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THE ETHICAL CHALLENGES FOR ENTERPRISE AND RISKS TO CONSUMERS OF LARGE MARKET SHARE THROUGH LOW-COST SUPPLIER STRATEGY

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Abstract: A corporate strategy of high market share, through being a low-cost supplier and rushing to market, carries ethical risks to the corporation and consumers. There are several examples of US corporations that engaged in low-cost strategy and rushed to market, compromising product quality as well as consumer interests in the process. These companies suffered long-term, negative consequences. Recently, China has experienced lapses in product quality that have injured consumers and are likely associated with attempts to achieve market penetration, if not market dominance, through strategically serving as a low-cost supplier. Lessons can be learned from the example of earlier debacles in policies and programs implemented to minimize the risks of a high-market share/ low cost supplier strategy. Specific recommendations are suggested to ensure product safety.

Keywords: product safety, product quality, consumer, low cost supplier, strategy

A corporate strategy of achieving high market share can pose ethical risks to a corporation, particularly when companies serve as a low-cost supplier to achieve large market share. Interests of consumers can be injured under such circumstances. Moreover, rush to market is sometimes a means of achieving high market share. There is a sound rationale for a rush to market. Often a company which is the first, or an early entrant to a market, achieves high market share. A low cost supplier strategy combined with a strategy of early market entrant can be a formula for market dominance. With the "flattening" of the world,[1] global sourcing has increased, and China is a major beneficiary. For example, Wal-Mart, the world's largest manufacturer and retailer, produces 70% of its products in China; Wal-Mart is China's single largest customer.[2] In addition, China produces 70% of the world's toys.[3]

SINO-US INTERNATIONAL TRADE IN 2007

Recent events have raised concerns that some Chinese companies produce products harmful to consumers. The use of raw materials prohibited in the United States for consumer products (perhaps in violation of manufacturer standards) poses the risk that the ultimate consumers or purchasers of Chinese made goods will lose trust in the products. For example, during the summer 2007, there were successive waves of recalls of children's toys resulting from the use of leaded-paint as part of the manufacturing process. The lead paint recalls follow on the heels of pet food contamination with a toxic ingredient melamine, and the fraudulent use of an industrial chemical replacing glycerin in tooth paste. The substitution of this industrial chemical, diethylene glycol, for glycerin in tooth paste causes kidney damage.[4] Thousands of pets sickened or died from tainted pet food when an industrial chemical

melamine was added as filler.[5] An upsurge in the sale of toys manufactured in the United States has been reported, indicating that global consumers, particularly US consumers, can readily switch their buying habits to support different product manufacturers.

An American manufacturer reported an upsurge of orders for his children's toys, similar to the Thomas & Friends wooden train sets recalled by RC2 Corporation of Oak Brook, Illinois. This upsurge has extended to other American based toy manufacturers. The loss of sales by Mattel, RC2 Corporation and other manufacturers is likely to lead to closer monitoring of their China-based plants and of sub-contractors/ suppliers, as well as possible severance of relationships. Although Mattel has not severed its sub-contract relationship with one sub-contractor involved in the incident of lead-painted toys, Early Light Industrial Co., Mattel has terminated its relationship with Hong Li Da (HLD), which had been sub-contracted the painting of the toys by Early Light Industrial.[6]

RISKS OF RUSH TO MARKET: CASE STUDIES

Lessons can be learned from corporate debacles resulting from utilizing low cost suppliers and rushing to market. For example, Beechnut apple juice used a low cost supplier whose prices were 25% under the going rate for apple juice concentrate. Beechnut (an American company) marketed its baby apple juice as 100% juice, even though there were strong indications, including an internal whistleblower, that the concentrate was not a natural product. Beechnut was prosecuted for fraud in the late 1980's. This case provided the first instance where American executives were jailed as a result of fraud. However, in the end, the executives' sentences were overturned due to an appeal concerning the jurisdiction of the trial court.

Rush to market, in an effort to achieve market dominance for small, American-made fuel efficient cars led Ford (the American automotive company) under the leadership of Lee Iacocca, to market a defectively designed car, the Ford Pinto. The Ford Pinto was developed and brought to market in 24 months, weighed under 2000 lbs and sold at a cost of $2000 U.S. Ford engineers conducted tests that showed that a low impact rear collision would cause the precariously placed gas tank to catch on fire and explode. Ford executives decided not to recall, redesign, or repair the gas tank. It would have cost about $11 per vehicle to install a rubber bladder inside the gas tank to prevent leaks. Instead the Ford executives decided that they would pay damages to the burn victims.[7] Ford was wrong about its "cost-benefit" analysis, because U.S. juries awarded huge punitive damages. Moreover, Ford was prosecuted in the state of Indiana for reckless homicide. Ford was ultimately acquitted of the criminal reckless homicide charges after its trial in Indiana.[8]

POSITIVE EXAMPLES OF CRISIS MANAGEMENT

An alternative model for the management of contaminated or defective products is the case of Johnson and Johnson's handling of the Tylenol poisonings. In 1982 a number of deaths resulted from product tampering. Cycanide was inserted into the Tylenol capsules; this product tampering was enabled because the product was not sealed, allowing the poisoner access to the Tylenol capsules. In response to this crisis, the CEO of Johnson and Johnson company (J&J), (the corporate parent of the subsidiary company manufacturing Tylenol) broadly recalled the product, and re-designed the packaging to hinder product tampering.[9] In undertaking the broad recall, J&J risked its market share in the analgesic market, and its

stock price. Although J&J's stock declined drastically after the recall, J&J's stock price and Tylenol's market share increased. J&J's corporate culture and corporate mission, embodied in its Credo which puts the interests of consumers first, has been credited as the basis for J&J's management of the Tylenol crisis.[10]

Moreover, a good model could be provided by Nike, a company that uses sub-contractors as an essential component of its corporate production strategy. Nike was criticized for the conditions of its sub-contractor factories, which were characterized as sweat-shops.[11] To resolve the criticisms, Nike developed and implemented sub-contractor codes of conduct and inspection systems.[12] Nike is now widely respected for the rehabilitation of it sub-contractor factory conditions.

RECOMMENDATIONS TO STAKEHOLDERS USING LOW COST SUPPLIER STRATEGY

1. Punish the wrongdoers. For example, the head of China's Food and Drug Administration was executed for taking bribes and for approving sub-standard products.[13] The head of a company responsible for Mattel's recall of Dora the Explorer and other toys manufactured for the Fischer Price division of Mattel, committed suicide in August 2007,[14] which can be speculated to result from the desire to avoid punishment. But this is not enough in itself. Holding the executives of companies responsible for the injuries caused by their products is a good start, and certainly sends a message to other executives to prevent the same kinds of injuries from occurring. However, the root causes of the problems must be corrected.

2. Develop Enterprise Mission Statements and Codes of Conduct. Enterprise mission statements and codes of conduct embody the commitment of a company to its stakeholders, particularly its customers. The Johnson and Johnson Credo served to guide the company and its managers during the Tylenol poisoning crisis. Similarly, Nike developed a Code of Conduct and a Supplier Code of Conduct to remediate the criticisms that the factories where its products were manufactured were operated as sweatshops.

3. Develop warrantees and insurance. Suppliers should warrantee against fraud, so that materials not to specifications would be at the cost of the supplier, not borne by the purchaser. For instance, the law governing warrantee of merchantability is well developed in the United States. Prevailing law in the United States carries an implied warranty of merchantability. Implied warranty means that the expectations of consumers of a product that it is "reasonably suited for ordinary use" must be met, and that the manufacturer is liable to the buyer for damages if their product as manufactured is not "reasonably suited for ordinary use."[15] Contracts between merchandisers such as Mattel or Wal-Mart and their subcontrators could include an explicit designation of US or EU law to govern warrantees of merchantability in their choice of law clause. Damages could thus be collected in such cases as the substitution of lead paint on children's toys, melamine filler in pet food and diethylene glycol for glycerin in tooth paste. Since the substitution of low cost materials appears to be so rampant, the Chinese government could guarantee the insurance systems created for such crisis situations. Making the Chinese government ultimately liable for the breaches of its burgeoning private enterprise sector would likely increase the vigilance of Chinese state regulators.

4. Monitor supplier sub-contractors closely. It is recommended that Chinese suppliers monitor their sub-contractors, such as Early Light Industrial Company's sub-contracted relationship with Hong

Li Da. The Chinese suppliers should develop contracts and inspection systems which reflect the contract specifications between the supplier and its customer.

5. Punitive damages should result when products harm consumers. The development of a legal system that includes punitive damages and criminal prosecution for knowingly or recklessly using materials or designing products that will harm the consumer.[16]

6. Develop and enforce manufacturing standards. Multinational companies such as American companies doing business in China should include contractual clauses to require that manufacturing must be done in conformity to the production standards of the recipient customer, rather than the standards of the sourced factories. Contracts should also include choice of law clauses specifying that contract enforcement and litigation be done under the law system of the recipient customer.

7. Insist on right of inspection of sub-contracting activities. It is recommended that contracts of specifications for suppliers and supplier sub-contract include specification requirements subject to rejection by the corporate recipient of manufactured goods. A requirement should also exist that supplier sub-contracting must be approved by the customer. The contract should state that the cost of goods produced that are not in conformity with specifications will be borne by the supplier, including the out of specification production by sub-contractors arranged by the supplier.

8. Institute testing and documentation procedures. It is recommended that control procedures be instituted that include testing and documentation at all levels of the supply chain and documentation of all raw materials in the supply chain. Documentation and testing results should accompany the products at all stages in the supply chain. The inspection documentation should be bi-lingual or multi-lingual, in the language of the inspector and of the purchaser as to simplify the inspection process for quality control inspectors. In cases where a sub-contractor is producing products for a contractor, the documentation should be in the language of the merchandiser for which the products are being made.

9. Develop industry codes. It is recommended that industry codes such as the codes developed by the Pharmaceutical Industry and Toy Manufacturers' Association be developed for the Chinese industry, especially when the industry or product is at high risk for design defects or where products are inherently dangerous. For example, the Chain Saw Manufacturers' Association is an industry association that voluntarily develops standards for chain saws, an inherently dangerous product. Such a model can come from within China or be adapted to the Chinese situation.

10. Develop Government Regulatory Codes. It is recommended that government units develop regulatory codes. Such regulatory codes should include the right of testing and inspection by a governmental unit, as well as the right to close manufacturing operations, the right to recall unsafe or contaminated products and the right to fine or jail managers in extreme cases.

11. Development and implementation of international protocols. It is recommended that international protocols on the production of children's toys and food products be marketed and implemented internationally. These rules might prohibit the use of lead paint and known toxic materials and require documentation at all levels of the supply chain. Such conventions were developed, for example, for the marketing of infant formula and cigarettes, under the auspices of the World Health Organization (WHO).[17] A United States-Sino Product Safety Summit was held in September 2007; it was agreed at the Summit that lead paint in children's toys is prohibited.[18]

Loss of trust by consumers, decline of sales, more pervasive and more detailed control procedures,

and loss of business will likely be the result of fraudulent supplier and manufacturing practices such as the ones detailed herein. Corrective and control measures to prevent future wrongdoing will raise the costs of doing business in China, and may erode some of China's competitive edge in the world market. However such measures are necessary if China is to remain integrated in the global economy and its enterprises are to do business in a socially responsible and ethical manner. The ethical challenges experienced by China present the opportunity for Chinese-based enterprises to return to traditional Chinese ethical culture, Confucian history, and honor-based transactions. As China joins the global economy, the traditional norms of friendship (pengyou-pengyou relationships) must prevail with its global trading partners.

Jun Zi Ai Cai Qu Zi You Dao![19]

NOTES

1. Friedman, T. (2005). The World is Flat. New York: Farrar, Straus and Giroux.

2. http://www.hoovers.com/wal-mart/--ID__11600--/free-co-profile.xhtml. See also http://en.wikipedia.org/wiki/Wal-Mart

3. "Playtime is over for China's Toy Industry," Asia Times Online, June 21, 2006. http://www.atimes.com/atimes/China_Business/HF21Cb05.html

4. "China Investigates Contaminated Toothpaste," New York Times, May 22, 2007. Available at http://www.nytimes.com/2007/05/22/business/worldbusiness/22toothpaste.html?pagewanted=2&ei=5088&en=fd31a20be0326aad&ex=1337486400&partner=rssnyt&emc=rss. See also: "From China to Panama, a Trail of Poisoned Medicine," New York Times, May 6, 2007. at http://www.nytimes.com/2007/05/06/world/americas/06poison.html?ex=1187496000&en=0de9e8ba33d0e098&ei=5070

5. "Filler in Animal Feed is an Open Secret in China," New York Times. April 30, 2007. Available at http://www.nytimes.com/2007/04/30/business/worldbusiness/30food.html?ex=1187496000&en=f4692d18a605ed8e&ei=5070

6. "A Blow to Hong Kong's Toy King," Forbes.com., August 15, 2007. Available at http://www.forbes.com/2007/08/15/mattel-china-choi-face-markets-cx_jc_0815autofacescan01.html See also "Mattel Recalls Millions of Toys over Safety Fears," Timesonline, August 14, 2007. http://www.timesonline.co.uk/tol/news/uk/article2258997.ece, and "Lead Paint Prompts Mattel to Recall 967,000 Toys," New York Times, August 2, 2007. Available at http://select.nytimes.com/search/restricted/article?res=F60C10F634550C718CDDA10894DF404482

7. Mark Dowie, "Pinto Madness" in Mother Jones, September/October 1977. Available at http://www.motherjones.com/news/feature/1977/09/dowie.html

8. Reckless Homicide? Ford's Pinto Trial by Lee Patrick Strobel (And Books, South Bend, Indiana: 1980).

9. http://en.wikipedia.org/wiki/1982_Chicago_Tylenol_murders. There was a second round of Tylenol poisonings in 1986, even though there was tamper-proof packaging; after that, J&J stopped making Tylenol capsules.

10. Johnson and Johnson Company Credo. Source: http://www.jnj.com/our_company/our_credo/index.htm

11. Marc Kasky, Plaintiff and Appellant, v. Nike, Inc., et al., Defendants and Respondents, 27 Cal. 4th 939; 45 P.3d 243 (May 2002).
12. http://www.nike.com/nikebiz/nikeresponsibility/tools/Nike_Code_of_Conduct.pdf
13. China Execute Ex-Food and Drug Chief: Zheng Sentenced to Death for Taking Bribes to OK Substandard Drugs. Associate Press, July 10, 2007. Available at http://www.msnbc.msn.com/id/19686498/
14. Owner of Chinese Toy Factory Commits Suicide, New York Times, Aug. 14, 2007. Available at http://www.nytimes.com/2007/08/14/business/worldbusiness/14toy.html?ei=5088&en=d1dba19ac085d959&ex=1344744000&adxnnl=1&partner=rssnyt&emc=rss&adxnnlx=1187407146-mKO+LTFnZ9biKa/pn477Rw
15. The Uniform Commercial Code provides, with respect to implied warranties: "§ 2-314. Implied Warranty: Merchantability; Usage of Trade. (1) Unless excluded or modified (Section 2-316), a warranty that the goods shall be merchantable is implied in a contract for their sale if the seller is a merchant with respect to goods of that kind. Under this section the serving for value of food or drink to be consumed either on the premises or elsewhere is a sale. (2) Goods to be merchantable must be at least such as (a) pass without objection in the trade under the contract description; and (b) in the case of fungible goods, are of fair average quality within the description; and (c) are fit for the ordinary purposes for which such goods are used; and (d) run, within the variations permitted by the agreement, of even kind, quality and quantity within each unit and among all units involved; and (e) are adequately contained, packaged, and labeled as the agreement may require; and (f) conform to the promise or affirmations of fact made on the container or label if any. (3) Unless excluded or modified (Section 2-316) other implied warranties may arise from course of dealing or usage of trade."
Available at http://www.law.cornell.edu/ucc/2/2-314.html.
16. There was a major recall by Mattell announced on August 14, 2007 of products with magnets within. These magnets can choke young children who use the toys. See recall information at the Consumer Products Safety Commission website, http://www.cpsc.gov/cpscpub/prerel/prhtml07/07273.html.
17. See the description of the WHO's Tobacco Convention at http://www.who.int/tobacco/framework/download/en/index.html. The Global Compact is a vehicle for the protection of human rights in less developed countries. See "Third World Way: The UN Global Compact May Be The Best Way To Draw Corporations Into The Development Process. Is Its Optimism Justified?" The Economist, Jul 20th 2007. Available at http://www.economist.com/business/globalexecutive/displaystory.cfm?story_id=9531002.
18. "Sino-U.S. Consumer Product Safety Summit," People's Daily online, September 13, 2007, available at http://english.people.com.cn/90001/90783/6261664.html. See also, "China Signs Pact to Ban Lead Paint in Export Toys," The Associated Press, New York Times, Sept. 12, 2007, pg. C.9.
19. A Daoist saying, roughly translated as, "The wise man loves money, but gets it only by following the Way (Dao de Jing /Tao Te Ching)."

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