

## VOLKSWAGEN EMISSION SCANDAL: REPUTATION RECOVERY AND RECALL STRATEGY<sup>1</sup>

*Rachna Shah, Gaganpreet Singh, and Sandeep Puri wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.*

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Version: 2017-04-25

We have totally screwed up.

Michael Horn, chief executive officer, Volkswagen USA<sup>2</sup>

The trust-shattering exposure of the Volkswagen Group (VW) emission scandal on September 18, 2015, left Matthias Müller, VW's newly appointed chief executive officer (CEO), with a daunting management challenge—reputation recovery. Müller's task was to draw the German multinational automotive manufacturing company out of the abyss of one of the worst reputation crises it had faced since its inception in 1937. The matter came to the fore when the United States Environmental Protection Agency (EPA) slapped a legal notice on VW for violation of the Clean Air Act.<sup>3</sup> The EPA accused VW of manipulating nitrogen oxide emissions tests to ensure its EA 189 diesel engines, built during fiscal years 2009–2015, met EPA standards. The EPA claimed that VW used a “defeat device,” programming its engines to control emissions during laboratory testing and driving so that they remained within permissible limits. However, during actual on-the-road driving, the nitrogen oxide emissions were as much as 40 times higher.<sup>4</sup>

No sooner had VW admitted to the intentional fraud charges than its stock plummeted 20 per cent<sup>5</sup> and its market value declined by US\$26.8 billion.<sup>6</sup> This downturn forced VW to recall 11 million affected cars worldwide. VW also faced a penalty of approximately \$18.0 billion from the EPA.<sup>7</sup> An additional \$7.3 billion was required to fix all affected cars.<sup>8</sup> This full-blown crisis hit VW across the board, severely denting its market share, brand image, internal/external stakeholders' trust, and supply chain operations.

The consequences of the unethical conduct included investigations from over a dozen countries and lawsuits from many customers. It was imperative that the company have a fresh start to overcome this bleak scenario. Müller needed to meticulously reconceptualize the VW brand identity and devise an appropriate recall strategy, along with its key elements. Should he break down the recall strategy into distinct phases, with unique objectives for each phase? Should the strategy be different for different stakeholders and address their specific concerns? Finally, could different stakeholders be more relevant during different phases, and should the recall strategy be designed with this difference in mind?

## THE SCANDAL

In 2005, VW CEO Wolfgang Bernhard wanted to reaffirm VW's position in the world's most competitive market—the United States. He believed that diesel engines were the gateway to compete with VW's Japanese rival, Toyota Motor Corporation, and to capture the U.S. market, which had stricter environmental standards. Rudolf Krebs, an experienced engineer from Audi whose prototype had worked well in South Africa, recommended the additional use of AdBlue in the planned engine, which was later named EA 189. When Bernhard left and Krebs was transferred to another position, Martin Winterkorn became CEO in 2007. After taking office, Winterkorn instructed Ulrich Hackenberg and Wolfgang Hatz, key Audi team members, to expedite the engine development.<sup>9</sup>

In 2007, VW introduced the diesel engine EA 189, which efficiently met tighter emissions controls and better fuel efficiency standards. EA 189 became an effective differentiator, which increased VW's U.S. market share. The increased clean diesel sales volume in the United States, which rose from 43,869 in 2009 to 98,500 in 2014, reflected the high customer acknowledgment.<sup>10</sup> VW positioned the innovation with the “clean diesel” mantra.<sup>11</sup> Its aggressive promotion campaign claimed the following:

This ain't your daddy's diesel. Stinky, smoky, and sluggish. Those old diesel realities no longer apply. Enter TDI Clean Diesel. Ultra-low-sulfur fuel, direct injection technology, and extreme efficiency. We've ushered in a new era of diesel.<sup>12</sup>

In addition, VW insisted “diesel cars are fun, quiet, efficient and, most critically, they are clean.”<sup>13</sup> According to iSpot.tv, VW spent \$77 million to endorse its clean diesel cars, which accounted for about 45 per cent of its total television advertising budget of \$165 million.<sup>14</sup> The technology was also showcased at various car shows.

In 2012–2013, various environmental organizations raised concerns that diesel cars were not as clean as claimed. In 2013, an environmental association, DUH (Deutsche Umwelthilfe), revealed audit reports highlighting significant irregularities between the test mode and the actual driving mode in Germany. The reason for VW's exceptional diesel performance was unveiled when the International Council on Clean Transportation conducted similar tests in the United States and informed the EPA and the California Air Resources Board about several VW brands and models that failed the tests (see Exhibit 1).<sup>15</sup>

After a series of investigations, VW admitted that it used a defeat device to improve performance and eventually change buyers' perception regarding diesel technology. VW's acknowledgment of manipulation led to several countries launching investigations and many customers filing lawsuits. VW then started a recall in January 2016, which was expected to last until the end of the year.

## PAST RECALLS IN THE U.S. AUTO INDUSTRY

Car recalls were among the most common issues in the auto industry. The recalls were mostly the consequence of design flaws and misses in the production line. Most manufacturers faced this problem, either voluntarily or imposed, at some stage in their businesses and at staggering costs. According to the National Highway Traffic Safety Administration, in 2013–2014, the recall amount in the U.S. auto industry was more than 30 per cent. The U.S. auto industry recalled 22 million vehicles and sold just over 15 million.<sup>16</sup> Some of the most famous recalls in the United States related to Toyota's out-of-control gas pedals, 2009–2010; Ford's failure-to-park recall, 1980; the Takata seatbelt scandal, 1995; and the Ford ignition

problem, 1996.<sup>17</sup> Although these were some of the most costly recalls to affect the U.S. auto industry, they were neither the only ones nor the last ones.

The latest VW recall would also find a place on the list of biggest and most expensive recalls; however, it was distinct. Unlike the others, this global recall was the result of intentional infringement rather than a manufacturing defect. Generally, after a manufacturing defect, the relaunch of a car did not involve a complete overhaul of the positioning strategy; neither were customer trust and market share dynamics greatly affected. However, the emissions scandal made it imperative for the VW marketing team to put something new in place.

## PAST USE OF DEFEAT DEVICES IN THE AUTO INDUSTRY

VW's use of the defeat device was not the only time the device was used in the auto industry. In fact, VW had repeatedly used the device. General Motors Company, Ford Motor Company, and American Honda Motor Company had also paid heavy penalties for using the device.

**VW:** In 1974, VW paid \$120,000 to resolve an objection the EPA raised. The EPA's complaint maintained that VW did not reveal the existence of two devices that altered the emission control on about 25,000 cars manufactured in 1973.<sup>18</sup>

**GM Cadillac:** GM's first environmental-related recall occurred in 1995 following the installation of illegal devices in 470,000 Cadillac cars. The total penalty, including a hefty fine, recall cost, and cost of altering the infrastructure to offset the excess emission, was \$45 million.<sup>19</sup>

**American Honda and Ford:** In 1998, Honda and Ford were alleged to have used a defeat device called a "misfire monitor." The use of the emission-control mechanism led to both companies being forced to pay millions of dollars in penalty, recall, and fixing costs.<sup>20</sup>

## THE DISRUPTION

### Suppliers

The VW scandal disrupted the value chain for most of its stakeholders. Limited or halted VW production affected the sales of first-tier suppliers of wheels, engines, fenders, and so on. In turn, these suppliers stopped the delivery from their own suppliers of spark plugs, engine blocks, and other such parts (second tier). The subsequent chain reaction continued to increase the magnitude of the disruption.

VW used the best supply chain management practices such as lean inventory levels. However, the just-in-time system, and its high dependence on single suppliers for each of its parts, intensified the speed and relative harshness of the impact on suppliers. VW's subcontracting represented about 70 per cent of the car sticker price. If the 70 per cent figures persisted, the first-tier suppliers had \$280 billion at stake. Similarly, if 70 per cent revenue of the first-tier suppliers was generated for second-tier suppliers, the total impact would be about \$476 billion, and this could be expected to increase further while moving down the supply chain. Thus, the consequences of one organization's unethical practices drastically affected the related value chains and eventually affected the entire industry.

The unexpected incident brought a sense of hesitation to the relationships among business partners and distorted their strategic business planning. One supplier acknowledged that the VW scandal had ushered in disruptive uncertainty.<sup>21</sup> As VW was held accountable, it had to effectively manage the relationships with its suppliers during the crisis.