CASE 4

Tyco International: Leadership Crisis

On September 12, 2002, Tyco International's former chief executive officer, L. Dennis Kozlowski, and former chief financial officer, Mark H. Swartz, were seen in handcuffs on national television after they were arrested and charged with misappropriating more than $170 million from the company. They were also accused of stealing more than $430 million through fraudulent sales of Tyco stock and concealing the information from shareholders. The two executives were charged in a Manhattan federal court with numerous counts of grand larceny, enterprise corruption, and falsifying business records. Another executive, former general counsel Mark A. Belnick, was also charged with concealing $14 million in personal loans. Months after the initial arrests, charges and lawsuits were still being filed in a growing scandal that threatened to eclipse the notoriety of other companies facing accounting fraud charges in the early 2000s.

TYCO'S HISTORY

Tyco Inc., was founded by Arthur J. Rosenberg in 1960, in Waltham, Massachusetts, as an investment and holding company focusing on solid-state science and energy conversion. It developed the first laser with a sustained beam for medical procedures. With a shifting of focus to the commercial sector, Tyco became a publicly traded company in 1964. It also began a pattern of acquisitions—sixteen different companies by 1968—that would continue through 1982 as the company sought to fill gaps in its development and distribution network. The rapidly growing and diversifying firm grew from $34 million in sales in 1973 to $500 million in 1982.

In 1982, Tyco reorganized into three business segments (fire protection, electronics, and packaging) to strengthen itself from within. By 1986 Tyco had returned

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to a growth-through-acquisitions mode. In the 1990s Tyco maintained four core segments: electrical and electronic components, health-care and specialty products, fire and security services, and flow control. The company changed its name to Tyco International in 1993 to signal its global presence to the financial community. By 2000 the firm had acquired more than thirty major companies, including well-known firms such as ADT, Raychem, and the CIT Group.

THE RISE OF DENNIS KOZLOWSKI

Leo Dennis Kozlowski was born in Newark, New Jersey, in 1946. His parents, Leo Kelly and Agnes Kozlowski, were second-generation Polish Americans. His father worked for Public Service Transport (later the New Jersey Transport), and his mother was a school crossing guard in Newark's predominantly Polish neighborhood. Kozlowski attended public school and graduated from West Side High in 1964. He lived at home while he studied accounting at Seton Hall University in South Orange, New Jersey.

After brief stints at SCM Corp. and Nashua Corporation, Kozlowski went to work for Tyco in 1976. He soon found a friend and mentor in CEO Joseph Gaziano, whose lavish style—including company jets, extravagant vacations, company cars, and country club memberships—impressed Kozlowski. However, the luxurious lifestyle came to an end when Gaziano died of cancer in 1982. Fellow MIT graduate John F. Fort III, who differed sharply in management style, replaced Gaziano. Where Gaziano had been extravagant, Fort was analytical and thrifty, and Wall Street responded approvingly to his new course and direction for Tyco. Fort's goal was to increase profits for the shareholders of Tyco and cut out extravagant spending that had characterized Gaziano's tenure.

Kozlowski, who had thrived under Gaziano, had to shift gears to adapt to the abrupt change in leadership. However, Kozlowski's accounting background helped push him up the ranks at Tyco. He was very adept at crunching numbers and helping achieve Fort's vision of taking care of shareholders first. Fort soon noticed Kozlowski's talents.

Kozlowski's first major promotion within Tyco was to president of Grinnell Fire Protection Systems Co., Tyco's largest division. At Grinnell, Kozlowski cut out extras and reduced overhead, eliminated 98 percent of the paperwork, and reworked compensation programs. Although he slashed managers' salaries, he also set up a bonus compensation package that gave them greater control over the money they could earn. He gave public recognition to high achievers at a yearly banquet, but he also recognized the underachievers, giving out an award for the worst-producing unit as well as the best. Perhaps most important, Kozlowski systematically began to buy out and acquire each of the fire protection division's competitors. As described in a *BusinessWeek* article, he gained a reputation as a "corporate tough guy, respected and feared in roughly equal measure."

Over the next few years, Kozlowski continued his rise up Tyco's corporate ladder, becoming the company's president in 1987, before rising to CFO and eventually CEO in 1992. However, his aggressive approach to acquisitions and mergers during this period became a concern for then-CEO Fort, who wanted to slow the rate of activity in Kozlowski's division. His largest acquisition was Wormald International, a $360 million global fire-protection concern. However, integrating Wormald proved problematic and Fort was reportedly not happy with so large a purchase. Fort and Kozlowski also disagreed over the rapid changes that Kozlowski made in the fire-protection division. Kozlowski responded by lobbying to convince Tyco's board of directors that the problems with Wormald were a "bump in the road" and the firm should continue its strategy of acquiring profitable companies that met its guidelines. The board sided with Kozlowski, and Fort resigned as CEO and later as chairman of the board, although he remained a member of Tyco's board of directors until 2003.

KOZLOWSKI'S TYCO EMPIRE

At the age of 46, Kozlowski found himself at the helm of Tyco International in 1992. He eventually moved out of his North Hampton home, leaving his wife and two daughters for a waitress, Karen Lee Mayo Locke, whom he eventually married in 2000. Before 2000 Kozlowski's lifestyle was comparatively ordinary for a person of such rank; however, some subtle changes in lifestyle did occur after the North Hampton move but before his second marriage. His new lifestyle—which included parties that were regular gossip-column fodder and homes in Boca Raton, Nantucket, Beaver Creek, and New York City—appeared to emulate that of Kozlowski's mentor, former CEO Joseph Gaziano. Indeed, Kozlowski's aggressive strategy of mergers and acquisitions made Tyco look more like the company it had been under Gaziano.

Kozlowski had learned Tyco and its businesses from the bottom up, giving him an advantage in his determination to make Tyco the greatest company of the new century. Among other things, he recognized that one of the conglomerate's major shortcomings was its reliance on cyclical industries. Thus, he decided to diversify into more non-cyclical industries. His first major acquisition toward that objective was the Kendall Company, a manufacturer of medical supplies, which had emerged from bankruptcy just two years before. Kozlowski quickly revived the business, which became very profitable and doubled Tyco's earnings. Although Tyco's board of directors had initially balked at the Kendall acquisition, the directors were pleased with the subsidiary's turnaround and contribution to profits. Kozlowski made Kendall the core of his new Tyco Healthcare Group, which quickly grew to become the second-largest producer of medical devices behind Johnson & Johnson. The board rewarded Kozlowski's performance by increasing his salary to $2.1 million and giving him shares of the company's stock.

Kozlowski's next strategic move was the acquisition of ADT Security Services, a British-owned company located in Bermuda, in 1997. By structuring the deal as a "reverse takeover," Tyco acquired a global presence as well as ADT's Bermuda registration, which allowed the firm to create a network of offshore subsidiaries to shelter its foreign earnings from U.S. taxes.

While Kozlowski continued to acquire new companies to build his vision of Tyco, he handpicked a few trusted people and placed them in key positions. One of these individuals was Mark Swartz, who was promoted from director of Mergers and Acquisitions to CFO. Swartz, who had developed a strong financial background as an auditor for Deloitte & Touche and a reputation for being more approachable than Kozlowski, was aware of Kozlowski's business practices. Kozlowski also recruited Mark Belnick to become Tyco's general counsel.

By this time, Tyco's corporate governance system was composed of Kozlowski as CEO and the firm's board of directors, which had eleven members, including Joshua Berman, a vice president of Tyco and former outside counsel; Mark Swartz, CFO; Lord Michael Ashcroft, a British dignitary who came with the ADT merger; James S. Pasman, Jr., also from ADT; W. Peter Slusser, also from ADT; Richard S. Bodman, a venture capitalist; Stephen W. Foss, CEO of a textile concern; Joseph F. Welch, CEO of snack-food maker Bachman Co.; Wendy Lane, a private equity investor; John F. Fort III, former CEO and chairman of Tyco; and Frank E. Walsh, Jr., director of the board. Kozlowski particularly liked the prestige of Lord Ashcroft being associated with his company. The majority of the directors had been on the board for ten to twenty years, and they were very familiar with Tyco's strategies and Kozlowski's management style. As directors, they were responsible for protecting Tyco's shareholders by disclosing any questionable situations or issues that might seem unethical or inappropriate, such as conflicts of interest. However, after the arrests of Kozlowski and Swartz, investigations subsequently uncovered the following troubling relationships among the board's members:

- Swartz participated in loan-forgiveness programs.
- Bodman invested $5 million for Kozlowski in a private stock fund managed by Bodman.
- Walsh received $20 million for helping arrange the acquisition of CIT Group without the knowledge of the rest of the board of directors.
- Walsh also held controlling interest in two firms that received more than $3.5 million for leasing an aircraft and providing pilot services to Tyco between 1996 and 2002.
- Foss received $751,101 for supplying a Cessna Citation aircraft and pilot services.
- Ashcroft used $2.5 million in Tyco funds to purchase a home.

With his handpicked board in place, Kozlowski decided to open a Manhattan office overlooking Central Park. However, the firm maintained its humble Exeter, New Hampshire, office, where Kozlowski preferred to be interviewed. According to *BusinessWeek,* he bragged to a guest that, "We don't believe in perks, not even executive parking spots." The unpublicized Manhattan office essentially became the firm's unofficial headquarters, and Kozlowski lavished it with every imaginable perk. He used Tyco funds to purchase and furnish apartments for key executives and employees in New York's pricey Upper East Side as well.

Meanwhile, Jeanne Terrile, an analyst for Tyco at Merrill Lynch, was not so impressed with Kozlowski's activities and Tyco's performance. Stock analysts like those at Merrill Lynch make recommendations to investors whether to buy, hold, or sell a particular stock. After Terrile wrote a less than favorable review of Tyco's rapid acquisitions and mergers and refused to upgrade Merrill's position on Tyco's stock, Kozlowski met with David Komansky, the CEO of Merrill Lynch. Although the subject of the meeting was never confirmed, shortly thereafter, Terrile was replaced by Phua Young, who immediately upgraded Merrill's recommendation for Tyco to "buy" from

To restore investors' faith in the company, Tyco's new management team worked hard to reorganize the company and recover some of the funds taken by Kozlowski. At its annual meeting, shareholders elected a completely new board of directors and voted to make future executive severance agreements subject to shareholder approval and to require the board chairman to be an independent person, rather than a Tyco CEO. However, the shareholders elected to keep the company incorporated in Bermuda. In 2006 Breen announced that Tyco would be splitting into three entities: Tyco Healthcare ($10 billion, 40,000 employees), one of the world's leading diversified health-care companies; Tyco Electronics ($12 billion, 88,000 employees), the world's largest passive electronic components manufacturer; and the combination of Tyco Fire & Security and Engineered Products & Services (TFS/TEPS) ($18 billion, 118,000 employees), a global business with leading positions in residential and commercial security, fire protection, and industrial products and services. Tyco has survived the doomsday predictions with over $40 billion in revenue, and their employees have sighed a breath of relief for their jobs and pensions.

QUESTIONS

1. What are the ethical and legal issues in this case?
2. What role did Tyco's corporate culture play in the scandal?
3. What roles did the board of directors, CEO, CFO, and legal counsel play?
4. Have Tyco's recent actions been sufficient to restore confidence in the company?
5. What other actions should the company take to demonstrate that it intends to play by the rules?
6. How will the implementation of the Sarbanes–Oxley Act of 2002 prevent future dilemmas in Tyco?
7. Can the SEC trust Tyco's new board?

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