

Crisis at Sunrise Medical: **Impact, Causes, Lessons**

Richard H. Chandler

Adjunct Professor, University of California, Irvine
Founder and Former CEO, Sunrise Medical Inc.

October 23, 2008

The Markkula Center for Applied Ethics
Santa Clara University

In October 1995, Sunrise Medical was on a 7 year roll.

- **First Quarter Results (9/30/95):** 26th straight record in sales, earnings, EPS
- **Market Leader:** Custom wheelchairs, ambulatory aids, nursing home furniture, pressure sore mattress overlays, respiratory products
- **Global Footprint:** Products sold in 80 countries, 40% outside the US.
 - 22 manufacturing plants worldwide, 14 foreign distribution subsidiaries
- **Sales Growth:** \$172M in 1990 to \$604M in 1995 (Y/E 6/30) **CAGR: 29%**
- **Net Income Growth:** \$5.3M to \$30.7M. **CAGR: 42%**
- **EPS Growth:** \$0.53 to \$1.63 **CAGR: 25%**
- **Stock Price:** at all-time high: **\$36.75 (12X gain in 7 years)**
- **Recognition:** CBS, PBS, CNN, Barron's, Forbes, Harvard, *Quantum Companies, Companies with a Conscience, America's Fastest Growing Companies.*
- **Company Culture:** Known for socially responsible, ethical leadership.

A Sunrise Tsunami: Bio Clinic Division Financial Reporting Fraud

A Week in October, 1995:

Fri, 10/20 Two Bio Clinic Division accounting managers confessed to financial reporting irregularities. (Est: \$1-2 million earnings overstatement.)

Sat, 10/21 Co. retained outside attorneys, forensic auditors, and security consultant to conduct internal investigation. (CEO in route to Europe.)

Mon, 10/23 Division controller gave full confession to financial reporting fraud. (Estimated magnitude now: \$8-9 million.)

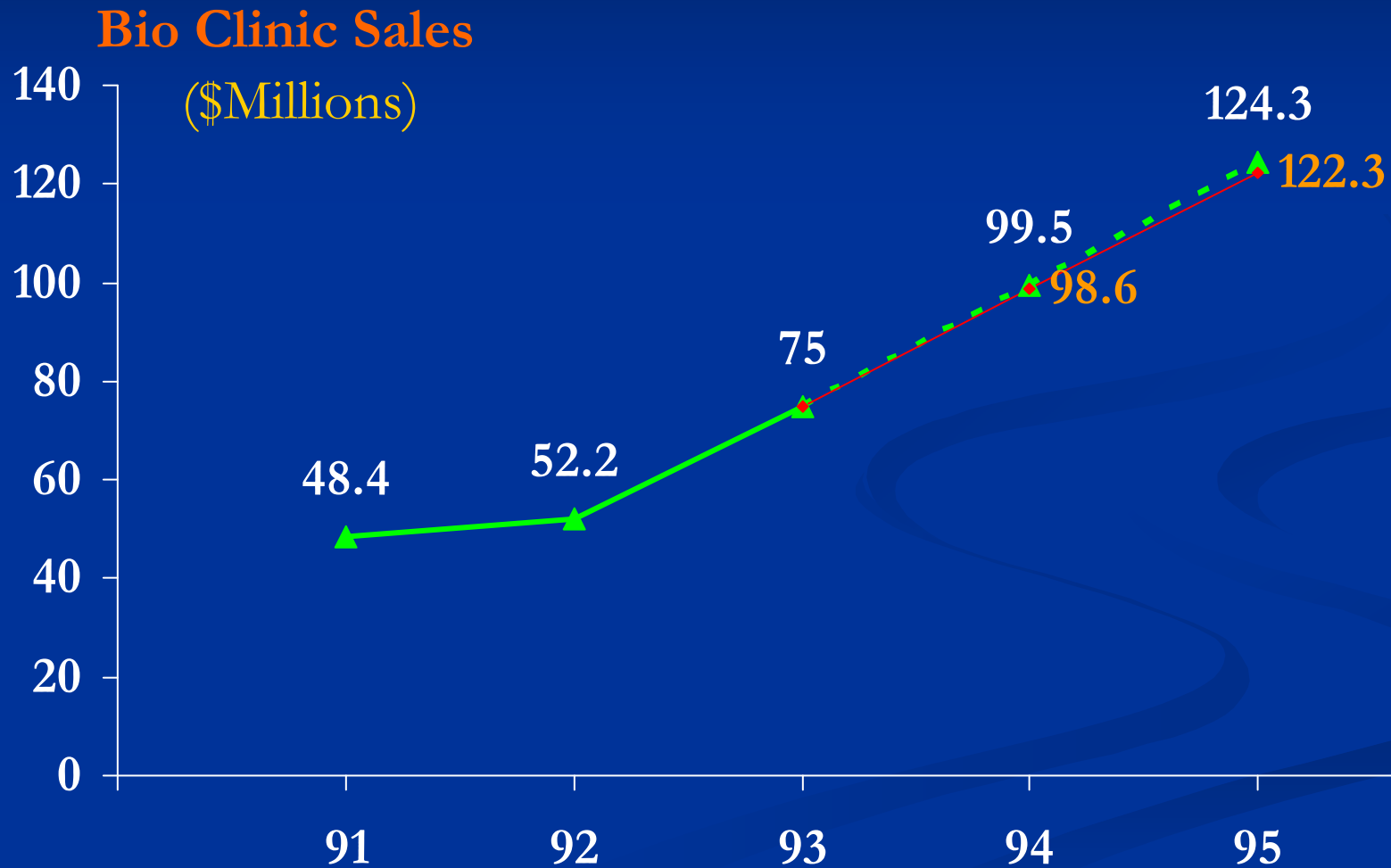
Tue, 10/24 Board formed Special Committee, retained outside counsel.

Wed, 10/25 Six Sunrise managers suspended, including Corp COO and Sr VP

Thur, 10/26 Press release, conference call, SEC and NYSE notification of financial restatement. Stock opens at \$14 vs \$24 Wed pm (- 42%)

Fri, 10/27 Ten shareholder lawsuits and derivative actions filed against Sunrise in various jurisdictions. Lerach firm appointed lead.

Bio Clinic subsidiary was our fastest growing division over past five years



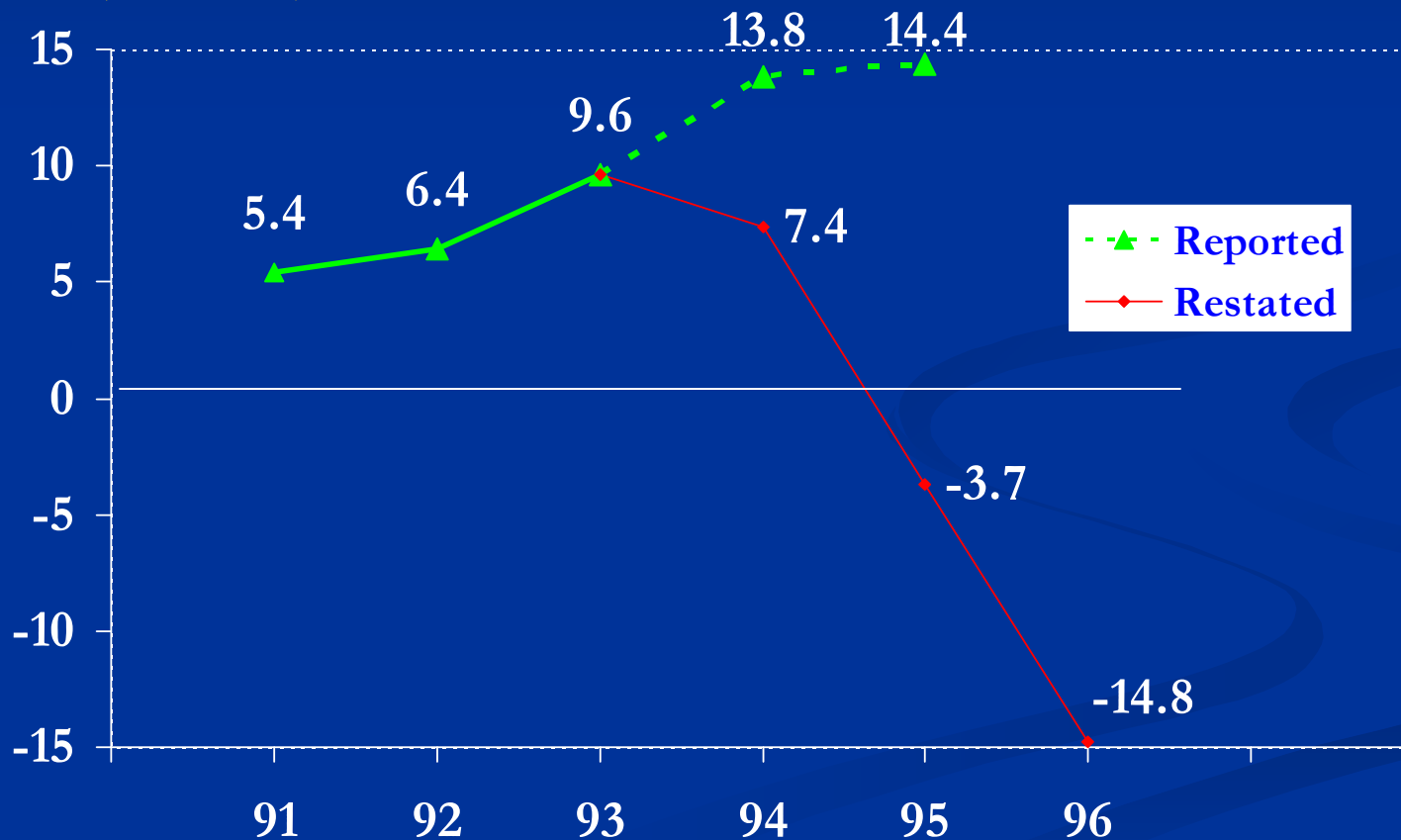
Bio Clinic's operating margin, as reported to Sunrise Corporate, appeared reasonably stable

Bio Clinic
Operating margin

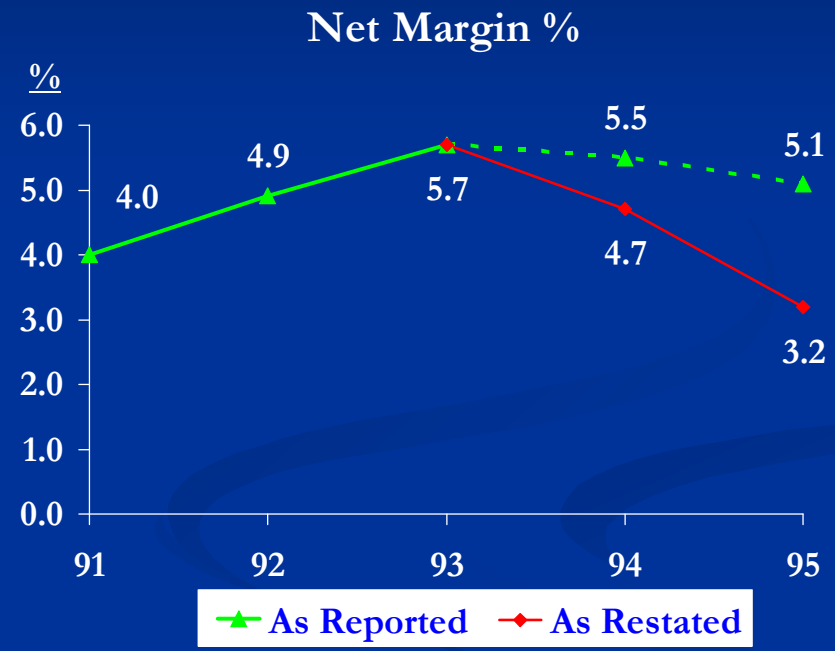
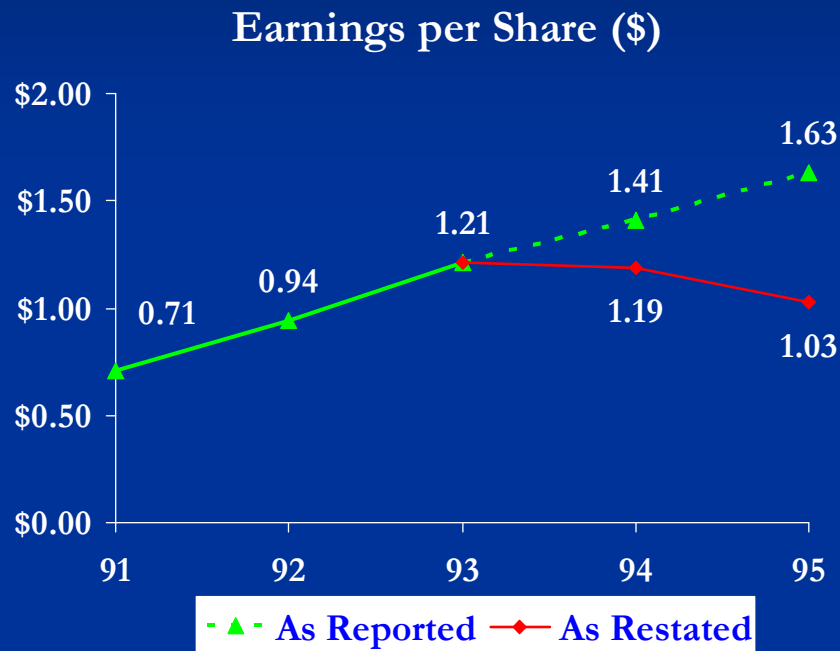


In reality, Bio Clinic profits declined significantly in 94 and plunged into losses in 95 and 96

Bio Clinic Operating profit
(\$Millions)



New Sunrise reality: EPS and net margin peaked in fiscal 1993

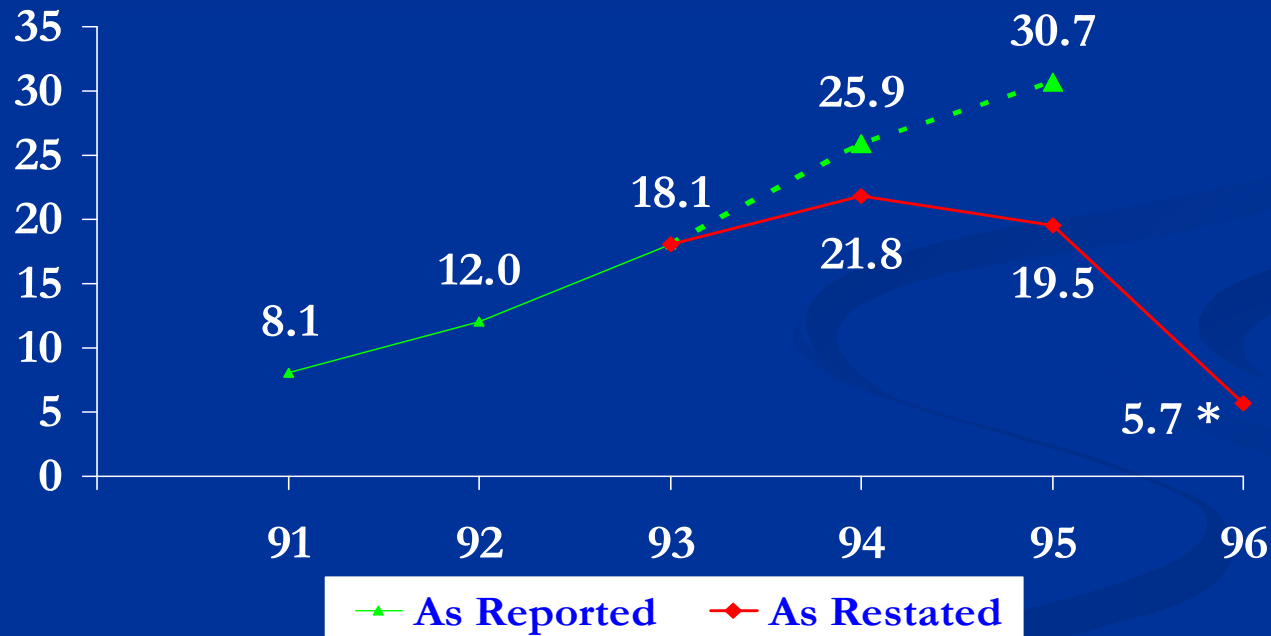


Fraudulent reporting delayed management response by 2-3 years.

Bio Clinic caused Sunrise re-stated net income to decline dramatically after 1994.

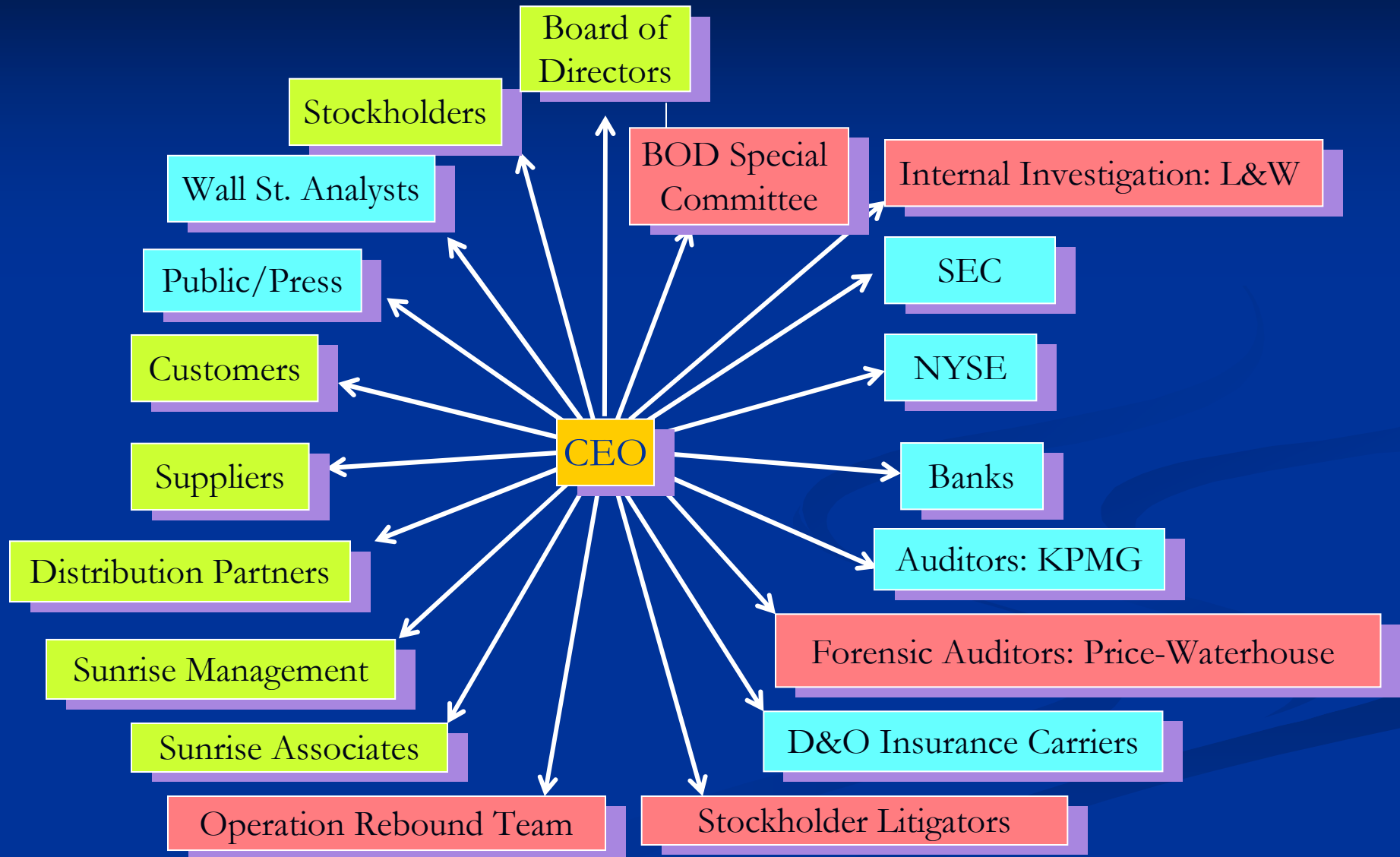
- Bio Clinic lost \$6 million in Q1 of FY96, once accounting corrected
 - \$24 million annual loss rate required dramatic management action

Sunrise Medical
Net Income (\$ millions)



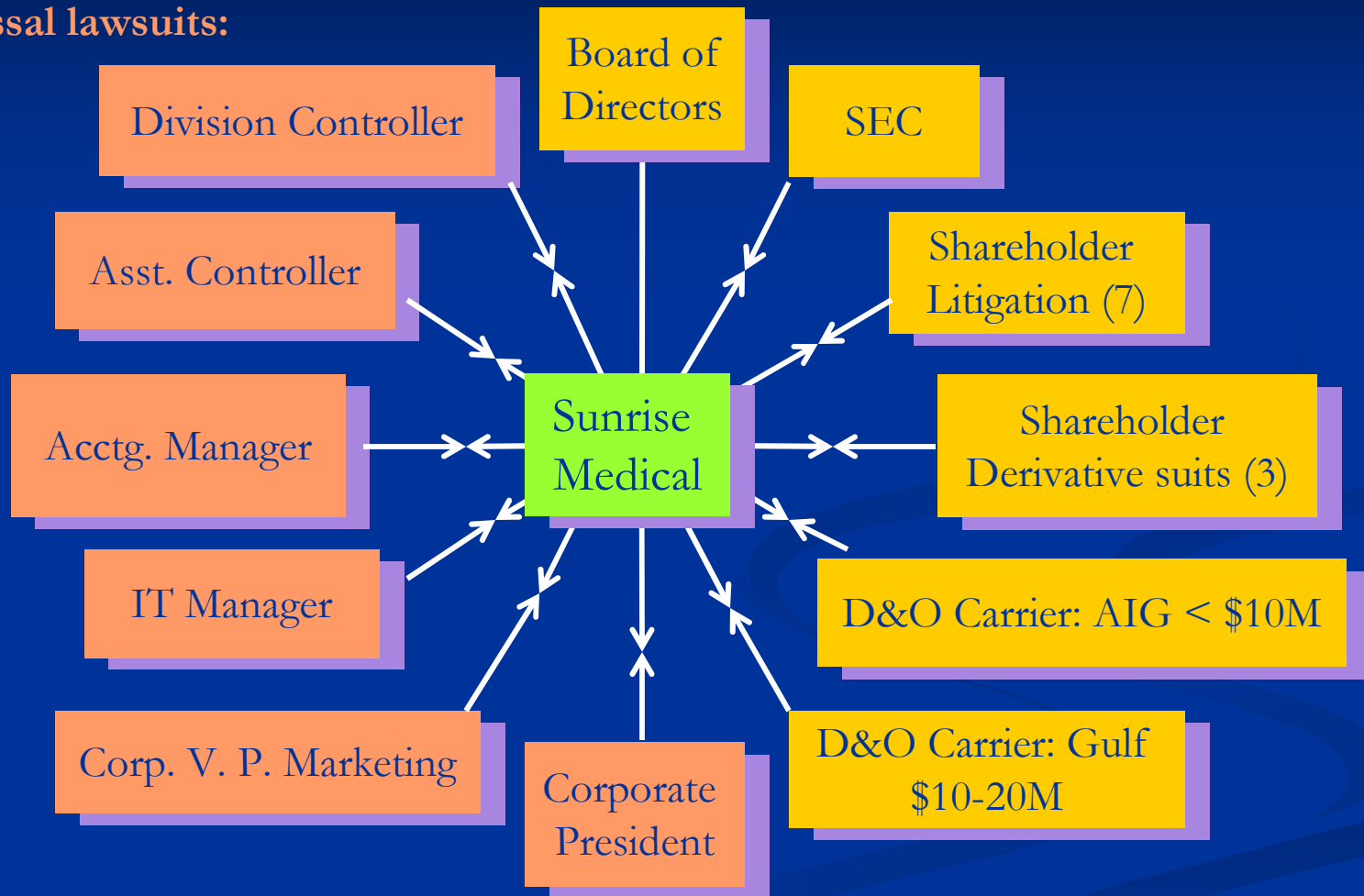
* In addition, there was special charge of \$65 million to cover fraud!

Constituencies: In a crisis, CEO must satisfy many new parties, plus others with much intensified interest.

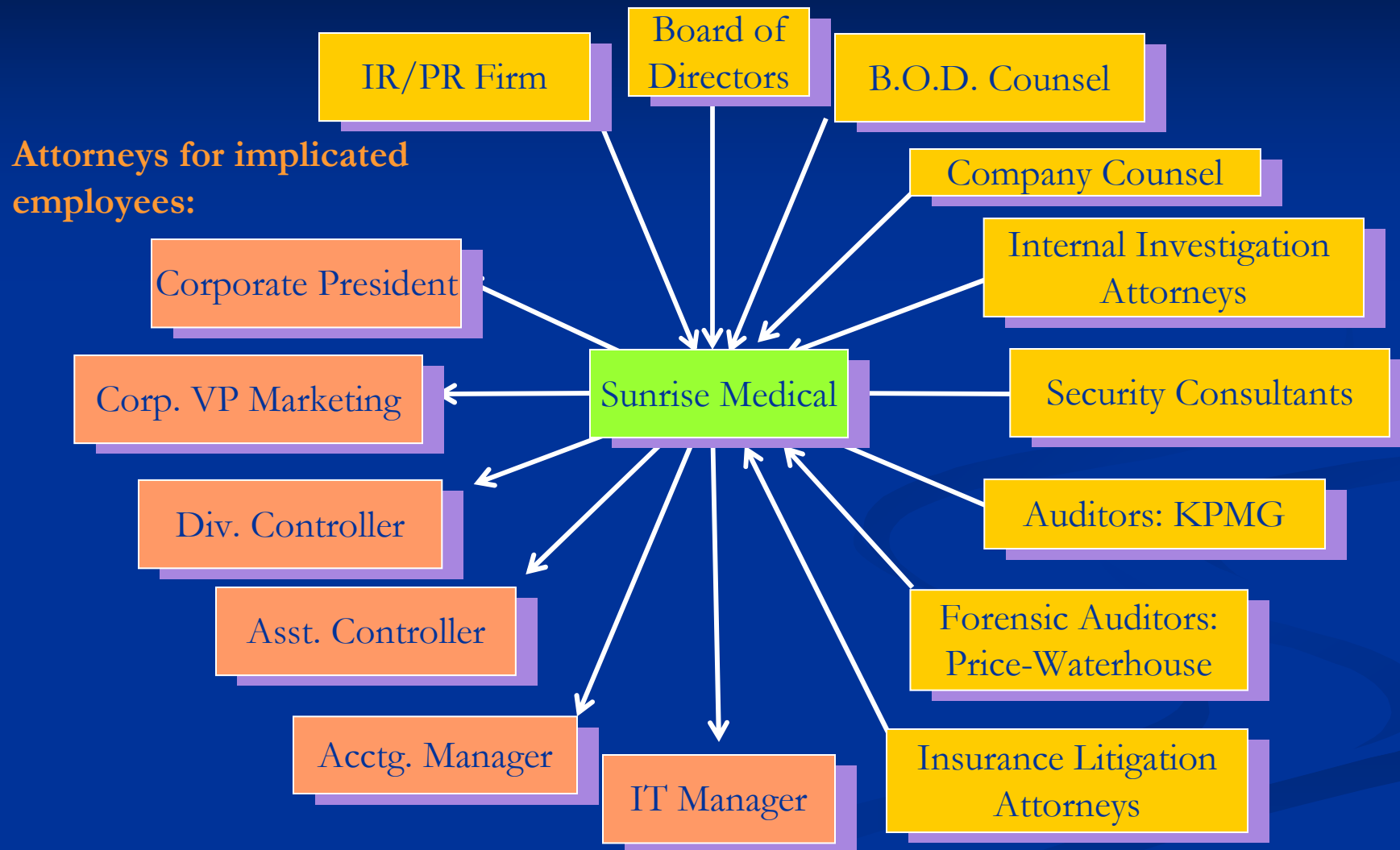


Threats: Company caught in web of litigation actions

Potential wrongful dismissal lawsuits:



Advice Givers: Sunrise must retain and pay for expanded network of professional advisors



When It Rains Rule: Sunrise was also hit with other major distractions at time of crisis.

- Oct. 95** **Acquisitions:** Sunrise acquires Parker Bath in U.K. for \$30 million week before crisis hit. Third major acquisition in 1995 (\$80 MM).
- Oct. 95** **Healthcare Reform:** Apria, industry's biggest customer, introduces competitive bidding formulary. Sunrise upscale products lose out.
--Triggers industry-wide 15% price decline
- Nov. 95** FDA issues **Warning Letter** to Quickie-Fresno wheelchair factory regarding its internal manufacturing practices.
- Dec. 95** **Competitor Harassment:** Invacare files lawsuit against Sunrise claiming false advertising on power wheelchairs.
- Jan. 96** **Inventory Theft:** Sunrise Canada warehouse manager implicated in stealing wheelchairs and selling to Saudi Arabia.

Result: By August 1996, we had put the entire Bio Clinic incident largely behind us.

Nov. 2, 1995 Formed **Operation Rebound Task Force** with 65 people to untangle accounting mess. Made senior management changes to fill vacancies.

Dec. 31, 95 Implemented comprehensive **Profit Improvement Plan**: organizational restructuring; sales force consolidation; 6% headcount reduction.

Jan 4, 96 Results of internal investigation and revised historical earnings announced.

Feb. 1, 96 Bio Clinic air therapy rental business sold for \$6.5 million cash.

Feb. 23, 96 Amended 10Ks filed for 94 and 95, along with 96 Q1 and Q2 results.

May 7, 96 Court dismissed Invacare lawsuit.

June 5, 96 Shareholder litigation settled for \$20 million. Carriers paid \$17 million.

June 10, 96 Bio Clinic Division dissolved. Product lines merged into Joerns division.

Sept. 15, 96 Comfort Clinic consumer division sold for \$14 million cash.

Root Causes: What really happened and why?

- **Human Frailty:** Controller admitted he was “morally weak”
 - Out of 4000 Associates, some will always be corruptible. Where are they?
- **Intimidation:** Division president who had “made max bonus every year of his career.” Shoot the messenger mentality: missing forecast unacceptable.
- **Inadequate Internal Audit Function:** One person to cover 22 divisions
- **Failure of KPMG:** Superficial external audit; stupidity in audit plan.
 - Board Audit Chair beat them up on fees every year.
- **IT Reporting to Controller.** Auditors audit IT reports. For financial reporting fraud, IT complicity is required. Check & balance missing here.
- **Surface Validity Effect:** Once numbers are in print, consolidated and reviewed, their validity is *assumed*. Lack of management skepticism.
- **Cash Flow Tip-off Missed:** Accepted explanation for negative cash flow, increased assets, deteriorating asset mgt. ratios (DSO, ITO, ROI.)
- **Lack of Formal Ethics Program:** No specific training, Associate ethics handbook, anonymous reporting mechanism, whistle blower encouragement

Leadership & Ethics Lessons Learned:

- **Culture based on trust was inadequate**
 - Motivation and team building not enough as organization grew
 - There is no substitute for **controls**.
- **Individual character flaws showed up in earlier tell tale signs**
 - Excessive competitive intensity by division president (later COO)
 - Controller (via acquisition) with no credit cards, mysterious background
- **Divisional structure inherently more risky.** Decentralized financial reporting.
- **Cost of prevention miniscule vs. cost of system failure**
 - Expanded internal audit function (**\$400K**) vs. failure cost (**\$65 MM**)
- **Crisis caused me to lose control of company for 8 months**
 - **Result:** Poor communications with Board, bad decision making
- **Long Term Negative Impact:** Weathered crisis, but began downward spiral.
 - Board and shareholder fatigue led to my replacement in 1999, four years later.
 - Company taken private in 2000. Declining market share & earnings ever since.

A crisis is *moment of truth* for any leader.

As a CEO, it will define your presidency—and probably your career.

- Crisis soon develops life of its own and can quickly get out of control.
- The leader must manage the entire process. Some traits required:
 - Willingness to admit responsibility and quickly face new reality.
 - Mastery of technical and operational issues; seizing the helm.
 - Ability to inspire confidence
 - Constancy of purpose, built around basic statement of principles.
 - Creative problem solving.
 - Calm demeanor coupled with sense of humor. Remaining “presidential.”
- Symbolic actions very important: Presence at the scene, shirtsleeves image.
- Words also become very important.
 - Leader must distill meaning from complex events, shape perceptions.
 - Written statements will be dissected
- **The ultimate crisis managers:** Franklin Roosevelt & Winston Churchill

Conclusion: Adversity is always a test of character, both for organization and leader

- Any company or non-profit organization is a **fragile biological organism**.
 - Crisis is like traumatic injury or critical illness.
 - Hyper-stress can lead to irreversible mortal infection.
- Organizations under stress must demonstrate determination, teamwork, courage under fire
 - Past investments in corporate culture will pay off in motivation & loyalty.
 - Means traversing rough terrain with no road maps.
- Success not defined as **victory**, but **survival** with minimal damage and some positive changes.
- May become management team's finest hour, but don't expect credit.
- Goals of a crisis are basically defensive:
 - Survive and free up organization to pursue its primary mission again
 - If not stronger, at least leaner and wiser.

Addendum: Crisis Management Guidelines

War Cabinet: Assemble immediately a strong crisis management team to function as a War Cabinet.

- Divide and conquer. Distribute key tasks to trusted team members.
- Big decisions should involve open discussion & consensus building
- Micro-manage progress and decision making in key areas.
- Hold frequent ad hoc, topic-specific meetings.
- CEO must also be head cheerleader.
 - Liberal with recognition and rewards for milestones achieved.
- Find ways to make work still fun.

Divide and Conquer: Delegate and empower to handle flood of new tasks

CEO	Strategy issues, B.O.D., S.E.C., key customers, analysts, business partners, management team, public perceptions.
Sr. VP & CFO	Accounting restatement, banks, auditors, Wall Street, NYSE.
Sr. VP & General Counsel	Liaison with Special Committee, internal investigation, all litigants, attorneys
Dir., Corp. Commun.	Communications plan, general press, trade press, stockholders.
VP and Controller	Internal financial controls, corrective actions, cost reduction programs.
VP of Human Resources	Associate communications, mid-level perpetrators, reduction in force, corporate ethics program.
Director of Risk Mgmt.	D&O carriers, insurance litigation.
Chm., Comp. Comm.	Settlements with two corporate officers

Crisis Management Guidelines (cont'd)

Clear Ground Rules: Establish early the basic objectives and ground rules for your organization's response.

1. "Let's set speed record for re-filing corrected financials with SEC."
2. "Sunrise will be a model of corporate rectitude in handling crisis. We will always do the right thing."
3. "We'll use crisis to trigger bold actions that let us *rebound higher than we fell*. "Superball Model"
4. "We will use candor in all communications. No sugar coating."
5. "We will minimize negative energy & resolve all litigation promptly."
--Allowed us to shift to positive energy quickly.
6. "We will maintain all historical relationships if possible."
--Not the time for scape-goating, name calling, angry divorces.
7. "We will be resolute and tough where necessary, but not vindictive."
--Better for perpetrators to feel guilt rather than resentment
--Problems greatly magnified if they lie to investigators

Crisis Management Guidelines (cont'd)

Communication Policy: Communicate to all constituencies fully, promptly, and candidly.

- Give Wall Street basis for re-pricing the stock **correctly**.
 - Should not be too high or too low. Avoid aftershocks.
- Aim high in all communications.
 - Target the *intelligent investor/reader/Associate*.
- Use frequent press releases to give clear, factual updates to all constituencies at the same time
- **Key Rule: Link disclosure of any problem with action taken toward solution.**
 - **Goal:** Inspire confidence in the *company* and its *management*
- **In a crisis, perception is as important as reality.**
 - With external constituencies, **perception becomes the reality.**
 - **Main stakeholder question:** Is company in competent hands?

Crisis Management Guidelines (cont'd)

Catalyst for Action: Use crisis as catalyst for bold action

- Opportunity for profound change
 - Leader can shortcut time consuming, consensus-building processes.
 - If mistakes are made, fix them later.
- People want strong leadership in crisis, understand need for decisiveness.
- **Challenge for leader:** how to turn negative into long term positive
 - Superball metaphor: requires figuring out how to make it true.

Crisis Management Guidelines (cont'd)

Trusting Instincts: CEO must sometimes over-rule advice of experts.

Frequent tension arises between legal vs. human response:



Only leader can balance these issues properly.

- Lawyers give inadequate weight to “soft issues” that impact perceptions and confidence of your stakeholders.

Example: Product or service failure that causes injury to someone.

- **Legal advice:** Don't talk to victims, admit mistakes, or offer settlements.
Result: company appears defensive and uncaring, triggering anger and backlash.
- **Human response:** Admit mistakes, apologize, offer compensation.
However, financial and legal risks must always be carefully weighed.
- **Solution:** Leader must *trust his or her own instincts*.

Sunrise Medical's "success" in handling crisis indicated by these accomplishments

- Company and core (innocent) management team survived.
- Announced restated earnings in 10 weeks (January, 1996)
- Filed restated financials (2 yrs. & 2 qtrs.) with SEC in 15 weeks (Feb., 1996)
- Restructured company during crisis to address profit decline
- Settled D&O insurance litigation in 5 months. Secured new coverage.
- Settled stockholder litigation in 8 months (\$20 million)
- Terminated six affected executives without litigation
- Maintained stock price at \$14-15, as originally re-priced on Oct. 26, 1995.
- All company relationships maintained with board members, banks, auditors, D&O carriers, and attorneys.
- SEC did not find *company* guilty of fraud, but simply incorrect report filings.
- Company received awards for its handling of crisis, re: public disclosures, director performance, annual report re-issuance.