CASE 20

Tyco: I'm Sure That It's a Really Nice Shower Curtain

THE RISE OF DENNIS KOZLOWSKI

On May 18, 2002, Tyco CEO Dennis Kozlowski, who had received his degree in accounting and finance from Seton Hall University in 1968, gave the commencement address to St. Anselm's College in Manchester, New Hampshire. He talked about the difficult decisions that the graduates would have to address during their lifetime. He stated that the graduates would have questions that would test their moral standards. He told the students that the questions would get tougher and the potential consequences would be more severe, so his advice was to do not the easy thing, but the right thing.[1] Less than two weeks later, on June 1, 2002, Dennis Kozlowski, who had worked at Tyco since 1975, announced to the board of directors for Tyco International that he was the subject of a criminal investigation in New York for evasion of sales taxes on a painting he had purchased in Manhattan. The board of directors demanded that he step down as CEO of Tyco, and he did on June 3, 2002. Tyco told the media that Kozlowski had resigned for "personal reasons." By resigning and not being fired, Kozlowski was no longer eligible for a severance package that was valued at approximately $120 million. Previous Tyco CEO John Fort took over as interim CEO. Fort, Tyco's CEO from 1982 to 1992, had stopped using the company jet and sold off the president's house and other corporate-held apartments during his first reign. In an ironic example of déjà vu, Fort, who was on the board of directors of Tyco, had to address the same issues in 2002 that he dealt with in 1982.[2]

THE FINANCIAL TROUBLES BEGIN

It was not a pleasant time for Tyco because it had lost $86 billion in market capitalization because of concerns investors had about the company's strategic focus. In addition,

TABLE 1 Some of the Major Tyco Acquisitions during the Kozlowski Era

Date	Company	Products	Cost
July 1994	Kendall International	Medical	$1.4 billion
March 1997	ADT	Home Security	$5.4 billion
April 1997	AT&T Cable	Underwater Cable	$850 million
May 1998	U.S. Surgical	Medical Supplies	$3.3 billion
November 1998	AMP	Electronic Components	$11.3 billion
June 2000	Mallinckrodt	Health-care Products	$4.2 billion
February 2001	Scott Technologies	Lifesaving Equipment	$400 million
March 2001	CIT Group	Financial	$9.2 billion
May 2001	C. R. Bard	Health-care Products	$3.2 billion

Source: Adapted from Alex Berenson, "Tyco Chief out as Tax Inquiry Picks up Speed," New York Times, June 4, 2002, www.nytimes.com.

a number of critics were complaining about the compensation levels given to Kozlowski and other members of Tyco's management. Tyco's stock had fallen from $60 in December 2001 to $16.05 in June 2002. In addition, Tyco had accumulated $27 billion in debt through various acquisitions. Kozlowski was called "Deal a Month Dennis" for his aggressive acquisition style. He said his goal was to create the new General Electric. Some of the major acquisitions are shown in Table 1. In his ten years as CEO, through growth via acquisition, Kozlowski grew the size of Tyco from $2 billion when he took over the CEO position to create a conglomerate with annual sales of $36 billion at the end of fiscal 2001. Tyco had a quarter of a million employees worldwide and had a market capitalization of $120 billion. At the time of his resignation, Kozlowski had exercised $240 million in stock options and had been paid close to $100 million over the previous three years. The estimated tax that Kozlowski avoided on the painting was $1 million. In addition, Kozlowski owned residences in New York, New Hampshire, Florida, and Nantucket Island. His New York apartment was reportedly bought for $18.5 million in 2000. His distaste for paying taxes led him to move the corporate headquarters to Bermuda from Exeter, New Hampshire, in 1997 to reduce Tyco's tax liability to 20 percent, which is approximately half of the average corporate rate for United States–based firms.[3]

PAYING FOR EMPTY CRATES

It was alleged that Kozlowski had bought approximately $15 million worth of paintings in New York and had the art gallery ship them to New Hampshire to avoid paying the 8.25 percent New York State and Manhattan combined sales tax even though they were to be hung in his Fifth Avenue apartment.[4]

On June 4, 2002, Kozlowski was indicted by a grand jury for tax evasion for avoiding paying more than $1 million in taxes on six paintings that he had purchased in the fall of 2001. In addition, he was also charged with tampering with evidence and willfully falsifying financial records. He was ordered to surrender his passport and was released on a

$3 million bond. One piece of evidence that prosecutors were able to obtain was a fax that listed the paintings Kozlowski had purchased, which were supposed to be shipped to New Hampshire, with the words *wink, wink* in parentheses. Kozlowski had bought approximately twelve paintings including a Renoir and a Monet that were valued at more than $15 million from August to December 2001. Karen Kozlowski, Dennis's wife, worked with art director Christine Berry to help purchase the art for their Fifth Avenue apartment. Some of the paintings would be sent to the apartment to see how they would look on the wall before they were purchased. In December 2001 the Kozlowskis purchased a Monet for close to $4 million from a private Manhattan dealer. The art dealer, Alexander Apsis, did not charge sales tax on the painting because Kozlowski gave him a written document that stated that the painting was going to be shipped to New Hampshire. However, the painting went to the Manhattan apartment, which is less than two blocks from the art dealer's office. During the same time period, the Kozlowskis purchased four additional paintings that were valued at close to $9 million and included a Renoir. For those purchases, Kozlowski told the art dealer to ship empty boxes to New Hampshire to represent the shipment of the paintings. On January 2, 2002, five empty boxes were shipped to New Hampshire and signed for by a Tyco employee.[5]

THE INVESTIGATION EXPANDS

On June 6, 2002, prosecutors announced that the investigation had been expanded to include an examination to see whether Kozlowski used Tyco funds to finance the maintenance of his Florida homes as well as paying for other personal expenses. The investigation started to focus on whose money was used to purchase the artwork that was hanging in Kozlowski's Fifth Avenue apartment. In addition, it appeared that Tyco money was used to purchase the $18.5 million apartment in Manhattan for the Kozlowskis. The investigation also examined whether Tyco money was used to purchase the Kozlowski home in Boca Raton, Florida.[6] The Boca Raton home had been owned by Lord Michael Ashcroft, who became a Tyco board member in 1997 when Tyco purchased ADT, which Ashcroft's company owned. In October 1997 Ashcroft sold his house to his wife for $100. She sold it the same day for $2.5 million to a Tyco vice president, Byron Kalogerou. The investigation was to determine whether the home was purchased with Tyco funds and Kalogerou's name was put on the title to avoid having the appearance that Tyco bought the home for Kozlowski from a Tyco board member.[7] By June 9, 2002, Tyco's stock had fallen from a high of more than $60 in December 2001 to $10.10, resulting in a reduction of market capitalization of approximately $95 billion.

On June 26, 2002, Dennis Kozlowski was indicted on two additional charges of tampering with evidence in the tax evasion case. The new indictment was based on the disclosure that Kozlowski had physically taken a bill of lading from the Tyco offices in Boca Raton that had falsified the shipment of the paintings from New York to New Hampshire before the files were sent to the New York district attorney's office in May 2002. As with all the previous charges, Kozlowski pleaded not guilty to the new felony charges.[8] On July 23, 2002, Tyco reported a third-quarter loss of $2.32 billion, compared with a net profit of $1.18 billion for the third quarter of 2001.[9] On July 25, 2002, Tyco announced that it had hired Motorola's president, Edward Breen, as the new CEO and chairman of the board. Breen had also previously been the CEO of General Instrument Corporation, which was acquired by Motorola in 2000.[10]

On September 12, 2002, Dennis Kozlowski and CFO Mark Swartz were indicted for illegally obtaining hundreds of millions from Tyco for their own use. It was alleged that the two former Tyco executives were involved in racketeering by being involved in stock fraud, the disbursement of bonuses that were not authorized to employees, and the falsification of expense accounts. It was also alleged in the indictment that Kozlowski and Swartz "paid off" a Tyco board member and other employees to keep their fraudulent activities quiet. The prosecutors accused Kozlowski and Swartz of running a "criminal enterprise," which is commonly used when indictments are applied to members of organized crime. The Manhattan district attorney's office claimed that the two former Tyco executives started the covert fraudulent operation in 1995. The DA's office alleged that the two men had spent millions of Tyco's dollars for their personal use. It was also alleged that the two Tyco executives would control the focus of Tyco's internal audits and would file disclosure reports with the SEC without any input from the legal department to avoid any chance that their activities would be discovered. The prosecutors calculated that Kozlowski and Swartz had stolen $170 million directly from the company and had illegally gained another $430 million by selling Tyco stock while the price was artificially high due to financial statement manipulations. The prosecutors also alleged that Kozlowski had defrauded the company by giving himself and other Tyco employees unauthorized bonuses and loans that were not repaid to the company.[11] It was alleged that Kozlowski used a Tyco program designed to help executives pay taxes on stock options to improperly borrow an estimated $242 million for his own use. Kozlowski used the money to purchase paintings, real estate, yachts, and jewelry for himself and his wife. Swartz allegedly used the same program to borrow $72 million for his personal investments. In addition, Kozlowski and Swartz used $78 million in loans from Tyco's real estate "relocation" program, which was designed to help pay the costs of employees who were being transferred to the Boca Raton office from the New Hampshire office. The money was used by the two executives to purchase real estate and other personal expenses.[12]

THE PAYMENT OF EXPENSES

On September 18, 2002, it was revealed that Dennis Kozlowski had approved without authorization the forgiveness of loans to fifty-one Tyco employees in the amount of $95 million in return for their silence. The company also released the results of an internal review headed by David Boies, who found that Tyco paid for personal expenses of Kozlowski including an $80,000 payment to American Express, a traveling toilet box that cost $17,100, an umbrella stand designed to look like a dog for $15,000, a sewing basket that cost $6,300, a $6,000 shower curtain, two sets of bedsheets that cost $5,960, a set of coat hangers that cost Tyco $2,900, a metal wastebasket that cost $2,200, a $1,650 notebook, and a pincushion that cost $445.[13]

Tyco filed a lawsuit against Kozlowski, requiring the former CEO to return to Tyco his compensation and benefits since 1997 and the forfeiture of all of the components of his severance package.

HAPPY BIRTHDAY, KAREN!

One of the allegations was that Tyco paid $1.5 million of the $2.1 million total cost of the fortieth birthday party for Kozlowski's second wife, Karen, at Island Sardinia in Italy. Kozlowski had met Karen when she was working as a waitress in a New Hampshire restaurant near Tyco's U.S. headquarters. A memo given to *The Wall Street Journal* gave the details of the $2.1 million party. It was described as a Roman Empire theme with Kozlowski being the emperor. The party included gladiators, exotic animals, and an ice sculpture of Michelangelo's *David* that disbursed Vodka through its genitals. Not to be outdone, there was also a woman-shaped birthday cake that had an exploding bosom when sparklers were inserted in the cake. The servers were dressed in togas with an open bar for the seventy-five guests and more than twenty-five staff members. Elvis appeared on a huge screen apologizing for not being able to appear in person, and an extravagant light show ended the evening. Jimmy Buffett also performed for a fee of $250,000. The guests did not to pay for anything, including flying over to Italy. The birthday "week" was so elaborate that a logo was made and it was included on bags, hats, and other gifts given to the guests. Also part of the week-long events were a scavenger hunt, horseback riding, water skiing, and trips on Kozlowski's yacht. After the party was over, Karen and some of the guests took a Tyco jet and flew to Florence to participate in a cooking class. The only guidance Kozlowski gave the planners was not to do anything that he would be embarrassed to see on the front page of *The Wall Street Journal.*[14] In Tyco's 2001 annual report, which was published after the birthday celebration, Kozlowski informed Tyco investors that the company had a continuous drive to reduce costs throughout the organization.[15] Kozlowski described the party as primarily a business function.[16] At the retrial of the two executives, Mark Foley, who was the former senior vice president of finance, testified that the party was going to be a "management meeting" and would include a meeting with the board of directors.[17]

MARK SWARTZ, CFO

Chief financial officer Mark Swartz was more involved in the deal making for the acquisitions than the financial statements of Tyco. He was considered the protégé for Kozlowski. From 1999 to 2002, Swartz received more than $170 million, which included a salary of $48 million and $125 million in stock options. His compensation was one of the highest for a CFO during that time period.[18] Tyco's new CEO, Edward Breen, asked Swartz to leave Tyco on August 1, 2002. In agreeing to step down as CFO, Swartz gave up his previous severance package, which was estimated to be worth $100 million, and settled for $9 million and other retirement benefits when Breen threatened to challenge the previous severance agreement in court.[19] On September 11, 2002, David FitzPatick was hired by Tyco as the new CFO. He was previously a CFO and senior vice president for United Technologies Corporation.[20] On February 19, 2003, Mark Swartz was indicted for tax evasion for not paying federal income taxes on a loan of $12.5 million that was given to him in 1999. The tax due for the bonus would have been close to $5 million.[21] On April 1, 2003, Tyco filed a lawsuit against Swartz, asking for more than $400 million in money that Swartz had taken that had belonged to Tyco. The lawsuit was filed after Swartz refused to resolve the issue with arbitration.[22] In September 2004 Mark Swartz's Manhattan apartment near Central Park was sold by Tyco for $12 million. Swartz, using Tyco funds, bought the apartment in 2002 for $15.274 million.[23]

On January 27, 2005, the retrial for Kozlowski and Swartz started in New York. During his retrial Swartz stated that he did not remember checking his 1999 W-2 form to see whether he had reported the Tyco forgiveness loan of $12.5 million. The former accountant testified in court that he only remembered seeing the W-2 two years later in the summer of 2002.[24]

MARK BELNICK, TYCO LEGAL COUNSEL

On June 11, 2002, Tyco fired its general legal counsel, Mark Belnick, over disputed circumstances. Belnick, who had been at Tyco since 1998, stated that he was fired because he lost a power struggle with one of Tyco's board members, Joshua Berman, and the lawyer who was hired in April 2002 to be included in the Tyco corporate governance committee, David Boies. On the other hand, Tyco stated that the reason Belnick was fired was he was disrupting the internal investigation by having Tyco pay for executives' personal expenses as well as issuing previously undisclosed loans to Tyco executives.[25] Joshua Berman also became part of the investigation when it was discovered that Tyco was paying his law firm up to $2 million annually and Berman's compensation until 2000 was tied, in part, to how much business he could bring to the law firm from Tyco. Belnick had complained that Tyco was depending too much on Berman's law firm of Kramer Levin Naftalis & Frankel for its legal needs.[26] Boies had stated that Belnick had been given $20 million in compensation without the payment being disclosed to the board. Belnick's lawyer confirmed the payment of $20 million but stated that the proper disclosures had been made. The Securities and Exchange Commission required that the compensation for the five top-paid officers be disclosed. It was assumed that Belnick's compensation would have put him in the top five, yet Tyco did not disclose this information to the SEC in its filings.

In addition, initial results of the internal investigation done by Boies's firm, Boies, Schiller & Flexner LLP, raised questions as to whether Tyco money was used to buy Belnick's residences in New York City and in Park City, Utah, without full approval by the board of directors.[27] On June 17, 2002, Tyco filed a lawsuit against Mark Belnick that alleged that Belnick had accepted payments of $35 million from 1998 to 2001 without disclosing it to the compensation committee of the board of directors or to the SEC. In addition, the lawsuit also claimed that Belnick purposely deleted files relevant to the investigation on June 10, 2002, which was the day he was fired. On September 12, 2002, the Manhattan district attorney's office announced that Belnick was criminally charged with defrauding Tyco. It was alleged that Belnick hid the fact he received a "relocation loan" from Tyco that he used to buy a resort home in Utah. The district attorney's office claimed that Kozlowski "paid off" Belnick with the loan so Belnick would not say anything about the internal transactions that were occurring at Tyco.[28]