

# Tyco International: Leadership Crisis

## INTRODUCTION

On September 12, 2002, national television showcased Tyco International's former chief executive officer (CEO) L. Dennis Kozlowski and former chief financial officer (CFO) Mark H. Swartz in handcuffs after being 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 with more than thirty counts of misconduct, including grand larceny, enterprise corruption, and falsifying business records. Another executive, former general counsel Mark A. Belnick, was charged with concealing \$14 million in personal loans. Months after the initial arrests, charges and lawsuits were still being filed—making the Tyco scandal one of the most notorious of the early 2000s.

This case begins with a brief history of Tyco, followed by an explanation of Tyco CEO L. Dennis Kozlowski's rise to power. As Kozlowski rose to become the second-highest-paid CEO, some red flags pointed toward the impending disaster. Most notably, Kozlowski's aggressive approach to business, his lavish lifestyle, his clashes with the former, more conservative CEO, and his ousting of those who criticized Tyco's activities all acted as indicators of Kozlowski's unethical behavior. This analysis also shows how a decentralized corporate structure can make it difficult, even for the board of directors, to effectively monitor a firm's dealings and finances. Kozlowski's fall and the repercussions of his dirty dealings (financial penalties and jail time) are also detailed. Finally, an explanation of how Tyco survived the scandal is provided, along with safeguards the company has put into place to ensure that similar misconduct does not occur in the future.

## TYCO'S HISTORY

Founded in 1960 by Arthur J. Rosenberg, Tyco began as an investment and holding company focused on solid-state science and energy conversion. It developed the first laser with a sustained beam for use in medical procedures. Rosenberg later shifted his focus to the commercial sector. In 1964, Tyco became a publicly traded company. It also began a series of rapid acquisitions—sixteen companies by 1968. The expansion continued through 1982, as the company sought to fill gaps in its development and distribution networks. Between 1973 and 1982, the firm grew from \$34 million to \$500 million in consolidated sales. In 1982, Tyco was reorganized into three business segments: Fire Protection, Electronics, and Packaging.

By 1986, Tyco had returned to a growth-through-acquisitions model and had restructured the company into four core segments: Electrical and Electronic Components, Healthcare and Specialty Products, Fire and Security Services, and Flow Control, which Tyco maintained through the 1990s. During this time, the company changed its name to Tyco International, in order to signal its global presence to the financial community. By the early 2000s, 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

In 1975, armed with a degree in accounting, Dennis Kozlowski went to work for Tyco, following brief stints at SCM Corporation and Nashua Corporation. He soon found a friend and mentor in then

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CEO Joseph Gaziano. Kozlowski was impressed by Gaziano's lavish lifestyle—company jets, extravagant vacations, company cars, and country club memberships. However, Gaziano's reign ended abruptly in 1982 when he died of cancer. Gaziano was replaced by John F. Fort III, who differed sharply in management style. Where Gaziano had been extravagant, Fort was analytical and thrifty. His goal was to increase profits for shareholders and cut the extravagant spending characterizing Gaziano's tenure, and Wall Street responded positively to Tyco's new direction.

Kozlowski, who had thrived under Gaziano, was forced to adapt to the abrupt change in leadership. Adept at crunching numbers, Kozlowski focused on helping to achieve Fort's vision of putting shareholders first. He soon gained Fort's attention, and was promoted to president of Grinnell Fire Protection Systems Company, Tyco's largest division. At Grinnell, Kozlowski reduced overhead, eliminated 98 percent of paperwork, and revised compensation programs. Although he slashed managers' salaries, he also designed a bonus compensation package that gave them greater control over possible earnings. He publicly recognized both high and low achievers at a yearly banquet, giving awards to the best and calling attention to the lowest-producing units. Perhaps most importantly, Kozlowski systematically worked to acquire Grinnell's competitors. A *BusinessWeek* article described him as a "corporate tough guy, respected and feared in roughly equal measure."

Over the next few years, Kozlowski continued to rise up Tyco's corporate ladder. He became the company's president and later CFO. However, his aggressive approach concerned Fort, who wanted to slow the rate of acquisitions in Kozlowski's division. Kozlowski's largest acquisition was Wormald International, a \$360 million global fire-protection concern. Integrating Wormald proved problematic, and Fort was reportedly unhappy with such a large purchase. Fort and Kozlowski also disagreed over rapid changes made to Grinnell. Kozlowski responded by lobbying to convince Tyco's board of directors that problems with Wormald were a "bump in the road" and that the firm should continue its strategy of acquiring profitable companies that met guidelines. The board sided with Kozlowski. In 1992, Fort resigned as CEO and later as chair of the board, although he remained a member of Tyco's board of directors until 2003.

## KOZLOWSKI'S TYCO EMPIRE

After Fort's departure, Dennis Kozlowski, then 46, found himself helming Tyco International. With a new lifestyle—parties and multiple homes in Boca Raton, Nantucket, Beaver Creek, and New York City—and an aggressive management style, he appeared to be following in the footsteps of his mentor, former CEO Joseph Gaziano.

Kozlowski knew Tyco from the bottom up, and stated that he was determined to make it the greatest company of the next century. Among other things, he recognized that one of Tyco's major shortcomings was its reliance on cyclical industries, which tend to be very sensitive to economic ups and downs. He resolved to expand Tyco into noncyclical industries through even more acquisitions, such as the Kendall Company, a manufacturer of medical supplies that had declared bankruptcy two years earlier. Kozlowski quickly revived the business and doubled Tyco's earnings. Kendall became the core of Kozlowski's new Tyco Healthcare Group, which 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.

In 1997, Kozlowski acquired ADT Security Services, a British-owned company located in Bermuda. By structuring the deal as a "reverse takeover," wherein a public company is acquired by a private company so as to avoid the lengthy process of going public, Tyco acquired a global presence as well

as ADT's Bermuda registration. Tyco was then able to create a network of offshore subsidiaries to shelter its foreign earnings from U.S. taxation.

Kozlowski also restructured Tyco by handpicking a few trusted individuals and placing 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 a strong financial background as a former 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, a former litigator at Paul, Weiss, Rifkind, Garrison & Wharton, to become Tyco's general counsel.

By this time, Tyco's corporate governance system was comprised of Kozlowski and the firm's board of directors—including Joshua Berman, a vice president of Tyco; Mark Swartz, CFO; Lord Michael Ashcroft, a British dignitary who joined with the ADT merger; James S. Pasman, Jr., 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 Bachman Company; Wendy Lane, a private equity investor; John F. Fort III, former CEO and chair of Tyco; and Frank E. Walsh, Jr., director of the board. The majority of members had served for ten years or more, and they were familiar with Kozlowski's management style. As directors, they were responsible for protecting Tyco's shareholders through disclosure of questionable situations or issues that might seem unethical or inappropriate. Despite this, after the arrests of Kozlowski and Swartz, investigations uncovered the following troubling relationships among the board's members:

- " Richard Bodman invested \$5 million for Kozlowski in a private stock fund managed by Bodman.
- " Frank E. Walsh, Jr. received \$20 million for helping to arrange the acquisition of CIT Group without the other board members' knowledge.
- " 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.
- " Stephen Foss received \$751,101 for supplying a Cessna Citation aircraft and pilot services.
- " Lord Michael Ashcroft used \$2.5 million in Tyco funds to purchase a home.

With his handpicked board in place, Kozlowski opened a Manhattan office overlooking Central Park, although the move was not broadcast to the public. For appearances, the firm maintained its humble Exeter, New Hampshire, office at which Kozlowski preferred to be interviewed. According to *BusinessWeek* magazine, he boasted to a guest, "We don't believe in perks, not even executive parking spots." However, the unpublicized Manhattan office became the firm's unofficial headquarters, and Kozlowski furnished it with every imaginable luxury, using Tyco funds to purchase and decorate apartments for key executives and employees.

Meanwhile, Jeanne Terrile, an analyst from Merrill Lynch who worked for Tyco, was not impressed with Kozlowski's activities and Tyco's performance. Her job at Merrill Lynch was to make recommendations to investors on whether to buy, hold, or sell specific stocks. After Terrile wrote a negative 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 and Merrill's recommendation for Tyco was upgraded to "buy" from "accumulate." Merrill Lynch continued as one of Tyco's top underwriters as well as one of its primary advisers for mergers and acquisitions.

Between 1997 and 2001, Tyco's revenues climbed 48.7 percent annually and its pretax operating margins increased to 22.1 percent. The pace of mergers and acquisitions escalated, assisted by Mark Swartz, Tyco's CFO. In February 2002, Tyco announced that it had spent over \$8 billion on more than seven hundred acquisitions in the last three years. Some of the merged companies were dissatisfied with the arrangement. Kozlowski forced acquired companies to scale back sharply, eliminating any segments that were not profitable. The toll on workers in these companies was enormous. Tyco shareholders and directors, however, were thrilled with the company's performance, increasing Kozlowski's salary from \$8 million in 1997 to \$170 million in 1999, making him the second-highest-paid CEO in the United States at the time.

Between 1997 and 2002, Kozlowski's charismatic leadership style combined with the firm's decentralized corporate structure meant that few people, including members of the board of directors, accurately understood the firm's activities and finances. Tyco was organized into four distinct divisions—fire protection (53 percent); valves, pipes, and other flow-control devices (23 percent); electrical and electronic components (13 percent); and packaging materials (11 percent)—and there was little interaction between them. Each division's president reported directly to Kozlowski, who in turn reported to the board.

Those who dared to suggest that there were red flags at Tyco were shot down, including Jeanne Terrile at Merrill Lynch and David W. Tice, a short seller who questioned whether Tyco's use of large reserves in connection with its acquisitions was obscuring its financial results. A nonpublic investigation by the Securities and Exchange Commission (SEC) resulted only in Tyco amending its earnings per share (up 2 cents per share for the last quarter of 1999, and down 2 cents for the first quarter of 2000).

## THE FALL OF DENNIS KOZLOWSKI AND OTHERS

In early 2002, Kozlowski announced Tyco's split of its four divisions into independent, publicly traded companies: Security and Electronics, Healthcare, Fire Protection and Flow Control, and Financial Services. Kozlowski stated, "I am extremely proud of Tyco's performance. We have built a great portfolio of businesses and over the five years ended September 30, 2001, we have delivered earnings per share growth at a compounded annual rate of over 40 percent and industry-leading operating profit margins in each of our businesses. During this same period, we have increased annual free cash flow from \$240 million in 1996 to \$4.8 billion in fiscal 2001. Nonetheless, even with this performance, Tyco is trading at a 2002 P/E multiple of 12.0x, a discount of almost 50 percent to the S&P 500."

Soon after, everything began to crumble. The board of directors learned that Frank Walsh (one of its members) had received a \$20 million commission for his part in securing and aiding the CIT merger, without the knowledge of the rest of the board. Walsh was fined and later resigned. Troubled by the notion that Kozlowski had made a major payment without informing them, board members launched an investigation into whether other board members had earned such commissions. The probe uncovered numerous expense abuses.

Also in 2002, the New York State Bank Department observed large sums of money moving in and out of Tyco's accounts. What made this unusual was that the funds were being transferred into Kozlowski's personal accounts. Authorities discovered that Kozlowski had sought to avoid around \$1 million in New York state import taxes. After purchasing around \$14 million in rare artwork, Kozlowski had the invoices shipped to New Hampshire, although the paintings were actually destined for his apartment in Manhattan. To assist in perpetrating the fraud, Kozlowski instructed

the shipping company to send empty boxes to New Hampshire along with the invoices. Kozlowski was caught in the act and ended up facing jail time and having to pay out over \$100 million in restitutions and back taxes. Learning that he was about to be indicted for tax evasion, Kozlowski resigned as CEO on June 2, 2002. On June 3, he was arrested, but the scandal had barely begun.

In September of that year, Dennis Kozlowski and Mark Swartz, who also had resigned, were indicted on thirty-eight felony counts for allegedly stealing \$170 million from Tyco and fraudulently selling an additional \$430 million in stock options. Among other allegations, Kozlowski was accused of taking \$242 million from a program intended to help Tyco employees buy company stock. Together with former legal counsel Mark Belnick, the three faced criminal charges and a civil complaint from the SEC. Kozlowski was also accused of granting \$106 million to various employees through “loan forgiveness” and relocation programs. Swartz was also charged with falsifying documents in this loan program in the amount of \$14 million. Kozlowski and Swartz were sentenced from eight and one-third years to twenty-five years in prison with the possibility of reducing the minimum by one-sixth due to good behavior and enrollment in prison programs. Belnick was charged with larceny and attempting to steer a federal investigation, as well as taking more than \$26 million from Tyco. In 2006, he agreed to pay \$100,000 in penalties to the SEC.

In addition, several former board members have been cited for conflict of interest. Frank Walsh pleaded guilty and agreed to repay \$20 million plus an additional \$2 million in court costs. Jerry Boggess, the president of Tyco Fire and Security Division, was fired and accused of creating a number of “bookkeeping issues” negatively impacting earnings of shareholders. Richard Scalzo, the PriceWaterhouse auditor who signed off on Tyco’s 2002 audit, was fired. Tyco’s stock plunged from \$60 per share in January 2002 to \$18 per share in December 2002, and investors lost millions of dollars. Many of the firm’s 260,000 employees were also shareholders and watched their savings dwindle. Tyco’s retirees found that their savings and retirement plans, which were tied up in company shares, plummeted with the company’s stock price.

In 2005, Kozlowski and Swartz both were found guilty on twenty-two of twenty-three counts of grand larceny, conspiracy, and falsifying business records and violating business law. The judge ordered both to pay \$134 million to Tyco. Kozlowski was also ordered to pay a \$70 million fine and Swartz a \$35 million fine. Jail time for both appears to be a little less than seven years in a state facility. Both have appealed their sentences, but their sentences have so far been upheld.

## REBUILDING AN EMPIRE

After Kozlowski’s resignation, Edward Breen replaced him as CEO. The company filed suit against Dennis Kozlowski and Mark Swartz for more than \$100 million. The SEC allows companies to sue insiders who profited by buying and selling company stock within a six-month period. Tyco stated, “To hold him accountable for his misconduct, we seek not only full payment for the funds he misappropriated but also punitive damages for the serious harm he did to Tyco and its shareholders.”

Breen launched a review of the company’s accounting and corporate governance practices to determine whether any other fraud had occurred. Although the probe uncovered no additional fraud, the firm announced that it would restate its 2002 financial results by \$382.2 million. In a regulatory filing, Tyco’s new management declared that the firm’s previous management had “engaged in a pattern of aggressive accounting which, even when in accordance with Generally Accepted Accounting Principles, was intended to increase reported earnings above what they would have been if more conservative accounting had been employed.” Although Tyco’s

investigations located no further fraud, over the next six months the company repeatedly restated its financial results or took accounting charges totaling more than \$2 billion.

To restore investors' faith, Tyco's new management team reorganized the company and recovered some of the funds allegedly taken by Kozlowski. At its annual meeting, shareholders elected a new board of directors, voted to make future executive severance agreements subject to shareholder approval, and voted to require the board chair to be an independent person rather than a Tyco CEO. The company also hired Eric Pillmore as Vice President of Corporate Governance. Eric Pillmore was determined to revamp Tyco's ethical culture. Under his leadership, Tyco implemented a corporate ethics program and replaced 90 percent of the headquarters staff. The company also created the Tyco Guide to Ethical Conduct. The guide is 32 pages long and is available in a variety of languages for global employees. The purpose of the guide is to familiarize employees with company expectations and help them to make ethical decisions.

Eric Pillmore worked to incorporate three elements into Tyco's culture: 1) strong and ethical corporate leadership; 2) accountability; and 3) behavior tracking processes. Tyco had lacked all three under Kozlowski's leadership. Pillmore also created an ombudsman position at Tyco who can mediate between employees and management. Tyco published a confidential hotline, called ConcernLINE, so employees could report misconduct without fear of retaliation. Additionally, Tyco now publishes a quarterly report based upon the concerns that employees have brought up (employees are anonymous in this report). By including employees in the process, Tyco is holding employees accountable as well as giving them a chance to contribute to the company's ethical programs. In 2004 CEO Edward Breen was listed as one of *Businessweek's* "Best Managers." That same year Tyco would win the Center for Corporate Change Award "Outstanding Improvement in Board Governance."

Two years later, he announced Tyco's split 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 a 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 doomsday predictions, bringing in over \$40 billion in revenue before the split, and preserving employee jobs and pensions. Tyco has worked hard to overcome its negative image. Although Eric Pillmore departed from Tyco in 2007, he won the honor of being on Ethisphere's "100 Most Influential People in Business Ethics" list.

As of 2011, Edward Breen is still CEO of Tyco. Matt Tanzer occupies the Vice President and Chief Compliance Officer position at Tyco. Since the scandal, Tyco has been periodically reviewing employees and Tyco operations to identify areas of weakness. After one cultural diagnostic survey revealed that ethics and compliance was taken more seriously by top managers than employees, Tyco's compliance team implemented additional ethics talks for employees. Tyco created a website called the "Vital Values Ethics Reflections Website" that had scenarios dealing with common ethical issues in business. Managers would select scenarios from the website and go over the scenario in their teams. Under Tanzer's leadership, Tyco has also begun to track and collect data from its ethics initiatives to measure their success. These new tracking systems enabled Tyco to bring employee completion of ethics awareness training to over 100 percent.

Tyco continues to restore a reputation for ethical conduct. In 2010 Tyco joined the World Economic Forum Partnering Against Corruption Initiative to combat against bribery. Tyco appears to have

made a successful comeback. Kozlowski and company, however, have not recovered as well. Kozlowski and Swartz continue to appeal their convictions, most recently to the U.S. Supreme Court, but so far their efforts have been rebuffed.

## CONCLUSION

The Tyco scandal offers major lessons for the business world, particularly in areas of corporate conduct. Above all, the story of Dennis Kozlowski shows what happens when too much company power is put into the hands of an individual—it can lead to a decentralized corporate structure that makes it difficult to detect misconduct. Tyco's story also reveals the decreasing tolerance today's government and investors have for misconduct in any form, as even members of Tyco's board of directors faced consequences for their unethical behavior.

Tyco's survival proves that some companies can survive major ethical scandals if they take the correct courses of action. In response to the scandal, Tyco took actions that went beyond the bare minimum of what was needed. Although an investigation did not uncover additional fraud, the company still restated its financial results by hundreds of millions of dollars. It took measures to restore shareholder confidence by reorganizing the company and implementing safeguards to ensure greater objectivity on the part of the board of directors. As a result of its quick actions, the company has recovered significantly and has been praised by the public.

While the fortunes of Tyco International seem to be on the rebound, former CEO Dennis Kozlowski's fate remains in the hands of the law. After his sentencing in 2005 to twenty-five years in jail for grand larceny, securities fraud, other crimes, and for stealing \$137 million in unauthorized bonuses as well as selling \$410 million in inflated stock, Kozlowski remains adamant about his innocence. In an interview with Morley Safer for *60 Minutes*, Kozlowski claimed that jealous jurors sentenced him out of spite, not because he had done anything wrong. Kozlowski to this day feels that he was wrongly sentenced and claims to have no regrets over his dishonest behavior. Much to his frustration, a judge ruled in 2010 that Kozlowski must forfeit the compensation he had earned over a seven-year period.

On an ironic note, Kozlowski did have the foresight to recognize the impending subprime mortgage disaster that came to a head in 2008. Perhaps this just shows that it takes a criminal to know others.

## QUESTIONS

1. What role did Tyco's corporate culture play in the scandal?
2. How did Dennis Kozlowski have the opportunity to steal \$137 million in unauthorized bonuses?
3. Why is Kozlowski, now a prisoner for a long time, unrepentant about his conduct as CEO of Tyco?

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