XYZ Design Company: A **Problem of Ethics?**[1]

XYZ Design Company is a small, privately-owned firm in the Research Triangle of North Carolina, where it has done business for 17 years. The company founder, Jim Dix, is a self-taught expert and a pioneer in Turboencabulator technology and is widely regarded as one of the nation 's premier designers of this vital component for high-speed electronic switching systems. Major corporations and entrepreneurial start-up companies seek XYZD' s design service as they seek new ways to integrate turboencabulators into their new products.

Although XYZD has its own proprietary approach to turboencabulator design, it also has many competitors. Large companies often choose to hire and train their own TENABL designers, and many of those people later set up as independent contractors. Jim Dix's techniques produce a more efficient, more reliable design, although often at a higher cost than his competitors.

Now one of XYZD's biggest customers, ABC Networking, has asked Jim Dix whether he wants to extend the customer relationship into more of an alliance, by accepting warrants for ABC stock in partial payment for their design work. ABCN is expected to go public within a few months and the warrants, valued at $3 per share before that issue, might well convert into publicly-traded stock at many times that value. ABCN wanted preferential treatment for its projects.

XYZD already has four major projects in production for ABCN, and the combined value of those jobs might reach over $150,000. All four projects are vital to ABCN's introduction of a new network switching system, and Jim Dix knows that all four are subject to delays, as the engineers from ABCN continually change their specifications and correct errors they find in the network's simulated testing. ABCN's target date for the product delivery cannot change without jeopardizing the company's public issue date (although ABCN hasn't divulged that IPO schedule). Dix feels that his staff is taxed almost to the breaking point, struggling to meet ABCN's delivery schedule while still maintaining service to his other, smaller customers who also have their own product deadlines.

Dix is sure that ABCN' s offer of stock warrants is not a sign of financial weakness on the part of his customer. ABCN is well funded. It is financed by several of the largest venture capital funds in the country. It pays it bills on time, and has agreed to pay for work completed on its large projects, even before the jobs are delivered. Its jobs call for the largest turboencabulators ever designed by XYZD, and each project pushes the frontier of TENABL technology in new and different ways. Jim Dix is considering taking twenty percent of his payment for the work in the form of ABCN' s warrants. His employees, who all benefit from a profit- sharing program, favor even larger acquisition of the warrants.

Discussing the proposition at a meeting of his Board of Directors, Jim is urged to go slow. One director suggests the decision is simple: XYZD is in the design business, not the investment business. The second director is less certain this is an easy answer. While equity participation has become common in Silicon Valley, it is new to us in the Research Triangle area, and we should think the whole thing through carefully. What are the implications? Who are the stakeholders? How does accepting a stake in the customer relate to the company's strategy, or to its mission of providing cutting edge design to leaders in all industries? Is this a question of business ethics?

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[1] Submitted to the NACRA Annual Meeting, Oct. 12,2000, for critique and improvement. This case is not yet released for publication; reproduction and circulation outside the NACRA meeting are prohibited. Names and product have been disguised.

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Teaching Note

The Board of Directors of XYZ Design, Inc. is considering the offer of the firm's largest customer to permit XYZD to accept stock warrants in lieu of cash, as partial payment for some $150,000 in design work. The warrants, at $3 per share, are priced in line with the "friends and family" price for stock in ABC Networks, which expects an Initial Public Offering within months. Switching network companies were favorably looked upon by the market, and several new companies have recently seen their issue price double and triple within days of issue.

XYZD's 20 employees favor the company's acquiring the stock warrants. All the employees participate in a profit-sharing plan, and all have confidence that the forefront technology they are designing will give ABCN a real advantage in the fast-moving network switching industry.

Use of the Case

XYZ Design may be used in the introductory undergraduate Finance course, in Business Policy/ Strategic Management, or in any other course considering Business Ethics.

Learning Objectives

Students should learn to consider all the stakeholders in any partnering or alliance formation decisions at corporate levels. Ethical decisions often lie below the surface, as in this case.

Assignment Questions

1) Who are the stakeholders in XYZD's decision?

The employees of XYZ Design are clearly affected by the decision. All are convinced that the ABC public issue, when it comes, will be a major winner in the stock market. They want the company to gain on its warrants, because they will get a share in the profits. But there are other stakeholders as well: Jim Dix, who owns 90 percent of XYZD, and the two directors, who own 5 percent each, want the company to succeed -- although it does not pay dividends on the stock and does not plan an IPO of its own. The stockholders will not benefit from the hoped-for capital gain on the warrants. Other customers of XZYD are stakeholders, because their projects might suffer if XYZD gives preferential priority to ABCN.

2) What are the ethical implications if we accept warrants in lieu of cash?

If we take the warrants, we must decide whether to discriminate among our clients, giving priority to ABCN at the expense of other customers. That might be a conscious or unconscious decision. Either way, it would result in unequal treatment of the customers --a conflict with our mission.

3) Should Jim Dix accept the warrants in lieu of cash?

No, he should not. One of the other customers is LMNO Corporation, a direct competitor of ABC Networking. If our participation in ABCN's equity scheme became known --and it easily might -- then LMNO would surely perceive any delay in its work as caused by our favoritism to ABCN.

Utilitarianism --the greatest good for the greatest number --suggests denying the option, since there are more customers than just ABCN. The fairness doctrine suggests denying the option, since customers could feel unfairly treated. And the "rightness" doctrine, too, suggests no warrants: it is greed that drives us toward accepting the offer, and we would regret it if LMNO perceived discrimination against them.

Besides, we are not in the investment business. The warrants *could* turn out worthless.