	This UK company owned brands such as Dorset Cereals and Twinings tea, as well as the retailer Primark.	\$16.6 billion	United Kingdom
10. Kellogg's	In addition to Froot Loops and Frosted Flakes cereals, Kellogg's owned non-cereal brands including Eggo, Pringles, and Cheez-It.	\$13.5 billion	USA

### PepsiCo's Future

PepsiCo's success was built on a broad portfolio of mega brands, each of which generated more than \$1 billion in annual sales, supported by nearly 700 manufacturing facilities worldwide. PepsiCo's growth strategy was to increase sales and customer satisfaction through the introduction of new products, while enhancing existing products through global research and development (Hoovers 2017e). PepsiCo was becoming more focused on meeting consumer demands for more health-conscious products. For example, in 2016, PepsiCo acquired KeVita, a leader in fermented probiotic drinks with 20,000 retail locations across North America (Hoovers 2017e).

In response to an ongoing concern about obesity, PepsiCo created a plan to reduce sodium, fats, and sugar in its products and introduced more whole grain foods to its line-up. Additionally, the company launched a new line of 100-calorie-per-portion products repackaged as Mini Bites, and a variety of real fruit and vegetable crisps called Flat Earth (Hoovers 2017a).

It had a goal to reduce the overall salt content of its products by 25%. The company made low-sodium versions of its top-selling brands, including Lay's and Ruffles potato chips, Tostitos tortilla chips, and Fritos corn chips, and worked with seasoning partners to improve the taste of its products (Hoovers 2017a).

These developments were coupled with a focus on improving the company's profitability over the long term. Accordingly, the company continued to focus on lowering overhead costs, utilizing its global scale, getting rid of redundancy, and implementing new cost-saving technologies (Hoovers 2017e). Starting in 2014, PepsiCo was able to cut costs by \$1 billion in 3 consecutive years without compromising quality or efficiency. The savings were achieved through increased automation and restructuring of the company's global manufacturing and distribution (Hoovers 2017e).

Despite all the positive gains in recent years, studies concluded that snack foods were the key driver of the obesity epidemic and responsible for about 20% of the U.S. health care (Clark, 2013), PepsiCo faced a major challenge to accelerate and transform a winning model that profited from the sales of carbonated beverages and un-healthy snacks to a new giant that could benefit from healthy beverages and other foods.

While PepsiCo and its competitors faced many challenges, its future looked promising for success through innovation, leadership, and strategy. However, as consumers had grown more health conscious, PepsiCo investors and management had become fully aware that the decline in the consumption of carbonated beverages would continue. The big dilemma was whether PepsiCo would agree with its activist investors to spin off its beverages division. If so, what would PepsiCo do with it?



**Issam A. Ghazzawi** is Professor of Management and the Sam Walton Fellow at the University of La Verne. Professor Ghazzawi offers courses in organizational design, organizational theory, organizational behavior, and management.

He received his Ph.D. from the University of Pittsburgh; his Master in Labor and Human Resources (M.L.H.R.) from The Ohio State University; and his Master in Business Administration (MBA) from Sul Ross State University. He is a past president of the Western Casewriters Association.





**Appendix A**  
**PepsiCo's Important Event Timeline**

Year	Important Event
1893	Caleb Bradham, a pharmacist started serving customers at a soda fountain in his drugstore refreshing drinks that he had created himself.
1898	One of Caleb's formulations, known as " <i>Brad's Drink</i> ," a combination of carbonated water, sugar, vanilla, rare oils and cola nuts, was renamed " <i>Pepsi-Cola</i> ."
	Pepsi-Cola got its first logo.
1902	The popularity of Pepsi-Cola led Bradham to devote all of his resources and energy to develop Pepsi-Cola into a full-fledged business.
	Bradham applied for a trademark with the U.S. Patent Office and forms the Pepsi-Cola Company.
	The first Pepsi-Cola newspaper advertisements appeared in the <i>New Bern Weekly Journal</i> .
1903	Bradham moved the bottling of Pepsi-Cola from his drugstore into a rented warehouse.
	The company sold 7,968 gallons of syrup in the first year of its operation.
	Pepsi's theme line became " <i>Exhilarating, Invigorating, Aids Digestion</i> ."
1904	Bradham moved all bottling and syrup operations into a new purchased building in New Bern.
	Pepsi is sold in six-ounce bottles. Sales increased to 19,848 gallons.
1905	Pepsi-Cola's established its first bottling franchises in Charlotte and Durham, North Carolina.
	Pepsi received its new logo, its first change since 1898.
1906	15 U.S. Pepsi-Cola bottling plants were in operation.
	The Pepsi trademark was registered in Canada.
	Syrup sales rose to 38,605 gallons.
1907	Pepsi-Cola Company continued its expansion as the company's bottling network grew to 40 franchises.
	Pepsi-Cola sold more than 100,000 gallons of syrup.
	Pepsi trademark was registered in Mexico.
1908	Pepsi-Cola became one of the first companies to modernize delivery from horse drawn carts to motor vehicles.
1909	The company had two hundred fifty bottlers in 24 states to bottle and distribute Pepsi drink.
1923	Caleb Bradham gambled on fluctuations of sugar prices during World War I era, believing that sugar prices would continue to rise- they fell instead, leaving Pepsi-Cola with an overpriced sugar inventory.
	Pepsi-Cola went bankrupt on May 31, 1923.
	Pepsi-Cola trademark was purchased by a New York stockbroker Roy C. Megargel.
1931	The company struggled and Roy Megargel used his own funds to make up for the deficits the company incurred annually.
	Pepsi-Cola was declared bankrupt in 1931, for the second time.
	Charles G. Guth, a successful entrepreneur and a candy manufacturer purchased the trademark and the syrup recipe of the twice bankrupt Pepsi-Cola Company.
1930's	Pepsi-Cola set up bottling franchises across the country and expanded internationally.
	Trademark was also registered in Latin America and the Soviet Union.
	Pepsi-Cola awarded bottling franchises to bottlers in Canada.

Year	Important Event
1934	Pepsi-Cola moved its operations to a new headquarters in Long Island City, New York.
1938	Walter S. Mack became the company's new president.
1939	World War II started when Germany attacked Poland.
	Pepsi purchased a sugar plantation in Cuba.
1940	Introduced its first standardized bottle.
1941	Japan bombed Pearl Harbor on December 7th, the U.S. was at war. Pepsi-Cola disrupted because of sugar rationing.
1945	World War II ended.
	Pepsi-Cola moved its headquarters to Manhattan, New York.
	Expansion with operations into Latin America, the Philippines, and the Middle East.
1947	Hired Edward F. Boyd, a young African American executive to focus on the untapped African Americans market.
1950	Al Steele became the company's president.
1953	Pepsi-Cola reformulated with less sugar. " <i>The Light Refreshment</i> " slogan.
1959	Introduced Team, a lemon lime drink.
	Steel passed away.
1963	Introduced Diet Patio Cola.
1964	Re-introduced its sugar-free drink under the brand name of " <i>Diet Pepsi.</i> "
	Purchased Mountain Dew drink from the Tip Corporation.
1965	Merged with Frito Lay, a major snack company.
	Name changed to PepsiCo, Inc.
1977	Acquired Pizza Hut.
1978	Acquired Taco Bell.
1983	Roger Enrico became the chief executive of PepsiCo, Inc. USA
1986	PepsiCo acquired KFC from RJR Nabisco Inc.
1986	D. Wayne Calloway named PepsiCo CEO.
1996	Enrico named chief executive and chair of PepsiCo.
1997	PepsiCo spun off the company's restaurant division composed of Taco Bell, KFC, and Pizza Hut chains.
1998	Acquisition of Tropicana.
2000	Acquisition of Quaker Oats, which included Gatorade.
2001	Steven S. Reinemund became PepsiCo chairman and CEO.
2006	Indra Nooyi became PepsiCo CEO.

## Appendix B

### The World's Leading Soft Drinks Companies Ranked by Revenues

Source: Adbrands.net

1. **The Coca-Cola Company:** As the world's biggest drinks company, Coca-Cola Company controlled more than fifty percent of the global market in carbonated soft drinks in addition to a large number of non-carbonated drinks including brands such as Dasani, Minute Maid and Innocent.
2. **PepsiCo:** PepsiCo's biggest business was snacks, however, it remained the second largest soft drinks company globally. The company's Pepsi brand was out-grossed in sales by a broad portfolio that included other sports drinks such as: Gatorade, Tropicana, a large portfolio of juices, and Aquafina bottled water.
3. **Nestlé:** Nestlé was the world leader in bottled water. Additionally, the company had a substantial foods portfolio and Nescafe coffee. Nestlé's Pure Life was the global number one in its sector, supported by a portfolio of premium brands that included Perrier, Vittel, Poland Spring and Buxton. Nestlé was also the worldwide leader in the ready-to-drink (RTD) segment.
4. **Suntory:** Suntory was Japan's largest home-grown soft drinks company. In addition to its whisky and beer businesses, the company has a large drinks portfolio that was led by Boss RTD coffee and the local Pepsi license. In 2013, Suntory entered the European market through the purchase of Orangina Schweppes and later added Lucozade and Ribena.
5. **Dr Pepper Snapple:** The company was the third biggest marketer of carbonated soft drinks after Coke and Pepsi. While Dr Pepper Snapple was a spun off from what was then Cadbury Schweppes in 2008, it operated solely in North America and the Caribbean. In addition to its famous brands (Dr. Pepper and Snapple), the company also had a large portfolio of other drinks.
6. **Danone:** The number two bottled water company was strong in its core European market, but less dominant elsewhere. The company's global brands included Evian, Volvic and Badoit. Additionally, the company had regional products including Indonesia's Aqua and USA's Dannon.
7. **Kirin:** Although best-known for its beer, Kirin also controlled a collection of soft drinks in Japan including Fire coffee and the local license for Tropicana. The company was one of the biggest drinks companies in Australia; it also owned Pura milk and Berri juice.
8. **Red Bull:** The company was first introduced in Asia in the 1960s; it started a major shakeup in the global soft drinks market in the 1990s. Since its arrival in the West in 1987, the sickly sweet stimulant formula had created a whole new niche market of "energy drinks." Red Bull was the energy drink leader ahead of Coke and Pepsi.
9. **Master Kong:** One of China's biggest food and drink brands, as well as the local licensee for Pepsi. The company was a leader in Ready-to-Drink (RTD) teas, bottled water, instant noodles, and fruit juice.
10. **Asahi:** Asahi was best-known as a brewer. The company managed to become the number two soft drinks business in Japan, with Wonda coffee, Mitsuya Cider and Calpis brands. It also had a strong presence in Australia as it was Pepsi's local licensee and owner of Cottee's, Schweppes and Solo.

In addition to the above companies and brands, Jacobs Douwe Egberts was the world's biggest coffee company. The company was formed from the 2014 merger of Mondelez' coffee operations with DE MasterBlenders 1753.

Finally, Unilever was a global leader in tea-based beverages, both hot and cold. Its portfolio included Lipton, the world's top-selling tea brand. Additionally, Unilever owned a large collection of local brands that included: PG Tips, Brooke Bond, Red Label, Bushells, and Saga.

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## ***RISING FROM THE ASHES***

**DOUGLAS LYON**  
**STEPHANIE OWINGS**  
Fort Lewis College

The fire started early in the morning of Tuesday, October 4, 2016. Approximately 40 firefighters and five engines responded and largely extinguished the fire by 8:00 a.m. Fire damage was limited because of the sprinkler system, but water damage in the back of the restaurant, where the fire had started, was extensive. Smoke damage extended throughout the building and to several adjacent businesses. It was clear that the business would be closed for several months at least.

In the space of a few moments, El Moro Tavern (See Exhibit 1) had gone from a thriving part of the Durango restaurant scene and strong contributor to Peak Brewing Company's financial results to a significant financial obligation.

Kris Oyler, CEO of Peak Brewing Company, told *The Durango Herald* "We're going to rebuild it, and we'll get it back open, and we'll make it better than ever" (Benjamin, 2016). He committed to keeping all 40 workers employed during the closure.

Privately, Oyler worried about both the high cost of the repairs and the several months of payroll he would need to meet without revenue from the business. He hoped he could pull it off.

**Exhibit 1. The El Moro Sign**

Source: Photo by the case authors

**Background**

The restaurant business in Durango, Colorado was highly competitive. It was a point of pride for the community that Durango had more restaurants *per capita* than San Francisco (Olivarius-Mcallister, 2012). The publication of this fact led San Francisco to change its marketing materials to note that it had the most restaurants per capita of any *major* city. The competitive nature of Durango's restaurant business made identifying a unique and desirable niche both challenging and critical.

The food and beverage selection at El Moro was, in many ways, unique in Durango. For instance, the menu featured a variety of beers found nowhere else in Durango such as La Chouffe, La Fin Du Monde, and other exotic European and American craft brews (See Exhibit 2).

**Exhibit 2. Exotic Beer for the Connoisseur**

Source: Photo by the case authors



The food menu was equally creative. One could order Scotch Egg or Roasted Marrow Bones as an appetizer and Garam Masala Salmon as a main course. One “Wednesday Special” was Pot Roast Egg Rolls with Gravy and Salad -- \$10. The non-alcoholic cocktail? San Pellegrino Sparkling Prickly Pear & Orange. (See Exhibit 3). The alcoholic cocktail might be Felurian’s Florist (Aalborg Taffel Akvavit, Maurin Dry Vermouth, Cabrito Blanco Tequila, Lee Spirits Crème de Rose, DRAM Honey, Chamomile Bitters, begonia petal ice cube) or, in homage to the original El Moro Saloon, a cocktail called Coffin Varnish (Buffalo Trace Bourbon Whiskey, lemon juice, simple syrup, house absinth bitters, house grenadine).

Prices were approachable for a casual lunch or dinner while the menu and execution kept customers coming back. The restaurant was a winner – until the fire.



**Exhibit 3. A Wednesday Special of Pot Roast Egg Rolls**

Source: Photo by the case authors



### The Story

Peak Brewing, LLC owned El Moro Tavern and a second brew pub, Steamworks Brewing Company. Steamworks was a mature business while El Moro was a recent addition. Kris Oyler, CEO of Peak Brewing Company, was delighted with the success of the latest venture. El Moro Tavern occupied a unique niche in the vibrant restaurant scene of Durango. Classic cocktails, exotic beer and the unique and high-end food menu combined with an upscale interior with touches harkening back to the El Moro Tavern of 100 years ago had hit a sweet spot with locals and tourists alike.

The new El Moro benefited from an intriguing back story dating to 1906 (See Exhibit 4). The story was imparted to patrons via the décor of the El Moro. Miners, smelter workers, ranch hands, spittoons, pool, gambling, guns, and alcohol – what could go wrong? (See Exhibit 5.)

#### Exhibit 4. El Moro circa 1906

Source: Photo by the case authors



The story on display inside El Moro read:

*“El Moro lays claim as the site of Durango strangest shootout. In January in 1906, Sheriff William Thompson raided the saloon in the midst of a poker game and ... confiscated a roulette wheel that was also in play. On the sidewalk in front of El Moro, Thompson confronted the city marshal, Jesse Stansel, for his lack of enforcement. The two men exchanged insults and guns were drawn. When the smoke cleared Sheriff Thompson was dead and Marshall Stansel was injured.”* See Exhibit 6.

**Exhibit 5. The gambling in the lower left**

Source: Photo by the case authors



**Exhibit 6. Marshal Stansel in 1904**

Source: Photo by the case authors



The story on display inside El Moro read:

*“Animosity is brewing between two factions in our rapidly growing railroad town in the southwest. Gambling has recently been outlawed by the state of Colorado, but a rebellious gang made up of saloon owners and businessmen, are intent on keeping the rackets alive. The newly elected Sheriff boldly acts to shut down these illegal activities, but, by challenging the gang, the sheriff has made a high stakes wager of his own.”*

Lest the patrons forget the story, the drink coasters were a constant reminder (see Exhibit 7).

### Exhibit 7. Thompson and Stansel

Source: Photo by the case authors



A local production company, Fast Forward Media, had even made a movie about El Moro's back story (Trailer: <https://vimeo.com/126456155>). By the fall of 2016, the El Moro Tavern was a strong addition to Steamworks Brewing Company, the original Peak Brewing Company restaurant and brewery.

### Business Interruption Insurance

Fortunately, the El Moro Tavern had fire insurance as part of its property policy and a business interruption endorsement. After paying deductibles, the fire insurance would provide the funds needed to rebuild the physical structure of the restaurant. The business interruption endorsement would replace El Moro's lost income stream and pay its employees their foregone wages and benefits, as appropriate, during the time it took to rebuild. However, for the wait staff, wages represented only a fraction of income. Much of what they earned came from tips and the insurance policy did not cover foregone tips.

### Taking Care of Employees

It was not accidental that El Moro had chosen to purchase an insurance policy that replaced employee wages in the case of a fire. The firm placed a high value on its employees. According to Oyler, “If you do right by your team members, they will do right by you” (Oyler, 2017).

Peak Brewing Company was governed by a Board of Managers and had 90 shareholders. Twenty-six of those 90 shareholders were employees. Profit interest for employees in Peak Brewing started early on and in the late 1990s equity interest became available. If an employee was offered an opportunity to purchase equity in Peak Brewing, the firm would help the employee finance the purchase. Peak Brewing wanted employees to be fully integrated into the business.

Given its commitment to its employees, Peak Brewing wanted to do more than simply replace the lost wages of the wait staff. A GoFundMe was established to help replace lost tips. CEO Kris Oyler contributed the first \$1,000 to get it started. Eventually approximately \$10,000 was donated. These funds were dispersed to furloughed employees in December prior to Christmas. The money was distributed on a *pro rata* basis. Management used the employees’ pay in the two months prior to the fire to calculate the proportionate amount of the tip replacement funds the wait staff should receive.

But this still did not completely cover the financial hardship experienced by the employees. Kris Oyler announced that El Moro’s furloughed employees could stop by the sister establishment, Steamworks, for one shift per day. The Steamworks kitchen was able to absorb four El Moro employees. In addition, Peak Brewing’s 90 owners paid for part of the cost of compensating lost employee tips by accepting reduced fourth quarter profits.

This commitment to employees both enhanced productivity and created loyalty in a tight labor market. The highly competitive Durango restaurant scene made performance on price, product and atmosphere essential, which in turn required a highly trained and fully dedicated staff.

### Putting Down-time to Good Use

The El Moro employees were being paid but there were no customers for them to serve. Peak Brewing had some employees use down-time to participate in ServSafe online training programs. The ServSafe program was developed by the National Restaurant Association with the help of foodservice industry experts and regulatory agencies. ServSafe offered online training to food managers, food handlers and bartenders. The ServSafe Food Manager program addressed food-borne illnesses, how to prevent them, and how to train employees in food sanitation. The ServSafe Food Handler program taught basic practices for safely preparing and serving food. The ServSafe Alcohol training focused on responsible alcohol service and the risks and liabilities associated alcohol sales. Peak Brewing also directed bartenders to BarSmarts which provided the *“leading online bartender education program”* (Barsmarts.com).

These training programs did not take up all of the employees’ time. Chris Ruecker, Controller of the firm, suggested that employees take their remaining paid-time and volunteer in the community. According to Oyler, *“If you do right by the community, the community will do right be you”* (Oyler, 2017). Peak Brewing’s marketing plan had always been based on this notion. It did not advertise, but instead employees got involved in the community and were a presence at community events.

There were no restrictions placed on where employees could volunteer. It was suggested to the employees that their volunteer hours should be roughly equal the number of hours calculated for their compensation package while the tavern was being rehabilitated. However,

it was an honor system - no one checked to see if reported volunteer hours were the same as the hours for which the employees were being paid. Organizations where employees volunteered included the Manna Soup Kitchen (feeding the hungry), the San Juan Mountains Association (local environmental group), Community Connections (providing assistance for children and adults with intellectual and developmental disabilities), Wolfwood Refuge (providing a safe haven for wolves and wolf-dogs), La Plata County Humane Society (adoption shelter for dogs and cats without homes), and the local Sexual Assault Services Organization (operating a 24-hour hotline).

The commitment to employees and local nonprofits was genuinely altruistic, but had the ancillary benefit of painting El Moro in a positive light. El Moro's commitment to its employees and to the community received significant favorable coverage in the local newspaper, *The Durango Herald*. The paper even wrote an op-ed encouraging the community to come out and support El Moro upon its re-opening (Durango Herald Editorial, 2017).

### Epilogue

El Moro Tavern was closed for 3.5 months. It had 42 employees before the fire and 42 employees after it re-opened. Thirty-six of the original 42 returned. The loss of 6 employees over 3.5 months was, according to Kris Oyler, "about normal" for that time period (Oyler, 2017). No one who accepted compensation during the tavern closure didn't return. One employee refused the money because he knew he was leaving.

In the first full month after it re-opened, revenue was up more than 20% over the same time period in the previous year. However, that quickly trailed off and by the end of the third quarter of 2017, El Moro's revenue was up slightly less than 2% over the previous year.

Since the tavern re-opened, the labor market in Durango had become even tighter than it was before. The legal marijuana industry had started to offer highly competitive wages, which made it difficult to attract kitchen help workers.

El Moro won the Spirit of Durango Award at the annual Durango Chamber of Commerce awards ceremony on January 18, 2018. The purpose of the Spirit of Durango award was to honor a business for providing a unique and valued contribution to the character and economy of Durango. The winner was selected by the Durango Diplomats based on the following criteria provided by the Durango Chamber of Commerce:

- Business must be a Chamber of Commerce member;
- Business must promote and enhance Durango's spirit of accomplishment and community involvement;
- Business must project a positive image of the Durango area to residents and visitors.





**Douglas Lyon** is a Professor of Management at Fort Lewis College. He graduated from Fort Lewis College in 1987 with a degree in Accounting and holds a Masters in International Management from Thunderbird. He also holds a Ph.D. in Management Strategy from the University of Kentucky. He served as dean of the School of Business Administration July 2011 to December 2014. He was Senior Corporate and Foundation Officer at Fort Lewis from January 2015 to July 2016. His research interests include strategic management, leadership, and the scholarship of teaching and learning. He has published widely in academic journals such as *Journal of Management*, *Entrepreneurship Theory and Practice*, *Journal of Case Research and Inquiry*, and *Journal of Management Education*. Prior to entering academia, Doug held positions with Price Waterhouse and with Chevron Corporation. He is currently a board member of La Plata Electric Association.



**Stephanie Owings** is a Professor of Economics at Fort Lewis College. She holds an undergraduate degree in economics from University of Southern California, a Master degree in economics from University of California, Los Angeles, and a Ph.D. in economics from George Mason University. She joined the Fort Lewis College faculty in 2000. Before this, she taught at the U.S. Naval Academy, worked as an economic analyst for the law firm of Howrey and Simon, and worked for a federal government agency on matters of national security. Her areas of expertise are on the micro side of economics: firm analysis, market structure and antitrust. She finds case studies to be an excellent tool to build bridges between the business community and academia.

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## **LOS ANGELES FIRE DEPARTMENT: DIVERSITY IGNITES DISCRIMINATION**

**STEPHEN J.J. MCGUIRE, JEEWHAN YOON, PATRICIA ROBBINS, OSHIN BABAIAN, FERNANDO INIGUEZ, VARDUI KOSHKARYAN, MARIBEL PELAYO & TAGUHI SOGOMONYAN**  
California State University, Los Angeles

*“How can we diversify our workforce and get rid of discriminatory problems in our organization?”* asked Ralph Terrazas, the first Latino Fire Chief since the 1186 founding of the Los Angeles Fire Department (Exhibit 1). Terrazas was appointed by L.A. Mayor Eric Garcetti in the hope of transforming the Los Angeles Fire Department (LAFD) into an organization that reflected the communities it served. Since its founding, LAFD’s recruits had been predominantly White and overwhelmingly male. In 2018, Whites comprised just under half of the 3,397 uniformed LAFD employees, but were only 28.5% of the population of a city that was more than half Latino. In addition, despite repeated calls for reform, LAFD’s 109 female firefighters represented about 3% of the total — no real change since 1995. (See Exhibit 2.) It seemed that little progress had been made toward Mayor Garcetti’s pledge to diversify the fire department. Moreover, LAFD continued to struggle to overcome a long history of racial and gender discrimination.

From 2006 to 2018, lawsuits for discrimination and sexual harassment had cost taxpayers nearly \$30 million. How could LAFD optimize its recruiting efforts to women and ethnic minorities? What changes to human resources policies could the department make to increase diversity? Chief Terrazas was well aware that LAFD needed to change its organizational culture, but what actions could he take to create a culture of inclusion?

**Exhibit 1. Fire Chief Ralph Terrazas**

Source: Daily News

**Exhibit 2. Ethnic and Gender Breakdown of LAFD Uniformed Personnel in 2018**Source: LAFD 2018 Firefighter Recruitment Plan<sup>33</sup>

<b>Ethnicity</b>	<b>Male</b>	<b>Female</b>	<b>Total</b>
Black	11.13%	0.21%	11.3%
Hispanic	31.06%	0.41%	31.5%
Asian	5.56%	0.21%	5.8%
Caucasian	46.63%	2.36%	49.0%
Filipino	1.97%	0.03%	2.0%
Native American	0.44%	0%	0.4%
<b>Total Sworn Employees</b>	<b>3,288</b>	<b>109</b>	<b>3,397</b>

**Racial and Gender Discrimination**

*“Feed the Big Dog!”* touted 49-year-old African American fire-fighting veteran Tennie Pierce at the crew’s early morning beach volleyball game in October 2004 at Fire Station 5 in Westchester. Pierce, who called himself *“Big Dog”* during the games, taunted a much shorter Latino paramedic, 24-year-old Jorge Arevalo, as he repeatedly shouted, *“I take craps bigger than you!”*<sup>2</sup> The dinner bell rang at 6:00 that evening. It was Arevalo’s turn to cook dinner. Arriving 15 minutes late, Pierce began eating the spaghetti with meat sauce that awaited him

on the stove. After a few bites, he noticed some of the men laughing. Pierce demanded to know what was in his food, and as the others chuckled, he ran out. Jorge Arevalo apologized to Pierce that night for mixing dog food into his dinner. An Asian female firefighter stated that Pierce accepted the apology and called it “*water under the bridge*,”<sup>2</sup> so it was a surprise when Pierce later sued the City of Los Angeles for racial discrimination and was awarded \$1.43 million in settlement with \$60,000 in back pay.

LAFD’s long-held tradition of horseplay and pranks had resulted in a number of lawsuits alleging discrimination and harassment on the basis of race, gender, and sexual orientation.

In a field dominated by men, Captain Alicia Mathis (see Exhibit 3) felt that the voices of female firefighters were suppressed. Captain Mathis filed a claim in 2006 against the City of Los Angeles threatening a class-action lawsuit on behalf of female firefighters. She said,

*“It needed to be done. I really was fearful for women in the organization. I was really fearful that we would never go beyond.”*

Captain Mathis aggressively sought to reduce discrimination, harassment, and “*grueling*” drills that she felt were targeted at women. Several incidents motivated her to file the claim. For example, a woman was sexually assaulted at her assigned station and another woman was “*trained to the point where she had to have a hysterectomy.*” Captain Mathis believed that the LAFD’s problems needed to be made public in order to stop what she called rampant discrimination and harassment.

**Exhibit 3. Captain Alicia Mathis**

Source: Alumni.ucla.edu

**LAFD'S Mission**

Located in a “salad bowl” of ethnic communities, LAFD consisted of 112 fire stations spanning over 470 square miles. Fires attacked large industrial and commercial structures, single-family homes, oil tankers, and hillside brush communities. LAFD was a full-spectrum life safety agency and firefighting force that protected the “approximately 4 million people who live, work, and play in America’s second largest city.”<sup>3</sup> This was congruent with the LAFD’s mission statement:

*It is the mission of the Los Angeles Fire Department to preserve life and property, promote public safety and foster economic growth through leadership, management and actions as an all risk life safety response provider.<sup>4</sup>*

Complementing the department’s mission was its service statement:

*We owe the residents of Los Angeles the highest quality of service possible, characterized by responsiveness, integrity and professionalism. We will continually strive for quality improvement.<sup>4</sup>*

According to Captain Mathis, firefighters were expected to respond in full firefighting gear in 60 seconds and be on the scene within 5 minutes. Some of LAFD’s goals included managing an operating system to minimize the effects of disasters and life or property in emergencies.

Included in this plan was an effective emergency medical services system, fire prevention system, and public safety system.

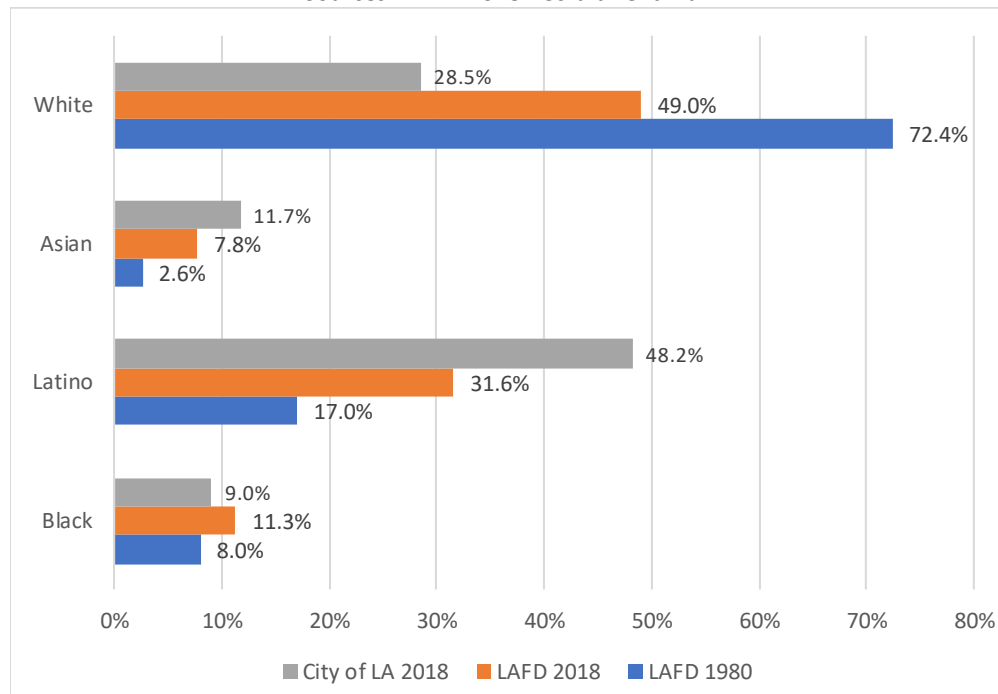
### LAFD'S Background and History

The first Los Angeles city-owned fire station, Engine Company No. 1, was established in 1887. In 1955, when fire stations became racially integrated, Black firefighters were prohibited from talking to Whites at work or even eating at the same time as Whites did. One station even posted a sign on the kitchen door specifying “*White adults.*”<sup>2</sup> Black firefighters’ beds were assigned near locker rooms and toilets. By 1972, the federal government filed a lawsuit against Los Angeles claiming that the city discriminated against Blacks, Latinos, and Asians. In 1974, to increase diversity and overcome discrimination, LAFD established a Minority Recruitment Unit and implemented an affirmative action program to hire and retain women and ethnic minorities. In 1980, 72% of the force was White. By 2018, the LAFD employee population had begun to look a bit more like the population of the city it served: nearly 32% of firefighters were Latino, 11.3% were Black, 7.8% were Asian, and 49% were White (See Exhibit 4).

Challenges continued in the recruitment of women. In 1980 there were female paramedics, but no female firefighters. Three years later, LAFD had on board the first female assistant chief, Captain Roxanne Bercik. By 1994, 5.4% of firefighters were female, but this figure dropped to the national average of 2.5% by the end of 2007. Women were provided with additional training to prepare them for the physical requirements of the position. Nonetheless, despite increased efforts to help women pass the drills, a 1990 video was released to the media, ridiculing women at the firehouse. The video, dubbed ***Female Follies***, portrayed “*a perfume saleswoman from Macy's and an 18-year-old babysitter awkwardly struggling to climb over a 5-foot wall.*”<sup>5</sup>

#### Exhibit 4. Racial Groups in LAFD and the City of Los Angeles

Sources: LAFD 2018 Recruitment Plan



In 1996, Fire Chief William Bamattre (see Exhibit 5) was hired by the Mayor with intentions to increase the number of minorities and women in the LAFD. Although Bamattre successfully hired 83 women, who were predominantly paramedics, there were rumors of a secret no-fail policy *“to pass women who plainly could not heft chain saws up ladders or run with heavy hoses, or who had other physical deficiencies.”*<sup>5</sup> Many male firefighters were upset and felt that the department was jeopardizing the public’s safety. Bamattre declared that he had not created a double standard. In 2002, a federal judge decided the city had fulfilled its hiring goal and removed the consent decree. By 2004, there were 90 women out of 3,300 firefighters, and in 2018 there were 109 women out of 3,397.



**Exhibit 5. Former Fire Chief William Bamattre**

Sources: Addiemiller.us



**LAFD'S Diversity Strategy**

According to Captain Armando Hogan (see Exhibit 6), a firefighter of 25 years and captain of 12 years, LAFD held five academies per year with a goal of bringing in at least 50 rookies per academy. Hogan said diversity was important because of the different points of views and mentioned that female firefighters were *“reminders to be more professional and more respectful.”*

**Exhibit 5. Captain Armando Hogan**

Sources: Farm4.static.flickr.com



Typically, of the 50 recruits, only one or two were female. Hundreds of female recruits were discouraged after the initial examination, the Candidate Physical Ability Test (CPAT), which entailed climbing and running with over 75 pounds of protective clothing and gear.

### ***The Candidate Physical Ability Test***

The CPAT was a timed pass/fail standardized test that was not administered by the City of Los Angeles but was the only test accepted by the City. The test consisted of eight separate events that simulated real, in-the-field, firefighter job duties: stair climb, hose drag, equipment carry, ladder raise and extension, forcible entry, search, rescue, and ceiling breach and pull.

Throughout the test, each candidate had to wear a 50-pound vest to simulate the weight of the self-contained breathing apparatus along with protective clothing, such as a hard hat and work gloves. The stair climb event required an additional 25 pounds, used to simulate a hose bundle, which was added to the shoulders. All events needed to be passed in a total of 10 minutes and 20 seconds or less. Candidates were required to have a passing score on the CPAT at the time of the certification to be eligible for hiring and to be scheduled for an interview. The physical requirements were the same for men and women. Firefighting equipment was very heavy and duties required repeated lifting, which men and women both agreed to be a difficult task. Firefighters pulled heavy lengths of hose, climb stairs while wielding giant power tools like chain saws, and lifted 180-pound, 35-foot wooden ladders—akin to carrying a concrete lamppost. Firefighters' physicians said that a human expected to pull the heaviest hose lines needed to weigh at least 143 pounds (see Exhibit 6).<sup>5</sup>

**Exhibit 6. The Candidate Physical Ability Test**

Sources: Lavc.cc.us.



In an attempt to recruit more women into the program, LAFD used different marketing strategies. It recruited at construction sites, military bases, truck stops, health clubs, and community colleges in search of physically fit women who were used to working in male-dominated workforces. Captain Hogan said, *“We will recruit anyone who is interested, but we have had more success with those accustomed to the lifting and moving. There is a certain amount of stamina needed to do it, not just with women but also with men.”* According to LAFD, finding the right candidates was the toughest part of the recruiting process.

One deputy chief hoped to utilize a new plan of pairing firefighters with potential candidates during each step of the application process to advise them and encourage them on a weekly basis. The Los Angeles City Hall invested millions of dollars into advertising and providing extra training and resources to recruit minorities and women. Billboards were placed in predominantly Black and Latino neighborhoods. Los Angeles had also *“outfitted most of its 106 fire stations with costly women’s lockers and women’s showers.”*<sup>5</sup> Yet few women actually fought fires in the department; the quiet locker rooms were bare and empty, sometimes being utilized for studying (see Exhibit 7).

### Exhibit 7. Firefighter in LA Weekly and LAFD's women's locker room

Sources: Media.newtimes.com and LAWeekly.com.



When asked her opinion on recruitment efforts and training programs, Captain Mathis said she believed that LAFD went about the recruitment process the wrong way. Mathis ran a high school recruitment program at Harbor College for 8 years and believed that such outreach programs were very cost-effective. She felt that the LAFD could collaborate and do more joint programs with community colleges and school districts to help the department reach its recruitment goals. She stated, *“If we had a more integrated, long-term approach, we would be much more successful.”*

### Internal Issues

Captain Mathis stated:

*“What we ended up with was a for cause finding with the EEOC Federal Government and they found a pattern in practice of discrimination against women and African Americans within the LAFD.”*

According to a letter written in December 2007 by the Los Angeles District Director of the Equal Employment Opportunity Commission (EEOC),

*“The commission further finds reasonable cause to believe that a pattern and practice of different terms and conditions of employment, harassment and retaliation exists for a class of female and Black firefighters based on gender and race.”<sup>6</sup>*

An internal audit in 1995 revealed that both harassment and hazing were more rampant than suggested by the number of investigations the LAFD had conducted. Furthermore, the audit critiqued the formal investigations as insufficiently documented, lacking independence, and undertaken by inexperienced personnel.<sup>8</sup> The report also addressed some of the decisions made by former Fire Chief Bamattre during his leadership, which stated that the fire chief overrode more than half of the LAFD’s training academy instructors’ recommendations to fail underperforming recruits, *“particularly women and African Americans. In 75 cases, the fire chief overruled 45 cases and graduated the recruit. The audit found that 77.8% of the women and 40% of the African Americans ultimately did not pass probation.”<sup>9</sup>*

In defense, the deputy chief of training and risk management argued that one reason these recommendations for termination were overruled was to improve diversity and hiring statistics among certain groups that were underrepresented in LAFD’s overall workforce. Bamattre added that he overruled several cases because the recruits’ scores were *“borderline”* in meeting drill tower standards.

### **Costs**

LAFD imposed a significant cost burden on the city’s taxpayers because of recruiting efforts, work-related injuries, and lawsuits. Millions of dollars were spent in providing marketing and appropriate accommodations, such as women’s locker rooms and housing, in efforts to recruit women.<sup>5</sup> And, although they accounted for only 3% of firefighters, females accounted for 56% of all multimillion-dollar lawsuits. With a large number of recruits who attended the academy and only a few who succeeded, a heavy price was paid. *“Taxpayers [are] ponying up \$82,692 to*

*send a single recruit through the drill-tower academy—and spending another \$82,692 each time a failed recruit is encouraged to try again.”<sup>5</sup>*

In addition, costs were incurred due to the payout to many injured trainees who automatically qualified to receive firefighter injury pay. Hogan said a substantial amount of costs had been allocated to disability pay, which compensated up to 1 year for set injuries with a reasonable accommodation process.

### ***Culture of Hazing***

Although hazing was prohibited in the 1940s, it continued. Many firefighters ignored the longtime ban on horseplay and Black firefighters were primary targets. According to Captain Hogan: *“A lot of pranks started before then, but I know they became more mean-spirited when African Americans joined the fire stations.”* A long-held tradition, hazing came under increased scrutiny and speculation as firehouses became progressively diverse. In late 2006, City Controller Chick, in addition to condemning former Fire Chief Bamattre’s lack of leadership for allowing the behavior to continue, stated, *“Part of the hazing and discrimination come from the perception that women and racial minorities are not qualified to work in the department.”<sup>9</sup>* On the contrary, according to Professor Carol Chetkovich, author of a book on gender and race in the fire service, *“Hazing and practical joking serve a purpose among firefighters. ... Firefighters are concerned with personal qualities of the people they work with, because lives depend on each other.”<sup>10</sup>* After Pierce sued the city, the city mayor issued an executive directive in November 2006 declaring a policy of zero tolerance against hazing in all city departments.

In the culture of hazing, whenever a firefighter was promoted to captain, the person was treated to a *“chairing.”* This meant that the firefighter was tied to a chair with duct tape and slathered with mustard, ketchup, salad dressing, and BBQ sauce (see Exhibit 8). Two days before the infamous dog food incident, four crewmembers including Pierce treated a newly promoted Captain to such a *“chairing.”<sup>2</sup>*

**Exhibit 8. Tennie Pierce sprays water in the face of an immobilized hazing participant**

Sources: LAWeekly.com



Photos surfaced that showed Pierce enjoying the culture and camaraderie of hazing other firefighters. Two weeks after the prank, Pierce took a series of paid sick leaves and stress leaves. It was later determined that he had been paid the equivalent of a full-time salary for approximately 2 years, during which he worked fewer than 40 days.<sup>2</sup>

The Pierce case led to the suspension of two fire captains, one for 24 days and the other for 30 days; additionally, they were later disciplined and relocated. Jorge Arevalo, the firefighter who put the dog food in Pierce's meal, received 6 days of suspension. The two captains filed a reverse racial discrimination lawsuit and eventually received \$1.6 million in settlement by a Los Angeles Superior Court jury. The captains alleged that they received a longer suspension than Arevalo because they were White. One of the captains admitted during the trial that he had bought the dog food, but only to give it to Pierce as a "Joke Trophy" for his volleyball victories, since Pierce called himself "Big Dog."<sup>2</sup>

Firefighters had often broken the “*unwritten rule*” to not mess with each other’s food, family, or equipment. Prior to Pierce’s case, there were many similar incidents, such as one in the 1970s in which a firefighter in South Los Angeles made lemon meringue pies out of sawdust and shaving cream. In the 1980s, a white captain was tricked into eating dog food when he did not chip in for daily meals. Lastly, a white colleague of Pierce’s was tricked into eating cat food after making offensive remarks about a firefighter’s cat.

### **Harassment**

Following in her grandfather’s steps and after years of fighting fires with the U.S. Forestry Service, Melissa Kelley decided to join the LAFD. Before entering, she understood, as a female, the firehouse could be an uncomfortable place for her. She was aware that other female recruits had endured harassment and ridicule. She said, “*I wanted to be a firefighter so bad, I was willing to put up with almost anything.*”<sup>11</sup> It wasn’t long before she had her own experience with harassment. When she was a rookie, one night a firefighter climbed into her bed and placed his hands under her clothes. After resisting, he mocked her by clucking like a chicken in her presence for several weeks. Kelley didn’t share this with anyone. She said, “*I didn’t want people to think I was a complainer.*”<sup>11</sup>

In 2004, Kelley’s situation was exacerbated when she was injured during a drill called “*the humiliator*,” which left her hospitalized with a back injury and off-duty with pay for 6 months. As part of the drill, Kelley had to hoist a 180-pound, 35-foot ladder, climb it holding a rotating saw, and, once at the top, cut through a window’s metal bars. In her attempt to lift and swing the ladder around, she dropped it and became pinned under the ladder. Her helmet got stuck between the rungs, and she was unable to elevate the ladder. As one firefighter colleague approached her to help, Captain Frank Lima ordered him to stop. Lima later said, “*She basically couldn’t raise the ladder. That’s it in a nutshell. After the first try, I gave her another chance. And I continually asked her if she was ok, and she insisted, yes.*”<sup>12</sup> After Kelley completed the drill, she was rushed to the hospital where she was diagnosed with lumbar and cervical spine



damage along with a torn rotator cuff, which required surgery and months of rehabilitation. Kelley, who did not report the incident, said, *“I made a mistake. I became pinned by that ladder. Everyone noticed I was pinned. A firefighter came to help me. Lima told him to stop.”*<sup>13</sup>

Fire Chief Bamattre suspended Captain Lima. Captain Lima filed a reverse retaliation discrimination lawsuit against the LAFD on the premise that he was a male who employed the same standards of training on a female that he would have applied to a man. Captain Lima’s attorney argued that Lima was told to treat women differently since it was a challenge to recruit and retain female firefighters.<sup>14</sup> In June 2007, a Los Angeles Superior Court jury comprising seven men and five women ruled in favor of Captain Lima and awarded him \$3.75 million.

Like Kelley, Captain Mathis recalled a colleague who crawled into her bed and tried to kiss her. Mathis, who initially suppressed the incident, ruefully said, *“Oh God, I never said anything.”*<sup>15</sup> Justifying to herself, she recalled thinking, *“That was just me. I got out of it and made my way and I was fine.”*<sup>15</sup> However, as time passed, Mathis realized that *“almost every female firefighter in the LAFD has suffered unwanted touching, leering or derogatory comments.”*<sup>15</sup>

After she filed her claim, Mathis was frightened of retaliation and fearful for her family, career, and personal safety. She feared that someone would try to hurt her in a fire or even kill her in an emergency situation. She felt the fire department was unique in the sense that all training exercises were justifiable because any emergency situation was possible. She noted that

*“There were no controls being put on the training that was happening. People were able to set up these sorts of punitive physical exercises that were destroying women, essentially.”*

Thirty-nine-year-old Brenda Lee became part of this diverse team after following a dream she had as a 6-year-old to one day become a firefighter. She found herself assaulted by the macho

culture that existed within LAFD Station 96 in Chatsworth. She claimed she was discriminated against on the multiple premises of being Black, a woman, and a lesbian. According to her, she incessantly endured disparagement from colleagues and her supervisor. One day when Lee complained about an unflushed toilet, her supervisor said to her, *“What’s the matter, Brenda? Does it look like you?”*<sup>16</sup> Additionally, according to Brenda, in coerced compliance, she performed rigorous exercises entailing a heavy ladder, her locker and personal unit were burglarized on several occasions, and urine was added to her mouthwash. Lee’s former colleagues testified against her, stating she displayed a *“lack of responsibility and accountability on the job.”*<sup>17</sup> They recalled one situation where Lee got into an altercation with another firefighter while putting out a fire and he slapped her in the face. According to Superior Court documents, Lee was initially offered \$2.5 million to settle by a city attorney. After declining the offer, she hired another attorney and left the LAFD upon filing of her lawsuit in 2005. In 2007, the jury awarded her \$6.2 million.

Cornell University’s Institute for Women and Work in the Institute of Labor Relations School reported that almost half of all female firefighting candidates passed the physical ability test, yet fewer than 4% of the nation’s firefighters were women, and more than half of all fire departments had never hired a female firefighter (See also Exhibit 1).<sup>18</sup> The research involved surveys from 675 firefighters in 114 departments in 48 states. Of the 175 female firefighters interviewed, 85% reported that they were treated differently than male firefighters; specifically, *“80 percent said they were issued ill-fitting equipment; 37 percent reported that their gender created barriers to career advancement; 50 percent felt shunned or socially isolated; and 37 percent were verbally harassed.”*

### **Fire Chief Bamattre Resigns**

Fire Chief Bamattre had made contributions to an improvement in funding and staffing for the department. However, persistent pressure from the City Council and Black leaders, along with his failure to control hazing and harassment, compelled Bamattre to resign in December 2006.

*“Bamattre was blamed for miserably failing to change the culture of the department. But as Bamattre notes, when he left, the LAFD had ‘more women than many large departments. We did that without a consent decree [or] mandatory hiring.’ The new Fire Chief Douglas Barry was chosen to diversify the department—and, yes, to recruit more women.”<sup>5</sup> Fire Chief Barry stated that one of his “key challenges will be to change the department culture while trying to satisfy the firefighters union, chief officers’ association, and employee organizations representing African American, female and Latino firefighters.”*

### Unresolved Problems

Despite the efforts of Fire Chief Barry, the LAFD continued to struggle with racial discrimination and sexual harassment. What was worse, some issues avoided public notice in part because the Los Angeles City Council approved deals barring the accusers from publicizing their settlements. One case quietly resolved in early 2013 included a \$325,000 payment to the department's first Black female firefighter, d'Lisa Davies. Davies alleged that she suffered discrimination over two decades. As part of that settlement, the city agreed to have the U.S. Equal Employment Opportunity Commission more closely monitor the LAFD's antidiscrimination training program for firefighters and supervisors. Federal fair employment regulators found Davies had been denied a transfer in retaliation for her protests discrimination.

### Enter Mayor Garcetti

Eric Garcetti was elected Mayor of Los Angeles in 2013. He vowed to fight against discrimination in the LAFD. He said, *“My priority in bringing new leadership to the Fire Department is bringing a much-needed change to the culture there.”<sup>20</sup>*

Some other cities have had more success hiring women, including Seattle, where almost 9% of firefighters were female, and San Diego, where nearly 8% were female. Nationwide, it was estimated that 4% of firefighters were women.

In early 2014, for the first time in 5 years, the LAFD formed a class of new recruits. However, nearly all class members were male and mostly White, despite repeated promises by the LAFD to diversify its ranks. According to Mayor Garcetti's office, the class of 70 firefighters had just one woman and was 60% White; 23% percent of the recruits were Latino, 11% were Asian American, and 6% were Black. The numbers continued not to reflect the population of the city of Los Angeles.<sup>20</sup>

Mayor Garcetti was not satisfied with the racial and ethnic balance based on information he received from the department. *"Mayor Garcetti thinks these numbers are unacceptable and wants the Fire Department to reflect the city it serves,"*<sup>21</sup> spokesman Yusef Robb said. Robb further said that the mayor's office was committed to working with the department to improve recruiting and ensure future classes included more women and minorities.

### First Latino Fire Chief Ralph Terrazas

On August 8, 2014, Ralph M. Terrazas was appointed by Mayor Garcetti and endorsed by the City Council.<sup>22</sup> Fire Chief Terrazas said, *“It’s an exciting and challenging time to be taking the helm and together we will redouble our efforts to transform the LAFD into a metric-driven, technologically sophisticated, community-focused organization that reflects the communities we serve.”*<sup>23</sup>

Mayor Garcetti appointed Chief Terrazas to be a permanent head of the LAFD to help improve community service as well as public safety in the city of Los Angeles. Mayor Garcetti explained that *“there is no better person to cut response times, improve technology, and bring reform to the Los Angeles Fire Department than Chief Terrazas.”*<sup>24</sup>

Chief Terrazas, who held a Master of Public Administration degree with a concentration in human resource management from California State University, Los Angeles, said he hoped to emulate the low-key style of former Fire Chief Bamattre. Terrazas said, *“I worked on his staff and appreciated the way he treated everyone with respect. He called me up and offered to talk with me to help me figure out where some of the pitfalls in the city are.”*<sup>26</sup>

As for recruiting, Fire Chief Terrazas planned to have all three drill towers open in the future to train recruits—classes he hoped would include more women. One of his goals was to revive a hiring program where firefighters recruit female athletes by encouraging and mentoring them to become firefighters.

Prior to becoming fire chief, Terrazas served as the first head of the LAFD’s Professional Services Division (PSD), formed after a series of expensive lawsuits and scandals involving hazing, pranks, and harassment, an appointment that often put him at odds with the United

Firefighters of Los Angeles City – the union. While the union ended up endorsing his appointment, the endorsement came about only through a collective effort of discussions.

Chief Terrazas commented,

*“I was the enforcer and the union was representing firefighters. It’s only natural there was some disagreement.”<sup>26</sup> “Before the PSD, there was an arbitrary system in place on how many days of suspension a firefighter would get or if it would go to a Board of Rights.”<sup>24</sup>*

He added, *“We tried to make it a fair system, so people would know what they would get in terms of discipline.”* The result, he said, has been a dramatic drop in the number of lawsuits against the city from firefighters.<sup>25</sup>

### The Trump Effect

In February 2018, the LAFD experienced a series of divisive workplace incidents – arguments and physical altercations between firefighters from different racial groups. Some firefighters – typically white – supported President Trump’s condemnation of NFL football players who knelt during the national anthem, while others – typically black firefighters – supported the players. Colin Kaepernick, a former San Francisco 49ers quarterback, had initiated a national debate by kneeling during the national anthem before games to call attention to racial injustice in the shooting of black Americans by police officers.

Fire Chief Terrazas noted, in a letter to the firefighters, noted that there had been *“on-duty heated discussions regarding the perception of a lack of patriotism by NFL players”* as well as a *“near physical altercation”* after someone showed up late to work.<sup>27</sup> *“These types of issues and incidents are divisive and can erode our ability to accomplish our collective mission to protect the lives and property of the people of Los Angeles,”* he wrote.<sup>27</sup>

Terrazas reminded the LAFD that he expected every firefighter to behave in a way that *“fosters a professional and respectful workplace free of discrimination, harassment, retaliation and hazing.”* He also reminded employees to use the job title firefighter, not ‘fireman.’<sup>27</sup>

See Appendix B for the Fire Chief’s letter to the LAFD employees.

### Additional Lawsuits

In August 2018, African American firefighter Emanuel Brown filed a lawsuit against the city alleging that he repeatedly faced discrimination while working at a fire station in South Los Angeles, and retaliation after he complained. On Easter Sunday, Brown opened his locker only to find that somebody had smeared his equipment with feces.<sup>28</sup> He reported the incident to a Captain outside his unit because he was afraid of retaliation. He further alleged that colleagues retaliated against him for complaining, calling him ugly racial slurs, including *“chocolate piece of shit.”*<sup>29</sup> One firefighter made *“cork-popping noises”* whenever Emanuel Brown walked into the room, Brown’s lawsuit claimed. During a drill, another firefighter *“mentioned that someone may die”* as a result of the training exercise. A co-worker mocked Brown by asking how much sugar he would be putting in his coffee, insinuating that Brown was *“soft and weak.”*<sup>29</sup>

In a separate 2018 lawsuit against the city, 5 Black and 2 Latino firefighters claimed that they had been *“systematically looked down upon”* because of their race, gender or association with black firefighters.<sup>29</sup> The lawsuit claimed:

*“The LAFD is essentially an all-white boys club, and anyone who fails to align themselves with this mentality is looked down upon and treated differently.”*<sup>29</sup>

Black and female firefighters in the bureau were branded by other department employees as *“lazy and afraid”* to fight fires.<sup>30</sup> The lawsuit also alleged that black and female firefighters were called *“slugs.”*<sup>29</sup>

*“If you’re a Black female, you’re pretty much a non-entity,”* remarked d’Lisa Davies, who claimed that she was denied a promotion for 10 years because of her gender and race.<sup>31</sup>

The firefighters’ lawyers claimed:

*“Due to this department-wide systemic racial and gender animus, plaintiffs have continuously been looked down upon and subjected to discrimination, harassment and retaliation because of their African-American race, and association with other African-American firefighter.”*<sup>29</sup>

Appendix A provides a link to a video clip of an NBC News report on discrimination in the LAFD.

### Struggling to Hire More Women

At the end of 2018, despite Mayor Eric Garcetti’s commitment to increasing diversity, only 3.1% of LAFD’s firefighters were women, up from 2.9% when Garcetti took office in July 2013. The Mayor was pushing Chief Terrazas to reach 5% women by 2020.<sup>32</sup>

In summer 2018, the newest class of firefighter recruits included 9 women and 56 men. To become a firefighter, the recruits would need to complete a rigorous five-month boot camp. The previous two classes finished with no women graduating, and in the past two years only 57% of women (but 83% of men) graduated and joined the Fire Department. *“Some women left the training academy after sustaining injuries. Others have left for personal reasons or because they failed to perform,”* said a Fire Department official.<sup>32</sup>

LAFD had added 17 female firefighters since July 2013, bringing the total number to 109. But during the same period, the department had added nearly 150 male firefighters, maintaining the same female-to-male ratio that LAFD had in 1995.<sup>32</sup>



### The Firefighter Recruitment Plan

In May 2018, Fire Chief Terrazas released the LAFD 2018 Firefighter Recruitment Plan, a part of the department's 2018-2020 strategic plan.<sup>33</sup> The plan began with an acknowledgement that while the department has not had difficulty attracting qualified applicants, it has done a poor job of hiring people who look the communities LAFD serves.

*“Being a firefighter is a highly attractive job that attracts many traditional applicants. The City of Los Angeles is seeking to enhance recruitment efforts so that the Los Angeles Fire Department (LAFD) reflects the diversity of the City it serves. The key to firefighter recruitment is to conduct targeted outreach to attract non-traditional, diverse, qualified applicants.”<sup>33</sup>*

The 2018-2020 plan included some specific goals, such as increasing the percentage of female firefighters to 5% by 2020. An applicant orientation program (AOP) would be put in place to give non-traditional applicants a good understanding of what LAPD jobs entailed. Job advertising would focus on under-represented groups (See Appendix C for a sample job poster.) Youth programs – including LAFD Girls camps – would be given more attention and greater funding to generate early interest in the profession. Recruiters would also develop relationships with athletic directors at local schools, junior colleges, and universities.<sup>33</sup>

But would it be enough? How could LAFD optimize its recruiting efforts to women and ethnic minorities? What changes to human resources policies could the department make to increase diversity and to promote an organizational culture of inclusion? What else would Fire Chief Terrazas need to do?

**Appendix A**

**Link to TV News Clip: Firefighter Claims Racial Discrimination at Department**



Source: <https://www.nbclosangeles.com/on-air/as-seen-on/Firefighter-Claims-Racial-Discrimination-at-Department-Los-Angeles-475939833.html>

**Appendix B**  
**Letter from the Fire Chief**

Source: Ralph Terrazas, Feb. 16, 2018. [http://clkrep.lacity.org/onlinedocs/2014-14-0560-S1\\_pc\\_6-27-18.pdf](http://clkrep.lacity.org/onlinedocs/2014-14-0560-S1_pc_6-27-18.pdf)



From the Office of  
the Fire Chief ...

**RECEIVED**  
JUN 27 2018  
BY: *AS. Keisler*

February 16, 2018

TO: ALL MEMBERS

SUBJECT: FIRE CHIEF EXPECTATIONS OF WORKPLACE BEHAVIOR

***"I firmly believe that our mission to protect lives, property  
and each other, is a much stronger bond among us...  
than any issue that may divide us"***

One of the most important responsibilities all Officers have, is to recognize small issues, which if not addressed immediately, can grow into larger issues. One such issue, is the importance of appropriate workplace behavior.

Recently, I have become aware of a few situations which have caused me concern over the workplace environments currently being experienced by our members. These include:

- On-duty heated discussions regarding the perception of a lack of patriotism by NFL players kneeling during the national anthem.
- A perceived lack of sensitivity in addressing members of color during an investigation.
- A near physical altercation due to a late relief issue between members of different ethnicities.

These types of issues and incidents are divisive and can erode our ability to accomplish our collective mission to protect the lives and property of the people of Los Angeles. For the sake of our members and those we serve, that is something we cannot afford. These occurrences can be attributed to a number of factors and theories such as:

- An individual's inability to understand the cultural, societal or historical experiences of different ethnic, gender, generational, and philosophical groups.
- The constant exposure to various media sources expressing varying opinions relating to current perceived acts of defiance towards our government, lack of respect for our flag or love for our country.
- An unrealistic belief that we must all have the same level of tolerance and acceptance for behaviors and comments which may be in conflict with our own.

**Appendix B, cont.**  
**Letter from the Fire Chief**

All Members  
February 16, 2018  
Page 2

To proactively address the issues I have previously described, I want to make clear my expectations of our members. **It is my expectation...**

- That all Officers, Managers and Supervisors perform their duties in a manner that fosters a professional and respectful workplace free of discrimination, harassment, retaliation and hazing.
- That all members work towards maintaining a respectful work environment, by behaving in a manner that is in line with our policy of zero tolerance towards discrimination, harassment, retaliation and hazing.
- And especially important, that all members use the title "**Firefighter**" rather than "Fireman" as defined in the Consent Decree between the LAFD and the Department of Justice in 1974.

For more detailed information regarding these expectations and proper conduct, members are encouraged to review the following documents:

- LAFD Rules and Regulations
- LAFD Discrimination Prevention Policy and Complaint Procedures
- LAFD Sexual Harassment Prevention Policy and Complaint Procedures

To reinforce my expectations and to address any questions or concerns expressed by our members, I have directed all Battalion Commanders to personally deliver this message to their areas of responsibility.

To further assist our members in meeting my expectations, we are currently creating a comprehensive personal and professional development plan. This plan will include various training classes and methods, developing a departmental unit focused on assisting our Officers, Managers and Supervisors with difficult workplace issues and the implementation of surveys to better gauge our effectiveness.

It is critically important that we recognize that we are not a team only because we work together. We are a team because we respect, trust and care for each other as we accomplish our collective mission of protecting the lives and property of the people of Los Angeles.

Stay safe,



RALPH M. TERRAZAS  
Fire Chief

Appendix C  
 LAFD Recruitment Ad  
 Source: [www.joinlafd.org](http://www.joinlafd.org)

*Come Join Us*

**LOS ANGELES  
 FIRE DEPARTMENT  
 APPLICANT ORIENTATION  
 PROGRAM**

**Every  
 Tuesday**  
6-9 PM

**FRANK HOTCHKIN  
 MEMORIAL TRAINING  
 CENTER**

1700 Stadium Way  
 Los Angeles, CA 90012

The best way to prepare for a career with L.A.'s bravest? Show off your skills, strength and smarts while learning about what it takes to be a firefighter at our hands-on orientation program:

- Try on personal protective equipment
- Try out EMS and firefighting tools and
- Review the NEW testing and hiring process
- Learn about job and fitness requirements
- Interview Prep Overview
- And much more!

All are welcome!



REGISTER TODAY AT

www.LAFD-AOP.eventbrite.com

For More Information:

Call the LAFD Firefighter Recruitment Section

(213) 893-9899



WEAR YOUR  
 PASSION

*On Your Sleeve*



WEAR YOUR  
 BRAVERY

*On Your Sleeve*



WEAR YOUR  
 SMARTS

*On Your Sleeve*

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