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Proceedings

A monthly newsletter from McGraw-Hill

February 2017 Volume 8, Issue 7

Contents

Dear Professor,

Happy Groundhog Day! Welcome to McGraw-Hill's February 2017 issue of Proceedings, a newsletter designed specifically with you, the Business Law educator, in mind. Volume 8, Issue 7 of Proceedings incorporates "hot topics" in business law, video suggestions, an ethical dilemma, teaching tips, and a "chapter key" cross-referencing the February 2017 newsletter topics with the various McGraw-Hill business law textbooks.

You will find a wide range of topics/issues in this publication, including:

1. The United States Department of Labor's new "fiduciary rule" pertaining to retirement accounts;

2. Rolls Royce's $809 million settlement over bribery probes;

3. A federal lawsuit against an employer for firing an employee who tried to call 911 to help a co-worker with a severed thumb;

4. Videos related to a) parents James and Bethany Modisette's lawsuit against Apple, Inc., claiming that FaceTime distracted a driver in a crash that killed their 5-year-old daughter and b) a judicial determination that a girlfriend lost her inheritance due to infidelity;

5. An "ethical dilemma" related to the Federal Bureau of Investigation's arrest of Volkswagen executive Oliver Schmidt on fraud charges in the Volkswagen emissions scandal; and

6. "Teaching tips" related to Video 2 ("Girlfriend Cheats Way out of Inheritance, Court Says") and the Ethical Dilemma ("FBI Arrests Volkswagen Executive on Fraud Charges: NYT") of the newsletter.

I hope your spring semester is progressing nicely!

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Of Special Interest

This section of the newsletter covers three (3) topics:

1) The United States Department of Labor's new "fiduciary rule" pertaining to retirement accounts;

2) Rolls Royce's $809 million settlement over bribery probes; and

3) A federal lawsuit against an employer for firing an employee who tried to call 911 to help a co-worker with a severed thumb.

Hot Topics in Business Law

Article 1: "This Is the Real Reason Wall Street Should Fear the 'Fiduciary Rule'"

http://fortune.com/2017/01/17/wall-street-fiduciary-rule-class-action/

According to the article, big banks and brokerages have been publicly fretting about how a new rule on retirement accounts might reduce their income. But at least one observer thinks they should be more worried about how it might jack up their legal fees.

The threat in question is the so-called fiduciary rule, a regulation approved by the Department of Labor last year and scheduled to go into effect this April. The rule applies to retirement accounts, and it states that when working with investors, "The Financial Institution and the Adviser(s) [must] provide investment advice that is, at the time of the recommendation, in the Best Interest of the Retirement Investor."

That concept may sound astoundingly obvious, but it is meant to address a significant problem in the retirement-savings world. Currently, many relationships between investment pros and retirement clients are required only to meet a "suitability" standard. In practice, under that rule brokers can and do park clients in investments that are either absurdly expensive—often because they generate chunky commissions for the broker—or highly risky, or both.

The fiduciary rule basically puts pressure on financial-services companies to justify the costs of the retirement accounts they offer. And as Fortune contributor Joshua Brown pointed out when the rule was passed, many big firms are already moving in that direction. They have seen the writing on the wall, as more investors have moved their nest eggs into low-priced index funds. They have also seen courts side with workers who sued their employers for offering overpriced mutual funds in their 401(k)s. They do not want to be the mustache-twirling villains charging 6% commissions and 2% annual fees on IRAs when index giants like Vanguard and BlackRock have proven you can get similar returns for fractions of a penny on the dollar.

But Michael Kitces, a financial planner who writes extensively about retirement investing, thinks financial services firms are focusing on one problem when it really faces two. In a recent post on his Nerd's Eye View blog, Kitces argues that the idea of fiduciary duty implicitly holds financial advisors to a minimum standard of competency—and that, disturbingly, many

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firms would not be able to prove that their staff met that standard. There are various designations that advisers can earn that require them to prove that they are competent at helping clients solve financial problems. (Kitces holds many of those designations, as it happens.) But many "client-facing" advisers are not required to earn those credentials.

The fiduciary rule would essentially enable a group of disgruntled retirement-savings clients to use this flaw as a key argument in a class-action lawsuit. As Kitces puts it (emphasis his):

"Financial institutions face the risk that they will be sued in a class action lawsuit for failing to put their financial advisors through the training and education (e.g., professional designations) necessary to ensure that the advisor would even *know* what the 'best' advice for the client was in the first place!"

If courts were sympathetic to that argument, he concludes, things could get uncomfortable, and expensive, very quickly.

Granted, Kitces's point could quickly become moot under a Donald Trump administration. Trump's advisers and cabinet picks, including Secretary of Labor nominee Andy Puzder, have generally been outspoken about their desire to roll back financial regulations. Earlier this month, Representative Joe Wilson (R, S.C.) introduced a bill to delay the implementation of the fiduciary rule, one that would likely get a sympathetic hearing from *laissez faire* GOP congressional leaders. But whether or not the rule survives, Kitces's take highlights an important point: Just because an advisor is not trying to fleece you does not mean he or she is qualified to help you.

Discussion Questions

1. In general, what does it mean to be a “fiduciary?”

A fiduciary is a type of agent in a principal-agent relationship. It is an arrangement involving pronounced trust and requiring extreme care. In a fiduciary relationship, the principal puts the fiduciary in a position of utmost trust and confidence to manage and protect property or money.

2. What is the specific “fiduciary rule” referenced in the article?

As the article indicates, the “fiduciary rule” is a regulation approved by the United States Department of Labor in 2016 and scheduled to go into effect in April 2017. The rule applies to retirement accounts, and it states that when working with investors, "The Financial Institution and the Adviser(s) [must] provide investment advice that is, at the time of the recommendation, in the Best Interest of the Retirement Investor."

3. What is the best argument for the “fiduciary rule” referenced in the article? What is the best argument against it?

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The best argument for the fiduciary rule is that it better ensures that an investment advisor will advise and act in the best interest of the retirement investor.

The best argument against the fiduciary rule is that it represents over-regulation by the government and exposes investment advisors to liability for not acting in the best interest of the retirement investor (as determined by a court).

Article 2: "Rolls-Royce Reaches $809 Million Settlement over Bribery Probes"

http://fortune.com/2017/01/16/rolls-royce-bribery-settlement/

According to the article, British engineering group Rolls -Royce Plc said recently that it had reached settlements with authorities in Britain, the U.S. and Brazil relating to bribery and corruption involving intermediaries, which would result in a series of payments totaling about $809 million.

Rolls also said in a statement that it would report its financial results for 2016 on February 14 when "an appropriate update on the implications of these agreements will be provided at that time." It said there were early indications that its full-year profits and cash for 2016 would be ahead of expectations.

The settlement and the profit outlook come about a month after the maker of aero engines said it would cut 800 jobs in its marine business, responding to weak demand from shipping and energy customers.

The settlement with British authorities, for $599 million, was the biggest ever for Britain's Serious Fraud Office.

Rolls said the deals with the three authorities would see the group pay about $353 million in the first year.

Under the terms of the agreements with the U.S. Department of Justice (DOJ), Brazil's Ministerio Publico Federal (MPF) Rolls said it has agreed to make payments to the DOJ totaling nearly $170 million and to the MPF totaling $25.58 million.

Under the terms of a deferred prosecution agreement with Britain's Serious Fraud Office the company said it will pay $599 million plus interest under a schedule lasting up to five years, plus a payment in respect of the SFO's costs.

The proposed agreement with SFO was still subject to court approval.

"These agreements relate to bribery and corruption involving intermediaries in a number of overseas markets, concerns about which the company passed to the SFO from 2012 onwards," the company said in its statement. "These are voluntary agreements which result in the suspension of a prosecution

provided that the company fulfills certain requirements, including the payment of a financial penalty."

Since the concerns were brought to light, Rolls -Royce has set up an audit committee at each of its units in a bid to curb bribery and corruption, according to the company's latest annual report. Its settlement with Britain's SFO is not the first of its kind. Military contractor BAE Systems Plc agreed to pay 288 million in 2010 to settle long-running corruption investigations.

Rolls is in the midst of a program launched in 2015 to cut costs and simplify its operations after a slowdown in several markets hit profits.

Discussion Questions

1. Define bribery.

Bribery is defined as the offering, giving, receiving, or soliciting of something of value in order to influence the action of an official in the discharge of his or her legal duties.

2. Does the settlement referenced in the article constitute an admission of guilt by Rolls Royce? Why or why not?

Legally, the settlement referenced in the article does not constitute an admission of guilt by Rolls Royce. Typically, settlement agreements include language asserting that payment of the agreed-upon settlement amount does not constitute an admission of guilt; rather such payment is made for the purpose of resolving the dispute and avoiding further judicial proceedings.

3. What/Who is a “marketing intermediary?” In your reasoned opinion, should it constitute a crime to bribe a marketing intermediary? Why or why not?

A marketing intermediary is a party in the chain of product distribution between the manufacturer and the ultimate consumer of the product. Marketing intermediaries include wholesalers and retailers, as well as any government officials who must approve further movement of the product in the chain of distribution.

Article 3: “Beef-Jerky Plant Employee Fired After Call to 911 over Severed Thumb”

http://www.cbsnews.com/news/beef-jerky-plant-employee-fired-after-severed-thumb-incident/

According to the article, the owner of a now-closed beef-jerky maker is being sued by the federal government for firing an employee who tried to call 911 to help a co-worker with a severed thumb.

John M. Bachman, who owned the Lone Star Western Beef plant in Fairmont, could be forced to pay back wages and punitive damages to the employee as a result of the lawsuit, which the U.S. Labor

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Department filed recently against him and his company in federal court in Clarksburg.

The lawsuit said that when a band saw severed part of a worker's right thumb in July 2014, his co-worker applied pressure to the wound while using her cell phone to call 911. But before responders could answer, Bachman allegedly ordered her to hang up, and she was fired two days later.

Instead of calling an ambulance, Bachman collected the severed part of Chris Crane's thumb and told a supervisor to take him to an urgent care clinic. Crane was ultimately transferred to a hospital, where efforts to reattach the thumb were unsuccessful, the lawsuit said.

The co-worker, Michele Butler-Savage, told a U.S. agriculture inspector later that day that Bachman did not fully clean or sanitize the area of the plant where the accident happened. She also mentioned a lack of personal protective equipment. After she was fired, she filed a complaint with the Occupational Safety and Health Administration, which found the company violated federal whistleblower protections for workers who report violations of the law.

OSHA regional administrator Richard Mendelson said Butler-Savage's effort to show "basic human decency" was protected under federal safety and health laws.

"Lone Star Western Beef punished an employee for seeking emergency medical care for a seriously injured co-worker," Mendelson said. "No worker should have to fear retaliation from their employer for calling 911 in an emergency, or taking other action to report a workplace safety or health incident."

Bachman did not immediately return a message left at a telephone number listed on the company's website. In January 2015, the plant closed and relocated to Reading, Pennsylvania, the Labor Department said.

Discussion Questions

1. Describe the regulatory responsibilities of the Occupational Safety and Health Administration (OSHA).

The Occupational Safety and Health Administration (OSHA) is a federal administrative agency charged with the responsibility of ensuring a safe work environment for workers. OSHA enforces the provisions of the Occupational Safety and Health Act, which mandates a general duty on the part of employers to provide a safe work environment, as well as industry-specific safety standards.

2. What is "whistleblower" protection?

Whistleblower protection seeks to protect workers (and others) who report company violations of law, including violations of the Occupational Safety and Health Act (OSHA). For example, according to the anti-retaliation provisions of whistleblower protection, an employer cannot make

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an adverse employment decision based on an employee's decision to report the company for a violation of law. Such protection exists on both federal and state levels.

3. What are punitive damages?

Punitive damages are designed to punish a defendant for an intentional, extremely reckless or grossly negligent act that "shocks the conscience" of a reasonable person. Since they are punitive in nature, punitive damages are not tied to the amount of compensatory damages awarded to the plaintiff for "out of pocket" losses resulting from the defendant's wrongful action(s). Punitive damages are often based on the size of the defendant corporation, the amount of profits generated by the defendant, the defendant's asset base, etc.

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Video Suggestions

Video 1: Family Sues Apple, Claiming FaceTime Distracted Driver in Crash That Killed 5-Year-Old Daughter

http://abcnews.go.com/US/family-sues-apple-claiming-facetime-distracted-driver-crash/story?id=44506168

Note: In addition to the video, please see the following article, also included at the above-referenced internet address.

"Family Sues Apple, Claiming FaceTime Distracted Driver in Crash That Killed 5-Year-Old Daughter"

According to the article, a Texas couple is suing Apple, claiming that its FaceTime app distracted a driver who rammed into the couple's car, killing their 5-year-old daughter.

Parents James and Bethany Modisette are suing Apple for damages on the basis that the electronics giant failed to install and implement a "safer, alternative design" for FaceTime that would have helped prevent a driver from using the app while traveling at highway speed, court documents show.

The lawsuit, filed December 23 in California Superior Court in Santa Clara County, also claims that Apple failed "to warn users that the product was likely to be dangerous when used or misused" or to instruct on its safe usage.

The accident occurred Christmas Eve in 2014 near Dallas, when, according to the lawsuit, the Modisettes were driving in a Toyota Camry, with daughter Moriah, 5, in a booster seat in the left rear passenger seat and her sister, Isabella, next to her in the right rear seat.

The Modisettes had slowed or stopped their car because police activity ahead of them on the highway had caused traffic to back up, according to the suit.

Another driver, Garrett Wilhelm, traveling in his Toyota 4Runner in the same direction and behind the Modisettes' car, had his attention diverted by his use of the FaceTime app, the suit alleges.

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"As a result of that distraction, his Toyota 4Runner, while traveling at full highway speed (65 mph), struck the Modisette family car from behind, causing it to be propelled forward, rotate and come to a final rest at an angle facing the wrong direction in the right lane of traffic," the suit says.

Wilhelm's car then "continued its trajectory by rolling up and over the driver's side of the Modisette car," the suit claims.

The crash caused extensive damage to the driver's side of the Modisettes' car, and rescue workers had to extract James Modisette and Moriah from the car, the suit says.

James Modisette was in critical condition after the crash. Bethany Modisette and Isabella were taken to a regional medical center to be treated for injuries. Moriah was airlifted to an area children's hospital, where she later died from her injuries, according to the suit.

"Wilhelm told police at the scene that he was using FaceTime on his iPhone at the time of the crash, and the police located his iPhone at the crash scene with the FaceTime application still active," the suit claims.

The Modisettes contend in their suit that, "At the time of the collision in question, the iPhone utilized by Wilhelm contained the necessary hardware (to be configured with software) to automatically disable or 'lock out' the ability to use [FaceTime] ... However, Apple failed to configure the iPhone to automatically 'lock out' the ability to utilize FaceTime while driving at highway speeds, despite having the technical capability to do so."

Wilhelm was indicted on manslaughter charges by a grand jury in Denton County, Texas, according to The Denton Record-Chronicle. He has been out of jail on bail since August, and a jury trial in the case is scheduled to begin February 27, the paper reports.

Wilhelm's lawyer, Ricky Perritt, issued statement reading, "The Wilhelm family offers their thoughts and prayers for the family of the young lady who lost her life in this tragic accident. We are confident that after all the facts are brought out in court, it will be shown that the use of a cellular device did not contribute and Mr. Wilhelm did not commit a crime ... It was simply an accident."

Discussion Questions

1. On what legal theory/theories should/would the Modisettes base their lawsuit against Apple?

The Modisettes' lawsuit is most likely based on negligence and product liability theories.

2. If the Modisettes' lawsuit alleges Apple's negligence, what is their best argument regarding negligence? If the Modisettes' lawsuit alleges product liability, what is their best argument regarding product liability?

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If the Modisettes' lawsuit alleges Apple's negligence, their best argument regarding negligence is that the company's failure to warn users that the product was likely to be dangerous when used or misused or to instruct on its safe usage constituted a breach of duty owed to their daughter, resulting in her death.

If the Modisettes' lawsuit alleges product liability, their best argument regarding product liability is that Apple failed to configure the iPhone to automatically "lock out" the ability to utilize FaceTime while driving at highway speeds (despite having the technical capability to do so) and that such lack of configuration constituted a design defect resulting in their daughter's death.

3. In your reasoned opinion, is Apple legally responsible for Mariah Modisette's death? Explain your response.

This is an opinion question, so student responses will likely vary.

Video 2: "Girlfriend Cheats Way Out of Inheritance, Court Says"

http://www.usatoday.com/story/news/nation-now/2017/01/03/girlfriend-cheats-loses-inheritance/96099584/

Note: In addition to the video, please see the following article, also included at the above-referenced internet address:

"Girlfriend Cheats Way Out of Inheritance, Court Says"

According to the article, eight years into their relationship, John Scott decided to add his girlfriend's name to the title of 10 acres he had long since inherited. But the Indiana man had a condition: She could not cheat on him.

And they put it in writing.

About two months after they signed the handwritten contract, his girlfriend, Tina Hemingway, became pregnant. By another man.

Their relationship was about to end. Their court battle was about to begin.

Hemingway delivered the child in January 2013. She moved out in early June 2013, and that same month, Scott sent Hemingway written notice that she was in breach of the contract and must return her interest in the property to him, according to court documents.

Hemingway filed a suit to partition the property, and subsequently, Scott filed a counterclaim for breach of contract.

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Scott, of Madison, Indiana, won round one last year when Jefferson Circuit Court judge Darrell M. Auxier ruled in his favor. Hemingway filed an appeal in April.

Neither party responded to requests for comment.

In her appeal, Hemingway argued that the property deed itself extinguished the contract and that the contract was unenforceable based on public policy that prohibits contracts in consideration of "meretricious sexual services."

But the three appellate court judges disagreed with Hemingway that the agreement was based on a sexual contract and affirmed Auxier's ruling.

"This contract is akin to a prenuptial agreement, in which the parties resolve ahead of time their relative rights in property should the relationship dissolve," states the decision, authored by Judge Terry A. Crone.

"Even so, we observe that the contract does not require either party to perform sexual services. Nor does it require either party to abstain from all sexual activity," Crone wrote. "Rather, it simply lists cheating by either party as one of the acts constituting breach."

Prenuptial contracts forbidding extramarital affairs are nothing new to the court system.

However, depending on the locale, they can have varying results.

In a 2002 case, *Diosdado v. Diosdado*, a California trial court found that an infidelity clause in a post-nuptial agreement was not enforceable because it was contrary to the public policy underlying California's no-fault divorce laws. However, in other states, infidelity laws reportedly are enforceable, provided the infidelity can be proven and the agreement does not violate state law.

In this case, the judges concluded that the appellant was inarguably unfaithful. In Crone's words, "Hemingway wasted little time in breaching the contract."

Discussion Questions

1. As the article indicates, in her appeal, Hemingway has argued that the property deed itself extinguished the contract between Scott and herself. Do you agree or disagree? Explain your response.

In your author's opinion, the lower courts were correct in concluding that the contract between Hemingway and Scott governed the obligations and rights of the parties. The provision expressed in the agreement, that Hemingway not commit infidelities, was a "condition subsequent" to Scott's transfer of a property interest to Hemingway. A condition subsequent is a specified condition occurring after a contract has been formed that operates to destroy or defeat a contract obligation.

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In the instant case, Hemingway's infidelity was a condition subsequent that defeated her contractual right to the property interest.

2. As the article indicates, in her appeal, Hemingway has argued that the contract between Scott and herself was unenforceable based on public policy that prohibits contracts in consideration of "meretricious sexual services." Do you agree or disagree? Explain your response.

The contract did not require Hemingway to have sexual relations with Scott; instead, it required her to not have sexual relations with others. This defeats the "meretricious sexual services" argument.

3. As the article indicates, in a 2002 case, *Diosdado v. Diosdado,* a California trial court found that an infidelity clause in a post-nuptial agreement was not enforceable because it was contrary to the public policy underlying California's no-fault divorce laws. Explain the court's reasoning in *Diosdado v. Diosdado*. Would the court's reasoning in *Diosdado v. Diosdado* be binding on the subject case? Why or why not?

As the article indicates, in a 2002 case, Diosdado v. Diosdado, a California trial court found that an infidelity clause in a post-nuptial agreement was not enforceable because it was contrary to the public policy underlying California's "no-fault" divorce laws. In a no-fault divorce, neither spouse is required to prove "fault" or marital misconduct on the part of the other. To obtain a divorce, a spouse must merely assert incompatibility or irreconcilable differences, meaning the marriage has irretrievably broken down. The public policy underlying California's no-fault divorce laws is freedom of association, meaning the people should have the freedom to decide whether or not to "keep company" with someone (including a spouse).

Since the subject case arises from Indiana and Diosdado v. Diosdado was decided in California, the California case would not be binding precedent. At most it would be persuasive authority, meaning the Indiana court can choose to either follow it or not. As the article indicates, in other states infidelity laws reportedly are enforceable, provided the infidelity can be proven and the agreement does not violate state law.

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Of Special Interest

This section of the newsletter addresses the Federal Bureau of Investigation's arrest of Volkswagen executive Oliver Schmidt on fraud charges in the Volkswagen emissions scandal.

Ethical Dilemma

"FBI Arrests Volkswagen Executive on Fraud Charges: NYT"

http://www.reuters.com/article/us-volkswagen-usa-idUSKBN14T0JA

According to the article, the Federal Bureau of Investigation has arrested a Volkswagen AG executive on charges of conspiracy to defraud the United States, the New York Times reported recently.

Oliver Schmidt, who headed the company's regulatory compliance office in the U.S. from 2014 to March 2015, was arrested recently by federal investigators in Florida, the newspaper said, citing people familiar with the matter.

VW admitted in September 2015 to installing secret software known as "defeat devices" in 475,000 U.S. 2.0-liter diesel cars to cheat exhaust emissions tests and make them appear cleaner in testing. In reality, the vehicles emitted up to 40 times the legally allowable pollution levels. Volkswagen declined to comment on the reported arrest.

"Volkswagen continues to cooperate with the Department of Justice as we work to resolve remaining matters in the United States. It would not be appropriate to comment on any ongoing investigations or to discuss personnel matters," it said.

The FBI was not immediately available for comment.

Senior VW officials are not attending this year's Detroit auto show, which is taking place this week.

The news comes as Volkswagen was nearing a deal to resolve criminal and civil allegations over its diesel cheating, crucial steps toward moving past the scandal, which has cost it billions of dollars and its reputation.

Discussion Questions

1. Define conspiracy.

Conspiracy is an illegal agreement made between two (2) or more parties for the purpose of committing an intended crime.

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2. In your reasoned opinion, what is the likelihood that other Volkswagen employees/executives will be charged criminally in the subject case?

This is an opinion question, so student responses will likely vary. In your author's opinion, other Volkswagen employees/executives will likely be charged criminally in the subject case, since the scope of the crime is so large.

3. Based on your review of the article, what makes Oliver Schmidt's alleged involvement in the Volkswagen emissions scandal particularly egregious from a business ethics perspective?

In your author's opinion, what makes Oliver Schmidt's alleged involvement in the Volkswagen emissions scandal particularly egregious from a business ethics perspective (assuming the allegations are true) is that he headed the company's regulatory compliance office in the United States from 2014 to March 2015. His primary job duty was regulatory compliance, not regulatory circumvention!

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Of Special Interest

This section of the newsletter will assist you in addressing Video 2 ("Girlfriend Cheats Way out of Inheritance, Court Says") and the Ethical Dilemma ("FBI Arrests Volkswagen Executive on Fraud Charges: NYT") of the newsletter.

Teaching Tips

Teaching Tip 1 (Related to Video 2: "Girlfriend Cheats Way Out of Inheritance, Court Says")

In addition to the subject video and its accompanying article, have students review the actual case, Tina L. Hemingway v. John P. Scott (Indiana Court of Appeals Case No. 39A04-1604-PL-957), also included at

http://www.usatoday.com/story/news/nation-now/2017/01/03/girlfriend-cheats-loses-inheritance/96099584/.

Teaching Tip 2 (Related to the Ethical Dilemma: "FBI arrests Volkswagen executive on fraud charges: NYT")

Have students read the following article, which provides further details regarding the Volkswagen emissions scandal:

"Revealed: How VW Designed the Greatest Scandal in Automotive History"

http://www.thedailybeast.com/articles/2016/07/19/revealed-how-vw-designed-the-greatest-scandal-in-automotive-history.html

According to the article, for the first time the true scale has been revealed of a coldly calculated, deliberate and sustained scheme by scores of Volkswagen executives and engineers to defraud American car buyers and deceive American regulators.

The biggest scandal in the 130-year history of the auto industry has been laid bare in a five-count civil complaint against VW announced by New York State Attorney General Eric Schneiderman and Massachusetts Attorney General Maura Healey on Tuesday.

It goes far beyond in detail what was revealed when the company last month agreed to pay $15.3 billion to settle consumer and regulator lawsuits, alleging a company-wide conspiracy to ignore the consequences of seriously polluting the atmosphere, to lie to regulators, spend millions on patently false advertising and to desperately persist in a cover-up.

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The complaint throws a devastating light on a company culture that from the top down remained committed for years to cheating on U.S. emissions tests for not just VW models but also Audi and Porsche models using diesel engines—to the extent that the engines on some models emitted up to 40 times the permitted levels of nitrogen oxide pollution.

Executives even carefully evaluated what the cost would be to the company if they were caught. Reviewing previous cases of violations of environmental regulations by auto manufacturers in the U.S. they predicted that the likely fines posed "only a moderate cost risk." They cited the highest fine, imposed against Hyundai/Kia as amounting to "barely $91 per vehicle" and added "fines in this amount are not even remotely capable of influencing the share price of a globally operative company such as Volkswagen."
Portraying what it calls "a cynical fraud on the American car-buying public," the lawsuit claims that once VW realized, last summer, that regulators in California were about to expose the scandal, the automaker's staff deleted or removed incriminating data from the company's records.

The company also embarked on a multi-million-dollar advertising campaign in the U.S. designed to sell diesel as a "green and clean" form of power (complete with ads using towels and coffee filters to show how pure the exhaust was) when they knew that it was anything but.

"Defendants sold vehicles that, based on initial estimates, have illegally emitted over 45,000 additional tons of NOx emissions in the United States," the lawsuit said, "often into economically disadvantaged communities adjoining highways whose residents are prone to asthma and other respiratory diseases that NOx emissions exacerbate."

The basic trick used by VW to cheat is already well known. Put simply, the software in the German cars could detect when the car was in the shop for an emissions test—or in a regulator's lab. On sensing this the computers adjusted the exhaust settings so that the emissions fell within the permitted range. Once the car returned to the road the engine reverted to its dirty normal.

This is known as a defeat device.

In the course of 10 years, VW produced six generations of defeat devices. Writing the software, VW engineers spotted that one sure indication that a car was being tested on a dynamometer was if, as it accelerated and decelerated, the steering wheel did not move.

And the New York case provides a whole lot more insight into the lengths VW went to cheat the system. It details six successive versions of defeat devices used across the range of VW, Audi, and Porsche diesels. Moreover, it reveals that VW went a further step to make sure it was not caught. In New York and other states the annual inspections do not actually measure the exhaust emissions. They rely on the car's onboard diagnostics (OBD) to detect whether the car is running clean.

"To allow its defeat device equipped vehicles to pass New York's inspection and maintenance tests," says the lawsuit, "Volkswagen therefore needed to, and in fact did, implement a further cheat: It

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programmed the OBD systems to falsely report at inspection time that the automobile emissions systems were working properly."

In part this astonishing narrative is the story of how a mighty corporation was brought down by a handful of dedicated investigators. The fake performance of the diesel engines was finally exposed by a team of engineers from West Virginia University. On drives between Los Angeles and Seattle they discovered that a VW diesel sedan's emissions exceeded by as much as 35 times the permitted amount of nitrogen oxide.

Following this revelation, according to the attorneys general, VW executives launched a 17-month campaign "to mislead and confuse regulators and the public about the true cause of the high real-driving NOx emissions."
In this their main adversary appeared in the defiant form of the California Air Reserves Board, or CARB, an environmental watchdog set up by then-Gov. Ronald Reagan in 1967.

VW executives were feeling the heat because they had a great deal at stake: the U.S. launch of new VW sedans for the 2016 model year, all of them being shipped with the sixth generation defeat devices.

In an October 2014 teleconference with the CARB, VW fielded a team of managers who "cited phony technical explanations for the high emissions, omitted any mention of the true cause of the high NOx emissions and assured regulators it could 'optimize' the vehicles' emissions performance by conducted software recalls."

One of the engineers cited in the complaint, James Liang, had been directly involved in developing the first defeat device in 2006. In 2014 he was sent to California to devise tests intended to bamboozle the CARB and also VW dealers into believing that everything could be fixed by a recall to update software.

By mid-July 2015 the new models were piling up in the docks awaiting clearance from the CARB that they met emissions standards. But the CARB demanded more information and, not getting it, got hold of a 2016 model and tested it. At that point VW knew that the campaign of obfuscation was not working and that their great fraud was finally about to be exposed.

At a meeting with the CARB on Sept. 3 six VW executives admitted to the illegal defeat devices, although it was not until Sept. 18, with an announcement from the Environmental Protection Agency that it was taking action, that the scandal became public and reverberated around the world.

The most senior VW officer listed in the indictment is Martin Winterkorn, who was CEO of Audi from 2002 to 2007, when the original defeat device was developed, and CEO of VW from 2007 until resigning on Sept. 23, 2015. The day before he resigned, Winterkorn made a video statement that referred to "irregularities" in the diesel engines and said the company would act with "the greatest possible openness and transparency."

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A few weeks earlier, according to the complaint, a senior VW attorney advised multiple employees that a litigation hold was about to be issued, making it impossible to destroy or delete documents. A team of at least eight employees, all in the departments involved in designing the defeat devices, then deleted or removed data from the company records.

"Some, but not all, of the data has been recovered," the lawsuit said.

At the same time VW's Management Board, the nine men who had presided over the perpetration of fraud, the cover-up and then a public relations debacle that followed its exposure, were awarded $70 million in executive compensation for 2015 alone.

While the true scale of the scandal and the complicity of company executives in the deliberate deception is now becoming a lot clearer, scant attention has so far been paid to the pressures that could have caused them to take such desperate steps in the first place.

Just how VW's corporate culture was corrupted, as alleged in the complaint, has a lot to do with the company's consistent failure to become a major player in the North American market, and the uniquely German mindset that they displayed over the many decades of that failure.

For example, a very telling clue to this mindset could be seen in 2001 at the North American International Auto Show in Detroit. One vehicle drew crowds by the thousands. It was a re-imagining of that Woodstock-era dreamboat, the Volkswagen Microbus.

VW presented the new version as a concept car. It brilliantly fused nostalgia for the original, that little bus with the cute rounded edges and panoramic windows, with 21st century technology and interior luxury.

Auto journalists raved. Pictures of the new Microbus appeared on the front pages of scores of newspapers, along with flashback images of the original in the psychedelic colors applied by hippie roadies.

For years VW had been struggling to find a breakout vehicle just like this that would give the brand a new energy in the North American market.

But the reborn Microbus was stillborn. A production model never got the green light from VW management in Wolfsburg, Germany.

Mark Rechtin, the auto editor at *Consumer Reports*, cited the Microbus episode as symptomatic of VW's Germany-first thinking.

"People would have gone berserk for this thing," he said, "but the politics of the organization and the pridefulness of the home headquarters leads to the attitude 'We are German engineers. We know

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how to make things that work right, that are logical, that show this is the way a car should be and Americans should understand how great this is."

The Daily Beast asked Rechtin, with many years of experience of covering the global auto industry, why, of all the world markets, the U.S. has always defeated VW's best efforts to become a major player.

"This is a brand that has the technology, the design skills, the scale of production and by all rights they should be as successful as any of the major Japanese brands in the U.S. but they just can't seem to get out of their own way," Rechtin said.

"You have to break a million to be a player in America, and VW shows no signs of getting close to that. They had planned to double sales to 800,000 units by 2018 but the scandal has put in doubt that they can get anywhere near that."

To give context to the competitive pressures on VW it is necessary to begin in 2005. Toyota was the most successful foreign manufacturer in the North American passenger car market. And Toyota, once viewed as conservative in its engineering, had produced a revolutionary sedan, the gas-electric-powered hybrid Prius that eco-minded Americans were suddenly warming to.

VW had no experience in hybrids and no inclination to go there. They did, however, have a long history with diesels, and diesels offered the potential of at least matching the high mileage-per-gallon of the Prius. The only problem was that even the newest diesel technology did not offer the hope of meeting tougher new U.S. emissions standards.

The New York lawsuit reveals internal VW documents under the title of "Volkswagen's Opportunities with Clean Diesel" and the company's declared intent to "OWN the segment before the competition comes to market" and to "own Clean Diesel in the way Toyota owns Hybrid." VW marketing was instructed to use Clean Diesel as an "environmental halo" in its campaigns.

In fact, the revelation of VW's cheating explained a lot to engineers at Honda and Mazda who had been trying to figure out the secret of VW's magic sauce. They were so effectively stymied that they decided not to compete with VW because they thought that the German diesels couldn't be matched.

But, ironically, even the great diesel swindle has done little to help build the VW brand in North America.

"They were basically making one car for the world," Rechtin told The Daily Beast. "The way they treat overseas markets is very paternalistic. If the overseas markets have any say at all it's basically in color and trim."

Looked at with a 60-year perspective VW's failure to give Americans a mass-produced sedan with, say, the record of Toyota's perennially dominant Camry is even more astonishing. In the annals of

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car marketing one campaign remains unequalled for its hutzpah and brilliance in branding: the launch of the original VW Beetle in the 1950s. They never found another campaign or product to match it.

So it's enlightening to note that the story of Toyota, the foreign brand that bestrides the North American market year on year, did not begin well.

"Their first products were terrible," Rechtin said. "In the early 1960s they basically walked away from the American market after three years. They went back with their tail between their legs, admitting that they didn't know what they were doing.

"It took until the late 1960s for them to produce a car that people could respect. They built a beachhead and market share on the West Coast, then moved to the Southwest and up the Eastern Seaboard. By the late 1980s they were building spectacular products."

And what did Toyota do that the Germans did not?

"*Genshi Genbutsu*"—a Japanese maxim usually interpreted as "go and see" but, more literally, "actual place, actual thing."

In other words, Toyota, Honda, and Nissan listened to what the Americans wanted.

"If you're a chief engineer at Toyota, working on products largely sold in America, you're going to live in America, you're not going to make ivory tower pronouncements from Japan," Rechtin said. "You're going to drive prototypes for hundreds of thousands of miles on American roads.

That's what they do. It's real world experience. German chief engineers may get on a plane to America once or twice, but that's it. For years German cars didn't have cupholders because in Germany they said 'You're driving, what are you doing drinking soda pop?'"

VW persisted in believing that "German engineering" was simply in itself enough to make a brand, employing the slogan "Das Auto" to make it language-explicit, even though they proved incapable of making a diesel engine that would meet emission standards.

And, it turns out that, notwithstanding the scandal, German engineering, at least in the hands of VW, is not always that great. *Consumer Reports* has unique independence and authority when it comes to testing new cars—they buy as many as 70 cars a year as regular customers from dealers, not taking special test cars with company plates, and 740,000 readers give annual follow-up reviews on reliability and satisfaction.

And reliability has been a persistent problem with VW models in the U.S.

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"They make fun vehicles to drive," Rechtin said, "and they always do well in the way they handle in the road tests but the reliability just isn't there, especially when the car is new to the market. For all the raves that the new Golf has received its reliability is below average and so therefore we cannot recommend it."

There is another puzzle. When it comes to quality and reliability, auto analysts and reviewers have often drawn a comparison between the corporate pairings of VW and its upscale sibling Audi and Toyota and its upscale brand Lexus.

The difference is striking. *Consumer Reports* combines the results of road tests with predicted reliability and owner satisfaction to score the relative performance of brands.

"Lexus and Toyota were within shouting distance of each other, well above the industry average, but while Audi topped the rankings VW finished a distant 15th," Rechtin said.

In the end, what's really damning is not just the "we don't need to listen to you, America, you need to listen to us" arrogance of VW's managers but how long they have persisted in this belief.

There's really not much of a mystery in why Toyota went from zero sales to selling two and a half million vehicles a year in the U.S. in little more than four decades.

Genshi Genbutsu—they came, they listened, they conquered. And they didn't cheat.

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	Hot Topics	Video Suggestions	Ethical Dilemma	Teaching Tips
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Bennett-Alexander & Hartman, Employment Law for Business	Chapters 2 and 16	N/A	N/A	N/A
Kubasek et al., Dynamic Business Law	Chapters 1, 7, 9, 33 and 42	Chapters 9, 10, 13 and 14	Chapters 2 and 7	Chapters 2, 7, 13 and 14
Kubasek et al., Dynamic Business Law: Summarized Cases	Chapters 1, 7, 9, 33 and 42	Chapters 9, 10, 13 and 14	Chapters 2 and 7	Chapters 2, 7, 13 and 14
Kubasek et al., Dynamic Business Law: The Essentials	Chapters 1, 6, 7, 20 and 24	Chapters 7, 9 and 25	Chapters 2, 6 and 9	Chapters 2 and 6
Mallor et al., Business Law: The Ethical, Global, and E-Commerce Environment	Chapters 5, 7 and 35	Chapters 7, 9 and 20	Chapters 4 and 5	Chapters 4, 5 and 9
McAdams et al., Law, Business & Society	Chapters 4, 7, 12 and 16	Chapters 6 and 7	Chapters 2 and 4	Chapters 2, 4 and 6
Melvin, The Legal Environment of Business: A Managerial Approach	Chapters 10, 11, 23 and 26	Chapters 6, 7, 10	Chapters 5 and 23	Chapters 5, 6, 7 and 23
Pagnattaro et al., The Legal and Regulatory Environment of Business	Chapters 10, 12, 13 and 21	Chapters 8, 9 and 10	Chapters 2, 8, 9 and 13	Chapters 2, 8, 9 and 13
Sukys, Brown, Business Law with UCC Applications	Chapters 5, 6, 22, 23 and 34	Chapters 6, 7, 8 and 15	Chapters 1 and 5	Chapters 1, 5, 7 and 8

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