THE SYSTEMS THINKER®
PEGASUS COMMUNICATIONS
BUILDING SHARED UNDERSTANDING
VOL. 10 NO. 4 MAY 1999

THE HAZARDS OF HOUNDING DEBTORS: SCANDAL IN THE RETAIL INDUSTRY

Personal bankruptcy has taken a frightening turn lately in the U.S. From 1994 to 1998, the number of such bankruptcies jumped from 780,000 to a whopping 1.3 million. This trend has had a devastating impact on individuals and creditors alike. The retail industry, in particular, has developed a dubious "solution" to the problem of collecting existing debt from bankrupt customers. Recently, Sears stores have become an example of what can happen as a result of taking an overly aggressive approach.

The problem begins when retail-store credit-card customers fall into bankruptcy and cannot pay off their accounts. To protect their bottom line, some retailers offer debtors a deal known as a reaffirmation. Under this agreement, the debtor agrees to pay the company a monthly fee, and the company agrees not to repossess the goods purchased before the individual went bankrupt. The retailer is then required to file each reaffirmation with the court so that a judge can determine whether the debtor can handle the new payment. As it turns out, Sears, along with several other big retailers, hasn't been filing the appropriate paperwork.

A Closer Look at Motives

Some of the motives behind the reaffirmation scam aren't hard to figure out. Many companies are awash in bad debt these days, and "reaffs" offer a way to reclaim at least some of the losses. Not filing them "keeps nosy judges from nixing many of [these] side deals" that essentially move the retailer to the head of the line of creditors.

Also, in the rush to generate sales by attracting new cardholders, companies can unwittingly take on customers who just aren't qualified (which only worsens the original problem). Indeed, in the early 1990s, Sears signed up so many new customers that, last year, the company earned 50 percent of its operating income from credit. The resulting dependency on credit-card revenues just adds to the pressure to aggressively pursue bad debts.

Finally, Sears has delved into its own culture to explain why the scam occurred. One group of managers postulated that Sears's "transformation from an exhausted, defeatist bureaucracy into an aggressive, can-do company had an unanticipated consequence: [Managers] hated to send bad news back up to the top." Sears's recent successes may have also boosted employee loyalty to the point where it conflicted with loyalty to the customer. As CEO Arthur Martinez explained: "I'm sure our people would say, 'These goddamn deadbeats; they took the merchandise and they didn't pay for it, and they filed for bankruptcy. I'm going to find a way to protect my company.' That's wrongheaded, but it's an accurate reflection of the culture."

A High Price Tag

The result of such misguided loyalty is that in February, after a 22-month FBI investigation, a Sears subsidiary pleaded guilty to bankruptcy fraud—and agreed to pay the government $60 million. In addition, six managers have been let go, the company has shelled out $300 million to repay wronged debtors, and the company's stock is once again languishing. Other retailers have rushed to settle with their own debtors. Clearly, the retail industry as a whole would do well to examine the dynamics driving the reaffirmation push. Sears has made a first step in that direction in examining its culture, but it has also paid a staggering price for its hard-earned lesson.

Source: "The Sorry Side of Sears," Newsweek, *February 22, 1999.*

—Lauren Johnson

YOUR WORKOUT CHALLENGE

Systems Thinking Workout is designed to help you flex your systems thinking muscles. In this column, we introduce scenarios that contain interesting systemic structures. We then encourage you to read the story; identify what you see as the most relevant structures and themes; capture them graphically in causal loop diagrams, behavior over time graphs, or stock and flow diagrams; and, if you choose, send the diagrams to us with comments about why the dynamics you identified are important and where you think leverage might be for making lasting change. We'll publish selected diagrams and comments in a subsequent issue of the newsletter. Fax your diagrams and analysis to (781) 894-7175, or email them to lauriej@pegasuscom.com. The question is also posted on our Web site (www.pegasuscom.com). **The deadline for responses is July 30, 1999.** Remember, most situations can be examined at several levels of complexity—there's something here for beginners as well as for advanced practitioners.