Tyco: US conglomerate falls amid revelations of greed and corruption

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The American-based conglomerate Tyco International Ltd. is in deep crisis following a wave of revelations concerning the corrupt practices of the company and its top management. Dennis Kozlowski has resigned as CEO and Tyco stock has plummeted, threatening the firm with bankruptcy. The collapse of Tyco, one of the world's largest corporations, with 240,000 employees, would send shockwaves throughout the US and global economy.

In many ways the company exemplifies the current state of American business. Tyco has registered huge profits over the past decade largely by means of acquisitions and financial manipulations. Its booming earnings reports and escalating stock value for much of the past decade were not the products of growing productive capacity, but were instead achieved through accounting tricks and outright fraud. Given the parasitic character of its economic operations, it quite naturally promoted the most unscrupulous elements into the highest ranks of management.

In these respects, Tyco is hardly unique. A string of corruption scandals has emerged following last year's collapse of Enron—from the energy industry to telecommunications, from retail chains to Wall Street investment banks—which reveals a systemic growth of corruption and lawlessness that goes to the foundations of American capitalism. These scandals share certain common features: financial manipulation, accounting fraud, greed and criminality.

In May, Manhattan District Attorney Robert Morgenthau opened a criminal investigation into the actions of Kozlowski. The CEO has been accused of using company funds to purchase millions of dollars worth of artwork as well as his $18 million apartment in Manhattan. Apparently, Kozlowski used company "loans" for the purchases, allowing him to avoid paying income tax on the money used. It is unclear that he ever paid back the loans.

Kozlowski is also accused of fraudulently transporting $13 million worth of art to Tyco's operating headquarters in New Hampshire, in order to avoid more than $1 million in New York state and city sales taxes. Under state law, any purchases for use inside the state are taxable. Rather than pay the $1 million, Kozlowski had the artwork, or, in some cases, empty boxes, sent to New Hampshire, where there is no sales tax. He then had them sent back on the sly to his Manhattan apartment.

Kozlowski has pled not guilty and has been released on $3 million bond. His next hearing is scheduled for June 26. His lawyer is, appropriately enough, Stephen Kaufman, who was the lawyer for financier/felon Michael Milken and hotel magnate/felon Leona Helmsley. New York prosecutors apparently want to make an example of Kozlowski, who, if convicted, could face many years in prison. Sales tax evasion by the rich, which deprives states of otherwise collectable funds, is a common phenomenon, expected to exceed $20 billion in 2003.

The Manhattan prosecutors are now expanding their investigation to include other company executives, perhaps leading to an indictment of the company itself. Questions are being raised as to whether the firm used its own funds to purchase a house from director Lord Michael Ashcroft and provided interest-free loans to many of its corporate employees.

The Securities Exchange Commission (SEC), in addition to joining with New York in the investigation of tax fraud, has announced it is reopening an investigation into the company's accounting practices. The original investigation took place in 1999-2000, with the SEC deciding to take no action. It looked into accounting practices surrounding the company's many acquisitions. These included a practice known as "spring-loading," a financial manipulation in which the pre-acquisition earnings of the acquired company are underreported, so as to give the merged company an artificial boost afterwards.

Most members of the company's board of directors have benefited personally in one way or another as a result of Tyco's practices. Theoretically, the directors are supposed to be independent of management, including the CEO, so they can objectively oversee the operation of the company. In practice, this is rarely the case in the American corporation, where directors are closely integrated with management and both sides enrich themselves at the expense of the company and its workers.

In addition to Lord Ashcroft, the board includes Joshua Berman, a lawyer whose law firm was paid as much as $2 million annually by Tyco. Berman's pay at the law firm was linked to the amount of work he helped bring in from Tyco. Another director recently received a $10 million payment for help in engineering an acquisition. Most of the "independents" on the board are partially paid in the form of stock options, thereby tying their interests to the value of the company's stock.

The next high-level Tyco executive to go may be the company's chief financial officer, Mark Swartz, who had close ties to Kozlowski and was a key force in engineering the company's acquisitions. Swartz reaped over $170 million in salary and stock options over the past three years.

Also implicated is Tyco's auditor, Pricewaterhouse Coopers, which signed off on all of the shady accounting practices. In addition to auditing the company, PwC received millions of dollars for work on computer systems, tax services and other work unrelated to the financial statement audit, presenting conflict of interest problems.

Tyco's criminal business practices are rooted in the nature of the company. Its economic activity was not so much production, as acquisition. In the process of rising from a medium-sized engineering company to a giant conglomerate, Tyco, under the leadership of Kozlowski, absorbed hundreds of companies. Today, the company makes everything from hospital supplies to underwater optical cable and security systems. Kozlowski came to be known as "Deal-a-month Dennis."

The company's modus operandi was a modern-day version of slash and burn: acquiring companies and cutting costs by downsizing, in order to inflate short-term revenue. Last year it made plans to lay off more than 13,000 people and shut down over 240 facilities.

Tyco is not so much a company in the traditional sense of the word, producing a specific commodity or service and making profit on that basis. While Kozlowski dreamt of transforming Tyco into another General

Electric, the company resembled more the corporate raiders that first proliferated during the 1980s, using leveraged buyouts to make money through the looting of existing corporations and the workers employed by them.

While the raiders of the 1980s funded their acquisitions through the sale of highly speculative junk bonds (the king of the junk bond market was Milken), Tyco financed its deals primarily through the stock market. Debts from acquisitions could be financed by stock, the price of which would go up following the deal, allowing for further acquisitions. This worked quite well for much of the late 1990s and the early years of this decade, with Tyco stock achieving a 20 percent annual growth rate, making the company a darling of Wall Street. In the process, however, the company accumulated $27 billion worth of debt.

The objective source of this practice lies in the crisis of the normal process of profit accumulation. Beginning particularly in the 1970s, the rate of profit dropped markedly. Under constant pressure by big investors—banks, hedge funds and the like—to produce high rates of return, companies resorted to the looting of existing social and corporate assets, as well as financial manipulation and speculation.

Because the continuation of Tyco's business depended above all else on the value of its stock, everything was done to keep it high, including accounting fraud. Illicit practices included "spring-loading" as well as the accumulation of a massive amount of so-called "goodwill." Goodwill is used to cover the difference between the actual value of an acquired asset and the amount paid for it. It is supposed to represent the potential value that the acquisition will create in the course of the further development of the company.

The process worked something like this: Tyco paid high prices for acquired companies, and rather than writing this cost off as an expense, which would have to be reported to shareholders as a reduction in earnings, the company created a massive amount of goodwill (about $35 billion) on its balance sheet. Since the middle of 2000, Tyco accumulated over $20 billion of goodwill on companies that it acquired for $24 billion. That is, the actual hard assets of these companies were less than $4 billion.

AOL used similar accounting practices to cover its acquisition of Time Warner, and was subsequently forced to write off $54 billion of goodwill, the largest write-off in corporate history.

Tyco could not indefinitely conceal the fact that it was not actually making real profits. The collapse of the stock market over the past two years has undermined the basis of its operations.

The company issued a series of profit warnings early in the year. In the aftermath of the Enron collapse, big investors became more suspicious of "aggressive accounting," and Tyco was one of the first targets.

Investors were also concerned about what was seen as a blundering management, after a series of reversals linked to a possible breakup of the company. From its peak in January 2001 of $62.80, the stock is now hovering around $13, down about 80 percent on the year. Its shareholders have lost over $80 billion.

Tyco lived by the stock bubble and now it is dying by it. Twelve billion dollars of its debt is due in 2003, about $6 billion in February. With a collapsed stock, it has no way of financing this debt other than through the sale of its corporate assets.

With its bond rating downgraded to junk or near-junk grade by the major rating agencies, the company is no longer able to tap the commercial paper market and other sources of cheap credit. Thus it is planning on carrying through an initial public offering of its financial services arm, CIT Group, in the hope of earning enough cash to stay solvent.

It remains to be seen whether the sale will be successful. According to Rob Plaza, an investment analyst at Morningstar Inc., if the CIT sale goes badly, "There is a very real risk of a Chapter 11 [bankruptcy] filing."

Given the parasitic nature of Tyco's economic operations, it is not surprising that the leaders of the company should manifest the traits of social parasitism themselves. Certainly, Kozlowski fit this bill until his resignation earlier in the month.

Kozlowski was born in the rundown industrial city of Newark, New Jersey, the son of a police investigator. He worked his way through Seton Hall University and trained as an accountant, before finding his way to Tyco. At that time the company had sales measured in tens of millions, a modest figure compared to what was to come.

Kozlowski became the personification of the acquisition mania of the 1990s, and assumed the qualities necessary for the task—brutishness, aggressiveness, and a commitment to the accumulation of his own personal wealth, above all else. He was one of the best-paid CEO's of the decade.

For this he was hailed by the business establishment as a whole. In January, *BusinessWeek* named Kozlowski one of the 25 outstanding managers of the year. He was featured on the cover of the magazine in 2001, lauded for being the "most aggressive CEO" and for his "willingness to test the limits of acceptable accounting and tax strategies."

Kozlowski made a fortune for himself during the stock market boom of the 1990s, selling Tyco stock and devising handsome remuneration packages for himself. He received more than $40 million in 2001, and earlier this year was awarded an enormous compensation deal, even as the stock of the company fell. During the past four years, Kozlowski brought home over $450 million in salary, share options and bonuses. This fueled his collection of racing yachts, private helicopters, motorcycles and, of course, art.

Given this enormous wealth, the fact that Kozlowski would conspire to avoid paying a million or so in sales taxes is an indication of his social outlook. This is a man who built himself and his company on the basis of greed and fraud.

Even with his departure, Kozlowski is expected to benefit with a severance deal worth millions. The package that Tyco agreed with the CEO in 2001 included a $3.4 million annual pension, in addition to a $135 million lump-sum payment. The final agreement is expected to be somewhat less than this original deal, since Kozlowski resigned rather than being fired. A "golden parachute" for departing CEOs is a common occurrence, even for executives who have left after destroying their companies.

Tyco is not an isolated corporation, but, like Enron, has a web of ties to other firms. A recent article in the *Wall Street Journal* —which had the somewhat worried title, "Tyco's Meltdown is Kryptonite for Wall Street's Superstars"—described how many of Wall Street's big investors, including some of the biggest hedge funds, have been badly hurt by Tyco's collapsing share prices.

Moreover, other corporations face similar crises with similar causes, including WorldCom, a company that was also based largely on acquisitions. Acquisition-frenzy was at its peak in 2000, when the value of deals reached $1.8 trillion, more than triple the level of the mid-1990s. The collapse of some of the biggest companies that engaged in this practice will have a cascading effect through the economy as a whole.