CASE 18

JOHNSON & JOHNSON*

Information presented on January 25, 2013, during an ongoing trial, revealed that executives from health care conglomerate Johnson & Johnson had known about a critical design flaw with an artificial hip but decided to conceal this information from physicians and patients. Johnson & Johnson's DePuy Orthopaedics unit kept selling the hip replacement, called the Articular Surface Replacement, although its design flaw caused it to shed large quantities of metallic debris after implantation. The firm finally recalled the unit in 2010, almost five years after problems had begun to surface. Johnson & Johnson may now face more than 10,000 lawsuits in the U.S. as a result of one of the largest medical failures in recent history.

The problems with the artificial hip represented yet another problem for Johnson & Johnson, which has struggled to emerge from a swarm of product recalls, manufacturing lapses, and government inquiries that have tarnished the name of one of the nation's most trusted brands. Serious problems surfaced a couple of years ago at McNeil Consumer Healthcare, which has had to recall many of its products—including the biggest children's drug recall of all time—that were potentially contaminated with dark particles. The Food and Drug Administration also slapped one of McNeil's plants with a scalding inspection report, causing the company to close down the factory to bring it up to federal standards.

Much of the blame for Johnson & Johnson's stumbles fell on William C. Weldon, who stepped down as CEO in April 2012 after presiding over one of the most tumultuous decades in the firm's history (See Exhibits 1 and 2). Critics said the company's once vaunted attention to quality had slipped under his watch. Weldon, who had started out as a sales representative at the firm, was believed to have been obsessed with meeting tough performance targets, even by cutting costs that might affect quality. Erik Gordon, who teaches business at the University of Michigan, elaborated on this philosophy: "We will make our numbers for the analysts, period."[1]

Weldon was replaced by Alex Gorsky, who had headed the medical devices and diagnostics unit. The division generates the largest amount of sales for

*Case developed by Professor Jamal Shamsie, Michigan State University, with the assistance of Professor Alan B. Eisner, Pace University. Material has been drawn from published sources to be used for purposes of class discussion.
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EXHIBIT 1
Income Statement*

Go to library tab in Connect to access Case Financials.

	A	B	C	D
1	Income Statement*			
2		Year Ending		
3		Dec. 30, 2012	Dec. 31, 2011	Jan. 1, 2011
4	Total Revenue	67,224	65,030	61,587
5	Cost of Revenue	21,658	20,360	18,792
6	Gross Profit	45,566	44,670	42,795
7	Operating Expenses			
8	Research & development	7,665	7,548	6,844
9	Selling, general, and administrative	20,869	20,969	19,424
10	Nonrecurring	1,163	569	–
11	Operating Income or Loss	15,869	15,584	16,527
12	Income from Continuing Operations			
13	Total other income/expenses net	(1,562)	(2,652)	875
14	Earnings before interest and taxes	14,307	12,932	17,402
15	Interest expense	532	571	455
16	Income before tax	13,775	12,361	16,947
17	Income tax expense	3,261	2,689	3,613
18	Minority interest	339	–	–
19	Net Income	10,853	9,672	13,334
20	Net Income Applicable to Common Shares	10,853	9,672	13,334

*Figures in millions of dollars.

Source: *finance.yahoo.com.*

EXHIBIT 2
Balance Sheets*

Go to library tab in Connect to access Case Financials.

	A	B	C	D
1	**Balance Sheets***			
2			Year Ending	
3		Dec. 30, 2012	Dec. 31, 2011	Jan. 1, 2011
4	**Assets**			
5	Current Assets			
6	Cash and cash equivalents	14,911	24,542	19,355
7	Short-term investments	6,178	7,719	8,303
8	Net receivables	14,448	13,137	11,998
9	Inventory	7,495	6,285	5,378
10	Other current assets	3,084	2,633	2,273
11	**Total Current Assets**	**46,116**	**54,316**	**47,307**
12	Property plant and equipment	16,097	14,739	14,553
13	Goodwill	22,424	16,138	15,294
14	Intangible assets	28,752	18,138	16,716
15	Other assets	3,417	3,773	3,942
16	Deferred long-term asset charges	4,541	6,540	5,096
17	**Total Assets**	121,347	**113,644**	**102,908**
18	**Liabilities**			
19	Current liabilities			
20	Accounts payable	19,586	16,153	15,455
21	Short/current long-term debt	4,676	6,658	7,617
22	**Total Current Liabilities**	24,262	**22,811**	**23,072**
23	Long-term debt	11,489	12,969	9,156
24	Other liabilities	17,634	18,984	12,654
25	Deferred long-term liability charges	3,136	1,800	1,447
26	**Total Liabilities**	56,521	**56,564**	**46,329**
27	**Stockholders' Equity**			
28	Common stock	3,120	3,120	3,120
29	Retained earnings	85,992	81,251	77,773
30	Treasury stock	(18,476)	(21,659)	(20,783)
31	Other stockholder equity	(5,810)	(5,632)	(3,531)
32	**Total Stockholder Equity**	**64,826**	**57,080**	**56,579**
33	**Net Tangible Assets**	**13,650**	**22,804**	**24,569**

*Figures in millions of dollars.

Source: *finance.yahoo.com*.

Johnson & Johnson and is expected to grow further with the acquisition in 2012 of Synthes, a Swiss-American medical-device maker. Like his predecessor, Gorsky worked his way up by meeting tough performance targets as a sales representative and continues the firm's 126-year tradition of hiring leaders from within. "The future of Johnson & Johnson is in very capable hands," said Weldon.[2]

At the same time, the decision to hire another insider may indicate that Johnson & Johnson was not serious about changing the corporate culture that had created so many of its recent problems. "As somebody steeped in J.&J. culture, I would be very surprised to see big changes," said Les Funtleyder, a portfolio manager at a firm that owns the firm's stock. Furthermore, even if Gorsky attempted to make changes that would address the growing list of problems, it would be a daunting task. "It's so big that it would take a very long time to move a big battleship like that," added Funtleyder.[3]

Cultivating Entrepreneurship

Johnson & Johnson has relied heavily upon acquisitions to enter and to expand in a wide range of businesses that fall broadly under the category of health care. It has purchased more than 70 different firms over the past decade. In 2008 it paid $1.1 billion to acquire Mentor Corporation, a leading supplier of products for the global aesthetic market. It topped this last year with a $20 billion purchase of Synthes, a leading player in trauma surgery. A person familiar with the industry remarked that this latest acquisition of a maker of orthopedic devices was "a good match for them."[4]

As it has grown, Johnson & Johnson has developed into an astonishingly complex enterprise, made up of over 250 different businesses that have been broken down into three different divisions. The most widely known of these is the division that makes consumer products, such as *Johnson & Johnson* baby care products, *Band-Aid* adhesive strips, and *Visine* eye drops. The division grew substantially after J&J acquired the consumer health unit of Pfizer in 2006

for $16.6 billion, the biggest in its 120-year history. The acquisition allowed the firm to add well-known products to its line up such as *Listerine* mouthwash and *Benadryl* cough syrup.

But Johnson & Johnson has reaped far more sales and profits from its other two divisions. Its pharmaceuticals division sells several blockbuster drugs, such as anemia drug *Procit* and schizophrenia drug *Risperdal.* A new drug, named *Zytiga,* prescribed to treat prostate cancer has been selling well. Its medical devices division is responsible for best-selling products such as *Depuy* orthopedic joint replacements and *Cyper* coronary stents. These two divisions tend to generate operating profit margins of around 30 percent, almost double those generated by the consumer business.

To a large extent, however, Johnson & Johnson's success across its three divisions and many different businesses has hinged on its unique structure and culture. Most of its far-flung business units were acquired because of the potential demonstrated by some promising new products in its pipeline. Each of these units was therefore granted near-total autonomy to develop and expand upon their best-selling products (See Exhibit 3). That independence has fostered an entrepreneurial attitude that has kept J&J intensely competitive as others around it have faltered. The relative autonomy that is accorded to the business units has also provided the firm with the ability to respond swiftly to emerging opportunities.

Johnson & Johnson has been quite proud of the considerable freedom that it has given to its different business units to develop and execute their own strategies. Besides developing their strategies, these units have also been allowed to work with their own resources. Many of the businesses even have their own finance and human resources departments. While this degree of decentralization has led to relatively high overhead costs, none of the executives that have run J&J, Weldon included, had ever thought that this was too high a price to pay. "J&J is a huge company, but you didn't feel like you were in a big company," recalled a scientist who used to work there.[5]

Pushing for More Collaboration

The entrepreneurial culture that Johnson & Johnson has developed over the years has allowed it to be successful with its various businesses. Indeed, Johnson & Johnson has top-notch products in each of the areas in which it operates (see Exhibit 4). It has been spending heavily on research and development for many years, taking its position among the world's top spenders (see Exhibit 5). It currently spends about 12 percent of its sales on about 9,000 scientists working in research laboratories around the world. This allows each of the three divisions to continually introduce promising new products.

In spite of the benefits that Johnson & Johnson has derived from giving its various enterprises considerable autonomy, there have been growing concerns that they can no longer be allowed to operate in near isolation. Weldon had begun to realize that J&J is in a strong position to exploit new opportunities by drawing on the diverse skills of its various business units across the three divisions. In particular, he was aware that his firm could benefit from the combination of its knowledge in drugs, devices, and diagnostics, since few companies were able to match its reach and strength in these basic areas.

This required him to find ways to make its fiercely independent businesses work together. In his own words: "There is a convergence that will allow us to do things we haven't done before."[6] Through pushing the various far-flung units of the firm to pool their resources, Weldon believed that the firm could become one of the few that may actually be able to attain that often-promised, rarely delivered idea of synergy. He created a corporate office that would get business units to work together on promising new opportunities. "It's a recognition that there's a way to treat disease that's not in silos," Weldon stated, referring to the need for collaboration between J&J's largely independent businesses.[7]

For the most part, Weldon confined himself to fostering better communication and more frequent collaboration among Johnson & Johnson's disparate operations. But the company had to take care that these attempts to achieve synergy through collaboration among the business units did not quash the entrepreneurial spirit that has spearheaded most of the firm's growth to date. Jerry Caccott, managing director of consulting firm Strategic Decisions Group, emphasized that cultivating those alliances "would be challenging in any organization, but particularly in an organization that has been so successful because of its decentralized culture."[8]

These collaborative efforts have led to the introduction of some highly successful products. Even the company's fabled consumer brands have been starting to show growth as a result of increased collaboration between the consumer products and pharmaceutical divisions. Its new liquid *Band-Aid* is based on a material used in a wound-closing product sold by one of J&J's hospital-supply businesses. And J&J has used its prescription antifungal treatment, *Nizoral,* to develop a dandruff shampoo. In fact, products that have developed in large part out of such a form of cross-fertilization have allowed the firm's consumer business to experience considerable internal growth.

Confronting Quality Issues

Even as Johnson & Johnson has been trying to get more involved with the efforts of its business units, it ran into problems with quality control with several over-the-counter drugs made by McNeil Consumer Healthcare. Since 2008, FDA inspectors have found significant violations of manufacturing standards at two McNeil plants, leading to the temporary closure of one of these. These problems have forced the firm to make several recalls of some of its best-selling products. Weldon admitted that problems

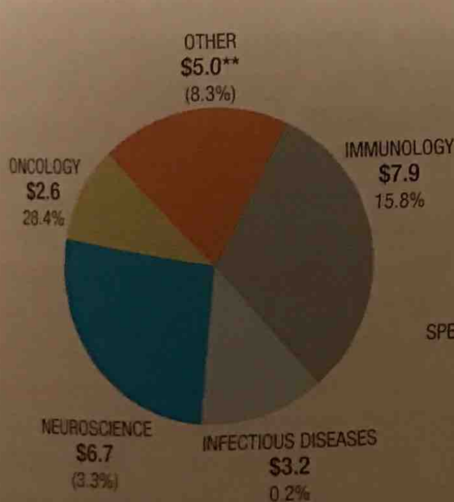
EXHIBIT 3 Sales and Profits by Segment and Region*

Johnson & Johnson is made up of over 250 different companies. These individual companies have been assigned to three different divisions: Consumer, Pharmaceutical, and Medical Devices and Diagnostics.

Go to library tab in Connect to access Case Financials.

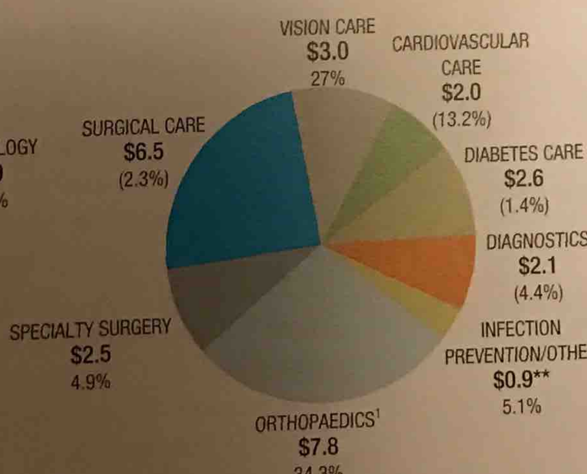
	A	B	C	D
1	Sales and Profits by Segment and Region*			
2		Sales to Customers		
3		2012	2011	2010
4	Consumer –			
5	United States	$ 5,046	5,151	5,519
6	International	9,401	9,732	9,071
7	Total	14,447	14,883	14,590
8	Pharmaceutical –			
9	United States	12,421	12,386	12,519
10	International	12,930	11,982	9,877
11	Total	25,351	24,368	22,396
12	Medical Devices and Diagnostics –			
13	United States	12,363	11,371	11,412
14	International	15,063	14,408	13,189
15	Total	27,426	25,779	24,601
16	Worldwide total	$ 67,224	65,030	61,587
17		Pre-Tax Profit		
18		2012	2011	2010
19	Consumer	$ 1,693	2,096	2,342
20	Pharmaceutical	6,075	6,406	7,086
21	Medical Devices and Diagnostics	7,187	5,263	8,272
22	Total	14,955	13,765	17,700
23	Less: Expanse not allocated to Segments	1,180	1,404	753
24	Worldwide total	$ 13,775	12,361	16,947

Pharmaceutical Segment Sales
Sales by Therapeutic Area (in billions of dollars)
2012 Sales: $25.4 billion
Sales Change:
Total: 4.0%
Operational*: 6.8%



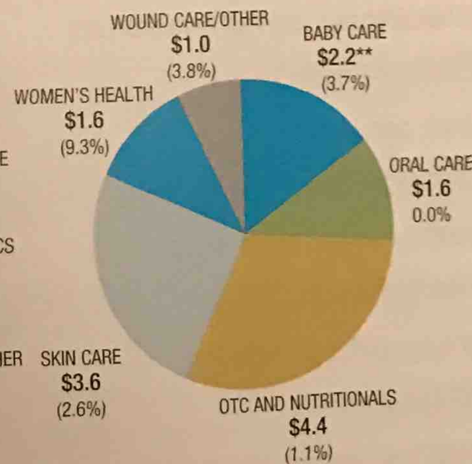
*Operational excludes the impact of currency.
** Rounded for visual accuracy.

Medical Devices and Diagnostics Segment Sales
Sales by Major Franchise (in billions of dollars)
2012 Sales: $27.4 billion
Sales Change:1
Total: 6.4%
Operational*: 8.7%



(1) Excluding the net impact of the Synthes acquisition, MD&D total change = (1.5%) and Orthopaedics total change = (0.4%)

Consumer Segment Sales
Sales by Major Franchise (in billions of dollars)
2012 Sales: $14.4 billion
Sales Change:
Total: (2.9%)
Operational*: 0.5%



*Figures in millions of dollars.

Source: Johnson & Johnson.

had surfaced, but he insisted that these were confined to McNeil. In a recent interview he stated, "This is one of the most difficult situations I've ever had to personally deal with. It hits at the core of who J&J is. Our first responsibility is to the people who use our products. We've let them down."[9]

Quality problems have arisen before, but they were usually fixed on a regular basis. Analysts suggest that the problems at McNeil may have been exacerbated in 2006 when J&J decided to combine it with the newly acquired consumer health care unit from Pfizer. The firm believed that it could achieve $500 to $600 million in annual savings

EXHIBIT 4 Key Brands

PHARMACEUTICALS
RISPERDAL for schizophrenia
PROCRIT for anemia
REMICADE for rheumatoid arthritis
TOPAMIX for epilepsy
DURAGESIC for chronic pain
DOXIL for ovarian cancer
HALDOL for psychosis
NATRECOR for heart failure
ELMIRON for bladder pain
MEDICAL DEVICES
DEPUY orthopedic joint reconstruction products
CORDIS CYPHER stents
ETHICON surgery products
LIFESCAN diabetic testing products
VERIDEX diagnostic devices
ANIMAS insulin pumps
ACUVUE contact lenses
CONSUMER PRODUCTS
BAND AID bandages
JOHNSON & JOHNSON baby care products
NEUTROGENA skin and hair care products
LISTERINE oral health care
TYLENOL pain killers
ROLAIDS antacids
BENADRYL cold and cough syrups
BEN GAY pain relief ointments
TUCK'S hemorrhoidal ointments
VISINE eye drops
ROGAINE hair regrowth treatments
STAY FREE women's health products
SPLENDA sweeteners

Source: Johnson & Johnson.

by merging the two units. After the merger, McNeil was also transferred from the heavily regulated pharmaceutical division to the marketing-driven consumer products division, headed by Collen Goggins. Because these consumer

EXHIBIT 5 Research Expenditures*

Go to library tab in Connect to access Case Financials.

	A	B
1	Research Expenditures*	
2	2012	$ 7,665
3	2011	7,548
4	2010	6,844
5	2009	6,986
6	2008	7,577
7	2007	7,680
8	2006	7,125
9	2005	6,462

*Figures in millions of dollars.

Source: Johnson & Johnson.

executives lacked pharmaceutical experience, they began to demand several changes at McNeil that led to a reduced emphasis on quality control.

Weldon was aware of the threat faced by Johnson & Johnson as a result of its problems with quality. He was especially concerned about the allegation by the FDA that the firm initially tried to hide the problems that it found with Motrin in 2009, hiring a contractor to quietly go around from store to store, buying all of the packets off the shelves. McNeil's conduct surrounding the recalls led to an inquiry by both the House Committee on Oversight and Investigations and by the FDA's office of criminal investigations.

Various changes were made at McNeil to resolve these quality issues. Goggins was pushed out of her post as senior executive in charge of all consumer businesses. Weldon allocated more than $100 million to upgrade McNeil's plants and equipment, appoint new manufacturing executives, and hire a third-party consulting firm to improve procedures and systems. Bonnie Jacobs, a McNeil spokeswoman, wrote in a recent email, "We will invest the necessary resources and make whatever changes are needed to do so, and we will take the time to do it right."[10]

The problems at McNeil, coupled with growing problems with its artificial hips and contact lenses, led Johnson & Johnson to make changes to its corporate oversight of its supply chain and manufacturing. In August 2010, the firm appointed Ajit Shetty, a longtime executive, to oversee a new system of companywide quality control that involves a single framework for quality across all of the operating units and a new reporting system. The need for these changes was highlighted by Erik Gordon, a professor at the Ross School of Business at the University of Michigan: "Nothing is more valuable to Johnson & Johnson than the brand bond of trust with consumers."[11]

Addressing New Problems

In April 2013, Johnson & Johnson appointed Alex Gorsky to lead the health care conglomerate out of the difficulties that it has faced over the past few years. He had been with the firm since 1988, holding positions in its pharmaceutical

businesses across Europe, Africa, and the Middle East before leaving for a few years to work at Novartis. Shortly after his return to Johnson & Johnson in 2008, he took over its medical device and diagnostic group. Because of his extensive background with the firm, and with the division that was being investigated about its faulty hip replacements, Gorsky might have been regarded as the ideal person to take over the job.

When he took over, DePuy, the firm's orthopedic unit was already running into trouble with its newest artificial hip. It was facing resistance from the Food and Drug Administration even as complaints about the device were mounting from doctors and regulators around the world. Gorsky moved quickly to phase out the defective hip replacements, although he did not publicly disclose the problems that it had been experiencing with the FDA over the sale of these. The decision not to publicize the agency's findings to doctors, patients, and others while continuing to market the device has exposed Johnson & Johnson to the lawsuits that can tarnish its reputation.

DePuy finally recalled the artificial hip in August 2010, amid growing concerns about its failure among those who had received the implant. Until then, however, executives from the firm had repeatedly insisted that the device was safe. Gorsky continued to state publicly that Johnson & Johnson had decided to drop it because of declining sales rather than out of safety concerns. Andrew Ekdahl, the president of DePuy, recently reiterated that position. "This was purely a business decision," he said.[12]

In the trial in Los Angeles Superior Court regarding the defective hip replacement, however, Michael A. Kelly, the lawyer making the case against Johnson & Johnson, suggested that company executives might have concealed information out of concern for firm profits. DePuy officials, for example, never told doctors that the device had failed an internal performance test. "They changed the test and tested it against other things until they found one it could beat," he stated.[13]

In spite of all these issues, Johnson & Johnson has not attempted to clarify what information Gorsky may have had about the problems associated with the artificial hip. Under these circumstances, his promotion to lead the firm surprised Dr. Robert Hauser, a cardiologist and an advocate for improved safety of medical devices. "He's been overseeing one of the major J.&J. quality issues and the board of J.&J. sees fit to name him the new C.E.O.?" he questioned.[14]

Is There a Cure Ahead?

Moving forward, Gorsky must try to maintain a balance at Johnson & Johnson between the controls throughout the firm that are necessary to protect its reputation and the freedom for the business units that can allow it to keep growing. Quality problems have persisted, as the firm announced in early 2012 that it would recall about a half-million bottles of liquid Infants' Tylenol because of a faulty dosing system. Additionally, McNeil is still working with the FDA to bring the plant that was the source of many of the over-the-counter recalls up to federal standards.

In order to repair the damage to its consumer brands from the recalls, Johnson & Johnson recently announced that it would remove a host of potentially harmful chemicals, like formaldehyde, from its line of consumer products by the end of 2015. It is the first major consumer products company to make such a widespread commitment. "We've never really seen a major personal care product company take the kind of move that they are taking with this," said Kenneth A. Cook, president of the Environmental Working Group.[15]

Even as its DePuy unit is trying to recover from its problems with the faulty artificial hips, Johnson & Johnson is completing its biggest ever acquisition that would reinvigorate its device business. Its $20 billion purchase of Synthes would make the firm a dominant player in a major segment of the medical device market. Synthes, a maker of equipment used in trauma surgery, accounts for nearly 50 percent of sales of plates and screws that are used to treat broken bones. The $5.5 billion trauma category grew 8 percent last year, according to estimates by Wells Fargo Securities.

Even as he tries to provide more direction and assert more control, Gorksy is also aware that much of its success has resulted from the relative autonomy that Johnson & Johnson has granted to each of its business units. Like others before him, Gorsky knows that even as he pushes for more control and direction, he does not want to threaten the entrepreneurial spirit that has served his firm so well. But he must also decide how much to push on its business units to try to work more closely together than they have done in the past. Johnson & Johnson must be able to tap into many more opportunities when it tries to bring together the various skills that it has managed to develop across different divisions.

But it is clear that the health care giant has to rethink the process by which it manages its diversified portfolio of companies in order to ensure that there are no further threats to its reputation. "This is a company that was purer than Caesar's wife, this was the gold standard, and all of a sudden it just seems like things are breaking down," said William Trombetta, a professor of pharmaceutical marketing at Saint Joseph's University in Philadephia.[16]

ENDNOTES

1. Thomas, K. 2012. J.&J.'s next chief is steeped in sales culture. *New York Times*, February 24: B6.
2. Thomas, K., & Abelson, R. 2012. J.&J. chief to resign one role. *New York Times*, February 22: B8.
3. Thomas. 2012. J.&J.'s next chief: B1.
4. Rockoff, J. D. 2011. J&J, Synthes hold talks. *Wall Street Journal*, April 18: B1.
5. Loftus, P., & Wang, S. S. 2009. J&J sales show health care feels the pinch. *Wall Street Journal*, January 21: B1.