

Case Study

Atlanta Home Loan

In late 2002, Albert (Al) Fiorini was becoming more and more frustrated and depressed. In September 2002, he had taken a leave of absence to return to school to earn his MBA, and he had trusted some employees to run the mortgage lending business he had founded. Now it was clear to Al that those employees had schemed to wrest control of the business away from him. And, amazingly, they seemed to have been successful. Al lamented, "They didn't just steal some of my assets. They stole my whole business!" Being 2,500 miles away and busy with his studies, Al felt nearly powerless to stop them. He had spent many sleepless nights wondering what he could and should do to get his business back. He also thought about where he went wrong — what he should have done to prevent this problem from happening in the first place.

THE COMPANY

Atlanta Home Loan (hereafter AHL) was a mortgage lending and financing company based in Atlanta, Georgia. Al Fiorini founded the company in April 2002 with an initial investment of about \$40,000. He started operating the company from his home.

Al had many years of experience in the mortgage lending industry. He had worked for several different companies and had also served a year as president of the Orange County Chapter of the California Association of Mortgage Brokers. Under his direction, AHL's business grew rapidly in its first quarter of operation. By the summer of 2002, the company consisted of four telemarketers and eight loan officers, all of whom worked from their homes. "Telecommuting" was convenient for the employees because Atlanta was a large city with heavy traffic.

Al established banking relationships that allowed AHL clients to borrow money at wholesale rates. The actual loan terms varied depending on the clients' FICO scores.¹ In summer 2003, banks might offer an AHL client with a very high FICO score (over 620) a rate of 6.25–6.75% on a fixed 30-year mortgage. This rate provided the bank with an operating margin of 1.5–2.0%. AHL earned a fee of 1.50% of the loan amount for every loan funded. This provided AHL with an average revenue per loan of \$3,200.

AHL bought leads from list brokers for \$0.20 per name. These lists provided information as to whether the individuals owned their homes, and if so when they bought their homes and when, if ever, they had refinanced their mortgages.

The telemarketers called people on the lead lists to assess their interest in refinancing. Al knew from industry experience that telemarketers should generate a minimum of one lead per hour. They were paid a combination of an hourly wage plus a performance bonus (\$10.00) for each lead produced. Since most of them worked part-time, AHL's telemarketers generated, on average, about four new leads per person per day.² They gave the leads, the potential clients' names, to Al Fiorini. Al distributed the names to AHL's loan officers.³

¹ FICO® scores provide a numeric representation of an individual's financial responsibility, based on his or her credit history. FICO scores are based on a scale from 300–900. Most individuals actually have three FICO scores, one from each national credit bureau (Equifax, Experian, TransUnion). These three FICO scores are the measure that most lenders look at when evaluating credit or loan applications. FICO is an acronym for Fair Isaac Credit Organization, the developer of the credit-rating analytics.

² AHL also developed leads from the Internet, as it operated the website www.lowerrate.com.

³ In Georgia, unlike in some other states, loan officers are not licensed.

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The loan officers helped the prospective clients to fill out their loan applications and to assemble the needed back-up documents, such as W-2s, pay stubs and bank statements. After the clients' information had been collected, office support personnel, called "loan processors" would order an appraisal and a credit report, open escrow and independently verify the financial information. After all the information was collected and verified, the completed file would then be submitted to the prospective lenders either electronically or in paper form.

AHL did not yet have electronic links to the processors files that would allow monitoring of the progress of the applications before they were submitted, but capabilities for those links were being put into place. However, each application required a credit inquiry, so Al monitored the activities of his loan officers by tracking the number of credit inquiries each requested. This provided him with an early indication of how many applications were being submitted. The loan application per lead ratios varied from 5–20% depending on the skill of the loan officer. Al also closely monitored these ratios and their trends.

In the mortgage lending industry, a 30% "fallout ratio" (the proportion of loans submitted to processing that were not funded) was typical. AHL's fallout ratio was slightly less than 30%.

Once approved, the legal loan documents were prepared. At that time Al knew the revenue due to his company and the fees due to the loan officer involved. AHL paid the loan officers 40% of this total loan revenue on loans that AHL originated, and 60% on loans they originated (by generating their own leads). At closing, AHL received its funds directly from the proceeds. A broker's check would be overnight mailed to AHL's office or the money would be wired directly into AHL's general account.

BACK TO SCHOOL

For years Al had been thinking about earning an MBA degree. In June 2002, he was admitted to the executive MBA (EMBA) program at the University of Southern California in Los Angeles, California, and he decided to enroll. While in California, he planned to start another mortgage lending company.

Al had several options for AHL. He could find someone to run it; he could try to sell it; or he could shut it down. If he chose to shut it down, he would

turn the unfunded applications over to a contract processing firm. The contract processing firm would be responsible for ordering credit reports and appraisals and for interfacing with the escrow companies and attorneys until the loans were funded. For its services, this firm would charge AHL \$300–400 per contract.

But Al decided that he did not want to close AHL. It was a profitable business with considerable growth potential. In September of 2002 alone, AHL loan officers were preparing to submit 30–40 new applications to banks for funding, and the volume of business was continuing to grow. Al enlisted the services of a business broker who placed a value of \$600,000 on the company. However, Al doubted that he had enough time to find a buyer before he left for California. He decided to find someone to operate the company in his absence.

A PARTNER

Joe Anastasia⁴ was one of AHL's loan officers. He had 20 years' experience in the mortgage lending business. Although Al had known him only about two months, his initial judgments about Joe were quite favorable. Joe seemed to have excellent sales ability; he was people-oriented; and he was knowledgeable about all areas of mortgage lending and financing. On his résumé, he described himself as "dependable and honest." Before joining AHL, Joe had worked for ten years as vice president of operations for a sizable financial corporation and had previously operated his own mortgage service company for three years. Since Joe joined AHL, he had closed a higher loan volume than any of the other loan officers.

Impressed by Joe's background and performance, Al decided to make Joe a deal to be his partner. In July 2002, Al and Joe reached a verbal partnership agreement. Joe would invest \$8,400, which was used to rent an office and to purchase some office equipment, and Joe and Al would share AHL's profits equally.

Curiously, however, on the day when the two partners were to meet with their new landlord, Joe did not show up for the meeting. Al could not find him for two days.⁵ In the first 10 working days after

⁴ All names, with the exception of Al Fiorini's, are disguised.

⁵ Al found out later that Joe had a problem with alcoholism.

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becoming Al's partner, Joe showed up in the office only three times.

Al did not feel comfortable letting Joe continue to run the company. Two weeks after their partnership agreement had been struck, he made Joe a deal. In exchange for terminating their agreement, Al agreed to pay Joe 100% of the fees earned on loans that Joe closed. Al then brought in an acquaintance, one with banking experience, to run AHL in his absence, but this manager lasted only three days before quitting. Faced with limited options and desperate to find someone to run the company before he left for Los Angeles the next day, Al turned again to his first option — Joe. Joe apologized for his absences with the admittedly weak excuse that "he had been partying, but it wouldn't happen again." So Al and Joe reinstated the previous agreement. When Al left for Los Angeles in August 2002, AHL had 90 loan applications in the pipeline, constituting \$300,000 in potential revenue.

Al started monitoring AHL from afar. In the following two weeks, Joe went to the office only four times. One day he took a large batch of loan files home and did not return to the office for three days.

A NEW PARTNER AND LICENSING AGREEMENT

In September 2002, Al made a final decision that he could not trust Joe. He turned to Wilbur Washington, to whom Al had been introduced by Joe several months earlier. Like Al and Joe, Wilbur had considerable experience in mortgage banking. Al judged quickly that Wilbur would be quite good at sales. He had the requisite knowledge, and "he was smooth." On the basis of these quick judgments, on September 1, 2002, Al signed a written partnership and licensing agreement with Wilbur. This agreement stated that Al would offer Wilbur the use and privileges of AHL as an ongoing business until he returned, and Wilbur would provide AHL with his management services. AHL would make commission payments to Wilbur at 100% on all loans closed less a monthly licensing fee of \$5,000 or 10% of all revenue, whichever was greater. Wilbur would also be responsible for interviewing and hiring all new loan officers, paying the expenses of running the office, and managing the entire staff.

Wilbur asked for authority to sign checks written against AHL's main bank account, but Al refused.

Instead, as a gesture of good faith Al left with Letitia Johnson (office manager) four signed, blank checks written against the main account. Al's instructions to Letitia were that the checks were not to be used without Al's permission.

Letitia had been with Al since May of 2002. She had effectively managed the telemarketers and had demonstrated her loyalty to Al. In August 2002, because of slow funding loans, Al was unable to pay Letitia her full salary. He asked her whether she would like to find employment elsewhere or to go through the hardship with AHL. Letitia responded that she would like to stay with AHL. Al promised to pay Letitia the deferred part of her salary as soon as some loans got funded, which they did in September. Al trusted Letitia.

Later that month, when Joe found out what was happening, he became quite upset. Not only was he no longer the managing partner of AHL, he thought Al owed him quite a lot of money. He wanted his \$8,400 investment back. But Al refused to pay him until he returned all of AHL's leads and loan files in his possession. Not only had his dereliction of duty caused AHL great harm, none of Joe's loans had closed since August, which Al found suspicious.⁶ In response, Joe filed a civil lawsuit demanding payment.⁷

MONITORING FROM CALIFORNIA

While he was no longer managing the day-to-day operations of the company, Al continued to monitor AHL's operations closely. Daily, or as soon as the information was available, he tracked the employee head count, the number of leads produced, credit inquiries requested, loan applications funded, office expenses, and bank activity. Al was also on the phone 3–4 hours per day talking with employees and, particularly, loan officers. He thought that this would allow him to monitor the employees' emotional states, important leading indicators of forthcoming company performance. Al also had all of AHL's corporate mail forwarded to his California

⁶ Al later also found out that Joe had used a friend to close his own loans, which violated legal regulations for the mortgage business. Another reason for Al's suspicion was that one of AHL's loan officers had originated a loan and asked Joe to bring it to the office, but Joe never brought it in.

⁷ The court dismissed this lawsuit on December 5, 2002.

address. Al was particularly concerned about Wilbur keeping overhead expenses in line with production so that he would be able to pay the employees, to whom Al continued to feel a responsibility, as well as Al himself.

In late September, Wilbur hired a new processor. Al knew from experience that every loan officer believes that there is never enough processor time available to get "his" particular loan documents completed on a timely basis. But Al's experience also told him that each processor should be able to fund 20 loans per month, so the company needed only one processor for every four loan officers. Al thought that Wilbur was now employing one, or maybe even two, too many processors and/or salaried, overhead personnel. He sent Wilbur a note telling him that his processor-to-loan-officer ratio was too high. But Wilbur reacted angrily. He told Al "not to tell him what to do," that he was managing the company in the best way he saw fit.

SUBSEQUENT EVENTS

At the time Wilbur took over the operation of AHL, four loans, which would generate total revenues of \$11,700, were about to be funded. This amount was supposed to be wired into AHL's main corporate checking account at Bank of America (BoFA). When the loans funded, however, on October 1, 2002, without Al's permission, Wilbur personally collected the four checks himself from the closing attorneys, pooled them together, and deposited them into BoFA. After depositing the checks, Wilbur immediately wrote checks to himself and Letitia for the entire amount of \$11,700 using the four presigned checks Al had left.⁸ However, since Wilbur wrote the checks against uncleared funds, the checks bounced.

Al had been monitoring the activity in the BoFA account on the Internet from Los Angeles. He noticed that the four checks had been written without his knowledge and that they had all bounced. He immediately called Wilbur for an explanation. Wilbur told Al that he had withdrawn money from the account to pay the employees. Al did not believe this explanation, in part because the checks were made out to Wilbur and not run through the payroll

account where payroll taxes would be withheld if the checks were meant for employees. On October 7, 2002, Al sent a fax and certified letter to Wilbur and Letitia and also spoke directly to them, ordering them not to write any more checks without his permission and to make sure that there were sufficient funds in the account to cover the checks they wrote. With the returned check charges, the main AHL account was already \$1,533.09 overdrawn.

Al also called BoFA to stop payments on the four checks and asked the bank to transfer the funds from the general checking account to a side payroll account to which Wilbur would not have access. However, Wilbur managed to release the stop payments on the checks. He transferred the money from the payroll account back into the general account and cashed the checks. Bank personnel apparently assumed that Wilbur had authority over the account since he had deposited the funds in the first place.

Angry and frustrated, Al decided that he could no longer trust Wilbur and could not do business with him. On October 9, 2002, Al asked a friend of his who used to be a sales manager in the mortgage company that Al had worked for previously to act as his agent. The friend was to go to AHL's office and fire all the employees. Among other things, Al was particularly concerned that AHL had over 100 client files with sensitive personal information that might be misused. However, when Al's agent went to the AHL premises to fire the employees, they all refused to go. Al called in the police to support the firing action, but when they arrived Wilbur told the police that he was the owner, not Al. Not knowing who was telling the truth, the police just left.

On October 14, 2002, Al sent a letter to all 100+ clients whose loans were in process that AHL had to drop their applications. The key phrase in the letter was, "We are no longer going to be able to service your application."

On October 15, Wilbur opened a new account at Citizens Bank & Trust (CBT) in Atlanta, a bank where he did his personal business and where he knew the manager personally. Wilbur wired the funds being held in AHL's corporate name at the offices of the closing attorneys into this new bank account. He now had signing authority over the checks.

Al discovered the second bank account when a "Welcome" letter from CBT arrived to his California address. Al was outraged that personnel at CBT did not ask Wilbur for any corporate documents:

⁸ Al found out later that Wilbur and Letitia were actively dating.

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Wilbur showed no documentation whatsoever... You would expect highly regulated institutions like banks to provide better protection for the public, but... Al immediately called bank personnel and informed the manager that Wilbur had opened a fraudulent account with CBT, but CBT refused to freeze the account or return the money. As a last resort, Al informed the Atlanta police and the FBI, thinking that they might be interested in this identity theft case. However, possibly due to the relatively small amount of money involved, neither the police nor FBI gave the case any attention. To make things worse, the day Wilbur opened the fraudulent bank account at CBT he also filed two applications for warrants for Al's arrest. Wilbur claimed that Al was the one who had taken the proceeds received from the closing attorneys out of the company's accounts. Al had to return twice to Atlanta to defend himself. Both cases were dismissed; but Al incurred over \$7,500 in legal fees and travel costs, and he wasted substantial time and energy dealing with these frivolous lawsuits. During all this time, the AHL personnel were maintaining their daily routines. Wilbur renegotiated a lease with the landlord and established AHL

as his own company. Al suspected that Wilbur had used all his means of persuasion to mislead the employees in order to break their bonds with Al. Al received his \$5,000 licensing fee in September, but that was the last money he received. By December, Al realized that he had already lost at least \$15,000 in licensing fees, and possibly more that might have been realized from the funding of the loans in the pipeline. Moreover, he had lost his company. Al said, sadly, "I have no idea how much revenue ended up being taken in my name." Sensing defeat, Al finally asked the Georgia Department of Banking and Finance to withdraw AHL's mortgage banking license. Not only had he lost his business and his income, he had also lost his credit rating since he had incurred bills that he was unable to pay. And in February of 2003, Al was forced to sell his home. In the summer of 2003, Al had still not decided what he should do. Should he fight to regain control over AHL? But what was left of it? Perhaps only about \$25,000 worth of equipment. Or should he give up, let these crooks get away with it, and try to rebuild somewhere else? Al also pondered how he had gotten into this mess. What might he have done to prevent this disaster from happening?

Case Study

Alcon Laboratories, Inc.

In early 1985, George Leone, senior vice president of Science and Technology at Alcon Laboratories, Inc., reflected on his concerns about the challenges his company faced in measuring the productivity of its research and development (R&D) activities:

R&D is perhaps the most critical part of Alcon's business; the company will thrive only if we are effective at developing new breakthrough products. In managing the research function, we have to address three

difficult but important issues. The first is how much to spend on R&D. The second is how to allocate the resources among the various programs and projects. The third is how to ensure that the resources are used effectively. The combination of answers to these three questions determine how productive our research activity will be.

While all three questions are important, I am especially concerned about the third one – how to control the use of our resources. What causes me concern is

This case was prepared by Research Assistant Chris S. Paddison and Associate Professor Kenneth A. Merchant.
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