

On February 3, 2003, Mark Belnick was indicted for three more criminal charges, including obtaining a \$12 million bonus that was not authorized. The three charges were grand larceny, fraud, and falsifying documents.<sup>29</sup> During his trial, prosecutors claimed that Belnick did not disclose \$14.9 million in company relocation loans that were used to purchase an apartment in New York and a home in Utah. Belnick was listed as the only Tyco employee in Utah.<sup>30</sup> Belnick was accused of taking up to \$32 million through loans and bonuses without proper authorization. After a two-month trial in which the jury deliberated for five days, Belnick was found not guilty on all charges.<sup>31</sup> On May 2, 2006, Belnick agreed to pay the SEC a \$100,000 penalty as part of the settlement for civil fraud charges. In addition, Belnick agreed not to serve as a corporate officer of a publicly traded company for five years.<sup>32</sup>

## TYCO'S BOARD OF DIRECTORS

On June 13, 2002, it was also announced that the board of directors at Tyco was investigating the actions of interim CEO and board member John Fort for conflict-of-interest violations. Fort was an investor and advisor for DLJ Merchant Banking Partners II, which bought Tyco's flow-control products division for \$810 million in August 1999. Fort did not disclose this information to the board of directors at Tyco. In addition, it was alleged that Fort had sold a Rye, New Hampshire, house to Kozlowski in 1996, which was paid for with Tyco funds. Furthermore, another Tyco board member, Stephen Foss, had a business relationship with the leasing of an airplane to Tyco.<sup>33</sup> The lack of control by Tyco's board of directors pertaining to the decision-making process by the top executives at Tyco is evident by examining the compensation levels given to Kozlowski and Swartz from 1998 to 2001 as shown in Table 2. While their salaries ranged from more than \$1 million to \$4 million per year, the issuing of stock bonuses and options ballooned the total compensation package for the two top Tyco executives combined to close to half a billion dollars for the four years.

On October 22, 2002, it was revealed that Kozlowski had a close financial relationship with another board member, Richard Bodman. Bodman had been a Tyco board member since 1992, and Kozlowski had invested \$5 million into a private stock fund that was managed by Bodman. Bodman was a member of Tyco's oversight board committees—audit, corporate governance, and nominating.<sup>34</sup> Bodman's close relationship with Kozlowski did not hinder his opinion of a \$20 million payment made to another board member, Frank Walsh. Bodman called the payment made without board approval corrupt and a complete violation of the responsibilities given to the board of directors by the investors.<sup>35</sup>

On June 17, 2002, it was announced that former independent board member Frank Walsh, Jr., created a conflict of interest by taking a secret \$20 million from Kozlowski for helping Tyco buy CIT Group. The fee was not disclosed when it took place, but six months later Tyco disclosed the fee, and it resulted in a decrease of \$16.7 billion in market capitalization of Tyco stock.<sup>36</sup> On December 17, 2002, Frank Walsh pleaded guilty to securities fraud. Walsh admitted that he had taken a payment of \$20 million for helping Tyco acquire CIT Group, but he did not disclose that information

**TABLE 2** Compensation for Kozlowski and Swartz, 1998 to 2001

Dennis Kozlowski's Total Compensation from 1998 to 2001 (Rounded to Millions of Dollars)

Year	Salary	Bonus	Restricted Stock		Stock Options (Present Value)	Grand Total
			Subtotal	Bonus		
1998	1.250	2.500	3.750	20.140	25.430	49.320
1999	1.350	3.200	4.550	25.707	68.420	98.677
2000	1.350	2.800	4.150	21.207	80.610	105.967
2001	1.650	4.000	5.650	30.399	21.810	57.859
Total	5.600	12.500	18.100	97.453	196.270	311.824

Mark Swartz's Total Compensation from 1998 to 2001 (Rounded to Millions of Dollars)

Year	Salary	Bonus	Restricted Stock		Stock Options (Present Value)	Grand Total
			Subtotal	Bonus		
1998	0.559	1.250	1.809	10.700	14.540	27.049
1999	0.750	1.600	2.350	12.030	31.480	45.860
2000	0.769	1.400	2.169	10.061	41.560	53.789
2001	0.969	2.000	2.969	15.199	12.000	30.168
Total	5.600	6.250	11.850	47.990	111.527	168.814

Source: Adapted from Dan Ackman, "The Millions Kozlowski Didn't Steal," *Forbes*, May 23, 2005, [www.forbes.com](http://www.forbes.com).

to any other members of the board of directors. In exchange for not being sentenced to jail, Walsh agreed to pay back the \$20 million with an additional \$2.5 million as a fine for his actions. The \$20 million "finder's fee" was given to Walsh so Tyco could buy CIT Group, which was owned by Walsh's friend Albert Gamper, Jr. Tyco bought CIT for \$9.2 billion and sold it in 2002 for a loss of \$7 billion.<sup>37</sup> In the first criminal trial against Kozlowski, evidence was presented that showed Kozlowski had admitted to Fort in a January 2002 phone conversation that the \$20 million payment was a mistake and it was an action that should have been done only with board approval. Fort testified at the trial that board members usually arranged potential acquisitions without any additional compensation. Fort told Kozlowski that the payment would have been denied by the board if the board had been aware of the deal.<sup>38</sup>

### THE WONDERFUL WORLD OF TYCO ACCOUNTING

On June 13, 2002, the SEC announced that it was starting an investigation of Tyco based on its accounting procedures. The SEC wanted to determine whether Tyco was using its reserve accounts to artificially increase its level of profitability after a number of acquisitions by the conglomerate. The investigation was a reopening of an investigation the SEC had started in 1999 and finished in 2000 after Tyco had acquired more than 120 companies in six years during the 1990s. There were questions pertaining to the \$3 billion in restructuring charges that Tyco realized after the acquisitions took place. The 1999 SEC investigation took place when Albert Meyer, from the firm David W. Tice, raised concerns about how Tyco was using aggressive accounting

methods during its acquisition spurge.<sup>39</sup> The internal audit to examine the books for Tyco took 25 lawyers, 100 accountants, and 65,000 hours to review the financial transactions of more than 45 Tyco operating units.<sup>40</sup> On December 30, 2002, Tyco admitted that it had artificially inflated profits for years and would have to eliminate the \$382 million in profits that had previously been reported by the company. The five-month internal investigation revealed that Tyco had a corporate culture that encouraged managers to bypass accounting rules to inflate the results of their departments' performances. One department memo stated that the employees for one of the Tyco divisions had to try to reduce costs through the process of "financial engineering." Another division stated that the employees had to "create stores" to validate the accounting changes that occurred, which increased the level of profitability of the division. The internal audit also discovered that Tyco would force companies that it was acquiring to report lower performance numbers so when Tyco took over the company, it could present a dramatic increase in financial performance. The investigation also found that there was poor documentation of transactions, the policies and procedures in place to control for fraud were not adequate, and there were inadequate procedures for authorizations of employees' actions. Some examples of improper authorizations included employees' having company cars and also receiving car allowances and having a \$150,000 charitable contribution given to an organization that was not a charity.<sup>41</sup> By April 2003, Tyco had estimated that it had an additional \$1.2 billion in accounting problems that had to be restated. This announcement came after two announcements in March in which Tyco had estimated restatement of its financial statements of \$265 million and \$325 million.<sup>42</sup> From October 2002 to August 2003, Tyco had to revise or restate its financial statements on five separate occasions with the net result being a reduction of \$2 billion in pretax profits from Tyco's previous financial statements from 1998.<sup>43</sup>

### **KEY EMPLOYEE LOAN PROGRAM**

In 1983 then-CEO John Fort established the Key Employee Loan Program as a way in which top executives could borrow money from Tyco to pay for taxes on their stock options. The premise behind the program was that Tyco did not want the executives to be forced to sell shares in Tyco stock to pay the taxes when they exercised their stock options. The purpose of the program was to pay taxes only on stock options, and that was explicitly stated in Tyco's 1995 proxy statement.<sup>44</sup> Tyco's former treasurer, Barbara Miller, testified in the first trial that in 1997 the scope of the program moved beyond loans for tax payments. Tyco's former CFO, Swartz, told Miller that executives could now borrow money for any reason with the only restriction being that the total amount borrowed must not surpass a calculated percentage of the executive's restricted stock holding based on the executive's tax rate. As a result, Kozlowski and Swartz borrowed Tyco money through this program to buy real estate, jewelry, and other personal items.<sup>45</sup> One of the charges was that Kozlowski and Swartz were "stealing" \$37.5 million from the loan program. Kozlowski had loans worth \$25 million wiped out while Swartz did not have to repay \$12.5 million from the loan program. A third person, Barbara Jacques, who joined Tyco as a secretary in 1986, also

had \$1 million “forgiven” from the loan program. The prosecutors in the first trial asked why a secretary also benefited from the select Tyco forgiveness program. The reason was, they concluded, that Jacques had an affair with Kozlowski starting in 1986 when he was still married to his first wife. The prosecution also concluded that Kozlowski must have controlled the forgiveness program to allow only himself, Swartz, and Jacques to be able to participate in the program.<sup>46</sup> Jacques would eventually become the event planner for Tyco and was in charge of coordinating the infamous fortieth birthday party in Sardinia, Italy, for Kozlowski’s wife. Linda Auger, head of Tyco’s accounting department, testified in court that Kozlowski used his loan account to buy an \$8 million painting, \$50,000 in flowers for a Christmas party, and restaurant tips that sometimes reached up to 50 percent of the bill on Kozlowski’s corporate credit card.<sup>47</sup> In 1998 Kozlowski used his account to pay for his \$8.3 million investment in the New Jersey Nets and to buy a 1999 Porsche Carrera for his future wife. In September 1999 he used the account to buy his own sailboat, *Endeavour*, for \$13.5 million.<sup>48</sup> In 2001 Kozlowski used his account to purchase a \$5 million diamond ring for his wife.<sup>49</sup>

### KEY EMPLOYEE RELOCATION PROGRAM

The employee relocation program was designed to compensate employees when they moved to the New York office of Tyco. After the board approved the design and use of the program in 1995, it was alleged that Kozlowski and Swartz adjusted the scope of the program. The limited scope of the program was based on the legal opinion of a Boston law firm that concluded that if additional benefits were given to the executives as part of the relocation program, it would be considered additional compensation for the executives, which would require a disclosure of that information in Tyco’s proxy statements. The two executives told Barbara Miller, who was Tyco’s treasurer from 1993 to 1998, that the relocation program would now include additional expenses such as paying for second homes for executives and paying for private school tuition for children of the executives. At the time of this adjustment, Swartz had three school-aged children. Miller had testified that Swartz would give her handwritten alterations to the criteria of the program.<sup>50</sup>

### TYCO BONUS PROGRAM

In 2002 the Tyco Bonus program was introduced even though it was not authorized by the board of directors. The purpose of the program was to forgive relocation loans for employees who had bought homes and moved to the Tyco offices in Boca Raton, Florida. As a result, Tyco paid for the homes of the employees transferred to Florida as well as the related taxes when they purchased the houses. When Patricia Prue, who was head of Tyco’s human resources department from 1998 to 2002, asked Swartz if this bonus plan had been approved by the board of directors, he and Kozlowski told her the program had been approved. Kozlowski received a forgiveness loan of \$33 million from the program, while Swartz got \$16.6 million.<sup>51</sup> A total of \$96 million was paid to approximately fifty employees in September 2000.

## PRICEWATERHOUSECOOPERS, TYCO'S EXTERNAL AUDITOR

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On February 7, 2003, prosecutors accused PricewaterhouseCoopers (PWC) of knowing about the unauthorized bonuses and loans and not investigating them. It was reported that PWC met with Kozlowski and Swartz about the unauthorized transactions and PWC had determined that they were not material and did not need to be disclosed.<sup>52</sup> The SEC accused Richard Scalzo, who was a partner at PWC and the chief external auditor for Tyco, of ignoring the accounting practices that were occurring at Tyco. The SEC claimed that Scalzo did not press for information pertaining to the unauthorized loans and bonuses and other extravagant perquisites that were given to the top executives at Tyco. Based on his actions in the Tyco account, Scalzo agreed to an SEC settlement that stated he would no longer be allowed to practice as an accountant before the SEC, meaning that he would not be allowed to be an auditor. An example of Scalzo not performing due diligence was that he knew that Tyco had a general reserve that was being used to offset expenses that management had not anticipated. The setting up of this reserve is not allowed under generally accepted accounting principles. In addition, Scalzo knew that Kozlowski and Swartz had borrowed \$35.5 million and \$8 million, respectively, interest free. Scalzo agreed with Swartz's argument that the loans were not material.<sup>53</sup> Tyco's former senior vice president for finance testified in court that Scalzo knew of the \$96 million in forgiveness loans that were implemented in Bonus 2000 and did not stop it when it was classified as a direct cost associated with an initial public offering of the Tyco optical fiber subsidiary. Scalzo reportedly stated that was an unusual accounting treatment but he would not overturn the transaction.<sup>54</sup> In court, Scalzo testified that he did review how some of the bonuses and loans were accounted for on Tyco's books. When asked if he ever verified that the board of directors had approved the bonuses and loans, Scalzo said that he did not because it was not part of the auditing procedure.<sup>55</sup>

## THE BEGINNING OF THE END

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On September 29, 2003, the first trial of Dennis Kozlowski started in Manhattan. The prosecutor in the courtroom accused Kozlowski and Swartz of shamelessly violating the trust that investors had in the management of Tyco. In addition, the prosecutor accused the two former executives of considering Tyco assets to be their own and that they were using them when the executives wanted Tyco to pay for their expenses.

On November 4, 2003, Tyco announced a net loss of \$297.1 million for the quarter and stated that it would close 219 operations and lay off seventy-two hundred employees, which represented 3 percent of its workforce.<sup>56</sup> On November 11, 2003, Tyco announced that it had signed a five-year contract with Legal Knowledge Company so every employee could take ethics classes. It was the first comprehensive ethics training program ever at Tyco.<sup>57</sup> On March 18, 2004, the prosecution in the trials of Kozlowski and Swartz concluded its closing arguments and the jury was sent out to reach a verdict. The chance of a mistrial became larger and larger as notes from the jury commented that the atmosphere within the jury room became "poisonous" with

one jury member holding out. The suspected juror was Ruth Jordan, also known as Juror No. 4, who was a former teacher with a law degree. On March 26, 2004, Jordan gave the "OK" sign to the defense table as she walked past it.<sup>58</sup> On April 2, 2004, Judge Michael Obus declared a mistrial after the judge had been informed that one of the jurors had complained about being pressured into convicting the two former Tyco executives. The other jurors stated that after twelve days of deliberations that the rest of the group was ready to convict both men on many of the most serious criminal charges presented by the prosecution. The Manhattan district attorney's office immediately stated that it would have a retrial for Kozlowski and Swartz.<sup>59</sup> In October 2004 Kozlowski's New York apartment, home of the \$6,000 shower curtain, was sold for \$21 million. The price included many furnishings but not the shower curtain because prosecutors had taken it for evidence in his trial.<sup>60</sup> On April 27, 2005, Dennis Kozlowski took the stand in defense of the charges against him in his retrial. He did not take the stand in the original trial. He denied that he had committed any crimes and that his goal was for Tyco to grow as a company. Kozlowski could not tell the court why the \$25 million that was a forgiveness loan from Tyco was not reported as income on his 1999 W-2 form. He stated in court that he wasn't thinking that he had a forgiveness loan when he signed the tax form.<sup>61</sup>

On May 31, 2005, the jury deliberations started for the retrial of the two executives. On June 17, 2005, L. Dennis Kozlowski and Mark Swartz were convicted of fraud for falsifying business documents, grand larceny, and conspiracy. After ten days of deliberations, both men were convicted on twenty-two criminal counts and were acquitted on one count of falsifying business records. Ruth Jordan, the OK juror from the first trial, commented that she was a little shocked because she still believed they were both not guilty.<sup>62</sup> The jurors in the second trial stated that they felt that Kozlowski was not believable and that Swartz was a very good liar.<sup>63</sup> An executive who is caught stealing money from his employer is guilty of an extremely egregious crime with the executive being sentenced to the maximum term allowed by law. No, this was not the prosecution's recommendation for the two Tyco executives; the author of this statement was L. Dennis Kozlowski, who wrote a letter to the sentencing authorities after a conviction of an assistant controller at Tyco in 1995. The prosecution weighed whether to include this letter when Kozlowski and Swartz were to be sentenced for their crimes.<sup>64</sup>

After the conviction of Kozlowski and Swartz, the government inventoried both of their assets to determine what could be seized for restitution with the proceeds going back to Tyco and its investors. The government claimed that combined, the two executives looted Tyco of more than \$600 million, which included illegal stock transactions. Some of the assets are listed in Table 3. On September 19, 2005, Dennis Kozlowski and Mark Swartz were both sentenced to the same prison terms. The judge sentenced them both to eight years and four months to twenty-five years for their crimes. Both men would be eligible for parole after six years, eleven months, and nine days. The maximum sentence they could have faced was fifteen to thirty years, and the minimum was one to three years. The court also ordered the two executives to pay \$134 million in restitution to Tyco, and Kozlowski was fined \$70 million and Swartz was fined \$35 million. The prosecutors had asked for the maximum sentence and concluded that Tyco had become a global symbol of kleptocratic management. Because

**TABLE 3** Some of the Assets Available for Seizure from Kozlowski and Swartz

<b>Kozlowski</b>	
Yacht called <i>Endeavour</i>	\$17 million
Fifth Avenue, New York, Apartment	\$17 million
Park Avenue, New York, Apartment given to his ex-wife	\$7 million
Boca Raton, Florida, Home	\$15.2 million
Colorado Rockies Home	\$9.4 million
Nantucket Home	\$12.7 million
BMW Roadster	\$150,000
<b>Swartz</b>	
Boca Raton, Florida, Home	\$16.1 million
Virginia Estate	\$12.2 million
Total value of assets that were to be seized by both men was estimated at \$600 million	

Source: Adapted from Charles Forelle, "Seeking Restitution, Government Targets Tyco Duo's Fortunes," Wall Street Journal, June 30, 2005, [www.wallstreetjournal.com](http://www.wallstreetjournal.com).

Kozlowski and Swartz were convicted in state court and not federal court, they would be sentenced to a state prison, considered to be much harder to serve their time than a federal prison, which houses white-collar criminals.<sup>65</sup> In New York state, if a convicted felon is sentenced to more than six years in jail, he or she is usually sent to a maximum-security state prison. The state prison houses mostly violent offenders, and the inmates get paid \$1.05 per day for doing six hours of work.<sup>66</sup>

On the same day, the SEC recommended that an accounting fraud case be started against Tyco for allegedly inflating its profits by approximately \$1 billion. A defense attorney for the executives complained that the SEC intentionally announced the investigation the same day as the sentencing to influence the length of the sentence for the two men.<sup>67</sup> On April 17, 2006, Tyco settled with the SEC by paying a fine of \$50 million for artificially inflating by \$1 billion from 1996 to 2002 profits it reported to the SEC.<sup>68</sup>

In an ironic twist, on May 3, 2006, Tyco sold two of the paintings that were "shipped" in empty boxes in New Hampshire for \$7.8 million. *Fleurs et Fruits* by Renoir sold for \$2.8 million and *Pres Monte-Carlo* by Monet sold for \$5 million. Nine days later Kozlowski agreed to pay \$21.2 million to settle tax evasion charges that had been filed against him in New York for the purchase of the artwork. Kozlowski also agreed to pay \$3.2 million in sales taxes that were not paid and an additional \$15 million for fines and penalties related to the tax evasion.<sup>69</sup>

In June 2006 Kozlowski requested that Tyco reimburse his legal costs under his "officer and director" liability policy at Tyco. Kozlowski had submitted a claim of almost \$17.8 million to Corporate Officers & Directors Assurance Company, which had provided liability insurance for Tyco.<sup>70</sup> In an apparent case of "what have you done for me lately," Karen Kozlowski filed for divorce on July 31, 2006. Karen Kozlowski, who enjoyed her \$2 million fortieth birthday party in Sardinia, had declared that their marriage had been irretrievably broken. She had requested that a lien be put

on their Boca Raton mansion to protect the asset from the government and potential lawsuits. The fifteen-thousand-square-foot waterfront estate was purchased for \$19 million using interest-free Tyco loans. The settlement requested that all of the assets of the couple be equally distributed with the additional stipulation that Dennis pay Karen financial support.<sup>71</sup> A prisoner in the New York state penal system averages a wage rate of one dollar per day.<sup>72</sup>

In an ironic full circle, on December 15, 2006, New York state sales tax charges against Kozlowski were dismissed when prosecutors reached a deal with the former CEO. Kozlowski had agreed to pay approximately \$21.2 million to pay off his tax liabilities as they related to New York income and sales taxes. Along with the \$21.2 million, Kozlowski had also agreed to pay \$97.7 million in restitution. The dismissed charge came when Kozlowski had already liquidated \$125 million in assets to pay for the penalties and fines.<sup>73</sup>

### Questions for Thought

1. What do you think Kozlowski's motivation for trying to avoid sales taxes on his art purchases was? Explain.
2. Explain the concept of commingling assets with respect to the Tyco case.
3. Would it have been possible for the board of directors to see the adjustments taking place in the many different programs at Tyco? Explain.