Catalya Hats: My Hat Instead of Myself[1]

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CASE DESCRIPTION

This disguised ex-post facto instructional field case study describes a family owned business, Catalya Hats that had been acquired by an "outsider" firm. This firm proceeded to outsource the firm's core competency, hat manufacturing, in an attempt to grow the business. Their hat contractor, a Chinese concern, subcontracted the work to a firm that violated Chinese safety and labor standards. These violations reached the local newspapers who then named Catalya Hats, resulting in negative press and a drop in sales. The case details how decisions were made to contract out the work and how the firm reacted to the negative press.

The case has a difficulty level appropriate for sophomores taking an introductory entrepreneurship/small business management or international business course. Secondarily, the case may also be used in an introduction to business or introduction to management course. The case is designed to be taught in one class period (may vary from fifty to eighty minutes depending upon instructional approach employed, see instructor's note) and is expected to require between seven and ten hours of outside preparation by students given their knowledge of outsourcing and entrepreneurial decision-making.

JEL Codes: M13, M14, L24
Keywords: Entrepreneurship, Small Business, Ethics

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[1] "This is an expression from Ecuador, home of the "Panama" hat. It means what is says; it is preferable to give up your hat than your life".

CASE SYNOPSIS

Derived from a preponderance of primary data and field interviews and supplemented by secondary research, the case describes two dilemmas that Mr. Ralph Dweck, as the new owner of Catalya hats, a family-owned firm, faced. First, in order to grow the business some form of outsourcing of production seemed to make the most sense to Mr. Dweck given his limited ability to finance additional local investments. He therefore determined that there was a need to find international business collaborates in order to expand the firm's production of hats. His management team, made up of former managers from the family firm, opposed the proposal. His management team's pride would not allow them to see Catalya hats made anywhere else but in Ecuador and certainly not by anyone else but by "family" members. A compromise was reached to produce hats in-house and to operate using a shift system.

Demand for the hats rose and then fell accordingly driven by numerous factors including an overly high price point. The second shift seemed "unnecessary "yet cutting the second shift would negatively affect employee wages. Reluctantly top management agreed with Mr. Dweck that although it would break with Catalya tradition, they would relent and allow certain lower priced models of the hat line to be made overseas. This would allow operations in Ecuador to concentrate on the higher quality, more difficult hats to mass manufacture, specialty hats that made Catalya the Rolls Royce of the market.

Once the offshoring hurdle was overcome and outsourcing commenced, Mr. Dweck had to then address the negative press derived from the fact that his contractor in China was subcontracting the work to other factories in China who forced their workers to work long hours in harmful working conditions and for less than minimum wage. Mr. Dweck, nor anyone else in the firm, was informed that their manufacturer was subcontracting the work. The case ends with Mr. DeGast (a consultant originally hired to set up the outsourcing arrangements and later hired as a full-time employee) having to confront Mr. Dweck with the bad news that the firm's agreement with their contractor did not preclude subcontracting the work. This unfortunately included the subs not being bound by any requirement for employee working conditions that Catalya set with the contractor.

A short primer on outsourcing and the methods of handling negative press are provided in the teaching note and are strongly suggested for students' perusal.

This is no Tea Party![2]

It was march of 2012 and Mr. Ralph Dweck, a normally mild mannered and peaceful man, was pacing back and forth in an alarming manner in the conference room during an emergency meeting of the top management of Catalya Hats. His panama hat, the symbol of his company and the top of their cherished hat product line, bounced up and down in synch with his pacing. Everyone in the room was anxious since they knew that Mr. Dweck rarely if ever called an emergency meeting – and pacing was just not in his behavioral repertoire. At least not until now!

As the President of Catalya Hats he had a significant amount of responsibility, running a former privately owned business that went back nearly three generations with nearly one hundred employees who were all regarded as family. He took upholding the tradition of making quality Panama hats very seriously and thought of his employees and their families as an extension of his own. It was apparent to everyone in the room that he was under heavy duress, exasperated and clearly distressed.

"How did this happen!" He shouted to no one in particular. He then suddenly threw a bundle of hard copied e-mails on the conference table with a loud thud causing all of the managers to jump back in surprise. "Look at these copied articles from the press in Shanghai. Our label has been in Shanghai for only four months and every day for the past week the press has been publishing articles about our licensee Xion International and the poor working conditions in their factory; and of course we are named as the licensor!"

[2] Organization and individual names have been changed to protect their anonymity.

"Actually it wasn't even Xion's factory that got hammered in the press." The President corrected himself. "The journalist reported that Xion International was actually subcontracting the work to other factories in China who forced their workers to work long hours in harmful working conditions and for less than minimum wage. They stated the subcontractors had no written management or ethical codes of conduct that would ensure that supervisors and the executives would act socially responsible." Murmurs could be heard from the group with each person wondering who was responsible and ultimately whose head or heads would roll.

President Dweck then dumped another pile of papers of the table, with the overflow spilling all over the floor in disarray. "And if that wasn't bad enough, these are just a few of the posts on XiaoNei, the Chinese version of Facebook (renren.com). They include pictures and videos of employees, working conditions, pay stubs, and testimonials as to the horrendous treatment the workers have been receiving in the factory. It makes me very angry to think that anyone would treat their employees in such a fashion – I know we wouldn't! Luckily nothing as of yet has hit the American press, Facebook, Twitter, or LinkedIn but it would seem just a matter of time before some American reporter surfing the net will come across these little gems and go viral with them. Do any of you know have the faintest notion of what this will do to our company and brand image?"

They all knew this was a rhetorical question yet all heads instantly turned to Janice Warling head of Public Relations, hoping that she not only had an explanation but a prepared solution for dealing with this catastrophe. Yet she too was very much caught by surprise by this latest development and seemed like a deer in the headlights – frozen in time and space. Brian Bianco the Vice President of Operations, started to try to explain how this "might possibly could have happened" yet he was immediately cut off by the President with a stern, hawk-like stare. Tori Baugmart the Vice President of Human Resources, and Evelyn Choi Manager of Production both took a deep breath knowing their turn would come to describe their role in this tragedy.

All eyes then turned to look for Armando Degast the recently appointed Vice President of Licensing and the one responsible for brokering the deal with Xion International. Everyone including the president was anxiously awaiting not only an explanation but the implications and possible brand damage due to this public relations debacle. Yet Armando was nowhere to be found – he had received a "sneak preview" of the articles from Dweck's personal secretary before the meeting and was at that moment on the phone with Xion International trying to figure out if the articles were not only true but also how Xion was handling these allegations. He knew that "the hare had certainly lost his spectacles"[3] and was running out of time before the "red queen chopped of his head."[4]

Panama Hats: Not from Panama!

Panama hats ironically were the cultural icon of Ecuadorians for thousands of years and became popular in Ecuador when hat weaving became a cottage industry in the 1600's. It wasn't until the 1800's and the building of the Panama Canal that Ecuadorian hat makers found a ready market for their products in Panama City and by 1850 the United States market had "discovered" these hats buying over 200,000 hats per year. (Anonymous, 2016)

Figure 1

Classic Fedora Hat

In 1906, President Theodore Roosevelt visited the construction site of the Panama Canal where he is photographed wearing one of these unusual hats. This picture published in world newspapers and magazines publicized this hat and made it a fashion phenomenon. From then on the hats kept its name

[3] From Jethro Tull (1973). A *Passion Play. http://jethrotull.com/?portfolio=a-passion-play.*
[4] From Lewis Carrol (1865). *Alice in Wonderland* http://comminfo.rutgers.edu/~mjoseph/Alice.html.

of “Panama” Hats, though Ecuador received its recognition as their place of origin through time and the clarification with the history behind these gorgeous hats. (See Figure 2, below). Later, the glamorous style of the 1940’s gave these hats even more place and recognition. Throughout history, people from all walks of life, including presidents, artists, and politicians, wore and benefited from “Panama” hats. Many famous heads have worn them too, such as Humphrey Bogart, Orson Welles, Gary Cooper, Ernest Hemmingway, Winston Churchill, Harry Truman, Paul Newman, Alberto Santos Dumont and celebrities of today like Johnny Depp, Sean Connery, Kevin Spacey, Madonna, Monica Bellucci, and Javier Bardem amongst many others. (Lopez, 2012)

Figure 2

“Teddy” Roosevelt and the Panama Hat

(http://www.thegenuinepanamahats.com/History)

Industry Background (SIC Code 2353: Hats, caps, and millinery)

This industry code refers to "Establishments primarily engaged in manufacturing hats, caps, and millinery, and hat bodies.

- Baseball caps, except plastics
- Caps: textiles, straw, fur-felt, and wool-felt-mfpm
- Chauffeurs' hats and caps, cloth
- Harvest hats, straw
- Hat bodies fur-felt, straw, and wool-felt
- Hats, trimmed
- Hats textiles, straw, fur-felt, and wool-felt
- Helmets, jungle-cloth: wool-lined
- Millinery
- Opera hats
- *Panama hats*
- Police hats and caps, except protective head gear
- Uniform hats and caps, except protective head gear" (OSHA, n.d.)

Hoovers' industry analysis lumps this industry category into Apparel Accessories Manufacturing (NIACS 315990: Apparel Accessories and Other Apparel Manufacturing) and reports that:

> Demand is determined by consumer tastes and the level of consumers' discretionary income. The profitability of companies depends in part on effectively controlling the costs of manufacturing, both in the US and internationally. Smaller companies can compete effectively by specializing. The US industry is concentrated: the top 50 companies account for about 80% of sales. Imports account for nearly all of the US market. The largest suppliers to the US are China,

> Mexico, Vietnam, and Italy. Major export markets for US apparel accessories manufacturers include Canada, Mexico, and the Dominican Republic. Exports account for more than 95% of US production. … US retail sales for clothing and clothing accessories stores, a potential measure of apparel accessories demand, increased 0.5% in the first nine months of 2016 compared to the same period in 2015. … The men's market for apparel accessories has improved as men have been more willing to embrace certain styles, such as hats. An increase in hat purchases can be tied back to more celebrities, such as Justin Timberlake, Pharrell, and Usher, wearing hats, as well as the popularity of the television show Mad Men, in which central character Don Draper favored fedoras. Male consumers are expected to be a major growth driver for personal accessories sales in the US, according to Euromonitor. (Hoovers, n.d.)

Industry Specifics

According to the Commercial Office of Ecuador in Los Angeles (9/16), Ecuador is known as a country specialized in producing fine varieties of straw hats that meet high standards and demands of consumers internationally.

The straw hats, also known by the famous name "Panama Hats" worldwide have been well received in the United States the last few years. The demand for these hats has experienced a significant increase and it is estimated that demand will continue to increase. The hats have various designs, shapes, colors and different qualities.

Prices. When it comes to price, the quality of the hat is a determining factor, and its quality is determined mainly by three factors: tissue, tissue quality and uniformity of color. The hat color is generally a natural beige, although it can be processed to obtain other colors either pure or more white and bright colors.

Hats are categorized by degrees, with 1 being the degree of lower quality and lower price, and grade 40 the better quality and higher price. The higher the grade, the more expensive and better quality will be the hat. The word "degree" is used to indicate the number of threads per linear inch which the hat has. The finer the hat is, the longer it takes the manufacturing process.

Ecuadorian hats are sold at a higher value because the quality of Ecuadorian hat is higher than that of its competitors. Hats from China are hats lowest priced in the market. These are made of an artificial material and fluctuate between US $ 15 and US $ 50.

Hats degrees between 1 and 4 of the Ecuadorian competition reach a price range between US $ 90 to US $ 130, while hats between grades 4 and 8 fluctuate from US $ 200 to US $ 250. For fine hats highest level, prices range from US $ 340 to US $ 500.

Demand. In the last 5 years' straw hats imported to the United States from Ecuador has quadrupled. It can be seen that the vast majority of products entering the United States through Florida, Hawaii, Puerto Rico, California, among others, indicating that Ecuadorian hats are marketed and distributed from places with warm climates, where a hat can be included and adapted to the style of clothing worn in these places.

Hats, generally do not have a definite style since there are a number of designs and prices. You can find many hats of low quality and lower value in the US as well as in more reputable stores and shops known as high quality. However, Ecuadorians in order to have a better quality and to be recognized for their fine hats seek to promote their hats to people with purchasing power. High quality hats are products that are commonly seen on golfers, owners of sailboats and yachts. These are also promoted in world events such as tennis, golf, among others.

Panorama in Ecuador. Exports from Ecuador to the world represent US $ 29,122,100 during the period January 2013 to June 2016. The United States is the country with the most demand, accounting for 19% of total exports. Countries such as Japan, France, Germany, Spain, United Kingdom and Panama, follow. Currently, Ecuador is focusing on the production of straw hats with fair trade, this so that the Toquilleras and all those who weave hats may benefit directly from marketing them.

Imports: Increased competition in price has been due to the importing of China hats. These are of lower quality and inexpensive to make. They are made of synthetic fiber and are perfect for consumers who do not focus on quality and want to wear the hat only in the summer. Direct competition comes from European hats: Germany, England and Italy, which have a small disadvantage in quality but an advantage in price.

Consumer: This product is trends in the summer. Thus, typical consumers are located in warm areas of the country, especially in areas close to the beaches, because of the environment they have and fashionable clothes that people in these areas wear.

With demand for these hats increasing worldwide, and the implementation of fair trade in Ecuador, there is a promising future for all Ecuadorian producers of hats. In conjunction with this, the industry should focus on promoting hats in warm areas of the United States, where the product has increased demand and better reception, given the environmental, climatic and trend dress consumers in these areas, particularly, during the summer. (Commercial Office of Ecuador in Los Angeles, 2016)

Catalya Hats: A Family Success Story

Catalya Hats, a millinery company began from a simple design of a Panama hat in Ricardo Catalya's home in Ecuador. Mr. Catalya had no idea that when he crafted his first Panama hat in 1906 to protect himself from the sun, it would become an iconic fashion classic. His hats were crafted from the finest natural toquilla straw fiber; no fibers were ever the same. In fact, each hat had its own character because the materials were different in shape and color. Toqilla comes from a straw plant, which cannot be woven by a machine it can only be woven by hand. Depending on the weave count one hat could take anywhere between one week to three months to manufacture.

It did not take long for many powerful businessmen and celebrities from the United States to take recognition of these handcrafted pieces at the time. The company's strategy was to become a globally integrated quality hat company. For over 100 years the industry has praised the company, and helped the company raise its annual revenue to $25.5 million by 2006.

Nearly all of the top managers started their careers with the firm and had worked their way up to their positions. The firm's practice, started by its founder, was for all employees to learn the business from the ground up starting with working on the production line assisting the hat makers (regardless of their actual field of expertise) and then rotating through every job dealing with hat production and distribution including actual hat making. This approach to employee training ensured that everyone in the firm, regardless of their specific tasks and responsibilities, had a personal connection to not only every job performed but also to most the people who performed them.

The company's accomplishments were due in no small part to its cross functional corporate structure; a structure that reinforced egalitarian decision-making. By definition, the company's team or project members came from more than one functional area of the company, working together toward a common goal and a common bound; a love of hats. This structure ensured that the work groups were able to carry out the company's mission of making every hat a unique experience. Catalya's organizational culture was therefore family-based and family driven as enlivened through the managers' and employees' work attitudes and behaviors. The top-level managers were leaders in regard to setting and implementing these values, beliefs and how an employee should be treated as well as how an employee should perform when representing the firm both within and without.

Throwing Your Hat into the Ring: The New Owner

The firm finally maxed out its production capacity at the turn of the 21st century, stalling the family's plans for international growth and expansion. Although profitable, the family did not have the financial wherewithal to support a sizable plant investment and therein continued focusing on process and production improvements through technological innovation. In 2006 the firm was reluctantly sold to a private investor, Ralph Dweck, who had the capital needed to expand the name and brand. An essential part of the purchasing agreement was that Mr. Dweck agreed to retain the current employees and staff for a minimum of two years and that he would remain true to the quality and traditions of the firm.

Mr. Dweck understood that his new staff may not see or agree with his “big picture”, his vision for international growth and expansion, and hoped that he could move them out of their “familial” surroundings and transition them into a more corporate, professional milieu and mindset.

At the first major executive meeting he rolled out his plans to enter into new international markets and distribution channels. Everyone seemed onboard with these growth plans until Mr. Dweck discussed the need to find international business partners in order to expand the firm’s operation. These partners, specifically firms with excess production capability, would dramatically increase the firm’s production capacity while leveraging Catalya’s good name. Some form of outsourcing of production seemed to make the most sense to Mr. Dweck given the limited financial investment required nonetheless his proposal received opposition from many of the top managers within the firm.

Brian Bianco the Vice President of Operations argued that no one could make Catalya hats like Catalya employees and that unless these “partners” were going to be trained by Catalya hat makers that the products would be of inferior quality. He proposed instead to increase the current plant size and capacity, take on a larger work force, and continue the tradition of producing high quality hats made in Ecuador. He felt that local monitoring and quality control techniques would ensure that the firm would maintain high production standards; standards that would allow the firm to continue to excel as a top flight connoisseur hat maker.

Evelyn Choi Manager of Production echoed his concerns about outsourcing production reminding everyone of Ricardo Catalya’s legacy and the pride employees had in working for such a prestigious firm. Janice Warling in Public Relations thought that they would garner for more public support by “making local, being global” and that they could leverage the “fair trade” movement by touting how well their workers were paid as well as their pristine working conditions. She thought that they could even seek government funding and support to help them grow the business (low or no interest loans, tax abatements or rebates, etc…). Tori Baugmart the Vice President of Human Resources reinforced these sentiments and indicated that labor was plentiful, fairly well skilled and was not overly costly as compared to other workforces.

In response to these negative comments Mr. Dweck tried to explain to his team the need to ride the wave of consumer demand for these hats without committing a huge amount of resources for gearing up production. He was afraid that this increased demand might be short-lived, having quadrupled in the last five years, and that the firm might get caught in a fad downturn rather than climbing up the surging wave of a fashion trend. Outsourcing seemed to be the best short term solution to solving the supply gap, a gap that could not be shrunk through price increases.

The Hat Still Has a Silver Lining

Mr. Bianco asked that the management team be given some time to study the situation and to make a counterproposal that would specifically address the need to increase production capacity locally and maintaining the same high quality standards. This new “solutions task force” (though far more informal in operations then it sounded as named by Mr. Dweck) was given three months to propose a viable alternative that could be quickly implemented. The team first chatted with the employees to see if they had any ideas and then did some external research including talking with suppliers, competitors and government officials. At the end of the three months the team proposed the following options:

1. Several competitors had excess production capacity which could be utilized on a “need only” basis. In order to protect the proprietary nature of hat production, Catalya would supply their own work force and train them to utilize their competitors’ equipment and facilities. The team though was not comfortable “exporting” their core competency and skilled employees to a competitor’s location in fear of intellectual theft and recruitment of key employees.

2. Once they approached the competitors in terms of excess capacity, one or two of them suggested that Catalya buy them outright and take over their entire operation. These competitors were much smaller in capacity and therefore would only incrementally add to the firm's capacity and therefore would allow the firm to incrementally meet demand while not potentially overproducing. After touring the plants in question though, the team concluded that the energy and cost involved in converting the plants to the "Catalya way" was going to take far too much expense and effort.
3. Catalya's current plant operated using a single shift system – the shift arrived at 7 AM, performed programmed maintenance and supply replenishment, and by 8 AM started assembling hats; production ended at 4 PM so with cleanup and maintenance the workday ended at 5 PM. Short breaks (15 minutes) occurred every two hours with an hour lunch break at noon. Being with family was so important to the Catalya's and their employees that altering these routines seemed out of the question. Yet when asked for alternatives to outsourcing certain employees indicated that they would be willing to work an evening shift if it would keep production "in-house" – their pride would not allow them to see Catalya hats made anywhere else but in Ecuador and certainly not by anyone else but by "family" members. Of course they would expect a pay differential that would warrant working this later shift and they also expected that shift deployment would be rotated so that everyone, including top management, would have the opportunity to serve the firm.

A Tip of the Hat or Keeping It Under your Hat?

The team agreed that the third option seemed the most viable, especially since the answer came from employees who would then be implementing the solution. The task force developed a detailed plan of operations that addressed machine and supply maintenance, personnel needs and assignments (including management), budget (including projected cash flows and profits), projected quantities, as well as special needs pertaining to quality control. The second shift would start at 5 PM, start production at 6 PM, have a light meal at 9 PM (1/2-hour break) and end at 1 AM. This second shift was shorter than the first since the team feared that workers would become overly drowsy and quality would slip. The team presented all of the alternatives to Mr. Dweck who agreed that option three was the best short term solution and asked them to go ahead with executing a second shift.

Mr. Dweck however did not drop his plans for licensing the firm's brand and manufacturing processes. He firmly believed that the business path to buildup brand recognition and market share and to catapult the brand to the top of the clothing accessories market was through licensing and in essence franchising the company name. Competition in this industry was deemed as very challenging and licensing to him seemed the best choice to quickly and with minimal costs enter new markets while leveraging the company's brand. Mr. Dweck, unbeknownst to the management team, then hired a consultant, Mr. Armando Degast, to investigate possible licensing partners and to then make the necessary contractual arrangements to finalize a deal.

Hats Off to the Management Team but then Hold onto Your Hats!

Mr. Bianco and his management team seemed to have accomplished the impossible. Their second shift plan took only three months to implement and was quite a success, not only adding an additional 40% to the firm's production capacity (the estimates were around 25%) but also adding an additional 10% to the firm's bottom line and increasing employee annual income by 20% (due to overtime). By 2010 however, even operating at maximum overtime (including working holidays) and increasing the base price of the hats by 15%, the plant could not keep up with the skyrocketing demand. Mr. Dweck was cautioned by a marketing consultant not to push the price point too high but for the next year the firm was successfully able to creep up the price another 10% without impacting demand.

By January of 2011 demanded not only slackened but started to drop off, reducing back orders from 120 days to 60 days. In six months, assuming sales held firm, the firm would be "caught up" with back orders and would no longer require a second shift. Field research indicated that local competitors with similar quality hats were operating at near 100% capacity at slightly lower prices thereby cutting into Catalya's client base. More important, customers were becoming more price sensitive and that lower cost "panama style" hats were flooding the market, mainly from Asian manufacturers, creating a price ceiling for luxury hats.

Mr. Dweck presented these findings to his management team, indicating that lower demand in the long term would necessitate dropping the 2nd shift. Tori Baugmart in HR immediately admitted that dropping the 2nd shift would reduce employee salaries by 20%, an unacceptable alternative given the negative impact it would have on their employees' standard of living and quality of life; they had become accustomed to these higher wages and could not afford wage reductions. Janice Warling in Public Relations denoted that this would become a PR nightmare. Not only would employees become disgruntled, leading to negative word of mouth, but the press would have a field day with the story – perhaps negatively impacted the brand name and certainly bringing disfavor from the government.

Mr. Dweck then discussed with the team alternatives to dropping the second shift – he brought up the possibility of worker layoffs, reduction in benefits (i.e. vacation, personal and sick time) including retirement plans, reduced operating hours for each shift, and even dropping the price of the hats. Each alternative met with strong resistance from the management team, except a drop in price.

Mr. Dweck was not only prepared for this eventuality, he in fact banked on it. He indicated that a drop in price would cut into profits and that the firm needed those additional funds for product design and technology-based investments. Both Mr. Bianco and Ms. Choi indicated the need to reinvest in the plant and to streamline product design since their plant was aging. They needed newer, more flexible and efficient hardware and software to create and manufacture new hat lines with better consistency and lower costs.

Pulling the Hat Over Their Eyes

An argument ensued amongst the team members based upon the notion that employees came before machines with Mr. Dweck silencing the group and asking for cooler heads. At this point he reintroduced the licensing idea. Profits would be derived from licensing the hat, a new revenue stream, with the royalties going straight to the bottom line. Mr. Dweck saw this venture as generating a profit with minimal risk to the firm while adding to brand equity and value in the long run. As the licensor, Catalya Hats would grant rights to the licensee to use Catalya's intellectual property including its trademark, logo, slogan and production trade secrets. More important, employees could keep their second shift while operations would get their equipment and software; a win-win for everyone (and just as he had planned and hoped for).

Mr. Bianco thanked Mr. Dweck for putting forward this alternative and asked that the team be provided with more detailed information so they could analyze the pros and cons for the firm. Two weeks later each team member received from Mr. Dweck an electronic packet of information detailing the pros and cons of a licensing agreement including a standard licensing agreement form and a hotlink to a list of the major foreign manufacturers of Panama hats.[5] (See Appendices A and B.)

A few weeks later the team came back to Mr. Dweck and reluctantly agreed that although it would break with Catalya tradition, they would relent and allow certain lower priced models of the hat line to be made overseas. This would allow operations in Ecuador to concentrate on the higher quality, more difficult to mass manufacture, specialty hats that made Catalya the Rolls Royce of the market. More specifically, they wanted the licensee's hats to be distributed in fairly local markets and more specifically not in the US. They felt that the US market would devalue non-Ecuadorian Peruvian hats and therefore negatively impact the firm's brand name; a name that took many years to develop and protect.

Mr. Dweck outwardly reluctantly agreed with his team's recommendations though this was exactly what he wanted, to subcontract out production, reduce operating costs and grow profit margins.

[5] Approximately 285 suppliers of Fedora Hats are listed on Alibaba.com., predominately in China. https://www.alibaba.com/trade/search?f1=y&indexArea=company_en&n=38&category=100009086&viewType=L&keyword=fedora_hat, 11/29/16.

A day later he e-mailed an announcement to the team that he would bring into the firm some expertise on international licensing, an area they had no experience with. Mr. Dweck had Mr. Bianco research LIMA (The International Licensing Industry Merchandisers' Association - http://www.licensing.org/). After initially reading about the organization, Mr. Bianco then surfed their "consultant" site, lamenting that only one firm that provided this type of service was located south of the US border, in Mexico; not a very promising start. (http://www.licensing .org/limanet/directory/consultants/, 11/29/2016) He contacted them and found that they had limited experience in apparel licensing and they recommended him to several large US firms.

In the interim, Mr. Dweck e-mailed the team that he had conducted his own personal search on LinkedIn which yielded a list of just a few individuals with a strong background in apparel licensing and who were familiar with Ecuadorian trade laws. He was particularly fond of one consultant, Mr. Armando Degast, since he had brokered several deals between other South American apparel firms and Asian manufacturers. Mr. Degast's resume and client list was then circulated to the management team along with a list of potential licensees for Catalya Hats. The team ruminated over his resume and the list and decided that Mr. Degast's background was well suited to represent Catalya Hats since he had represented other family-based firms that decided to grow market awareness of their products and raise capital by leveraging their brand name with minimal investment costs. The team, with Mr. Dweck in the background, held a Skype interview with Mr. DeGast, who was then in China at the time. They were satisfied that the man on the screen could deliver to Catalaya Hats a client who would appreciate their tradition and values and produce a hat worthy of the Catalya name. A few days later Mr. DeGast was hired and immediately went to work finding a licensee who would live within the limitations imposed by the firm in terms of product quality and distribution.

A Feather in Mr. Dweck's Cap

After several months of meetings and negotiations with potential licensees, and several "near deals", Mr. Degast came back with what looked like a viable licensee, Xion International. The contract had been vetted through the legal department with no obvious problems and specifically included clauses pertaining to where the licensee could ship their products to, what "lines" of products they could produce under the Catalya name, and the fact that all products before mass production would need to be inspected by Catalya personnel. This would require that several of the staff at Catalya inspect Xion's operation and ensure that work process and product met their high standards. The management team was particularly impressed with the fact that the contract required that Catalya provide Xion employee training and technical support at the Licensee's expense.

Mr. Dweck was satisfied with the financial package – there was a flat annual fee for the licensing rights of $500,000 US dollars (Ecuador adopted the US dollar as their currency in March of 2000) as well as a 10% royalty on any item at wholesale cost. Mr. DeGast estimated that early production runs could reach as much as 100,000 units; with wholesale costs of the least expensive hats running $5/unit. That would add another $50,000 to the deal with no out of pocket expense for the firm except Mr. Degast's consulting fee (10% of the flat rate) and some fixed labor costs from the legal department.

The deal was finalized in summer of 2011 with personnel from Catalya on-site in Shanghai supervising Xion's employee training and production operation. Mr. DeGast was hired as VP of Licensing with the understanding that if this deal worked out well other deals with other vendors around the globe were in the offing. Xion had very modern computerized equipment, a highly motivated staff, and a very able workforce who quickly adopted to the Catalya way of hat making. Computerized quality controls worked quite well and employed ISO 9000 standards, with reject rates even lower than Catalya's own operation for mass produced hats. Although far more formal than their Ecuadorian counterparts, the Chinse workers took great pride not only in their work but in the firm they worked for; adding Catalya to their family was viewed as highly positive.

Pulling a Rabbit out of the Hat or Coming Up Empty Handed?

During the ignominy in Mr. Dweck's office, Mr. Armando Degast found out from the public relations officer at Xion International, through her connections with the press, that the factory in question was not a Xion factory but a factory of a subcontractor! Outsourced? He allowed the public relations officer to continue while he sat speechless and listened.

One of the subcontractor's factory workers, Hiro Lin, a 56-year-old employee in the factory, made an inquiry about the labor conditions to the local government. Mr. Lin felt it was worker abuse and since it was an International company he was ultimately making hats for, he expected to be treated as though he were working in their factory. A majority of the factory workers felt the same way and it reflected in the quality of the product; reject rates were well above Xion's acceptance rate from their subcontractor. This resulted in short-term production shortages with Xion stocking out with their deliveries to their retailers. This affected Catalya's brand reputation since consumers inevitably bought whatever brands of Fedora hats were on the shelves within their price range. Since this occurred within the first three months of the contract period, Catalya had no historical basis for determining production and sales irregularities; quantity and quality were not below contract standards.

In the interim, the government official told Mr. Lin she would file his report, but no report was ever filed. Instead, the official contacted a local member of the press who went undercover into the subcontractor's factory and recorded firsthand the substandard working conditions including pictures of Catalya hats in production. That lead to the series of articles published in the local papers as well as some minor news leaks in social media.

When the "story" was finally finished, Degast asked why this work was subcontracted out and not done in-house. He was told that the first few production runs were so small that it was not cost effective for Xion to manufacture them; Catalya hats were farmed out to smaller, "sweat shop" factories.

Degast was stunned that Xion had subbed out the work and worse Xion had not notified Catalya of such actions. Where in the contract were they allowed to do sub out production? After he finished his call with Xion, a quick call to the legal department confirmed that the licensing agreement did not preclude subcontracting. Subcontractors were therefore not held liable to Catalya work and product standards set in the contract with Xion. The head of the legal department said one could make an argument that quality control standards were certainly implied (if Xion had to meet those standards, any product produced for Xion had to meet the same standards) yet working conditions only applied to Xion factories. Any "damages" from this incident would therefore have to be directly addressed with Xion and not the actual factory in question.

The Final Straw

Degast knew that Mr. Dweck was not going to be happy with this turn of events. How could he tell him that the company's reputation had been tainted by an organization that Catalya's management team hadn't vetted? He could he tell Mr. Dweck that proper precautions were not taken (due diligence) in signing the contract with Xion? Although the legal department should have caught this glitch in the contract it was Degast's responsibility to research Xion including their propensity to contract work out (and to whom). Degast walked back to the meeting, hat in hand, preparing himself for the worst understanding what happens to the messenger who brings the king bad news.

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