

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

In re	)	
	)	
UAL CORPORATION, et al.	)	Chapter 11
	)	
Debtors	)	Case No. 02-B-48191
	)	(Jointly Administered)
	)	
	)	Hon. Eugene R. Wedoff
	)	
	)	

**DECLARATION AND EXPERT REPORT OF PROFESSOR THOMAS M. JONES IN
OPPOSITION TO THE MANAGEMENT EQUITY INCENTIVE PLAN (MEIP)**

I, Thomas M. Jones, being of legal age, and first duly sworn, do hereby swear and affirm that the following is true and accurate to the best of my knowledge and ability:

1. My name is Thomas M. Jones. I am a Professor of Business Ethics at the University of Washington Business School in Seattle, Washington and the holder of the Boeing Company Endowed Professorship in Business Management. I have been retained by Guerrieri, Edmond, Clayman & Bartos, P.C. to provide expert testimony regarding UAL's proposed Management Equity Incentive Plan (MEIP). This report contains, as required by Federal Rule 26, a statement of my qualifications as well as a general description of my expert opinions in this matter and the basis thereof. If called as a witness, I could and would competently testify to all facts stated herein.

2. I hereby attach my curriculum vitae as Exhibit A, subject to the following modifications. a) My term as Chairman of the Management and Organization Department ended

on June 30, 2005. b) In August 2005, I received the Sumner Marcus Award, a lifetime achievement award for major contributions to the Social Issues in Management (SIM) Division of the Academy of Management, for scholarship that brought SIM issues to the attention of a broad range of management scholars through publication in top-tier journals. c) I received an acceptance from the Academy of Management Review (AMR) for a paper to be published in early 2006.

3. Within the general field of business ethics, my current major research interests focus on the relationship between ethics and economics or, more specifically, ways that ethics can affect the financial performance of corporations. My first paper in this area was published in 1995 in AMR. In this paper, I argued that corporations that are able to establish and maintain mutually trusting and cooperative relationships with their stakeholders will have a competitive advantage over firms that cannot or do not. More recently, in another AMR article published in 1999, I argued that business ethicists should not focus on *behaviors* that firms ought or ought not engage in, but should focus instead on *moral postures* that firms could adopt that are grounded in moral principles and, very importantly, economically viable. This “convergent” stakeholder theory rejects the notion that good economic performance trumps all (other) moral considerations. It also specifically rejects the notion that moral positions should be taken without regard for their impact on the firm’s financial well-being. Convergent stakeholder theory is specifically intended to avoid the prospect of the business community immediately rejecting moral prescriptions advanced by business ethics scholars. This paper was also a not-so-subtle plea for business scholars and moral philosophers to understand and take into account each other’s work.

4. After a five-year stint as Chairman of the Management and Organization Department, I am currently at work on a series of papers linking “stakeholder culture” – a concept rooted in ethical theory – to various corporate behaviors and outcomes. The first paper in this series relates stakeholder culture to stakeholder salience – “who and what really count to corporate managers” – and is scheduled to appear in AMR in 2006. The second, and far more important in my view, application of the stakeholder culture concept relates it to corporate competitive advantage. Simply put, the argument is this: with respect to many types of firm/stakeholder relationships, firms with broadly moral cultures (i.e., genuine consideration for the interests of all corporate stakeholders, not just shareholders) will outperform firms that define their moral obligations more narrowly (i.e., to shareholders alone or, worse, to the firm’s managers alone). This paper is currently in the process of being written and should be completed within a month or two. It will be submitted to AMR as well. I offer this recent history as a scholarly backdrop to the more detailed arguments presented below as well as a means of establishing additional credibility with my audience(s).

I. Business Ethics and Competitive Advantage

5. In the following paragraphs, I briefly summarize the arguments that have led me to believe that *mutual trust* is an essential feature of efficient corporate operations. Some of these arguments are drawn directly from my academic publications, some less directly so. In what follows, I often use the term competitive advantage in place of superior corporate financial performance. This convention makes clear the fact that *no* profit enhancing behavior, by itself, will make one firm outperform other firms. Instead, it suggests that the behavior in question will, all else being equal, increase the firm’s financial position relative to other firms. In what follows, I do not suggest that good ethics at one firm will overcome serious deficiencies in other areas.

For example, good ethics will not help an automotive firm with a grossly ineffective dealer network, a pharmaceutical firm with few profitable drugs in its product line, or an airline with an aging fleet of fuel inefficient planes outperform their rivals. Good ethics will, however, help a firm outperform other similarly situated firms.

6. One way to categorize costs experienced by corporations is by three generic types: 1) agency costs; 2) transactions costs; and 3) team production costs. *Agency costs* arise when one party (the principal) hires another (the agent) to perform certain tasks. Under the assumptions of economics (the foundational discipline of business), individual actors are self-interested and strive to maximize their own welfare. With perfect knowledge of the task to be done and of the agent's behavior, the principal could easily assure that the agent was, in fact, serving him/her well. Unfortunately, full knowledge of the task and of the agent's behavior is almost never available, opening up the possibility that the (self-interested) agent will take advantage of the principal. This constitutes a brief description of the agency problem, a staple of economic theorizing and empirical work. In application, the agency problem is most acute (and most studied) in the relationship between corporate shareholders as principals and top corporate executives as agents. How can the former group be assured that the latter group will not exploit the advantage that results from incomplete information? In this setting, three solutions to the agency problem have emerged: a) contingent incentives such as performance bonuses; b) monitoring mechanisms such as boards of directors; and c) interest aligning devices like stock options. Each of these solutions has its advantages and disadvantages, but all are costly to implement.

7. A second cost category is *transactions costs*, costs that often center on buyer/seller relationships. Since corporate buying and selling is often far more complex than

retail buying and selling, the “contracts” that attend such activities can be complex as well. One potential problem is that the seller knows far more about the item or service for sale than the buyer and can exploit this informational advantage. Conversely, with respect to highly specialized “products,” the seller often must make substantial investments in the production of something that has little or no use to other potential buyers, placing the seller at a disadvantage if any renegotiation is in order. Put differently, the buyer can “hold up” the seller in subsequent negotiations. Again, there are solutions to these problems, but they are costly to implement and rarely work perfectly.

8. Finally, *team production costs* can also arise in commercial arrangements. In situations in which it is difficult to determine the contribution of an individual team member to team output, there is an incentive for each member to “shirk” or “free ride” on the efforts of others. Once again, economic solutions exist but are not costless to implement.

9. Economists have solutions to these problems, some of them quite sophisticated and elaborate. However, another class of solutions exists as well – *moral commitment*. Instead of assuming that individuals will invariably act in a self-interested manner and creating economic incentives to reduce the effects, some scholars have suggested the possibility of solutions wherein problems such as those outlined above are resolved by means of social norms that commit individuals to act morally and that are “embedded” in social institutions (such as corporations). These scholars see the problems as commitment problems and strive to discover moral means of solving them.

10. Demonstrating that moral solutions to commitment problems are more efficient than economic incentives is a relatively easy exercise. The problem is that what works well for the community as a whole may not work as well for the individual, as demonstrated in the

Prisoner's Dilemma (from game theory). In addition, the temptation for an individual to cheat increases when (virtually) everyone else is behaving morally. The challenge becomes one of convincing individuals that moral behavior is not only good for the system as a whole, but good for him/her individually as well. One answer to this question is that people who are trustworthy and cooperative help solve the commitment problem and, therefore, are desirable partners in economic arrangements that require commitment. (In fact, even those not seeking to embed morality in their relationships will prefer honest, trustworthy partners since the former can cheat the latter without worrying about being cheated themselves.) Simply put, honest, trustworthy individuals will have more opportunities than will those who lack these traits. If everyone wants to deal with honest individuals, how can such individuals be identified by those seeking morally embedded relationships?

11. Detecting dishonesty in others is a subtle process to be sure, but *reputation* is a major factor in the case of corporations or, more specifically, for those who make key decisions on behalf of the firm – i.e., the top executives. For obvious reasons, many, if not all, management teams will wish to be seen as honest, trustworthy, and cooperative. How can we separate the intrinsically ethical managers from those who are only *instrumentally* ethical? Intrinsically ethical individuals behave ethically because it is the right thing to do, not because it benefits them. Instrumentally ethical individuals, on the other hand, can be said to “invest” the potential payoffs from short-term dishonesty in the benefits in the longer term by acting dishonestly only when the stakes are high enough. In more colloquially terms, the question becomes: how can we detect “fake” honesty? For the answer, we turn to psychology. Psychologists have documented the tendency of human beings to excessively discount future events. Given this tendency, there will be a corresponding tendency for instrumentally ethical individuals to reveal their base

motives by acting in a self-interested manner *prematurely*. Therefore, it will be very difficult for such individuals to maintain a reputation for honesty and trustworthiness. Intrinsically ethical individuals, on the other hand, will not employ the calculus of self-interest, and thus will not reveal self-interested motives. It follows that good reputations will be fairly good indicators of honesty and trustworthiness. Thus, honest and trustworthy individuals will be sought after for the purpose of establishing morally embedded firm/stakeholder relationships. Dishonest and untrustworthy individuals will not be able to establish morally embedded relationships, and will not be able to take advantage of the efficiencies that accrue to them. In shorthand form, managers who cannot maintain the trust of their stakeholders will be at a competitive disadvantage relative to their trustworthy peers.

II. Application to the UAL Bankruptcy Emergence Case

12. Since my general disciplinary specialty is Business Ethics, I will first speak (briefly) to the issues basic to this field.

13. To begin with, the notion of *shared sacrifice* could be badly distorted by UAL (the Debtors). Although managers did, in fact, take a pay cut during negotiations with employee unions, the cuts were short lived. The pay of several top managers increased, substantially in some cases, in the intervening years, even with the company in bankruptcy. In sharp contrast, the sacrifices made by other employees have been substantial and enduring. The implementation of the MEIP would make this imbalance even more acute and make a mockery of shared sacrifice.

14. Second, an explicit *promise* to share the burdens of trying to keep UAL afloat seems to have been broken due to the imbalance noted above. The breaking of promises violates ethical principles as well. First, promise breaking violates Kant's Categorical Imperative –

specifically, *reversibility* (roughly, the Golden Rule) and *universalizability*. Second, any viable system of rule utilitarianism would certainly include an explicit endorsement of promise keeping.

15. Finally, and perhaps most importantly, the analysis presented above suggests that, having violated the trust of their employees, UAL management will find it virtually impossible to capture the economic benefits of establishing morally embedded relationships with their stakeholders, their employees in particular. In a service-oriented firm like UAL, poor relations with employees will surely make the firm's economic recovery much more difficult than it would otherwise be. In short, the MEIP could irrevocably sour important firm/stakeholder relationships and harm the company financially at a time when it desperately needs to operate at peak efficiency.

III. The Friske Report

16. Since UAL's Human Resources Subcommittee seems to have adopted the recommendations of the expert report of Douglas J. Friske, I will record my objections to the assumptions and conclusions of that report directly.

17. In my view, the Friske report is deeply flawed for three main reasons. First, it fails to take into account the very substantial sacrifices made by UAL's employees in terms of wages, benefits, vacation time, and pension benefits so that the firm can emerge from bankruptcy and survive economically. By one account, these sacrifices total about \$4 billion. The notion of shared sacrifice does not seem to have been considered at all in the Friske report. Second, the report does not take into account the contract that Mr. Tilton signed shortly before Chapter 11 protection was sought by UAL. This contract was the result of a voluntary acceptance by both parties (UAL and Tilton) of highly foreseeable events – the Chapter 11 filing in particular. This was a market transaction in the fullest sense of the term. Nothing that was not anticipated at that

time has changed. Why then should the terms of that contract be overridden now by terms considerably more favorable to Mr. Tilton -- i.e., a windfall in excess of \$11 million? Third, as suggested above, and particularly in view of explicit promises to the effect that sacrifice was to be shared by all company stakeholders, the Friske report does not account for the damage done to firm/stakeholder trust. The breaking of this pledge by richly rewarding top executives could seriously hamper UAL's future economic success. In my view, any credible recommendation regarding the MEIP should take all three of these factors into account.

Thomas M. Jones

Thomas M. Jones -- December 30, 2005

EXHIBIT A

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EDUCATION

Ph.D.	1977	University of California, Berkeley
M.B.A.	1970	University of Washington
B.S.E.	1964	University of Michigan

ACADEMIC EMPLOYMENT

Chairman, Management and Organization Department, 2001-present
Interim Chairman, Management and Organization Department, 2000-01
Connelly Visiting Scholar, Georgetown University, Spring Semester, 1999
Professor, University of Washington, 1991-present
Chairman, Business, Government and Society Department, 1983-85
Associate Professor, University of Washington, 1981-91
Director of Faculty Publications and Editor, Journal of Contemporary Business,
University of Washington, 1981-82
Assistant Professor, University of Washington, 1978-81

BUSINESS EMPLOYMENT

Financial Consultant, Levi Strauss & Company, 1973
Financial Analyst, Ford Tractor Operations, 1970-72
Survey Researcher, Pacific Northwest Bell Telephone, 1969
Stress Analyst, The Boeing Company, 1967-68
Designer/Stress Analyst, Pratt & Whitney Aircraft, 1965-67

FELLOWSHIPS AND AWARDS

Boeing Professor of Business Administration - July 2003-present

University of Washington Dean's Citizenship Award - 2003

University of Washington Dean's Faculty Research Award - 2000

Who's Who in the Management Sciences - 2000

Academy of Management Publications Honor Roll - Honorable Mention - 2000

Connelly Endowment Visiting Scholar - Georgetown University - 1999

Kirby L. Cramer Scholar in Business Ethics - 1998-2003

1990 Fritz Roethlisberger Memorial Award Finalist (for OBTR article, 1988-89)

Beta Gamma Sigma Business Honorary

PUBLICATIONS -- 100% Contribution Except as Noted

Jones, Thomas M., Review of Redefining the Corporation - Stakeholder Management and Organizational Wealth by James E. Post, Lee E. Preston, and Sybille Sachs (Stanford, CA: Stanford University Press, 2002) in Business & Society, Vol. 41, No. 4 (December 2002).

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Jones, Thomas M., Berman, Shawn L., & Wicks, Andrew C., "A Plan to Lend Theoretical Coherence and Conceptual Rigor to Research Relating Corporate Social Performance to Financial Performance," International Association for Business and Society - 1998 Proceedings (June, 1998) pp. 159-164.

Jones, Thomas M. & Bowie, Norman E., "Moral Hazards on the Road to the 'Virtual' Corporation," Business Ethics Quarterly, Vol. 8, No. 2 (April, 1998), pp. 273-292.

"Not Hopelessly Mired in Positivism," Business & Society, Vol. 37, No. 1 (March, 1998), pp. 76-77.

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"Ethical Decision Making by Individuals in Organizations: An Issue-Contingent Model," in Donaldson, Thomas & Dunfee, Thomas W. (Eds.), Ethics in Business and Economics, Vol. II (Hampshire, England: Dartmouth Publishing, 1997). (First appeared in the Academy of Management Review, Vol. 16, No. 2: 366-395.)

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Jones, Thomas M. & Bowie, Norman E., "Moral Hazards on the Road to the Virtual Corporation," in Logsdon, Jeanne M. & Rehbein, Kathleen (Eds.), International Association for Business and Society - 1996 Proceedings (March 1996) pp. 452-457.

"Instrumental Stakeholder Theory and Paradigm Consensus in Business and Society: Advances on the Methodological Front," in Nigh, Douglas and Collins, Denis (Eds.), Proceedings of the Sixth Annual Meeting of the International Association for Business and Society (June 1995) pp. 637-641.

"Instrumental Stakeholder Theory: A Synthesis of Ethics and Economics," Academy of Management Review, Vol. 20, No. 2 (April 1995) pp. 404-437.

Quinn, Dennis P. & Jones, Thomas M., "An Agent Morality View of Business Policy," Academy of Management Review, Vol. 20, No. 1 (January 1995) pp. 22-42.

"Is There Theory in Stakeholder Theory?" Business and Society: The Journal of the International Association for Business and Society, Vol. 33, No. 1 (April, 1994), pp. 98-101.

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"Two Cheers for Meritocracy," Proceedings of the Fifth Annual Meeting of the International Association for Business and Society (Hilton Head, SC, March 1994) pp. 26-31.

Jones, Thomas M. & Hunt, Reed O. III., "Ethics of Leveraged Management Buyouts Revisited," in Wright, M., Management Buy-Outs, (Aldershot, England: Dartmouth Publishing, 1994) pp. 259-266. (reprint)

Jones, Thomas M. & Quinn, Dennis P., "Taking Ethics Seriously: The Competitive Advantage of Intrinsic Morality" International Association for Business and Society - 1993 Proceedings, (San Diego, CA, March 18-21, 1993) pp. 262-266.

Jones, Thomas M. & Gautschi, Frederick H. III, "Moral Commitment and the Ethical Attorney," Business Ethics Quarterly, Vol. 2, No. 4 (October 1992), pp. 391-404.

Jones, Thomas M. & Huber, Vandra L., "Issue Contingency in Ethical Decision Making," International Association for Business and Society - 1992 Proceedings, (Leuven, Belgium, June 14-16, 1992), pp. 156-166.

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"Can Business Ethics be Taught? Empirical Evidence" Business and Professional Ethics Journal, Vol. 8, No. 2 (Spring 1990) pp. 73-94.

"Ethics and Agency Theory," in Meadow, H. Lee and Sirgy, M. Joseph, Quality of Life Studies in Marketing and Management (Blacksburg, VA: Omni Press, 1990) pp. 86-99.

"Ethics Education in Business: Theoretical Considerations," Organizational Behavior Teaching Review, Vol. 13, No. 4 (1988-89) pp. 1-18. [1990 Fritz Roethlisberger Memorial Award Finalist].

"Ethical Theory and Business Decision Making," Pacific Northwest Executive, Vol. 4, No. 4 (October 1988) pp. 2-4 (invited article).

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"Corporate Board Structure and Performance: Variations in the Incidence of Shareholder Suits," in Post, James E. (Ed.), Research in Corporate Social Performance and Policy, Vol. 8 (Greenwich, Connecticut: JAI Press, 1986) pp. 345-359.

"Corporate Control and the Limits to Managerial Power," Business Forum, Vol. 10, No. 1 (Winter 1985) pp. 16-21.

"The Shareholder Litigation Threat," in Mattar, Edward Paul, III (Ed.), Handbook for Corporate Directors (New York: McGraw-Hill, 1985) pp. 27.3-27.17.

"An Integrating Framework for Research in Business and Society: A Step Toward the Elusive Paradigm?" Academy of Management Review, Vol. 8, No. 4 (October 1983) pp. 559-564.

Jones, Thomas M. & Goldberg, Leonard D., "Governing the Large Corporation: More Arguments for Public Directors," Academy of Management Review, Vol. 7, No. 4 (October 1982) pp. 603-611.

The above article also appears in Gibbs, Manton C., Dimensions of Business and Society (Lexington, Mass: Ginn Custom Publishing, 1983) pp. 137-144.

Drexler, John A., Jr. & Jones, Thomas M., "Productivity Improvement Programs: An Overview," Journal of Contemporary Business, Vol. 11, No. 2 (Spring 1982) (Editorial Introduction) pp. 1-3.

"Industrial Policy: Political 'Hot Potato' of the 1980's?" Journal of Contemporary Business, Vol. 11, No. 1 (Winter 1982) (Editorial Introduction) pp. 1-3.

"Shareholder Suits: Good News and Bad News for Corporate Executives," California Management Review, Vol. 23, No. 4 (Summer 1981) pp. 77-86.

"What's Bothering Those Shareholder Plaintiffs?" California Management Review, Vol. 22, No. 4 (Summer 1980) pp. 5-19.

The previous article is abstracted in the C.F.A. Digest, Vol. II, No. 3 (Summer 1981).

"Corporate Social Responsibility Revisited, Redefined," California Management Review, Vol. 22, No. 3 (Spring 1980) pp. 59-67.

The above article also appears in Paine, Frank; Taylor, Marilyn L.; and Tate, Curtis (Eds.), Contemporary Readings in Business Policy and Strategic Management (Business Publications, Inc., 1984).

The above article also has been translated into Dutch and appears in The Handbook voor Managers.

The above article also appears in Allen, William R. and Louis K. Bragaw, Jr., Social Forces and the Manager (New York: John Wiley & Sons, 1982) pp. 36-45.

"An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits," Boston University Law Review, Vol. 60, No. 3 (May 1980) pp. 542-573.

"An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978," Boston University Law Review, Vol. 60, No. 2 (March 1980) pp. 306-330.

"Shareholders Are Getting Back Into Corporate Governance -- As Plaintiffs in Shareholder Lawsuits," Journal of Contemporary Business, Vol. 8, No. 1 (1979) pp. 93-102.

"Corporate Governance: Who Controls the Large Corporation?" The Hastings Law Journal, Vol. 30, No. 5 (May 1979) pp. 1261-1286.

ACADEMIC CONFERENCE ACTIVITIES

I have presented papers, organized sessions, served as a session chair, or served as a discussant at dozens of conferences, including those of the Academy of Management, the Society for Business Ethics, the International Association for Business and Society, and the Society for the Advancement of Socio-Economics. I have also arranged and/or participated in several doctoral student consortia and junior faculty workshops at the Academy of Management annual meetings.

EDITORSHIPS - SCHOLARLY JOURNALS

Nominated to be Editor of the Academy of Management Review - November 1998 (declined for lack of institutional support)

Editorial Board - Academy of Management Review (three terms - 1991-99) [Rated "Outstanding" by the Editor for each of the 1997, 1998, 1999]

Editorial Board - Academy of Management Review - 2002-present (current term)

Special Consulting Editor - Academy of Management Review - June 1999; January, 1998; August 1995; February 1995; August 1994

Chair of the 1997 Best Paper Award Selection Committee - Academy of Management Review

Chair of the 1996 Best Paper Award Selection Committee - Academy of Management Review

1993 Best Paper Award Selection Committee - Academy of Management Review

Nominated for board membership of the Academy of Management Journal (declined - AMR board members cannot concurrently serve on the board of AMJ.)

Editorial Review Board - Business Ethics Quarterly

Editorial Board - Business and the Contemporary World [other board members include Kenneth Arrow, Richard DeGeorge, Tom Donaldson, Lee Preston, David Reisman, Nobel Laureate Amartya Sen, Lester Thurow, & Murray Weidenbaum]

Founding Editor - Business & Society (The Journal of the International Association for Business and Society) 1992-93; Co-Editor 1993-94

Editorial Review Board - Business Forum

Ad Hoc Reviewer

Academy of Management Journal

Business Ethics Quarterly

Business and Society

California Management Review

Human Relations

Journal of Business Ethics

Organizational Behavior and Human Decision Processes

Organizational Behavior Teaching Review

Journal of Management Studies

Journal of Business Research

Journal of Applied Social Psychology

Business and Professional Ethics Journal

International Journal of Public Administration

Journal of International Management

Research on Accounting Ethics

Psychological Reports - Perceptual and Motor Skills

PROFESSIONAL AFFILIATIONS

Academy of Management - Social Issues Division
Governance Committee (most recently 1996-99)
Research Committee
Best Paper Award Selection Committee
Faculty Development Workshop Co-Coordinator
Chair - Best Paper Award Committee
Howard Chase Book Award Committee
Nominating Committee

International Association for Business and Society
Founding Member
Executive Committee
Co-Chair - Journal Establishment Committee
Board of Directors - Representative at Large
Chair - Publications Committee
Best Article Award Committee

Society for Business Ethics

Society for the Advancement of Socio-Economics

Note: Although I do not engage in consulting, I have served as an expert witness on matters of business ethics in civil litigation on a number of occasions.

January 27, 2004