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**Fonterra in the San Lu milk scandal – a Case Study of a New  
Zealand Company in a Product-harm Crisis**

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## **Abstract**

The 2008 Sanlu milk scandal shocked the whole China and world. It was a truly tragic crisis and should never happen again. Fonterra, as a company held a 43% share of Sanlu Group, was involved in this scandal. This case study was conducted to better understand the Sanlu Group and Fonterra's involvement in this scandal. Although this is not the first study of analysing the Sanlu milk scandal, it is a significant step towards exploring this case from a different perspective (news coverage). To accomplish this, a content analysis of 245 articles ranged from September 11, 2008 (the first time of the Sanlu milk scandal was revealed to the public by the media) to July 30, 2011 (the end of the data collection period), on different Chinese and global newspapers' websites was conducted. In particular, this study is aimed to explore the crisis management strategies by comparing different actions taken by Sanlu and Fonterra. In addition, the author sought to have better knowledge of how the media portrayed Fonterra's involvement in this scandal as well as the lessons learnt by Fonterra and the Chinese dairy industry.

**Key words:** The Sanlu milk scandal, Fonterra, Crisis management strategies, Lesson

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## Chapter 1 Introduction

In September 2008, a most infamous adulterated milk scandal unfolded in China.

Deadly high levels of melamine, which could lead to kidney stones and renal failure among young children, were detected in baby formula in the market. This milk powder contamination scandal caused 290,000 consumers to be affected around the world, more than 50,000 hospitalizations and six deaths in China (Morehouse, Freienstein & Cardoso, 2010). According to the official estimate, about 20% of the dairy companies were found selling products contaminated with melamine. The melamine scandal may have been driven by the aims of cost reduction and profitability improvement. Further probing suggests that the scandal was not about a single isolated accident, but a public health and food safety crisis (Li & Liu, 2010). Ironically, a company from New Zealand –an exemplary country in terms of food standards regulation and business ethics - was involved in the scandal. Fonterra was owner of 43% of the Chinese company Sanlu, and had three representatives on their board. It appears that Fonterra had known of the melamine contamination six weeks before it “raised the alarm” (Dellios, Yang and Yilmaz, 2009).

When a product harm crisis happens, many consumers suffer not only physically but also psychologically. We know some crises just cannot be avoided, but the important thing for a company involved in a product harm crisis is to handle the crisis successfully as well as to learn from the crisis. There are a number of objectives of this paper. The first is to understand the Sanlu milk scandal and how Fonterra was involved in the crisis. Here, the

timeline of Sanlu crisis will be drawn to show how the progression of this event from the beginning to the present. In this, how the risks associated with joint ventures contributed to the progress of events will also be explored. Secondly, this work seeks to describe how Fonterra's involvement was portrayed by the media from the beginning of the crisis to the present. The importance of having effective crisis management for a company to withstand a crisis as well as how crisis management influences reputation restoration will also be discussed.

This paper will undertake descriptive research to better understand the Sanlu milk scandal through using a case study approach. This crisis case study raises some very interesting questions and implications in the management of a food safety crisis as well as of reputation. Also this study aims to contribute to newer case-based research that continually seeks to enrich our understanding and knowledge of the importance of crisis management and the impact of a positive corporate reputation in protecting a company.

## **Chapter 2 Research questions**

Despite cases being highly context driven, key theoretical and managerial implications can be derived to improve our understanding and knowledge of this field. With this goal, the following research questions have been developed.

**RQ1.** What was the progression of the Sanlu milk scandal from the beginning to the present?

**RQ2.** What kind of crisis response strategies did Sanlu and Fonterra use?

**RQ3.** How did the media portray Fonterra's involvement in the Sanlu milk scandal from the beginning of the crisis to the present?

**RQ4.** What lessons can Fonterra learn from the Sanlu milk scandal?

To begin understanding potential answers to these research questions, the next section explores previously published work on crisis, food safety, and crisis management.

## Chapter 3 Literature Review

### 3.1 Background

New Zealand Company Fonterra Co-operative Group Ltd. is the world's biggest milk producer as well as one of the best-known international companies. Fonterra has become the world's largest dairy exporter, which dispatches 95% of its New Zealand-made dairy products to 140 countries since being formed in 2001 ("Fonterra's harsh Chinese", 2008).

Shijiazhuang Sanlu Group Co Ltd was China's biggest producer of milk powder. It produced product lines in liquid milk and other fresh dairy as well. Since Sanlu had been the number one dairy company in China for blended milk products for 12 years, the 2005 joint venture of Sanlu and Fonterra represented a marriage of complementary partners. Fonterra entered into a JV agreement with Shijiazhuang Sanlu by taking a 43% stake in the company (Manna, 2009).

However, Fonterra's global reputation for quality now faces a real risk of being harmed because of the infamous melamine milk powder crisis of 2008. This milk powder contamination scandal caused 290,000 consumers to be affected around the world, more than 50,000 hospitalizations and six deaths in China (Morehouse, Freienstein & Cardoso, 2010).

Whether Fonterra was negligent or naïve in its dealings with Sanlu, its China-based company, may never be known. But it is obvious that Fonterra forgot one of the fundamental rules of business: maintain control of your brand, and your product. A 43% ownership of a company will certainly apportion 43% of the blame, no matter company

control or not. Fonterra and its three members sitting on the Sanlu board should have been more cautious of its own supply chain for all intents and purposes (Swann, 2008). Another question needing to be explored is whether a New Zealand dairy trader could have done more to prevent China's milk scandal. Even if Fonterra executives were in the dark about the mass poisoning until eight months after their Sanlu partners found out, once in the loop, Fonterra failed to persuade Sanlu to go public for six weeks (Liu, 2008). It was remarkable that a huge company like Fonterra failed to learn of problems at Sanlu through other channels. Although strict controls of official media by the Communist government exist, important stories still come to light via the Internet and smaller outlets (Adam, 2008). Also other questions are aroused, if Fonterra made it so clear to Sanlu that selling melamine milk was unacceptable, why did Sanlu keep selling it? Did Fonterra, as a company held a 43% share, do enough to enforce its wishes over melamine? ("Fonterra should come", 2009).

After the Sanlu milk scandal broke in August 2008, Fonterra copped heavy criticism in New Zealand about keeping quiet for too long after learning the industrial chemical melamine had been detected in Sanlu milk powder. Some commentators predicted this crisis would cause irreparable harm to Fonterra's reputation. Canterbury University political scientist and fluent Chinese speaker Anne-Marie Brady said, "What would have happened if those were NZ babies drinking poisoned milk? I don't think Fonterra would have dared to sit on their hands then. Regardless of the cost, it should have been a matter of corporate responsibility" (Anthony, 2010).

Ironically, a more cynical “positive” to come from the crisis is that Chinese consumers will increasingly look overseas for their milk products. The 2008 melamine scandal regarding the safety of locally produced milk offered a golden opportunity for international manufacturers to enter the Chinese market. For example, in baby milk formula, Danone Groupe increased its retail value share from 11.6% in 2007 to almost 14% in 2008. Overall, Chinese consumers are willing to pay a premium for international brands since they are regarded as safer than locally produced ones. Research shows that safety and quality override price in milk formula, and the Chinese market just reflects the rule (Euromonitor International, 2010b).

This means that Fonterra’s export operations should benefit (Swann, 2008). Between 2004 and 2008, Fonterra increased its value share by 0.1% to 0.8% through expanding in the Asian-Pacific dairy market. Although in China, its largest Asian market, Fonterra suffered a setback as being involved with the Sanlu contaminated milk formula scandal in 2008, Fonterra announced in early 2009 that it intended to triple its milk exports to the Chinese market and grow its own business in the country instead of investing in local dairies (e.g. engaging in joint ventures) (Euromonitor International, 2010a).

Before the melamine scandal broke homegrown Chinese milk formula producers had been performing strongly. Over the 2002-2007 period, milk formula values sales rocketed by 158%. Also rising consumer confidence led to thriving “food nationalism”, which was reflected in parental milk formula choices as well. As a result, the value of sales of foreign

brands suffered, for example Nestlé's value share declined from 17% in 2002 to less than 6% in 2007. In contrast, homegrown Inner Mongolia Yili Industrial Group (Yili) more than doubled its share to 8% and Shijiazhuang Sanlu Group (Sanlu) gained 1%. It is no doubt that much cheaper prices than those foreign rivals is the most significant reason for the success of these Chinese companies (Euromonitor International, 2008). However, according to the latest report on drinking milk products in China from Euromonitor International, the 2008 melamine scandal continued to impact the overall sales of drinking milk products in 2009, with demand for powder milk the most heavily affected. In 2009, powder milk suffered an 18% decline in retail value as consumers keep placing little trust in brands associated with the scandal (Euromonitor International, 2010b).

Scandal destroys consumer trust in "Brand China". Euromonitor International predicted that those leading domestic milk formula brands, like Yashili, Mengniu, and Yili would be forced out of the baby formula market for at least 3-6 months. And even after that, consumer confidence in Chinese milk formula brands was not thought likely to fully recover for quite a long time (Euromonitor International, 2008).

### **3.2 Food safety**

#### ***Food safety as a global concern***

With the increasingly global food supply chain, the melamine scandal led major brands like Cadbury, Lipton, Kraft, and Mars to recall contaminated candy and cookies in certain

markets. The current era is a “world-risk” food chain, since food safety crises feature unclear consequences for public health because of uncertainties of transmission as well as their ease to spill over national boundaries (Wishnick, 2009). With globalization, goods and products can flow freely between regions, and countries. Therefore the food safety problem is no longer a regional or national issue, but rather a global one (Ho, 2011).

Recently, an industrial plasticizer has been detected in some beverages produced in Taiwan, causing health concerns among consumers around the world since Taiwanese beverages are very popular. Ironically, Taiwan boasts itself as having one of the most stringent food safety regimens in the world. The plasticizer has also been detected in some Hong Kong food and medicines. Worse still, people in Europe have been warned not to eat cucumbers until tests can identify the source of a deadly E. coli outbreak. The scare has spread across Europe and led to 16 people being killed. We often think European countries have the strictest standards and checking procedures on their food safety, but even they cannot avoid this kind of crisis (Ho, 2011).

Food safety is an important issue that remains unresolved in both the developed and developing countries (Dellios, Yang and Yilmaz, 2009). In China, local political supporters suppressed negative coverage of food safety during the Olympics, a possible reason that efforts by the media and consumers to call attention to problems with the milk proved a poor match for the mutually supporting efforts by central government propagandists and dairy industry executives. Moreover, low profit margins, widespread counterfeiting,

inadequately trained auditors, and corrupt management all reinforce a culture of inattention to product safety in Chinese market. China has been working with international organizations such as the World Health Organization (WHO), the Food and Agriculture Organization (FAO), and the World Trade Organization (WTO) to address global food safety concerns in the wake of the melamine milk crisis (Wishnick, 2009).

U.S. domestic food safety oversight has significant shortcomings. For example, the 2009 scandal over salmonella contamination in products made by the Peanut Corporation of America, infected 666 people and possibly contributed to 9 deaths. But the United States is still relatively strong when compared with China because of number of consumer groups focusing on food safety, the role of industry associations in promoting best practices, the unimpeded media coverage of problems with the food supply, and a legal system that is more responsive to these types of events (Wishnick, 2009).

### ***The reason for poor food safety in China***

According to recent food and product safety scandals, companies doing business in China have had difficulty in maintaining quality throughout the supply chain. Inherent problems in manufacturing processes and supply chains are the main causes cited for a breakdown of quality assurance. Obviously, the scandal severely harmed the Chinese dairy industry. In order to rescue consumer confidence, it is important for companies to place new efforts on quality assurance. Also managers must build more accountable, transparent, and ethically managed supply chains to achieve good quality control. In the Sanlu melamine scandal, the

lack of accountable supply chain partners as well as the lack of training and monitoring of business partners allowed Sanlu's suppliers to taint milk with melamine. As a result, weaknesses in the supply chain of Sanlu destroyed the company. Since Sanlu expanded relatively quickly after its founding in 1995, this led to a shortage of milk sources. The collection of milk without close supervision of quality ultimately caused the demise of the company (Delaurentis, 2009).

There are several potential pitfalls of building and managing an ethical supply chain in China. The following discussions are in the context of the dairy industry and the melamine scandal.

Although China has a primary quality watchdog – the PRC Administration of Quality, Supervision, Inspection, and Quarantine (AQSIQ), China's recall rules were not strictly followed or enforced, in addition the country had inconsistent standards for food additives prior to the melamine scandal. Now China's new Food Safety Law that took effect June 1, 2009, was designed to toughen China's recall rules and food safety standards, improve monitoring and supervision as well as increase fines and punishments. Weak omission of local dairy production due to corruption was another contributing factor to this crisis (Delaurentis, 2009).

Almost anyone can become a dairy farmer or milk station collection agent without quality assurance training or a background check in China. This means that farmers often raise cows without the knowledge or channels to protect the quality of their milk. Milk collection

stations do not necessarily regulate or organize the process of milk collection according to source. For example, milk may mix in the same container with milk from other farmers. Limited collection documentation prevents the identification of a problem's source (Delaurentis, 2009). The quality control problem is made more challenging when there are many small enterprises, many illegal, to monitor. It is these that are thought responsible for introducing illegal chemicals. Approximately 350,000 of China's 450,000 registered businesses in food production and processing employ as few as 10 people or fewer. The UN report blamed these small enterprises for presenting "many of the greatest food safety challenges" (Dellios, Yang and Yilmaz, 2009).

### ***The growing importance of food safety issues***

At least three reasons for the growing importance of food safety issues have been identified. The first concerns changes in food consumption patterns, since people are more likely to eat out, that result in greater consumer awareness of cleanliness. Second, manufactured food products and prepared meals can be bought easily from supermarkets and other food outlets, so that these food retailers have obligation to ensure hygiene standards are adhered to. Third, food safety has become a notable non-tariff barrier in international trade. When talking about who should be responsible for food safety, it is incumbent on the food industry to act with both integrity and within the legal guidelines, while governments should provide those guidelines and enforce them for the consumer's protection since consumers lack

the scientific and infrastructural capacity to evaluate food risks (Dellios, Yang and Yilmaz, 2009).

China also has recognized that it lags behind in international norms and practices. China's Vice Minister of Health Chen Xiaohong admitted that food safety in China did not match that of the developed world. He identified several problems: pollution; the low quality of some food products; inadequate technology, equipment, and quality testing systems; as well as weaknesses in food safety management (“300 Chinese Food”, 2007).

Chinese President Hu Jintao said lessons must be learned from the melamine milk scandal. All dairy products sold to the market should be ensured as qualified products (“Hu Jintao Inspects”, 2008). Meanwhile, Premier Wen Jiabao also said that China had to strengthen monitoring at the production level as well as inculcating a stronger sense of social conscience and business ethics at the management level (“Premier vows to”, 2008). Responding to the scandal, a draft food safety law was being considered by the National People’s Congress by late October 2008. The new law would seek to 1) “prevent any cover-ups by health authorities” and 2) confer on these same government health officials direct responsibilities for approval of any additives in processed food (Dellios, Yang and Yilmaz, 2009).

In mid-March 2010, the Chinese health authorities announced a new regulatory framework to improve national food safety. It highlights 11 action points to revise existing

laws on adding non-food substances to food, and also aims to achieve better enforcement of tests for pesticide residues on fresh produce. The Beijing authorities want to set up a national risk monitoring system and increase testing for high-risk foods, especially dairy products. In the wake of repeated food crises, which have damaged China's credibility both domestically and abroad, there is an urgent need to improve food safety standards. Especially after the most infamous melamine scandal that compounds commonly used in the plastics industry were fraudulently added to milk and baby milk powder in order to raise its apparent protein content. The Chinese government cracked down hard on the perpetrators of the melamine scandal and implemented new safety regulations so as to restore trust in the local dairy industry (Euromonitor International, 2011).

### **3.3 Crisis Management**

#### ***Attribution Theory***

Attribution theory postulates that people search for the causes of events, especially those negative and unexpected ones. People ascribe responsibility for an event and they will experience an emotional reaction (anger and sympathy) to the event. Behavioral responses are positive when one is judged not to be responsible and sympathy is evoked, while behavioral responses are negative when anger is evoked and one is judged responsible. So the attributions of responsibility and emotions can be used as motivations for action (Weiner, 2006). Also people like to seek causes for events since they want to establish a sense of control over their environment. For example, consumers are known to make attributions

about why a product failed, or why they switched brands. Within a product harm crisis context, the discounting principle as a corollary of attribution theory suggests that if a government agency determines that a company is responsible for this crisis, then consumers will likely exclude other explanations and attribute the negative outcome to the company. They think the company should be responsible for the tragic event (Dean, 2004).

### ***Situational Crisis Communication Theory (SCCT)***

Attribution theory is considered as a root for Situational Crisis Communication Theory (SCCT), so SCCT extends upon its base to predict the reputational threat presented by a crisis and to prescribe different crisis response strategies designed to protect reputation. SCCT provides guidelines for matching crisis response strategies to crisis types to best restore organizational reputations in times of crisis (Claeys, Cauberghe & Vyncke, 2010). Also SCCT provides a framework to explain how post-crisis communication can recover reputational damage during a recall (Coombs, 2007a).

### ***Crisis and Crisis Management***

In 2008, the United States experienced a large economic crisis that created a global recession. In 2010, a BP oil rig exploded in the Gulf of Mexico that created the largest environmental disaster in U.S. In 2011, at least 35 people have died and another 210 injured after the train collision in East China's Zhejiang province. Beyond these financial, environmental, and transportation crises, China experienced the most infamous

melamine-tainted milk scandal, which led to almost 290,000 infants affected and six confirmed deaths. Sanlu, was at the center of this scandal as well as other 21 dairy companies involved resulted in a global impact. In fact, great attentions have been paid to China's food safety problems, since China's food safety woes appear to be far from over. In 2002, high levels of the pesticide chlorpyrifos had been found in Chinese frozen spinach in Japan, which resulted in drastically reducing fruit and vegetable imports to Japan. In 2003, a fake baby formula crisis, the formula was composed mainly of sugar and starch, killed at least 13 babies in China. In 2007, melamine-adulterated pet food sourced from China caused thousands of cats and dogs to die in the United States (Euromonitor International, 2010). However, these are just several examples of food related crises in China in the past few years, and many other types of crisis are happening as well. It is obvious that we may continue to experience disastrous crises of all types. So the needs for understanding crisis and doing effective crisis management to handle crises keep growing.

The concepts of crisis and crisis management have received enormous attention in the previous research. The following table outlines the summary of definitions of crisis according to different scholars as well as the application of these definitions to the Sanlu milk scandal.

**Table 3.31 Definitions of crisis and application of the definitions to Sanlu**

<b>Definitions of crisis</b>	<b>Application of the definitions to Sanlu</b>
<p>A crisis is a disturbance that physically affects the whole system as well as threatens its basic assumptions, subjective sense of self and existential core (Pauchant and Mitroff, 1992).</p>	<p>The 2008 Sanlu milk scandal led to almost 300,000 infants hospitalized and six confirmed deaths. Sanlu Group, at the center of this scandal, experienced huge criticism and ruined reputation, finally declared its bankruptcy. Fonterra, as joint venture partner of Sanlu, also experienced criticism and negative impact of its reputation. Customers were harmed both physically and psychologically. This scandal has shaken the entire Chinese dairy industry and food safety system from the foundations to the core, and it continued to impact the overall performance of milk products in 2009. Especially milk powder products are the most heavily affected, which suffered an 18% decline in volume of sales since consumers keep placing little trust in local dairy brands. The recovery time period for Chinese dairy industry as well as food safety system will be long, since there are so many obstacles to reform, like weak enforcement and regulations, lack of traceability and transparency, among others.</p>
<p>A crisis is an important, unpredictable event that has potentially negative results. An organization as well as its employees, products, services, financial condition and reputation may be significantly damaged by this kind of event and its aftermath (Barton, 1993; Coombs, 1999).</p>	

In fact, we may see crises not only as inherently negative forces, but also as opportunities for learning and improvement. This thought is reflected in Chinese culture, the Chinese word for crisis is interpreted as dangerous opportunity (Luo, 2010). Hermann (1963) identified the essence of a crisis, which characterised by surprise, a serious level of threat and

a short response time. Seeger, Sellnow and Ulmer (1998) described a crisis as a specific, unexpected and non-routine event.

However, it is noted that not *all* crises are unexpected. One study from the Institute for Crisis Management (2008) indicated that two-thirds of crises could be spotted and fixed before they became a public issue. Guth and Marsh (2005) assumed that a crisis must contain some or all of the following traits: stressful, disruptive, dangerous, predictable, public, worsening, and pivotal. Here, 'public' refers to being in the full view of important stakeholders, while 'worsening' implies that a crisis may begin as a trickle and any inappropriate response may degenerate it into a flood. The last trait, 'pivotal', means that a crisis is a dialectical challenge to any organization, since the resolution of a crisis may result in either positive or negative (or both) outcome, which provides a best explanation to the Chinese word crisis – danger and opportunity (Guth & Marsh, 2005).

Numerous scholars have proposed various classifications of crises, differing greatly in terms of scope, dimensionality, and delineation as well as detail (Breitsohl, 2009a). Coombs (2007) identified that the Situational Crisis Communication Theory (SCCT) divides crisis types into three crisis clusters. *The victim cluster* is defined as crises with weak attributions to the organization (The organization was vulnerable to outside forces). *The accidental cluster* is defined as crises with certain, but low levels of attributions of organizational responsibility, and *the preventable cluster* is defined as crises that the organization is perceived as being responsible for. Breitsohl (2009a) identified three broad types of crises

when combining those typologies, meanwhile maintaining a stakeholder perspective.

*Scandals* consist of crises triggered by bribery, insider trading, price-fixing, or sexual harassment. Since this kind of crisis often happen within the organization, among its members, it is quite possible to identify the perpetrators as well as to even prevent the crisis.

*Accidents* contain events categorized by Shrivastave et al. (1988), which related to the production system, like explosions, airplane crashes, or the sinking of ships. They are much more difficult to control and prevent since they are usually unexpected, more complex and often devastating in their effects. According to Shrivastava et al. (1988), *product safety and health incidents* comprise postproduction effects and consumption-side harms, for example, sabotage, product defects and associated recalls, and production-related pollution. This kind of crisis is not as rare and vague as accidents, instead it features a combination of internal influences (e.g. production systems) and external influences (e.g. consumers) (Breitsohl, 2009b).

Appropriate crisis management is considered as the key to avoid negative outcomes for a crisis. The summary of definitions of crisis management is outlined as following.

**Table 3.32 Summary of definitions of crisis management**

A process of strategic planning for a crisis or negative turning point, which removes some of the risk and uncertainty and allows the organization to be in greater control of its own destiny (Fearn-Banks, 2002).
A process of preventing or lessening the damage a crisis can inflict on an organization and its stakeholders, which includes three phases: pre-crisis, crisis response and post-crisis (Coombs, 2007b).

Guth & Marsh (2005) identified that a crisis communication plan and crisis management team are necessary in crisis management, since they can allow troubled organizations to react faster as well as to prepare for dealing with a crisis more effectively. A crisis management team usually consists of financial and technical experts, attorneys, professionals of public relations, and support personnel.

### *Crisis management strategies*

The type of company response to the product harm crisis is a major factor that influences a company's crisis-handling success. Vassilikopoulou, Siomkos, Chatzipanagiotou and Pantouvakis (2009) identified that organizational response has a major impact on consumers during a product harm crisis. These responses can vary along a scale from least-to-most favorable for the consumer (Kabak & Siomkos, 1990). Compared to the crisis communication plan and the crisis management team, crisis management strategies are more various and complex (Luo, 2010). Varied crisis management strategies or response strategies have been identified and evaluated in prior crisis management analyses. Different strategies developed by different researchers will be discussed in the following section.

Siomkos & Kurzbard (1994) indicated four crisis response strategies that can be used in product harm crises. They are:

## 1) Denial

At the least responsive level, a company can simply deny any responsibility for a defective product. Coombs (1995) identified several kinds of denial, like denying that anything happened, denying responsibility by stating that the company had no other choice (denial of intention and volition). Many experts believe that companies involved in product harm crises should never deny their responsibility, especially for those companies with poor reputations. In product harm crises context, no amount of denial will convince consumers of the company's innocence. In contrast, denial is seen as a narrow, defensive, and selfish reaction of companies to consumers (Simokos & Shrivastava , 1993). However, in reality, many companies choose to deny their responsibility as well as to engage in an effort to minimize negative impacts based on cost-effect analysis.

## 2) Involuntary product recall

A more positive response than denial is to recall the product only after a regulatory agency orders it to do so. Jolly and Mowen (1984) found that consumers react differently to recall decisions ordered either by the government or by the company, and they take recall decisions more seriously when it was presented by government and not by the company. Even though involuntary recalls has similar actions to voluntary recalls, the effect of these two response strategies will be much different. While a voluntary recall may reassure consumers that companies are willing to take responsibility of their products and solve the problem, a government-ordered recall may be seen as the opposite signal, which implies that the products

are so defective that government needs to step in to correct the situation (Davidson and Worrell, 1992).

### 3) Voluntary product recall

Companies may choose to recall the defective product prior to governmental interference, because these companies are concerned with consumer interests, public safety and information disclosure. In reality, most companies use a voluntary recall when involved in product harm crises since doing so can not only protect the public, but also the corporate reputation as well as consumer trust. Also voluntary recall is less damaging than seizures or court injunctions by regulatory authorities (Shang, 2010). Moreover, current research shows that consumers perceive the companies engaged in voluntary recalls to be more responsible especially if these companies react before regulatory agencies take actions like the Consumer Product Safety Commission (CPSC) (Siomkos & Kurzbard, 1994).

### 4) Super effort

Siomkos & Shrivastava (1993) indicated that if a company can respond with a super effort, it thus shows primary concern for consumer welfare rather than saving company resources. In these cases, it uses an immediate voluntary recall which is widely advertised and made extremely easy for consumers. Also in order to make up for the inconvenience caused to consumers, the company may distribute free product samples, coupons for customers to substitute the product, or discount coupons for customers to buy another product of the

company. The company will try its best to prove that it is responsible. For example, J&J used a super effort strategy to help the company to manage the Tylenol, J&J recalled Extra-Strength Tylenol capsules immediately, and they established a toll-free hotline for questions as well as provided refunds or exchanges for consumers (Seymour & Moore, 2000).

Benoit (1995) identified five crisis management strategies, they are:

- 1) Denial – it has two forms, simple denial occurs when the troubled companies deny their wrongdoings or at least dispute their responsibilities in the crisis. Once the troubled companies are unable to deny, they often choose to shift the blame or find a scapegoat.
- 2) Evading responsibility – the troubled companies may claim that events were really beyond their control to evade responsibility. Also the troubled companies may define their actions as an accident that should not be blamed, or sometimes claim that their intentions were good but the act was misunderstood so as to defend their reputations.
- 3) Reducing offensiveness – once the troubled companies are unable to escape responsibility for the crisis, they often seek an alternative strategy to make their transgressions less problematic. This strategy is to reduce the offensiveness of their action. The troubled companies may use an identification strategy that helps to remind the offended of a formerly positive attitude toward them.
- 4) Corrective action – another strategy used to repair the troubled companies' ruined reputations. The troubled companies may promise to remedy the wrongdoing and make this unlikely to recur anymore.

5) Mortification – it occurs when the trouble companies apologize and ask for forgiveness.

This strategy is frequently linked with corrective action strategy.

Coombs (2007b) also identified nine reputation repair strategies, and they are arranged from the least to the most accommodative reputation repair strategies as following. Here, accommodate means that the responses from the troubled companies focus more on helping the victims than addressing corporate concerns.

- 1) Attack the accuser – the troubled companies confront the person or group claiming something is wrong with the companies.
- 2) Denial – the troubled companies declare no crisis exists.
- 3) Scapegoat – the troubled companies blame another person or group outside the companies for the crisis.
- 4) Excuse – the troubled companies deny intent to do harm or claim inability to control the crisis in order to minimize their responsibilities. Excuses include provocation, defeasibility (claim that conclusions about responsibilities would change if all the information were known), accidental and good intentions.
- 5) Justification – the troubled companies minimize the perceived damage caused by the crisis.
- 6) Reminder – the troubled companies remind stakeholders of the companies' past good works.
- 7) Ingratiation – the troubled companies praise stakeholders for their actions.

- 8) Compensation – the troubled companies offer money or other remedies to victims.
- 9) Apology – the troubled companies indicate their full responsibilities of the crisis and ask stakeholders for forgiveness.

Also Lee (2004) pointed out six crisis responses which could be considered as representative to Chinese culture, they are: 1) Shifting the blame, 2) Minimization, 3) No comment, 4) Compensation, 5) Corrective action and 6) Apology.

It is noted by Breitsohl (2009b) that studying crises from a stakeholder perspective is very useful, since it helps troubled organizations have more knowledge of impression management. Breitsohl (2009a) developed a typology featuring four classes of organizational reactions to crises with each containing three types, which can help to consolidate the multitude of available conceptualizations of impression management tactics. *Evasion* seeks to avoid any connection to a problematic incident by retreat, concealment or denial. *Defence* involves admitting the existence of a problem without taking responsibility through disassociation, offering excuses, or defining the situation. *Appreciation* is used when responsibility is accepted via the form of explanation, justification or apology; however, no further action is taken. *Accommodation* is associated with seeking resolution actively by compensation, divorce (legal dissolution), or restructuring (Breitsohl, 2009a).

### ***The impact of crisis management on reputation management***

Claeys, Cauberghe and Vyncke (2010) aims to test the matches between crisis types and crisis response strategies, as recommended by the SCCT, using a between –subjects

experimental design. The more attributions of organizational responsibility with respect to the crisis, the more negative are the impacts on the organizational reputation (Coombs, 1998). Thus, different types of crises impose different amounts of reputational damage on the troubled company. From the experimental design, Claeys, Cauberghe and Vyncke (2010) find that corporate reputation is least favourable when companies are confronted with a preventable crisis. Because companies are usually considered responsible for the crisis in this type of crisis (Coombs, 2007a), and this means that the preventable crisis leads to the most negative impact on corporate reputation compared with the victim or accidental crisis. Companies may respond to these instances with denial strategies which claim that no crisis exists (denial) or that the company has no responsibility for it (scapegoat) (Coombs, 2007a). Diminish strategies argue that a crisis may not be as serious as people think (justification) or try to minimize responsibility of the company (excuse), while rebuild crisis strategies offer compensation for the crisis or apologies. The findings also show that the reputations of troubled companies using rebuild crisis response strategies are more positive than the reputations of those using diminish strategies. There is also a relationship between the perceived severity of the crisis and corporate reputation. The more severe people perceive a crisis to be, the more negative are their perceptions of corporate reputation (Claeys, Cauberghe and Vyncke, 2010).

A crisis situation consists of four elements that serve to gauge its potential threat to the corporate reputation, they are: crisis type, severity of the damage, crisis history, and

relationship history. In order to minimize the negative effects, the company must select the most appropriate crisis response strategy or strategies. Different response strategies will have more or less effectiveness based on different crisis types. For example, if contaminated food product can be categorized as an accident, a different response might be more appropriate than if the contamination was a result of wilful neglect. The extent of the damage and the performance history of the company will be assessed by consumers when the contamination is verified (Miller & Littlefield, 2010). Different response strategies will then have different impact on consumers' perception of this event. Also consumers will consider questions like: was the crisis a result of uncontrollable factors or the company could control it? If the company is judged responsible, then its reputation suffers and consumers become angry; negative word of mouth will be created by consumers as a result (Coombs, 2007a). So according to SCCT, it is significant for those companies to determine what the type of crisis is and what kinds of response strategies should be used, because all these will influence consumers' perception of this crisis.

### **3.4 Corporate reputation**

The concept of corporate reputation may have different definitions in different fields. For example, in a marketing study, reputation maybe associated with the credibility of the company, while it may be in relation with product quality and price in an economics study. Corporate reputation is a result of past actions of a company, and it can be viewed as a mirror of the company's history – the performance, the quality of its products or services, fulfilling

its promises and its communication with consumers. Furthermore, corporate reputation can be defined as an overall evaluation of the extent to which people see a company as substantially “good” or “bad” (Keh & Xie, 2009).

The building of a good corporate reputation needs many good actions over time, while the destruction of it can be easily caused by a bad action, since the impact of a bad action on the consumer is much stronger than the good ones (Nguyen & Leblanc, 2001). Also corporate reputation has been shown to influence consumers’ reactions to product harm crises. Siomkos and Kurzbard (1994) found in their experiments that consumers’ likelihood to purchase a product after a product harm crisis increased in relation to a company’s favourable reputation, and consumers felt the products involved were less dangerous if sold by a company with better reputation. Laczniak, DeCarlo and Ramaswami (2001) found that their study’s sample attributed more blame to the users for problems with products in the well-known brand condition, while they attributed more blame to the company for the problems in the relatively unknown brand condition (a proxy for reputation). From these studies, consumers show different reactions to a product harm crisis based on a company’s reputation. Less crisis responsibility will be attributed to the company in a product harm crisis if it has a favourable reputation.

However, having a strong corporate reputation has a downside if companies get into trouble. Rhee and Haunschild (2006) in their study of product recalls in the U.S. automobile industry find that companies with good reputation suffer more than those with poor reputation

when they make mistakes. This may be due to the contrast effect from disconfirmation of high expectation.

### **3.5 Joint ventures and risks**

#### ***Joint ventures (JVs)***

A joint venture (JV) is defined as a separate entity formed by two or more partner companies to do business together in order to gain competitive advantage, diversify risk, and to gain access to markets and technologies (Ekanayake, 2008). From a controlling view point, the shared ownership and control makes a JV distinct from other forms of relationships, while cultural dissimilarity and complexities further characterize international JV.

Acquisitions and JVs represent two of the most widely used investment-based modes of entry. But joint ventures and acquisitions differ in several important ways. The levels of ownership and control over foreign operations are different between these two means. JVs represent a “doing-it-together” mode and partner firms share control and decision-making. Therefore, JVs yield a smaller share of the foreign firms’ profits when comparing with acquisitions. However, JVs may have fewer challenges and risks in the context of foreign markets (Datta, Musteen and Herrmann, 2009). Sanders and Carpenter (1998) identified that acquisitions and JVs have different levels of risk exposure according to heterogeneous cultural, political, institutional, and competitive environments in the foreign markets. Relative to acquisitions, JVs involve less exposure to such risks (Folta, 1998) since local

partners can use their local knowledge and network to reduce foreign firms' exposure to political and economic risks. JVs can also be viewed as option-based investments that represent an efficient vehicle for reducing risks since they enable foreign firms to acquire new market and partner knowledge so as to reduce decision-making uncertainties (Brouthers, Brouthers and Werner, 2008). Also relative to acquisitions, JVs usually require a shorter-term commitment on the part of entering firms (Gleason, Mathur and Wiggins, 2006) since JVs are often set up with a finite goal and planned dissolution and, thus, are more likely to be favored by those managers with a shorter time horizon in their mind. Gatignon and Anderson (1988) pointed out that firms using JVs to enter foreign countries might have a long perspective in mind but in this case, they see JVs as experiments, which, if successful, they will then convert to wholly owned subsidiaries.

### ***International joint ventures (IJVs)***

In today's international business environment, many firms use international joint ventures (IJVs) as a significant means for them to achieve strategic goals. However, an IJV can be an alternative mean when comparing with the full risk of investing in a foreign market, while it has an intrinsic risk if one partner is inadequate in its resources, contextual knowledge, or access to markets and local institutions (Hsieh, Rodrigues and Child, 2010). Hamel (1991) identified that the value of an IJV can be downgraded not only when partners are unable or have no intention to meet the other's financial expectations, but also when one partner expropriates key resources from the other. IJVs make partners vulnerable to the

uncertainties or risks pertaining to the relationship, for example, the difficulties of gaining cooperation of partners and the potential for opportunistic exploitation (Ekanayke, 2008).

Doz & Hamel (1998) summarized that the local partner contributes the knowledge and insider skills needed to crack the local market, while the foreign partner provides the specialized skills and other resources to serve it efficiently. The main advantage of the foreign partner in IJV is that it can be supported by a local partner in dealing with an unfamiliar environment. But this also brings disadvantage of IJV that the foreign partner remains short-sighted in the local environment (Hsieh, Rodrigues and Child, 2010).

The most challenging nature of the Chinese IJV environment is extensive complexity, which includes two components - crude complexity and effective complexity. Crude complexity refers to the number of elements in the business system as well as the numerous relationships between system elements. A high level of crude complexity consists of the absolute variety of business forms, like state, private, collective, or foreign-invested, enormous regional diversity, rapidly changing regulations, and industry fragmentation. Effective complexity explains the level of unrest existing in the business system and poses the greatest problems for business decision making. The widespread impact of local government on business decisions, lack of transparency and accountability in most affairs, variability managerial discretion of the autonomy, as well as the independent interpretation and enforcement of regulations by local authorities, all contribute to a high level of effective complexity (Enderwick, 2009).

## ***Risks of IJVs***

The concept of risk has been widely discussed in different management areas, such as strategy, finance, and marketing. Baird and Thomas (1990) defined risk as the possibility or probability of loss as well as variance in the expected outcomes. From the managerial point of view, risk is often associated with hazards, disappointing or negative outcomes and it has an important impact on the firm's value and its ability to achieve targets. Thus risk is also defined as the perception of potential instabilities and vulnerabilities that impose limitations, restrictions, or even losses in international business (Ahmed et al., 2002).

The IJV literature suggests that partners decide to cooperate through forming an IJV because of resource deficiency and other asymmetries between different firms, while agency theory suggests that these reasons may also encourage partners to cheat and use the partnership opportunistically to advance their interests (Child and Rodrigues, 2004). Inability or unwillingness to pursue agreed goals and maintain relationships between the partners can also be considered as potential risks of IJVs. While trust and commitment are essential to the development and maintenance of relationships in these business ventures, a multitude of factors in the external environment may also influence success (Hsieh, Rodrigues and Child, 2010). Many IJVs suffer from poor performance and management problems, so it is necessary for partners to develop a good understanding of risks involved in IJV management and learn how to manage them effectively (Das and Teng, 1999).

Das and Teng's (1999) research on risk perception identified two types of risk in inter-firm

collaborations. First, relational risk – the possibility that partner firms may lack commitment to the alliance, and it may include opportunism and cultural clashes. Also inequity, as perceived by partner firms, is considered as another source of relational risk. Das and Teng (2001) highlighted the importance of partner selection and control structure as means to minimizing relational risks. Second, performance risk – it may arise even when partner firms fully commit to the alliance since market or economic problems may also lead the alliance to fail.

Reuer and Tong (2005) find that JVs can face various sources of uncertainty, like changing market conditions and shifting technology trajectories. Especially IJVs tend to involve high levels of uncertainty since partners come from different cultural backgrounds and social norms, which is likely to magnify uncertainty (Kedia & Bhagat, 1988). Furthermore, heterogeneous external environments across national borders, such as political hazards, and macroeconomic factors provide some unique sources of uncertainty to IJVs (Peng, 2003). Political risk includes inconsistency in policies, changes in laws and regulations, restrictions on fund repatriations and import. All these may affect the IJV's ability to operate effectively in the host country. Macroeconomic conditions including inflation, foreign exchange rates, and fluctuations are likely to affect the performance of IJVs as well. Since the legal system in the host country regulates the management of claims, disagreements, conflicts, and all contract related problems, it is important to have a strong legal system in the formation and operation of IJVs. The relationship between IJV partners and the host government helps IJVs to be successful (Ozorhon, Arditi, Dikmen and Birgonul, 2007). IJVs have also been

viewed as an attractive foreign market entry means due to their special structural attributes.

Firms can spread risks over multiple capital providers by engaging in IJVs instead of outright acquisitions, while multinational corporations can manage risk through relying on local partners' resources, for example, their local knowledge as well as their relationships with the local government.

China is a transitional economy that has many characteristics of transitional markets, like underdeveloped infrastructure, mingling of state owned and private enterprise, increased consumption and so on (Davies & Waters, 2004). Also the unique social networks - guanxi in China - increases complexity for foreign partners. Burgers and Padgett (2009) pointed out that foreign partners begin outside the critical networks, and typically have difficulty determining who to connect with and how to establish a useful connection. Root (1987) defined that contextual risk includes uncontrollable elements of the environment like political and legal issues, for example, changes in government policies or currency issues. Miller (1992) differentiates three levels of risk helping to understand risks in a market like China: 1. General environment 2. Industry and 3. Firm-specific risks. Here, general environmental risk is similar to Root's (1987) contextual risk, industry risks include supply constraints, labor issues or demand uncertainty, and firm-specific risks are due to each individual firm's internal management or employee problems.

Conflicts between JV partners can limit JV performance. These conflicts include differences in organizational culture of the partners, different national culture of the home and

host country, and incompatible management styles and approaches (Ding, 1997). Especially for the Chinese and the Western culture, this might cause conflicts due to differing objectives (profitability vs. growth), decision making styles (individual vs. group), sales methods (short term vs. long term relationship with consumers), and personnel policies. When talking about conflicts over quality control, the range of acceptable tolerance was considerably broader for most Chinese managers and employees when comparing with American managers. In Chinese market, quality of products was often neglected or received inadequate attention (Ding, 1997).

## Chapter 4 Methodology

### 4.1 Case study research method

Although qualitative methods may not be able to answer questions like ‘how many?’ or ‘what is the cause?’, they do answer very different questions from those addressed by quantitative methods. As we know, quantitative research can identify statistically significant relationships between variables. However, it lacks the capacity to explain ‘how’ and ‘why’ questions while this is where qualitative research is able to provide a fuller picture.

Qualitative methods can allow researchers to access embedded processes as well as to study context. The range of qualitative methods ranges from documentary and visual sources, observational fieldwork, interviews, focus groups, diaries, enhanced case records, case study research, critical incident technique to action research (Barbour, 2008).

This study is using a single-case study as a research method to provide an in-depth, longitudinal examination of the Sanlu milk scandal. Case studies provide a systematic way of looking at events, collecting and analyzing data as well as information, and reporting the results to help the researchers gain a sharpened understanding of the event. For instance, why the event happened as it did, how the event progressed, and what might be significant to extensively research in the future (Flyvbjerg, 2006). A case study can be descriptive or explanatory, while explanatory is often used to explore causation so as to find underlying principles (Yin, 2009). The descriptive research is the most commonly used in order to identify the cause of something that is happening. This study will undertake descriptive research to better understand the Sanlu milk scandal and its ramification.

From Yin's (2009) book, documentation and interview are used as two sources of evidence in this study. The strengths of documentation are stability, unobtrusiveness, exact and broad coverage, while the weaknesses are retrievability (can be difficult to find), biased selectivity (if collection is incomplete), reporting bias (reflects bias of author) and access (may be intentionally withheld). The overall value of the documents plays an explicit role in any data collection in doing case studies. Interview is one of the most important sources of case study information, with strengths like being targeted and insightful as well as weaknesses such as response bias, reflexivity (interviewee may give what interviewer wants to hear), inaccuracies due to poor recall, and bias due to poorly articulated questions. In this study, instead of common ways of conducting interviews like face-to-face, or phone interviews, an email interview was taken to ask Fonterra's communication group to answer several questions relating to this study, since this kind of interview was required by the interviewee. The interview process is summarized as follows:

On 19 August 2011, Fonterra's chairman Henry Van der Heyden came to the Lincoln University MGMT340 lecture as a guest speaker. After his speaking, the researcher came up to ask him whether he could answer several questions about the Sanlu milk scandal or not. Sir Henry gave the researcher a contact number and invited the researcher to call him the following day at 7pm to complete a phone interview.

On 20 August 2011, when the researcher called Sir Henry, he said it would be better to do an email interview instead of the phone interview. So the researcher sent Sir Henry an email with all the interview questions and waited for the reply.

On 1 September 2011, the researcher received a phone call from Graeme McMillan, Fonterra's group director of corporate communications. Mr McMillan said he would replace Sir Henry to complete this email interview since Sir Henry went overseas. He emphasized twice that Fonterra prefer to call this scandal as a Chinese dairy industry scandal instead of the Sanlu milk scandal, since not only Sanlu was involved in it but also other 21 Chinese dairy companies were involved.

On 13 September 2011, Mr McMillan sent an email to ask whether the researcher want to change the interview questions as he thought that most of the materials the researcher looking for was in the public domain. However, the researcher disagreed with this opinion and decided not to change interview questions.

On 04 October 2011, Mr McMillan sent the answers for those interview questions to the researcher.

(Please see Appendix B for the interview of Fonterra)

A content analysis of articles on Chinese and global newspaper media Web sites was employed to summarize the whole progression of the Sanlu milk scandal, examine the organizational reactions of Sanlu Group and Fonterra during this scandal as well as the crisis management strategies of these two dairy companies, portray the media perspectives on Fonterra's involvement in this scandal, and analyze lessons learnt by Fonterra from this scandal. Babbie (2007) identified content analysis as the study of recorded human communications, like books, magazines, newspaper, websites, paintings, letters and etc. Content analysis is argued to allow people to look at qualitative data in a quantitative manner when considered as a research method (Stacks, 2002).

## **4.2 Sampling**

The sample for the study were complete news articles relating to 1) the Sanlu milk crisis, 2) melamine-tainted milk scandal, or 3) Fonterra gathered from many different online Chinese and global daily news sources for a thirty-four month period from September 11, 2008 (the first time of the Sanlu milk scandal was revealed to the public by the media) to July 30, 2011 (the end of the data collection period). All news articles were retrieved from the Internet.

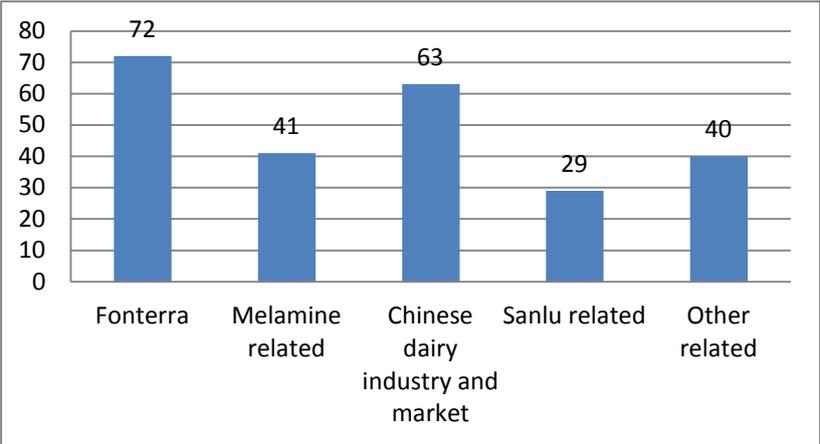
The reason for studying news articles from different sources was to have a complete understanding of this tainted milk scandal from many perspectives. Moreover, the media always needs to publish accurate, up-to-date, detailed news so as to meet readers' demands.

All the news articles were sorted in terms of published time and content. According to the published time, these articles were categorized into four periods: 1) 2008, 2) 2009, 3) 2010, and 4) 2011. Under each time period, according to different contents, these articles were categorized into five types: 1) Fonterra – All news about Fonterra, including its involvement in the Sanlu milk scandal, the lessons learnt from the scandal, or its future development in the Chinese market and so forth. 2) Sanlu related – All news related to the Sanlu Group, or the Sanlu milk scandal, for example, victims' lawsuits against Sanlu and Sanlu Group's bankruptcy. 3) Chinese dairy industry and market – All news related to the current Chinese dairy market and industry, like how the government enhances laws and standards to improve quality of dairy products, or consumers' reactions to domestic milk powder products. 4) Melamine related – All news related to melamine-tainted milk powder, such as re-emergence of melamine in 2009, or parents of melamine victims being sentenced on charges of 'provoking an incident.' 5) Other related – All news not so related to Fonterra, Sanlu, or melamine, but talking about food safety, product recalls, or other food product crises like Taiwan drinks including DEHP, etc.

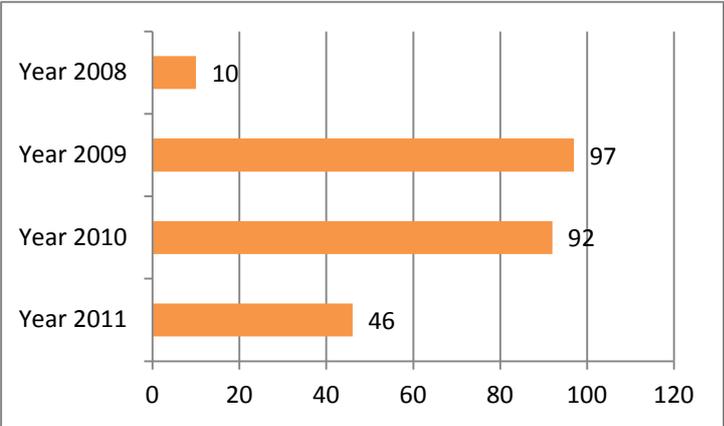
News articles were collected from the Internet by searching several different key words, like 'Fonterra', 'Sanlu', 'Fonterra in the Sanlu milk scandal', 'the melamine-tainted milk

scandal’, ‘the 2008 melamine milk crisis’ in the full article. When searching, articles that were repeated, and articles that were not so relevant to Sanlu, Fonterra and the 2008 melamine milk scandal were eliminated. For example, since some articles were mainly concerned about Mengniu or Yili in the milk scandal, or Fonterra’s dairy business in other countries and so forth they were not used as the current study was designed to focus on specific events related to Fonterra in the context of the general scandal. A total of 245 news articles were collected. Figure 4.1 presents the distribution of news coverage by five different news contents, while Figure 4.2 presents the distribution of news coverage by publication time.

**Figure 4.1 Distribution of news coverage reviewed**



**Figure 4.2 Distribution of news coverage by publication time**



### 4.3 Data analysis and coding

All news articles meeting the selection criteria were coded both in an Excel spreadsheet and NVIVO program to do content analysis for following variables: publication date, article type, event (who), event (what), the stage of the crisis, evidence of crisis communication, media portrayal (Fonterra), and implications (focus).

Under each variable, these variables and categories are operationalized as following:

*The stage of the crisis:* The stage of the Sanlu milk scandal when the article was published. According to Fink's (1986) four-phase crisis evolution pattern framework, the Sanlu milk scandal can be divided into the following four stages: 1) The prodromal crisis stage – Period 1, the time before the disclosure of Sanlu milk scandal; 2) The acute crisis stage – Period 2, the first two days after the day the Sanlu milk scandal was reported widely by the media; 3) The chronic crisis stage – Period 3 and 4, the first week and the first month after the scandal, and during this period, both Sanlu and Fonterra tried to take effective crisis management strategies to go through the scandal; and 4) The crisis resolution stage – Period 5, the remaining time until the end of the scandal.

*Evidence of crisis management:* Sanlu and Fonterra's response or action was categorized into denial strategies, diminish strategies (justification or excuse), rebuild strategies (apology or compensation), involuntary recall, voluntary recall and so forth. Also Sanlu and Fonterra's organizational reaction was categorized into evasive, defensive, appreciative and accommodative. These four classes of organizational reactions to crises were developed by

Breitsohl (2009a), and each contains three types: 1) evasion – retreat, concealment or denial; 2) defence – disassociation, offering excuses, or defining the situation; 3) appreciation – explanation, justification or apology; and 4) accommodation – compensation, divorce or restructuring.

*Media portrayal (Fonterra):* This can also be considered as the tone of the article, such as the general feelings, attitudes, opinions or presuppositions toward Fonterra's involvement in the Sanlu milk scandal or Fonterra's crisis management expressed in the article. News articles were categorized as the following three kinds of tone: positive, neutral and negative. Positively toned stories were those that expressed a positive attitude or opinion as well as an agreement and support of what Fonterra's did in this scandal. For example, Fonterra took effective crisis management in this scandal. Negative tone was coverage that expressed a negative or criticizing attitude or opinion as well as disagreement to Fonterra's involvement. For instance, Fonterra was criticized for waiting too long to react, or Fonterra did not do enough in this scandal. Neutral tone was coverage that, as defined by Bowles (1989), was an unbiased report with a neutral manner to address a matter of public concern. For example, an article that simply reported the progression of Fonterra's involvement, the melamine-tainted milk reappearance or the action of Chinese government or Sanlu was regarded as in a neutral tone.

*Implications (focus):* The important content or theme that warranted giving special attention. Summary of the highlights of the article, like Fonterra talked about lack of control

of its own supply chain in the Sanlu milk scandal, which could be summarized as the lessons learnt from this scandal. Some articles talked about the Chinese government arresting offenders, or publishing new food safety law; all these could be summarized as the government's response or action. Also customers' anger, lack of trust of domestic dairy products, or purchasing foreign milk powder with high price, and all these could be summarized as the public's response or action, while other articles might talk about other countries' ban on Chinese dairy products, milk farmers' life after the scandal and so forth.

## Chapter 5 Results

This chapter will analyse and discuss each research question so as to give a clear explanation of these research questions' answers.

### 5.1 Research Question 1 – What was the progression of the Sanlu milk scandal from the beginning to the present?

**Table 5.1 Timeline of the Sanlu milk scandal**

1 December 2005	- Fonterra and San Lu enter into a joint venture agreement. <sup>1</sup>
February 2008	- The father of a young girl posts details on a website saying his daughter could not urinate. He removes the posting after Sanlu gives him four packages of free milk powder. <sup>2</sup>
March 2008	- San Lu begins to receive reports of ill health of children being fed its formula (other sources suggest reports began in December of 2007). <sup>3</sup>
June 2008	- Fonterra CEO Andrew Ferrier says tests performed on the milk product in question showed no quality problems. <sup>4</sup>
July 2008	- Southern Weekend editor found that 20 babies had been hospitalised after using Sanlu's formula, but the government propaganda department blocks the story. <sup>5</sup>
1 August 2008	- Chairwoman Tian Wenhua orders a cover-up when Sanlu's tests show 15 of 16 batches of formula contained potentially poisonous levels of melamine. <sup>5</sup>
2 August 2008	- Fonterra directors on San Lu board informed that tests of milk powder indicated melamine contamination. <sup>6</sup> - Bob Major, one of Fonterra directors on Sanlu board, says board agreed to full recall of milk products, but the local government authorities had overruled the board. <sup>5</sup>
6 August 2008	- Trade recall initiated. <sup>7</sup>
14 August 2008	- Fonterra "informally" informed the embassy in Beijing of the problem; this was done by making a comment to an official while at a social function. <sup>8</sup>
19 August 2008	- Fonterra calls the embassy for advice. <sup>9</sup>
22 August 2008	- Fonterra meets with embassy personnel. <sup>9</sup>
31 August 2008	- NZ ambassador sends report on problem to the Foreign Affairs and Trade Ministry. <sup>8</sup>

2 September 2008	- Foreign Affairs Minister Winston Peters informed of problem. <sup>10</sup>
5 September 2008	- Prime Minister Helen Clark is issued a formal report about the situation. <sup>5</sup>
8 September 2008	- NZ officials given directive by Clark to notify Chinese officials in Beijing. <sup>5</sup>
9 September 2008	- Chinese government officials notified. <sup>8</sup>
11 September 2008	- Public recall of milk powder begins in China. <sup>11</sup> - Sanlu ordered to stop production. <sup>12</sup> - 2176 tons of milk powder seized from a Sanlu warehouse while 8,218 tons on the market had been recalled. Another 700 tons was on their way back to Shijiazhuang. The plan is for all the tainted milk powder to be destroyed. <sup>13</sup>
15 September 2008	- PM Clark defends Fonterra in public media. <sup>5</sup> - China arrests 19 and interrogates 78. <sup>14</sup> - One baby reported as dead while another 432 are cited as being sick with kidney damage. <sup>12</sup> - Estimates are quickly raised to two infants dying and 1253 being made ill by the product. <sup>14</sup> - Sanlu Group apologized to the public for its contaminated milk powder. Zhang Zhenling (Sanlu's vice president) read a letter of apology at a news briefing in Shijiazhuang. <sup>15</sup>
16 September 2008	- Li Changjiang, head of the General Administration for Quality Supervision, sends officials to three different provinces to inspect other dairies and baby milk food factories. It is promised that the results of these inspections will be released in two days. <sup>16</sup> - Blames suppliers for providing tainted milk. <sup>17</sup>
17 September 2008	- Melamine is found in the infant milk powder made at 22 separate Chinese dairy companies. Sales halted. <sup>18</sup> - More dairies slated for inspection. <sup>18</sup> - Problem has been found in frozen yogurt made by Inner Mongolia Yili Industrial Group. <sup>18</sup> - Looking for answers, parents go to Sanlu's headquarters in Shijiazhuang. <sup>19</sup> - Sanlu's chairwoman, Tian Wenhua, resigns. <sup>20</sup> - Two more arrested. <sup>21</sup> - China's biggest milk producer, the Mengniu Dairy Group, issues a recall of its baby formula. <sup>22</sup> - At least 14 infants in Kunming have developed kidney stones due to consumption of Sanlu milk powder. <sup>23</sup>
18 September 2008	- China's health minister announces that a third baby has died. <sup>17</sup> - 6,244 infants sickened; 154 have acute kidney failure. <sup>24</sup>

19 September 2008	<ul style="list-style-type: none"> <li>- Arrests total 18. Six of those arrested were suspected of selling melamine while others were suspected of adding melamine to the milk.<sup>25</sup></li> </ul>
21 September 2008	<ul style="list-style-type: none"> <li>- In Hong Kong, a small amount of melamine found in Nestle's Dairy Farm brand milk, a Chinese-made product. Nestle is forced by Hong Kong's food-safety governmental department to recall the product.<sup>26</sup></li> <li>- A three year old Hong Kong toddler is the first child outside of China to be documented as suffering as a result of ingesting melamine contaminated milk powder.<sup>27</sup></li> </ul>
22 September 2008	<ul style="list-style-type: none"> <li>- Government announces 53,000 infants and children sickened by contaminated milk.<sup>28</sup></li> <li>- Li Changjiang, minister of China's General Administration of Quality Supervision, Inspection, and Quarantine, is encouraged to resign as was Wu Xianguo, the top official of Shijiazhuang city, headquarters locality for San Lu. Both did so.<sup>29</sup></li> <li>- A fourth child is reported to have died as a result of the tainted formula, but is not added to the official figure.<sup>28</sup></li> <li>- Other countries start to ban all Chinese milk products.<sup>30</sup></li> <li>- Melamine discovered in non-dairy products motivates other countries to broaden the scope of their Chinese food product bans.<sup>30</sup></li> </ul>
23 September 2008	<ul style="list-style-type: none"> <li>- PM Clark now criticizing Fonterra for the delay they allowed to pass before acting on the knowledge they had. Yet it wasn't a criticism directed at the lack of communication between Fonterra and the Chinese public; instead she is quoted as saying "There was no sign of a proper communications strategy to the New Zealand public."<sup>31</sup></li> <li>- Four children dead, 104 in serious conditions, 12,892 admitted to the hospital, 39,965 treated without being admitted and 1,579 children were discharged from the hospital.<sup>32</sup></li> </ul>
30 September 2008	<ul style="list-style-type: none"> <li>- Cadbury PLC, one of the world's largest confectioners, recalls 11 different chocolate candies made in its Beijing factory after they were found to contain melamine.<sup>33</sup></li> <li>- Police raid more than 40 dairy farms in northern China (the biggest dairy production area), arrest 22 managers of pastures and other establishments involved in the production of milk and seize 485 pounds of melamine.<sup>34</sup></li> <li>- Government announces that two suspects admitted producing or selling to milking stations a 'protein powder' made from melamine.<sup>34</sup></li> </ul>
7 October 2008	<ul style="list-style-type: none"> <li>- Six more people detained, bring the total to 32.<sup>34</sup></li> <li>- Government tests show recently produced batches of milk to be melamine-free.<sup>35</sup></li> </ul>
November 2008	<ul style="list-style-type: none"> <li>- Andrew Ferrier told the cooperative's 10,724 farmers that Fonterra would have to write off their entire investment in this Chinese joint venture.<sup>36</sup></li> </ul>

December 2008	- Sanlu and 21 other dairy companies offered 200,000 yuan for families whose children died, 30,000 yuan for serious cases such as kidney stones and acute kidney failure, and 2,000 yuan for less severe cases. <sup>37</sup>
19 December 2008	- Sanlu Group borrowed 902m yuan to pay the medical fees of children sickened by its tainted milk powder and to compensate the victims. <sup>38</sup>
31 December 2008	- The mayor of the local authority is fired. Li Changjiang, head of the government food inspection service, is forced to resign. <sup>5</sup>
01 January 2009	- Sanlu Group and 21 other dairy firms implicated in the tainted milk scandal, apologized to the public via text messages. <sup>39</sup>
22 January 2009	- The court announces the sentences: Chairwoman Tian is sentenced to life in prison; two men, Geng Jinping and Zhang Yujun were sentenced to death for their involvement in this tainted milk scandal. <sup>40</sup> - Outside of the prison sentences, Tian was fined 20 million yuan (USD \$2.92 million) while bankrupt Sanlu was fined 50 million yuan (USD \$7.3 million). <sup>41</sup> - 39 others awaited trial. <sup>42</sup> - Fonterra issues no comment on the sentences. <sup>42</sup> - Families of the 262,662 children nationwide who were affected after drinking melamine-tainted milk products had signed compensation agreement with the companies involved. <sup>43</sup>
26 January 2009	- Tian Wenhua claimed that Fonterra implicitly consented to the level of melamine Sanlu was adding to its milk products when it provided a memo regarding European limits for a safe level of melamine in food. <sup>44</sup> - Although Fonterra agrees that the memo was given, the company claims that it was with the proviso that the only acceptable level of melamine in its own products was zero. <sup>44</sup>
28 January 2009	- The Green Party is calling on Fonterra to set the record straight on the Chinese milk scandal and release the minutes of a phone conversation with Sanlu. <sup>45</sup> - Mr Ferrier said he would not release it to media while an appeal was pending in China. <sup>44</sup> No follow-up news.
1 February 2009	- Tian appeals her life sentence on the grounds that the court was wrong to say milk powder produced by Sanlu after August 2 damaged people's health as, after that date, melamine levels were limited to what the memo Fonterra gave to her suggested would be safe. <sup>46</sup>
12 February 2009	- Sanlu declared bankrupt after having amassed \$US161 million of debt. Its real estate, buildings, equipment and investment rights in other dairies are scheduled for auction in early March. <sup>47</sup>
16 February 2009	- Shares of Beijing Sanyuan Foods Co. Ltd. went up sharply after the company announced that it would bid for Sanlu's assets. <sup>48</sup>

3 March 2009	<ul style="list-style-type: none"> <li>- Chinese courts will begin accepting lawsuits over melamine-tainted milk scandal.<sup>49</sup></li> <li>- The Qingdao Intermediate People's Court in northern China was the first to accept a compensation case.<sup>49</sup></li> </ul>
4 March 2009	<ul style="list-style-type: none"> <li>- Sanyuan Group bought Sanlu's core assets at an auction for CNY 616.5 million (\$90 million).<sup>48</sup></li> </ul>
6 March 2009	<ul style="list-style-type: none"> <li>- Fonterra ended with its \$201 million investment in the Sanlu Company being written off.<sup>50</sup></li> </ul>
16 April 2009	<ul style="list-style-type: none"> <li>- Fonterra, which currently owns 85% of a farm that set up with Sanlu in 2007, looks to buy Sanlu's 15% stake in its 3,000 cow dairy farm at Tangshan in Hebei province and become the outright owner.<sup>51</sup></li> </ul>
6 May 2009	<ul style="list-style-type: none"> <li>- The stakes of Sanlu were auctioned in Shijiazhuang and the assets included Sanlu's shares in four Hebei-based companies and a Tianjin company – Tianjin Sanlu Ltd.<sup>52</sup></li> <li>- Two more auctions of Sanlu are expected to be held on May 8 and May 12, when more shares, as well as trademarks and 12 patent rights, are to be sold.<sup>52</sup></li> </ul>
18 May 2009	<ul style="list-style-type: none"> <li>- The brand of Sanlu Group reported to have been recently sold at auction for CNY7.3m (\$1.1 million) by an unidentified individual entrepreneur from southern China.<sup>53</sup></li> </ul>
3 June 2009	<ul style="list-style-type: none"> <li>- A total of 3,908 substandard milk collection stations have been shut down in China due to lack of proper equipment or hygiene.<sup>54</sup></li> <li>- Song Kungang, head of the China Dairy Industry Association, said authorities had inspected all the nation's 20,393 milk stations between Nov 2008 and April 2009.<sup>54</sup></li> </ul>
4 June 2009	<ul style="list-style-type: none"> <li>- China's new Food Safety Law China went into effect beginning this month.<sup>55</sup></li> </ul>
28 June 2009	<ul style="list-style-type: none"> <li>- The families of 118 Chinese children poisoned during melamine milk powder scandal are planning a class-action lawsuit against Sanlu.<sup>56</sup></li> </ul>
July 2009	<ul style="list-style-type: none"> <li>- Since June 1, the court in Shijiazhuang has accepted two cases against Sanlu Group. Neither has yet had a hearing.<sup>57</sup></li> <li>- Sanlu Group, which was at the center of the scandal, and 21 other dairy companies set up a \$171.4 million compensation fund for tainted milk victims after the 2008 melamine milk scandal.<sup>57</sup></li> </ul>
31 July 2009	<ul style="list-style-type: none"> <li>- Xu Zhiyong, who acted on behalf of the victims of last year's melamine-tainted milk scandal, has been detained by the authorities in the latest clampdown on civil rights activities.<sup>57</sup></li> </ul>
11 September 2009	<ul style="list-style-type: none"> <li>- The one-year anniversary of the Sanlu melamine-tainted milk scandal.<sup>58</sup></li> <li>- Parents of tainted-milk victims attended a commemorative ceremony marking the scandal.<sup>58</sup></li> </ul>

12 September 2009	- Two of the parents, Zhou Jingzhong and Xiang Qingyu who attended the commemorative ceremony, were arrested at noon by plainclothes police. <sup>58</sup>
20 September 2009	- 15 Chinese firms were named and shamed by a domestic association for lacking sense of social responsibility, and Sanlu Group was on the top of the list. <sup>59</sup>
24 November 2009	- Two men were executed in China for their roles in the melamine-tainted milk powder scandal. <sup>60</sup> - Zhang Yujun, was found guilty of producing 776 tons of melamine-laced “protein powder” and selling 600 tons of it to middlemen for \$998,000. Geng Jinping was convicted of adding 443 kg of melamine-laced powder to about 900 tons of fresh milk to increase “protein content” during quality tests. <sup>60</sup>
27 November 2009	- A public hearing of the first trial for the families suing Sanlu Group lasted just two hours without a verdict, and the matter was rescheduled for trial on Dec 9. <sup>61</sup>
9 December 2009	- China’s first trial for civil compensation targeting Sanlu Group was postponed because the defendants requested further investigation into the connection between the baby’s illness and the tainted milk powder. <sup>62</sup>
10 December 2009	- Police detained three people at Shaanxi Jinqiao Dairy Co. Ltd, who were accused of selling 5.25 tonnes of milk powder laced with melamine. <sup>63</sup>
1 January 2010	- Li Changjiang, who resigned over the melamine-tainted milk scandal in 2009, was promoted to deputy director of the National Office Against Pornographic and Illegal Publications. <sup>64</sup>
1-10 February 2010	- A 10-day crackdown cross the country came after the discovery of melamine-tainted dairy products reappearing on store shelves in the southern province of Guizhou. <sup>65</sup>
3 March 2010	- Three executives of Shanghai Panda Dairy Company jailed for terms of three to five years for their roles in the production and sale of melamine-tainted dairy products last year. <sup>66</sup>
4 May 2010	- Chen Lu and three other families have brought their compensation claim to Hong Kong and they are suing NZ dairy cooperative Fonterra. <sup>67</sup> - Chen and her lawyer Peng Jian attended the first hearing at the Hong Kong’s Small Claims Tribunal. <sup>67</sup> - The case was adjourned till May 25th. <sup>67</sup>
27 May 2010	- HK’s Small Claims Tribunal has rejected the compensation bid four Chinese mainland parents mounted against Fonterra. <sup>68</sup>
24 June 2010	- Indian government had further extended the ban on import of Chinese milk and milk products for another six months. <sup>69</sup> - The ban came into existence on Dec 1, 2008 for one year and was extended until Dec 23, 2009. <sup>69</sup>

July-December 2010	<ul style="list-style-type: none"> <li>- 2,130 tons of melamine-tainted milk powder were seized by authorities.<sup>70</sup></li> <li>- 96 people detained, with 17 convicted, including 2 people sentenced to life in prison; 38 people are awaiting trial and 41 others are under investigation.<sup>70</sup></li> </ul>
July 2010	<ul style="list-style-type: none"> <li>- Xiangtan Yuanshan Dairy Industry Company has production halted since it concealed the fact that it was using melamine-tainted milk powder to produce dairy beverage.<sup>71</sup></li> </ul>
6 July 2010	<ul style="list-style-type: none"> <li>- The Codex Alimentarius Commission (CAC), announced formal international limits for melamine allowed in food, infant formula and animal feed.<sup>72</sup></li> <li>- Tang Lin, a father who expressed his anger in an online forum for losing his son in the melamine-tainted milk scandal, was sentenced to a year of hard labour.<sup>73</sup></li> </ul>
9 July 2010	<ul style="list-style-type: none"> <li>- Authorities have seized 76 tonnes of raw material contaminated with melamine in northwest China's Gansu and Qinghai provinces.<sup>74</sup></li> <li>- Police traced the source of the milk powder to Dongyuan Dairy Factory in Minhe Country.<sup>74</sup></li> </ul>
23 August 2010	<ul style="list-style-type: none"> <li>- Chinese police arrested 6 people and detained 41 in connection with the distribution of melamine- tainted milk powder.<sup>75</sup></li> </ul>
30 August 2010	<ul style="list-style-type: none"> <li>- Working with the China Soong Ching Ling Foundation, Fonterra planned to donate \$NZ8.4m over five years to provide medical care and advice to pregnant women and mothers of infants in rural communities.<sup>76</sup></li> </ul>
10 November 2010	<ul style="list-style-type: none"> <li>- Zhao Lianhai, the parent of a melamine-tainted milk powder victim and a core organizer of affected families nationwide was sentenced to two and half years in prison at the Beijing Daxing District Court on charges of "provoking an incident."<sup>77</sup></li> </ul>
23 November 2010	<ul style="list-style-type: none"> <li>- China may free Zhao Lianhai on medical parole.<sup>77</sup></li> </ul>
24 November 2010	<ul style="list-style-type: none"> <li>- Market regulators asked local businesses to trace 50 packages (with 15 bottles in each package) of corn-flavoured dairy drink that containing melamine in Xiangfan (the central province of Hubei).<sup>71</sup></li> </ul>
December 2010	<ul style="list-style-type: none"> <li>- The families of 271,869 children who were sickened after drinking the melamine-tainted products had accepted one-off compensation.<sup>78</sup></li> </ul>
3 April 2011	<ul style="list-style-type: none"> <li>- About 45% of China's 1176 registered dairies are being shut down after failing to obtain new licenses following renewal inspections.<sup>79</sup></li> <li>- 107 were forced to halt production before they improve quality controls and the other 426 have had their licence simply revoked.<sup>79</sup></li> </ul>
27 April 2011	<ul style="list-style-type: none"> <li>- 26 tons of melamine-tainted milk powder found in Chongqing 3 years after the Sanlu scandal.<sup>80</sup></li> <li>- 5 suspects were arrested and three of them placed in criminal detention.<sup>80</sup></li> </ul>
31 May 2011	<ul style="list-style-type: none"> <li>- The International Dairy Federation (IDF) released its "Integrated Supply</li> </ul>

	Chain Management”, which were initiated in response to the Chinese melamine-tainted milk powder scandal in 2008. <sup>81</sup>
19 July 2011	<ul style="list-style-type: none"> <li>- Since October 2010, inspectors were aware that melamine in milk powder fed to piglets exceeded limit by 515 times in some large-scale pig farms. But it took another eight months for the media to find out and report on the case.<sup>82</sup></li> <li>- Fonterra announced its expansion of production in China with an agreement to invest \$US40 million in its third Chinese dairy farm.<sup>83</sup></li> </ul>

(Please see Appendix A for the Footnotes)

## 5.2 Research Question 2 - What kind of crisis response strategies did Sanlu and Fonterra use?

From the prior literature review section, it is noted that different authors have different definitions of types of crises. According to these different definitions, the Sanlu milk scandal was categorized as a product safety and health incident from Breitsohl’s (2009a) view, while it was categorized as being within the preventable cluster from Coombs’s (2007a) view. There is a predictable four-phase pattern followed by all crises; Fink’s (1986) analysis of crisis stages identified that the pattern comprises the:

*Prodromal crisis stage* –a warning stage that, if an organization is aware of the signs here, it may have an ability to be proactive and avoid potential trouble.

*Acute crisis stage* –the outbreak of the crisis; some damage will be done at this stage and whether the troubled company can survive or not staying unclear.

*Chronic crisis stage* – refers to a reaction period when a troubled organization takes actions to resolve the crisis.

*Crisis resolution* – the last stage; at this time, things return to a “new” normal (Luo, 2010).

After the Sanlu milk scandal, the Sanlu Group declared bankruptcy while Fonterra still stands as the top dairy company within the global industry. It is obvious that these two giant dairy companies used different crisis management strategies and had varied organizational reactions during the scandal, which might lead them to the entirely different endings.

Understanding the crisis response strategies used by the Sanlu Group and Fonterra would help to gain an understanding of differences between successful and unsuccessful crisis management. So the progression of these two companies’ reactions to the Sanlu milk scandal was compared in order to have a clear knowledge of the kinds of crisis management strategies taken by them. The Sanlu milk scandal was divided into five periods, which spanned the time before the crisis uncovered (Period 1), the first two days (Period 2), the first week (Period 3), the first month after the crisis (Period 4), and the remaining time until the end of it (Period 5). According to Fink’s (1986) four-phase pattern, Period 1 will be matched to the prodromal crisis stage, Period 2 will be matched to the acute crisis stage, Period 3 and 4 will be matched to the chronic crisis stage, and Period 5 will be matched to the last stage, crisis resolution. Reactions of these two companies were classified according to the typology of Breitsohl (2009a) as outlined in the literature review section, from evasive to accommodative. Crisis management strategies would also be reflected from these organizational reactions.

**Table 5.2 Reactions of Sanlu Group and Fonterra by crisis stage**

	<b>The prodromal crisis stage</b>	<b>The acute crisis stage</b>	<b>The chronic crisis stage</b>		<b>Crisis resolution</b>
	<b>Period 1</b>	<b>Period 2</b>	<b>Period 3</b>	<b>Period 4</b>	<b>Period 5</b>
<b>Evasive</b> – seeks to avoid any connection to a problematic incident by retreat, concealment or denial.	<i>Sanlu:</i> Insisting no problem with its products; saying they are genuine.	Sanlu pays families to stay quiet.			<i>Fonterra:</i> Refuses to release the record of phone conversation with Sanlu.
<b>Defensive</b> – involves admitting the existence of a problem without taking responsibility through disassociation, offering excuses, or defining the situation.	<i>Fonterra:</i> Since tests showed formula ok, Fonterra declares it as an accident.	<i>Sanlu:</i> Delayed announcement claimed to result from retailers refusing to remit products for further investigation.	<i>Sanlu:</i> Blames milk suppliers for providing tainted milk.		
<b>Appreciative</b> – is used when responsibility is accepted via the form of explanation, justification or apology; however, no further action is taken.	<i>Fonterra:</i> Fonterra directors on Sanlu board say they kept trying to full recall products, but failed.	<i>Sanlu:</i> Equipment imported in August helped Sanlu test for melamine. Admits to its milk powder containing melamine.	<i>Sanlu:</i> Vice President apologizes for the scandal. Verified selling contaminated products for at least half a year. Confesses that hazardous products are still on the market.  <i>Fonterra:</i> Makes a statement to explain knowing about this scandal.	<i>Fonterra:</i> Apologizes and justifies itself as doing right things during the scandal.	<i>Sanlu:</i> This dairy company and 21 others involved in this scandal apologize to the public via text message.  <i>Fonterra:</i> Claims that the only melamine acceptable level was zero.
<b>Accommodative</b> – is associated with seeking resolution actively by compensation, divorce, or restructuring.	<i>Fonterra:</i> After negotiating, trade recall initiated. Calls the embassy for advice.	<i>Sanlu:</i> Large-scale recall of affected milk powder products.	<i>Sanlu:</i> Chairwoman Tian Wenhua fired and arrested shortly after.  <i>Fonterra:</i> Announces a voluntary recall of its ANMUM Materna milk products.		<i>Sanlu:</i> It and 21 other dairy companies set up a compensation fund for victims.  <i>Fonterra:</i> Writes off \$201m in this investment.

## **Period 1: Prodromal stage**

Examples of the two companies' reactions are listed in Table 5.2, while more details of these reactions are described as following. For Period 1, six months before the crisis was reported to the public on 11 September 2008, Sanlu began to receive complaints about its formula from sickened children parents, while other sources suggested these kinds of reports began in December, 2007.

At that time, Sanlu denied the problems of its products and insisted on saying that its formula was genuine. Two months before Fonterra directors on the Sanlu board were informed of melamine-tainted milk powder on 2 August 2008; Fonterra said that tests of these questioned products showed no quality problems, so it did not appear to pay further attention to this incident. One day before 2 August, Chairwoman Tian Wenhua ordered a cover-up when tests showed Sanlu formula containing poisonous levels of melamine. During the period from 2 August to 11 September, Fonterra was devoting its efforts to full recall of formula products. Yet, since the local government and Sanlu only agreed to undertake a trade recall (taking unsafe products out of the distribution chain), Fonterra transferred to the embassy for help. Finally, Chinese government officials were notified and the crisis began to be revealed to the public. Although the reason for why Fonterra was about 6 weeks late to persuade Sanlu to inform the public about the melamine-tainted milk powder remained unclear, Fonterra was playing a role as a whistleblower within this scandal.

## **Period 2: Acute crisis stage**

One day after reporting on one baby dead and over 400 infants suffering from melamine-tainted milk powder (Period 2), Sanlu Group confirmed to the public that its products were severely melamine contaminated. Sanlu also had to initiate a large-scale public recall so as to pull several thousand tons of milk powder from the market as well as out of the value chain. When speculations occurred whether Sanlu had already known about such problems earlier, a statement was issued to explain that although there had been indications of melamine problems, Sanlu had only gained access to more sophisticated foreign tests recently. However, there was no clear evidence showing whether Sanlu had informed authorities or not. A public warning had been abstained by Sanlu since it said that large retailers had refused to remit contaminated products for Sanlu to do further investigation (Breitsohl, 2009b). In a news conference, Yang Chongyng, the vice governor of Hebei Province said that Sanlu Group did try to hush the scandal up by paying the victims' families and the media up after knowing the truth. It was obvious that this action was "evasive" rather than "accommodative". Although Sanlu paid victim families, this was not compensation, Sanlu just wanted to let these families stay quiet.

## **Period 3: Chronic crisis stage, 1<sup>st</sup> week**

Sanlu was extremely criticised by Chinese consumers in the following days (Period 3). The company blamed the middlemen as the real perpetrators for supplying tainted milk to it, and refused to explain how the melamine could end up in the milk powder. However,

Sanlu's Vice President apologized to the public for the scandal ("China's Sanlu apologizes", 2008). (See Figure 5.21) With the continually increasing number of victims, Sanlu confessed to having been selling melamine-tainted milk powder for at least half a year. Sanlu's Chairwoman was fired and arrested shortly after, and then Sanlu conceded that hazardous products were still on retailer shelves. Meanwhile, a few days after the melamine-tainted milk scandal broke, Fonterra China, which is Fonterra's own Chinese business, had announced a voluntary recall of one batch of its ANMUM Materna milk product (See Figure 5.22). This product is intended for use by pregnant women. Fonterra recalled the batch since it was licensed under Sanlu, which was believed to have been used contaminated local raw milk. Since putting consumer safety as Fonterra's greatest concern, Fonterra decided to do a voluntary recall. Fonterra then made a statement to a media conference on 15 September 2008 to explain its knowing about this scandal. In this statement, Fonterra said the melamine-tainted milk scandal was a truly tragic occurrence, it was shocked and dismayed about this scandal and it was really concerned about the victims and would do everything it could to assist investigation. Fonterra also shared its knowing about the sequence of events so far and what it had established from the available information, for example, the source of contamination was the raw milk, not the production, storage and sales process (Fonterra, 2008).

### Figure 5.21 Sanlu's apology

**China's Sanlu Apologizes for Milk Powder Contamination: A Message from Zhang Zhenling**

**15 September 2008**

The serious safety accident of the Sanlu formula milk powder for infants has caused severe harm to many sickened babies and their families. We feel really sad about this.

Sanlu Group expresses its most sincere apology to you.

We solemnly declare we will recall all the infant milk powder produced prior to August 6. And for those produced after that date, we will also make a recall if consumers have doubts and worries.

### Figure 5.22 Notice of voluntary product recall-ANMUM Materna

**Media Release 16 September 2008: For ANMUM Materna product recall**

This particular batch had been manufactured and distributed under licence by San Lu using what we believe to be contaminated local raw milk.

A company spokesman said this issue applies to the one batch of ANMUM Materna which was distributed in China (excluding Hong Kong, Macau and Taiwan). None of the batch in question was exported out of China.

All other ANMUM and ANLENE products in the market have been produced using only 100% fully imported milk from New Zealand and are free from any possibility of contamination with melamine from locally sourced milk, and adhere to the strictest New Zealand and international standards.

Fonterra China said the stock was being recalled because consumer safety was the company's utmost concern.

### Period 4 and 5: Chronic crisis stage, 1<sup>st</sup> month After and Resolution

After the first week following the public exposure to the melamine-tainted milk scandal (Period 4 and 5), Sanlu was placed under supervision by the Chinese government, so control over the situation had largely been taken out of its hands. Fonterra apologized to the public in a media release. It justified that the company had gone through all the decisions it had made and Fonterra believed that it had done the right things during the scandal. Yet,

Fonterra apologized for its neglect of supply chain, as it should have had more control. According to Tian Wenhua's claim about Fonterra providing her a memo of safe level of melamine, Fonterra agreed that the memo was given, but it also claimed that the only acceptable level of melamine was zero as shown in this memo. However, when the Green Party asked Fonterra to release the record of the minutes of a phone conversation with Sanlu, it declined to do so. Later, on 1 January 2009, the Sanlu Group and 21 other dairy companies implicated in the melamine-tainted milk scandal set up a compensation fund for the victims, and sent out a text message to millions of mobile phone subscribers apologizing for the contamination (See Figure 5.23). Finally, Sanlu Group filed for bankruptcy and was broken up. Fonterra had to write off the entire \$201 million investment in this joint venture and left with empty hands. In 2010, Fonterra donated \$NZ 8.4 million to provide medical care and advice to pregnant women and mothers of infants in rural communities in China instead of compensating directly to victims of the scandal, since it thought the Chinese government had taken over the compensation issue.

**Figure 5.23 China dairies' text apology**

“We are deeply sorry for the harm caused to the children and the society. We sincerely apologise for that and we beg your forgiveness.”

**Period 5: Crisis Resolution**

Andrew Ferrier had said “We’re not sitting here counting money; we’re sitting here just making sure we do the right thing...Right now, we understand the Chinese Government has

stepped in and is looking after the health of the children. We will see...if there's something else we can do" (Hembry, 2008). When being asked if Fonterra was ruling out compensation for parents of the sick children, Mr. Ferrier said it had to find out how the Chinese system worked and do what it could to help. After all that had been said, did Fonterra really do what they said they were going to do?

On May 4 2010, eight parents of melamine babies filed a writ at the Small Claims Tribunal in Hong Kong to seek \$NZ 16,000 compensation from Fonterra. According to attorney Peng, since part of Fonterra's income came from Sanlu (\$US6.6 million in 2007 alone), it was only natural that Fonterra as Sanlu's beneficiary and shareholder should be liable for the compensation after Sanlu's bankruptcy. But Fonterra's General Counsel David Matthews stated that the tragedy happened in China and was compensated there, and the Small Claims Tribunal was not suitable to process such cases (Li, 2010). It was no doubt that once this lawsuit was successful, then more and more similar lawsuits would go against Fonterra. Unfortunately, the melamine claim against Fonterra was rejected. Parents of victims were left desperate, since Fonterra was the only hope for them to get more compensation of the Sanlu milk scandal when the compensation provided by the Chinese government was far from enough.

It was obvious that the Chinese system did not handle the compensation well enough. Many victims could not receive enough compensation or just simply did not get compensation. It's time for Fonterra to do something to help these victims; however, it was apparent that

Fonterra was doing nothing and just shifting responsibility to the Chinese system. Later on August 2010, Fonterra did donate \$NZ 8.4 million to Chinese rural communities so as to provide medical care and advice to pregnant women and mothers of infants, but it was probably not the best way from the victims' perspective.

### **Crisis Management Strategies**

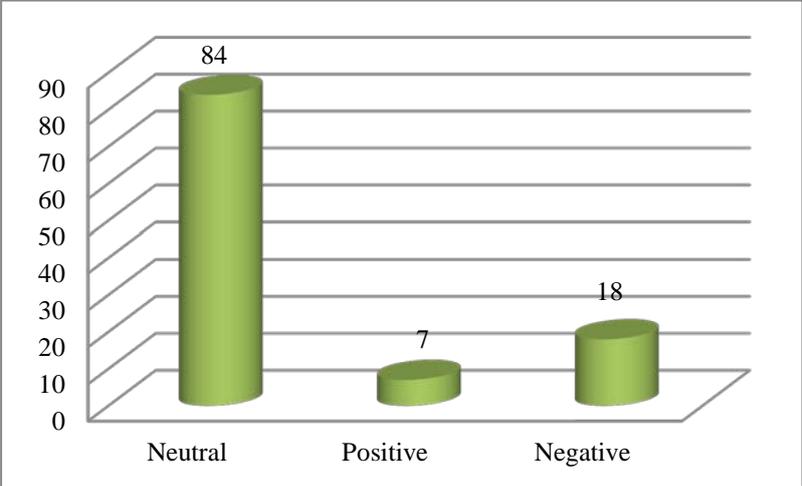
Overall, crisis response strategies exhibited by Sanlu and Fonterra were diverse since they both employed various tactics, which included evasive, defensive, appreciative and accommodative actions. Sanlu took crisis management strategies like deny, excuse, apology, compensate, involuntary recall, while Fonterra took strategies such as explanation, justification, apology, voluntary recall. However, the most important differences between Sanlu Group and Fonterra's organizational reactions were time period and attitude. From news reports highlight more of Fonterra's actions from Period 1, largely focused on appreciative and accommodative crisis management strategies while appearing honest, active, open, and cooperative at most times. Sanlu, on the other hand, was considered as trying to conceal and deny the fact at the beginning (evasive tactics), making customers angry. Sanlu appears to have only begun to use appreciative and accommodative tactics from Period 2; meanwhile it also employed defensive ones.

### **5.3 Research Question 3 - How did the media portray Fonterra's involvement in the Sanlu milk scandal from the beginning of the crisis to the present?**

The media is the most popular and fast way for people to learn about what happening in the world. In recent years, more and more product harm crises captures the media headlines, especially food safety-related crises raises the main concern from customers. To those companies involved in the crisis, news coverage is crucial for these troubled companies to manage their reputation since most customers and other external stakeholders learn about the firm and how it is involved in the crisis through the news media (Luo, 2010). Through the use of a content analysis of 245 articles on Chinese and global newspaper media websites, this study analyzed how the news media reported and evaluated the Sanlu milk scandal as well as Fonterra's involvement in this scandal. Excluding the news articles not mentioning Fonterra, 44.5% of the total news articles reported and evaluated Fonterra's involvement in the Sanlu milk scandal. The result of the coding (See Figure 5.31) showed that nearly three-fourths of the news coverage (77.1%) reported Fonterra or Fonterra's involvement in a neutral tone. The percentage of negatively toned coverage (16.5%) was almost three times than that of positively toned coverage (6.4%) in the remaining articles. It is interesting to find that Fonterra was not even mentioned in most news articles from China newspaper media websites. It appears that Fonterra had managed to avoid being portrayed as the villain in this scandal (Taylor, 2008). Also this might be largely because China considered this scandal as a domestic crisis. By contrast, the focus of international media was on whether Fonterra did enough in this scandal or not. Furthermore, although most of the remaining articles were

still in a neutral tone, some news articles from global newspaper websites showed quite incisive evaluations of Fonterra’s involvement in the Sanlu milk scandal, while some showed approval. In the next section, the Sanlu milk scandal timeline is divided into several time phases in order to have a clear illustration of the involvement of media in the most important events happening during the whole progression.

**Figure 5.31 Distribution of Media portrayal of Fonterra’s involvement by tone**



**February 2008 – 1 August 2008**

As early as in February, a Wenzhou man posted his daughter’s reaction to Sanlu milk powder on various blogs and, doubting the products being genuine, he claimed to have returned some packs to Sanlu. Sanlu insisted its products were genuine but refused to provide results of test. When the father kept complaining, Sanlu reportedly offered him four packages of milk powder that were worth \$364, which the man accepted (He, 2008). Sanlu

began to receive more complaints from customers about kidney stones and “red urine” in babies who drank its milk powder. Later in June, Fonterra CEO Andrew Ferrier said that tests showed no quality problems of these questioned milk product. Fonterra decided to take this as an accident, hence, no further investigation was taken. The Chinese government propaganda department blocked this story or news relating to food safety, since it did not want to ruin the Beijing Olympics. As a result, Sanlu Group ordered a media cover-up when it found potentially poisonous levels of melamine in its formula on 1 August 2008. It was obvious that Sanlu must have already known something about the problems of its milk powder products before being reported, however, whether Fonterra did know or did not know remained as a question. But criticisms still went to Fonterra, although the mass media was restricted to not report any food safety related news, Fonterra still could get knowledge about this through other sources, like the Internet. Fonterra should have noticed this serious event earlier only if it could pay more attention to those signs or complaints.

## **2 August 2008 – 9 September 2008**

Fonterra said that the Sanlu board was told of the melamine contamination first on August 2. Fonterra directors demanded an immediate public recall at the August meeting with local government officials, but both Sanlu and local officials refused to do public recall, and they only agreed to start a trade recall from wholesalers on August 6 since the first thing they did not want was the public humiliation of a tainted-milk scandal on the eve of the Olympics

(Waldmeir, 2008). Fonterra eventually went over the local officials and called the embassy for help, however, it took almost six weeks before Fonterra blew the whistle. Fonterra was widely criticized for waiting too long to facilitate the media informing the public, but Andrew Ferrier argued that Fonterra just decided to work within the Chinese system as this would be more effective. Mr. Ferrier said that Fonterra did the thing that in their judgment was to get the tainted products off the shelves as quickly as possible (Hembry, 2008).

### **11 September 2008 – 31 December 2008**

Early on in the scandal, Prime Minister Helen Clark defended Fonterra in public media as having “behaved responsibly at all times” (“NZ officials blew”, 2008). She explained that Fonterra was trying to recall products at the earliest possible time but faced resistance from local officials. Also she blamed local officials and Sanlu as being likely to try and put a towel over the scandal. On the other hand, Fonterra was blamed by China’s health minister for not having warned the public earlier about the risks it knew were associated with the formula. Fonterra spokesman Graeme McMillan said “our research tells us that people have differentiated quite clearly between the large number of Chinese dairy companies involved and Fonterra” (“Melamine issue lands”, 2008). The above quotes make people wonder if Fonterra really understand its level of complicity in a scandal that thousands of children were sickened.

The interesting point here was that Fonterra did not differentiate Sanlu from the other dairy companies (just as it emphasized in the interview), but there were clear differences in

the level of culpability if focusing on the seriousness of the scale of contamination in Sanlu formula. The level of contamination in Sanlu's formula were 2563 mg/kg or parts per million (ppm), while samples from other 21 dairy companies implicated in the scandal ranged from only 0.09 ppm to 619 ppm ("Court rejects melamine", 2010). In addition, it is also interesting to notice that when everything was going well, Fonterra and Sanlu was recognized as exactly that – a JOINT venture, but once the scandal hit, Fonterra was desperate to distance itself from Sanlu partner. It was obvious that Sanlu was painted as being evil while Fonterra was portrayed by both Fonterra representatives and NZ government spokespeople (at least initially) as just being naïve in its dealing with the foreign partner.

Henry Chung, a Massey University lecturer claimed that it would be a serious business mistake if Fonterra had issued a public recall of tainted formula without co-operation in China. He agreed with Fonterra's decision to work within Chinese rules, with the implication being that it made sense for Fonterra to not involve the media early on. Since face saving as a Chinese tradition had existed for thousands of years, also it is the key issue in doing business in China (Hembry, 2008). Yet, on September 22, Helen Clark changed her attitude from defending Fonterra to criticizing Fonterra for the delay it allowed to pass before acting on the knowledge it had. She attacked the crisis handling at Fonterra by saying "There was no sign of a proper communications strategy to the New Zealand public" (Janes, 2008). Clark said that Fonterra had been too slow to speak out as well as to pursue alternatives when the local government blocked its request for a public recall. She was also critical of Fonterra in

lacking adequate quality assurance and supply chain management as well as the manner that Andrew Ferrier dealt with the scandal once it hit the media (“Fonterra bungled crisis”, 2008). Chinese consumers thought that Fonterra should apologize instead of just pushing the blame onto the Chinese for the scandal. Pansy Wong, New Zealand’s only Chinese MP went public with the criticism that Fonterra should have ensured that the same high safety standards practiced in New Zealand were also done in its joint venture partner. It was not only about the reputation, but lives of babies were at stake (Tan, 2008).

The public often learns about corporate actions via the media. Based on what is read, and how it is interpreted, attitudes will be formed which will either confirm or disconfirm prior opinions about corporate reputation. On November 12, Fonterra was ranked sixth, while Sanlu took first place in a top-10 world list of companies most criticized for their impacts on the environment, health and communities because of its association with Sanlu and its involvement in the Sanlu milk scandal. Fonterra spokesman Graeme McMillan said that it was disappointing to see Fonterra listed separately, since people supposed to have differentiated quite clearly between the involved Chinese dairy companies and Fonterra (“Melamine issues lands”, 2008). Meanwhile, Sinogie Consulting conducted a survey among primary food buyers for households in Beijing, Shanghai and Guangzhou in order to examine how their buying habits had changed after recent food related crises. The results showed that the reputation of the Chinese dairy industry had been ruined badly. Perhaps due to Fonterra’s involvement in the Sanlu milk scandal, a significant majority were concerned

about not only Chinese brands of formula but also foreign ones. Since NZ food has always enjoyed a good reputation in China for its purity, safety and trustworthiness, although Fonterra was involved in this scandal, its reputation did not appear to have suffered as much as supposed. Only 51.2% of respondents said that they trust NZ dairy companies less than they did before the scandal, and 56.2% of respondents increased purchase of foreign brands of dairy products since the scandal broke. It was obvious that foreign companies were benefiting from this (McLaughlin, 2008). On the basis of this situation, critics have suggested the Sanlu crisis has actually helped Fonterra in the Chinese market. Fonterra gave responses to this opinion in the interview (See Figure 5.32)

#### **Figure 5.32 Fonterra's responses to the opinion**

**Critics have suggested that the Sanlu crisis has actually helped Fonterra in the Chinese market. How might you respond to this opinion?**

We wrote off our \$189 million investment and withdrew our consumer brands from the market – this clearly has not helped our business in China.

There has been a short term increase in imported dairy ingredients, but forecasts show that China's demand for dairy will increasingly be met by local production. That's why we are investing further in developing a local supply on the ground in China.

It is obvious that media is not only restricted to informing people about the world happenings, but also affecting out the public's thinking patterns. Sometimes the media even affects the public's attitudes via an incident as well. The prior section especially identified the role of the media in the acute crisis stage of the Sanlu milk scandal.

## **01 January 2009 – 28 June 2009**

On January 28 2009, the Green Party was calling on Fonterra to set the record straight on the Sanlu milk scandal and released minutes of the phone call with Sanlu in which Fonterra passed on the advice that the only acceptable level of contamination was zero. But Fonterra declined to release this record to media, thus the truth was still remaining unclear. Fonterra was always claiming itself as open, honest during the Sanlu milk scandal; however, it might be not open or honest enough as it supposed to be.

### **5.4 Research Question 4 - What lessons can Fonterra learn from the Sanlu milk scandal?**

Leading dairy company Sanlu Group, which is now non-existent, sat at the heart of the Sanlu milk scandal. Though 21 other dairy companies also tested melamine in their products, all of the publicly reported deaths and most of the controversy were linked to Sanlu Group in this scandal (DeLaurentis, 2009). New Zealand dairy company Fonterra Cooperative Group Ltd., which at the time owned 43% shares in Sanlu, was forced into the international spotlight because of the scandal. As we know, Fonterra had three members on the seven-member Sanlu board, but only one of them spoke Mandarin, also there was only one quality-control specialist from Fonterra who worked permanently at Sanlu. Fonterra said that it advised Sanlu on quality testing but no independent check of Sanlu's products was done (Waldmeir, 2008). Though Fonterra had three people on the board, it was still in the dark about the mass contamination until August – about eight months after its Sanlu partners

found out the scandal. Once in the loop, Fonterra failed to persuade local government officials and Sanlu to do a national product recall for six weeks. Paul French, chief China analyst for the Shanghai-based consultancy Access Asia said: “Fonterra apparently believed all the books in which foreign executives are taught not to let their Chinese partners get offended or ‘lose face’.” In fact, Fonterra took pride in its “trust –based” relationship with Sanlu, however, that trust was evidently misplaced (Liu, 2008). O’Sullivan (2008) pointed out one big question that Fonterra might face up to, if Fonterra trumpet food safety as its major selling point on the world stage, why it did not take a more aggressive approach to ensuring its joint venture partner also placed product safety as a prime value? O’Sullivan thought that Fonterra acted more like a passive investor in Sanlu instead of a joint venture partner with three directors on Sanlu’s board in this scandal.

Fonterra paid a heavy price for its involvement in the Sanlu milk scandal in China. It had to write down the entire Sanlu investment to reflect the cost of product recalls and brand damage. It is a cautionary story for any foreign firm seeking a joint venture (JV) in China. Since the typically complicated production process in China, foreign partners need to monitor quality at every step of the process. Drew Thompson, director of China studies at the Nixon Center in Washington said that this case should serve as a warning for others about the utility of JVs and it is necessary for potential investors to carefully consider different exposure of different forms of partnership since respective consumer safety principles may vary widely between JV partners (Waldmeir, 2008). Andrew Ferrier said: “We’ve learnt an incredibly

painful lesson through this and we will be much, much more suspicious world-wide on ensuring the safety and integrity of our supply chain everywhere in the world” (Taylor, 2008).

Fonterra identified the main lessons it can learn from the Sanlu milk scandal in the email interview conducted for this study. (See Figure 5.41)

**Figure 5.41 Fonterra’s answer to JV with Sanlu**

<p><b>If everything could be done afresh, what would Fonterra have done differently in terms of managing its JV with Sanlu?</b></p> <p>The melamine issue was tragic for everyone involved, including Fonterra. It showed us that we must have complete control of our supply chain to operate in China, as we do elsewhere in the world, to ensure we maintain our world class quality standards. That’s why we are investing in our own Fonterra-managed farms in China. The high demand for dairy in China will increasingly be met by local supply, so we are committed to investing in a high quality, New Zealand-standard source of raw milk in China.</p>
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Obviously, the control of supply chain is an extremely significant lesson for Fonterra to learn from this scandal. Furthermore, not completely knowing the Chinese international joint venture (IJV) environment is another important lesson for Fonterra. If Fonterra understood the Chinese business system well before it built the JV with Sanlu, it may have had the chance to take more effective actions at that time.

***Unique features of the China international joint venture (IJV) environment***

Shenkar (1990) identified that partnering in transitional economies like China offers unique challenges and opportunities. For the foreign companies, IJVs provide a way for them to gain localized knowledge and navigate the domestic legal and political environment, while host companies consider IJVs as a way of acquiring new technology and expertise. Fonterra

and the Sanlu Group formalised their relationship in 2005, and the joint venture between these two giant dairy companies was supposed to make a win-win outcome. Fonterra needed a local company to help it enter into China's dairy industry, while the Sanlu Group needed a foreign giant to help it uplift its marketing position in China's dairy market. It was obvious that this IJV could bring advantages to both sides; however, Fonterra should have noticed that it is not easy for IJVs to be successful in the Chinese business environment. Even veteran companies with successful JVs in other countries may find difficult to establish JVs in China, since there is a far more complex environment in China (Burgers & Padgett, 2009).

Enderwick (2009) identified the most difficult factor for foreign company doing business in China is the unique relationship-based business system ("guanxi" relations – dominated by formal and informal networks). Burgers and Padgett (2009) also identified this unique characteristic that increases the environmental complexity for IJVs. It makes foreign companies difficult to gain access to information and in the implementation of exchange terms. For example, there is a high extent of business and political connections in Chinese dairy industry, thus processors must maintain strong relations with government authorities at all levels so as to be able to secure stable supplies from very widely scattered collection sites.

It is extremely difficult for foreign companies, which begin outside the critical networks, to develop network ties. Specifically, it is hard for foreign companies to determine who to connect with and how to establish a useful connection. In the Sanlu milk scandal, Fonterra may have been informed about the melamine contamination almost eight months later than its

partner. Once Fonterra was informed, it tried hard to pull tainted products off the shelves. But local officials fretted that antigovernment anger might jeopardize social stability during the Beijing Olympics, so they refused to do a national product recall. Since just like what Fonterra CEO Andrew Ferrier said, the risk of going against the will of the local government was that Fonterra would have been shut out of the process altogether. In Fonterra's own judgment, it believed that it would work more effectively within the Chinese system.

A second notable feature of the Chinese business system is the high level of corruption characteristic. This becomes a particular challenge for an international business like Fonterra since the normal moral constraints expected to observe in developed market economies may not be found in transitional economies like China. Fonterra is used to operating in New Zealand, one of the least corrupt economies in the world, so it is particularly difficult for Fonterra to operate in China where corruption is rife particularly at lower levels of government (Enderwick, 2009). It is obvious that widespread corruption causing inadequate enforcement at local level, led to the proliferation of contaminated food and it is not favourable to food safety management as well.

A third unique characteristic of the Chinese business system is the emphasis on control of the local government – from an IJV perspective, when there is a conflict existing, the local government might interfere in business dealing (Burgers & Padgett, 2009). In the Sanlu milk scandal, even though Fonterra required a voluntary public recall right after it knew about the melamine contamination, this requirement was rejected by the local government. There

was a claim that the Beijing authorities exercised a “propaganda ban” on food safety issues in the run up to the Olympics, and additional fears of social unrest were the main reasons the authorities postponed a public recall (Spencer and Foster, 2008). Andrew Ferrier said: “The biggest single lesson that Fonterra has learnt is: we didn’t have enough say in the management of the business”. Fonterra has had to write down the book value of its Sanlu investment by 70 per cent to reflect the cost of product recalls and brand damage. The main lesson for Fonterra is: “don’t trust, verify”. Foreign partners need to monitor quality at every step of the typically complicated production process (Waldmeir, 2008).

### ***The control of the supply chain***

The Sanlu milk scandal implies that companies doing business in China should pay more attention to maintaining quality throughout the supply chain since inherent problems in food manufacturing processes and supply chains cause the breakdown of quality assurance. The scandal badly damaged the dairy industry in China. According to a dairy analyst, it took more than six months for China’s dairy industry to recover 70-75% of its pre-scandal sales from the time the scandal broke. This scandal provides lessons not only to Fonterra but also to the Chinese dairy industry on how they can better control their supply chains. Several potential pitfalls should be aware of when foreign companies try to build and manage ethical supply chains in China. Moreover, it is necessary for dairy industry to place new importance on quality assurance so as to salvage consumer confidence in China. Building more

accountable, transparent, and ethically managed supply chains is the key to achieve good quality control (Delaurentis, 2009).

The dairy supply chain in China is both long and complex as a result of the uneven distribution of raw milk supply nationwide. Most dairy processors source raw milk through third-party collection stations based in villages (Enderwick, 2009). So did Sanlu, it collected raw milk from middlemen. However, the collection of milk without close oversight of quality as well as the lack of accountable supply chain partners allowed Sanlu's suppliers to taint milk with melamine, which led to Sanlu's demise eventually (Delaurentis, 2009).

### ***Pitfalls of supply chain management in China***

Weak regulations and enforcement is a severe problem of China's supply chain. Since lack of strong local, provincial, and national product safety laws as well as consistent, transparent enforcement, Sanlu missed and even ignored melamine-tainted issues. According to Xinhua reports, Sanlu received consumer complaints about its milk powder as early as December 2007. In Sanlu Chairwoman Tian Wenhua's court testimony, she admitted knowing that Sanlu was selling melamine-tainted milk powder by May 2008. Fonterra CEO Andrew Ferrier said in September that although Fonterra would have preferred an immediate public recall, it had to follow the procedures of the local authority and local regulations.

Another contributing factor to the Sanlu milk scandal was the weak supervision of local dairy production due to corruption. Lack of accountability in the industrial inspection

system allows quality assurance violation to go unnoticed or unreported (Delaurentis, 2009).

In addition, it was ironic that Sanlu Group as a state-owned enterprise had been exempted from quality assurance tests because of its high status and good brand image before the scandal broke (He, 2008). Also low entry barriers result in a phenomenon that almost anyone in China can become a dairy farmer or milk station collection agent since there is no requirement for quality assurance training or a background check. This caused the raw material supply to be in utter disorder.

Lack of traceability and transparency is another big problem of food supply chain in China. This poses a major obstacle to food safety in China. Especially scattered and unreliable tracking information of milk collection stations result in highly difficulty of identifying a problem's source (Delaurentis, 2009). Incomplete record keeping is not the only cause for poor traceability, since intentional obfuscation to hide the trail of adulteration or contamination is also a widespread corporate effort in China (Euromonitor International, 2010a).

### ***Ethical supply chain management***

When considering a joint venture, the potential foreign partners should focus on the importance of establishing an ethical supply chain management process early in the contractual negotiation stage. Both of the partners should agree on a set of values, which

become the foundation that partnership builds its supply chain and quality assurance management systems on.

Foreign companies can discuss with consultancies that focus on ethics and corporate social responsibility since this kind of consultancies can help foreign companies locate partners with strong corporate values. Also such consulting companies can help to build trust between JV partners and emphasize the importance of ethical considerations in business decisions. For example, the global network Business for Social Responsibility helps its member companies develop more sustainable supply chains by moving beyond policing of the supply chain and looking at holistic solutions.

Foreign companies should invest in greater integration and ownership of the supply chain, since only integrated and company-owned supply chain can guarantee quality assurance. Just like Sanyuan, this dairy company was not involved in the melamine-tainted milk scandal since its raw milk came largely from its own dairy farms that have strict quality-control systems. Fonterra are investing in its own Fonterra-managed dairy farms in China now so as to ensure a high quality, New Zealand-standard sources of raw milk. Foreign partners should also organize training programs and quality assurance processes that link product safety as well as consumer safety. Therefore, this can encourage employees to identify quality as a company trademark. Also conducting training seminars in leadership and business ethics should be considered, since this help develop a deeper ethical sense among its employees (Delaurentis, 2009).

## ***Food safety reform***

Just like what Fonterra said in its interview (See Figure 5.42), the melamine scandal was a serious blow to Chinese dairy industry, but the Chinese government has responded with new and stronger regulations and management after this scandal, which will benefit both customers and the industry.

### **Figure 5.42 Fonterra's answer to food safety issue in China**

**What are your thoughts about how food safety could be improved in China?**

The melamine crisis was a severe blow to the industry. But Chinese consumers are ultimately benefiting from the changes that have been made since the crisis. There is now a renewed focus in China on quality and safety.

The Chinese Government has responded with new, stronger regulations, which will benefit the industry. But the Government can't do it all – there needs to be cooperation between Government and all the players along the supply chain to work together to create a quality culture in China.

After the Sanlu milk scandal, China entered a major new era of food safety reform. Restructuring the entire food safety system is one of the key aims. Although as many as 14 government bodies had tangible involvement in regulating food safety, the poor co-ordination between central and local government bodies causes disjointed policies, laws and standards. For example, when the Sanlu milk scandal occurred, none of these government bodies seemed to have been in charge of the milk collection stations, where the contamination happened. In June 2009, China's new Food Safety Law came into effect so as to eradicate existing gaps and assign clear responsibility to each agency. Every period of the food production process

would be covered under this law. A new Food Safety Commission (FSC) was set up by the Chinese government in 2010 to supervise the entire food safety system and strategy.

A national food safety observation network will be completed within two years from June 2009. This means that farmers will be required to keep detailed records of anything they produce, which is intended directly or indirectly to enter the human food chain, like pig feed. Hence, transparency and traceability can be ensured from the beginning of the food production chain. Moreover, food manufacturers are also required to keep records for at least two years of the sources of their raw materials as well as how they are processed. An effective recall system for unsafe food products will be set up as well. Information about troubled companies involved in any recalls is going to be stored on a particular database of food safety, which can provide help to the government's monitoring activities as well as increase traceability. Celebrities need to be careful for their product endorsing, since if they endorse any questioned products, they will be responsible for that too. In addition, more severe penalties will be imposed on producers as well.

Chinese government seems to have recognized the insufficiency of heavy reliance on top-down surveillance in China's supply chain management. It is necessary to foster food producers to shoulder more responsibility. Therefore, as part of the reform, the Chinese government intends to shift the obligation onto producers so as to prompt a better Corporate Social Responsibility environment.

It is unclear whether another product harm crisis like what happened with Sanlu might happen or not, since just as Fonterra said in its interview: “It is impossible to guard against every possible scenario, particularly a deliberate act of criminal sabotage.” But Fonterra now has strong measures in place to help ensure it is not faced with such a crisis again, while the Chinese government also tries hard to avoid this kind of product harm crisis happening. There is no doubt that the Sanlu milk scandal hit Fonterra at some stage, but as time goes by, Fonterra has recovered from this scandal and enters a new chapter in Chinese marketing (See Figure 5.43).

#### **Figure 5.43 Fonterra’s answer to its current development in China**

**What are Fonterra's plans in the Chinese market now? Has the company thought about launching any NZ-brands in the Chinese market now that there is more consumer concern about local brands?**

We have four main businesses currently in China:

- **Imported standard ingredients:** Fonterra supplies high quality dairy ingredients, imported from New Zealand, such as cheese, milk powder and specialty ingredients such as whey protein, to other food manufacturers.
- **Foodservice:** Fonterra Foodservices supplies high quality cheese, creams, milk, and butter to bakeries, restaurants, hotels, and fast food restaurants throughout China. Fonterra, for example, supplies the cheese for 7 out of 10 pizzas sold in China. We have an ‘Innovation Kitchen’ based in Shanghai to test new products and recipes.
- **Consumer brands:** Fonterra is bringing the latest in dairy nutrition research to China through its adult milk powder Anlene, which helps build strong bones, and Annum Materna, a product developed specifically to support women during pregnancy. We re-launched Anlene and Annum Materna in China in 2009 and have been focusing on sales in Shanghai and Guangzhou. We recently extended the sales network of Anlene into eight cities in Jiangsu Province.
- **Dairy farming:** We established our first farm, Tangshan Fonterra Farm, in 2007 as a pilot project to demonstrate that Fonterra can produce New Zealand standard milk in the China environment. Following the successful pilot, Fonterra and the Government of Yutian County formally agreed in 2010 and 2011 to develop a second and third farm in Hebei Province. The two farms are expected to increase Fonterra’s overall milk production in China to around 90 million litres or 360 million cups of fresh milk every year, once at operating capacity. We plan to build a hub of farms in Hebei Province in the next five years.

## Chapter 6

### Conclusion

This study was conducted to better understand the Sanlu milk scandal and different crisis management strategies used by Sanlu and Fonterra. In addition, the author sought to have better knowledge of how the media portrayed Fonterra's involvement in this scandal as well as the lessons learnt by Fonterra and the Chinese dairy industry. Although this is not the first study of analysing the Sanlu milk scandal, it is a significant step towards exploring this case from a different perspective (news coverage). In particular, this study explored the crisis management strategies by comparing different actions taken by Sanlu and Fonterra. The need for effective crisis management strategies was also highlighted so as to maintain and protect a troubled company's reputation.

Fink (1986) identified a predictable four-phase pattern followed by all crises: Prodromal crisis stage, Acute crisis stage, Chronic crisis stage and Crisis resolution. From the prior discussion of Sanlu and Fonterra's organizational reactions, although they all employed various tactics like evasive, defensive, appreciative and accommodative ones over the four phases, the most difference between Sanlu and Fonterra's reactions were in time period and attitude. It was clear that Fonterra employed appreciative and accommodative tactics beginning from the prodromal crisis stage, and been honest, active, open and cooperative at most times. On the other hand, Sanlu tried to conceal and deny the fact as well as employed evasive tactics most times in the prodromal crisis stage, and then it began to use defensive, appreciative and accommodative approaches from the acute crisis stage. Sanlu used crisis

management strategies such as deny, excuse, involuntary recall, apology, and compensate, while Fonterra used strategies like explanation, justification, voluntary recall and apology. Both the different crisis management strategies and different organizational reactions in different time period give us insight regarding the entirely different endings of these two dairy companies.

Since most customers and other external stakeholders learn about the troubled company and its involvement in a crisis through the news media, like newspapers, news coverage is of critical important to the troubled companies since it can help to manage their reputation (Luo, 2010). In addition, analysis of the news articles with how the media portray Fonterra's involvement in the Sanlu milk scandal explored that most news articles from the Chinese newspaper media websites did not even mention Fonterra, while news articles from the global newspaper media websites focused more on whether Fonterra did enough in this scandal or not. Although most of the articles were in a neutral tone, the percentage of negative toned coverage was almost three times than that of positively ones. Fonterra was badly criticised in the media for the 6 weeks delay before blowing the whistle, its lack quality assurance and control of its own supply chain, as well as not compensating the victims.

After the Sanlu milk scandal, it was obvious that Fonterra had paid a heavy price for its involvement in this scandal, since it had to write down the entire Sanlu investment. Both Fonterra and the Chinese dairy industry learnt incredibly painful lessons from this scandal. This case could also be considered as a cautionary story for any foreign company seeking a

joint venture in China. Always remember to monitor quality at every step of the production process. To Fonterra, the first lesson learnt from this scandal was that it did not completely know the Chinese international joint venture (IJV) environment. From the prior discussion, we can learn the unique features of the Chinese IJV environment may include crude complexity and effective complexity, the unique relationship-based business system, the high level of corruption characteristic, and the emphasis on control of the local government. All these features resulted in the whole situation being extremely challenging for Fonterra's JV with Sanlu. The second lesson learnt by Fonterra was that it should have paid more attention to its control of the supply chain in China. There are several pitfalls of supply chain management in China, like weak regulations and enforcement, and lack of traceability and transparency. It is necessary for the dairy industry to place new importance on quality assurance so as to salvage consumer confidence in China. Also more accountable, transparent, and ethically managed supply chains should be built in order to achieve good quality control (Delaurentis, 2009).

It is no doubt that the Sanlu milk scandal has seriously threatened the thriving dairy business in China as well as hit Fonterra at some level, however, the most important thing is to learn from this scandal as well as to prevent similar crises happening again. Just like the explanation of the Chinese word crisis – danger and opportunity. As time goes by, not only Fonterra has recovered from this scandal and enter a new chapter in Chinese dairy marketing,

but also the Chinese dairy industry has responded with new and stronger regulations and management after this scandal so as to reform the food safety.

### **Limitations and Recommendations for Future Research**

First, this study was limited to collect data only from the Chinese and global newspapers' websites. This might result in lack of sufficient information to analyse the Sanlu milk scandal from various perspective (like customers' perspective) since most news articles from the Chinese newspapers' websites reported this scandal by just stating the related information of this scandal instead of expressing customers' or their own opinion. This was largely due to the control of the Chinese government over the media. But more and more people use other online communication tools as platforms for self-expression, networking in China, especially blogs. Chinese bloggers dare to express their own thought and opinion, sometimes even censure the authority. Hence, future research can collect data from more other online communication tools (for example, blogs, popular Internet portals, or bulletin boards services) so as to provide stronger support for analysis.

Second, this study was limited to the role of Sanlu Group and Fonterra in the melamine-tainted milk scandal. However, there were 21 other dairy companies involved in this scandal, like Mengniu and Yili. Mengniu as another giant dairy company in Chinese dairy market was also criticized badly for its involvement in this scandal, but not like Sanlu,

Mengniu finally survived and got to recovery from this scandal. Now Mengniu plays an active role in the Chinese dairy industry. So what kinds of crisis management strategies did Mengniu use? What's the difference between Sanlu and Mengniu's crisis management? Therefore, future research can be conducted to answer this kind of questions by comparing the difference crisis management between Sanlu and Mengniu in order to broaden our understanding of effective crisis management.

Third, since this study only analyzed a Chinese dairy industry crisis case, further research of product harm crises in other industries will be worthwhile to produce interesting and useful analysis of this arena. Moreover, since consumers' reactions may vary across different industries, for example, customers may give more severe reaction to the product harm crises in the food industry than other industries like clothing or cosmetics. Hence, further cross-industry studies can be conducted to research the impact of different customer reaction on product harm crises.

Fourth, this study mainly analyzed the involvement of Fonterra as a joint venture partner of Sanlu. Therefore, further examining other similar cases will be helpful to better identify the role of a foreign company as a joint venture partner in a product harm crisis.

Fifth, from the prior discussion of the Sanlu milk scandal, it was found that lack of effective supply chain management in the dairy industry might be the main cause for this crisis. So there is a great need for investigation of effective supply chain management strategies so as to prevent or lower the chance of this kind of crisis happening again.

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## Appendices

### Appendix A – Footnotes for Table 5.1 Timeline for the Sanlu milk scandal

1. Sanlu Ties up with Fonterra. (2005, December 1). *SinoCast China Business Daily News*. Retrieved from <http://www.accessmylibrary.com/article-1G1-139333511/sanlu-ties-up-fonterra.html>
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## Appendix B – the Interview of Fonterra

### 1. What are your thoughts about how food safety could be improved in China?

The melamine crisis was a severe blow to the industry. But Chinese consumers are ultimately benefiting from the changes that have been made since the crisis. There is now a renewed focus in China on quality and safety.

The Chinese Government has responded with new, stronger regulations, which will benefit the industry. But the Government can't do it all – there needs to be cooperation between Government and all the players along the supply chain to work together to create a quality culture in China.

### 2. Do you think that another product harm crisis like what happened with Sanlu could happen again?

It is impossible to guard against every possible scenario, particularly a deliberate act of criminal sabotage. But Fonterra certainly has strong measures in place to help ensure we are not faced with such a crisis again.

### 3. What are Fonterra's plans in the Chinese market now? Has the company thought about launching any NZ-brands in the Chinese market now that there is more consumer concern about local brands?

We have four main businesses currently in China:

- **Imported standard ingredients:** Fonterra supplies high quality dairy ingredients, imported from New Zealand, such as cheese, milk powder and specialty ingredients such as whey protein, to other food manufacturers.
- **Foodservice:** Fonterra Foodservices supplies high quality cheese, creams, milk, and butter to bakeries, restaurants, hotels, and fast food restaurants throughout China. Fonterra, for example, supplies the cheese for 7 out of 10 pizzas sold in China. We have an 'Innovation Kitchen' based in Shanghai to test new products and recipes.
- **Consumer brands:** Fonterra is bringing the latest in dairy nutrition research to China through its adult milk powder Anlene, which helps build strong bones, and Annum Materna, a product developed specifically to support women during pregnancy. We re-launched Anlene and Annum Materna in China in 2009 and have been focusing on sales in Shanghai and Guangzhou. We recently extended the sales network of Anlene into eight cities in Jiangsu Province.
- **Dairy farming:** We established our first farm, Tangshan Fonterra Farm, in 2007 as a pilot project to demonstrate that Fonterra can produce New Zealand standard milk in the China environment. Following the successful pilot, Fonterra and the Government of Yutian County formally agreed in 2010 and 2011 to develop a second and third farm in Hebei Province. The two farms are expected to increase Fonterra's overall milk production in China to around 90 million litres or 360 million cups of fresh milk

every year, once at operating capacity. We plan to build a hub of farms in Hebei Province in the next five years.

**4. If everything could be done afresh, what would Fonterra have done differently in terms of managing its JV with Sanlu?**

The melamine issue was tragic for everyone involved, including Fonterra. It showed us that we must have complete control of our supply chain to operate in China, as we do elsewhere in the world, to ensure we maintain our world class quality standards. That's why we are investing in our own Fonterra-managed farms in China. The high demand for dairy in China will increasingly be met by local supply, so we are committed to investing in a high quality, New Zealand-standard source of raw milk in China.

**5. Critics have suggested that the Sanlu crisis has actually helped Fonterra in the Chinese market. How might you respond to this opinion?**

We wrote off our \$189 million investment and withdrew our consumer brands from the market – this clearly has not helped our business in China.

There has been a short term increase in imported dairy ingredients, but forecasts show that China's demand for dairy will increasingly be met by local production. That's why we are investing further in developing a local supply on the ground in China.