

**UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA**

UNITED STATES OF AMERICA,	)	
	)	
Plaintiff,	)	
	)	
v.	)	Civil Action
	)	No. 99-CV-02496 (GK)
PHILIP MORRIS USA INC.,	)	
f/k/a PHILIP MORRIS INC., et al.,	)	Next Scheduled Court Appearance:
	)	Trial (ongoing)
Defendants.	)	

WRITTEN DIRECT EXAMINATION

OF

MAX H. BAZERMAN, Ph.D.

SUBMITTED BY THE UNITED STATES PURSUANT TO ORDERS #471 AND #924

1 **I. SUMMARY OF CONCLUSIONS**

2 **Q: Please state your full name.**

3 A: Max Hal Bazerman.

4 **Q: What is your occupation Dr. Bazerman?**

5 A: I am a professor at Harvard University. I also consult with a number of for-profit
6 corporations and non-profit organizations.

7 **Q: You have been shown a copy of U.S. Ex. 89,457. Do you recognize this to be a
8 copy of your curriculum vitae as of December, 2004?**

9 A: Yes.

10 **Q: What were you asked to do by the United States as an expert in this case?**

11 A: The United States has asked me (a) to outline theory from the field of behavioral decision
12 research relevant to potential remedies in this case, (b) to discuss applications of this theory to
13 business contexts, and (c) to apply that theory to this case.

14 **Q: Based on this assignment, could you briefly describe the subject of your testimony?**

15 A: The United States has instructed me to assume that it has established defendants' liability
16 and that defendants' misconduct continues to this day. Making those assumptions, and applying
17 theory from behavioral decision research as it relates to issues of incentive and bias, I conclude
18 that defendants' misconduct will continue absent significant Court intervention to change the
19 incentives and systematic biases operating on defendants' managers and executives.

20 **Q: Why will misconduct likely continue absent Court intervention?**

21 A: Managers and executives at defendant companies will make decisions affected by the
22 incentives for sales and profits that dominate most firms. In addition, even if managers and
23 executives at defendant companies want to fulfill their stated objectives regarding a number of

1 other behaviors, such as not marketing their products in a fraudulent manner, as long as
2 incentives primarily reward profit and sales, managers and executives will be incapable of
3 making unbiased judgments, and these biases will operate in the systematic direction of their
4 incentives even for the most honest of managers and executives. As a result, managers and
5 executives within the defendant firms will act consistent with these incentives and biases. There
6 are various structural changes that would affect the incentives operating on the intentional and
7 unintentional behavior of the defendants' managers and executives. These should be
8 implemented as a comprehensive set of organizational changes. In addition, there are a variety of
9 additional Court interventions that will affect the incentives and systematic biases defendants'
10 managers and executives experience.

11 **Q: What structural changes do you recommend the Court consider?**

12 A: I recommend the Court consider structural changes for defendant companies that include:
13 (a) eliminating economic incentives for defendants to sell cigarettes to young people; (b)
14 changing compensation and promotion policies for managers and executives to produce
15 outcomes inconsistent with misconduct; (c) removing senior management; (d) requiring
16 subcontracting of all research to private companies monitored by the Court; and (e) requiring the
17 defendants to sell intact their research and development, current product development activities,
18 and all other relevant material regarding safer cigarettes so that safer cigarettes can be brought to
19 the marketplace.

20 **Q: Dr. Bazerman, are you recommending specific structural changes to defendants'**
21 **businesses?**

22 A: No, I recommend that the Court appoint monitors who will have the authority, with the
23 utilization of outside experts as needed, to review all aspects of defendants' businesses and make

1 particularized and specific recommendations for structural changes, or with a mandate from the
2 Court to implement structural changes, such as those that I have identified, that address the
3 incentives and biases that in my opinion will likely cause misconduct to continue.

4 **Q: What are other Court interventions that would affect the incentives and biases**
5 **defendants' managers experience?**

6 A: I would recommend the Court consider interventions that include: (a) educating managers
7 in such a way to address bias in decision making; (b) creating internal mechanisms for employees
8 to report misconduct without fear of retribution; (c) changing oversight and reporting
9 arrangements; (d) requiring the disclosure of any information concerning an actual or potential
10 health or safety risk with which a consumer of cigarettes would be concerned; (e) requiring the
11 discontinuance of or change to advertising and promotional campaigns or practices; (f) severe
12 monetary fines for participation in or association with individuals or organizations engaged in
13 activities that constitute or will reasonably result in corporate or individual misconduct; and (g)
14 requiring defendants to fund cessation programs and counter-marketing programs that affect
15 consumer demand for their products.

16 **Q: On what do you base your opinions?**

17 A: I base my opinions on the assumption that the United States has proven liability in this
18 case and that misconduct continues to this day, and on the application of theory from behavioral
19 decision research.

20 **Q: Broadly speaking, what is the field of behavioral decision research?**

21 A: Behavioral decision research is a scientific field of inquiry that identifies systematic ways
22 in which judgment deviates from rationality. It does not simply note that humans make mistakes.
23 Rather, behavioral decision research pinpoints the systematic and predictable ways in which

humans act inconsistently with the common assumption of rational behavior. The errors are not limited to particular groups of individuals or less intelligent individuals. Rather, behavioral decision researchers identify errors that virtually all humans make. This area of scientific inquiry dates back to Herbert Simon's work for which he won the Nobel Prize in Economics in 1978. The importance of behavioral decision research as a rigorous area of scientific inquiry was further recognized by the recent Nobel Prize in Economics to Daniel Kahneman in 2002.

Q: In what academic settings is behavioral decision research undertaken?

A: Behavioral decision research is a well-established field, with economics, finance, psychology, and professional school faculty currently engaged in this area of research. Variations of behavioral decision research have developed as behavioral economics, behavioral finance, decision research in marketing, legal decision making, a decision perspective to negotiations, medical decision making, and other fields of study.

Q: Within the broader field, what is your particular area of expertise?

A: My specific expertise is in the area of behavioral decision research in managerial/organizational contexts. Specifically, I extensively study misconduct and unethical behavior in managerial/organizational contexts.

II. BACKGROUND AND EXPERTISE

A. Education

Q: Please describe your education.

A: I received my undergraduate degree at the Wharton School of Business at the University of Pennsylvania and a masters degree and Ph.D. in organizational behavior at the Graduate School of Industrial Administration at Carnegie-Mellon University in Pittsburgh, Pennsylvania.

Q: Broadly speaking, what is the field of organizational behavior?

1 A: Organizational Behavior is the study of behavior of individuals in organizations and the
2 study of the behavior of organizations as entities. Organizational Behavior rests heavily on
3 insights from psychology and sociology, but focuses on the relevance of these insights in
4 organizational contexts.

5 **Q: You testified that you are an expert in the field of behavioral decision research and**
6 **your Ph.D. is in organizational behavior. What is the relationship between behavioral**
7 **decision research and organizational behavior?**

8 A: As I mentioned, organizational behavior includes the study of psychological behavior in
9 organizations. I played a central role in making behavioral decision research part of
10 organizational behavior (as it is a part of many other fields as well). More specifically, I am
11 credited with being one of the first individuals to connect behavioral decision research to the
12 managerial context. Today, behavioral decision research is represented in all leading
13 management schools.

14 **Q: Dr. Bazerman, as part of your academic studies were you trained in scientific**
15 **research methodologies?**

16 A: Yes. My training included rigorous study of multiple methodologies, including the
17 analysis of archival data, survey research, and experimental studies, among other methods. In
18 addition, I studied econometrics and psychometrics.

19 **Q: What is the primary research method used by behavioral decision researchers?**

20 A: The core, but not only, method of behavioral decision research has been the use of tightly
21 controlled, laboratory experiments.

22 **Q: When you say laboratory experiments, what do you mean?**

23 A: Laboratory experiments create a simulated environment where many people make

1 decisions in an identical environment, but one or more variables are systematically manipulated
2 across subjects. So in an experiment that manipulates just one variable, half of the decision-
3 makers experience one condition and half experience another condition. Since everything else is
4 held constant, any statistically significant difference in decisions between people who experience
5 version A vs. version B (where A and B manipulate one variable) can be causally linked to the
6 manipulation.

7 **Q: Can you give an example of one such line of experimentation relevant to this**
8 **lawsuit?**

9 A: Babcock and Loewenstein summarize a number of studies that show self-serving biases.
10 In one study, participants were provided with diverse materials, such as depositions, police
11 reports, and doctors' reports, concerning a lawsuit that resulted from a collision between an
12 automobile and a motorcycle. Participants were assigned the role of either plaintiff or defendant
13 and were instructed to negotiate a settlement in a simulated negotiation. They were told that if
14 they were unable to reach an agreement, they would pay substantial penalties and that an
15 impartial judge who had earlier read the same case materials and reached a judgment would
16 determine the amount paid by the plaintiff to the defendant. After reading the exact same
17 materials, but before they negotiated, participants were asked to predict the amount of the judge's
18 award. Participants were informed that their estimates would not be disclosed to the other party
19 and would not affect the judge's decision. Once in this role, plaintiffs' predictions of the judge's
20 award amount were substantially higher than those of defendants. Babcock and Loewenstein
21 concluded that the study participants were not aware, and not able to control, their bias to see the
22 world as they wanted to see it. Only one factor was then manipulated – whether the study
23 participant was in the plaintiff or defendant role – and Babcock and Loewenstein found that this

1 variable leads to a roughly two-to-one difference in the assessment that parties make about the
2 worth of the case.

3 **Q: How has the use of laboratory experiments affected behavioral decision researchers'**
4 **ability to reach scientific conclusions?**

5 A: This methodology has dominated the field both to identify how certain variables affect
6 decision making and to allow irrefutable causal inferences.

7 **Q: How are the results of these experiments reported to the scientific community?**

8 A: The vast majority of the published empirical research in behavioral decision research has
9 appeared in peer-reviewed journals.

10 **Q: Can the results of experiments, such as the one you described, be extrapolated to**
11 **managerial contexts?**

12 A: Yes, hundreds of experiments such as these have been successfully generalized to
13 business contexts. None of the central results from behavioral decision research have been
14 overturned as researchers have generalized from the laboratory to the executive populations and
15 real world simulations. In my own experience in teaching executives and in consulting,
16 executives find the concepts useful and relevant in their organizations.

17 **B. Employment**

18 **Q: You testified you are a professor at Harvard University. In what schools or**
19 **departments are you a professor?**

20 A: I am the Jesse Isador Straus Professor of Business Administration at the Harvard Business
21 School. I have an appointment to the John F. Kennedy School of Government. I also have an
22 appointment in the Department of Psychology in the Faculty of Arts and Sciences at Harvard.
23 Finally, I am Vice Chair for Research and the Head of the Psychological Processes and

1 Negotiation Group of the Program on Negotiation at the Harvard Law School.

2 **Q: What subjects do you teach at the Harvard Business School?**

3 A: I currently teach a doctoral seminar entitled "Behavioral Aspects of Decision Making and
4 Negotiations." Twice a year, I coordinate and teach in a course entitled "Changing the Game,"
5 which is a decision making and negotiation class that 60-80 executives take at a time. I also
6 teach in a variety of other executive programs on decision making and negotiations, and these
7 programs include the Advanced Management Program, the highest level long program for senior
8 executives. In addition, I also teach senior executives in the Behavioral Finance program offered
9 by the Kennedy School of Government at Harvard, and in negotiations programs for Senior
10 Executives at the Program on Negotiations at the Harvard Law School.

11 **Q: You testified that you have an appointment at the John F. Kennedy School of**
12 **Government. What are your responsibilities?**

13 A: I am a voting faculty member of the Kennedy School of Government. I have the option
14 of voting on all promotion decisions in the Kennedy School of Government, and the School calls
15 on me to play a central role on promotion decisions regarding organizational behavior and
16 negotiations faculty members.

17 **Q: You also testified you have an appointment in the Department of Psychology. What**
18 **are your responsibilities as a member of the Department of Psychology?**

19 A: My doctoral seminar is cross-listed with the Psychology Department. I also serve on
20 dissertation committees of doctoral students in Psychology.

21 **Q: Dr. Bazerman, have you ever been invited to lecture at conferences and at other**
22 **universities?**

23 A: Yes. I have been the keynote speaker at a number of professional meetings (including

1 Behavioral Decision Research in Management, American Psychological Society, IAREP/SABE,
2 Morris Colloquium, Philosophy Department, University of Colorado, and the Subjective
3 Probability, Utility and Decision Making meeting (European Decision Research community). I
4 have also been ask to present my research on decision making at universities including Stanford,
5 University of Chicago, Berkeley, Carnegie-Mellon, Harvard, Cornell, Wharton, Northwestern,
6 MIT, Ben Gurion University, Notre Dame, Rice, Minnesota, Yale, UCLA, Ohio State, Princeton,
7 London Business School, University of Tilburg, Dartmouth, Colorado, Virginia, MIT, Boston
8 College, NYU, Columbia, Duke, Tulane, Pittsburgh, and Toronto. Recently, the decision
9 processes seminar series at Wharton asked me to be their distinguished speaker for the year.
10 Similarly, the Katz School of Business at the University of Pittsburgh asked me to be their annual
11 speaker for their Distinguished Lecture Series in 2003.

12 **Q: Have you served on the faculties of universities other than Harvard?**

13 A: Yes, I have been on the faculties of the University of Texas at Austin, Boston University,
14 the Sloan School of Management at the Massachusetts Institute of Technology (MIT), and at the
15 Kellogg School of Management at Northwestern University.

16 **Q: Have you received funding for research projects from entities other than the**
17 **universities where you have been a faculty member?**

18 A: Yes. I have been regularly funded by leading peer-reviewed scientific organizations,
19 including the National Science Foundation. I have received no research funds from private
20 corporations or associations.

21 **C. Publications**

22 **Q: Dr. Bazerman, have you published articles on behavioral decision research?**

23 A: Yes. I have published numerous articles on how people make decisions. More

specifically, my articles focus on the systematic mistakes they make during this decision making process. I have also published articles on negotiations, consumer behavior, arbitrator decision making, ethical decision making, and other related topics.

Q: Approximately how many articles have you published?

A: I have published over 150 articles and chapters. Over 80 of my papers have appeared in peer-reviewed journals.

Q: In what kinds of publications has your work appeared?

A: I publish in the leading peer-reviewed economic journals including *American Economic Review*, *Econometrica*, *Quarterly Journal of Economics*, *Games and Economic Behavior*, and *Journal of Economic Behavior and Organizations*, and the leading peer-reviewed psychology journals including *Journal of Personality and Social Psychology*, *American Psychologist*, *Psychological Bulletin*, *Journal of Applied Psychology*, and *Current Directions in Psychological Science*. I also publish in the leading peer-reviewed journals in accounting, marketing, organizational behavior, and behavioral decision research.

Q: Do you serve on the editorial boards of any academic journals?

A: Yes. I serve on the editorial boards of the *American Behavioral Scientist*, *Journal of Applied Psychology*, the *Academy of Management Review*, the *Journal of Behavioral Decision Making*, *Organizational Behavioral and Human Decision Processes*, *Mind and Society*, and the *Journal of Psychology and Financial Markets*. I am also a member of the international advisory board of the *Negotiation Journal*.

Q: Have you written any books?

A: Yes. I have written or co-written six books, and I have edited or co-edited nine others.

Q: Have you written books on decision making?

1 A: Yes. All of my authored and co-authored books deal with decision making. One
2 example is Judgment in Managerial Decision Making, which is a text on behavioral decision
3 research in managerial contexts. This book has been adopted for use in economics and
4 psychology classrooms at leading universities.

5 **Q: You testified that you have edited books, what were the subject areas of these**
6 **books?**

7 A: I have edited books that deal with conflict of interest, decision making, and ethics. This
8 year, I published a three-volume collection of papers, Negotiation, Decision Making, and
9 Conflict Resolution, as well as another edited book with Don Moore, Daylian Cain, and George
10 Loewenstein, Conflicts of Interest. Earlier, I also published an edited volume, with David
11 Messick, Ann Tenbrunsel, and Kimberly Wade-Benzoni, Environment, Ethics, and Behavior.

12 **D. Consulting**

13 **Q: Dr. Bazerman, do you consult for organizations outside of Harvard?**

14 A: Yes, I do. Over approximately the last 20 years, I have spent between 15-35 days a year
15 consulting for corporations, international financial institutions, professional associations, not-
16 for-profit organizations, and municipalities.

17 **Q: What is the subject of your consulting work for these corporations and not-for-**
18 **profit organizations?**

19 A: I teach customized decision making and negotiation programs. More specifically, I teach
20 executives to think more clearly in competitive business environments. Much of my teaching
21 focuses on negotiation, and uses a decision making perspective throughout. I also teach courses
22 that deal with ethical aspects of decision making, including issues related to unintentional
23 unethical behavior, or what my colleagues and I call "ordinary unethical behavior."

1 **Q: In what industries have you been a consultant?**

2 A: I have consulted in many industries, including accounting, automaking, banking,
3 biotechnology, construction, consumer products, energy, financial services, hospitality,
4 insurance, management consulting, media, metals, pharmaceuticals, retail, and
5 telecommunications.

6 **Q: What companies have employed your services?**

7 A: I have consulted and taught for numerous corporations, institutions, and professional
8 associations, including Abbott, Aetna, Alcar, Alcoa, Allstate, Ameritech, Amgen, AstraZeneca,
9 AT&T, Aventis, BASF, Bayer, Becton Dickenson, Boston Scientific, Bristol-Myers Squibb,
10 British Petroleum, Business Week, Celtic Insurance, Chevron, Chicago Tribune, Deloitte and
11 Touche, Dial, Ernst and Young, First Chicago, Gemini Consulting, General Motors, Harris Bank,
12 Home Depot, Hyatt Hotels, IBM, John Hancock, Johnson and Johnson, Kohler, KPMG, Lehman
13 Brothers, Lucent, The May Company, McKinsey, Merrill Lynch, Monitor, Motorola,
14 PriceWaterhouseCoopers, R. P. Scherer, Sara Lee, Siemens, Sprint, Sulzermedica, Unicredito,
15 Union Bank of Switzerland, Wilson Sporting Goods, Xerox, and Zurich Insurance.

16 **Q: Have you ever done any consulting work in the tobacco industry?**

17 A: No.

18 **Q: What organizations do you consult for other than for-profit corporations?**

19 A: The Asian Development Bank, the World Bank, City of Chicago, National Association of
20 Broadcasters, The Nature Conservancy, and the Young Presidents Organization.

21 **Q: Have you ever done any consulting work for a tobacco control organization?**

22 A: No.

23 **E. Awards and Honors**

1 **Q: Have you received any professional awards?**

2 A: Yes. I have been elected as a fellow of the American Psychological Association (1987-
3 1993), the American Psychological Society (1988-present), the Center for Advanced Study in the
4 Behavioral Sciences (1989-1990), and the Academy of Management (2001).

5 **Q: What is the Academy of Management?**

6 A: The Academy of Management is a prominent association of professors teaching in
7 management schools. Fellows of this association are those people who have made significant
8 contributions to the scholarly understanding of management research and practice.

9 **Q: How many of these fellows are there?**

10 A: I believe that there are only slightly more than 100 Fellows of the Academy of
11 Management.

12 **Q: Any other awards or honors you wish to discuss?**

13 A: Yes. I have been recognized by multiple research design award committees, including
14 receiving the Ghiselli Award for Research Design from the American Psychological Association.

15 **F. Expert Witness Work**

16 **Q: Dr. Bazerman, have you ever served as an expert witness before your work in this**
17 **case?**

18 A: Yes, I have. In 1982, I served as an expert for a group of employees in their lawsuit
19 against the Polaroid Corporation. In 2002, I served as an expert for the Federal Trade
20 Commission in its case against Schering-Plough Corporation, Upsher-Smith Laboratories, and
21 American Home Products.

22 **Q: Have you ever worked in any capacity on a case involving a tobacco company?**

23 A: No.

1 **III. ASSUMPTIONS**

2 **A. United States Has Proven Liability**

3 **Q: Dr. Bazerman, you mentioned earlier that the United States has asked you to**
4 **assume it has proven liability. What are you assuming?**

5 A: I am assuming the United States has proven a scheme to defraud, including one or more
6 of the seven categories of fraud it has alleged.

7 **Q: I am showing you a demonstrative exhibit that has been marked U.S. Ex. 17,235.**
8 **Are these the seven categories of fraud of which you were speaking?**

9 A: Yes.

10 **Q: What are the categories of fraud upon which your assumptions are based?**

11 A: They are: (1) adverse health effects; (2) the myth of independent research; (3) addiction;
12 (4) nicotine manipulation; (5) design and marketing of light/low tar cigarettes; (6) youth
13 marketing; and (7) suppression.

14 **Q: In your own words, what are you assuming the United States has proven with**
15 **respect to the adverse health effects category of fraud?**

16 A: Defendants deny or misrepresent information on the health effects of cigarettes. So while
17 the public health community has found cigarette smoking to cause a large number of different
18 diseases in people who smoke, the cigarette company defendants to various degrees limit and
19 make misrepresentations in what they expressly say about the various results that the public
20 health community has proven to be true. I am also assuming that while the public health
21 community has concluded that environmental tobacco smoke causes disease, defendants continue
22 to deny this fact publicly even in the face of their own internal company documents, which show
23 it to be true. These misrepresentations on the part of defendants continue to this day.

1 **Q: Dr. Bazerman, what are you assuming the United States has proven with respect to**
2 **the myth of independent research category of fraud?**

3 A: Defendants promised the American public they would sponsor research into the health
4 effects of smoking. In contrast, they support biased research which has a goal of attacking
5 established public health research rather than advancing scientific and medical knowledge in the
6 area of smoking and health.

7 **Q: What are you assuming the United States has proven with respect to the addiction**
8 **category of fraud?**

9 A: While the public health community has established that smoking is addictive and that
10 nicotine is the addictive substance in cigarettes, defendants continue to mislead the public about
11 the role of nicotine in cigarettes.

12 **Q: With respect to the nicotine manipulation, what are you assuming the United States**
13 **has proven?**

14 A: Defendant cigarette companies manipulate cigarette design and manufacturing processes
15 to ensure delivery of the amount of nicotine necessary to create and sustain addiction in
16 individuals who smoke; yet, defendants publicly deny this fact.

17 **Q: Dr. Bazerman, what are you assuming the United States has proven with respect to**
18 **the design and marketing of light/low tar cigarettes category of fraud?**

19 A: Defendants design cigarettes that they know will produce reduced tar and nicotine
20 readings on an FTC smoking machine but with features that allow a smoker to get higher doses
21 of tar and nicotine. Also, through public statements and marketing efforts, the defendants lead
22 consumers to falsely infer health benefits from low-tar and light cigarettes despite the fact that
23 public health community has conclusively proven that no such health benefits exist. In addition,

1 defendants have sought to take advantage of consumer perceptions in order to target those who
2 wish to quit smoking; that is, defendants have attempted to convince smokers to switch to light
3 cigarettes as an alternative to quitting.

4 **Q: Dr. Bazerman, in your own words, what are you assuming the United States has**
5 **proven in the youth marketing category of fraud?**

6 A: The defendant cigarette companies intentionally market to young people under age 21 and
7 deny that they do so.

8 **Q: Finally, Dr. Bazerman, what are you assuming the United States has proven with**
9 **respect to the suppression of evidence category of fraud?**

10 A: Defendants suppress information, and in fact, utilize a wide variety of measures to keep
11 information that they know, and have known for some time, to be true from reaching the public
12 and the public health community. They have also deliberately destroyed documents or taken
13 other measures to keep them from public view.

14 **B. Misconduct Continues to this Day**

15 **Q: You testified that you are assuming misconduct continues to this day. What**
16 **misconduct are you assuming continues?**

17 A: I assume that at least some of the misconduct related to the seven categories of fraud that
18 I described above continues to this day in some form. For example, defendants continue to deny
19 and misrepresent the adverse health effects and addictiveness of their products, manipulate
20 nicotine, manipulate research when they have pledged to sponsor independent research, design
21 and market light and low tar cigarettes as less hazardous and as an alternative to quitting, market
22 to young people, and suppress evidence.

23 **C. Opinion Not Dependent on Court Finding Liability for Any Particular Fraud**

1 **Q: Is your opinion dependent on the United States proving any specific category of**
2 **fraud?**

3 A: No.

4 **Q: Why not?**

5 A: My opinions flow from the theory that incentives and biases produce misconduct.
6 Behavioral decision research tells us that regardless of what form it takes, defendants'
7 misconduct will continue absent Court intervention that addresses the environment in which
8 incentives and biases exist. The key pieces of the organizational environment includes the tasks,
9 competencies, culture, and senior management. In addition, the organizational architecture of
10 these firms and the internal processes they employ are important factors for the Court to consider.

11
12 **D. Opinion Not Dependent on Finding of Liability for Particular Defendants**

13 **Q: Are you assuming that liability has been proven against any particular defendant?**

14 A: No.

15 **Q: Why not?**

16 A: I've been asked to assume that the defendants as a group engaged in behavior that has led
17 the Court to conclude liability, and some of that misconduct continues to this day. I have not
18 disaggregated on a defendant-by-defendant basis. I think that it is the Court's responsibility to
19 conclude liability based on various defendants.

20 **Q: Do the interventions you recommend the Court consider vary depending on the**
21 **defendant?**

22 A: Certainly at the implementation stage there may be variations. However, the five
23 structural changes I recommend the Court consider and the seven other Court interventions

1 related to incentives and biases I also recommended have application to each defendant based on
2 the assumptions I have made.

3 **E. Materials Reviewed**

4 **Q: In addition to making assumptions, have you reviewed materials from this case?**

5 A: Yes, I have reviewed materials about or from each of the defendants in this case.

6 **Q: Dr. Bazerman, are you aware of who the defendants are in this matter?**

7 A: Yes. There are the defendant cigarette companies: Philip Morris USA Inc. and its parent
8 company Altria Group, Inc.; R.J. Reynolds Tobacco Company, which now includes Brown &
9 Williamson, as Reynolds American Inc.; Lorillard Tobacco Company; British American Tobacco
10 (Investments), Limited; and Liggett Group, Inc. Then there are two industry-funded groups, the
11 Tobacco Institute (TI) and the Center for Tobacco Research (CTR), which are no longer in
12 existence.

13 **Q: What materials have you reviewed?**

14 A: I have reviewed written direct examinations, trial testimony, exhibits, materials produced
15 by defendants, material from defendants' websites, expert disclosures, and orders of the Court.

16 **Q: Dr. Bazerman, without listing everything you have reviewed could you highlight**
17 **some of the more important materials?**

18 A: I have reviewed the opening statements of both the United States and the defendants and
19 the demonstratives exhibits both sides used in their openings. I have also reviewed the trial
20 testimony for first and second interim summations and the demonstratives used by the United
21 States and the defendants. I have reviewed the written direct examinations and trial testimony of
22 senior executives at the defendants' firms including Martin Orłowsky (Lorillard), Susan Ivey
23 (Brown & Williamson), Andrew Schindler (R.J. Reynolds), Lynn Beasley (R.J. Reynolds),

1 Bennett LeBow (Liggett), Michael Szymanczyk (Philip Morris), Steven Parrish (Altria), and
2 Denise Keane (Altria). I have reviewed various company documents, both public and internal
3 ones, including form 10-K filings with the Securities and Exchange Commission (SEC), Proxy
4 Statements, and others. I have also read the expert reports of Dr. Jonathan Gruber and Dr.
5 Michael Fiore.

6 **Q: For what purpose did you review the materials that you have just described?**

7 A: I reviewed the materials for background purposes to understand the assumptions I have
8 been asked to make. In addition, I reviewed the materials and applied behavioral decision
9 research theory to arrive at my conclusions regarding Court interventions to affect the incentives
10 and biases operating on defendants' managers and executives.

11 **IV. DEFENDANTS WILL CONTINUE TO ENGAGE IN FRAUD IN THE**
12 **FUTURE ABSENT COURT INTERVENTION**
13

14 **Q: Dr. Bazerman, based on the assumptions you have made and your expertise in**
15 **behavioral decision research applied to managers in businesses and firms, will the**
16 **defendant firms likely continue to engage in misconduct?**

17 A: Yes, I have assumed that the United States has established defendants' liability and that
18 defendants' misconduct continues to this day. Given those assumptions and applying theory from
19 behavioral decision research as it relates to issues of incentive and bias, I conclude that
20 defendants' conduct will continue to be consistent with their current profit seeking incentives and
21 systematic biases absent strong court intervention.

22 **A. Defendants are Incentivized to Engage in Fraud**

23 **Q: Why will defendants continue to engage in misconduct as a result of the incentives**
24 **they experience?**

25 A: Understanding how incentives affect the conduct of business organizations is critical to

1 understanding the current and future behavior of the defendants in this case. Incentives affect
2 behavior both through changes in the intentional actions of managers and executives, and
3 through implicit processes. The allegations in this case, and therefore the assumptions I have
4 made, are not that a few managers engaged in isolated illegal conduct, but rather that the
5 defendant companies, as institutions, have engaged in a 50 year scheme to defraud that goes to
6 the core of their businesses and transcends several generations of managers and executives.
7 Evidence demonstrates that these frauds have been highly profitable. For instance, evidence
8 shows that most adults who smoke start smoking as young people, which leads to the conclusion
9 that defendants have a significant incentive to market their products to young people. Evidence
10 also shows that most adults who smoke would like to quit, which leads to the conclusion that
11 defendants have substantial incentives to market light/low tar cigarettes as an alternative to
12 quitting. My assumptions are based on a showing by the United States that defendants' actions
13 on both issues are fraudulent. Therefore, absent Court intervention, there is no reason to assume
14 that these fraudulent behaviors will cease to be profitable for defendants in the future and as a
15 result, defendants will experience incentives to engage in them.

16 **Q: I want to show you some testimony that Mr. LeBow provided to this Court on April**
17 **4, 2005. Dr. Bazerman, do you know who Bennet LeBow is?**

18 A: Yes. Mr. LeBow is Chairman of the Board and CEO of Vector Group, Ltd., which owns
19 Liggett.

20 **Q: I would like to turn your attention to transcript page 17576, line 20 through page**
21 **17577, line 7, which reads:**

22 ***Q: Now, in 1993, you held a similar view about the disease consequences of***
23 ***secondhand smoke or environmental tobacco smoke as you held about cigarette***
24 ***smoking and disease generally; correct?***
25

1 A: *Correct.*

2
3 Q: *And specifically it was your position that the question of whether environmental*
4 *tobacco smoke hurt the health of nonsmokers was somebody else's battle and that your*
5 *role and your business was to make as much money as you possibly could selling*
6 *cigarettes; right?*

7
8 A: *That's what a business person normally does.*

9
10 Q: *Is that a yes?*

11
12 A: *That's a yes.*

13
14 **What conclusions do you draw from this testimony?**

15 A: Mr. LeBow states clearly that his incentives are profit-maximization. Also, Mr. LeBow
16 makes the comment that profit-maximization is "what a business person normally does" and I
17 think both the economics literature and the literature from management schools are consistent
18 with that admittedly broad statement.

19 **Q: Based on your laboratory work and your general work in the managerial field, do**
20 **economic incentives motivate all actions by managers and executives in firms?**

21 A: No. Economic incentives do not provide the sole motivation for all actions by firm
22 managers and executives.

23 **Q: Do managers and executives ever engage in behavior merely because that behavior**
24 **is the right thing to do?**

25 A: Absolutely.

26 **Q: You have testified that you teach executives. With reference to the executives you**
27 **teach, do you find the majority of them are trying to do the right thing?**

28 A: While the majority of the executives that I work with avoid engaging in unethical
29 behaviors, a small to moderate number do engage in unethical behavior that remains evident even
30 in the artificial environment of the classroom.

1 **Q: What incentives do executives have to conform their conduct to the law?**

2 A: The law creates one set of incentives. For instance, the defendants in this case face the
3 threat of potential legal action if they engage in misconduct. However, there are other incentives
4 like profitability and maximizing shareholder value that, given the assumption I have made that
5 misconduct continues to this day, overwhelm the incentive to conform their behavior to the law.

6 **Q: Dr. Bazerman, you have referred at various points in your testimony to biases.**

7 **What do you mean when you use the word bias?**

8 A: I am referring to cognitive bias.

9 **Q: What is cognitive bias?**

10 A: Cognitive bias refers to systematic errors in decision making where researchers can
11 predict the direction by which people will depart from rational judgment. These errors occur
12 without the awareness of the decision maker. This awareness separates how behavioral decision
13 researchers use the term "bias" from the more common use of the term.

14 **B. Court Intervention Must Address Systematic Bias that Affects the**
15 **Defendants' Managers and Executives or Misconduct will Continue**

16 **Q: Why will systematic bias, in addition to incentives, lead the managers and executives**
17 **at the defendant firms to continue to engage in misconduct?**

18 A: The operation of systematic bias will prevent defendant managers from acting in a way
19 that is inconsistent with the incentives they experience.

20 **Q: What is systematic bias?**

21 A: Systematic bias refers to a bias that has a predictable and reliable direction. It is not
22 simply error. Rather, it results from the systematic ways in which humans process information
23 that departs from rational thought. Systematic bias takes a number of forms. In this case, self-
24 serving bias, escalation of commitment bias, the confirmation trap bias, the statistical victim bias

1 and the framing bias predict that the defendants will continue to engage in misconduct absent
2 court intervention to change the incentives managers experience.

3 **Q: Has your scholarship addressed the issue of systematic biases that influence**
4 **judgment?**

5 A: Yes it has. The majority of my peer reviewed publications include work on systematic
6 biases, and my book Judgment in Managerial Decision Making, the leading text on behavioral
7 decision research in the managerial context, discusses this issue in depth.

8 1. Self-Serving Bias

9 **Q: What is self-serving bias?**

10 A: Self-serving biases occur when individuals are influenced by what is rewarded, and make
11 decisions based on these incentives, without their own awareness. They justify their decisions
12 through a cognitive adjustment of their understanding of the situation at hand.

13 **Q: How does self-serving bias affect the decision making process?**

14 A: Self-serving bias distorts the decision making process in part due to intentional
15 corruption. A more common distortion is the unintentional bias that results from partisan
16 preference.

17 **Q: What is intentional corruption?**

18 A: Intentional corruption describes a situation in which a person engages in behavior
19 knowing it is against the norms or laws of society.

20 **Q: What is an example of intentional corruption?**

21 A: Executives who knowingly engage in fraudulent activity.

22 **Q: What is an example of intentional corruption in this case?**

23 A: Based on the assumptions I have made, there are examples of intentional corruption in

1 each of the seven categories of fraud. For example, defendants' public statements denying the
2 adverse health effects of smoking including ETS; their manipulation of research; their
3 misrepresentations of the addictiveness of smoking; their manipulation of nicotine; their
4 marketing of light and low tar cigarettes as less hazardous and as an alternative to quitting; their
5 marketing to young people; and their suppression of evidence are examples of intentional
6 corruption.

7 **Q: What is partisan preference?**

8 A: Partisan preference refers to the bias that occurs when people see information based on
9 the role they hold in a specific context.

10 **Q: What is an example of partisan preference?**

11 A: Sellers typically think that their house is worth more than buyers typically think that it is
12 worth.

13 **Q: What is an example of partisan preference in this case?**

14 A: A tobacco executive's partisanship leads him/her to systematically reach conclusions that
15 are consistent with the financial preferences of his/her tobacco firm, and this results in the biased
16 interpretation of information regarding health issues, the effects of advertising, the degree to
17 which his/her firm is accurately communicating to citizens, and so forth.

18 **Q: If partisan preference is unintentional how can it be remedied?**

19 A: All of the interventions that I recommend the Court consider address incentives and the
20 intentional conduct produced by incentives, as well as the unintentional conduct caused by
21 systematic bias.

22 **Q: Why is it important to consider unintentional conduct in fashioning a remedy?**

23 A: My conclusion is that, in order to be effective, any remedy has to take into account both

1 incentives that produce intentional conduct and systematic biases that produce unintentional
2 errors in decision making.

3 **Q: Why does the phenomenon of self-serving bias predict that defendants' misconduct**
4 **will continue absent court intervention?**

5 A: Defendants promised the public that they would act in a certain way. For example, they
6 promised to fund independent research and to not market to young people under age 21. This
7 then committed their managers to make decisions in support of those positions. However, the
8 companies then rewarded their managers, through bonuses tied to financial performance, for
9 conduct at odds with those public promises. This creates conflicts of interest for defendants'
10 managers and conflicts of interest generate self-serving bias.

11 **Q: Why does conflict of interest generate self-serving bias?**

12 A: Behavioral decision research has demonstrated that when people are asked to make
13 impartial judgments, those judgments are likely to be unconsciously and powerfully biased
14 according to each individual's self-interest. People tend to form a preference for a certain
15 outcome on the direction of what benefits them, and then justify this preference on the basis of
16 biased interpretation of fairness.

17 **Q: Can self-serving bias lead one to reach predictive conclusions?**

18 A: With self-serving bias, directionality allows for predictive conclusions. In other words,
19 when you know the side that someone identifies with, you can predict that the person's biases
20 will run in that direction.

21 **Q: Dr. Bazerman, other than the self-serving bias that we have discussed, are there any**
22 **other biases relevant to the defendants in this case?**

23 A: Yes. These biases include, but are not limited to, escalation, the confirmation trap, the

1 statistical victim effect and framing.

2 **2. Escalation of Commitment**

3 **Q: What is escalation of commitment?**

4 A: Escalation of commitment refers to the tendency to continue commitment in order to
5 justify a prior commitment to a course of action, beyond the degree to which it is rational to
6 continue that course of action.

7 **Q: What, if any, predictive value does the concept of escalation of commitment offer?**

8 A: Escalation of commitment involves situations where people make decisions in order to
9 justify prior decisions, rather than based on a future-oriented rational analysis. Precisely because
10 this bias affects serial decision making, an initial decision will have a strong effect on the
11 outcome of subsequent decisions in the future. Thus, we can predict that when specific
12 individuals are responsible for an initial decision, they are more likely to escalate commitment
13 than other individuals who were not responsible for the initial decision.

14 **Q: Based on your assumptions and review of the evidence in this case, why is this**
15 **concept relevant to these defendant firms?**

16 A: Applying this concept to this case, when defendants make statements regarding the lack
17 of evidence of causal connections between their products and various diseases in individuals who
18 smoke, they continue to attempt to justify these positions through escalation even when further
19 evidence develops that is inconsistent with these earlier statements.

20 **Q: In reviewing the materials in this case did you encounter testimony that suggests**
21 **escalation of commitment?**

22 A: Yes. I saw testimony from several of defendant companies' Chief Executive Officers,
23 including Andrew Schindler and Martin Orlowsky, relating to smoking and health issues. The

CEOs' statements on these issues are indicative of this escalation of commitment.

Q: Based on your review of the materials in this case, are you aware of the positions that each of the defendant cigarette companies takes with respect to smoking and health?

A: Yes. I am aware that Philip Morris admits that smoking causes lung cancer, heart disease, emphysema, and other serious diseases. BATCo states that it recognizes smoking as a cause of certain diseases in the most simple and commonly understood sense. Reynolds states that smoking, in combination with other factors, causes disease in some individuals. Lorillard states that smoking causes certain diseases and may be a risk factor for others. Finally, Liggett formerly admitted causation, but appears to be moving toward the view that smoking is a risk factor for disease.

Q: I am showing you testimony that Martin Orlowsky gave to this Court on October 13, 2004. Do you know who Mr. Orlowsky is?

A: Yes. He is the CEO of Lorillard, a defendant in this case.

Q: I would like to draw your attention to transcript page 2303, lines 7 through 22, which reads:

Q: Why hasn't Lorillard specifically stated publicly that smoking causes any diseases other than smoking, emphysema, COPD or heart disease?

A: We have – in certain instances, we do not know if in fact the evidence, the scientific evidence is such that it warrants saying that it does cause. However, Lorillard's longstanding position, as long as I've been with the company, is that certainly smoking can, and is a risk factor for those diseases.

Q: But not a cause?

A: It is not a cause by our own internal view, but from a public perspective, our acceptance of the Surgeon General's statements would, in effect, conclude that we agree. And that's what we're saying.

Q: But again, you don't state that specifically?

1 A: *Not in those specific terms.*

2 **What conclusions do you draw from this testimony?**

3 A: These statements are indicative of the escalation of commitment bias. Mr. Orlowsky's
4 testimony is designed to provide support to defendants' public position that it is still an open
5 question whether smoking causes disease, at least as far as these other diseases are concerned.

6 **Q: I now want to turn your attention to the testimony that Andrew Schindler gave to**
7 **this Court on January 24, 2005. Who is Andrew Schindler?**

8 A: Mr. Schindler is currently the non-executive chairman of Reynolds American, the new
9 parent entity formed by the merger of Brown & Williamson and R.J. Reynolds Tobacco Co., and
10 was formerly the CEO of R.J. Reynolds Tobacco Company.

11 **Q: I want to draw your attention to transcript page 10811, line 24 through page 10812,**
12 **line 22, which reads:**

13 *Q: Well, I'm asking you. Your testimony here today is not that cigarette smoking*
14 *causes disease, you will not admit to that, will you, on behalf of R.J. Reynolds?*

15
16 *A: I believe it has significant health risks, smoking.*

17
18 *Q: I'm not talking about significant health risks, I'm talking about causation.*
19 *We've been talking about it all day. You will not admit, will you, on the stand here*
20 *today on behalf of R.J. Reynolds, that cigarette smoking causes disease, will you?*

21
22 *A: I believe it significantly increases the risk and very well, may, in some people. I*
23 *mean that's the testimony.*

24
25 *Q: So that's a no?*

26
27 *A: You're saying it's a no. Okay. Fine.*

28
29 *Q: Not okay fine, this is your testimony, not mine. We have the Website, we can*
30 *review the Website.*

31
32 *A: Right.*

33
34 *Q: What I am getting at is in your position sitting here today, yes or no, does*

1 *cigarette smoking cause disease?*

2
3 *A: My answer has been in this testimony, and still is, that there are significant and*
4 *inherent health risks to this product that may contribute to causing certain diseases.*

5
6 *Q: So you say it's possible, it's likely, but you don't say it does, do I have that right?*

7
8 *A: Yes.*

9
10 **What conclusion do you draw from this testimony?**

11 A: This exchange, like the previous one with Mr. Orlowsky, is also indicative of the
12 escalation of commitment bias for the reasons I have discussed.

13 **Q: Dr. Bazerman I am showing you U.S. Ex. 89,455. Do you recognize it?**

14 A: It appears to be a statement on smoking and health from the R.J Reynolds website.

15 **Q: Dr. Bazerman, I am going to represent to you that this statement is from the new**
16 **website for R.J Reynolds Tobacco Co. since it merged with Brown & Williamson. I want**
17 **you to direct your attention to the first paragraph under the subheading "Smoking &**
18 **Disease," it says:**

19 **R.J. Reynolds Tobacco Company believes that smoking, in combination with other**
20 **factors, causes disease in some individuals. Epidemiological science clearly**
21 **establishes smoking as a significant risk factor for many chronic diseases including**
22 **heart disease and lung cancer. Most, if not all, chronic diseases result from the**
23 **interaction of many risk factors including genetics, diet and lifestyle choices.**

24
25 **Dr. Bazerman, how does this statement on the new R.J Reynolds website relate to your**
26 **opinions regarding defendants' escalation action?**

27 A: R.J. Reynolds' position, that smoking in combination with other factors causes disease in
28 some individuals, is indicative of defendants' attempts to justify a position on smoking and health
29 that has been rebutted by an overwhelming body of research.

30 **Q: You testified earlier that you are aware that some defendants admit that smoking**
31 **causes some diseases. Do such statements disclosing some of the health effects of smoking**

1 **remedy the effects of defendants' past behavior?**

2 A: No. Disclosure itself does not solve the problem. In fact, Cain, Moore and Lowenstein
3 found that disclosure could actually increase self-serving bias, as those who make public
4 disclosures feel that they have met their obligations, and feel more free to engage in self-serving
5 behavior. In addition, these researchers found that the recipients of disclosures often ignore the
6 disclosure. This is not an argument against disclosure in general, which is necessary to create
7 well-informed consumers. Rather, it is an argument that disclosure will typically be an
8 insufficient means for solving self-serving behavior. Thus, if an organization really wanted to
9 change its behavior in a serious manner, I see disclosure as playing a limited supporting role in
10 the context of strong structural and motivational changes.

11 **Q: Dr. Bazerman, how does the phenomenon of escalation of commitment support your**
12 **conclusion that defendants will likely continue to engage in misconduct in the future?**

13 A: It is my conclusion that the defendants have a history of escalating their commitment to
14 prior positions that they have taken, and will have a strong tendency to continue to escalate their
15 commitment absent strong court-monitored intervention. My assessment is that the changes that
16 have occurred in the defendant firms discussed in the testimony of their top managers have been
17 too weak, too late, and too limited to correct the misconduct that I have been asked to assume.

18 **3. Confirmation Trap**

19 **Q: You also mentioned the confirmation trap as another form of bias relevant to**
20 **defendants. What is the confirmation trap?**

21 A: The confirmation trap refers to the tendency to seek information that confirms what you
22 believe to be true or what you want to be true, rather than rationally entertaining disconfirming
23 information.

1 **Q: Why is the concept of the confirmation trap relevant to the defendant firms in this**
2 **case?**

3 A: My opinion is that defendants have sought and will continue to seek information that
4 confirms their previously stated views. They will also underweight or ignore disconfirming
5 evidence.

6 **Q: In the materials you reviewed did you find any examples of the confirmation trap?**

7 A: I think Dr. Viscusi's testimony is an example of the confirmation trap.

8 **Q: How so?**

9 A: During his cross examination, Dr. Viscusi was confronted with evidence that he had
10 selectively chosen the survey evidence he used to support the opinions provided in his written
11 direct testimony. In his written direct testimony, Dr. Viscusi cited a Gallup survey response that
12 showed that 70% of individuals polled responded yes to the question of whether smoking was
13 harmful. However, at trial, he conceded that he had not informed the Court that the same Gallup
14 poll indicated that only 8% of respondents responded that smoking was harmful because it
15 caused cancer. Dr. Viscusi was using only figures that supported the position that the general
16 public was aware of all the harms associated with cigarette smoking.

17 **Q: Dr. Bazerman, how does the phenomenon of the confirmation trap support your**
18 **conclusion that defendants will likely continue to engage in misconduct in the future?**

19 A: The defendants have made numerous public statements reflecting positions they have
20 taken and have sought to generate research supporting those positions. For example, defendants
21 have claimed, and still claim, that the effects of ETS on health are unproven and that marketing
22 does not contribute to youth smoking. The confirmation trap will lead the defendants to
23 overweight any evidence consistent with these positions.

1 **4. Statistical Victim Effect**

2 **Q: You also mentioned the statistical victim effect as another form of bias relevant to**
3 **defendants. What is the statistical victim effect?**

4 A: The statistical victim effect refers to the tendency to underweight the harm created to
5 future victims of a course of action when those victims are "statistical," in other words, the
6 victims cannot be identified at the time the decision is made. Behavioral decision research has
7 shown that people tend to be far more willing to impose harm on statistical victims than on
8 known victims and that decision-makers are more likely to make self-serving interpretations of
9 what is fair when the harm occurs to unidentifiable victims.

10 **Q: Can individuals who die from smoking-related illnesses be considered statistical**
11 **victims?**

12 A: Yes. Executives and managers at defendants' firms know that their products will kill a
13 certain percentage of their users, but they do not specifically know who those individuals will be.
14 Thus, these individuals are prototypical statistical victims.

15 **Q: Why is the concept of statistical victims relevant to the defendant firms in this case?**

16 A: Smoking kills people. But, as long as the people are statistical, this harm is easier for the
17 defendants to ignore.

18 **Q: How does the phenomenon of the statistical victim effect support your conclusion**
19 **that defendants will likely continue to engage in misconduct in the future?**

20 A: The fact that the victims are statistics, and not vivid images of suffering individuals,
21 makes it easier for the defendants to engage in misconduct, and to not confront the harm that they
22 are creating through their actions.

23 **5. Framing**

1 **Q: The last systematic bias you mentioned earlier was framing. What is framing?**

2 A: Framing refers to the empirical result that people are systematically affected by the way in
3 which information is presented. For example, people tend to be risk averse when problems are
4 framed positively (gains), but risk seeking when problems are framed negatively (losses).
5 Kahneman and Tversky's Prospect Theory describes the fact that even perceived differences
6 based on a change in the "framing" of choices—from losses to gains—can dramatically affect
7 how people make decisions. While rational decision makers should be immune to the framing of
8 choices, behavioral decision research has demonstrated that frames can have amazingly strong
9 effects on decisions. The concept has been responsible for helping researchers develop a more
10 thorough understanding of errors and inconsistencies in human judgment.

11 **Q: Have you reviewed the Master Settlement Agreement (MSA)?**

12 A: Yes.

13 **Q: Dr. Bazerman, are you aware that the MSA has certain enforcement provisions that**
14 **allow the states to take the defendants to court if they violate the MSA?**

15 A: Yes, I am aware of that.

16 **Q: Would an enforcement action under the MSA represent a situation of gain or a**
17 **situation of loss?**

18 A: An enforcement action under the MSA would represent a situation of loss. If a court
19 finds that the defendants have violated the MSA, the defendants face a range of penalties.

20 **Q: Dr. Bazerman, I am going to pose a hypothetical question to you. Assume the Court**
21 **found liability and enjoined the defendants from committing whatever misconduct it**
22 **found. Further assume that violations of the Court's injunction would result in a penalty**
23 **for the defendant that violated the injunction. Applying the concept of framing, what is the**

1 **likely effect of such a remedy on defendant managers' behavior?**

2 A: Such a scheme presents the defendants with a situation of loss. Therefore, their managers
3 and executives, and the companies as a whole, are more likely to be risk seeking than risk averse
4 in this situation.

5 **Q: Would defendants' managers and executives be aware that they are more likely to**
6 **be risk seeking in such a situation?**

7 A: No, framing is an implicit process and the individual is unaware of this bias. That is why
8 an executive could make statements that he/she would comply with such a system and then be
9 incapable of doing so even if he/she consciously tried to comply with the Court's injunction.

10 **6. Decision making in an Environment of Ambiguity**

11 **Q: We have discussed the systematic biases relevant to defendants in this case. Let's**
12 **now discuss the environment in which defendant companies operate. What effect, if any,**
13 **does the clarity of the rules under which a decision maker operates affect biases?**

14 A: Behavioral decision research has shown that unintentional processes are going to be
15 strongest in more ambiguous environments. The greater the ambiguity, the greater the ability for
16 people to justify their own unethical behavior. Basically, when the information is clear, it is hard
17 to contort your judgment. However, when it is ambiguous, self-serving interpretations become
18 easier to make. Thus, people engage in greater self-serving interpretations to the degree to which
19 they see themselves as environmentally responsible than the degree to which they consistently
20 recycle. The broader question creates more ambiguity for self-serving biases to operate.

21 **Q: Assuming the defendants in this case operate in a situation in which the rules are**
22 **ambiguous, what effect would it have on their biases?**

23 A: Given this assumption, defendants would be even more likely to engage in biased

1 decision making, which would lead to further unethical behavior.

2 7. Siege Mentality

3 **Q: Based on your review of the materials in this case, are you aware of any external**
4 **actors that monitor the behavior of the defendant companies?**

5 A: Yes, I am aware both from the specific materials I have reviewed in this case but also
6 from reading the newspapers and other sources that these defendants face the risk of litigation by
7 private parties, as well as scrutiny by law enforcement agencies at the state and federal level and
8 by non-profit organizations such as the Center for Tobacco Free Kids. More specifically, based
9 on the materials I have reviewed, it is clear that defendants operate in an environment in which
10 they perceive themselves as being under siege.

11 **Q: Is the existence of external monitors like watchdog organizations sufficient to**
12 **prevent misconduct in the future?**

13 A: No.

14 **Q: Why not?**

15 A: Such threats to organizations do not lead organizations to simply comply with the
16 directives of states or the courts. In fact, there are multiple reasons why a perceived state of siege
17 will lead to greater, rather than less, unethical behavior.

18 **Q: Why might a perceived state of siege lead to greater, rather than less, misconduct?**

19 A: Behavioral decision research demonstrates that organizations under siege, or more
20 generally under threat, demonstrate three consistent patterns of behavior. One pattern relates to
21 how executives will make decisions under great cognitive load, which a siege mentality creates.
22 A second pattern relates to the emotional reaction that individuals develop in response to such a
23 threat. Finally, the third pattern relates to what is known as the threat rigidity effect.

1 **Q: Dr. Bazerman, what is cognitive load?**

2 A: Cognitive load refers to excess demands that are made on the minds of decision makers.
3 Basically, when our minds are heavily loaded with information and thoughts, we make decisions
4 differently than when our minds are less cognitively loaded.

5 **Q: How does cognitive load affect executive decision making?**

6 A: Decision makers under greater cognitive load are more likely to engage in biased
7 processing. Thus, self-serving biases such as escalation, confirmatory search, the statistical
8 victim effect, and framing, will all have greater weight under a high cognitive load. This allows
9 greater misconduct outside the awareness of the decision-maker to occur.

10 **Q: You also mentioned an emotional reaction to a siege mentality. How would this**
11 **affect misconduct in the current case?**

12 A: Decision makers under siege tend to have a negative emotional response which creates
13 contempt for the actors that put the party under siege. This creates an "us versus them" mentality
14 that will lead to greater self-serving interpretations.

15 **Q: How does the threat rigidity effect work?**

16 A: While organizations need to be flexible in difficult times, research demonstrates that
17 organizations become rigid under threat, rather than developing the flexibility needed to
18 effectively respond to the threat. Thus, they try to do what they have done in the past better,
19 rather than evolving to a different approach to their business.

20 **Q: With respect to the defendants in this case, do you see any evidence supportive of**
21 **misconduct under a state of siege?**

22 A: Yes. As I mentioned earlier, defendants operate in an environment where they are
23 subject to litigation and scrutiny by law enforcement agencies and other actors. Assuming

1 defendants' misconduct continues to this day, the defendants still engage in misconduct despite
2 legal monitoring of their behavior.

3 **C. Other Examples of Systematic Bias**

4 **1. Systematic Bias in Expert Testimony**

5 **Q: Dr. Bazerman, we have been discussing how systematic biases affect people's**
6 **judgment. Could bias affect you?**

7 A: Absolutely. I do my best to use the tools from the literature that I know very well to be as
8 objective as possible and to counteract biases but I don't believe that there is a human that does
9 not suffer from these biases to some extent. I think that there are good reasons why I think I am
10 less likely to be affected by those biases than other people, but I wouldn't claim that I'm a purely
11 objective person.

12 **Q: How do you keep your biases in check?**

13 A: I think what helps hold my biases in check in this context is that my awareness of these
14 biases helps me take appropriate steps to counteract such biases and that's something that I work
15 hard at as a professional.

16 **Q: Are you saying that you have to be an expert in the area of bias in order to**
17 **counteract bias?**

18 A: I am not saying you have to be an academic who studies bias to take steps to counteract
19 bias. The reason why private corporations hire me to conduct executive education is because
20 managers can be trained to employ methods that counteract bias.

21 **Q: Dr. Bazerman what is your expert fee for this case?**

22 A: I am charging the United States an expert rate of \$800 per hour.

23 **Q: What fee do you charge private clients for consulting work?**

1 A: Between \$16,250 and \$25,000 a day.

2 **Q: What fee do you charge not-for-profit organizations?**

3 A: I work for many on a pro bono basis. Others pay a reduced fee.

4 **Q: Why do you charge private clients a higher rate than the United States?**

5 A: I have previously served as an expert witness for the Federal Trade Commission and I
6 know that the government typically does not pay the same rate that private corporations pay.

7 **Q: Is it possible that because you are being paid by the United States that your**
8 **testimony to the Court is biased?**

9 A: While I believe that my training dramatically reduces my susceptibility to bias, it is
10 possible. Thus, I decided when I agreed to do this work for the United States to donate my fee.

11 **Q: What do you mean?**

12 A: I intend to deposit the money in an irrevocable charitable trust I maintain when I receive
13 the funds.

14 **2. Systematic Bias in the Accounting Industry**

15 **Q: Dr. Bazerman before your work in this case did you apply concepts of systematic**
16 **bias to other industries and firms?**

17 A: Yes, in 1997, I published a paper with Kimberly Morgan and George Lowenstein titled,
18 *The Impossibility of Auditor Independence*. We concluded that to the extent that auditors want to
19 sell consulting services to their clients, have their contracts renewed or be offered higher paying
20 jobs in-house at the client firm, they are more likely to provide more positive audits than an
21 unbiased view would suggest. More importantly, they are likely to engage in self-serving bias
22 without even being aware of it. This compounded the problem with intentionally corrupt audits
23 performed by corrupt people.

1 **Q: Did you reach any conclusions about what had to be done?**

2 A: Yes, we concluded that certain structural changes in the accounting industry were
3 necessary to eliminate this self-serving bias.

4 **Q: What were those changes?**

5 A: There were three clear ways to restructure the auditing industry so that incentives that
6 create corruption and bias would not occur in the future. First, auditing firms should only audit
7 and not provide other services to their audit clients. Second, auditing firms should only be hired
8 for fixed-term, non-renewable contracts that cannot be terminated by the client. Finally,
9 employees from audit firms should not be allowed to accept positions with their clients until an
10 extended period of time has elapsed between the audit and an offer of employment.

11 **Q: In addition to publishing on this topic did you present your recommendations for**
12 **structural changes in any other way?**

13 A: Yes. I appeared before the SEC in 2000.

14 **Q: Why did you appear before the SEC?**

15 A: I received a telephone call from the Chief Accountant at the SEC who was familiar with
16 my article on auditor independence. Shortly thereafter, I, along with the CEOs of three of the
17 major accounting firms, appeared at a hearing on auditor independence.

18 **Q: Among the recommendations for court interventions you make in this case, are**
19 **there any parallels to the recommendations you made in the context of the auditing**
20 **industry?**

21 A: Yes. The first recommendation we made to the SEC, that auditing firms be prohibited
22 from selling non-auditing services to their clients, was designed to address a market opportunity
23 that provided an incentive for misconduct by auditing firms. There are two recommendations I

1 have made in this case that are designed to address market opportunities that provide incentives
2 for misconduct by defendants. Specifically, those recommendations are eliminating the incentive
3 to market to young people and requiring the defendants to fund counter-marketing and cessation
4 programs. In the auditor context, the market opportunity for accounting firms was selling
5 consulting services to their audit clients. In this case, the market incentive is selling cigarettes to
6 children and to individuals who want to quit.

7 **Q: Turning back to your discussion of conflict of interest, did conflicts of interest**
8 **produce self-serving biases in the auditing industry context?**

9 A: Yes. In the auditing case, the companies made public promises that they would conduct
10 independent audits. However, conflicts of interest were produced by the incentives existing in
11 that industry. These incentives included the sale of other services to their clients, the renewal of
12 their contracts, and the potential for individual auditors to take jobs from the companies they
13 were auditing. This situation is similar to the present case where the defendants promise they
14 will reduce youth smoking or deny that they market for any reason other than brand-switching
15 and then reward their managers with salaries and bonuses based on traditional financial
16 measures.

17 **Q: After your testimony before the SEC, what action, if any, did the agency take?**

18 A: The SEC imposed new disclosure requirements on auditors that required them, in part, to
19 reveal that they also sold other services to the companies they were auditing. This new
20 requirement was weak, and was based on the political influence of the auditing industry.
21 Without any strong action, the disasters at companies such as Enron, Adeptia and Worldcom
22 soon followed.

23 **Q: Dr. Bazerman, the list of corporate clients you testified to earlier included Deloitte**

1 **and Touche, Ernst and Young, KPMG, and PriceWaterhouseCoopers. Do you continue to**
2 **consult with these accounting firms?**

3 A: No. After I published my first article on auditor independence, accounting firms no
4 longer sought consulting arrangements with me. I anticipated as much when I was developing
5 the article.

6 **Q: Why did you decide to publish on this topic if you anticipated that it would cost you**
7 **consulting business?**

8 A: Because it was the conclusion of my research and developing fair and honest public
9 policy was at stake.

10 **Q: Did the concepts discussed in your SEC testimony grow out of the study of a specific**
11 **industry?**

12 A: No, they developed out of my research into the process by which people make decisions.
13 They can be applied to a number of contexts, including managerial ones, and within managerial
14 contexts to specific industries and firms.

15 **Q: Are the concepts of behavioral decision research limited to only certain industries**
16 **and firms?**

17 A: No, the ideas from behavioral decision research have proven robust with a variety of
18 different subject populations, across cultures, and across a variety of professional contexts.

19 **V. COURT INTERVENTION IS NECESSARY TO ELIMINATE THE INCENTIVES**
20 **AND BIASES THAT PRODUCE MISCONDUCT**

21
22 **A. Court-Ordered Structural Changes to Defendants' Businesses**

23 **Q: Dr. Bazerman, you have testified that there are various structural changes that**
24 **would affect the incentives operating on the intentional and unintentional behavior of the**
25 **defendants' managers and executives. What are these structural changes?**

1 A: To be clear, I am recommending a process involving court-appointed monitors. These
2 monitors would assist the Court in implementing appropriate structural changes for defendant
3 companies that include: (a) eliminating economic incentives for defendants to sell cigarettes to
4 young people; (b) changing compensation and promotion policies for managers and executives to
5 produce outcomes inconsistent with misconduct; (c) removing senior management; (d) requiring
6 subcontracting of all research to private companies monitored by the Court; and (e) requiring the
7 defendants to sell, intact, their research and development, current product development activities,
8 and all other relevant material regarding safer cigarettes so that safer cigarettes can be brought to
9 the marketplace.

10 **Q: How did you arrive at these suggested structural changes?**

11 A: Based on my work in behavioral decision research and organizational behavior, my
12 experience consulting with large corporations and the materials I have reviewed in this case.
13 Each of these remedies logically responds to the assumptions I have made about liability.

14 **Q: Did the United States suggest these changes to you?**

15 A: No.

16 **Q: If asked by the Court which of these structural changes should be imposed on these**
17 **defendants, how would you respond?**

18 A: At this stage in the litigation, I am not recommending the Court impose any specific set of
19 structural changes on defendants. Rather, I think what is necessary is a process that entails court-
20 appointed monitors. Those monitors may have various roles, such as studying the defendants'
21 policies and operations, with the help of other experts, if necessary, and then recommending
22 changes that eliminate the defendants' incentives to engage in misconduct. The monitors may
23 also oversee the implementation of those changes or other changes that may be ordered by the

1 Court. I would recommend to the Court that the package of structural changes must be
2 comprehensive.

3 **Q: Why is comprehensive change necessary?**

4 A: Defendants are profitable firms, and based on the assumptions I have made, engage in
5 widespread misconduct. I see my task as advising the Court on how to eliminate the latter. The
6 allegations in this case are not that a few top managers engaged in a relatively discrete episode of
7 illegal behavior. This is not a case where the problem is limited to a CEO or top executive who
8 embezzled money from a company and where the company itself, as an organization, is not
9 involved in any wrongdoing.

10 Rather, the allegations in this case are that the defendant firms as organizations over a
11 span of 50 years have engaged in fraudulent behavior, and that this fraudulent behavior crosses
12 over all aspects of the businesses of defendant firms, including how they design and market their
13 products as well as how they communicate with the public about them. The defendant firms
14 must move from a business model based on misconduct to a fundamentally different model that
15 tries to maximize profitability without engaging in misconduct. I do not see this as an
16 incremental adjustment. Rather, I see this change as a fundamental shift in the way in which
17 these business must operate.

18 **Q: How is comprehensive change implemented?**

19 A: Based on the management literature and my own experience, for a company to change its
20 business model, two things must typically occur: leadership succession and discontinuous
21 change. If the wrong leaders are in place, the environment is very unlikely to change. Similarly,
22 simply changing the leaders of the firm, without addressing the tasks, competencies, and culture
23 of the firm, is also insufficient. The five structural remedies I have recommended the Court

1 consider reflect both elements.

2 **Q: What is leadership succession?**

3 A: Leadership succession involves new leadership taking charge at the company. That is
4 why I recommended the Court consider a remedy that would lead to the removal of senior
5 management.

6 **Q: What is discontinuous change?**

7 A: Discontinuous change is a break with past practice in key areas. It refers to the
8 magnitude of changes that have to be made in order to fundamentally change the way a company
9 does business. It is not incremental change. In order to create and sustain a new business model,
10 there must be discontinuous change in the tasks, competencies, and culture of defendant
11 companies.

12 **Q: What are the tasks of the defendant firms in this case?**

13 A: These can really be divided into legitimate and fraudulent tasks. The legitimate tasks
14 relate to the sale and marketing of cigarettes in a way that does not violate the law. The
15 fraudulent tasks relate to the categories of fraud alleged in this case and discussed earlier in this
16 testimony.

17 **Q: What are the competencies of defendant firms?**

18 A: The defendant companies have core competencies in engaging in both the legitimate and
19 fraudulent tasks I have previously discussed. The defendants have competencies in the design
20 and marketing of cigarettes to adults who actually want to smoke. However, they also have
21 competencies in designing products that addict, marketing them to young people, marketing to
22 people who are concerned about their health and want to quit, and in denying and
23 misrepresenting information about the health effects and addictiveness of their products.

1 **Q: What are the cultures at defendant firms?**

2 A: When I consult with companies, I get a sense of the culture from talking with employees
3 and I think the monitors will similarly get such a sense of culture from interacting with
4 employees at the defendant companies. The one broad conclusion I can reach, given my
5 assumptions, is that the existing culture at defendant companies encourages and rewards
6 misconduct.

7 **Q: What other aspects of defendants' business, if any, should the Court consider as**
8 **part of a comprehensive package of comprehensive change?**

9 A: In addition to the tasks, competencies, and culture of defendant companies, the Court and
10 its monitors should be thinking in terms of the organizational architecture of the companies and
11 the processes employed by the companies in various parts of their organizations.

12 **Q: What do you mean when you say organizational architecture?**

13 A: Organizational architecture refers to the ways in which the people, tasks, competencies,
14 structures, incentives, and culture of a firm interrelate. Just as an architect thinks beyond specific
15 parts of a house and deals with creating an integrated design, organizational architecture thinks
16 about how to create all of the parts of an organization that best achieves the goals of the
17 organization. Based on my assumptions, the existing architecture of defendant companies is one
18 that supports misconduct. The goal of the structural remedies that I have recommended to the
19 Court is to build an organizational architecture that is based on avoiding misconduct. A core
20 idea of organizational design is that organizations are not changed in profound ways by changing
21 one piece of the company. Rather, you must move entirely from the existing organizational
22 architecture to a fundamentally new one. In the context of this case, the challenge is to re-
23 organize these companies in such a way that fraud is unlikely to occur.

1 **Q: What specific processes do you think are important for the Court to consider in this**
2 **architectural process?**

3 A: Again it relates to the categories of fraud alleged. For example, and this list is not
4 exhaustive, the Court must review the design process because it produces cigarettes that deliver
5 nicotine to addict the smoker, the marketing processes because it produces advertising that
6 causes young people to start smoking and adults who want to quit to smoke light and low tar
7 cigarettes, and the companies' public relations and communications processes because they
8 produce false and misleading statements.

9 **1. Eliminate Economic Incentives for Defendants to Sell Cigarettes to**
10 **Young People**

11
12 **Q: The first structural change you suggest involves "eliminating economic incentives**
13 **for Defendants to sell cigarettes to young people." Please explain why this structural**
14 **change is necessary to prevent misconduct from continuing?**

15 A: As long as expected profit from cigarette sales to young people exists, the misconduct of
16 marketing cigarettes to young people will continue. Therefore, a necessary remedy would
17 identify the value of having a young person start and continue to smoke and then eliminate that
18 value.

19 **Q: What information do you consider significant to the issue of defendants' economic**
20 **incentives to sell cigarettes to young people?**

21 A: The fact that a substantial majority of adults who smoke regularly started smoking before
22 they turned 18.

23 **Q: Dr. Bazerman, you testified earlier that you had read the expert report of Dr.**
24 **Jonathan Gruber. Does the remedy proposed by Dr. Gruber address the incentives these**
25 **defendants experience to market their products to young people?**

1 A: Yes. Dr. Gruber's expert report proposes a mechanism aimed at eliminating the economic
2 incentives that defendants experience to market cigarettes to young people.

3 **2. Changing Compensation and Promotion Policies for Managers and**
4 **Executives to Produce Outcomes Inconsistent with Misconduct**
5

6 **Q: The next structural change you suggest is "changing compensation and promotion**
7 **policies for managers and executives to produce outcomes inconsistent with misconduct."**
8 **Please explain why this structural change is necessary to prevent misconduct from**
9 **continuing?**

10 A: As long as defendants reward people for profitability and not for complying with the
11 various representations the defendants make to the public, their managers and executives will
12 continue to engage in misconduct.

13 **Q: What information do you consider relevant to the issue of changing defendants'**
14 **compensation and promotion policies?**

15 A: I found it significant that Mr. Schindler testified that profit was an important part of the
16 reward system, but that avoided conduct was not. I also found Lynn Beasley's (current President
17 and COO of R.J. Reynolds Tobacco Company) definition of winning, which I will discuss later
18 in this testimony, significant. Both examples provide compelling evidence on how current
19 compensation systems are likely to lead to misconduct.

20 **Q: Are you generally familiar with the annual amount of compensation that the**
21 **managers and executives of the defendant companies receive?**

22 A: Yes. I have seen testimony from several company executives and managers including
23 Andrew Schindler, Bennett LeBow, Steven Parrish, and Michael Szymanczyk, in which they
24 discuss compensation. I have also seen documents related to the compensation that the
25 defendants' executives receive.

1 **Q: In reviewing the testimony of these executives and managers regarding their**
2 **respective compensation, what, if anything, did you find relevant for your analysis in this**
3 **case?**

4 A: I found it relevant that these executives and managers, for example Andrew Schindler of
5 Reynolds, testified that their annual compensation was tied to company performance.

6 **Q: Why is this relevant?**

7 A: It is relevant because company performance was defined in terms of traditional financial
8 considerations, and not in terms of the avoidance of misconduct that the defendants have claimed
9 to have changed in recent years.

10 **Q: Is it appropriate for defendants in this case to compensate their executives**
11 **according to traditional financial considerations?**

12 A: Yes, given that these are legal companies. However, these defendants have also pledged
13 to engage in certain conduct, like not marketing to youth, that is actually at odds with what is
14 profitable for their firms. What is significant is that they provide specific rewards for
15 profitability by some measurable amount, but not specific rewards for reducing youth smoking by
16 some measurable amount.

17 **Q: I am handing you a document marked as U.S. Exhibit 89,456, are you familiar with**
18 **this document?**

19 A: Yes, I am. It is the Reynolds American 2005 Proxy Statement.

20 **Q: I would like to draw your attention to page 26 of this document, where there is a**
21 **paragraph dealing with executive compensation principles and policies. Do you see this**
22 **paragraph?**

23 A: Yes.

1 **Q: What are the executive compensation principles outlined in that paragraph?**

2 A: There are two principles that guided RAI's Compensation Committee: "(1) compensation
3 opportunities must enable RAI to attract and retain individuals with the high caliber of talent and
4 skills critical to RAI's success and (2) a substantial portion of each executive officer's
5 compensation must be tied to quantifiable measures of RAI's financial performance and/or stock
6 price performance." U.S. Ex. 89,456.

7 **Q: Are these principles consistent with Mr. Schindler's testimony?**

8 A: Yes, the document affirms the fact that Mr. Schindler's compensation is tied to company
9 performance.

10 **Q: If you turn to page 29 of the Reynolds American Proxy Statement, what, if any,**
11 **relevant information is contained on that page?**

12 A: That page contains a chart demonstrating the salaries of the Reynolds' executives: Susan
13 Ivey, Andrew Schindler, Lynn Beasley, Charles Blixt, and Dianne Neal.

14 **Q: I am handing you an exhibit identified as JD-052854. Are you familiar with this**
15 **document?**

16 A: Yes, this document is the 2004 Proxy Statement that was issued by Altria Group, Inc. and
17 discussed in the current CEO of Philip Morris USA Michael Szymanczyk's testimony.

18 **Q: Dr. Bazerman, are these the only proxy statements from Altria/Philip Morris**
19 **Companies that you reviewed during the course of your assignment as an expert in this**
20 **case?**

21 A: No. I also reviewed various proxy statements from defendant Philip Morris Companies
22 for the years 1999 through 2001.

23 **Q: Generally what information did you focus on in your review of the defendants'**

1 **respective proxy statements?**

2 A: For all proxy statements that I reviewed, I focused on the compensation information for
3 senior executives. I noticed that these executives have significant amounts of equity ownership,
4 providing an incentive to maximize shareholder value. I also paid attention to the shareholder
5 proposals issued by the various defendant companies.

6 **Q: I am directing your attention to page 18 of the Altria Proxy Statement, where there**
7 **is a paragraph titled "Compensation Committee Report on Executive Compensation." Do**
8 **you see that?**

9 A: Yes.

10 **Q: What are the factors that Altria's Compensation Committee considers in**
11 **determining executive compensation under the Company's compensation plans?**

12 A: The document states that

13 the Committee considers the following in determining executive compensation under the
14 Company's compensation plans:

- 15
16 • the Company's financial performance compared with its annual and long term
17 goals, as measured by net earnings, earnings per share growth, return on equity, volume growth
18 and implementation of strategic initiatives, as well as financial comparisons to companies within
19 the performance peer group measured by total stockholder return and net earnings;
- 20
21 • each executive's contributions to the Company's overall results;
- 22
23 • the external challenges to the Company's ability to recruit and retain executive
24 talent, given the environment surrounding the tobacco industry; and
- 25
26 • the Company's size and complexity compared with companies in the
27 compensation survey group.

28
29 **Q: How does this document relate to your analysis concerning changes to executive**
30 **compensation?**

31 A: I see an inconsistency between what is rewarded versus the behaviors that are promised to

1 society in the mission and value statements. This document demonstrates that executives are
2 being rewarded for conventional financial performance and not other non-financial behaviors.

3 **Q: Please focus your attention on page 23 of Altria's Proxy Statement, what, if any,**
4 **relevant information is contained on this page?**

5 A: This page contains a chart demonstrating the salaries of Altria's key executives, including
6 Altria Senior Vice President Steven Parrish and Philip Morris USA Chairman and CEO Michael
7 Szymanczyk.

8 **Q: I am handing you what have been marked as U.S. Exhibits 87,738; 20,531*; and**
9 **87,740. What are these documents?**

10 A: Notice of Annual Meeting of Stockholders issued by Philip Morris Companies Inc. in
11 1999, 2000, and 2001, respectively.

12 **Q: Are these the Philip Morris proxy statements that you mentioned earlier in your**
13 **testimony?**

14 A: Yes, they are.

15 **Q: Are you aware that Philip Morris Companies Inc. is now known as Altria?**

16 A: Yes, I am aware of that fact.

17 **Q: Was the content of these documents relevant to your analysis regarding the**
18 **structural remedy involving company compensation and promotion policies?**

19 A: Yes. These documents are certainly connected to the proposed structural remedy of
20 changing compensation and promotion policies for managers and executives, so that they are
21 motivated to produce outcomes inconsistent with misconduct. For example, in two of these
22 documents, there is a particular shareholder proposal that talks about tying executive
23 compensation to the reduction of teen tobacco use and it certainly is not warmly received by the

1 board of directors of Philip Morris Companies at the time.

2 **Q: Turning to page 24 of U.S. Exhibit 87,738, and page 30 of U.S. Exhibit 20,531*, are**
3 **these the shareholder proposals that you just mentioned?**

4 A: Yes.

5 **Q: And what do these proposals entail?**

6 A: Both documents explicitly state that the:

7 shareholders request that the Board voluntarily create a formula linking future
8 executive compensation packages with achievement of specific decreases in teen
9 consumption of our company's brands, using the terms of the now-defunct
10 'settlement' as a guide. The formula should penalize executives when the
11 company is not found in compliance with the goals determined and reward them
12 for meeting these goals.

13
14 **Q: Is the response by the Board of Philip Morris Companies Inc. the same in each of**
15 **these documents?**

16 A: Yes, the same general response was given by the Board.

17 **Q: What is the response by the Board to the proposal that tobacco executives'**
18 **compensation be tied to reduction in teen smoking?**

19 A: The Board recommended a vote against the proposal each time it was offered. The
20 rationale of the Board, as explained in both of these documents, was that this proposal would not
21 be effective in reducing the incidence of youth smoking. The Board then pointed to its "Action
22 Against Access" initiative, the MSA, and its youth smoking prevention effort as ways that the
23 company was dealing with the issue of teen smoking.

24 **Q: Did you see a similar proposal and response with regard to any of the other**
25 **defendants?**

26 A: Yes I did.

27 **Q: I am handing you what has been marked as U.S. Exhibit 87,743. Have you seen this**

1 **document before?**

2 A: Yes. It is the 1999 Proxy Statement issues by Loews Corp., which owns Lorillard.

3 **Q: If you turn to Bates page TLT102 2251, what is Shareholder Proposal 5?**

4 A: It is a shareholder proposal requesting that the Board adopt an executive compensation
5 structure that links executive compensation to a reduction in teen smoking. The shareholder
6 proposal also requests that the Company penalize executives when the company is found to not
7 be in compliance with these goals.

8 **Q: How did the Loews Board of Directors respond to this shareholder proposal?**

9 A: The Board recommended that shareholders vote against the proposal

10 **Q: How do these Boards' responses relate to your analysis regarding the structural**
11 **remedy involving company compensation and promotion policies?**

12 A: To the extent that the defendants have engaged in misconduct and that this misconduct
13 continues to this day, if one of the liabilities found is related to this shareholder proposal, the fact
14 that the board of directors did not recommend engaging in a better link between executive
15 compensation and reduction of teen tobacco use is important. It is even more telling, since the
16 document also discusses executive compensation and makes clear that there are rewards for
17 maximizing shareholder profitability rather than achieving important goals such as a reduction in
18 the teen smoking rate.

19 **Q: Now, Dr. Bazerman, is the remedy of changing the defendants' compensation and**
20 **promotion policies limited only to the salaries and bonuses of senior executives from**
21 **defendant companies?**

22 A: No, if the monitors choose to implement this remedy, it should cover incentives for all
23 employees.

1 **Q: I am showing you U.S. Exhibits 29,946; 29,967; 29,968; 29,969; and 61,781. Are you**
2 **familiar with these documents?**

3 A: Yes. Each of these documents is a Commendation Award Recommendation issued to a
4 scientist at R.J. Reynolds in the late 1980s and early 1990s.

5 **Q: According to these documents, who in the company authorized the commendation**
6 **awards?**

7 A: In each of these documents, there is a place for the manager, department head, and the
8 CEO to sign and approve the recommendations.

9 **Q: How are these documents relevant to your opinion that this structural remedy of**
10 **changing compensation policies is necessary?**

11 A: These documents are examples of how R.J. Reynolds' managers and executives reward
12 employees for reports or testimony in litigation that were consistent with the prior statements of
13 the company on issues related to ETS and smoking and health. Even more telling, two
14 documents, U.S. Ex. 29,946 and U.S. Ex. 61,781, explicitly mention the litigation that the
15 scientists participated in and the fact that the outcomes were favorable to the company.

16 **3. Removal of Senior Management**

17 **Q: The next structural change you suggest is "removing senior management." Please**
18 **explain why this structural change may be necessary.**

19 A: Assuming Defendants are liable and misconduct is still occurring, the current
20 management teams cannot and will not move away from the environment of misconduct. It is
21 safe to say that this will not change in the future. For example, there are still senior executives
22 who continue to deny the health information that is well known in the medical and scientific
23 community. Removing these executives will allow a new corporate environment to develop, one

1 that is free of the biases that lead and have led to their misconduct.

2 **Q: What information do you consider relevant to the issue of removal of defendants'**
3 **senior management?**

4 A: This information included but was not limited to the lengthy tenures of and substantial
5 compensation for the key senior executives of each defendant tobacco company.

6 **Q: Why is it necessary for the Court to consider removing senior management at the**
7 **defendant companies?**

8 A: The defendants as a group, and the senior managers at each defendant company, have
9 developed competencies in executing their existing and historically anchored business models.
10 Quite simply, it is highly unlikely that incumbents will be able to undertake the changes
11 necessary to prevent fraud from occurring in the future.

12 **Q: Why is it highly unlikely that managers will be able to undertake these changes?**

13 A: Inertial forces prevent managers from recreating their organizations in the face of changed
14 circumstances. In the present case, the changed circumstances are a series of actions that still
15 include fraud and thus make defendants' current way of doing business no longer tenable. Inertia
16 takes several forms, including people anchoring on old practices and organizational architecture
17 that makes inertia comfortable. Even when managers see that they have to change, there is a gap
18 between knowledge and action. It's difficult for incumbents who know they have to move to
19 execute. Often, success in the old business model prevents executives from being willing to take
20 the bold steps needed to move to a new business model.

21 **Q: Dr. Bazerman, how far into the defendant companies should removal be pursued?**

22 A: I would defer to the monitors and Court to determine who should be removed, if that is a
23 structural change that the monitors recommend. I think at the least the CEO and the executives

1 who directly report to the CEO should be considered for removal. In the case of Philip Morris,
2 this would include their senior team. In general, the extent of removal depends in part on the
3 degree to which the company is centralized. For example, in the case of Tyco, 290 of the 300 top
4 managers were replaced. This was due in part to the fact that Tyco consisted of many smaller
5 companies and the removal affected the very top people at each of these companies. When Louis
6 Gerstner was hired to restructure IBM, he only replaced 10 managers. However, this was due to
7 the fact that IBM was much more centralized than Tyco.

8 **Q: Would removal be limited to certain operations within the company?**

9 A: That would depend on the Court's decision on liability. Certain operations are obviously
10 related to certain frauds, for instance the marketing and R&D departments to the light/low tar
11 fraud. I am deferring to the Court and the monitors to consider removal where appropriate both
12 in terms of level of management and functionally which departments.

13 **Q: In your experience, is succession of leadership uncommon when a company is**
14 **changing its business model?**

15 A: No, it is very common. In fact, if significant change is to occur, change in leadership is
16 expected. This is understood both in practice in the private sector and in the study of
17 management.

18 **Q: Do the cognitive biases you discussed earlier support your conclusion that the Court**
19 **should consider removing management as a remedy?**

20 A: There is significant evidence from my area of expertise, behavioral decision research, that
21 executives who have made a decision to pursue a particular course of action are much more
22 likely to escalate their commitment to that course of action than other executives. Similarly, the
23 confirmation trap bias, which I discussed earlier, predicts that executives and managers who have

1 taken particular positions on behalf of their companies are more likely to seek confirmatory
2 evidence to support that position than other executives. So the logic behind the removal of
3 senior management is that to the extent that executives have committed to particular positions,
4 they are likely to escalate their commitments to those positions and to seek information that
5 conforms with those views. For defendants in this case, those positions include, but are not
6 limited to, first, ETS has not been shown to cause disease; second, that smoking is a risk factor
7 rather than a cause of disease; third, that addiction is like a card-playing habit rather than a
8 physical addiction; and fourth, that there is no deception involved in light/low tar marketing. To
9 the extent that new people are brought in to operate defendant companies, these biases would be
10 dramatically reduced.

11 **Q: Are there examples of other companies where senior management was removed as a**
12 **result of misconduct?**

13 A: Yes. Tyco and Salomon Brothers are examples.

14 **Q: Under what circumstances do you think it would be advisable to remove senior**
15 **management?**

16 A: I would certainly recommend that removal should be based on whether those individuals
17 were involved in any misconduct in the past having to do with misrepresentation, obfuscation or
18 acting in a way inconsistent with the public commitments and obligations the defendant firms
19 had made.

20 **4. Subcontracting Research Under Court Supervision**

21 **Q: The next structural change you suggest is "requiring subcontracting of all research**
22 **to private companies monitored by the Court." Please explain why this structural change**
23 **is necessary to prevent defendants' misconduct from continuing.**

1 A: Assuming that defendants have supported and continue to support biased research, this
2 behavior will continue absent a structural remedy requiring the subcontracting of research to
3 private companies monitored by the Court.

4 **Q: What research would you recommend the defendants subcontract?**

5 A: Broadly speaking, the structural remedy needs to address the misconduct alleged in this
6 case. Specifically, the Court and its appointed monitors must focus on subcontracting research
7 on the health effects of smoking, including ETS, research on addiction, nicotine content and
8 delivery, less hazardous products as well as consumer research. In addition, the court should
9 consider subcontracting defendants' marketing research.

10 **Q: What information do you consider relevant to the structural remedy of requiring**
11 **defendants to subcontract research functions?**

12 A: I have assumed that defendants suppressed scientific research about the health effects of
13 their products and manipulated this research; and I have seen evidence that supports these
14 assumptions. For example, this Court has heard testimony from Drs. Farone, Wigand, and
15 DeNoble in particular that reveal widespread misuse of scientific research in defendant
16 companies.

17 **5. Divestiture of Less Hazardous Cigarette Operations**

18 **Q: The next structural change you suggest is "requiring defendants to sell intact their**
19 **research and development, current product development activities, and all other relevant**
20 **material regarding safer cigarettes so that safer cigarettes can be brought to the**
21 **marketplace." Please explain why this structural change may be necessary to prevent**
22 **defendants' misconduct from continuing?**

23 A: I have assumed that defendants have the technical knowledge and know how to make

1 safer cigarettes, but have delayed bringing them to market. Thus, the safer cigarette research and
2 development should be sold to companies outside of defendants' core business. That way, if it is
3 handled by companies that have no interest in defendants' core business, the misconduct related
4 to this structural remedy will not occur.

5 **Q: How would this remedy be implemented?**

6 A: In this process, the court-appointed monitors would determine what company assets
7 relate to defendants' activities concerning less hazardous cigarette products. The monitors would
8 then arrange the sale of these assets to companies outside of defendants' core business.

9 **B. Structural Changes that Will Support Efforts to Eliminate the Misconduct**
10 **the United States Has Proven**
11

12 **Q: Are these remedies the only actions the Court should consider?**

13 A: No. The monitors should be empowered to arrange for and implement the changes
14 necessary to eliminate ongoing fraud. In addition, there are other Court interventions that also
15 can affect incentives and biases that I would recommend the Court consider.

16 **Q: What are the other Court interventions that it should consider?**

17 A: The structural changes to defendant firms could be supported by additional efforts that
18 focus on (a) educating managers in such a way to address bias in decision making; (b) creating
19 internal mechanisms for employees to report misconduct without fear of retribution; (c) changing
20 oversight and reporting arrangements; (d) requiring the disclosure of any information concerning
21 an actual or potential health or safety risk with which a consumer of cigarettes would be
22 concerned; (e) requiring the discontinuance of or change to advertising and promotional
23 campaigns or practices; (f) severe monetary fines for participation in or association with
24 individuals or organizations engaged in activities that constitute or will reasonably result in
25 corporate or individual misconduct; and (g) requiring defendants to fund certain activities, such

1 as cessation programs and counter-marketing programs, that affect consumer demand for their
2 products.

3 **1. Educating Managers to Address Bias in Decision making**

4 **Q: Please explain how educating managers in such a way to address bias in decision**
5 **making would support the structural changes you recommend the Court consider?**

6 A: Substantial evidence exists that managers can be trained to reduce the degree to which
7 they are affected by bias. Managers can also be trained to be aware of their inability to make
8 unbiased decisions and then to change the structures so that the biases will not reoccur.

9 **Q: What type of training would the managers receive?**

10 A: The managers would be educated on the ethics of this new organization and on what is
11 appropriate behavior. As I will discuss later in this testimony, having a mission statement
12 become something that lives within the organization helps to reinforce the education that the
13 managers receive.

14 **2. Mechanisms for Employees to Report Misconduct**

15 **Q: Please explain how creating mechanisms for employees to report misconduct**
16 **without fear of retribution would support the structural changes you recommend the Court**
17 **consider?**

18 A: I am familiar with past incidents where employees within the defendant companies were
19 punished rather than rewarded for reporting misconduct. As a result, the court-appointed
20 monitors need to develop a system wherein employees are able to report misconduct without fear
21 of punishment.

22 **Q: What incidents are you referring to?**

23 A: The events testified to by Drs. Farone, Wigand and DeNoble all stand out as examples of

1 instances where employees were retaliated against for either reporting misconduct or attempting
2 to disseminate information the companies deemed adversarial to their own interests.

3 **3. Changing Oversight and Reporting Arrangements**

4 **Q: Please explain how changing oversight and reporting arrangements would support**
5 **the structural changes you recommend the Court consider?**

6 A: Currently, the companies are overseen by compliance boards that have operated in the
7 same incentive-based environment where misconduct occurred. Through the process established
8 by the Court, monitors would investigate each defendant's present day corporate policies and
9 practices and set up the appropriate oversight and reporting arrangements so that the biased
10 environment that led to the misconduct can be eliminated.

11 **Q: What information do you consider relevant to the issue of changing oversight and**
12 **reporting arrangements?**

13 A: I have reviewed information that suggests there are problems within management in terms
14 of oversight and reporting. For instance, I recall that in Denise Keane's testimony, she stated that
15 she was not shown research related to light and low tar cigarettes when she prepared Philip
16 Morris' response to a request from the FTC for such research.

17 **Q: Dr. Bazerman, who is Denise Keane?**

18 A: Ms. Keane is the General Counsel of Philip Morris USA Inc.

19 **Q: I am showing you the Written Direct Testimony of Denise F. Keane, As Corrected**
20 **by Denise F. Keane. Please turn your attention to Ms. Keane's testimony beginning at page**
21 **48, lines 12 to 23:**

22 ***Q: At that May 1996 meeting with the FTC, you and lawyers for other Defendants***
23 ***were asked by FTC staff to provide any research that you had bearing on consumer***
24 ***perception of tar and nicotine ratings and the brand descriptors, correct?***
25

1 A: Yes.

2
3 Q: In response to that request, Philip Morris did not provide the FTC with any
4 information or research results about how smokers and consumers interpret brand
5 descriptors, did it?

6
7 A: No, it did not. I was not aware that Philip Morris had such research at the
8 time.

9
10 Q: And no one at Philip Morris provided the FTC with such information after that
11 meeting, correct?

12
13 A: Correct. No one at Philip Morris provided the FTC with such information,
14 because it was my understanding at the time that we had not conducted such research.

15
16 ***

17 And then continuing the line of questioning on page 49, line 14, Ms. Keane testified:

18
19 Q: You don't know whether Philip Morris has consumer research in its files
20 showing that consumers perceive cigarettes sold with descriptors such as 'light' to be
21 relatively less harmful than cigarettes without such descriptors, do you?

22
23 A: I did not know that Philip Morris had such consumer research prior to the time
24 that I received the exhibits designated in connection with my testimony. As indicated
25 above, those exhibits include some consumer research commissioned by Philip Morris
26 that references consumer perceptions of the relative health risks of low-tar cigarettes.

27
28 Dr. Bazerman, what conclusions do you draw from this testimony?

29 A: The testimony reveals that there was dysfunction, at least in this instance, in certain
30 reporting relationships at Philip Morris. The research function at Philip Morris was not
31 providing important information that Ms. Keane needed, and as a result, the FTC was not
32 provided with the information it specifically requested.

33 **4. Disclosure of Health and Safety Information**

34 Q: Please explain how requiring the disclosure of information concerning actual or
35 potential health or safety risks for cigarette consumers would support the structural
36 changes you recommend the Court consider?

37 A: Evidence exists that defendants have not been forthcoming with accurate and complete

1 information concerning the health and safety risks associated with cigarette smoking. Through
2 the process established by the Court, monitors would consult with experts on consumer behavior
3 and then create the best way to disseminate the most accurate and complete information
4 concerning these health and safety risks.

5 **Q: What information do you consider relevant to the issue of requiring disclosure of**
6 **health information?**

7 A: I have seen evidence, in the form of defendants' own website statements and testimony
8 from various defendant company executives and other employees, that defendants have
9 suppressed information about the health effects of their products.

10 **5. Discontinuance of Advertising or Promotional Practices**

11 **Q: Please explain how requiring the discontinuance or change to advertising and**
12 **promotional campaigns or practices would support the structural changes you recommend**
13 **the Court consider?**

14 A: Based on my assumptions, defendants have engaged in deceptive marketing practices.
15 Through the process established by the Court, monitors can act to discontinue marketing
16 practices that promote fraud.

17 **Q: I am now returning you to the Philip Morris proxy statements (U.S. Exhibit 87,738;**
18 **U.S. Exhibit 20,531*; and U.S. Exhibit 87,740) that we reviewed earlier. I would like to**
19 **draw your attention to the shareholder proposal that appears respectively in each**
20 **document on page 25 of U.S. Exhibit 87,738; page 32 of U.S. Exhibit 20,531*; and page 22**
21 **of U.S. Exhibit 87,740. Do you recognize this proposal?**

22 A: Yes. This proposal requested that Philip Morris implement a policy whereby the
23 company would be required to submit any promotional, marketing and/or advertising campaign

1 presently running or inaugurated in the future to independent and certifiable testing to ensure that
2 it is not equally or more appealing to the 14-18 age group than those over age 18.

3 **Q: What is the response by the Board of Philip Morris Companies Inc.?**

4 A: In response to this proposal each year, the Board recommended that the shareholders vote
5 against this proposal arguing that it was unnecessary due to the MSA and the company's existing
6 efforts.

7 **Q: How do the Board's responses relate to your analysis concerning changes to**
8 **defendants' advertising and promotional campaigns or practices?**

9 A: If the corporation really wanted to change, and they wanted to avoid marketing to youths,
10 this proposal appears very reasonable. Unfortunately, an inconsistency exists between the stated
11 claims of the defendants regarding their intentions and their reactions to shareholder proposals
12 that appear to be directly targeted at the misconduct that the defendants claim that they do not
13 want to see exist.

14 **6. Monetary Fines for Collusion**

15 **Q: Please explain how severe monetary fines for participation in or association with**
16 **individuals or organizations engaged in activities that constitute or will reasonably result in**
17 **corporate or individual misconduct would support the structural changes you recommend**
18 **the Court consider?**

19 A: The United States has produced evidence to the Court that defendants have participated in
20 a long-standing conspiracy to commit the seven categories of fraud that form the basis for the
21 United States' case. Severe monetary fines are necessary to reduce the incentives for defendants
22 to engage in collusively engage in misconduct in the future. For this remedy to affect behavior,
23 these fines must be significant and easy to implement. In addition, they must be used in

1 conjunction with some of the structural changes above for reasons that I have testified to earlier.

2 **7. Requiring Defendants to Fund Certain Activities that will Change the**
3 **Marketplace for their Products**
4

5 **Q: Please explain how requiring defendants to fund certain activities, such as cessation**
6 **programs, would affect the incentives operating on defendants managers and executives?**

7 A: Presently in the marketplace, there are smokers who want to quit and smokers who have
8 quit that want to abstain from smoking. I have assumed that defendants are aware of this
9 population of consumers and potential consumers of their products and defendants design and
10 market light and low tar cigarettes to address this population. To the extent that effective
11 cessation programs eliminate this population in the long term, or immunize this population
12 against defendants' misleading marketing campaigns, they will also eliminate the incentives that
13 encourage defendants to design and market cigarettes in ways intended to appeal to this
14 population.

15 **Q: How would requiring defendants to fund counter-marketing activities affect the**
16 **incentives operating on defendants' managers and executives?**

17 A: The logic is the same. If a counter-marketing campaign is effective in the long-term, it
18 will remove from the marketplace a population of consumers and potential consumers of
19 defendants' products, namely children. Thus, their incentive to market to this population will be
20 eliminated and their behavior will change accordingly.

21 **Q: You mentioned in both the case of cessation and counter-marketing that there will**
22 **be long-term effects. What are the short-term effects, if any?**

23 A: The short-term effects may actually move in the opposite direction from the long-term
24 effects. While effective cessation and counter-marketing campaigns have the potential to
25 eliminate incentives in the long-term, they may actually generate stronger incentives to market to

1 people who want to quit and to children in the short-term. For this reason, it is important that the
2 Court consider requiring defendants to fund these activities for a sustained period of time.

3 **Q: How can those short-term effects be remedied?**

4 A: The court-appointed monitoring system I recommended addresses these short-term
5 effects. This is why it is important that the Court consider subcontracting research, including
6 market research, and giving monitors the power to discontinue advertising practices that are
7 determined to cause misconduct.

8 **Q: How should monitors choose among the various alternatives you have suggested?**

9 A: There a number of variables that monitors will consider. First, and perhaps most
10 importantly, they will want to consider the Court's finding on liability. Second, the monitors
11 could conduct various analyses, including a cost-benefit analysis, of contemplated changes, and
12 determine the most efficient ones from the standpoint of addressing the misconduct while
13 minimizing the impact on other stakeholders, including employees and shareholders.

14 **Q: Dr. Bazerman, will structural remedies impact stakeholders at the companies?**

15 A: Yes, depending on what is pursued.

16 **Q: Did you consider that fact when arriving at your recommendations?**

17 A: Yes, of course. At the same time, I understand that the issue in this case is stopping fraud
18 that harms society as a whole.

19 **Q: Would you recommend that the court-appointed monitors consider the impact of**
20 **any structural change or other interventions on stakeholders?**

21 A: Yes, I would recommend that they take stakeholders into consideration and select
22 structural changes and interventions that accomplish the goal of creating organizations that will
23 not engage in misconduct with a minimum negative impact on stakeholders.

1 **C. Defendants' Ability to Undertake Changes Absent Court Intervention**

2 **Q: Dr. Bazerman, you have testified that it is necessary for the Court to order certain**
3 **structural changes to defendants' businesses. Why is it necessary for the Court to order**
4 **such changes?**

5 A: I understand that defendants have testified, and otherwise argued, that their behavior has
6 changed for the better and this good behavior will continue into the future. However, my overall
7 conclusion is that there exists substantial evidence that when managers and executives have the
8 incentive to act in a particular direction, they will be incapable of making unbiased judgments,
9 and that these biases will operate in the systematic direction of their incentives, even for the most
10 honest of managers and executives. Simply put, as long as executives and managers are
11 rewarded for increasing market share and for increasing profit, while not being rewarded for
12 stopping misconduct, accepted theories of behavioral decision research lead to the conclusion
13 that the same conduct of the executives and managers of the defendants alleged to be wrongful
14 will continue. Therefore, the Court must order structural changes that affect incentives or
15 misconduct will likely continue.

16 **Q: You just stated that defendants have testified that their behavior has changed for**
17 **the better and this behavior will continue into the future. Have you read some of that**
18 **testimony?**

19 A: Yes.

20 **Q: Whose testimony have you read where statements such as that were made?**

21 A: The testimony of Michael Szymanczyk, the current CEO of Philip Morris USA.

22 **Q: What, if any, information did Mr. Szymanczyk provide in his testimony that you**
23 **found relevant to your analysis in this case?**

1 A: In his testimony, Mr. Szymanczyk pointed to the Mission Statement and Core Values of
2 Philip Morris USA drafted in the late 1990s as evidence that the company had changed its
3 corporate culture and that this new culture was incompatible with committing fraud.

4 **Q: I am handing you a copy of the Written Direct Testimony of Michael Szymanczyk.**
5 **Please turn your attention to pages 21 and 34 of that document. Do these pages contain**
6 **Philip Morris's Mission Statement and Core Values, respectively?**

7 A: Yes.

8 **Q: Dr. Bazerman, are Philip Morris's Mission Statement and Core Values sufficient to**
9 **remedy the environment that led and leads to the company's misconduct?**

10 A: No. In order for a Mission Statement to have meaning and be effective, the company's
11 actions must reflect the values expressed in the mission statement. I have consulted with
12 companies that have mission statements and I constantly hear about the values and the ethics in
13 those companies, because the executives and other employees have embraced the values and act
14 in accordance with them. But, firms vary in the degree to which these are living documents.
15 Unfortunately, for many firms, mission statements are PR documents that do not seriously guide
16 the behavior of employees.

17 **Q: Dr. Bazerman, based on the materials you have reviewed, are there examples of**
18 **conduct by Philip Morris that you conclude are inconsistent with the Mission and Core**
19 **Values?**

20 A: Yes, there are examples. First, in its mission statement, Philip Morris says it will "align
21 with society" and do so by being an "active participant in resolving societal concerns that are
22 relevant to our business." Given that research shows and the consensus of the public health
23 community is that ETS causes disease, the mission statement is at odds with the company's

1 position that ETS does not cause disease. The company also fails to provide clear statements on
2 issues like addiction and the health risks of light/low tar cigarettes, as well as take any action to
3 change the use of light/low tar descriptors despite the company's knowledge that such descriptors
4 are misleading to consumers.

5 Similarly, as part of this alignment with society, Philip Morris says it will help reduce
6 youth smoking and yet the only two senior executives that Philip Morris CEO Michael
7 Szymanczyk put in charge of youth smoking had no prior experience in that field. Further, no
8 outside experts in youth smoking were brought in-house at Philip Morris USA to help run these
9 programs. If Philip Morris wanted to act consistently with its mission statement, they would
10 have found the very best youth smoking experts, who did not have a career that focused on
11 selling more cigarettes.

12 Finally, I have reviewed this Court's Order wherein Philip Morris was sanctioned for
13 destroying email communications in violation of a previous Order issued by this Court.

14 **Q: Dr. Bazerman, have you reviewed any materials from other defendants where**
15 **similar mission statements were made?**

16 A: Yes, I have. I have seen similar statements in the written direct testimony of Lynn
17 Beasley, the current President and Chief Operating Officer for defendant R.J. Reynolds Tobacco
18 Company. I have also seen the Corporate Principles On Marketing, Promotion, and Youth
19 Smoking issued by Martin Orlowsky, President and CEO of defendant Lorillard.

20 **Q: Dr. Bazerman, I am showing you pages 17-18 of Ms. Beasley's written direct**
21 **testimony, in a subsection titled "Reynolds' Core Values and Guiding Principles":**

22 ***Q: Ms. Beasley, I would now like to ask you about how Reynolds operates its***
23 ***business today and for the future. Has Reynolds identified any fundamental principles***
24 ***that form the basis for how the company operates today?***
25

1 ***A. Yes we have. Reynolds recognizes it manufactures legal adult products that***
2 ***have significant and inherent health risks for a number of serious diseases, and that***
3 ***smoking in combination with other factors causes diseases in some individuals.***
4 ***Therefore, we have established four simple but very important principles that we***
5 ***adhere to in conducting our business. These principles form the foundation of our key***
6 ***business practices, and the policies and procedures that we employ in operating the***
7 ***company. They are:***

- 8
- 9 - ***We fully recognize that we produce a product that has significant health***
10 ***risks.***
11 - ***We believe that people should – and do– know about these risks, and we***
12 ***are committed to trying to develop products that might present less risk.***
13 - ***We definitely do not want children to smoke.***
14 - ***We do not encourage nonsmokers to start smoking.***
15

16 **At page 19-20 of this same testimony, Ms. Beasley describes the company's new corporate**
17 **vision, Passion for Winning:**

18 ***Q. Ms. Beasley, we have now talked about the fundamental principles that form***
19 ***the foundation for how Reynolds operates. Has Reynolds created a new corporate***
20 ***vision since the merger?***
21

22 ***A. We have defined our vision as a Passion for Winning. We want to win in the***
23 ***marketplace, win as individuals, win as a team, and win as an entire company. Our***
24 ***vision for winning encompasses three critical areas. First, to win in the marketplace,***
25 ***we need to reverse our declining market share trend and, over time, grow our total***
26 ***market share at the expense of our competitors. Second, we need to deliver growing***
27 ***profits every year so we can create and return value to our shareholders. Finally, we***
28 ***need to create a company culture where our employees are empowered, motivated and***
29 ***rewarded for their successes. If we can achieve these goals, we can be a winning***
30 ***company.***
31

32 **What, if any, conclusions do you draw from this testimony?**

33 **A:** As I just testified, in order for a Mission Statement to have meaning and be effective, the
34 values expressed in the mission statement must live through everything that occurs in the
35 company. On the one hand, R.J. Reynolds identifies the principle that everyone should know the
36 risks of smoking and that children should not smoke. However, the company's lack of
37 commitment to these new principles is evident in its corporate vision which emphasizes and
38 cultivates the same incentive-based environment in which biased decision making, and

1 subsequently, company misconduct thrives. Profit is the focus, not stopping youths from
2 smoking, not communicating as honestly and clearly as possible, nor stopping any of the other
3 misconducts that are a focus of this case.

4 **Q: Dr. Bazerman, I am handing you United States Exhibit 55,455, which is in evidence**
5 **in this case. Do you recognize this document?**

6 A: Yes. This is the Lorillard Corporate Principles On Marketing, Promotion, and Youth
7 Smoking.

8 **Q: Turning to Bates page 82225803, when was this document issued by Lorillard?**

9 A: This document is dated June 30, 1999.

10 **Q: Turning your attention to the first sentence on this page, what is the goal of**
11 **Lorillard's Corporate Principles?**

12 A: Mr. Orłowsky states that he is "writing this message to restate an important principle your
13 company has historically adhered to in the conduct of our business with respect to youth
14 smoking." He goes on to discuss the fact that Lorillard has voluntarily followed the tobacco
15 industry's Cigarette Advertising and Promotion Code.

16 **Q: I am showing you U.S. Exhibits 21,228 and 20,519, which have been received into**
17 **evidence. What are these documents?**

18 A: They are the 1964 Cigarette Advertising Code and the revised Cigarette Advertising Code
19 from 1990, respectively.

20 **Q: Are you familiar with these documents?**

21 A: Yes, I have reviewed them.

22 **Q: How does this document compare to United States Exhibit 20,519, and United States**
23 **Exhibit 21,228?**

1 A: This document appears to be essentially identical to the Advertising Code. In some
2 instances, Lorillard's Corporate Principles simply restate the same language of the Code.

3 **Q: What, if any, conclusions do you draw from Lorillard's actions in this regard?**

4 A: Similarly as I testified regarding the R.J. Reynolds mission statement, in order for
5 Lorillard's Corporate Principles to have any meaning and to be effective, Lorillard must
6 demonstrate its commitment to these Principles through its actions, and not just its words.
7 Wholesale adoption of the industry's position on advertising and marketing is not enough.

8 **Q: You have testified that you have read defendants' statements that their conduct will**
9 **be different in the future. Are there systematic differences between the decisions**
10 **individuals say they will make or plan to make in the future and the decisions they actually**
11 **make in the future?**

12 A: Yes, there has been very substantial research that when people are thinking about decision
13 making in the future they have a much more objective view than when they are in the moment of
14 decision. For example, when a group of managers get together in a corporation and they estimate
15 how long a project will take there is a clear pattern that work takes dramatically longer than most
16 provided for in their business plans. At some level, most good executives know projects take
17 longer than planned. If you ask them, they will tell you that fact. That's what is called the
18 outsider view. There's an insider view and that's a person who is actually working in a firm
19 writing business plans and estimating the amount of time projects take who makes the same
20 biased decision over and over again. So despite the fact that an executive knows projects take
21 longer than planned, he/she doesn't fully incorporate that outsider's knowledge and continues to
22 misestimate. So in sum, when many executives make plans for the future, they do so looking
23 through a less biased lens but on implementation a wide variety of biases come out.

1 **Q: Dr. Bazerman, the testimony you have read has been from corporate employees**
2 **testifying on behalf of their employer. What effect, if any, does this fact have on whether a**
3 **decision is self-serving?**

4 A: Behavioral decision research shows that people are more likely to make self-serving
5 decisions when the favorable outcome that individuals receive can be attributed to the
6 individual's group rather than to just the individual. As a result, people are more comfortable
7 with their self-serving claims if they can base their biased judgments on their company's needs or
8 their family's needs rather than their personal needs. As my colleague David Messick has noted,
9 when a football coach quits one job for a better paying job, we do not hear him say, "I wanted to
10 make more money." Rather, we are much more likely to hear him say, "I wanted to ensure the
11 financial security of my family." In reality, these are very similar statements. Thus, as long as
12 the executives of the defendant firms can explain their actions as being for their shareholders and
13 for their employees, self-serving behavior becomes even more likely.

14 **Q: Dr. Bazerman, we have discussed defendants' attempts at remedying their past**
15 **behavior. Are you aware of limitations on behavior that defendants have imposed upon**
16 **themselves?**

17 A: Yes.

18 **Q: What are some of those limitations?**

19 A: These include the 1964 Voluntary Cigarette Advertising Code and the revised Voluntary
20 Cigarette Advertising Code from 1990.

21 **Q: How are self-imposed limitations on defendants' behavior, such as the Cigarette**
22 **Advertising Code, consistent with your opinions that defendants act and will continue to**
23 **act in self-serving ways?**

1 A: Despite any self-imposed limitations on their behavior, defendants act and will continue
2 to act in self-serving ways because responsibility for enforcing these self-imposed limitations
3 would fall to company employees who have long worked in an environment that rewards
4 misconduct and thus have engaged in the biased decision making that led to the defendants'
5 failure with these voluntary, self-imposed restrictions.

6 **D. A System of Injunctions**

7 **Q: Dr. Bazerman, assume the Court were to enjoin defendants from engaging in the**
8 **alleged fraudulent conduct. Would such a remedy counteract incentives that defendants**
9 **experience to commit misconduct?**

10 A: No. It may well be the case that the defendants could still maximize profits by running
11 the risk of enforcement of the injunction. In addition, executives tend to overweight current
12 profitability, and to discount the future. Thus, executives will focus more on current profits, and
13 less on the risks of legal penalties in the future.

14 **Q: Assuming such injunctive relief included rapid enforcement and high penalties,**
15 **would this type of remedy counteract incentives defendants experience to engage in**
16 **misconduct?**

17 A: The speed and magnitude could have some marginal effect on intentional corruption.
18 However, bias will remain, and executives will continue to see information in a self-serving way
19 that will allow them to engage in misconduct unintentionally.

20 **Q: Will the risk of the losses from the penalty of the injunction be sufficient to stop**
21 **misconduct?**

22 A: Earlier in this testimony, I testified about the impact of framing on risk taking. It is my
23 opinion that if remedies were put into place that created an injunction against marketing to youth,

1 the defendants would be focusing on what they are losing in comparison to the status quo. Thus,
2 they would have the choice between taking the sure loss of stopping all misconduct, or taking the
3 risk of engaging in some misconduct, and the probabilistic loss of penalties through an
4 injunction. The common finding of risk taking in the domain of losses leads me to conclude that
5 risk taking and misconduct will be common if remedies were limited to enjoining the parties
6 from misconduct.

7 **Q: Professor Bazerman, how does this risk seeking behavior compare in laboratory**
8 **settings as opposed to real world decisions?**

9 A: Behavioral decision research demonstrates that risk aversion is stronger in the real world
10 than in the laboratory in the domain of gains, and risk seeking is stronger in the real world than in
11 the laboratory in the domain of losses. Thus, in the context of defendants' risk seeking behavior
12 under threat of injunction, I expect risk seeking to be strong, and the frequency of misconduct
13 high.

14 **Q: Dr. Bazerman why wouldn't a court-appointed monitor suffer from the same biases**
15 **that you conclude managers suffer from?**

16 A: As I discussed earlier, decision makers have two perspectives on decision making: an
17 *insider* view and an *outsider* view. The insider is the biased decision-maker who looks at each
18 situation as unique, while the outsider is more capable of generalizing across situations and
19 making rational decisions. Kahneman and Lovallo provide convincing evidence that the outsider
20 makes better decisions than the insider because the outsider is less affected by bias, and the
21 outsider view incorporates more relevant data from previous decisions. Yet, when decisions are
22 made, the insider view is the one often taken. It is my opinion that it would be the more rational
23 outsider making the decision that the company wants to act responsibly, but it would be the

insider who would act against the outsider perspective, and continue to make biased decisions, be risk averse in the domain of losses, and engage in misconduct. In this case, the monitor institutionalizes an outsider view in decision making at defendant companies until the companies themselves change sufficiently to eliminate the incentives to engage in misconduct. .

E. The Court-Appointed Monitors

Q: What goals should the monitors have in overseeing defendants' businesses?

A: The overall goal for the monitors is to help create ongoing business organizations that will not engage in misconduct in the future.

Q: What skill sets should court-appointed monitors possess?

A: Among the talents that court-appointed monitors should possess would be a strong knowledge of corporate governance, incentives, implicit processes, structural issues within organizations, and organizational change. The court-appointed monitors should also possess a strong working knowledge of legal issues, as corporate governance is connected to a legal process in this case.

Q: Where could the Court find individuals with these talents?

A: I think that these talents can be found in people from different places. A law firm unconnected with the case could provide legal expertise and the resources to manage the monitoring process. Much of the other kinds of expertise I mentioned can be found on academic faculties. In addition, a business person from outside the industry might have many of these skill sets. For instance Warren Buffett was brought in to run Salomon Brothers after it came out that traders at Salomon had illegally sold U.S. Treasury bonds and the Department of Justice was considering indicting the company. Another example would be the Gehman Commission, the Commission led by Retired Admiral Gehman that looked into structural changes at NASA

1 following the Columbia disaster.

2 **Q: How would experience in the tobacco industry rate as part of the skill set of the**
3 **monitors?**

4 A: It would be a double-edged sword. While knowledge of the industry could certainly be
5 useful for understanding the current state of the industry, the biases that I have testified about
6 could also be present. If the Court were to ask me whether the industry expertise would be
7 useful, my answer would be "yes," if it could be obtained without a significant amount of the
8 bias that might come with an industry expert.

9 **Q: Practically speaking, how could a monitor avail herself of an expert with industry**
10 **experience without the advice being biased?**

11 A: By aiming for an executive that would be vigilant about creating appropriate conduct.
12 Obviously, three former tobacco employees have come forward as part of this case and spoken
13 about misconduct in persuasive ways. Thus, there are individuals with industry experience who
14 would not have the biases of defendant executives.

15 **Q: How many monitors would you recommend be involved?**

16 A: Once again, this is a point for the Court to determine; however, a monitor at each
17 company that retained various experts in advisory capacities is reasonable. In addition, some
18 integration of monitors across defendants could occur for fairness and completeness.

19 **Q: What operations of the defendant companies should be subject to court monitoring?**

20 A: That decision is dependent upon the Court's ruling with respect to each defendant's
21 liability. For example, there is an alleged fraud having to do with the deceptive marketing of
22 light and low tar products. If a remedy is to address that fraud, there are very specific parts of the
23 defendants' operations, such as their marketing departments, that the monitors would oversee.

1 **VI. CONCLUSION**

2 **Q: Dr. Bazerman, in conclusion, what is the most important piece of information that**
3 **you want the Court to take away from the testimony that you have presented here today?**

4 A: That the Court needs to consider structural changes to defendant companies that
5 defendants are unable to make themselves.

6 **Thank you, Dr. Bazerman.**