CORPORATE GOVERNANCE CASE STUDIES

VOLUME FIVE

Edited by **Mak Yuen Teen**

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CPA AUSTRALIA

Corporate Governance Case Studies

Volume five

Mak Yuen Teen, PhD, FCPA (Aust.)

Editor

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Foreword

Disruption has become a mainstream corporate buzz word and added even more complexity to the uncertain business and economic climate. The pace of disruption has been unprecedented and a game changer for many established organisations.

Against this backdrop, directors and senior management of organisations will most likely be singularly focused in the near term on finding growth for their companies and managing strategy to survive in these difficult times. But when the going gets rough, it is even more critical for organisations to continue building a strong culture of governance. Sound corporate governance is the bedrock of the corporate sector and Singapore's valued position as a global financial centre.

As a professional accountancy body with more than 155,000 members worldwide, CPA Australia believes that the journey towards better corporate governance and transparency must go on relentlessly if companies are to thrive. More than ever, investors and stakeholders have greater expectations for organisations.

In this regard, CPA Australia is proud to have partnered Associate Professor Mak Yuen Teen of the NUS Business School on a very successful series of corporate governance teaching case studies. Over four collections, published annually since 2012, there are now more than 100 cases in total.

With this fifth volume, we continue our commitment to producing an important discussion resource for boards and management in Singapore, Asia-Pacific and beyond to raise the bar on sound governance.

We thank Prof Mak for his meticulous efforts in editing the case studies and the students of the NUS Business School for their work in researching and producing the cases. We hope this new collection of case studies will facilitate robust discussions to advance corporate governance standards and best practices in Singapore and international markets.

Philip Yuen FCPA (Aust.)
Divisional President – Singapore
CPA Australia

Preface

It did not seem that long ago when I started having conversations with Melvin Yong at CPA Australia about collaborating on this annual collection of corporate governance case studies. We are now into the fifth year of this collaboration and it has been an extremely fulfilling experience for me.

The cases are increasingly used by universities, professional bodies and other organisations involved in corporate governance education here and around the world.

This year's collection includes 23 cases. There are six Singapore cases, including the very recent Singapore Post case, and others involving companies that are listed in Singapore or are Singapore subsidiaries, including Lian Beng, Nobel Design, Noble, OW Bunker and ST Marine. The types of companies and issues involved differ widely. OW Bunker is especially interesting as it shows how poor risk management and corporate governance in a subsidiary can cause the collapse of an entire group.

There are also six Asia Pacific cases, including Cabcharge in Australia, Hanergy in Hong Kong, Takata and Toshiba in Japan, and Hyundai and Samsung in South Korea. The Takata case, about "killer" airbags in cars, highlights the serious impact of poor governance and management on the company's customers – the major automakers - and end consumers, some of whom paid with their lives.

In terms of global cases, we continue to expand the countries that are covered. For the first time, we have a French company (Sanofi), a German company (Volkswagen), a Swedish company (SCA) and a Swiss company (Sika). This allows readers to be exposed to corporate governance systems in other parts of the world. For example, in the SCA case, which is a case about poor ethics and corporate governance leading to excessiveness in an egalitarian society, we see how the role of the external auditor and the composition and functioning of the nominating committee are so different in Sweden.

The Sika case is about corporate governance in a family-controlled company, or more precisely, a family that wants to get out of the business by selling to an external investor. At the heart of this case is dual class shares and the transfer of superior voting rights when the founder or family exits the business. The issue of dual class shares has of course become quite relevant in Singapore, where there has been a debate as to whether to allow it for listed companies.

Other global cases include the Tesco case about a major accounting misstatement; the HSBC case on the bank's alleged role in helping clients evade taxes; and the Wynn Resorts case about the feud between the co-founders and former husband and wife, which provides interesting twists on director independence and gender diversity. There is also a case about Carl Icahn and his brand of shareholder activism in the US.

Finally, three of the global cases deal with bribery and corruption. The Walmart case involves alleged bribery in Mexico implicating senior management of the company. The Petrobras case in Brazil is still unravelling and continues to pose difficult questions for two major Singapore government-linked companies which have been accused of using third parties to pay bribes, with recent allegations of senior management's knowledge in one of these companies. Finally, we have a case about FIFA, which shows that poor ethics and governance afflict sporting bodies too, with equally devastating consequences.

I would like to thank the students who wrote the original cases, the students who assisted in editing them, and particularly Chloe Chua, who did a great job as my editorial assistant. However, most of all, I would like to thank Melvin Yong and his wonderful team at CPA Australia, and especially Sheryl Koh, for their continuing support of this project over these past five years.

Associate Professor Mak Yuen Teen
Department of Accounting
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LIAN BENG: DECONSTRUCTING REMUNERATION

Case overview

In July 2015, two independent directors of Lian Beng Group Ltd, Sitoh Yih Pin and Wan Soon Bee, resigned abruptly from their positions due to differences over the performance bonuses received by the group's executive directors. This incident was intensely scrutinised by the Singapore Exchange (SGX), as well as experts. The objective of the case is to allow a discussion of issues such as the determination of directors' remuneration; the use of service agreements and their impact on the remuneration of key executive personnel; board composition; and corporate governance of family companies.

Crunch time

Ong Pang Aik stood up from his chair and sighed. He had worked hard for a good part of his life to turn Lian Beng Group into one of the largest and most well-known construction and engineering companies in Singapore, registering strong consistent growth year after year. However, a remuneration controversy had thrust the group into the spotlight for the wrong reasons. Stock prices were on a downward trend even though profits and revenue had gone up. The group had also come under much scrutiny by the SGX, and was on the receiving end of a barrage of criticisms by various commentators.

This is the abridged version of a case prepared by Jason Pang, Jamie Pang, Matthew Tang, Charmaine Ho and Yik Chun Leong under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Sarah Ho under the supervision of Professor Mak Yuen Teen.

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Humble beginnings

While it was Ong's father, Ong Sek Cheong, who had founded the company in 1973, it was the younger Ong who had had bigger dreams for the company. Ong Pang Aik wanted Lian Beng to be more than just a sub-contractor; he wanted to expand and take on bigger projects.[1] Ong joined the company five years after his father founded the company, and was put in charge of supervising work sites and tendering for projects. Slowly but surely, under his guidance, the company grew in terms of its revenue and capacity. From 1978 to 1988, the company started to take on larger contracts and expand its scope of work by tendering for larger scale projects, such as the main contractor role in building projects. In 1988, the company expanded its capabilities further and started taking on large-scale public sector projects for the government, including the upgrading and construction of several academic institutions, polyclinics, libraries and factories. In the private sector, the company was also successful in securing residential and industrial construction projects.[2]

In order to cope with the ever-increasing pace of expansion, Ong invited his sister, Ong Lay Huan, to join his business in 1991. Following that, his other sister, Ong Lay Koon, also joined the family business in 1992. Together, the family drove the business to an even higher level and achieved several key milestones.

In 1993, Lian Beng made its first major breakthrough by landing its first Housing and Development Board (HDB) project in the Tampines area. That contract opened up the floodgates for a flurry of successful tenders for HDB projects, enabling Lian Beng to carve out a niche for itself in the process. Riding on this wave of success, Lian Beng went on to grab its first project worth more than S$100 million in 1996. That very same year, Lian Beng registered with the Building and Construction Authority (BCA) in Singapore to establish itself as a Grade 8 (G8) building contractor – the highest classification attainable then (the equivalent of the current A1 grade).[3] Ong's dream of creating a corporate giant out of Lian Beng was finally taking shape.

An emerging corporate giant

From 1996, Lian Beng's corporate structure saw a shift as new subsidiaries were incorporated. In 1996, Lian Beng went into engineering, as well as the leasing of construction machinery and equipment, and incorporated Lian Beng Engineering & Machinery Pte Ltd in the process.[4] In 1997, it also incorporated Tradewin Machinery & Equipment Pte Ltd. The venture was motivated by a desire to diversify earnings and complement the core business by rendering services to the construction industry. On 16 December, 1998, Ong was appointed executive director of the group, after rising through the ranks over the years. Ong's appointment was followed swiftly by his sisters' – both were appointed executive directors on 20 March 1999.[5] At the same time, Tan Swee Hong, who had been with the company for a long time, was also appointed as director and General Manager. Ong's drive for further expansion led him to list the group on the SGX later in 1999.[6]

From local to global

Upon listing, two independent directors were appointed to the board: Sitoh Yih Pin, who later became a member of the Singapore Parliament, and Dr Wan Soon Bee, who was a former Minister of State and was also, at the time of his appointment, a member of the Singapore Parliament. Over the next decade, Lian Beng grew aggressively by incorporating a series of companies to diversify its business and to expand overseas. This included Rocca Investments Pte Ltd in 2000 (to take up development projects), Millennium International Builders Pte Ltd in 2008 (to take up ultra-luxury niche projects), PT Lian Beng Energy in 2004 (to undertake an overburden removal project in Indonesia) and Lian Beng - Amin Joint Venture Pte. Ltd in 2006 (to undertake housing projects in the Maldives). Lian Beng also acquired Deenn Engineering Pte Ltd, a recognised *"design-and-build"* company with G8 certification. The highlight, however, came in 2007 when the group secured the high-profile construction project for the development of the Marina Bay Sands Resorts.[7]

As of 2014, Lian Beng Group had a presence in China, Bangladesh, Maldives, Malaysia and Australia, with more than 60 associates and subsidiaries. The group registered strong financial performance, with profit increasing by more than 20 times from 2005 to 2014.

On top of their strong financial performance, the group also received numerous awards, such as the BCA construction excellence award 2014 and the RoSPA Gold Award for Occupational Health & Safety Award 2014,[8] cementing its position as one of the top local construction groups in Singapore. Over a span of 36 years, Ong transformed his father's small engineering sub-contractor company into one of the most formidable corporate entities in the construction industry.

Board of Directors

Lian Beng's board consisted of five directors, with three executive directors and the two independent directors Sitoh and Dr Wan. Ong was the Chairman and Managing Director. His two sisters, Ong Lay Koon and Ong Lay Huan, were the other two executive directors. Ong Lay Koon heads the finance and human resource departments, while Ong Lay Huan heads the contracts department. The company did not appoint a lead independent director.

First signs of trouble

However, not everything was rosy. In 2012, Ong was involved in a court case in which various parties were paid to take the rap for his parking offences.[9]

In recent years, cracks began to appear in the business. Various observers pointed out that in spite of its stellar historical track record, Lian Beng's future outlook did not look as promising. While it had recently secured a number of construction contracts that provided some assurance with regard to the sustainability of its growth, it potentially faced a demand crunch due to the recent introduction of property-cooling measures by the government.[10] These measures included an increase in stamp duties, which made the purchase of residential properties more costly, as well as reduced Loan-to-Value Ratios, which limited the amount of debt that a person could take on to finance their purchase of properties.

In addition, as the government continued to curb the intake of foreign workers, the company faced the prospect of rising labour costs. Since 2010, the government had been reducing the intake of foreign workers with the aim of maintaining the growth of the foreign workforce at its current pace. In 2014, the foreign workforce grew by only 26,000, down from 80,000 in 2011.[11]

Perhaps most worrying of all, Lian Beng's share price had been gradually declining since July 2014, falling from a high of S$0.73 to S$0.535 as of 6 July 2015 despite many positive indicators: the company's rosy financials, bulging property development order book which would ensure a sustained revenue for the next few years[12], and a steady increase in the company's share price over a four-year period from 2010 to 2014 after the 2009 global financial crisis. Even though many analysts found Lian Beng's stocks to be undervalued and conferred it a 'Buy' recommendation, the stock price continued on in its downward trajectory throughout 2015. As of 2014, the Ong family collectively held 30% of the total outstanding shares of the company.

Dropping the bombshell

On 10 July, 2015, the company announced the resignation of both of its independent directors, Sitoh and Dr Wan. They had served on the board for more than 15 years.[13] The abruptness of the news caught the industry and the stock market by surprise. At the time of their resignation, Sitoh was the chairman of the remuneration committee and a member of the audit and nominating committees, while Dr Wan chaired its audit and nominating committees, and was a member of the remuneration committee. The initial reasons stated by Sitoh and Dr Wan for their resignations were "differences in opinion from the management over certain company affairs".[14] Following their resignations, Lian Beng acted swiftly and appointed Ko Chuan Aun, executive director of KOP Limited, along with Low Beng Ting, executive director of OEL Holdings to the board as independent directors.

Digging deeper into the matter

In the days following the resignations of Sitoh and Dr Wan, Lian Beng came under intense scrutiny. The SGX queried the company twice over a period of three days, asking for more information related to the sudden resignations. It emerged that the resignations were due to a difference in opinion over the computation of bonuses received by the group's executive directors.

In its first query on 13 July, 2015, the SGX requested for the group to elaborate on how differences in opinion had resulted in the cessations of the two former independent directors.[15] In response, the group replied that the two former independent directors were of the opinion that the performance bonus provision for executive directors for the financial year ended 31 May 2014 (FY2014) should have been computed based on group profit before taxation and after minority interest. Minority interests, or non-controlling interests, is the share of ownership in a subsidiary's equity that is not owned or controlled by the parent company.

The independent directors had requested for the re-computation of the executive directors' performance bonus starting from 1999 when the company was listed, based on "after minority interest" basis. The adjustments were to be made to the remuneration of the executive directors accordingly. However, Ong and his sisters had insisted that the performance bonus should be calculated based on a "before minority interest" basis, given that the company had consistently relied on this basis for the computation of their performance bonuses. Ong further argued that this arrangement was appropriate as it was consistent with what was laid out in the service agreement put in place between the company and the two executive directors (Ong and Tan Swee Hong) at the time of the group's listing in 1999, which was later extended to Ong's two sisters in 2009.

Performance bonus: Before or after minority interest?

Dissatisfied with the response, the SGX sought further clarification on the matter in a second query two days later. IIn this second query, SGX asked for, among other matters, the quantification of the difference in amount of performance bonus payable to the executive directors for FY2013 and FY2014 based on the "before minority interest" basis and on an "after the deduction of minority interest" basis, as well as whether it was fair for the performance bonus to be calculated based on the company's profits "before minority interest".

The company's responded to this second query by reiterating that this basis had been consistently relied upon since the service agreements had been signed in 1999. It also stated that since the management had contributed the same efforts in managing partially owned subsidiaries compared to wholly-owned subsidiaries, it was fair and equitable for the basis of their compensation to include minority interest.[16]

In FY2014, Ong Pang Aik was paid between $5.25 million and $5.5 million, with bonus and profit sharing making up 86% of his total remuneration. Ong Lay Huan received between $2.75 million and $3 million, with bonus and profit sharing of 83% of her total remuneration. Ong Lay Koon was paid between $2 million and $2.25 million, with bonus and profit sharing accounting for 80% of the total remuneration. Three other Ong siblings are key executives in the group, with one being paid between $500,000 to $750,000 and two others being paid between $250,000 to $500,000 each. In addition, two of Ong Pang Aik's children are employees of the group and were reported to be paid more than $50,000 each. The company cited market competititon, information sensitivity and confidentiality as reasons for not providing more detailed remuneration information.

With an increase in the minority interest to S$39.9 million, compared with S$18.6 million in the previous year, computing the performance bonuses before minority interest meant that the bonuses for the three Ongs were calculated based on a profit of S$127 million, instead of S$87 million.[17] Had the total performance bonus been calculated based on the "after minority interest" basis instead, there would have been a difference of more than S$2,000,000 in the total performance bonuses paid out to the executive directors in FY2014, up from a difference of just S$64,000 in FY2013.

In an interview with The Straits Times, the former independent directors expressed their willingness to cooperate with the SGX and to disclose information pertaining to the case, stating that they "intend to meet the SGX to provide a full account of what happened".[18] Even though the company was forthcoming in answering the queries, investor confidence in the company was noticeably shaken by the negative publicity generated in the days following the queries. Lian Beng's share price fell by 0.93% to S$0.535 and 2.78% to S$0.525 on 16 and 17 July, 2015 respectively.

The aftermath

The debate among experts raged on after the SGX queries. Among the contributors to the discussion were pay consultants Freshwater Advisers, who highlighted that the "before minority interest" basis, used to calculate the bonuses of Lian Beng's executive directors, was a common industry standard. They argued that Singapore-listed companies typically worked out bonuses for directors using a profit-based formula that did not remove the minority interest component. This was because "minority interests is usually an insignificant item in most accounts".[19] However, in Lian Beng's case, minority interests was a material amount, having doubled from FY2013 to FY2014.

Dr Wan, following the termination of his directorship at Lian Beng, commented that the computation method had not been fair and should have been based on *"what is earned in this company"*.[20] Jon Robinson, Managing Director of Freshwater Advisors, added that using a profit-based formula to compute bonuses was not the best from a corporate governance perspective, and that bonus agreements should change according to the business model of the firm. He also pointed out that the remuneration committee should decide each year or every three years on what the appropriate reward for the directors was, and regularly review bonus arrangements in service contracts regardless of industry norms or company norms at the time when the contracts were signed.[21]

Dr Mak Yuen Teen, Associate Professor of Accounting and former Vice-Dean (Finance and Administration) at the National University of Singapore Business School, added his views on the issue.[22] He argued that in principle, not taking minority interest into account was problematic because the executive directors should be rewarded for profits attributable to shareholders of the group and not to minority interest outside of the group. He also stressed the importance of having clear definitions in service agreements, employment contracts and bonus plans, and concurred with the need to review them periodically and update them if necessary.

Even as the debates slowly subsided, many questions still remained unanswered. Why did the disagreement over the computation of bonuses only surface when the independent directors have been on the board for 16 years? Were the directors negligent in not raising the issue earlier? Did the matter go unnoticed simply because minority interests remained a relatively insignificant until the most recent year?

Troubling times ahead

After the scandal died down, many investors were displeased with the sluggish performance of Lian Beng's shares. At its Annual General Meeting (AGM) in September 2015, this issue was brought up by concerned shareholders, who clamoured for a response by the company in the form of increased dividend payouts or share repurchases. In response, the Ong family stated that while the company did not have a dividend pay-out policy, the amount of dividends it paid out is generally in line with the company's performance. In addition, it was mentioned that the company had been actively repurchasing shares since October 2014, right after the share price started to fall. Indeed, the company had repurchased more than 25 million shares since then.[23] However, it was unclear whether the share repurchases were a direct consequence of the company's falling share price.

With the conclusion of the AGM and the scandal, it was apparent to Ong that he would have a lot on his plate to deal with in the following year. Slouching back into his chair, Ong could not help but wonder how the future would pan out for the business he spent his entire life building. How would the group fare in the upcoming year? What would be the long-term impact of the recent controversy on the company? Perhaps most importantly, how would the group be able to sustain its growth? These were indeed trying times for Ong and his empire.

Discussion questions

1. Examine the size and composition of the Lian Beng board. To what extent has the company complied with the code of corporate governance in Singapore?

2. What are the potential conflicting interests present in Lian Beng's board? Discuss the difficulty that independent directors may face in light of the current board composition.

3. Discuss the role of independent directors in the review and approval of remuneration policy and packages. Explain whether the independent directors had discharged their duty from the time they were appointed to the time of their resignation from the board.

4. Is it equitable to shareholders that bonuses are awarded to management based on group profits that include non-controlling interests? Discuss some best practices firms can adopt in formulating remuneration practices.

5. What are the key issues with the service agreement and the remuneration packages received by each director?

6. Comment on the disclosure of remuneration by the company. What are the risks to minority shareholders from the remuneration practices of the company?

7. Based on this case, comment on some of the key corporate governance challenges in family companies.

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NOBEL DESIGN: THE FOUNDER STRIKES BACK

Case overview

The discovery of Studio 216, a furniture retailer incorporated in Kuala Lumpur, led to the unearthing of several corporate governance and management issues plaguing Nobel Design Holdings Ltd ("Nobel"), including allegations of breach of fiduciary duties by Nobel's founder and its former Chairman, Choong Chee Peng Bert ("Choong"). This led to a bitter feud between the firm's current Board of Directors and Choong. The objective of this case is to allow a discussion of issues such as the duties and responsibilities of directors; conflict of interest; role and competencies of the Audit Committee (AC); accounting treatment for interest in other businesses; and responsible shareholder activism.

The birth of Nobel Design Holdings

Incorporated in 1982, Nobel Design Holdings Ltd ("Nobel") was founded by Choong Chee Peng Bert ("Choong") and Wee Ai Quey ("Wee"). Despite humble beginnings, the company had great ambition and aimed to be a trendsetter in lifestyle furnishing.

This is the abridged version of a case prepared by Chan Siong Woon, Lim Yi Xiu, Shannon Chan, Gan Jia Hui and Toh Xiu Han under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Chua Chloe under the supervision of Professor Mak Yuen Teen.

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Nobel flourished despite the tough competitive environment in the furniture industry.[1] It quickly grew to become the exclusive distributor for fine imported European home furnishings brands, and even began designing its own house-label furniture. Nobel was able to achieve strong growth by strategically looking beyond Singapore and expanding its business internationally.

The founding father

As the founder, Choong was primarily responsible for the growth and development of Nobel until its listing in 1996. Choong held the role of Chief Executive Officer (CEO) of Nobel upon its listing, and continued to provide leadership, vision and guidance to the Board and overall operations of the group. Aside from his appointment as CEO, Choong sat on the Board and served as the Executive Chairman.

In March 2010, Choong stepped down from his role as CEO after having served for 14 years. Terence Goon ("Goon"), personally groomed for the role by Choong, became the new CEO and Managing Director, while Choong remained as the Group Executive Chairman.[2]

In 2013, the Board claimed that Choong's business strategies had resulted in significant losses, and that his track record in managing the company was "unsatisfactory". Facing pressure from the Board to step down, and coupled with the lapse of his contract on 30 April, 2013, Choong relinquished his position as Chairman and remained on the board as a non-independent non-executive director.[3] Adrian Chan ("Chan") was appointed as the new independent Chairman.[4] Chan is a senior partner in the law firm Lee & Lee, was first Vice-Chairman of the Singapore Institute of Directors and serves on the boards of five other companies listed on the Singapore Exchange (SGX). Chan chairs the Nominating Committee (NC) of Nobel and is a member of its Audit Committee (AC) and Remuneration Committee (RC).

Board of Directors

The Singapore Code of Corporate Governance 2012 recommends that the board size be determined based on what is appropriate for the scope and nature of the company's operations – it should not be so large as to be unwieldly, and yet should be large enough to facilitate effective decision making and to avoid undue disruption when there are changes in board composition. Independent directors should make up at least a third of the Board, and any director who has served more than nine years should be subject to particularly rigorous review. Additionally, board members should collectively provide a diversity of skills, experience, and gender, alongside core competencies such as accounting or finance, business or management experience, industry knowledge, strategic planning experience and customer-based experience or knowledge.

As at December 2014, Nobel's Board had nine directors. In addition to Chan, Choong and Goon, there were two other executive directors, three other independent directors and another non-independent non-executive director.[5] The two other executive directors were Wee Ai Quey, the Chief Operating Officer, and Ong Cui Hwa, who was responsible for the financial reporting and accounting function, taxation, banking, and administration matters.

The other three independent directors were Dr Teh Ban Lian ("Teh"), Heng Chye Yam ("Heng") and Wong Soon Chiu ("Wong"). Teh, who joined the Board in June 2005, has a background in property and retail, and had held an executive director role in a retail company and served as independent director in another SGX-listed company. He was the Chairman of the AC and a member of the NC. Heng was the managing director of Metalwood Pte Ltd. and was appointed to the Board in April 2005. He was Chairman of the RC, and a member of the AC and Risk Management Committee (RMC). Wong is an accountant by training and a fellow member of the Association of Taxation and Management Accountants, Australia. He had joined the board as a non-independent non-executive director in January 2003 and was re-designated to an independent director in February 2014. Wong was Chairman of the RMC and a member of the AC. Chan Kum Leong, the other non-independent non-executive director, was the group financial controller of Lian Huat Group, a substantial shareholder of Nobel. He was a member of the RC and RMC.

The turmoil

The first sign of turmoil came with the discovery of a seemingly ordinary furniture retailer incorporated in Kuala Lumpur, Malaysia. Going by the name of Studio 216, the company's opening ceremony in February 2014 was a grand affair which attracted much publicity from many Malaysian lifestyle bloggers. The company pride itself on being a specialist furniture store that offered premium furniture from leading Italian brands.[6]

However, it was soon discovered that the sole shareholders and directors of Studio 216 were Pauline Wee and Leon Choong, the wife and son of Choong. Choong was alleged to have not disclosed this business of his immediate family members to the Board. Studio 216 sourced furniture from premium Italian furniture suppliers like Cierre and Porada, the latter of which was also the principal supplier to Nobel's subsidiary Marquis Furniture Gallery. This made Studio 216 a direct competitor to Nobel in Malaysia.

Furthermore, Leon Choong had previously been a showroom manager at Marquis, and had resigned back in 2014.[7] To Nobel's Board, a rival furniture retailer run by the immediate family members of Choong and supplied by the same premium suppliers used by Nobel was too much of a coincidence. The Board set out to investigate this issue.

The Board allegedly discovered that Choong had emailed Porada that he was "helping Marquis to set up a showroom in Kuala Lumpur".[8] This was done without any authorisation or knowledge from Nobel's Board. If the Board's investigations were accurate, it would imply that Choong had failed to disclose his interest and may have breached his fiduciary duties to Nobel by setting up a competing firm.

The Board then made several requests to Choong to clarify his involvement in Studio 216. According to the Board, Choong did not respond "satisfactorily to all the company's enquiries".[9]

In October 2014, the Board took the drastic step of issuing a public announcement on the SGX regarding Choong's potential breach of fiduciary duties.[10] The Board highlighted that it wanted clarification on the extent of Choong's involvement in the incorporation of Studio 216 and whether he had offered any financial assistance to Studio 216. The Board also wanted an explanation for Leon's resignation as the showroom manager of Marquis, and a statement as to whether this was related to the incorporation of Studio 216.[11]

It is uncommon in companies for Board members to turn against one another, and in Nobel's case, this was ostensibly done in a bid to protect the company's interests. This announcement did not have much impact on the company's share price as it was thinly traded.[12]

The fightback

Choong did not take the accusations lying down and fought back hard. On 18 February, 2015, he sued four Nobel directors for defamation: Non-Executive Chairman Adrian Chan, Independent Director Teh Ban Lian, Chief Operating Officer Wee Ai Quey and CEO and Group Managing Director, Terence Goon.[13]

Choong vehemently denied the Board's claim that he had helped his son set up Studio 216. According to him, it was the supplier Porada that had approached his son as they were looking for a partner to enter the Malaysian market. Despite this, Choong did not make any public clarification regarding the Board's allegations of his use of the company's email to misrepresent himself as acting on behalf of Nobel's subsidiary.

Choong further protested his innocence by publicly declaring that he had harboured "no sinister intention to set up a competing business in Malaysia against the interest of the company". Moreover, Choong mentioned that "(Nobel) did not even have an equivalent furniture retail business in Malaysia."[14]

Choong sought to turn the tables on his accusers. He criticised the board for failing to disclose the defamation suit in a timely manner, which he called "an instance of corporate governance lapse".[15]

With the other directors now under public scrutiny from this legal tussle, Nobel was quick to issue a second SGX announcement with clarifications on its previous announcement and its stance on the counter lawsuit. The directors stood their ground, stating that they "individually and collectively, are of the view that Choong's claims are baseless and wholly without merit".[16] Nobel also responded that the defamation lawsuit was "made primarily to the directors and the company is not part of this lawsuit".[17]

Just the tip of the iceberg

The internal tussle was not the end of Nobel's troubles. While the animosity between the Board and its founding member continued to brew, additional discord was sown between Nobel and its shareholders in the upcoming AGM.

With earnings per share of S$0.11216 for FY2014, some shareholders were dissatisfied with a dividend pay-out of S$0.0065 per share - less than six percent of earnings. Despite announcing a 10.84% increase in cash and cash equivalents, Nobel increased its final dividend by only 8.3% in the period, from S$0.006 to S$0.0065. Shareholder activist Mano Sabnani cried foul about the dividend payment, claiming that the company was "doing its shareholders a disservice".[18]

Nobel's accounting also came under scrutiny. Shareholders and financial specialists, Matthew Fleming, who has a background in financial forensics and was a partner at financial services firm KordaMentha, and Mick Aw, senior partner at accounting firm Moore Stephens LLP, pointed out inconsistencies in Noble's asset and liabilities reporting in the FY2014 Financial Statements which they argued potentially amounted to a breach of FRS 111, a newly modified standard on joint operations and joint ventures released in 2012.[19] This revised standard became effective for annual periods beginning on or after 2014.

The accounting issue revolves around how Nobel accounted for its interests in business and operations for material entities under the group. Under the standard, such joint arrangements could be classified as either (i) joint operations or (ii) joint ventures, depending on the entity's judgment of the rights and obligations that arise from the arrangement. In a joint operation, parties in joint control of the arrangement have rights to the assets and obligations for the liabilities relating to the arrangement. In a joint venture, parties in joint control have rights to the net assets of the arrangement.[20]

Joint operations are to be recognised and measured at the assets and liabilities (and the related revenues and expenses) in relation to their interest in the arrangement in accordance with the relevant financial reporting standards applicable to the particular assets, liabilities, revenues and expenses at the consolidated and separate financial statements level. Joint ventures are to be recorded using the equity accounting method in the Group's consolidated financial statements, and as an investment at cost or fair value according to FRS 39 in the separate financial statements.[21]

Nobel had classified the joint arrangements as joint operations.[22] It was argued by Fleming and Aw that the difference in accounting treatment could result in the accounts being off by more than S$100 million.[23]

Choong sided with the shareholders and encouraged more shareholders to attend the upcoming AGM "to seek clarifications on dividend policies, director fees, and the Board's efforts to improve transparency on reporting and governance".[24] Choong had hoped that the unhappiness towards Nobel would ultimately help him gain the "support of shareholders to be re-elected as Nobel's non-executive director".[25]

The Board's defence

Shareholders attended the Annual General Meeting (AGM) held on 28 April, 2015, determined to get answers.

Nobel attempted to explain their stance. Goon justified the low dividend payout by arguing that it was important to take a long-term view and stating that "a strong balance sheet" was crucial for their plans to take on new development projects.[26] Regarding the accounting discrepancies, the Board of Directors stood by the financial statements and directors' report, claiming that the issue had simply been "due to differences in interpretation".[27] After a gruelling five-hour debate, the AGM finally ended with most of the resolutions and the FY2014 Financial Statements passed.

The only resolution not passed during the AGM was for Choong's re-election as a non-executive director, which only received a 31.22% backing from shareholders.[28] Choong claimed to be unsurprised at the outcome, attributing it to the support the Board received from substantial shareholder Patrick Kho, who held a combined 25.33% stake with his brother, Kho Choon Keng.[29]

The Board responds

Following the heated arguments at the five hour-long AGM, Nobel felt it necessary to take extra measures to appease the agitated shareholders and tackle the issues raised.

In May 2015, Nobel announced the delay of the FY2015 Q1 unaudited results release. The company decided to engage PricewaterhouseCoopers (PwC) as an independent special adviser to re-examine the issues and advise the Board on their financial statements.[30]

Ultimately, Nobel chose to change the accounting treatment in their financial statements. In the revised financial statements, joint arrangements were reclassified as joint ventures (from joint operations). On the advice of PwC, it also decided to revise the FY2014 Financial Statements in May 2015 by reclassifying S$8.09 million in relation to loans to an associated company as "cash flows from investing activities" (from "cash flows from operating activities"). According to Nobel, "this reclassification has no impact on the net cash flows of the group".[31]

The EGM

"We are trying our best to make sure the business is done properly. We can't stop someone from throwing stones at us." – Adrian Chan, Chairman[32]

An extraordinary general meeting was called on September 7, 2015 to tie up loose ends and to consider the audited revised FY2014 Financial Statements.

For the second time that year, the Board was faced with an onslaught of questions and displeasure from shareholders. Many shareholders were reportedly unimpressed with the explanations provided for the financial statement changes, calling the exercise a "waste of shareholders' money and an embarrassment".[33] While the Board Chairman declined to comment on whether an accounting error had been made – emphasising instead that "accounting issues were a matter of judgment" – it was reported that "a number of shareholders and proxies attending the meeting saw the revision as proof that the original statements were inaccurate".[34]

Aggravated by the accounting issues and the change in interpretation of the accounting standards, shareholders raised questions as to who should ultimately be held responsible for the discrepancy in financial reporting. The spotlight turned on the AC, headed by Dr Teh Ban Lian. Shareholders questioned the Committee's competence, with some suggesting the removal of Teh from his post.[35]

Choong was once again a vocal participant in the heated exchanges. During the meeting, he accused the Board of poor corporate governance.

At the end of the EGM, Choong, who held about 25% of shares in the company, threatened to call for more EGMs to sway shareholders towards a vote of no confidence against the Board. The founder saw no possible compromise between himself and the Board and declared an ultimatum.[36]

"I have to protect my rights. And if I don't take the stand, what will happen to the smaller shareholders? This is a house which I own 25 per cent, and we can't stay together. Either they go, or I go." – Choong, founder and former CEO[37]

Amidst the ruckus raised by his predecessor, Chairman Chan remained unfazed. He claimed that Nobel's Board was "quite confident" of support from the broader base of shareholders.[38]

A game of scrabble?

During the EGM, a resolution was also passed to change its external auditor from Nexia TS to Ernst & Young, despite an earlier approved resolution in the April AGM to reappoint Nexia TS as the external auditor.[39]

Additionally, Teh would be replaced by Wong as AC Chairman. In turn, Teh would assume Wong's role as RMC Chairman.[40]

A flourishing past and an uncertain future

After over three decades of success and impressive growth, Nobel faced one of its toughest challenges due to the bitter feud and discontentment of some of its shareholders.

The end of the saga is not yet in sight, with some critics predicting a possible buyout of Choong's shares in future to resolve the conflict. It is also not clear if shareholders will be appeased by the remedial actions taken by the company and if Nobel would be able to regain the confidence and support from the shareholders.

Discussion questions

1. Were Bert Choong's actions justifiable? Discuss his actions in terms of his fiduciary duties, as well as his actions in response to being sued by the Board for a breach of fiduciary duties.

2. Who are responsible for ensuring the accuracy of financial statements? Comment on the role of management, the AC, the Board and the external auditors.

3. Evaluate the company's communications with stakeholders following the discovery of the financial statement discrepancy. Do you believe that the Board's response was adequate?

4. What were the remedial actions Nobel took in response to this crisis? Do you think they are sufficient? What other actions do you recommend?

5. Evaluate the composition of the Board and the AC. Do you think it could have contributed to the issues faced by the company? What improvements to the corporate governance of Nobel would you recommend?

6. There has been a rise in shareholder activism. Explain the goals of shareholder activism. How effective were shareholder activists in ensuring that Nobel complied with strict regulatory and corporate governance guidelines? How can a company guard itself against these shareholder activists? In the case of Nobel, do you think that the shareholder activists were acting responsibly?

7. Explain whether you agree with Nobel Board chairman's statement that "accounting issues were a matter of judgment". Do you think that an accounting error had been made (intentionally or otherwise) in Nobel's case? For joint arrangements, explain how a company should determine the appropriate accounting treatment. Are there any reasons why Nobel might be motivated to classify its joint arrangements as joint operations instead of joint ventures initially?

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HIT BY ICEBERG: NOBLE GROUP

Case overview

In 2015, financial research firm Iceberg Research ("Iceberg") released three reports highlighting alleged accounting malpractices and governance deficiencies in the Noble Group ("Noble"). The reports included accusations of an abnormal size and rate of growth in the fair values of Noble's unrealised mark-to-market commodity contracts and the company's governance. Iceberg also questioned the credibility of Noble's auditor Ernst & Young (EY), and whether Noble's board of directors was truly independent. Noble defended itself by questioning Iceberg's motives in choosing to publish its report just before the release of Noble's financial results, without any prior notification. It then claimed that the mastermind behind the reports was a former employee of Noble who had a grudge against Noble for terminating his employment. The objective of the case is to discuss the role of the board and its effectiveness in monitoring management; board structure; role of external auditors; and accounting issues relating to fair value accounting and investments in associates.

This is the abridged version of a case prepared by Ang Yi Hern, Koh Wen Xin Clara, Kow Yi Wu Wesley, Lam Wen Yan Jane and Ong Su Min Shermane under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

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Humble rise to nobility

Noble Group manages global supply chains in diverse sectors, from commodities trading in metals, to raw materials for energy production such as coal, oil and gas.[1] Founded by Richard Elman in 1987 with US$100,000 of his personal savings,[2,3] Noble had achieved remarkable success since its humble beginnings, securing a ranking of 77th in the 2015 Fortune Global 500 under Elman's leadership.[4] While Noble's headquarters are located in Hong Kong, it was incorporated in Bermuda with a listing on the Singapore Exchange (SGX) in 1997.[5] In the company's 2014 annual report, Noble claimed to be committed to maintaining a high standard of corporate governance in order to protect the interests of its shareholders.[6]

The iceberg hits

On 15 February, 2015, just before Noble's release of its 2014 financial results, financial research firm Iceberg Research ("Iceberg") released a scathing report questioning Noble's accounting practices via an anonymous blog post, alleging that Noble's classification of its associates hid huge impairments and exaggerated the valuation of its associates to create the illusion of profit.[7] In the report, Noble's valuation of its associates – most notably Yancoal, which was valued at US$603 million above its book value – was brought into question. Despite owning only 13.2% of the shares in Yancoal, Noble had classified Yancoal as an associate, justifying that the provision of "essential technical information to Yancoal", its position as "the second largest shareholder with its own representative on the board of directors", and having "material transactions with Yancoal" equated to having significant influence over it.[8] Iceberg contested Noble's claims of having significant influence over its associates, suggesting that Noble had exploited the accounting treatment for associates to avoid huge impairments. Similarly, Iceberg questioned the reclassification of PT Atlas as an associate and the recognition of a "re-measurement gain on the pre-existing interest of US$25.5 million" resulting from that reclassification.[9] The recovery of Noble Agri was also deemed by Iceberg to be "manufactured" through questionable depreciation cuts and subsidies, and it was alleged that these associates resulted in cash drains from Noble due to a need for recapitalisation.[10]

In an SGX announcement, Noble responded to Iceberg's comments, citing its adherence to financial reporting standards and the clean bill given by its auditors.[11] Noble then cast doubt on Iceberg's intent and credibility for choosing to release the report anonymously without giving prior notification to Noble's management. In its rebuttal, Iceberg maintained its stance and continued to press for answers.[12]

Iceberg followed up with the release of a second report, which focused on what it said was the extraordinarily large size and growth rate of Noble's mark-to-market (MTM) valuations, highlighting the inherent risk of manipulation of these fair values due to the wide discretion given to the company in determining the valuation inputs and methods.[13] Noble's MTM valuations had grown tremendously over the years, reaching a value of US$3.8 billion in the third quarter of 2014, making up 68% of its equity. Noble's MTM valuations were also much larger than its competitors.[14] Although Noble's competitor Glencore had an equity value 10 times larger than Noble's, Noble's fair values were almost five times that of Glencore.[15] Iceberg further criticised Noble's auditor, Ernst & Young (EY), for its complicity in giving Noble's management the autonomy to judge the validity and appropriateness of its valuation inputs. Pointing out the large divide between Noble's poor operating cash flows and its reported profitability, Iceberg concluded that Noble was caught in a vicious cycle of having to "print more and more" MTM valuations in order to generate returns for its shareholders.[16] In its report, Iceberg concluded that there would be "no miraculous recovery" given that Noble's fair values were "largely fabricated", with Noble being unable to realise most of the MTM values.[17]

Although Noble was scheduled to release its 2014 financial results the day after Iceberg's second report, EY abruptly called for "more time to review their own internal processes in the light of the third party allegations before signing off on the accounts".[18] Noble had made the decision to impair the valuation of its share in Yancoal but insisted that the decision was not due to Iceberg's allegations. In its rebuttal to Iceberg, Noble went on the offensive, alleging that a former disgruntled employee was the mastermind behind Iceberg's accusations and that the group was in the process of taking legal action against Iceberg.[19]

Not letting up, Iceberg then released a third report on Noble, bringing shareholders' attention to Noble's understatement of debt and key governance issues within the company.[20]

Board of Directors

In 2014, Noble's board of directors consisted of 13 members, eight of whom were non-executive directors considered to be independent by Noble. The executive directors consisted of the founder and chairman, Richard Samuel Elman; the CEO, Yusuf Alireza; and president William James Randal. Among its independent directors, Iain Ferguson Bruce, Alan Howard Smith, Robert Chan Tze Leung and Burton Levin have served as independent directors for extended period of time – 13 years for Bruce and Smith, and 19 years for Chan and Levin.[21]

The remuneration policy of its independent directors has been further challenged by critics. A number of independent directors on Noble's board were given a large amount of shares and share options as part of their remuneration. As the remuneration of these independent directors was tied to the company's performance, Iceberg argued that there would be little incentive for the board of directors to go against or to question management's decisions.[22]

In an article for The Business Times, Associate Professor Mak Yuen Teen of the National University of Singapore reiterated Iceberg's concerns over the independence of Noble's non-executive directors, many of whom had exceeded the tenure of nine years as specified in Singapore's Code of Corporate Governance 2012. Professor Mak commented on the lack of diversity in the experience and expertise of the company's directors given its relatively large board size – none of the directors had any experience in the trading of commodities, with most having a background in banking. He raised concerns over the board's knowledge and capacity to question strategies proposed by Noble's management. He also pointed out that the involvement of executive chairman Elman in the audit, remuneration and nominating committees resulted in an outsized influence on the corporate governance of Noble. He further noted that geographical diversity seemed to be lacking on the board, with most directors being based in Hong Kong despite Noble's international operations and its listing in Singapore, with no Singapore-based director on its board. Additionally, Professor Mak was of the the opinion that Noble could do with some younger directors on its board, as the experience and competencies of younger directors might be more relevant to the current business environment faced by Noble. Professor Mak concluded that the "stakeholders of Noble should not expect the board to be an independent and effective monitor of management."[23]

The auditor's role

EY (Hong Kong) had been Noble's auditor for more than two decades. Iceberg suggested that EY was aware of Noble exploiting loopholes in accounting standards to portray an unrealistic picture of its financial status without contravening any rules that would result in legal implications. With regards to the inputs and valuation models used to estimate the fair values of Noble's unrealised contracts, Iceberg alleged that EY took a passive stance, placing the responsibility on Noble's management to use their judgement to determine the reasonableness and appropriateness of the inputs. In particular, EY allowed Noble's management to determine how fair values were categorised based on its own internal assessment of the inputs used in the valuation.[24] Investors depended on the assurance given by EY that the financial statements prepared by Noble's management were reliable. Moreover, Noble's credit rating was based on information reported in the financial statements.

Noble responded to the allegations of its valuation methods by setting up an independent board committee consisting of existing members of its audit committee, and appointing another accounting firm, PricewaterhouseCoopers (PwC), to investigate the appropriateness of its valuation methods in estimating its MTM. PwC's verdict was that the valuation methods used by Noble were consistent with industry practices and accounting standards. It noted that in comparison with other firms in the industry, Noble had a "more sophisticated" approach towards its fair value estimation, with a "strong segregation of duties between the different teams that provide key inputs".[25] In its report, PwC also advised Noble to provide greater transparency regarding MTM movements from one time period to the next, and to strengthen its overall corporate governance and oversight.[26]

Iceberg was quick to dismiss PwC's report, stating that the report had failed to address the shareholders' primary concern regarding the true value of the MTM contracts, and instead merely confirmed that Noble's valuation assumptions and methods were in line with the financial reporting standards.[27]

Other governance issues

In its third and final report released on August 12, 2015, Iceberg noted the absence of negative assurance confirmations on Noble's website and the departure of key shareholders. Major shareholders, most notably the Chinese Sovereign Fund and CIC, had divested their shares. Additionally, Noble's co-founder, Harry Banga, had sold all his shares in the company.[28]

Several key executives had also left the company, including the CFO of Noble's Hard Commodities division, Andy Cornfield. The position of chief risk officer had also been re-filled several times over the past three years, which Iceberg highlighted as a red flag.[29]

Chorus of criticism

Following Iceberg's reports, other critics joined in the call for Noble to provide greater transparency in its accounting policies, especially regarding its MTM valuations. Muddy Waters Research released its own report on Noble on 9 April, 2015, raising the same issues brought to light by Iceberg regarding the recording of MTM values, with a particular focus on the purchase and subsequent sale of PT Alhasanie.[30] Muddy Waters alleged that the transactions between the parties involved – namely Noble, PT Dayana, PT Atlas – served only to allow Noble to generate substance-less accounting profits and to mask the transactions.

Michael Dee, former CEO of Morgan Stanley Southeast Asia and previous Senior Managing Director of Temasek Holdings wrote an open letter specifically addressed to Noble's employees.[31] Dee appealed to employees to ensure that "Noble straightens itself out" given that they had a "much greater personal stake". In his letter, he implored Noble to stop pursuing legal action against Iceberg and instead commit its efforts to clarifying the issues brought up. More specifically, Noble should focus on its justification for their valuation of Yancoal at a figure 30 times greater than its purchase price and answer if its inventory sales to banks were in fact repos. Dee then went on to advise Noble to change its auditors, noting the penalties imposed on EY for their role as the auditor of Lehman Brothers and its collapse. He also called for Noble to be more transparent about its senior executives' remuneration policies. Dee left Noble's employees with a warning to take the red flags raised by Iceberg and other critics seriously, especially if Iceberg's accusations had been made by a former employee.

Drastic, 'Noble' changes

In the wake of the accusations, Elman stepped down as a member of the audit committee and the nominating committee.[32] On 3 October, 2015, three senior executives – Ellen Chon, Brian Falik and Stephen Brown – left the company.[33]

As a result of the upheaval over Noble's questionable accounting practices, and amid a commodity rout, the three major credit rating agencies – Standard & Poor's, Moody's Investors Service and Fitch Group – downgraded its debt to junk status.[34] This has led to Noble experiencing great difficulty in raising funds. Standard & Poor's cited the company's need to refinance US$3 billion of credit lines in the coming year as a reason for downgrading Noble's credit rating.[35] In response, Noble revealed a deeply discounted rights issue to raise US$500 million from its shareholders on 3 June, 2016[36], and announced plans to sell one of its remaining crown jewels, Noble Americas Energy Solutions[37], in an effort to reduce its debt and free up capital for its trading operations.[38]

On 30 May, 2016, Noble's CEO Alireza announced his resignation for "family reasons"[39]. The CEO's role was jointly taken over by William Randall and Jeff Frase, who both held senior roles in the company.[40] Randall was president and an executive director at Noble[41], while Frase, previously head oil trader at Goldman Sachs and JP Morgan, played a crucial role in expanding the company's liquids trading operation.[42] In relation to the change in top management, Iceberg commented that it was "long overdue".[43]

In the same week, on 3 June, 2016, Noble announced that its founder, Elman, would step down as executive chairman by the following year.[44] Additionally, the beleaguered company also stated changes to be made to its corporate governance, including having a non-executive chairman, and an addition of an independent non-executive director with a backgound in international commodities and futures trading to its board of directors.[45] A sub-committee, chaired by David Eldon, would be set up by Noble's board to identify the company's next non-executive chairman.[46] The Singapore-listed company's shares fell 13% to S$0.26[47], the lowest in the past 13 years[48]. Within a span of five years, Noble's market capitalisation has fallen from more than S$10 billion to S$2 billion.[49] On 6 June, 2016, yet another executive, Gareth Griffiths, Noble's global head of gas and power trading, left the company; this was purportedly in line with the company's plans to simplify its organisational structure.[50]

Noble's plan to raise US$500 million in a fully underwritten one-for-one rights issue received an overwhelming backing from its shareholders at a special general meeting held on 24 June, 2016.[51] The issue price of S$0.11 per rights share represents a discount of approximately 63.3% to the closing price of S$0.30 per share on SGX just three weeks earlier on 2 June, 2016 – a day prior to the rights issue announcement.[52] On 28 June, 2016, Noble shares fell by a further 24.7% to S$0.16 after its stock started trading ex-rights on SGX. Through the one-for-one rights issue, Noble managed to raise US$528.25 million.[53]

While Noble seems to be increasing transparency and taking active steps to improve its corporate governance and financing structures in light of the series of events, it remains to be seen whether the group will survive.

Discussion questions

1. Discuss the accounting issues relating to Noble raised by Iceberg. Do you agree that there are concerns with Noble's accounting? Do you agree with the classification of Yancoal as an associate? How does the classification affect the accounting treatment?

2. Discuss whether Noble's auditor, Ernst & Young, had fulfilled its role as an external auditor adequately. To what extent should an external auditor be involved in or be responsible for a company's use of estimates and assumptions in determining mark-to-market values?

3. Do you feel that mere compliance with current accounting standards in its financial statements is sufficient to provide a true and fair view of a company's financials? Examine the ethical considerations of Noble's accounting practices, bearing in mind the unqualified opinion which EY had given it.

4. Iceberg criticised EY for being Noble's auditor for a long period of time. Would the adoption of mandatory audit firm rotation help to make audit reports more reliable? Explain.

5. In your opinion, were Noble's questionable accounting practices related to the quality of corporate governance of the company? Suggest ways to improve Noble's corporate governance, focusing in particular on board independence and board structure.

6. Would greater public oversight and a more active regulator ensure sufficient transparency and efficiency of Singapore's capital markets? What roles would you suggest that MAS and SGX play in the larger framework of regulation?

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THE SINKING OF OW BUNKER

Case overview

After a successful Initial Public Offering (IPO) in March 2014, OW Bunker, a Danish shipping giant, filed for bankruptcy just seven months later due to risk management failures and alleged fraud committed in a Singapore-based subsidiary, Dynamic Oil Trading (Singapore) Pte Ltd (DOT). Profits were booked where losses were incurred under the unique trading relationship between DOT and its primary client, Tankoil Marine Services (Tankoil), which accounted for the bulk of DOT's revenues. Due to reliance on misleading and omitted information in the IPO Prospectus, investors suffered huge losses. The objective of this case is to allow for discussion of issues such as director duties in company groups; subsidiary governance; non-compliance of subsidiaries with group policies; the role of the board in risk management; and disclosure and transparency.

This is the abridged version of a case prepared by Chua Yun Xin, Joanne, Sheryl Ann Tan Yi-Shi, Tan Xiu Wen Alicia and Vivian Tai Huan Fen under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Toh Jia Yun under the supervision of Professor Mak Yuen Teen.

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Scraping the bottom of the barrel

Founded in 1980 in Aalborg, Denmark, the OW Bunker Group became one of the world's leading traders in bunker oil, controlling an estimated seven percent of the global bunker trade.[1] By 2013, the company boasted revenue of US$17 billion, landing itself a position as Denmark's largest listed company by revenue after its IPO in 2014.[2]

The company supplied bunker fuel through two distribution models: physical distribution and reselling. Physical distribution involves the company performing the main stages of the fuel value chain such as sourcing for bunker fuel. On the other hand, under the reselling model, bunker fuel and physical delivery services are purchased from a third-party supplier. As such, OW Bunker did not directly control its inventories and supply ships, and faced main risks such as credit and oil price risks.

A fleeting moment of success

In March 2014, the company went public with an IPO on the NASDAQ OMX Copenhagen Exchange. Within the first day of trading, OW Bunker's shares surged as much as 19%, valuing the company at US$980 million.[3]

However, the success of its IPO was short-lived. Falling oil prices triggered a profit warning and the company announced a loss of US$22 million on 7 October, 2014. This loss was largely attributed to the mark-to-market valuation of the company's derivative contracts that were used to hedge its commercial inventories. On 23 October, 2014, the company further restated the loss to US$24.5 million, citing reasons such as sliding oil prices and additional downside protection for the restatement. OW Bunker's shares then fell by more than 40%.

On 5 November, 2014, NASDAQ OMX Copenhagen announced a halt on the trading of OW Bunker's shares.[4] On the same day, OW Bunker restated its loss from the previously announced US$24.5 million to US$150 million, attributing it to a review of its risk management contracts. Additionally, the company made an announcement relating to an alleged fraud committed by senior employees in its Singapore-based subsidiary, DOT, with the potential loss estimated at US$125 million. OW Bunker eventually filed for bankruptcy on 7 November, 2014.

Harbouring a secret

Central to the collapse of OW Bunker was its Singapore-based subsidiary, DOT. DOT was incorporated on 24 August, 2012 and reported revenue of US$2.1 billion in 2013, which accounted for approximately 11% of the total group revenue of US$17 billion.

Despite its relative importance in the group, DOT was rarely publicly discussed. DOT was never mentioned in OW Bunker's final IPO Prospectus. In addition, CEO Jim Pedersen had not once mentioned DOT during "the more than 100 meetings with investors and analysts ahead of the IPO".[5] The only mention of DOT was alongside other Singapore-based subsidiaries such as OW Bunker Far East (OBFE), under the list of subsidiaries found in the notes of OW Bunker's 2013 Annual Report.[6]

Altor Fund II (Altor), OW Bunker's private equity backer, justified the omission of DOT with its treatment like a sales division, similar to other selling units in the Group, where it was not separately mentioned. However, Johnny Madsen of Dansk FI believed that DOT was omitted from the final Prospectus as its business substantially differed in risk and earnings from the rest of the Group.[7]

The Starboard - Steering the company in the right direction?

OW Bunker had a two-tier governance structure consisting of the Board of Directors and the Executive Management. The Executive Management was supported by a number of key employees. The two non-independent directors on the board, Søren Johansen and Petter Samlin, were from Altor, the majority shareholder of OW Bunker.[8] An independent director, Niels Henrik Jensen, was elected as the Chairman of the board in March, 2014, while the company was undergoing its IPO.[9]

Name	Position	Independence
Niels Henrik Jensen	Chairman	Independent
Søren Johansen	Deputy Chairman	Non-Independent
Tom Behrens-Sørensen	Member	Independent
Jakob Brogaard	Member	Independent
Kurt K. Larsen	Member	Independent
Petter Samlin	Member	Non-Independent

Figure 1: Board of Directors of OW Bunker (As at 31 December, 2013)[10]

Name	Position(s)
Jim Pedersen	Chief Executive Officer (CEO)
Morten Skou	Executive Vice President and Chief Finance Officer (CFO)*
Jane Dahl Christensen	Executive Vice President - Physical Distribution Head of Risk Management
Götz Lehsten	Executive Vice President - Reselling
**Kent Larsen was appointed as Chief Financial Officer and Executive Vice President on 7 October, 2014 to replace Morten Skou. Skou was subsequently appointed as Head of Strategic Development.*	

Figure 2. Key Management Personnel of OW Bunker (As at 31 December, 2013)[11]

There was no separate Remuneration Committee and Nomination Committee in OW Bunker. The reason given in OW Bunker's IPO Prospectus was that they believed such committees were irrelevant. It was further stated that the tasks of the committees could be efficiently handled by the entire Board of Directors due to the board size and seniority that each member possessed with respect to the Group. There was also no separate Audit Committee established. Instead, the Audit Committee included all board directors, with Johansen as Chairman.[12]

The Board of DOT

DOT was a wholly-owned subsidiary of OW Bunker. All four directors of DOT were employees of OW Bunker. Three of the directors were part of the parent company's management team. Lars Møller was a director and CEO of DOT.

DOT's directors as of 31 December, 2013 are shown below.

Name	Position	Independence	Other Related Roles
Lars Møller	Director	Non-Independent	Chief Executive Officer of DOT
Jim Pedersen	Director	Non-Independent	Chief Executive Officer of OW Bunker
Götz Lehsten	Director	Non-Independent	Executive Vice-President of Reselling of OW Bunker Director of OW Bunker Far East
Morten Skou	Director	Non-Independent	Chief Financial Officer of OW Bunker

Figure 3. Board of Directors of DOT as at 31 December, 2013[13]

Cracking the code - The end of the line

On 5 November, 2014, OW Bunker released a statement announcing suspected fraud in DOT. DOT's CEO, Møller and finance manager, Kimmie Goh had allegedly extended a credit line of US$125 million to Tankoil despite its poor credit worthiness. Subsequently, the credit was deemed unrecoverable, resulting in a massive loss for the DOT, crippling the Danish giant.[14]

On 20 November, 2014, Chairman of OW Bunker, Jensen said, "the unrecoverable credit granted by DOT to Tankoil … was never submitted to the board, let alone authorised by it".[15]

The following table shows the required approval for different amounts of credit with regards to DOT's customers as disclosed in a report prepared by OW Bunker's ad hoc trustee.[16]

Amount	Temporary Increases	Permanent Limits
Up to US$500,000	CEO (*)	CEO
Up to US$1,000,000 (Temporary Increases)	GCM or by the Group CFO - on its own (**)	–
Up to US$2,500,000 (Permanent Limits)	–	GCM or by the Group CFO - on its own (**)
Up to US$5,000,000	GCM or Group CFO (**) – Increases up to US$1,000,000 on its own – Increases above US$1,000,000 by 4 eyes	DOT Credit Committee (***)
Up to US$10,000,000	GCM or Group CFO (**) – Increases up to US$1,000,000 on its own – Increases above US$1,000,000 by 4 eyes	DOT Credit Committee & Group CEO
Above US$10,000,000	GCM or Group CFO by 4 eyes	DOT Credit Committee, Group CEO & Board

* Can approve 15% increase (up to a maximum of US$300,000) on top of an already approved credit limit up to US$5,000,000 (equivalent to a maximum of US$5,300,000)

** Credit delegation authority to staff members within Credit can be delegated by Group Credit Manager

*** DOT's credit committee consisted of Morten Skou, Lars Møller and the Group Credit Manager *(whose name was not released)*.

Figure 4. Credit Approval Authorities with regards to DOT's Customers[17]

Subsequent investigations by the ad hoc trustee of OW Bunker verified that the only ordinary credit facility that was available was Møller's facility for granting credit, which was limited to US$500,000. This limit was way below the credit line of US$125 million extended to Tankoil.[18]

The debt situation

There was speculation as to whether the Group's management was aware of the ballooning amount of net receivables due from Tankoil. Subsequent investigations revealed evidence of ongoing reporting and discussions between DOT's and the Group's management, covering issues including that of the trading activities with Tankoil and the credit rating of Tankoil. These discussions mainly involved Møller, Goh and Pedersen, among others. DOT's board and management were also apparently aware of Tankoil's constant failure in meeting the agreed payment terms, resulting in an accumulation of interest.[19] Nevertheless, they did not put a stop to the trade with Tankoil.[20]

Relationship between Tankoil and DOT

At the time of OW Bunker's bankruptcy, Tankoil owed DOT US$156 million.[21] One of the suggested reasons behind the amount accumulated was the unique trading relationship between DOT and Tankoil, which appeared questionable to OW Bunker's ad hoc trustee.[22]

Tankoil effectively operated as a physical distributor for DOT. However, instead of purchasing distribution services from Tankoil as per its regular business model, DOT sold the entire bunker deliveries to Tankoil on credit. It then repurchased approximately the same amount back from Tankoil, at less than the sale price. The repurchased bunker was then resold to end customers. This resulted in DOT recording paper profits from both sales transactions, creating an overall profit which should have been a loss.[23] Such a trading relationship also meant that DOT was consistently making more credit available to Tankoil through drawdowns of OW Bunker's credit facilities.[24]

This trading relationship was only implemented with Tankoil and a closely related entity, Petrotec Pte Ltd. Both companies were owned and managed by the same person, Dennis Tan, and accounted for about 85% of DOT's net sales.[25]

A risky business - Navigating in choppy waters

"The company's risk management failures may be a bigger concern than the fraud." – PFA Pension, Denmark's biggest commercial pension fund and an investor in OW Bunker[26]

OW Bunker's alleged fraud and the announcement of a US$150 million loss due to risk management issues came as a shock to many investors. Given the international operations of its business, OW Bunker was often subjected to economic and political risks. As such, the company's risk management and hedging policy were important topics during the IPO process.[27] The following risk management policies were conveyed to its potential investors in its IPO Prospectus:

"The primary goal of the marine fuel and marine fuel component price risk management policy is to ensure that the business generates a stable gross profit per tonne by limiting the effects of marine fuel price fluctuations."

"The overall risk limit set in the policy is defined by a maximum net open (unhedged) position for the Group. Currently the maximum net open position approved by the BOD is 200,000 tonnes. However, we operate with a lower internal risk management guideline with a maximum net open position on 100,000 tonnes, which is set by the CEO and applied in our operations."[28]

Despite disclosure of its risk management policy, ShipAndBunker.com observed that the information disclosed was of limited benefit to potential investors as it did not allow the assessment of the dimension and the severity of market risk the company is facing.[29]

Moreover, in the investigation report by the ad hoc trustee of OW Bunker, it was stated that "the original draft of the Prospectus contained some information about proprietary trading. But this had been 'written out' during the process associated with the production of the final Prospectus".[30]

The Chief Investment Officer at PFA in Copenhagen, Jesper Langmack, also commented that OW Bunker's risk management policy was difficult to comprehend. "When we asked before the IPO, we were left with the impression that all they did was more or less clean hedging, and now it turns out that they've been gambling. They've been taking up massive market positions," he said.[31]

In addition, there was also no mention of any employee responsible for risk management in its 2013 Annual Report. It was only reported that "the Executive Vice President (EVP) for physical distribution operations would be responsible for marine fuel price management and would report directly to the CEO."[32] OW Bunker's EVP for physical distribution was Christensen at that point in time. On the day OW Bunker shares were suspended from trading on NASDAQ OMX, she was fired by the company due to the huge risk management losses.

Remuneration policies

OW Bunker's remuneration policy for incentive pay to the members of the Board and Executive Management was prepared in accordance with the Danish Companies Act. Under Section 139 of the Act, it was stated that the guidelines must be made available to the public on the company's website and the date they were adopted must be specified.[33] However, OW Bunker's guidelines were not publicly available on its corporate website.

It was disclosed that the four directors on the Board were to receive a total fixed pay of DKK 300,000, while the Chairman would receive a fixed fee of DKK 750,000.

On the other hand, the compensation package of the executive management consisted of a fixed base salary, a short-term performance cash bonus, a long-term stock option incentive and other benefits. The two members of the Executive Management – Pedersen and Skou were to receive an aggregate amount of DKK 5.3 million and an aggregate cash bonus of DKK 7.6 million. Additionally, Pedersen was entitled to receive up to DKK 2 million worth of stock options if certain bonus objectives were met. As for the other two key employees – Christensen and Lehsten, they were to be paid total fixed salaries of DKK 3.1 million, pension contributions of DKK 0.1 million and a cash bonus of DKK 6.6 million.[34]

For managers and traders of OBFE and DOT, it was common for them to receive a discretionary bonus that was tied to their performance. In 2012 and 2013, Møller and an employee received a bonus which was largely driven by the company's financial results.[35]

Employees of OW Bunker also had stringent financial targets to meet. "I had a budget that required me to make a US$1.5 million profit every month. It was speculation," said Kenneth Rosenmeyer, the former risk manager. Rosenmeyer had reportedly been given the task of securing the company's million-dollar profits by trying to "beat the market". He quit in March 2014, shortly after the IPO, saying that the listing would make it more difficult for him to maintain good results.[36]

From ship to wreck

After OW Bunker filed for bankruptcy on 7 November, 2014, OBFE and DOT followed suit and filed for liquidation a few weeks later. OW Bunker owed 13 banks a total of US$750 million, with more than half a dozen companies having an exposure of above US$10 million to OW Bunker.[37] Debtors of DOT, of which Tankoil was the largest, are estimated to owe a total of US$329 million in gross receivables according to DOT's liquidators, KPMG on 13 February, 2014.[38] That same month, the Maritime and Port Authority of Singapore (MPA) revoked Tankoil's bunker supplier licence, citing "discrepancies and wrongful declarations in the records kept on board their bunker tankers," and "incidences of transfers of bunkers between bunker tankers that were done without MPA's approval".[39] Subsequently, on 7 August, 2015, Tankoil was declared bankrupt.[40]

On 3 March, 2016, the Attorney General's Office for Fraud and Economic Crime in Denmark filed criminal charges against former senior executives of the defunct OW Bunker.[41] Amongst those charged were CEO Pedersen, CFO Skou and the CEO of DOT, Møller. Christensen, ex-risk manager of OW Bunker, and Goh, former finance manager of DOT, were reportedly not included in the list of those charged. Investigations are still ongoing according to Danish media, with a consortium of Danish institutional investors leading a claim for damages amounting to approximately DKK 769 million.[42] Responsibility over the debt built up in Singapore thus remains uncertain.[43]

Discussion questions

1. Evaluate the board composition and structure of OW Bunker and its subsidiary, DOT. What are the advantages and disadvantages of having employee representation from the parent company on the board of its subsidiary?

2. Discuss the legal responsibilities of OW Bunker's and DOT's board. What are the issues with such laws in the context of OW Bunker? Should the Board of Directors of the holding company be responsible for the governance of its subsidiary?

3. What are the possible factors that allowed the alleged fraud to occur? What are the concerns given that the Group's management was apparently aware of the fraud occurring in DOT but failed to take action?

4. In the case of OW Bunker and its Singapore-based subsidiaries, was the remuneration policy for their directors and management appropriate?

5. Jane Dahl Christensen held both the roles of Chief Risk Officer (CRO) and Executive Vice President (Physical Distribution). Evaluate the appropriateness of the assignment of these roles.

6. How can companies exercise good corporate governance when its subsidiaries operate in different countries?

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SINGAPORE POST: SIGNED, SEALED, UNDELIVERED

It was an "honest mistake"[1] that led to the beginning of the whole saga…

Case overview[1]

In December 2015, Singapore Post Limited ("SingPost") acknowledged an "administrative oversight" regarding the omitted disclosure of their Lead Independent Director Keith Tay Ah Kee's interest in an acquisition. This event triggered a special audit to investigate the issues surrounding the director's interest in the acquisitions. Further scrutiny revealed other corporate governance concerns. The objective of this case is to allow a discussion of issues such as board composition, board renewal, director independence, conflicts of interest, director duties, and external auditors.

About SingPost

SingPost, Singapore's first public postal licensee, was formally privatised and incorporated on 1 April, 1992.[2] SingPost was subsequently listed on the Singapore Stock Exchange on 13 May, 2003.[3]

Once referred to as "the most important post office in the East"[4] by novelist Joseph Conrad, SingPost seeks to deliver trusted, reliable and affordable services while focusing on sustainable growth.[5]

This is the abridged version of a case prepared by Abigail Lum, Lee Szu Yee, Lim Si Min Sally and Toh Wen Hui under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Chua Chloe under the supervision of Professor Mak Yuen Teen.

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The two largest shareholders of SingPost are Singapore Telecommunications Ltd ("Singtel"), which owns about 23% and Alibaba Group Holdings Ltd, which owns about 10%. Other institutional investors own about a third of the company.

A new chapter

The changing postal landscape and technological advances led to challenges to Singpost's traditional postal business.[6] SingPost responded with a strategy to transform its business. It appointed Dr Wolfgang Baier as Group Chief Executive Officer (CEO) and Director on 5 October, 2011.[7] He had earlier been appointed as the CEO (International). Prior to his appointment at SingPost, Dr Baier was a partner at McKinsey and a consultant for SingPost. SingPost also appointed several other McKinsey consultants to its senior management team. Figure 1 shows the organisation chart of SingPost.

By pursuing an aggressive strategy into e-commerce and logistics, Dr Baier transformed the stagnant domestic mail provider into a parcel of potential growth opportunities.[8] In 2015, he won the Best Chief Executive Officer Award for large-cap companies at the Singapore Corporate Awards 2015.[9]

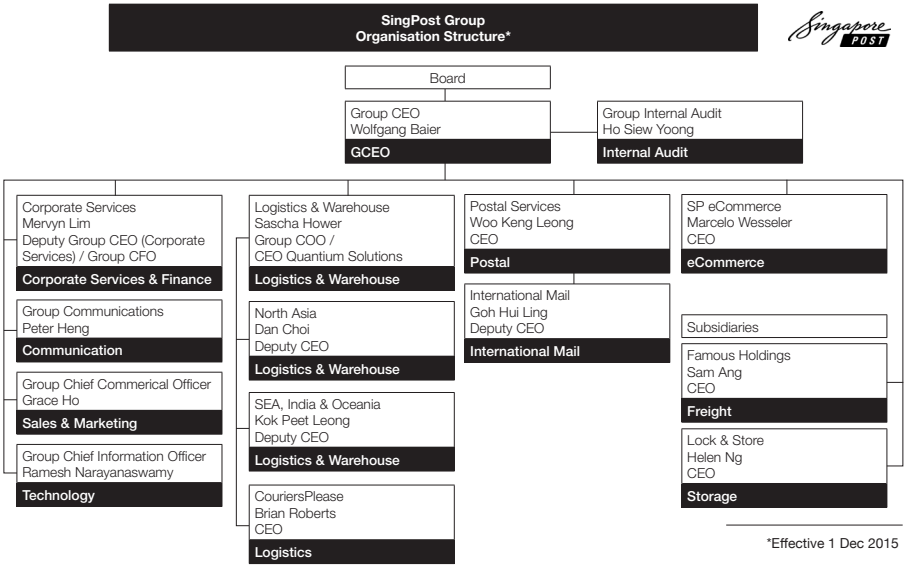

Figure 1: SingPost's organisation structure[10]

People in the post

In FY2014/2015, SingPost had 12 board directors, of which eight were classified as independent and four non-independent.[11] With the exception of Dr Baier, all the directors were non-executive. The Chairman, Lim Ho Kee (aged 70), was an independent director. The board also appointed a Lead Independent Director, Keith Tay Ah Kee (aged 71). Both were first appointed to the board on 25 April, 1998. Another director, Tan Yam Pin (aged 74), had been on the board since 25 February, 2005.

In July 2014, SingPost appointed two new directors – Goh Yeow Tin (aged 63) who was appointed as an independent director and Deputy Chairman, and non-executive and non-independent director Chen Jun (aged 41), who was a nominee director of Alibaba Group Holdings, a substantial shareholder in SingPost. Goh had started his career with the Economic Development Board and had spent 12 years as the vice-president and general manager of Times Publishing Limited. He was also the lead independent director of Vicom Limited and Sheng Siong Group Ltd, an independent director of Lereno Bio-Chem Limited and AsiaPhos Limited, and the non-executive chairman of Seacare Medical Holdings Pte Ltd.

Other independent directors on the board include Soo Nam Chow (aged 61), an ex-KPMG partner, who was the Audit Committee Chairman; Professor Low Teck Seng (aged 60), CEO of the National Research Foundation, who was Chairman of the Board Risk and Technology Committee; Zulkifli Baharudin (aged 55), Executive Chairman of Indo Trans Logistic Corporation and a former Nominated Member of Parliament; and the only female director on the board, Aliza Knox (aged 54), who is in charge of online sales for Asia Pacific at Twitter Inc., Singapore, and who was formerly managing director for online sales and then commerce at Google.

There were two other non-independent non-executive directors – Bill Chang (aged 49), who is CEO (Group Enterprise) at Singtel and its nominee director to the SingPost board; and Michael James Murphy (aged 61), who is the founder and CEO of Postea Group, Inc., a SingPost investee company.[12]

The July 2015 AGM

In June 2015, Associate Professor Mak Yuen Teen, a SingPost shareholder and a well-known corporate governance advocate, sent an email to SingPost's Board of Directors, through the company's investor relations unit, raising issues about SingPost's corporate governance.[13] The following is a reproduction of his email[14]:

"Hi,
I am a shareholder of SingPost. First of all, thank you for sending the notice and annual report out in good time and not holding the AGM in the last week of the 4-month deadline like many other companies do. I plan to attend the AGM and would like the following questions to be addressed by the board at the AGM:

1. SingPost is venturing more into e-commerce and financial services (such as its partnerships with Alibaba and AXA). It is at the same time disposing interests in traditional postal services. How will this new direction affect the quality of services of its postal services? What is the risk assessment that the board and management have done before embarking on these new activities? Will SingPost be subjected to regulation by MAS in its financial services business?

2. Compared to other companies here and many other global companies, SingPost has a relatively large board with 12 directors. Have the nominating committee and board carefully considered the board size and are satisfied that the board size is appropriate, notwithstanding the standard statement in the CG report that it has done so?

3. SingPost has an executive committee which met 14 times during the year, and with due respect, a relatively young CEO. Why is it necessary to have an executive committee which meets so often and is the executive committee managing the company together with the CEO? If so, should the independent directors on the executive committee still be considered independent?

4. The board has added new independent directors in recent years who appear to be well qualified, given the nature of SingPost business. However, there are a number of long-serving independent directors, some of whom have served on the board for almost 20 years. They are also more than 70 years of age. Given the change in the business of SingPost, do these directors have the necessary skills and competencies for the new strategies that SingPost is pursuing?

5. The board has engaged Egon Zehnder to support the review of independence of the long-tenure directors which has concluded that all the long-tenure directors remain independent. Does the board plan to repeat the practice of having Egon Zehnder facilitate a "particularly rigorous review" of independence annually and is there any plan for these long-tenure independent directors to retire in the near future in order to renew the board?

6. In addition to assisting with the board assessment and the review of director independence, what other services, if any, does Egon Zehnder provide to the company? What was the amount of fees that the company paid in total to Egon Zehnder during each of the last two financial years? Thank you for forwarding these questions to the board."

At the July AGM, he asked a director if he had seen the questions he had sent and was told by the director that he had not. As the AGM proceeded, it appeared to him that his questions were not going to be answered, and he proceeded to ask some of these questions.

Delivery problems

On 10 December, 2015, the company suddenly announced that its group CEO, Dr Baier was resigning "to pursue new endeavours".[15] It also mentioned that its group CFO, who had just joined the company in September, would serve as acting group CEO. Goh Yeow Tin, the Deputy Chairman and independent director, was to be appointed as executive director for twelve months to oversee the post-merger integration work, while Lim Ho Kee, the independent Chairman would step up his "involvement to provide management with more time and guidance over and above the normal oversight of the role".

This led Professor Mak to publish a commentary in the Business Times on 15 December, 2015.[16] He mentioned the questions he had sent to the company for its July AGM which he felt the company did not adequately address at the meeting, and also raised issues about prior turnover of CEOs in the company and the transition plans that the company has put in place.

He compared the board size of SingPost with other Singapore government-linked companies, such as its major shareholder SingTel, which had a board of nine directors despite having a market capitalisation of more than 16 times that of SingPost. He opined that the large board size could be a result of a lack of proper succession planning and board renewal and questioned whether the board comprised individuals with relevant skills, expertise and experience who would best serve SingPost's transition into e-commerce.[17]

He also questioned the composition of the executive committee and the number of meetings it had held. Five directors, including Chairman Lim Ho Kee, Deputy Chairman Goh Yeow Tin, Group CEO Dr. Wolfgang Baier, and directors Tan Yam Pin and Keith Tay, were on the executive committee.

"If you look at the executive committee, it's made up of long-serving or older independent directors rather than... individuals who have skills and experience relevant to SingPost's new direction."[18]

The executive committee had met 14 times in FY2014/15.[19]

SingPost's first Group CEO, Lau Boon Tuan, left in August 2007 after approximately two years of service, and his successor Wilson Tan relinquished his position after two years in April 2010.[20] Dr Baier held the Group CEO role for about four years before his unexpected resignation in December 2015.[21]

There was also high turnover of CFOs. Ng Hin Lee resigned as group CFO on 31 July, 2014 after serving for about three years. His successor, Daniel Phua, resigned after a year on 24 July, 2015[22], and was succeeded by Mervyn Lim on 1 September, 2015.[23] Two months after his appointment as Group CFO, Mervyn Lim was also appointed Deputy Group CEO (Corporate Services).[24] With Dr Baier's departure, he stepped up as Acting Group CEO.[25] SIAS challenged his appointment, arguing that he hailed from an academic background as a business advisor and lecturer with little experience.[26]

On the company's transition plans, Professor Mak said: "One must question whether Mr Goh has the necessary knowledge about the business, experience and time, to undertake what sounds like a rather onerous task – especially working alongside an acting group CEO who is also new and who appears to be still holding the group CFO reins. Shareholders of the other companies should probably also ask if Mr Goh will still have enough time for them." He also queried whether the Chairman's designation as an independent director would be affected by his closer involvement in management in the transition plan.

Blunders in the mailroom

Much worse was to come.

In line with its move towards e-commerce and logistics, SingPost undertook numerous acquisitions.[27] Three of these acquisitions ("Famous acquisitions") – that of Famous Holdings in 2013[28], freight forwarder FS Mackenzie UK in 2014, and Famous Pacific Shipping (NZ) Limited in 2015[29] – brought SingPost to its tipping point.

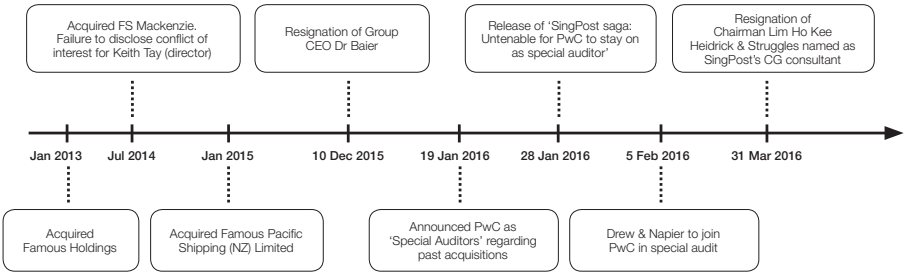

Figure 2: Timeline of events

SingPost failed to disclose the interests of its Lead Independent Director, Keith Tay, in its 2014 FS Mackenzie acquisition. In a July 2014 SGX filing, SingPost revealed an agreement to buy the entire share capital of FS Mackenzie for up to £7 million, noting that the acquired UK company's net asset value was £2.5 million based on the unaudited financial statements for the financial year ended 31 December, 2013. SingPost claimed that "none of the directors or controlling shareholders of the company has any interest, direct or indirect, in the acquisition".[30]

On 23 December, 2015, Business Times published a follow-up letter from Professor Mak, this time raising issues about inadequate disclosures for acquisitions, conflicts of interest and turnover of company secretaries.[31] He pointed out that there had been three different company secretaries assisting on the three Famous transactions which occurred over the span of just two years – Genevieve Tan McCully, who had been involved in the acquisition of Famous Holdings, resigned in August 2014, Winston Paul Wong resigned in January 2015, and Jaqueline Woo left in July 2015 at the end of her contract. Jocelyn Ng was appointed on 19 August, 2015, but replaced by Tan McCully again shortly after, on 25 November, 2015.[32]

Therefore, over a span of less than three years, SingPost had changed company secretaries four times. Professor Mak argued that this was rather unusual and required explanation, especially as the company secretary played a major role in compliance.

The day before the letter was published, Business Times queried the company about the issues raised in Professor Mak's letter. This led the company to immediately issue an amended statement as follows: "The Company would like to clarify that none of the directors or controlling shareholders of the company had any interest, direct or indirect in the transaction, save for Mr. Keith Tay Ah Kee…"[33] The company claimed that the earlier incorrect announcement was an "administrative oversight". [34]

In addition to being the lead independent director, Keith Tay was chairman of the Nominations Committee, member of the Executive Committee, and former Chairman and a current member of the Audit Committee. He was a former Managing Partner of KPMG, former President of the Institute of Certified Public Accountants of Singapore (now called Institute of Singapore Chartered Accountants) and former Vice-Chairman of the Singapore Institute of Directors. Tay was also the non-executive chairman and a major shareholder of the corporate finance advisory firm, Stirling Coleman Capital Limited ("Stirling Coleman"), owning 34.5 percent of its shares. Stirling Coleman was involved in all three "Famous acquisitions".[35] SingPost stated that the board had been aware of Keith Tay's association with Stirling Coleman since the first acquisition and that this association was disclosed in its annual reports. SingPost also stated that Keith Tay had abstained from voting on the three acquisitions[36].

In the January 2015 filing for the Famous Pacific Shipping (NZ) acquisition, SingPost did not disclose whether its directors or controlling shareholders had any interest in the Famous Pacific deal.[37]

Diverging interests

"…It is also important to bear in mind that disclosing, abstaining or even recusing does not make a conflict magically disappear"
– Professor Mak Yuen Teen[38]

Stirling Coleman is an independent corporate finance advisory firm headquartered in Singapore.[39] It does not have representative offices in United Kingdom nor New Zealand where FS Mackenzie and Famous Pacific Shipping are located.[40] On its website, Stirling Coleman had disclosed that it was the "arranger" for the Famous Holdings deal and "financial advisor to the seller" for the FS Mackenzie and the Famous Pacific deals.[41] According to Professor Mak, this "undoubtedly raises conflict-of-interest issues".[42]

SingPost did not explain how Stirling Coleman came to be appointed as the arranger or financial advisor for the seller for the three acquisitions.[43] SingPost had paid 2.8 times and 9.8 times of Net Asset Value (NAV) for the purchase of FS Mackenzie and Famous Pacific Shipping (NZ) respectively.[44] Professor Mak raised possibilities of "conflict of interest and perception issues" regarding the relationship between the independent director and Stirling Coleman, especially since Stirling Coleman has to act in the interest of the sellers, while the director has to act in the best interest of SingPost.[45] He asked if Tay had disclosed his interest, abstained from voting and recused himself from discussions relating to the transactions.

Special audit

On 23 December, 2015, SingPost announced its intention to appoint special auditors to investigate the concerns raised by Professor Mak.[46] On 19 January, 2016, SingPost announced PricewaterhouseCoopers (PwC) as their special auditor. The scope of the special audit was to cover SingPost's compliance with its constitution, internal policies and procedures relating to the three acquisitions.[47] This led to further criticism of SingPost by Professor Mak and other commentators.

SingPost and PwC: More than just penpals

PwC had been SingPost's external auditor since the latter's listing in 2003. PwC had also provided non-audit services to SingPost. Its cumulative percentage of non-audit fees to audit fees totalled 80.8% over the past five years. The nature of these non-audit services was not disclosed.[48]

Under the Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities, annual non-audit services fees compared to the annual audit fees from the audit client should not exceed 50% or more.[49] If this is exceeded, the external auditor is expected to ensure certain safeguards are considered and applied as necessary. In four out of past five years, SingPost's payment to PwC exceeded this threshold.[50]

SingPost was also criticised for failing to go through a Request for Proposal (RFP) in selecting the special auditor.[51]

The Counter-Post

On 1 February, 2016, SingPost justified its choice of PwC as special auditor and for not going through an RFP, stating that appointing a Big Four accounting firm with global name recognition, credibility, and adequate resources was necessary in this situation. It claimed that the other three major accounting firms were unsuitable as one was the existing external auditor of Stirling Coleman Capital Limited; one was involved in due diligence for the two acquisitions being investigated by the special audit, and the last provided consultancy services relating to internal audit and corporate governance matters to SingPost.[52]

It stressed that the PwC external audit and special audit teams would be entirely separate. Additionally, all members of the special audit team had no prior or existing professional relationship with SingPost. SingPost believed that the performance of the special audit would not result in a self-review threat which would impact the external audit of SingPost.[53]

In response to the high percentage of non-audit fees to audit fees mentioned, SingPost stated that its Audit Committee had reviewed the amount of non-audit fees and special audit fees paid to PwC.[54]

Bounced mail

Professor Mak expressed disappointment towards SingPost's response. He argued that in addition to questions about the long-standing relationship between PwC and SingPost and the amount of non-audit fees received by PwC over the last few years, there was a self-review threat in having PwC undertake the special audit, since he felt that the external audit should have reviewed whether there was proper governance in place with regard to the acquisitions.[55]

He further contended that if PwC was able to overcome possible conflicts by using different partners and members, other firms could also do so.[56]

Similarities were also drawn between the appointment of PwC as special auditor and the hiring of Stirling Coleman as financial advisor. Professor Mak questioned if the board was "not concerned at all about the conflict of interest and perception issues".[57]

Pipped at the post

On 5 February, 2016, SingPost appointed Drew & Napier as joint special auditor alongside PwC. The scope of work and detailed terms of reference in Drew & Napier's special audit was to be identical to that of PwC, and the special audit report was to be jointly issued.[58]

Investors run for cover

The corporate governance issues took its toll. SingPost's share price fell from S$1.80 at the start of December 2015 to S$1.30 in less than two months.[59] SingPost blamed its weak share price on the ongoing corporate governance issues plaguing the company.[60]

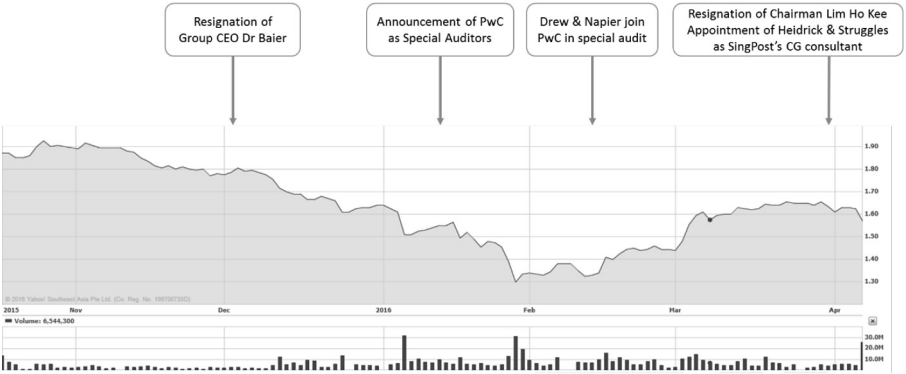

Figure 3: Changes in SingPost's share price from December 2015 to April 2016[61]

Post-Script

"[Chairman Lim] Ho Kee is just initiating the start, there will be more announcements coming."
– SingPost Independent Director Zulkifli Bin Baharudin[62]

On 31 March, 2016, Lim Ho Kee announced that he would step down as chairman and director in the next AGM in July 2016, citing family commitments. An analyst commented that the poor timing of his departure created uncertainty before the release of the special audit report. The board unanimously voted for Independent Director Professor Low Teck Seng to take over as chairman. However, Professor Low declined the appointment a few days later, citing that it would "demand more time and focus" than he could give.[63]

SingPost named Heidrick & Struggles as their corporate governance consultant after a detailed RFP, to look into SingPost's corporate governance issues relating to mergers, acquisitions and divestments and conflicts of interest.[64]

On 8 April, 2016, SingPost announced that Keith Tay would be leaving the board.[65] Zulkifli Baharudin took over as Chairman of the Nominations Committee after Keith Tay stepped down.[66] This was followed by the resignation of Goh Yeow Tin in June and an announcement that Tan Yam Pin will not be seeking re-election at the July 2016 AGM. In June, the company announced that its Chief Operating Officer, Dr Sascha Hower (aged 38), will resign with effect from August "to pursue new opportunities overseas".[67]

SingPost is still undergoing investigation by the Accounting and Corporate Regulatory Authority (ACRA) for potential breaches of the Companies Act. Former executive director and president of Temasek Holdings and the current chairman of Singtel, Simon Israel, took over from Lim Ho Kee as chairman – "a move expected to lend stability to the firm, which was suffering from a leadership crisis". However, a suitable replacement for Group CEO since Dr Baier's resignation has yet to be found.[68]

In June, SingPost announced a code of business conduct and ethics for directors and new policies governing directors' conflicts of interest and board renewal and tenure.[69] One of the changes is a tenure limit of six years for directors, with an absolute limit of nine years if necessary "to accommodate phasing, giving due regard to critical skill sets needed". It also dissolved the Executive Committee and renamed its Nominations Committee as the Corporate Governance and Nominations Committee. The report by Heidrick and Struggles on SingPost's corporate governance review was released on 4 July, and the company held its highly anticipated 2016 AGM on 14 July, under its new Chairman Simon Israel.[70]

Discussion questions

1. What are potential red flags suggesting poor corporate governance in SingPost?

2. Evaluate the structure and composition of the Board before the saga.

3. Discuss issues arising from Stirling Coleman's role as an arranger or financial advisor for the seller in the three SingPost's acquisitions. What is a director required to do under such circumstances? How does the independent director's role in Stirling Coleman affect his independence as a director in SingPost, if at all? How should the independent director have handled the situation?

4. What issues arise from PwC's appointment as special auditor of SingPost? Evaluate SingPost's rationale for the appointment of its special auditor(s).

5. Do you think that SingPost handled the conflict of interest and other corporate governance issues well? What would you have done differently if you were on the board?

6. Comment on the steps taken by SingPost to regain investor confidence. Do you think they are enough? Is there anything else that you think the company should have done?

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SOMETHING FISHY: THE ST MARINE CORRUPTION SCANDAL

Case overview

On 11 December, 2014, as Singaporeans prepared for the upcoming holiday season, the Corrupt Practices Investigation Bureau (CPIB) announced that it had charged three former employees of Singapore Technologies Marine Ltd ("ST Marine"), a subsidiary of Singapore Technologies Engineering Ltd ("ST Engineering"), for alleged bribery and corruption. The alleged bribes occurred between 2004 and 2010, amounting to hundreds of thousands of dollars.[1] The news was particularly shocking given that it involved a Singapore blue-chip engineering giant – one that had won several awards for best corporate governance from 1999 to 2004.[2]

As shareholders of ST Engineering saw the stock price fall following the announcement, they were left wondering in disbelief. How could this have possibly happened?

The objective of this case is to allow a discussion on issues such as factors that could lead to the occurrence of bribery and corruption in organisations; the role of the board, senior management and external auditors in monitoring and detecting corruption risk; and policies that could be put in place to minimise corruption risk.

This is the abridged version of a case prepared by Chelsea Foong Min Er, Chua Kah Swee, Danny Chee Wei Ming and Wong Wei Ming, Paul under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Ang Qun Yun under the supervision of Professor Mak Yuen Teen.

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Background

ST Marine is the wholly-owned subsidiary of ST Engineering, which is a subsidiary of Temasek Holdings,[3] an investment company wholly-owned by the Government of Singapore.[4] ST Engineering, incorporated in 1997, is an integrated engineering group that provides "innovative solutions and services in the aerospace, electronics, land systems and marine sectors".[5] It is listed on the Singapore Exchange.

ST Marine is a leading shipyard that engages in the turnkey shipbuilding, ship conversion and ship repair business.[6] It provides services to naval and commercial customers in the global market, including the Republic of Singapore Navy and the Royal Navy of Oman, as well as customers from the Netherlands and the United States. It operates out of its shipyards located in Singapore and the United States. ST Marine has main facilities and offices in USA, Brunei and Shanghai. In the financial year ending 31 December, 2014, ST Marine accounted for 21% of ST Engineering's revenue, and 20% of net profits.[7]

Directors on Board

ST Engineering has a 15-member Board of Directors. Its non-executive chairman, Kwa Chong Seng, was appointed on 25 April, 2013. Kwa was previously the Chairman and Managing Director of ExxonMobil Asia Pacific Pte Ltd. He is also the Chairman of Neptune Orient Lines Ltd and Olam International Ltd, and also serves on the boards of other companies such as the Singapore Exchange Ltd.[8]

ST Engineering has increased the size of its Board of Directors gradually over the years, from 11 directors in 2004, to 15 in 2015. Its directors are mostly non-executive – in 2015, there was only one executive director, the President and CEO of ST Engineering – and they come from a wide range of industries. For instance, the Chief of Defence Force in Singapore's Ministry of Defence sits on the Board, alongside senior management from law firms, financial advisory firms, and the civil service. The number of independent directors has also gradually increased over the years, from five independent directors in 2004, to 11 in 2015.[9]

There are various committees within the Board of Directors. Besides the Audit, Remuneration and Nominating Committees found in many public companies, the ST Engineering Board also has committees related to business investment and divestment; budget and finance; research development and technology; senior human resource; risk review; and tenders.[10]

Murky waters: The story

On 8 September, 2011, CPIB arrested Patrick Lee Swee Ching, then chief financial officer of Vision Technologies Systems, Inc. ("VT Systems"), an ST Engineering holding company based in the United States. Lee was previously ST Marine's group financial controller from 2001 to 2006. He was arrested for an offence under section 477A of the Penal Code, Chapter 224.[11]

Lee was subsequently released on bail and given permission to leave Singapore by CPIB. He returned to the United States on 10 September, 2011 to resume his responsibilities in VT Systems. The statement from ST Engineering, released on 12 September, 2011, revealed that two current and one former employees were also arrested by CPIB, none of whom held management positions in ST Marine. ST Engineering also announced that an internal inquiry had been set up with respect to this matter.[12]

On 16 September, 2011, Lee took a leave of absence pending the CPIB investigation and the abovementioned internal inquiry.[13] He retired in October 2012, without giving any reason.[14]

The years 2012, 2013 and most of 2014 went by without any updates from CPIB and ST Engineering regarding the investigation. However, the calm was broken on 11 December, 2014, when CPIB charged three senior executives from ST Marine under the Prevention of Corruption Act and the Penal Code. The three senior executives were

1. Chang Cheow Teck, president from March 2008 to April 2010,

2. Ong Teck Liam, group financial controller and senior vice-president (Finance) from April 2007 to December 2012, and

3. Mok Kim Whang, senior vice-president (Tuas Yard) from June 2000 to July 2004. [15]

On 30 December, 2014, a fourth person, See Leong Teck, was also charged. See had been president of ST Marine for more than 10 years, from December 1997 to February 2008.[16]

Chang was charged with three counts of corruption and accused of conspiring with his subordinates, Teh Yew Shyan and Ong. From 2004 to 2010, they had allegedly paid bribes in exchange for ship repair contracts, amounting to a total of S$273,778.[17] These included a bribe of more than S$234,000 to an employee from Hyundai Engineering and Construction Co., Ltd (HDEC) in March 2009, and two bribes to staff of Myanma Five Star Line (MFSL) worth more than S$39,000 between February to April 2010.[18]

In addition to allegedly conspiring with Chang, Ong was slapped with 118 charges under section 477A of the Penal Code. She was accused of making false petty cash claims for bogus, non-existent entertainment expenses exceeding S$521,000.[19]

Mok was accused of conspiring with See and Lee to bribe a HDEC employee S$43,700 in May 2004, for the purpose of winning shipbuilding contracts.[20]

Lastly, See faced seven counts of conspiring with Ong, Mok, Teh, and Lee to bribe agents of ST Marine's customers in return for ship repair contracts between 2004 and 2010. The alleged bribes involving HDEC and MFSL amounted to more than S$556,000.[21]

In a press release dated 11 December, 2014,[22] ST Engineering stated that the charges were "not expected to have any material impact on the consolidated net tangible assets or consolidated earnings per share of the ST Engineering Group for the financial year ending 31 December 2014." Despite ST Engineering's reassurance that the incident had no material impact on the company's financials, its stock fell three cents, closing at S$3.39. This drop continued to a one-year intra-day low of S$3.14 on 17 December, 2014.[23]

Professor Mak Yuen Teen from the National University of Singapore commented on the announcement: "while ST Engineering has won awards for best corporate governance, good compliance processes are no guarantee that people will keep in line. Three factors come into play — the nature of the industry, interaction with overseas governments, and the remuneration system."[24]

Naval mines

ST Engineering's main business is in the defence industry. In addition to the Republic of Singapore Navy and the Royal Navy of Oman, it has other military customers such as the Brazilian Navy and US Navy.[25] According to Professor Mak, "when you have a company with businesses in defence, they tend to deal with a lot of government procurement and subsequently get exposed to public-sector corruption."[26]

Government overseas procurement contracts tend to be of a "winner-takes-all" nature. These contracts often include renewal and escalation clauses, decreasing the likelihood that they will be re-offered in the near future. According to Richard Bistrong, who used to be involved in military sales in the United States, it is common for such contracts to have "renewal clauses over the course of three or four years". As such, the contracts are significant in value and failure to win the contract would imply that there would be no business opportunities in the years to come. Hence, there are high stakes involved for sales teams to clinch the contract and seal the deal.[27]

According to Transparency International, the defence sector poses 'unique' corruption risks: "… at least US$20 billion is lost to corruption in the sector every year. And that is only a modest estimation of the costs incurred when national security concerns become a veil to hide corrupt activity. Single source contracts, unaccountable and overpaid agents, obscure defence budgets, unfair appointments and promotions… waste taxpayer funds and put citizens' and soldiers' lives at risk."[28]

Moreover, the nature of the procurement process may be unstable. Factors affecting international procurement in this industry, such as regime change and personnel turnover, and logistics all culminate to give rise to increased international procurement instability. Regime change may result in "a cancellation and re-bidding of all outstanding tenders in state ministries". Replacement of existing procurement staff can lead to an indefinite delay of tenders. Delays may also arise from licensing requirements, especially if regulatory authorities are involved, and the necessary arrangements and costs of logistics such as warehousing, shipping and forwarding.[29]

The shipbuilding industry also appears to be prone to corruption. The level of corruption in the Russian national shipbuilding industry has significantly risen in recent years, leading the government to focus more attention on the problem.[30] Similarly, the anti-corruption team in China's central government also recently began investigating the operations of China Shipbuilding Industry Corporation following allegations of corruption activities in the procurement department.[31]

There was also a previous incident of corruption in ST Marine, in which Senior Assistant Engineer Norrudin Bin Jalaluddin had exploited his position as the person in-charge of procurement to receive bribes in the form of loans from a supplier, totalling S$650. Norrudin was subsequently fined S$3,500 and ordered to pay a penalty of S$650.[32]

Foreign waters

As Professor Mak commented on the case, "When you have a company with businesses in defence, they tend to deal with a lot of government procurement and subsequently get exposed to public-sector corruption. A lot of civil servants overseas are not well paid, so the risk of bribery and corruption in some countries is high."[33]

Indeed, several of the corrupted transactions involved foreign entities such as HDEC, a large Korean conglomerate, and MFSL, the national flag carrier of Myanmar.[34] This could be worsened by the fact that the discussions might have taken place overseas, leading to a lack of witnesses to any corrupt acts. As mentioned by Bistrong, "for the most part, front-line sales, marketing and business development personnel travel alone to their overseas territories. Agent meetings (maybe including a public official) also usually occur without anyone else present."[35]

While Singapore is known to have the lowest corruption levels in Asia,[36] there is very little control when it comes to the bribery and corruption that occurs in a foreign jurisdiction. The CPIB and the Attorney-General Chambers deal with acts of misconduct in Singapore seriously, but when the acts take place overseas, they are challenging to handle. Given that ST Marine deals with many foreign clients, the exposure and inherent risks of engaging in bribery and acts of corruption could potentially be higher.

Furthermore, bribery may pose an "illusion" of a "win-win" situation with no victims, as the sales person wins the deal and the client wins the bribe.[37] Hence, they require effective compliance measures for preventing and detecting bribery.

Professor Mak concluded: "Singapore is one of the major exporting economies in the world and is well regarded for having low public sector corruption by Transparency International and other organisations. However, as our companies increasingly venture overseas into emerging markets, there is considerable risk that we will also become a major exporter of corruption."[38]

Risky pay

A large variable compensation component may place an emphasis on winning sales and contracts. This may tempt employees to use aggressive and unethical strategies especially when their compensation plan is tied to individual performance in a high-risk environment.[39]

Professor Mak commented that "if staff are set aggressive targets or paid in a way where they aim for profits, then they may not pay heed to compliance as much."[40]

During his stint as president of ST Marine, Chang received high remuneration, a considerable proportion being variable compensation. Variable compensation made up 59% and 65% of his total compensation in 2009 and 2010 respectively. Variable compensation includes "annual wage supplement, performance target bonus paid and economic value-added (EVA) earned" for the year. The EVA earned each year is added to the balance carried forward in an executive's EVA Bank, and one-third of the total is paid out. The remaining two-thirds is carried over to the following year.[41] According to its 2010 Annual Report, ST Engineering has been earning a positive EVA since its formation in 1997. Similarly, contingent shares granted are subject to key performance indicators being met over a specified period of three years.[42]

In another article, Professor Mak commented, "…[Employees] are expected to comply with a business conduct code which says all the right things about zero tolerance for bribery, corruption and other forms of unethical behaviour on the one hand, while being incentivised to pursue aggressive growth through pay for performance plans."[43]

Could the compensation plan at ST Engineering, comprising a considerable proportion of variable pay, have sent mixed signals to the employees, creating ethical dilemmas for them?

Calm after the storm?

Following the initiation of investigations by CPIB in 2011, and the subsequent arrest of former ST Marine employees suspected of bribery and corruption, ST Engineering made a statement that they "take a zero tolerance approach to all forms of corruption including fraud and bribery"[44] and had taken steps to remedy the situation.

In its 2014 Annual Report, ST Engineering identified corruption as an inherent top risk when operating in a global market. ST Engineering also introduced an e-learning course on anti-corruption for employees identified to be exposed to corruption risks; 1,885 employees finished the course in 2014, and the course was subsequently rolled out to all identified employees in Singapore and other countries.[45]

The company has also completed fraud risk assessments and will review existing policy and procedures against significant corruption or fraud risks, with the objective of ensuring adequate preventive and detective anti-fraud controls. Between 2012 and 2014, it completed briefings relating to anti-corruption policies and procedures for 42% of its employees.[46]

With the exception of Lee, who was fined S$210,000 in July 2015, the remaining cases are still pending before the courts.[47]

Discussion questions

1. How can bribes of small amounts be detected? What is the appropriate action for the company to take when bribes are detected?

2. ST Engineering has adopted a whistleblowing policy since 2006.[48] However, the bribes and corruption still went on until 2010. Why do you think the whistleblowing policy failed to surface the corruption to senior management and the Board? What other measures should ST Engineering have instituted?

3. In response to the corruption scandal, ST Engineering has put in place a more rigorous anti-corruption and anti-fraud programme. Do you think the measures are effective and sufficient to prevent future cases from happening? What are some of the common practices implemented by other companies?

4. How can the (i) board of a large group with many wholly-owned subsidiaries (ii) internal auditors and (iii) external auditors provide sufficient oversight and monitoring of corruption risks?

5. ST Engineering has won multiple awards for good corporate governance. Is this a classic case of having form over substance? Does this indicate problems with disclosure-based corporate governance ratings and awards?

6. Why do code of conduct/ethics, compliance programmes and whistleblowing policies often fail to prevent corruption risks, especially for companies that do business in countries or industries that are highly corrupt? What can boards and senior management do to minimise such risks?

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FIXED FARE: THE CASE OF CABCHARGE

Case overview

In 2011, Cabcharge was in the spotlight for the high fixed remuneration of its CEO Reginald Kermode and its alleged failure to align executive remuneration with shareholders' interests. Other corporate governance issues such as the independence of its board of directors also surfaced with the introduction of the "two-strikes" legislation in July 2011. The objective of this case is to allow a discussion of the key corporate governance issues such as executive remuneration policies; shareholder activism; board independence; and the effectiveness of legislation in enforcing board accountability.

Cabcharge: The taxi empire

Cabcharge Australia Limited was founded in 1976 by Reginald Kermode and is based in East Sydney, Australia.[1] It was listed on the Australian Securities Exchange (ASX) in December 1999 and is one of the top 200 ASX-listed companies by market capitalisation. Its key activities include the provision of taxi-related payment, booking and dispatch services; taxi payment software development; and the development of taxi-related hardware and software such as taxi security cameras, equipment and meters.

This is the abridged version of a case prepared by Phoon Wai Kit Hunter, Shi Ruoying, Soh Zhao Wei and Thng Wan Ying under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Sarah Ho under the supervision of Professor Mak Yuen Teen.

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Remuneration controversy: How it all started

For many years up to 2011, Cabcharge's remuneration structure comprised two components – fixed annual remuneration (FAR), and short-term incentives (STI)[2] that were based on individual performance and overall Group performance.

The company justified Kermode's annual cash salary (consistently in the range of A$2-3 million)[3] by claiming that it reflected "his unique leadership and vision, his extensive industry experience and his contribution to the performance of the Group since listing on the ASX" on a "market competitive basis". However, the company failed to justify the STI of senior executives and the increases in director fees of non-independent directors.[4]

Kermode's high remuneration, coupled with the lack of transparency in Cabcharge's remuneration structure, drew much flak from investors, who frequently voiced protests against Cabcharge's remuneration reports at annual general meetings (AGMs).

Dark clouds approaching: The 'two-strikes' rule

On 1 July 2011, new legislation known as the 'two-strikes' rule was introduced in Australia to hold directors accountable for executive salaries and bonuses.[5] A strike occurs when a company's remuneration report for the year receives a 'no' vote of 25% or more from shareholders at the company's AGM.[6] On the second strike, the shareholders conduct a spill vote at the same AGM to determine whether the board should stand for re-election. If the spill resolution passes with a simple majority of 50% or more, a spill meeting for re-election is required within 90 days. All directors (as named in the directors' report at the latest AGM) would have to stand for re-election, except for the managing director.

The 'two-strikes' rule alerted Cabcharge to an impending problem for its board of directors. Cabcharge had been consistently receiving 'no' votes of 25% and above for its remuneration reports in the years prior to 2011[7], before the new legislation was introduced.

No love for remuneration: Strike one for Cabcharge

On 16 November 2011, Cabcharge held its first AGM[8] following the implementation of the 'two-strikes' rule. The first strike came with 40.6% of shareholders rejecting the remuneration report. Much of the discontentment stemmed from Kermode's remuneration package. Shareholders found his fixed salary of A$2 million excessive, and were unhappy that there was no performance-variable component to his compensation plan. Yet, instead of appeasing investors, Kermode went on the offensive and attacked the two-strike system.[9]

Double trouble: Strike two arrives on time

Following the first strike, Cabcharge did little to rectify the problem. Instead, the total remuneration of other key executives and Kermode increased by 16.5% and 5.6% respectively from 2011 to 2012, with the board continuing to attribute Kermode's high compensation to his contributions as both Chairman and CEO.

Shareholders were also dissatisfied with the lack of a long-term incentive (LTI) structure. However, Cabcharge's board of directors countered this strongly by saying that an equity-based LTI plan would dilute existing shareholdings. The long horizon in an LTI plan also meant that it would be difficult to claw-back incentives paid following poor performance. Furthermore, the regulated environment in which the business was operating made FAR and STI more appropriate than LTI as public transport fares were determined by various state governments. Nevertheless, shareholders remained largely unconvinced, as evidenced by the 38.7%[10] 'No' votes regarding the remuneration report.

A bullet dodged: No need for spill meeting

In the spill resolution following the two consecutive strikes, only 13.8%[11] of shareholders voted for a spill meeting, which fell vastly short of the 50% required to pass it. Kermode attributed this to the improved transparency and communication with shareholders following the hiring of Henry Bosch AO, the former Chairman of the National Companies and Securities Commission (the predecessor of the Australian Securities and Investments Commission)[12], and public relations firm Kreab & Gavin Anderson.[13] The outcome of the spill resolution also raised concerns over whether shareholders were using their votes to express their dissatisfaction objectively about the remuneration report or about the board's general performance and conduct.[14]

Yikes, more strikes: Root problem persists

Despite avoiding a spill meeting, the remuneration controversy persisted, with shareholders becoming increasingly frustrated with the compensation packages of executives. A few measures were taken by Cabcharge in response to shareholders' concerns. The remuneration committee was reconstituted as the Corporate Governance Committee (CG Committee). A long-term incentive plan (LTIP) for executives was established key elements of which included offering performance rights and options assessed over a four-year period and no re-testing of performance. The LTIP was expected to be implemented later in FY2014. As for the FAR, Cabcharge justified the high fixed portion of executives' pay with their competence and their consistency in meeting expectations and Kermode's high FAR on his past contributions. However, the shareholders were still not convinced. As a result, a third strike came with 45.3% of shareholders voting against the remuneration report.

End of a King's reign: The passing of Reginald Kermode

Months following his absence from the AGM in 2013, Kermode announced his resignation[15] from Cabcharge on 28 April 2014. He passed away two days later.[16] His passing triggered a separation of the Chairman and CEO role, which were assumed by Russell Balding and Andrew Skelton respectively. Despite the passing of a key figure at the centre of the remuneration controversy, tension continued to build up.

A new era: Remuneration framework revised

Following the third strike, Cabcharge restructured the remuneration package of its new CEO through the introduction of a LTIP. LTIP rewards would take the form of rights, which would vest over four years. Vesting would be determined by absolute total shareholder return (TSR) and annual turnover growth.[17] The absolute TSR aligned executive rewards with shareholders' interests, while the annual turnover growth reflected the importance of this source of revenue and the benefits to shareholders from delivering consistent results.

"We want change": ASA enters the fray

The Australian Shareholders' Association (ASA)[18] threatened to vote for a spill meeting if Cabcharge got a fourth strike.[19] This tension was a result of Cabcharge's nonchalance towards numerous remuneration protests. ASA claimed that there was a lack of disclosure regarding short-term bonuses, and the fact that they were all paid out in cash was a misalignment with shareholders' interest.

History repeats: Fourth strike but spill avoided

During the AGM in 2014, the LTIP was well received by the shareholders, with 96.0%[20] voting in favour of adopting it. Yet, a fourth strike came, with 57.4%[21] of votes against the remuneration report, the highest ever. This was largely attributed to the fact that total senior executive remuneration had increased by 37.2%. Specifically, other short-term benefits had increased by 169%, long term incentives were higher by 184%, and bonuses for executives were up A$97,337 from the previous year.[22] In addition, the LTIP was only implemented for the new CEO and not for other senior executives, and it only formed a small portion of total remuneration for the new CEO.[23] This made it the second time Cabcharge had received two consecutive strikes. The spill resolution that followed failed again with an underwhelming 2.45% favouring a re-election. Once again, the board was safe and the effectiveness of the 'two-strikes' legislation was questioned.

What really went wrong with the remuneration?

Cabcharge's remuneration structure was generally in line with the Corporate Governance Principles and Recommendations (CGPR)[24] as the structure had been clearly disclosed in all their annual reports with the exception of 2011. In the 2011 annual report, the remuneration structure was stated but there was no clear distinction between executive and non-executive directors.

Cabcharge's remuneration committee, reconstituted as the Corporate Governance Committee (CG Committee), had generally conformed to the CGPR. However, the issue lies in its structure. The CGPR states that the remuneration committee should consist of a majority of independent directors, be chaired by an independent Chairman and have at least three members. However, the independence of majority of the members on the CG Committee, including the Chairman, was questionable given that all of them had been in Cabcharge for at least 10 years. While Cabcharge acknowledged that the Chairman, Neil Ford, was not independent, their justification for appointing him as Chairman was that "his experience of remuneration matters makes his appointment a valuable transition measure to an independent Chairman".[25] However, there was no supporting evidence for Neil's experience in remuneration matters other than the fact that he had 40 years of experience in taxi company management. There was also no evidence to show that the other committee members had relevant experience in remuneration matters.

Remuneration consultants: The white elephants

In 2012 and 2013, Cabcharge hired HLB Mann Judd to provide a CEO benchmark report for the CG Committee and the board, to determine the remuneration of the Chairman and CEO. In 2014, HLB Mann Judd and Ernst & Young (EY) were both appointed as consultants. EY provided recommendations regarding the Executive Chairman & CEO while HLB Mann Judd provided recommendations with respect to non-executive director fees and CEO remuneration.[26] Despite the external consultants, executive remuneration remained high. This raised the question of whether the external consultants were mere white elephants hired only to show compliance with the CGPR.

Adding fuel to the fire

Apart from the strikes, other corporate governance issues began to surface. One such issue was the independence of the Cabcharge's board.

The CGPR recommends the majority of the board to be independent directors. Furthermore, the board should be regularly assessed for directors who have served for more than 10 years. This was also supported by ASA who no longer considers a director who has been on the board for more than 12 years independent.[27] However, many of Cabcharge's directors had been serving on the board for more than 12 years prior to the passing of Kermode.

Dual role of Kermode: Both the King and Queen

The CGPR recommends the Chairman and CEO to be separate persons but Kermode had been both CEO and Chairman for 34 years, and this was criticised by investors and governance experts. The 2014 version of the CGPR recommended companies to have an independent deputy Chairman or senior independent director if the Chairman was not independent. After the death of Kermode, Cabcharge spilt role of the Chairman and CEO and appointed a deputy Chairman. These were improvements to Cabcharge's corporate governance.

Questionable independence of Rodney Gilmour

Gilmour was as an independent director in 2014. However, Gilmour's independence was questioned since he had been a paid consultant of Cabcharge for nearly two years. He was also a close, long-standing colleague of the new Chairman Russell Balding. As a result, Gilmour resigned at the AGM in 2014.[28]

Looking forward to a fresh start

In 2014, Cabcharge showed progress towards better corporate governance. Various improvements to the remuneration policies and board independence were introduced. Even though there still remained some unresolved corporate governance issues, Cabcharge would have a fresh start under the leadership of the new Chairman and the CEO.

Discussion questions

1. Evaluate the effectiveness of the "two-strikes" policy in ensuring greater board accountability in Australia. How has shareholder activism influenced the behaviour of Cabcharge's management?

2. What was the remuneration mix and level of each key management personnel in 2014? How were they determined by the Board? How did it align management's interests and shareholders' interests as set out in the CGPR?

3. Do you feel that Kermode's compensation package was reasonable? In companies where a director is a controlling shareholder, what measures should be in place to prevent him from paying himself excessively? Evaluate the effectiveness of the measures implemented by Cabcharge.

4. Accounting firms provide a variety of services for companies. Are there any potential conflicts of interest arising from the provision of such services? If so, what are the measures that can be put in place to avoid such conflicts of interest?

5. Evaluate Cabcharge's board independence. Should there be stricter rules with regards to board independence?

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NO MORE HANERGY?

Case overview

Hanergy Thin Film Power Group Limited (HTF) was one of the most actively traded stocks on the Stock Exchange of Hong Kong (SEHK) from October 2014. A rapid rise in its share price led to scrutiny that cast doubt on the credibility and sustainability of the company's growth. Eventually, HTF's share price collapsed on 20 May, 2015, leading to a trading suspension on its shares. The objective of the case is to allow a discussion of issues on the corporate governance of Chinese companies listed in Hong Kong; corporate governance red flags; the roles and responsibilities of different stakeholders including regulators and auditors; and the difficulties faced in enforcing rules for foreign listings.

"I always believe that when you are doing something with a sense of mission, then God or heaven will empower you with magic, and you can get everything right and do everything with good luck." – Li Hejun, February 2014[1]

Glory of Tesla, or shame of Enron?

It was 29 September 2015.

Some months earlier, Li Hejun took the world by surprise when he topped Forbes' 2015 list of richest mainland Chinese.[2]

This is the abridged version of a case prepared by Allen Chng Chun Kiat, Ang Qun Yun, Ng Wei Sheng Dominic, Ong Kay Yuen and Wu Zijun under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Nie Yuanqiu under the supervision of Professor Mak Yuen Teen.

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Today, as HTF celebrates its 21st anniversary, it has shelved its expansion plans. The Hong Kong-listed solar equipment manufacturer had laid off more than one-third of its 5,500 employees.[3] It was also in the midst of negotiating the sale of its solar factories in an attempt to restructure the company that was once hailed as China's Tesla.[4]

As the glory of its past achievements came under greater scrutiny, some are questioning if HTF could potentially be China's Enron.

Always sunny, in a rich man's world

It all started in August 1967 in a small village 20 kilometers from Heyuan, Guangdong, China.[5] Little did anyone expect that a boy born to a middle-class family was to take the helm of China's "miracle maker". A mechanical engineer by training, Li's entrepreneurship manifested at a tender age when he organised 30 of his classmates into a sales force peddling camera film in front of his university's dining hall.[6]

Li started amassing his wealth by securing private ownership of hydroelectric assets, including the Jin' An Qiao Hydropower Station in southwestern China which generated about RMB10 million a day.[7] The saga over the development of the power station, which saw his decade-long wrestle with various stakeholders, proved to be good PR for him – despite having "no known relatives in the top echelons of the Communist party".[8] Li emerged as a determined entrepreneur leading China in the new energy revolution.

The rainmaker who loves the sun

The magical tale of Hanergy as the wunderkind of the solar world first began when a college professor loaned Li RMB50,000 to start a business selling electronic devices.[9] Six years later in 1994, Li founded Hanergy Holding Group Ltd ("Hanergy Holding") in the People's Republic of China and made his first foray into the power industry.

Hanergy's venture into SEHK could be traced back to the Town Health Technology Centre. Located in the suburban district of Shatin in Hong Kong, this office building housed many other small listed companies, many of which bought and sold each other's shares, provided loans to one another and swapped senior executives.[10] In particular, Dr. Hui Ka Wah Ronnie, owner of the office building, served as CEO and finance director of HTF between 2011 and 2014, amongst other executive and directorship positions he held in other small companies housed in the building.

Following a series of acquisitions and company name changes, HTF listed on SEHK in October 2014, listing on the main board under the ticker 566:HK.

Headquartered in Hong Kong, HTF is a high-tech energy enterprise whose principal activities include the manufacturing and assembly of thin-film power production lines, and the technological development and production of thin-film power projects and application products.

The Board of HTF, chaired by Li, consisted of 10 directors, with six executive directors. Five out of the six executive directors also hold management positions in the unlisted parent group, Hanergy Holding, where Li serves as both the Chairman and Chief Executive Officer.

Board of Directors

Of the four independent non-executive directors, both Zhao Lan and Xu Zheng did not have prior experience sitting on the board of a listed company. All four independent non-executive directors sit on the Remuneration, Nomination and Audit Committees, with Zhao chairing both the Audit and Remuneration Committees and Wang Tongbo taking on the role as the Chairman of the Nomination Committee. Li and CEO Dai Frank Mingfang are also members of the Nomination Committee. The Board has diverse competencies in business management, science, engineering, accounting and economics.

The Board held 62 full board meetings for the year ended 31 December, 2013.[11] For the following year, only four board meetings were held.[12]

Bigger Hanergy, less smog?

It was a "miracle maker" indeed as HTF's share price rose five-fold from its listing in October 2014 until May 2015.[13]

The rise in HTF share price was partially fueled by demand from Mainland Chinese investors. With the establishment of the Shanghai-Hong Kong Stock Connect ("SHSC") on 17 November 2014, Mainland Chinese investors could now trade on the SEHK and vice versa. HTF's shares emerged as the most frequently traded shares by Mainlanders via the SHSC in February and March 2015 as Mainland investors were lured by its promising prospect of building the Chinese Dream in pursuit of clean and sustainable energy.[14]

An official from Heyuan, Li's hometown, commented that buying shares in Hanergy had become a hot topic with the introduction of the SHSC, as "many people said they had information that the stock will continue rising".[15]

By March 2015, about 32% of HTF shares were traded via the scheme's southbound route.[16]

In April 2015, Bloomberg reported that Li bought 53.9 million shares as HTF's market value climbed northwards, further increasing his stake in the company.[17]

While the share prices of other solar companies in China experienced a downward trend due to falling oil prices between September 2014 and March 2015, HTF shares advanced 479%.[18] Intrigued by Hanergy's ability to go against the tide, analysts began scrutinising the company.

Solar eclipse

The Wall Street Journal's publication "Solar Giant Hanergy Requires Extra Sunscreen" dated 5 January 2015 raised suspicion on the then little-known HTF which had come out of nowhere to become the world's largest solar-power company by market value.[19] Beyond the exceptional share price performance, HTF's then market capitalisation of HK$14.4 billion approximated the combined market capitalisation of the three largest solar companies in the world – SolarCity, Sun Edison and First Solar.[20]

Hanergy did not respond to the article. By May 2015, the market value of HTF had grown six-fold to overtake the combined market capitalisation of the entire public solar sector in China.[21]

Unproven technology

On 9 March 2015, an article published by Bloomberg Business called HTF out for "unproven" technology.[22] Bloomberg New Energy Finance had been "unable to find a detailed list of solar-power projects that would help explain why the company's shares have risen fivefold in the past year". Bloomberg also discovered that "the main items of value for Hanergy Thin Film are the thin-film technologies, which are unproven in large-scale commercial production, and the project development pipeline in China"[23]. However, HTF did not respond to the questions raised.[24]

Unusual trading patterns

"Hanergy: The 10-minute trade" by the Financial Times highlighted unusual trading patterns of HTF's shares within 10 minutes before the close of trading on SEHK.[25] The article observed that "shares consistently surged late in the day, about 10 minutes before the exchange's close", and remarked that such a trading pattern was "extremely unlikely to have occurred randomly", suggesting that the stock price may have been "systematically manipulated".

In response to the "innuendo" that Li was manipulating share prices, HTF published an announcement saying the company was "not aware of any such alleged market misconduct activities by any person".[26]

Unconventional accounting practices

On 1 April 2015, Forbes published an article claiming that Hanergy employed questionable accounting methods.[27]

- HTF essentially only had one customer: parent company Hanergy Holding and its affiliates. More than 99% of the company's sales originated from transactions with these related parties.
- There was a huge discrepancy between profits and cash flow because a significant proportion of its accounts receivable remained uncollected. Total receivables increased from 129% to 195% of revenues between 2013 and 2014, and more than 80% of total receivables were overdue.
- Rather surprisingly, for a manufacturing company, 95% of the company's long-term assets were in goodwill and intangibles.

Again, HTF did not clarify the accounting practices employed by the company. Despite the heightened suspicion of analysts, and the queries left unanswered by the company, HTF's share price continued its surge at an astonishing rate.[28]

On 18 May 2015, Li increased his short position by 796 million shares.[29] By 20 May 2015, he had accumulated a net 74.96% of the stock according to regulatory filings, creeping very close to the minimum 25% free float requirement specified by the SEHK Main Board Listing Rules.[30]

Where there's smoke, there's fire

Heavy trading in HTF's shares started shortly before the commencement of company's annual general meeting at 10 a.m. in Hong Kong on 20 May 2015. Stock trading was intense, with traders offering to buy and sell millions of shares each time.[31]

In the span of less than a second, a series of buy orders ranging from 8,000 to 30,000 shares were made at rapidly declining prices. Consequently, the market price of HTF shares fell from HK$6.80 to HK$3.91, wiping out US$20 billion worth of market value in less than 60 seconds.[32]

At 10:40 a.m., trading of HTF shares was suspended at the request of HTF. Some 175 million shares had changed hands by then – the share's highest daily trading volume since 24 April 2015.[33]

HTF did not immediately comment on the nosedive in share price. Neither did Li attend the company's annual general meeting. When questioned by the press, Li's representative replied that Li "had something to do".[34]

In a subsequent interview with China's official news agency, Xinhua, on 27 May 2015, Li denied the possibility of any investigation by Hong Kong's Securities & Futures Commission (SFC). "This is purely rumour, there is no such possibility," he said, "I would be the first to know if the authorities were really planning a probe. But I know nothing about such news."[35]

On 28 May 2015, in response to Li's statement, SFC took the unusual step of confirming that an inquiry into HTF's "affairs" was underway.[36]

Part VI: The Chinese fire drill

On 15 July 2015, the SFC directed SEHK to prolong the suspension of Hanergy shares.[37] This was a rare move that is deployed only when SEHK discovers that a company has distributed "any materially false, incomplete or misleading information". This rule has been applied only seven times since 2003. Only one of the seven firms was allowed to restart trading without any punishment.[38]

The next day, HTF broke its usual silence and commented that the SFC rule was "unfair and unreasonable", because the company was not able to provide "Documents not in the Company's Possession".[39] HTF appealed to the SFC to cancel the rule and resume trading, not ruling out the possibility of challenging the regulator in court.

Subsequently, the SHSC announced that Hanergy would be removed from the Stock Connect and investors would no longer be able to buy the company's shares under the scheme but could sell if trading resumes.[40]

The company considered a share buyback to compensate employees who bought the shares at about HK$6 prior to HTF's suspension on 20 May 2015.[41] However, individual retail investors in the mainland who held 1.6 percent of shares worth HK$2.6 billion, were not so lucky. It was estimated that HTF had four billion shares being traded, and that the company would incur HK$16 billion in the event of share buybacks, based on the price when trading was halted.[42]

HTF also made multiple announcements in the subsequent months regarding the termination of related party transactions with Hanergy Holding and its affiliates. These cancellations had massive repercussions, as HTF went on to report a net loss of HK$59 million for the six months to 30 June 2015, compared to a HK$1.7 billion profit reported in the same period one year ago.[43]

Part VII: Firefighting – Too little, too late

"The government and the regulators just haven't kept pace with the responsibility they are charged with." – Paul Gillis, June 2015[44]

Criticisms of the SFC

After the Hanergy debacle, Quartz released an article criticising the regulators for not looking deeper into the well-publicised reports that raised red flags on HTF's operations and share performance.[45] One of the reasons cited was the lack of manpower in the SFC. With the implementation of the SHSC, trading volume increased tremendously while the number of employees in the SFC did not increase proportionately. In addition, compared to other regulators in mature markets (e.g. US, UK and Australia), SFC had a relatively small budget. The ineffectiveness of SFC was further aggravated by the departure of its long-time Head of Enforcement, Mark Steward.[46]

Another structural problem was the alleged lack of oversight by the auditors despite the regulatory system's reliance on them (and not the SFC) to verify company's reported results.[47]

The SFC was also castigated for not disclosing HTF's investigations earlier in accordance with the non-disclosure rules. Although HTF had been the subject of a probe by SFC for alleged market manipulation for at least two months prior to the drastic fall in share price,[48] disclosures were only made when Li publicly denied the investigations. Critiques believe that the disclosures should have been made earlier, as "that would at least put people on notice," said David Webb, a corporate governance activist.[49]

Criticisms of the SEHK

The Quartz article also cast doubt on the competence of the SEHK's Listing Committee, which played a deciding role in determining which companies should be allowed to list.[50]

The phoenix rising from the ashes?

"I had enormous direct losses, but what makes me even hurt are the losses for the shareholders, investors, investment institutions and our employees."
– Li Hejun, October 2015[51]

The issues plaguing HTF for months led Li to highlight fractures within the company in retrospect. Moving forward, he laid out the changes that would be introduced, which included a "more open, transparent cooperation mechanism". He also reiterated his non-participation in manipulating the company's shares. However, only time will tell if "the error has ended, the right has begun".[52]

Epilogue

Exactly one year after the trading halt, Li resigned as the Chairman of the Board and Executive Director for the reason of "strengthening corporate governance" after the listed company's Board Meeting on 17 May 2016.[53] Even so, Li still remained a "conspicuous promoter" of HTF's technology.[54] HTF's debacle has affected its relationship with a few notable banks such as Bank of Jinzhou.[55] Li's successor, Yuan Yabin, was a formal member of the Chinese People's Political Consultative Conference Committee, providing a reminder of the political connections the company enjoys.[56]

Discussion questions

1. Comment on HTF's board structure and procedures, and identify any issues in the corporate governance of HTF.

2. Discuss the factors that may have contributed to the sharp increase in HTF share prices. Which factor do you think is the most important?

3. Identify the red flags in HTF's operations that were raised in the published articles. What more do you think the different stakeholders (i.e. the board, investors and employees) could have done in light of these concerns?

4. Comment on the roles and responsibilities of SEHK and SFC, and how they have responded to the concerns raised by reputable publications. Do you think the SFC's non-disclosure rules are effective in helping them to fulfill their responsibilities?

5. In light of the related party transactions, discuss the appropriateness of the "true and fair" opinion issued by EY. Singapore and some other countries are introducing the expanded auditor's report in 2016. Do you think such a report would have made a difference in the HTF case and provided more protection for investors?

6. HTF has refused to provide relevant documents relating to Hanergy Group because it is an unlisted company and under the jurisdiction of China, not Hong Kong. How can such situations be prevented? What concerns does this raise about such companies listing in Hong Kong?

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GANGNAM STYLE: HYUNDAI'S LAND PURCHASE

Case overview

On 18 September, 2014, Hyundai Motor Group ("Hyundai") offered a bid price of ₩10.55 trillion for a land purchase in Seoul's high-end Gangnam district. However, the offered sum was more than three times the appraised value of the land of ₩3.33 trillion and significantly above market watchers' expected bid price of ₩5 to 6 trillion.[1] Skagen Funds ("Skagen"), one of Hyundai's largest shareholders, strongly expressed their discontentment.

The objective of this case is to allow for a discussion of issues such as the corporate governance in South Korean conglomerates; board composition and board decision-making; and shareholder activism.

Company overview

Hyundai Motor Company, the largest automobile manufacturer in South Korea,[2] manufactures and distributes a wide range of automobiles, vehicles and auto parts.[3] The Hyundai Motor Group also consists of Kia Motors Corporation ("Kia"), Hyundai Mobis Co. Ltd. ("Hyundai Mobis") and other affiliates. Many foreign investors, such as Skagen, own shares in Hyundai.

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Skagen funds

Based in Norway, Skagen is an independent mutual fund management company, and its strategy is to identify "undervalued and often slightly misunderstood companies in unpopular sectors and regions with the potential to increase in value".[4] South Korean shares made up 8.6% of Skagen's portfolio.[5] It was believed that the lower price-to-earnings multiples of South Korean shares were a result of the complex ownership structure in many of the family-run conglomerates.[6]

Hyundai became part of Skagen's portfolio when the stock was on sale at the height of the financial crisis in 2009.[7] Hyundai was perceived to have good fundamentals and low valuation.[8] As at the end of September 2014, Skagen held at least 5.7 million of Hyundai's preferred shares[9] and was thus considered to be Hyundai's largest holder of preferred shares.

The foreign ownership dissension

With many South Korean companies facing an increasing level of foreign investment, South Koreans harboured feelings of dissent towards foreign ownership. This could be attributed to the nationalistic nature of the country. The Asian Financial Crisis further exacerbated their resentment towards foreign investors, when the sudden withdrawal of foreign bank lending contributed to the collapse of the banking system, and subsequently the weakening of the won and South Korea's asset values. As a result, significant portions of South Korean businesses fell into foreign ownership at a deep discount.[10]. In 2005, South Korea's Financial Supervisory Commission Chairman Yoon Jeung-hyun even pushed for penalties on foreign investors attempting to exercise shareholder rights.[11]

Triumphs and tribulations of shareholder activism

Until the mid-2000s, shareholder activism in South Korea has been rather muted. Most shareholder activism was driven by the People's Solidarity for Participatory Democracy (PSPD). PSPD's first successful case won ₩40 billion on behalf of minority shareholders against Korea First Bank in 1997.[12]

However, the effectiveness of foreign shareholder activism has been largely dismal. In 2003, Sovereign Asset Management, a Dubai-based investment fund, failed to oust Chey Tae Won, SK Corp.'s Chairman and CEO who was convicted in a US$1.3 billion accounting fraud.[13] In 2006, American investor Carl Icahn attempted to force Korea Tobacco & Ginseng Corporation (KT&G), South Korea's largest cigarette maker, to boost shareholder value. Although KT&G eventually gave in, shareholder activism efforts were deemed to be too risky and returns were unjustified.[14]

The *"corporate cash-hoarding"* tax

Following the 2008 financial crisis, leading companies in South Korea hoarded extravagant cash balances. In total, these firms held 34% of the country's GDP in cash at the end of 2013.[15] However, they continued to be miserly in paying dividends despite the increasing pressure from shareholders for distribution. The government was worried that such behaviour would "deter foreign interest in the stock market."[16]

On 6 August, 2014, the South Korean government introduced an extensive package of tax reform measures. Large companies were required to spend a minimum on dividend payments or face an additional 10% tax on profits.[17] The goal was to unlock billions of dollars in corporate cash reserves in a bid to address the country's exceptionally low dividend yields.

The new tax laws excited investors, who began to build up expectations of higher dividends. They were optimistic in thinking that Hyundai would raise dividends to avoid the punitive cash hoarding tax. Heo Pil Seok, CEO at Midas International Asset Management Ltd., which oversees US$10 billion including Hyundai shares, said that "the market's hopes that Hyundai may increase its dividend to avoid extra tax".[18]

But they were wrong; the management of Hyundai had something else in mind.

Breaking new ground

On 18 September, 2014, Hyundai offered a bid price of ₩10.55 trillion for the site of its new headquarters in Seoul's high-end Gangnam district. The 79,345 square meters of land was the main headquarters of the state-run Korea Electric Power Corp. However, the offered sum was more than three times the appraised value of the land of ₩3.33 trillion and significantly above market watchers' expected bid price of ₩5.6 trillion.[19]

Hyundai's offer for the piece of real estate had outbid rivals such as Samsung Electronics Co., Ltd. (Samsung Electronics).[20] With this, Hyundai broke the record for the highest auction price for an individual plot of land in South Korea. According to analysts, the scale of the transaction was sufficiently large to be the "world's biggest single asset real estate deal ever".[21]

The price is right?

To justify this astronomical purchase, Hyundai assured shareholders that the decision was a "calculated one to company growth". It had plans to house about 30 of its affiliates under one roof to improve efficiency, which would result in ₩250 billion worth of savings in rent.[22] There were also plans to build an automobile theme park at the new location to enhance its brand image. Hyundai was quick to dismiss market concerns that they may have confused their priorities and undermined long-term global competitiveness.[23]

Some analysts agreed with the long-term profitability of Hyundai's actions. Ryu Yenhwa, a researcher of automobile industries at I'M Securities & Investment, commented that investors have no need to be worried about potential liquidity or funding issues. He explained that "since 30 affiliates of the conglomerate will take part in the building process, any arising financial issues will be short-lived". Other analysts agreed that the move could greatly improve Hyundai's brand equity and possibly result in sizeable earnings, especially if land prices increase.[24]

However, a majority of the analysts felt otherwise. "There's nothing investors can benefit from the company's purchase of the land," said Hong Jin-ho, an analyst at IBK Securities.[25]

Crash and burn

On 18 September, 2014, the day of the land purchase, the share price of Hyundai tumbled by more than nine percent, the steepest single-day decline in three years. Both Kia and Hyundai Mobis, who were also in the bid group, witnessed a dip in their stock price as well, of 7.8% and 7.9% respectively.[26] By the next day, the combined market capitalisation among the three companies fell by more than ₩11 trillion, exceeding the purchase price offered for the Gangnam investment.[27]

This huge fall in Hyundai's share price further reduced investors' confidence in the South Korean market, which contributed to a sell-off of South Korean equities in the following month. There was a net withdrawal of US$2 billion from Korean equities by foreign investors in October 2014 – the highest since June 2013.[28] Furthermore, Hyundai experienced operational disruptions as a result of a labour strike as workers were against the deal.[29]

Hyundai's extravagant purchase of the overvalued land greatly aggravated investors, who had been waiting for higher dividends in light of the government's new tax reforms. Shareholders generally agreed with analysts that excess cash should have been paid out as dividends.[30] Amidst a cut-throat business environment, where carmakers are struggling to keep up with competitors, there were further concerns that the land purchase would invariably limit the resources left available for research and development.[31]

Skagen flares up

In October 2014, Skagen outwardly expressed their strong disapproval towards Hyundai, and eventually reduced their holdings of Hyundai's shares by 25% to 6.9%.[32]

Knut Gezelius, a money manager at Skagen, chided that the deal was "an embarrassment to Hyundai's management team".[33] He represented the sentiments of investors at Skagen who allegedly disagreed with the decision and called for a better use of shareholders' money.

Gezelius also compared Hyundai's land deal with the decision made by Samsung Electronics; the latter decided to invest US$15 billion in a new semiconductor chip plant in October 2014.[34] "One company spends money on building an auto theme park and another company spends money on making solid investments generating high returns," he lamented. Moreover, unlike Hyundai, Samsung had promised to increase its dividend from 0.6% to 1% of the annual share price for the year 2013.[35]

Yet, in spite of their huge ownership of preference shares, Skagen was not able to have a say in Hyundai's business decisions, due to the unique *chaebol* structure of South Korean firms. As a result, "shareholder activism in South Korea tends to be muted", according to an analyst at Solidarity for Economic Reform, an activist group.[36]

The bane of *Chaebols*

Chaebols are a form of conglomerate unique to South Korea. The ownership structure of *chaebols* has once again been thrown into the spotlight after the Hyundai saga. A typical *chaebol* has a single founding family at the helm that controls the entire group through a complex shareholding structure. Cross-shareholdings are commonplace in *chaebols* – affiliates within the same group tend to own each other's shares, resulting in a circular ownership structure.[37] This allows the chairman of the group to effectively control the entire group despite having a tiny shareholding. Moreover, family power is maintained through dynastic succession, where the retiring chairman of the group passes the title to one of his family members.[38]

The person with effective control over the *chaebol* has a strong influence on resource allocation and decision-making. Major boardroom decisions are often passed without much disclosure to shareholders.[39] This lack of transparency contributes to poor corporate governance within the *chaebol*, which is further exacerbated by the lack of checks and balances on a controlling shareholder that wields too much power.[40]

The Chung empire

Hyundai's board consists of nine directors: four internal and five external directors.[41] CEO and Chairman Chung Mong-koo is the son of the Chung Ju-Yung, founder of the Hyundai Group. A controversial figure, Chung Mong-koo had a brush with the law after an embezzlement scandal in 2007.[42] His son, Chung Eui-Sun, is the Vice-Chairman on the board.[43]

External board members are appointed to represent shareholders' interests and monitor the management. However, they are "appointed with recommendations from *chaebol* owners or management under the influence of the government, so they cannot make independent decisions", commented Park Yoo-Kyung of AP Asset Management Asia.[44]

Offering an alternative perspective, Nam Sung-il, a professor at Sogang University who sits on Hyundai's board[45], shared that family-run business structures have their own advantages too, such as "quick decision-making on tough issues and long-term investments by owners that can see a company through crises."[46]

Fast and furious

According to minutes of Hyundai's board meetings, the Chairman was not at the meeting when Hyundai's board of directors convened to discuss the planned purchase.[47] External directors told the press that it was common for him to skip such board meetings. The puzzled press went on to raise many questions for the board:[48]

"Do we need the land?"
"Why is the company going to buy an expensive Gangnam area?"
"Is there no other choice?"

However, many of the questions were not fully addressed. One thing was clear: that Chairman Chung was set on the land purchase. He repeatedly told the directors during the bidding process that "money [for the land purchase] is no problem".[49]

"Company executives were desperate to persuade external directors to approve [the purchase] at the board meeting. For Hyundai, the land wasn't just an investment, it was something the company couldn't afford to lose", an external director revealed to the press.[50]

Nonetheless, the board was not privy to the bid price as it was deemed "top secret". Despite the Chairman's absence at the meeting, the board had unanimously agreed with the bid and "rubber-stamped" the deal, all within 30 minutes. "That means the meeting was just a formality", said Kim Sang-Jo, a professor at Hansung University.[51]

Chairman Chung only had a 5.2% stake in the company but effectively pulled the strings behind the land purchase decision – usual of a *chaebol* where the controlling family could typically undertake major corporate decisions unchallenged.[52]

Damage control

On 23 October, 2014, Hyundai announced plans to increase their annual dividends and shareholder payments from 2015 in a bid to appease shareholders.[53] This resulted in a rise in the price of Hyundai's shares by 5.9%, the highest increase in two years. The move also helped ease concerns that the overvalued purchase would limit the prospects of increased dividends.[54]

On 11 November, 2014, both Hyundai and Kia pledged to buy back common stock "to maximise shareholder value by stabilising share prices", driving share prices up by 4.8% and 2.2% respectively. Seo Sung-moon, an analyst at Korea Investment & Securities remarked that Hyundai "wanted to repair the damage" caused by the land purchase.[55]

On 22 January, 2015, Hyundai announced its biggest-ever dividend. The year-end dividend for 2014 was raised by over 50% to ₩3,000 per share. Hyundai announced it would continuously increase its dividend payouts in coming years even though its operating profit was at a four-year low.[56]

Throughout the process, Hyundai declined to comment on the decision-making process by the board. In spite of their subsequent actions, the cost of staying silent was reflected in Hyundai's and its two affiliates' share prices, which have yet to recover to pre-deal levels.[57]

A bunch of AGMs

The clustering of Annual General Meetings (AGMs) among South Korean companies makes it a challenge for shareholders to actively exercise their rights. On 13 March, 2015, 68 listed companies – including affiliates of Samsung, Hyundai and LG – held their AGM.[58] Investors were concerned over the clash of AGM dates, as they would have to prioritise which AGMs to attend. The massive overlap could make it difficult for shareholders to raise salient questions on issues such as unauthorised expenditures.[59]

Shareholders' uprising

At Hyundai's 2015 AGM, several disgruntled shareholders spoke up against the unilateral corporate decisions and ethical lapses that had decreased shareholder value. Some investors even urged Hyundai to set up a board committee to focus solely on improving corporate communication and governance.[60]

Hyundai's second-largest shareholder, National Pension Service, had voted against the reappointment of non-executive board members involved in the land purchase, citing that their "consent to Hyundai's extravagant land deal … caused the company's stock price plummet".[61] Although the outcome of the meeting was in the directors' favour, the "no" votes reflected investors' unhappiness regarding the lack of transparency in decision-making within *chaebols*. Market watchers remarked that while such efforts "weren't able to turn the tide, their movements still count as a warning signal to conglomerates".[62]

Moving forward

The Corporate Governance Watch 2014 published by the Asia Corporate Governance Association revealed consistently poor corporate governance scores in South Korea.[63] However, shareholder activism is on the rise, as can be seen from the Hyundai's case. Investors such as Skagen are increasingly aware of their rights as shareholders. However, whether their efforts are successful in pushing for improvements in corporate governance remains to be seen.

Discussion questions

1. Discuss how the chaebol business model affects corporate governance in South Korea.

2. "Company executives were desperate to persuade [external] directors to approve [the purchase] at the board meeting. For Hyundai, the land wasn't just an investment, it was something the company couldn't afford to lose". Evaluate Hyundai's board of directors and comment on the decision-making process by the board with regards to the land purchase.

3. Do you think Skagen's purchase of Hyundai's shares was a sound investment? If you were Skagen, would you have decided to invest in Hyundai?

4. Comment on shareholder activism in South Korea. Evaluate the effectiveness of shareholder activism by Skagen and other shareholders. Do you think this was successful?

5. Comment on the bunching of AGMs in South Korea. What improvements do you think could be made? Do you think such a phenomenon would have occurred in Singapore?

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SYNC OR SWIM? SAMSUNG C&T AND CHEIL

Case overview

In late May, Cheil Industries ("Cheil") declared an all-stock takeover of Samsung C&T Corporation ("C&T") with Cheil offering 0.35 new shares for each C&T share. The move, led by Lee Jae-Yong, acting Chairman of Samsung Electronics, and aimed at solidifying the Lee family's control over Samsung Group, triggered one of South Korea's most intense proxy fights. American hedge fund Elliott Associates ("Elliott"), a shareholder of C&T, led a public campaign that was heavily scrutinised by C&T supporters and the media, to block the proposed takeover. The campaign sought to garner shareholders' support, citing that the move significantly undervalued C&T and that the terms were neither fair nor in the best interests of the shareholders of C&T. In what was a rare case of shareholder activism in South Korea (the first to defy South Korea's largely dominated Chaebol Circular Shares Ownership Structure), Elliott went head-to-head with Cheil and C&T in an attempt to block the merger. On 17 July 2015, shareholders voted in favour of the merger, approving one of the most controversial mergers in South Korea.[1] The objective of this case is to allow discussion of issues such as shareholder rights and activism; family businesses and circular ownership; takeovers in different jurisdictions; succession planning issues; and the role of mergers and takeovers as a corporate governance mechanism.

This is the abridged version of a case prepared by Edmund Xue Jia Jun, Johnson Ooi, Low Zheng Han Hans, Leong Guo Feng and Tan Jing Jie under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Nick Wee under the supervision of Professor Mak Yuen Teen.

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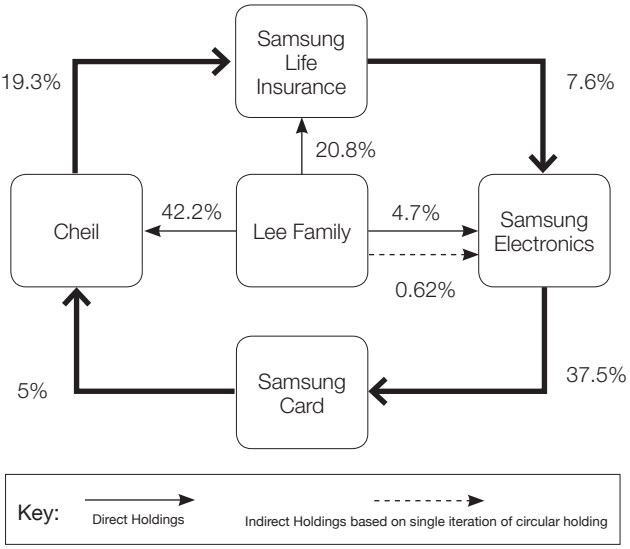
The story of Samsung: A circular affair

Samsung Group Holdings was founded by Lee Byung-Chull in 1938 as one of the first chaebols[2] in South Korea. In 1987, the ownership was inherited by the current chairman, Lee Kun-Hee, who had globalised Samsung's operations through its flagship company, Samsung Electronics. Under Lee Byung-Chull, Samsung grew to be the largest chaebol in South Korea. As of 2014, Samsung Group consisted of 74 companies in various industries, including construction, consumer electronics, financial services, shipbuilding and medical services. It also generated ₩204 trillion in revenue, making up 17% of South Korea's GDP.

Samsung had 17 major circular shareholding relationships within the group, with Samsung Life Insurance, Cheil (previously known as Samsung Everland), Samsung Electronics, Samsung Card, and C&T at the core of the group's links. The Lee family owned a mere combined 1.53% of the total shares in the group, but wielded an effective control of 49.7% via its circular holdings (See *Figure 1*[3]). Ultimately, the Lee family owned 42.2% of Cheil, which owned 19.3% of Samsung Life Insurance, which had a 7.6% stake in Samsung Electronics, which owned 37.5% of Samsung Card, which owned five percent of Cheil.

Diagram: Example of one circular holding by the Lee Family



Source: The Economist magazine

Figure 1: Circular holdings by the Lee Family

Keeping within the family

In light of Lee Kun Hee's hospitalisation and unsettled state of health since May 2014, succession plans for his son were in order. Lee Jae-Yong looked to solidify the family's control over Samsung Group via a merger between Cheil and C&T. Under Samsung's existing circular structure, Lee Jae-Yong already owned a 23.3% stake in Cheil Industries and 0.6% in the flagship Samsung Electronics. The merger would give him a direct 16.5% share in the merged entity and allow him to gain control over Samsung C&T's 4.1% stake in Samsung Electronics,[4] making the merger proposal a related party transaction between entities within the Samsung Group.

On 26 May 2015, both companies released the merger announcement. The merger was an all-stock deal and would be paid in shares, whereby shareholders would receive 0.35 Cheil shares for each C&T share. The merger ratio was not negotiated but rather in accordance with South Korean law that mandated all-stock merger ratios to be based on existing share prices.[5] Shareholders of C&T were scheduled to vote on 17 July 2015 to decide on the merger, and a 66.67% majority of votes would be needed for the merger to pass.

Activist hedge fund looks to thwart merger

During the period from 26 May to 3 June 2015, American hedge fund Elliott announced its objection to the merger and increased its existing holdings in C&T to 7.12%, becoming C&T's third largest shareholder. On 4 June 2015, Elliott announced its intention to gather support from other shareholders to oppose the merger.

Founded in 1977, Elliott managed two funds, Elliott Associates L.P. and Elliott International L.P., with assets under management totalling more than US$26 billion. Elliott's investors include pension plans, sovereign wealth funds, hospitals and university endowments. With a primary focus on risk control, stability, and steady growth of capital, Elliott was a multi-strategy hedge fund, carrying out a diverse range of investment activities,[6] such as its holdings in C&T.

Subsequently, on 9 June 2015, Elliott filed a court injunction to block the merger by citing that the proposed takeover is "unlawful" and not in the best interest of C&T's shareholders. The next day, C&T announced that it would sell nine million of its treasury shares to an allied company, KCC Corporation (KCC), making it the fourth largest shareholder of C&T. KCC was expected to vote in favour of the merger.

In response, on 11 June 2015, Elliott filed another injunction to stop C&T's sale of treasury shares to KCC, intending to remove KCC's ability to vote for the merger.

The attack on Samsung C&T escalates

To justify the two injunction requests, Elliott publicly published a critical deck of slides laying out its case against the deal on 18 June 2015. The slides were prepared for proxy advisory firm Institutional Shareholder Services Inc. who would then issue a recommendation that hopefully supported Elliott's campaign against the merger. The slides built upon Elliott's initial reaction and claims, citing the merger as 'unlawful' and not in the interests of shareholders with the following key points:

Findings and Claims from Elliott[7]	Corporate Governance Issues
The current merger ratio undervalued C&T	
The terms of the proposed takeover significantly undervalued C&T. Despite its status as a leading Engineering and Construction company, C&T's share price had consistently underperformed the equity market valuations of its peers, including Cheil, ever since the latter's IPO in December 2014. On the day before the announcement, C&T was trading at a 40% discount to its net asset value.[8] As such, the terms provided new shares in Cheil to existing shareholders which were extremely overvalued.	Elliott believed that an inflexible formula based on the parties' historical share prices, i.e. the Merger Formula, had been used in determining the consideration ratio for the all-shares merger of both companies. The Proposed takeover could not be properly or fairly assessed based on the existing equity market valuations of both companies - an appropriate assessment must be based on the respective fair values of the two companies. The Board of Directors of C&T should have considered if the merger ratio was disadvantageous at the time of merger.

The synergies arising from the two companies appear dubious	
The merger proposal carried minimal evidence of the claimed synergies and benefits. Additionally, C&T's highly complex Engineering, Procurement, and Construction (EPC) contracts were vastly different to Cheil's vanilla building and remodelling portfolio. As such, Elliott saw little sense in the diversification benefits claimed by the Samsung Management.	The merger was largely seen as an attempt to strengthen acting Chairman Lee Jae-Yong's foothold in the Samsung Chaebol. It illustrated that C&T's board of directors did not properly discharge their duties to act in the best interests of the company and its shareholders when transacting the merger. Due to the loss of value and benefits, the board of directors of C&T should have withheld and called off the proposed takeover.
The merger strengthened the Lee family's grip on the Samsung group	
Cheil was a de facto financial holding company with more than 50% of the aggregate value of its total assets being held in the Samsung Group. The proposed takeover would further create new shares of the merged entity, in turn creating substantial circular shareholdings for the Lee Family.	There are key regulatory concerns, including potentially open-ended regulatory risks of Cheil Industries as a financial holding company. Such risks could be highly detrimental to C&T shareholders if the transaction were to proceed.
Elliott considered the sale of treasury shares by C&T to KCC Corp on the proposed takeover date to be especially alarming.	The act infringed the rights of C&T shareholders by diluting both the value and voting rights of their holdings. This spells a lack of Board independence as well as a disregard of shareholders' rights.

Samsung C&T strikes back

Following Elliott's online attack, C&T launched a similar investor presentation on the Cheil-C&T merger on 24 June 2015, which was released on C&T's corporate website.[9] In its presentation, C&T focused on re-stating the benefits of the merger, such as the attractive growth opportunity to improve C&T's top line, an optimal diversification of its business portfolio, and the marrying of both companies' core competencies.

Synergies were illustrated through detailed revenues and targets in the areas of Engineering & Construction, Trading, Fashion, Food/Leisure and Biotech[10] which provided seemingly compelling quantitative evidence. In particular, C&T highlighted that the proposed merger ratio was mandated by South Korean laws and regulations. Furthermore, C&T claimed that its own Board of Directors, as well as other third party professionals, had made a conscientious effort to review the proposed merger thoroughly before concluding that the merger was in the best interest of C&T and its shareholders.

Elliott's indignation grows

Clearly dissatisfied with C&T's answer, Elliott continued to express its criticism of the proposed deal. On 25 June 2015, Elliott requested that C&T and Cheil prove that proper due diligence had been performed. In a second online presentation, Elliott called for both companies to provide supporting documents to "substantiate the aggressive targets" that C&T had earlier described.[11] Elliott also questioned the objectivity of C&T's targets, believing that the proposed deal was crafted by "a board with questionable independence".[12]

Elliott also countered that although the offer price for C&T was in compliance with Korean law, it did not change the fact that the offer price was grossly undervalued, which was against the interests of C&T shareholders.

In an email response, C&T asserted yet again that the proposed takeover was "clearly in the best interests" of shareholders, and called for investors to ignore Elliott's criticism of the deal.[13] Both sides campaigned over their stand for and against the merger, in order to galvanise support for their own cause.

The central district court passes a verdict

On 1 July 2015, the Seoul Central District Court denied Elliott's attempt and injunction to block the proposed C&T merger. The court justified its decision by affirming that the merger price offered for C&T's shares was "based on relevant laws", and not "significantly unfair" to C&T's shareholders. The court also based its decision on the fact that the share price of C&T had gone up after the proposed merger was announced, rejecting Elliott's claim that the merger would harm the interests of the shareholders of C&T.[14]

In response to the court ruling, Elliott expressed its disappointment in a press statement; insisting that "the proposed merger [was] neither fair nor in the best interests of C&T's shareholders." It emphasised that it would "continue to seek to prevent the proposed merger from being consummated," and continued to urge the shareholders of C&T to vote against the merger.[15] Subsequently, on 3 July 2015, Elliott sought an appeal to overturn the court's decision.[16]

On 6 July, Elliott was dealt yet another blow, when the same court denied its second injunction request to stop KCC Corp from using the treasury shares that were recently bought from C&T to vote on the Samsung merger. The Seoul Central District Court ruled that C&T's sale of treasury shares was valid and fairly priced, and was not solely beneficial to the Samsung group.[17]

In response, Elliott maintained that the deliberate sale of treasury shares to ensure the success of the proposed merger was "wholly improper, not least from a corporate governance perspective."[18] It would, once again, seek to appeal this decision.[19]

C&T responded by defending that the sale of treasury shares was a "legitimate and fair move that was made with the best interests of the company and shareholders in mind." To this end, Cheil declined to comment, citing that the issue was a "matter between C&T and its shareholders".[20]

Investors and shareholders to choose sides

With regards to the proposed merger, investors such as APG Groep NV, the world's second-largest pension fund, and Aberdeen Asset Management PLC, agreed with Elliott that the merger should not be passed. APG Groep NV criticised C&T for "burning the bridge" by not listening to shareholders' views. Aberdeen also questioned the merits of the deal for C&T shareholders. Proxy advisory firms, such as Institutional Shareholder Services Inc. and Glass Lewis & Co also urged investors to reject the merger on the grounds that it was detrimental to the shareholder value of C&T. Although minority shareholders had limited influence in the merger, these shareholders in South Korea did still voice out their concerns about the merger in online forums.

On the other hand, C&T was also trying its best to win over the support of the undecided shareholders for its proposed merger. C&T sent its employees to visit the homes of shareholders, carrying gifts of watermelons and walnut cakes to garner support.[21] Concurrently, the company launched an aggressive advertising campaign by splashing the front pages of most South Korea's newspapers and Internet search engines, persuading its shareholders to vote for the merger.

As C&T's shareholders began to choose sides, its largest investor, South Korea's National Pension Service (NPS), had yet to announce its voting decision. NPS had previously blocked a merger between Samsung Heavy Industries and Samsung Engineering by exercising its option to request a buyback of its stock in both companies. This caused the two companies to abandon the deal due to the high cost of share buyback.[22] Thus, the NPS could play a key role in preventing the merger from going through.

The beginning of the new Samsung C&T

On 16 July 2015, the Seoul High Court rejected both appeals by Elliott regarding the two injunction requests.[23] The shareholder meeting was now expected to proceed without any interruption. On 17 July 2015, Cheil's shareholders unanimously passed a resolution approving the merger. On the same day, the proposed merger was voted on and narrowly passed, with approximately 70% of C&T's shareholders supporting the merger, including NPS. However, it was found that NPS made its decision without first consulting an external committee, which was its usual practice before making difficult decisions, to which the committee found "regrettable".[24]

In a joint statement made by C&T and Cheil, C&T promised higher dividends for its shareholders, as well as setting up a governance committee, in response to "those who opposed the deal" and promised to be more open and receptive to the views of its shareholders in the future.[25]

On the other hand, Elliott said that despite the outcome of the vote, it will reserve "all options at its disposal", and is expected to continue opposing C&T in its future dealings.[26] The market reacted negatively to the vote, with the share prices of both C&T and Cheil falling by 10.4% and 7.7% respectively.[27] As C&T made headway into its transformation as the new Samsung C&T,[28] it remained questionable if the merger was indeed beneficial to the shareholders of C&T and Cheil, or whether the sharp drop in share prices reflected future market expectations.

Discussion questions

1. How did the chaebol culture and cross ownership structure in South Korea affect shareholders? Are the rights of foreign and institutional shareholders protected? If Elliott were to be a Korean hedge fund instead of a US company, could things have turned out differently?

2. Given that Chairman Lee was hospitalised, was the need for his successor Lee Jae-Yong pledging to solidify his stake in the Samsung Group a legitimate reason for the merger? Were the reasons against the merger provided by Elliott justifiable in your view? Explain the divergence of interests between both parties.

3. After the merger had been passed, Samsung C&T promised to increase the amount of dividends and to include a governance committee. How effective do you think these would be in improving the corporate governance of Samsung C&T?

4. How would such a merger affect international and public perception of shareholder activism? What are the likely outcomes of such future challenges and opposition against such mergers?

5. In Asia, a large number of businesses are family-run firms like the Samsung Group and there is little shareholder activism. Do you think shareholder activism is beneficial from a corporate governance standpoint for such firms? Weigh the pros and cons. If a similar case of shareholder activism were to occur in your country, what do you think the outcome would be like? What are the barriers to shareholder activism in your country?

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THE KILLER TAKATA AIRBAG

Case overview

On 20 November, 2014, Hiroshi Shimizu, Senior Vice President for Global Quality Assurance for Takata Corporation ("Takata") testified before the US Senate Committee in Washington. The airbags of the world's second largest airbag manufacturer, Takata, had been linked to five deaths worldwide by November 2014.[1] Faced with allegations of a defective airbag product that was likened to "live hand grenades",[2] the family-managed Takata was accused of lacking transparency and urgency in managing the crisis, drawing public criticism and the attention of US transportation authorities.

The objective of this case is to allow a discussion of issues such as the entrenchment of the founding family in the ownership and management of a company; Japan's corporate governance landscape; and crisis management.

This is the abridged version of a case prepared by Kon Li Hua, Pang Yuh Chyi, Tan Ser Lin Michelle Ivy and Yeo Shi Min Shermaine under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Ang Qun Yun under the supervision of Professor Mak Yuen Teen.

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The rise of Takada's era

Founded in 1933 by Takezo Takada as a textile manufacturer in western Japan, Takata started its own research to manufacture seat belts in 1956 and was incorporated under the name Takata Kojo Corporation. It began to grow rapidly by expanding into the production of automotive safety equipment.[3] Subsequently, a subsidiary named Takata Corporation assumed the operations for automobile safety components with a dream "to reduce the number of fatalities of traffic accidents to zero."[4] Today, Takata's core businesses include airbag systems, seat belts and other safety equipment such as child seats and steering wheels.[5]

In the later years, Juichiro Takada, son of Takezo, undertook aggressive marketing efforts to enable Takata's successful foray into overseas markets like America, Europe and Asia. In 2006, he led Takata to list on the Tokyo Stock Exchange,[6] and it rose to become the world's second largest manufacturer of auto-safety equipment.[7] To date, Takata has 58 plants in 21 countries, and airbag systems make up 38.1% of sales.[8] In 2011, Shigehisa Takada, Juichiro's son, took over the 81-year-old family legacy after Juichiro passed on.[9]

The web of power

The Takada family maintains control over Takata by holding a majority of its shares through TKJ Corporation, Shigehisa and his mother. The board of directors of TKJ Corporation includes Shigehisa and his mother. Adding to the family's influence, ST KK, an investment management firm that is represented by Shigehisa, holds a 1.5% stake in Takata.[10] Takata has one "external director"[11] sitting on its Board and it adopts the Japanese kansayaku (statutory auditor) system by which kansayaku members are appointed by shareholders.

As at 31 December, 2015, Shigehisa occupied the positions of Chairman and CEO. His mother remained vocal in Takata's business dealings as a special adviser even after her departure from the Board in 2007. She also heads the non-profit Takata Foundation.[12]

Driving on dangerous grounds

Having established itself as a global manufacturer of safety equipment, Takata has been recognised as the automakers' reliable choice for airbags. Unfortunately, its reputation was affected when reports of driver-side airbag inflator ruptures surfaced in 2007 that led to the first phase of vehicle recalls by Honda in 2008. Between 2007 and 2010, Takata collaborated with Honda to conduct tests on recalled inflators and reviewed its entire inflator manufacturing process, prompting an expansion of recalls for additional vehicles. The problems were eventually traced to the pressing of propellant wafers at its Washington production facility.[13]

The unending road of recalls

From 2009 to 2012, cases of ruptures in the passenger-side airbag inflators were on the rise. In 2010, a recall of vehicles sold mainly in Asia was launched. The crisis was exacerbated in 2013 when an even greater number of global recalls were made by automakers, possibly due to humidity in the manufacturing process.[14] This time round, Takata's decision to use ammonium nitrate as inflator propellant was thrown into the spotlight: despite concerns over the compound's vulnerability to moisture and temperature, ammonium nitrate was still used in its propellant to inflate the airbag.[15]

Manufacturing nightmares

The recalls pushed Takata to hunt for loopholes in its manufacturing processes and it was revealed that Takata's engineers had struggled to maintain airbag quality across plants since the start of 2001. It was once documented that workers at the Monclova plant had welded and sealed the inflators with the wrong kind of steel tube. In addition to erroneous welding techniques, rust was also reported to have contributed to the failure of the inflators. In 2002, the plant documented 60 to 80 defects for every million inflators sent to automakers. This figure exceeded Takata's quality control limit by six to eight times.[16]

The red herring

Amid the mounting recalls, Shigehisa ceded his role of President to Swiss-born Stefan Stocker in 2013. Stocker was the first non-family member to be at the helm of Takata, and his appointment gave rise to speculation that Shigehisa was not as sufficiently experienced "as automakers would have liked".[17]

Stocker's appointment was to bring segregation of "responsibilities of CEO and COO… to give greater and more coordinated attention to strategy and implementation". This move was meant to appease investors, yet there were conjectures that his appointment was "more symbolic than functional". It was claimed, "Stocker was never given full responsibility for the management of the company".[18]

Finally facing the music

In June 2014, following reports of at least six deadly Takata airbag inflator ruptures, the National Highway Traffic Safety Administration (NHTSA) launched investigations into a new series of airbag problems linked to humidity.[19] It demanded recalls of both driver-side and passenger-side airbags for vehicles in high humidity regions and insisted that Takata intensify its testing on returned airbags.

On 14 November, 2014, the US Justice Authorities launched a criminal probe into Takata's airbags.[20] Shortly after, on 26 November, 2014, NHTSA demanded a nationwide recall of driver-side airbags when a case involving driver-side airbag rupture occurred in a Ford vehicle outside an area of high humidity. Meanwhile, an article by the New York Times alleged that Takata had conducted secret tests on a 2004 rupture. Former Takata employees claimed that signs of defects were discovered in that same year but executives had ordered test data to be destroyed. Takata refuted these claims.[21]

Takata in denial

On 3 December, 2014, the US Energy and Commerce committee held the hearing "Takata Airbag Ruptures and Recalls." Takata's Chairman was absent and in his place was Hiroshi Shimizu, Senior Vice President for Global Quality Assurance.[22]

Just the day before, Takata had defied NHTSA's earlier demand for a nationwide recall of driver-side airbags, on the basis that "the currently available reliable information does not support a nationwide determination of a safety defect".[23] Takata had also announced that an independent "Quality Assurance Panel" would be formed to audit the manufacturing procedures largely blamed for the airbag failures, with Samuel Skinner, former White House Chief of Staff and Secretary of the US Department of Transportation (USDOT), leading the panel. Additionally, two former Secretaries of the USDOT were hired to advise Takata on the appropriateness of their responses to current challenges.[24]

When pressed for reasons on why Takata believed that a national recall was unwarranted, Shimizu cited zero anomalies from driver-side airbags during recent tests. Shimizu was also questioned on the acceptability of Takata's slow production speed for replacement airbags. It became clear that it was beyond Takata's capacity to cover all driver-side airbag replacements, and that Takata could only keep up with supply by focusing its recall on high humidity areas.[25] Shimizu's confidence that replacement parts from the new production line would not cause the same problems also came across as unconvincing to legislators, as he admitted that Takata still had not found the root cause for the recent recalls.[26]

The scramble to regain trust

Following the US congressional hearings, Takata attempted to improve crisis communication by hiring professional public relations firm Sard Verbinnen & Co. to handle corporate communications.[27]

On 24 December, 2014, Takata issued a formal apology to victims of their defective airbags. In a show of contrition, Takata's top management voluntarily took temporary pay cuts with Shigehisa and Stocker taking a 50% and 30% pay cut respectively for four months and a 20% pay cut for the rest of the Board.[28]

Shigehisa's scapegoat: Back to square one

To further placate the public, Takata announced that Shigehisa would be taking over Stocker's roles to "further unify the company's handling of the airbag recall problem and to accelerate and strengthen the decision-making".[29] Stocker, as a result, lost his executive role and was relegated to a back seat on the Board and the handling of the airbag crisis fell back into Shigehisa's hands.

Automakers: Taking matters into own hands

Frustrated with the technical issues surrounding Takata's airbag inflators, and the slow investigation progress made by Takata's Quality Assurance Panel, a consortium of 10 automakers decided to look into the cause of the problem together.[30] On 23 February, 2016, following investigations over a year, the coalition of automakers released its findings, attributing the ruptures to a combination of factors including the usage of ammonium nitrate as a propellant in its airbags, sustained exposure to high temperatures and moisture, and manufacturing glitches that did not prevent moisture from seeping into the airbags.[31]

A slap on Takata's face

Beyond the stress Takata faced from its customers to provide satisfactory answers, Takata also experienced mounting pressures from US regulators that came in the form of a US$14,000 daily fine imposed for uncooperative behaviour during investigations surrounding the airbag defects.[32] On 3 November, 2015, NHTSA slapped Takata with a US$70 million fine for lapses with rupture-prone airbags and demanded that the company stop using ammonium nitrate.[33]

Takata's efforts fall short

Yet another pressing problem for Takata was how demand for the inflator replacement kits could be met. Automakers had only been able to fix 28% of the 28.8 million vehicles recalled in 2014. Following the expansion of recall announced on 4 May, 2016, analysts were not sure "how many more years would be needed" to replace all faulty airbags.[34] Nonetheless, NHSTA was in talks with other manufacturers to increase the supply of replacement kits[35] as automakers looked to alternative airbag manufacturers for supplies.[36]

Digging into Takata's pockets

Unsurprisingly, replacement costs sent Takata reeling with an estimated net loss of US$258 million in FY2014[37] and US$120 million in FY2015.[38] Risk of bankruptcy loomed, yet analysts were confident that the industry would not let the world's second biggest airbag manufacturer go bust for fear of serious disruptions to the supply chain.[39] Furthermore, the tradition of "keiretsu" business culture in Japan may provide some protection to Takata.[40]

Safety is everyone's responsibility

The Takata saga pushed NHTSA and the US Congress into talks to introduce laws to facilitate the sharing of information regarding any safety issues between whistle-blowers and regulators, such as offering whistle-blowers up to 30% of any penalties.[41] Legislators hope that this would incentivise more employees to step out of the shadows in a more timely manner so that crucial information will be brought to the attention of relevant authorities even in circumstances where top management is adamant about burying the issue.

Mark Lillie, a former employee of Takata, decided to testify against Takata on their manufacturing malpractices. Lillie first raised his concerns regarding the use of ammonium nitrate to inflate airbags when he worked for Takata more than 15 years ago, but was simply dismissed by the company.[42] If the matter had come to light in 1999, Takata may not be in its current predicament and innocent lives may not have been lost.

Epilogue

In his 13 November, 2014 apology statement, Chairman and CEO Shigehisa mentioned, “Our whole company will strengthen our quality management structure and work to prevent an incident from occurring again.”[43] However, the company still has “little clue as to which cars used its defective inflators, or even what the root cause was”[44].

On 28 June, 2016, in what was seen as Shigehisa “bowing to calls for change”, the CEO finally offered to resign in June 2016 after a “new management regime” was found. News of his planned exit led to a surge in Takata’s shares.[45] In the meantime, the airbag recall list keeps getting longer.

Discussion questions

1. Consider the characteristics of a family owned corporation like Takata. What impact does this have on corporate governance in Takata? Discuss how this may have hindered the handling of the airbag crisis.

2. Takata adopts the Japanese system of corporate auditors (Kansayaku). What are the roles and responsibilities of the Kansayaku? Compare the Kansayaku-kai to the usual 3-committee Board structure. How effective is the Kansayaku-kai in ensuring good corporate governance as compared to the usual 3-committee Board structure?

3. Evaluate the Board composition of Takata in FY2014. Discuss how it could have affected Takata's effectiveness in handling the crisis. Would having more "outside directors" on the Board make a difference to their current progress on the recall and replacement of the defective airbags?

4. Consider the consequences of Takata's poor crisis management. Do you think Takata's poor handling of the crisis could be due to the lack of external corporate governance mechanisms to pressure the management to step up their progress in the handling of airbag recalls?

5. Would whistle blowing policies help regulators identify problems at earlier stages and prevent disastrous outcomes? What are the characteristics of a good whistle blowing policy? In Takata's case, do you think the new legislation passed in the US to incentivise whistle blowing would push employees to come forward with relevant information regarding the airbag issues?

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TOSHIBA: A SHORT CIRCUIT IN CORPORATE CULTURE

Case overview

Toshiba is a Japanese electronics company with humble beginnings as a factory in 1875. Through years of growth, Toshiba now offers a wide array of products and services, ranging from home appliances to medical equipment. However, in July 2015, Toshiba's questionable accounting practices were brought to light by an anonymous whistleblower. It was revealed that the company had overstated its profits by ¥151.8 billion between 2008 to 2014, a move driven in part by the performance-driven company culture. The objective of this case is to allow a discussion of corporate governance issues such as the impact of company culture; responsibilities of various stakeholders; effectiveness of corporate governance reforms; and whistleblowing policies.

Toshiba: Corporate culture gone wrong

"I deeply apologise to all stakeholders for causing all these problems."
– Hisao Tanaka, CEO of Toshiba Corporation[1]

This is the abridged version of a case prepared by Daniel Zheng, Nirmal Selvam, Xu Hao Yu, Cheong Song Yu and Koh Tien Leng Jeremy under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Nick Wee under the supervision of Professor Mak Yuen Teen.

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Hisao Tanaka, the then-CEO of Toshiba Corporation, expressed his remorse with a 15-second bow of contrition at a news conference in Tokyo for the accounting scandal that Toshiba had found itself embroiled in. Tanaka and vice chairman Norio Sasaki – former president of the company – stepped down on 21 July, 2015. Board Chairman Masashi Muromachi would take over the position of interim CEO as the company looked to regain public trust and investor confidence through reviewing and reforming its entire corporate governance structure.[2]

The accounting scandal dealt a huge blow to Prime Minister Shinzo Abe's efforts to attract more foreign investments through sweeping corporate governance reforms. Toshiba's overstatement of profits by ¥151.8 billion (US$1.22 billion) between April 2008 and March 2014, as well as Hisao Tanaka's departure, left Muromachi with the gargantuan task of restructuring Toshiba's corporate culture and revitalising the company.[3]

History of Toshiba

Toshiba was founded in 1875 when Hishagake Tanaka built a factory, Tanaka Seizo-sho (Tanaka Engineering Works), in Tokyo to develop telegraphic equipment.[4] Separately, Ichisuke Fujioka developed Japan's first new arc lamp in 1878 and established Hakunetsu-sha Co. Ltd in 1890 to manufacture light bulbs.[5] As co-members of the Mitsui zaibatsu, led by Mitsui Bank, Shibaura Seisaku-sho (Shibaura Engineering Works) and Tokyo Electric Company merged to form Tokyo Shibaura Denki in 1939, amidst growing demand for home appliances that incorporated the technological innovations in heavy electrical machinery. Tokyo Shibaura Denki was officially renamed Toshiba Corporation in 1983.[6] Toshiba rode the post-war Japanese expansion in the 1950s, creating many novel products and developing original technologies. It also established overseas sales and manufacturing subsidiaries to develop its international businesses. As of 2015, Toshiba provided a wide range of products and services including semiconductors, consumer electronics, home appliances, medical equipment and infrastructure.

The investigation

In February 2015, the Securities and Exchange Surveillance Commission ordered an inspection of Toshiba's projects that used percentage-of-completion accounting after receiving anonymous reports about accounting irregularities.[7] Realising the gravity of this issue, Toshiba set up a special investigation committee on 3 April, 2015. Chaired by board chairman Masashi Muromachi, the committee's focus was to further investigate the accounting issues.[8]

On 8 May 2015, Toshiba redacted its earning guidance and announced the scrapping of its year-end dividend payout. This was due to the committee's decision that the investigation would be widened to other non-percentage-of-completion projects. Subsequently, improper accounting was found to have been used in some of its other projects. The group had previously projected a 136% gain in net profit to ¥120 billion (US$1 billion) for the fiscal year ended in March and a 3% gain in sales to ¥6.7 trillion.[9]

The investigation was then passed to an independent committee, consisting of a panel of professionals including Koichi Ueda, the former superintending Prosecutor of the Tokyo High Public Prosecutors Office, and Taigi Ho, the former Deputy Chairman of the Japanese Institute of Chartered Accountants.

In June 2015, shareholders demanded a total management overhaul[10], which was sparked by Toshiba's plunging share price. The company then proposed to reappoint all 16 board directors, including four outside directors.

On 20 July 2015, the independent investigation committee identified ¥152 billion of inflated profits since 2008, detailing various "institutional" accounting malpractices.[11]

Rising tides leading to impossible "challenges"

In 2008, the global financial crisis caused stock markets worldwide to plunge. In 2011, Japan experienced one of the most devastating earthquakes in history, which caused extensive damage in north-eastern Japan. Furthermore, Japan's household electronics industry faced tremendous challenges for two decades due to the rise of low-cost competitor firms in Asia, such as Samsung and LG. This rising competition caused Toshiba's sales to take a hit, and put pressure on the board and management to take on more aggressive strategies.[12]

In the wake of these growing pains, Toshiba's situation became very difficult due to the dire state of the Japanese economy. Unrealistic targets known as "Challenges" were set by top management. In 2013, top management insisted on the achievement of these "Challenges" despite the weak global and domestic economy. Business Units (BUs) were threatened with possible shutdown, and had to intentionally overstate their profits in order to meet the "Challenges".[13] This resulted in a culture which prioritised the achievement of "Challenges" above all else.

The damaged pride in Toshiba

According to Sustainalytics, a financial research firm for investors, Japanese companies had the "lowest average governance ranking of developed markets, in line with the lowest levels of board independence and gender diversity."[14] Noting this, the Japanese government drafted a new code of corporate governance as part of Prime Minister Shinzo Abe's efforts to restructure the corporate governance landscape and bolster international investors' confidence in the country in order to boost economic growth.

For many years, Toshiba was lauded as one of the frontrunners for corporate governance in Japan. The company was said to be the embodiment of corporate strength in Japan. Even when the new code was introduced in June 2015, Toshiba had already satisfied many of the guidelines. For example, the new code recommended at least two independent directors on the board, and Toshiba already had four such directors since 2006. As such, the Toshiba scandal placed a huge dent in the government's corporate governance reform efforts, seeing as how one of its leading firms on corporate governance was implicated in such a scandal.

Management apathy and "tyranny"

The findings by the independent committee indicated that there was ineffective management monitoring in Toshiba. Top management were aware that there was "intentional overstating of apparent current-period profits, and the postponement of recording expenses and losses." Despite the knowledge of certain BUs needing to overstate their profits to meet the targets, top management continued to impose strict "Challenges", which only exacerbated the corporate culture of "meeting Challenges by any means necessary".

It was also found that there was a "lack of awareness and knowledge among top management about appropriate accounting treatment."[15] It was noted in some projects that the BU heads and even the president himself who carried out the accounting treatment did not have sufficient knowledge of accounting standards that are generally accepted as fair and appropriate. They understood the basic accounting principles (for example, in this case, they knew that they needed to record provisions), but did not know the exact appropriate accounting treatments.

Unwatched watchdogs: Inefficient *Kansayakus*

The investigation of Toshiba also highlighted the failure of supervisors, particularly that of the *Kansayaku* (Japanese for auditors) who did not operate efficiently. This was attributed to inadequate internal controls. For example, despite being aware of inappropriate conduct going on (e.g. selling a higher volume of parts than required to original design manufacturing), the audit committee's (AC) Chairman, CFO Makoto Kubo, failed to take any action. Even his predecessor, then CFO Tomio Muraoko, did not take any action despite having knowledge.

This behaviour was not limited to the CFOs. On 26 January 2015, even when AC member Seiya Shimaoka resurfaced accounting issues relating to their PC business (which was supposedly resolved in September 2014), no action was taken. This was the case after Shimaoka's repeated requests, even to executive officers like Hisao.

The way the internal audit was conducted was also questionable.[16] The main focus of the internal audit function within Toshiba was not to evaluate internal controls, risk management and governance processes, but rather, to inspect the efficiency of the operations.

Additionally, Toshiba's AC members did not have finance or accounting knowledge. A majority of the AC members, including the external AC members and supporting staff, were not trained or equipped with the requisite knowledge to discover inappropriate accounting treatments. Only the former CFOs had such knowledge, but these creative accounting methods were not discovered.[17]

Inappropriate performance measures?

Toshiba evaluated its employees and officers based on performance. For example, a typical executive officer compensation package consisted of base pay and bonus. Between 40% to 45% of the bonus was based on the officer's performance. Together with the aggressive "Challenges" that made attaining the target almost impossible through normal means, it caused management to eventually succumb to pressure and manipulate figures to meet the targets.

A culture of not challenging "challenges"

These incidents revealed that at the heart of Toshiba's corporate culture was a reluctance of employees to defy superiors and a very strong hierarchical system within the company. As a result, aggressive and unachievable "Challenges" set by top management were not challenged by employees and unethical methods were subsequently used. Furthermore, Japanese society is very hierarchical, and Japanese are also known to be very loyal to the company they work for.[18] Thus, when targets are set, it is common for employees to want to satisfy top management by any means necessary. Employees would also not challenge top management due to their strong cultural inclinations.

No wind from whistleblowers

The investigation report showed that Toshiba had a weak whistleblower system in place. Despite having reports made on other issues, there had been no employee complaints prior to the incident. Consequently, the committee "surmised that the whistle-blower system has not been sufficiently used for some reason".

Muromachi-ing ahead: What's next for Toshiba

In July 2015, nearly two thousand shareholders turned up at an investor meeting outside Tokyo to voice their concerns to the new management. Part of Toshiba's action plan focused on the correction of past accounting irregularities. These would be carried out by Toshiba's independent investigation committee and Ernst & Young ShinNihon LLC, the company's previous auditors. Toshiba also announced the creation of new divisions and emphasised the strengthening of the company's governance and internal controls.[19]

However, experts remained skeptical of Toshiba's ability to overhaul its corporate governance. The company's reform of the management team was seen as superficial on account that three members of the previous board of directors were re-appointed.

In October 2015, according to The Japan Times, Toshiba planned to carry out litigation against the former executives to recover compensation in order to cover expenses required for the investigations as well as to restore reputation to the company.[20] It was argued that even if the company did not file lawsuits against the executives within sixty days of the proposal, shareholders could look to directly sue the former executives on behalf of the company under Section 847(1) of the Japanese Companies Act.[21] Court intervention was seen to be unavoidable.

In early November 2015, Toshiba announced that it had officially sued five former executives, including former presidents Hisao Tanaka, Norio Sasaki, Atsutoshi Nishida, and two other CFOs. The lawsuit, filed at the Tokyo District Court, came after an outside panel of three lawyers found that the five individuals had neglected their duties, citing the improper accounting practices.[22]

In its efforts to recover from the scandal, Toshiba decided to focus its restructuring on its semiconductor business, the sector in which current president Masashi Muromachi had built his career.[23] In light of this restructuring, Muromachi seems to display the resolve needed to lift Toshiba from the scandal. However, the effectiveness of the company's efforts to restore its tattered reputation and regain public trust remains to be seen.

Discussion questions

1. Identify potential weaknesses in the corporate governance of Toshiba that may have contributed to the accounting problems. To what extent did Toshiba's corporate culture contribute to the scandal?

2. Do you think all three CEOs should be held responsible for the incident? Besides the CEOs, who else do you think is responsible for the scandal? Why?

3. Prime Minister Shinzo Abe had just embarked on corporate governance reforms for Japan, with a new corporate governance code effective from 1 June 2015. With regards to Toshiba, do you think that such a new code of corporate governance would be effective? Why?

4. Toshiba had implemented a whistleblower system which was well utilised until the scandal occurred. Why do you think the whistle-blower system lost its effectiveness for this particular incident? What steps should a company like Toshiba take to ensure that its whistle-blower system continues to operate effectively?

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VIVA LA FIFA

Case overview

Following a slew of bribery and corruption allegations over the past decade, the Fédération Internationale de Football Association (FIFA) entered into what appeared to be its biggest scandal yet in May 2015, when the New York Justice Department announced a 47-count indictment which pointed towards allegations of bribery, vote-buying, and questionable contracts over World Cup broadcasting rights, and arrested FIFA's top executives. Amidst it all, FIFA President Sepp Blatter's abrupt decision to resign after 17 years in office generated further interest over FIFA's "culture of corruption". Reforms were implemented to counter this, but only time would tell if FIFA could truly undergo a structural revamp. The objective of this case is to allow for discussion on issues such as corruption stemming from poor tone at the top; conflicts of interest between FIFA and its stakeholders; whistleblowing; transparency and disclosures pertaining to executive remuneration; and applicability of corporate governance principles and practices for listed companies to sports bodies.

Kick-off

27 May, 2015, 6.39 a.m. Swiss plainclothes policemen streamed through the *Baur au Lac* – a five-star hotel, the site of FIFA's annual committee meeting. The officers retrieved room numbers from the front desk and headed upstairs, where they arrested seven FIFA executives.[1]

This is the abridged version of a case prepared by Chen Jiajia, Huang Wen Feng Aaron, Parvathy Aarthy Annamalai, Poo Ruijin Nigel and Yip Ying Xian under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Nick Wee under the supervision of Professor Mak Yuen Teen.

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Hours later, the Justice Department in New York held a 47-count indictment against 14 defendants, comprising FIFA officials, and sports marketing and broadcasting personnel. The indictment included charges of racketeering, wire fraud, and money laundering dating back to 1991, with bribes and kickbacks adding up to a tune exceeding US$150 million.[2]

"It spans at least two generations of soccer officials who, as alleged, have abused their positions of trust to acquire millions of dollars in bribes and kickbacks." – Attorney General Loretta Lynch[3]

Historically, FIFA had deflected widespread allegations instead of addressing problems at an institutional level.[4]

Blatter's reign

Sepp Blatter won the 1998 FIFA presidential elections only by a close margin over Swedish rival Lennart Johansson. This came after 17 years as the right hand man to then President Joao Havelange. Despite his victory, Blatter's win was plagued with rumours of bribery.[5] Subsequent presidential elections were also shrouded in suspicion regarding the legitimacy and transparency of results.

"I am the president of everybody,
I am the president of the whole FIFA." – Sepp Blatter[6]

Amidst the unraveling of FIFA's biggest scandal yet, Blatter was re-elected as its president for the fifth consecutive term, his 17th year running. However, just a week into his re-election, Blatter abruptly announced his resignation. This came in the wake of the FBI confirming that Blatter was now the focus of their corruption investigations.

Sentiments soar

On 2 December, 2010, Russia and Qatar were announced as hosts of the 2018 and 2022 FIFA World Cup respectively.[7] Upon the announcement, Qatar's Stock Exchange responded strongly, and neighbouring countries like Iran also showed excitement and enthusiasm for the opportunity to promote and develop football in the Middle East.

FIFA vows reform

After allegations of corruption dogged FIFA throughout the bidding and voting process for the 2018 and 2022 World Cups, there was significant pressure on FIFA to conduct reforms on an institutional level. With that, Blatter launched a governance reform process at the 61st FIFA Congress, June 2011, in Zurich, Switzerland.[8]

Blatter announced at the launch:

> *"This committee will strengthen our credibility and give us a new image in terms of transparency. I will take care of it personally, to ensure there is no corruption at FIFA." – Sepp Blatter*[9]

The aim of the proposals was to improve governance, transparency, and to eradicate misconduct on and off the pitch. This resulted in a two-year road map for the subsequent establishment of the Independent Governance Committee (IGC).[10]

This was initiated shortly after Blatter was re-elected into his fourth consecutive mandate, which was also his 13th year of service as president. During that election, Blatter was the incumbent candidate again, with the only other candidate, Mohammed Bin Hammam of Qatar, withdrawing from the presidential race just three days before the vote.[11]

Whistle-blowing woes

Phaedra al-Majid was one of two whistleblowers who spoke up on Qatar 2022. al-Majid was a former media officer on the Qatar bid team.[12] If her corruption allegations surrounding the Qatar World Cup were true, Qatar could be stripped of its right to host the World Cup. After keeping mum for two whole years, she mustered up the courage to speak to Michael Garcia, then head of the investigatory arm of FIFA's ethics committee. al-Majid's allegations revolved around top FIFA executives receiving bribes in exchange of votes for Qatar. In return for Garcia's word that her identity would be kept confidential, al-Majid agreed to cooperate in the investigations of the 2018 and 2022 World Cup bidding process.

Unfortunately, in a 42-page summary of the investigations issued by Hans-Joachim Eckert, chief judge of FIFA's ethics committee, the identity of the two whistleblowers was revealed.[13] Although the summary did not explicitly expose the women by name, it was not difficult to connect the dots based on the evidence cited, and al-Majid's cover of anonymity was blown just hours after the summary was published.[14]

"I kept my promise. Herr (Mr.) Eckert breached that confidentiality. I did not. The disciplinary committee's avoidance of this undisputable violation is emblematic of its culture of self-protection." – Phaedra al-Majid[15]

Not long after she came forward in 2011, al-Majid retracted her claims, and later added that she was coerced into it, citing fear for the safety of her family as the reason.[16] Despite the withdrawal of the allegations, it sparked off investigations into the Qatar 2022 World Cup.

Sidelined

Garcia also alleged that Eckert's summary misinterpreted the findings and presented a materially fragmented and fallacious view of the facts. This ultimately resulted in Garcia "losing confidence in the independence" of Eckert.[17] On 17 December, 2014, Garcia's appeal to the FIFA committee to have his original report published in its entirety was rejected.[18] Garcia tendered his resignation, criticising the "lack of leadership" in the global football arena.[19]

The heated decision on Qatar

"Yes, it was a mistake of course, but one makes lots of mistakes in life, the technical report into Qatar said clearly it was too hot but the executive committee – with a large majority – decided all the same to play it in Qatar." – Sepp Blatter[20]

Since the announcement that Qatar would be hosting the 2022 World Cup, there had been much speculation over the landslide victory.[21] Outcry over Qatar's win arose over reasons such as its searing summers, strict alcohol restrictions and the lack of a developed football culture.

The 2022 World Cup bid attracted interest from Australia, Japan, Qatar, South Korea and the United States, and the final decision was voted on by FIFA's executive committee, where 22 members had one vote each.

During the bidding process, Qatar promised an advanced air-conditioning technology that would cool down the stadiums, training pitches and fan zones to a cool 23°C. This was in response to Doha's stifling summer heat, where average daily temperatures could range from low to mid 40°C in June.[22] Skepticism toward this ambitious technology was assuaged by Qatar's World Cup organising committee's confidence that the event would proceed as planned in summer under cooled conditions.

However, in March 2015, FIFA's Task Force decided that moving the tournament to end-November or December would be best. Furthermore, amidst the heavy media coverage on the bidding process over the 2022 World Cup, allegations against Qatari Mohammed bin Hammam quoted involvement in bribes to secure votes for Qatar. Following this, FIFA commissioned a report over the allegations and cleared Qatar of all suspicions. However, this report was never published.[23]

Waka Waka (This time it's Africa)

Investigations into FIFA uncovered other skeletons in the closet, this time pertaining to the 2010 World Cup hosted by South Africa. Jack Warner, then vice-president of FIFA, became the centre of allegations involving a US$10 million bribe paid by South African officials in return for securing the rights to host the 2010 World Cup. The monies were traced to accounts controlled by Warner. However, South Africa denied payment of any bribe in relation to the securing of the 2010 World Cup. Instead, sports minister Fikili Mbalula "categorically denied" the allegations, citing that the monetary payment went towards "an approved program to help the development of football in the Caribbean."[24] However, in another inquiry, Mbalula harped on the fact that the money did not constitute a bribe, but rather "a donation to support the African diaspora."[25]

Secret profits

It was not long before Blatter was also dragged into the scandal. Further investigations uncovered evidence pointing to Blatter's approval of a suspiciously small contract in relation to the 2010 and 2014 World Cup television rights. This allegation pointed to Blatter awarding the rights to the Caribbean Football Union (CFU), which was under the control of Warner – who had his own fair share of corruption allegations.

The contract dating back to 2005 was uncovered by Swiss broadcaster Schweizer Radio und Fernsehen (SRF), which documented the sale of the 2010 and 2014 World Cup broadcasting rights to the CFU for US$600,000.[26] This was a mere 5% of its true value. Warner subsequently sub-licensed the rights to his own company J & D International (JDI), whereby his subsequent profit was estimated to be about US$16.5 million.[27]

Blatter gets a yellow

The initial investigations unraveled one suspicious transaction after another. The Swiss police chased down a lead regarding a US$2 million payment made by Blatter to Michel Platini, then vice-president of FIFA and president of UEFA (Union of European Football Associations), just three months before he won his fourth term of office in 2011. Blatter asserted that the money was related to an overdue payment owed for work done by Platini in 1999. Similarly, Platini responded by insisting that the money was for work which he had previously performed. However, he did not address the issue of the near decade-long delay in receiving it.[28]

A very profitable non-profit

Contrary to FIFA's establishment as an "association of associations with a non-commercial, not-for-profit purpose", their commercial dealings rake in billions of dollars in revenues every year.[29] FIFA's expenditures, particularly the remuneration of top executives, are also ambiguous and poorly defined. In its 2014 financial report, FIFA showed a total of US$88.6[30] million in wages and salaries, of which US$39.7[31] million was paid to its top 13 executives. Despite immense pressure for greater disclosures in all aspects of FIFA operations, the organisation had yet to publicly disclose the exact amounts earned by FIFA's top echelon.[32]

Extra time

FIFA's proposed reforms first saw the light of day on 11 August 2015, when the new 2016 FIFA reform committee was established with the appointment of a fresh face[33] as the Independent Chairman. This was meant to build upon the reform work undertaken since 2011. There had also been unprecedented stress on FIFA to enhance and improve their corporate governance in order to restore its reputation as the governing body for world football.

> *"We need reforms now, we cannot wait. FIFA works very well operationally and has not come to a halt. But this is a watershed in terms of role going forward" – Domenico Scala*[34]

As at 2016, the ball had been set in motion. However, it would take a long while before any conclusive evidence can establish that the reforms have been effective in addressing the governance issues plaguing FIFA. Only time will tell if the reforms would truly score.

Substitution: Blatter out, Hayatou in

8 October, 2015. After years of deflecting corruption allegations and side-stepping his way out of the most convoluted scandals, Blatter faced a 90-day ban from all football activities, an order enforced by FIFA's Ethics Committee[35], following which he was relieved of all presidential duties with immediate effect. Issa Hayatou, the longest serving vice-president on the FIFA Executive Committee, filled the gap and took over as acting president of FIFA for the interim period prior to the following presidential elections in 2016.[36]

Discussion questions

1. What were the factors that may have facilitated bribery in FIFA?
2. Dissect the conflicts of interest inherent in the FIFA case. Examine the relationships of FIFA at both the organisational and personnel level.
3. Was the whistleblowing policy at FIFA effective? Comment on how it affected the organisation then, as well as how it may in the future.
4. In what ways are governance challenges in sports bodies like FIFA similar or different from those in listed companies? Should corporate governance rules applicable to listed companies also apply to FIFA?
5. In the case of companies, shareholders, directors, regulators and other stakeholders all play a role in raising corporate governance standards. To what extent does this apply to FIFA and other sports bodies?
6. If you are engaged as a consultant and asked to recommend the setting up of a proper governing board, what would you recommend in terms of structure and composition of such a board? What qualifications, skills and experience would you recommend? How would the concept of independent directors apply to such a board, if at all?

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CAN ICAHN MAKE IT?

Case overview

On 5 August, 2014, Gannett Company Inc. ("Gannett") announced that it would be splitting off its slower growing publishing business from its other operations. Nine days later, Carl Icahn, an activist investor, declared a 6.6% stake in Gannet through a Schedule 13D filing with the Securities and Exchange Commission (SEC) – suggesting that Gannet's move was a preemptive action against possible activist interest in restructuring the company. Despite being beaten to the spinoff, Icahn continued to push for his agenda. On 22 January, 2014, Icahn nominated two directors to Gannett's board, alleging that the company had mishandled communications with investors by not explaining plans for the new entity's capital structure, debt capacity and business strategy. Additionally, Icahn expressed his concern over Gannett's governance, fearing that management would adopt a poison pill that would make the publishing company a less attractive acquisition target. Both sides eventually compromised, with management making reforms in corporate governance, and Icahn withdrawing his proxy battle at Gannett.

The objective of this case is to allow for a discussion of issues such as pros and cons of shareholder activism; how shareholder activism is practised in different countries; barriers to shareholder activism; and nomination of directors by shareholder activists.

This is the abridged version of a case prepared by Melissa Shen Yuwei, Michael Ong Wei Shun, Yam Jia Hui, and Yap Nian Fang Melody under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Nick Wee under the supervision of Professor Mak Yuen Teen.

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About Carl Icahn

Carl Icahn, one of the richest men on Wall Street with a net worth in excess of US$20 billion[1], is seen by some to be a new type of corporate superhero – the activist shareholder – whose superpower was unlocking company potential. His main targets were public companies with undervalued assets, and he would use his shareholder rights to improve management accountability. Icahn monitored company effectiveness, efficiency and performance and regularly go into public tirades on management's exorbitant remuneration and the lack of correlation between pay and performance.

Over the years, Icahn has had his hands on conglomerates such as RJR Nabisco, Revlon, Phillips Services and Marvel Comics. He continues to tangle with big names like Apple, eBay, Chesapeake Energy, Herbalife and Netflix. No one can deny that Icahn rightfully deserves the title of "champion of shareholder activism".

Gannett Company, Inc.

An international media and marketing solutions firm, Gannett was the clear market leader in three sectors – broadcasting, publishing, and digital media. Gannett enjoyed exceptional performance in 2014, outperforming the S&P index and other media peer groups.[2] Buoyed by recent acquisitions and investments, Gannett had developed itself into the market leader in the broadcasting and digital media sectors, both of which enjoyed robust growth.

However, with the advent of social media and print alternatives, the publishing industry had been in decline since December 2007. While publishing contributed to more than half of Gannett's revenue, it was merely the result of its strong market position, not industry growth. Furthermore, synergies between its publishing and other divisions were not being harnessed. This decline took a toll on shareholder value, with share prices falling below the peer group by the end of 2013. On 5 August, 2014, a spin-off was officially announced. Debt-free, the publishing business made an attractive takeover target.

Compared to its peer group, Gannett had a relatively high debt structure. The debt-free nature of its publishing division meant that the proportion of debt would be even higher for the remaining divisions.

Additionally, the rising incidence of activist action in the industry and the tilting balance of power towards activists was a source of concern for Gannett. Activists often engaged in proxy fights that would cause severe operational disruption to companies and lead to board fragmentation and adversarial relationships. More often than not, management would end up having to make concessions after a long drawn battle.

Icahn's toeholds and nomination of Directors

On 14 August, 2014, Icahn announced the 6.63% stake he had been accumulating in Gannett since April, and his intention to split Gannett. Gannett's employees launched a pre-emptive strike – the first time a corporation had made a move even before Icahn initiated contact.[3] However, Icahn had more tricks under his sleeve to engage with management. In an open letter to Gannett on 21 January, 2015, Icahn spoke of unleashing shareholder value by reducing management's entrenchment.

Icahn planned to nominate two directors to have a more active voice during the spin-off, alleging that management's lack of communication on 'the capital structure, debt capacity and business strategy for each of the post-spin companies had led to an eight percent fall in share price after the announcement.[4] His nominees would provide the "substantive insight necessary for the Gannett directors to better consider how to structure and communicate the spin process." Set to join the board was Michael Dornemann, the former CEO of Bertelsmann AG and lead director at Take-Two Interactive Software.[5] He had more than 30 years of corporate development, strategic advisory, advertising and media experience. Paired with him was Courtney Mather, a former managing director at Goldman Sachs, complementing Dornemann with his extensive experience in mergers and acquisitions.

Icahn further called for changes to Gannett's board structure and charter provisions regarding potential anti-takeover provisions. He demanded a prohibition of poison pills and a classified board structure without shareholder support in order to prevent management entrenchment. Cognizant of the Publishing division's appeal as a takeover target, Icahn also wanted a provision permitting holders of at least 10% of outstanding shares to call special meetings.[6]

Icahn's clout — A result of proxy access and shareholder communication rights

Icahn's strategies have been successful partly due to the implementation of the Sarbanes-Oxley Act and a series of SEC proxy rule amendments. As a result, shareholders had been increasingly empowered to have their voices heard. Regulators saw the need for shareholders to act as checks and balances against management power in the wake of corporate scandals like Enron.

One of the more significant corporate governance reforms, Rule 14a-8, facilitated communication among shareholders by providing a process for shareholders to submit proposals for inclusion in company proxy materials during Annual Meetings. Proxy advisory firms, such as Institutional Shareholder Services, also served as strong allies to advance corporate governance agendas. Simply suggesting how shareholders should vote could "swing as much as 25% of the votes in proxy contests."[7]

The SEC also approved two amendments to NYSE Rule 452[8], prohibiting brokers from voting during director elections or approving management proposals on corporate governance matters (including the repeal of classified boards and supermajority charter provisions), without shareholder instruction. Additionally, distribution of proxy materials via the internet also minimised soliciting costs for proxy issuers and contestants. Although Rule 14a-11 (which provided that proxy materials contain information regarding directors nominated by shareholders, including the ability to vote for them) was overturned due to technicalities, public debate showed that there was widespread support for greater proxy access and it was only a matter of time before the SEC reinstituted another rule in the same spirit.[9]

While proxy rules facilitated shareholder participation, Icahn's 6.63% share was not compelling enough for management to heed his wishes. Furthermore, Vanguard (Gannet's largest institutional investor) included Gannett within its retirement funds and was unlikely to favour any destabilising activist action. However, Icahn's previous forays into activism and his relationship with other investors committed to his hedge fund meant that Icahn had the ability to increase his stake and garner support from smaller shareholders. This made him a credible threat.

Icahn and Gannett's agreements

On 2 March, 2015, Gannett's non-executive Chairman disclosed their active engagement in "productive conversations" with Icahn. A new corporate governance profile had resulted, which increased the likelihood of an acquisition.[10]

Gannett's Compromises

1. Annual Board elections:
Without a classified or staggered board, shareholders could more easily control board seat allocation and representation. A hostile acquirer could easily replace an incumbent board to improve the company's corporate governance profile as directors must now earn their re-elections.

2. Special meetings called by shareholders holding 20% of outstanding shares:
Pressing issues like BOD changes could be addressed without waiting for the next AGM. Icahn demanded the threshold to be 10%, but agreed to a compromise of 20%.

3. All shareholder rights to expire after 135 days:
This rule would hold unless the duration was extended through a majority vote by shareholders. It mainly limited the use of poison pills to deflect takeover offers. Also, requiring shareholders' votes for the renewal of poison pills allowed for comment on whether a poison pill served as legitimate economic protection or as an avenue to entrench management.[11]

4. A majority voting standard for uncontested director elections:
Board elections could proceed smoothly as a majority vote would approve a director in an uncontested election – a superior method to plurality voting, in which a director required only one vote in uncontested elections, thereby encouraging "rubber stamped" elections.[12]

Overall, the above elements increased Gannett's corporate governance appeal while enhancing attractiveness to its White Knight. As Gannett had respected and implemented numerous suggestions, Icahn returned the favour.

Icahn's Compromises

1. Icahn withdrew board nominations and proxy proposals

2. No director nomination or stockholder proposals during meetings:
Icahn was sufficiently pleased with the new corporate governance principles and agreed not to nominate directors. Thus his activism activities were limited and his participation was mostly restricted to shareholder voting.

3. Maximum 15% ownership of voting securities:
Icahn's voting rights alone could not compose a majority and thus prohibited him from calling special meetings. New corporate governance structures were also implemented including a robust shareholder engagement program and prohibiting option pricing without shareholder approval.

Shareholder activism in differing contexts

Asian economies have inherent traits that make it less conducive for shareholder activism. Unlike the dispersed shareholding structure in the US, controlling shareholders are commonplace in Asian companies, while confrontational activists are uncommon as people tend to prefer a more consultative and diplomatic approach. Foreign Direct Investment (FDI) barriers also increase the difficulty of shareholder activism, as it is harder for foreign shareholder activists to gain a foothold in the company.

Ownership dispersion

US ownership tends to be highly dispersed, with CEOs amassing significant power. On the other hand, Asian companies are typically dominated by concentrated ownership. Take for example the structures of the Japanese Keiretsu, Korean Chaebols, Singaporean Government-Linked Companies, and family firms, where a controlling shareholder model is prevalent. Such a structure makes it easier for companies to counter activists, who have a smaller stake.

Barriers

Many Asian countries impose FDI barriers (especially in service sectors) which provide an unconducive environment for shareholder activism. Such formal barriers include foreign investment approvals, bureaucratic red tape, and limits on foreign ownership. There are also informal barriers such as the complex nature of the Asian business environment.

As a result, shareholder activism has little standing in Asia, and may remain so. Increased FDI and relaxed barriers to entry may help amplify the voice of activist shareholders in the region.

A force for good?

The debate surrounding corporate activism rages on. There have been accusations of excessive short-termism by activists[13] whose actions only favour a takeover. Should they fail in a takeover, the firm ends up languishing in subpar performance after the activist exits. However, Icahn's record belies this claim[14], given that his long-term positions have improved boards, and he has worked with other shareholders and even won the support of institutional investors. Additionally, Icahn's interests are financed without incurring debt on the company (unlike the usual strategy in Private Equity buyouts which increases bankruptcy risk).

Today, retail investors who have diversified interests through index funds do not have the capacity for oversight, while institutional investors do not want to be overly active in management for fear of being accused for insider-trading. As such, activists like Carl Icahn can fill this vacuum by highlighting poor corporate governance to the attention of fellow investors.

Discussion questions

1. Discuss the factors or indicators that may attract intervention by activist shareholders like Carl Icahn.

2. How will activist shareholders benefit from intervening in the management of companies? What implications does it have on other shareholders?

3. Does the activist shareholder strategy demonstrated by Carl Icahn benefit or harm the corporation/other shareholders? Consider the interests of minority stakeholders.

4. If Icahn succeeds in getting his nominee directors to the Board, to what extent should such directors be considered independent?

5. Would Carl Icahn's strategy succeed in Asia or your home country? Explain your answer with a comparison between your country and the US.

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THE taX-FILES: HSBC GROUP

Case overview

In early 2015, HSBC was accused of knowingly helping its clients evade taxes. When faced with the allegations, HSBC admitted to control and compliance failings, but insisted that they were due to poor integration of its subsidiaries, and had not been intentional. The objective of this case is to allow a discussion of issues such as the ethics, whistleblowing, corporate governance in company groups, and tax governance.

Background

HSBC, "The World's Local Bank", began operations in 1865. Today, it has operations in over 80 countries and a total asset value of approximately US$2.67 trillion.[1]

HSBC's first foray into the Swiss private banking market was in 1999 after its acquisition of Republic New York Corporation and Safra Republic Holdings.[2] HSBC Private Bank (Suisse) S.A. was hence incorporated to take over the clients of the acquired firms. It offers clients private banking, investment and wealth management services.[3]

This is the abridged version of a case prepared by Choong Zhi Yong, Chuah Yih Hui, Tan Si Rui Bryan, Tan Zhe Ren and Tay Yi Qing under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Nie Yuanqiu under the supervision of Professor Mak Yuen Teen.

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When it rains, it pours

HSBC has had its fair share of controversies. Within the past four years, it has been involved in the 2012 LIBOR[4] and EURIBOR[5] fixing scandal, and the 2014 money laundering scandal. As a battered HSBC crawled out from the wreckage of its scandals, it was slapped with accusations that its Swiss private banking arm had actively abetted tax evasion for its clients.

Falciani takes a leak

"I worked with a group called 'change the bank' but this was against another group called 'run the bank' which wanted to do things without being monitored."
– Hervé Falciani[6]

Between 2006 and 2008, Hervé Falciani, a French national and a computer security specialist tasked with the migration of client data between HSBC Suisse systems, allegedly pilfered a significant amount of the data.[7] After a tip off about Falciani's illicit activities, the Geneva police picked him up on 22 December 2008 for questioning before releasing him on bail.[8] Falciani jumped bail and absconded to France with the two most important things in his life – his family and the stolen data.[9]

In France, Falciani proceeded to hand the data over to French authorities. Despite repeated attempts by Switzerland to extradite Falciani and recover the stolen data, France resisted on the grounds that the information was against France's national interest,[10] and that Falciani, being a French citizen, was not subject to extradition agreements.[11]

The stolen information was shared with other governments' tax bodies by the then French Finance Minister, Christine Lagarde.[12] This led to the tax authorities of various countries commencing tax recovery efforts amounting to hundreds of millions of unpaid taxes against offenders on the list.[13]

False-ciani?

"They will pay me for what I have done, which is worth a lot."
– Hervé Falciani[14]

It soon emerged that Falciani may have had other intentions for swiping the data. Guillaume Brachet, a fiscal consultant Falciani engaged to help monetise the data, indicated that while Falciani claimed that the data was obtained via the "expert mining of open, public sources", Falciani appeared nervous and evasive when probed further.[15] Geogina Mikhael, a HSBC contract employee at the time, was responsible for tipping-off the authorities about Falciani. The pair had set up a virtual company, Palorva, which served as a front for selling the data. In February of 2008, the pair flew to Beirut, Lebanon, to try to sell the data.[16]

In Lebanon, Mikhael and Falciani attempted to sell the data to various banks, but Falciani's evasive nature when questioned on the data's origins scuppered any possibility of a deal with the banks. One of the banks informed the Swiss Bankers' Association about Falciani's offer, alerting the office of the Attorney General in Switzerland which commenced an investigation.[17]

With the banks pulling out, Mikhael alleged that Falciani turned his attention to selling the data to the authorities.[18] Falciani and Mikhael sent emails to European tax authorities and intelligence agencies offering "the client list of one of the world's largest wealth management banks". Signed by a "Ruben Al Chidiack", the email was titled "Tax evasion: Client list available".[19]

Robin Hervé?

"I am not Robin Hood. I'm not a mercenary. I acted like a citizen."
– Hervé Falciani[20]

Falciani publicly denounced Mikhael's claims and stated his only intention was to expose the tax-evasion that HSBC was abetting. He claimed that he flew to Lebanon and attempted the sale only because he was instructed to do so from men claiming to be agents of Mossad.[21]

Falciani also maintained that he had handed the data to French authorities instead of the Swiss because the Swiss refused to protect his anonymity when he tried to whistle-blow on HSBC.[22]

Swiss secrecy laws

"Imprisonment of up to three years and/or a fine of up to 250,000 SFr will be awarded to persons who deliberately discloses a secret that is entrusted to him in his capacity as employee… of a bank... or attempts to induce such an infraction of professional secrecy." – Article 47, Swiss Banking Act

In Switzerland, there is a federal act that enshrines banking secrecy. The Swiss Federal Banking Act criminalises transgressions against banking secrecy by slapping imposing a prison term and a large fine on offenders. Under the law, it is illegal for anybody to deliberately disclose, or attempt to disclose, any bank related confidential information made privy to him/her. This restriction on divulgation extends to certain information by subsidiaries operating in Switzerland given to parent companies. HSBC therefore faced severe restrictions on the amount and type of information they were allowed to be made privy to with regards to HSBC Suisse.[23]

Swiss view: Tax avoidance vs tax evasion vs tax fraud

Swiss Law distinguishes between tax avoidance, tax evasion and tax fraud.. Tax avoidance is the reduction of one's tax exposure via legal exploitation of loopholes in the system.

Tax evasion constitutes the failure of the taxpayer to declare certain income or assets to tax authorities. Swiss law views tax evasion as a misdemeanour, but not a crime. Authorities are prohibited from lifting banking secrecy to obtain information regarding taxpayers' assets.[24]

Tax fraud is defined as the submission of falsified or forged financial documents with the intention to avoid payment of tax. As tax fraud is subjected to Swiss penal prosecution, a judge has the right to lift banking secrecy and subpoena client information directly from the bank.[25]

Swiss appease

Due to EU pressure over its banking secrecy, Switzerland signed an agreement in 2005 known as the Swiss-EU Savings Tax Agreement. Under this agreement, Switzerland would charge a final 15% withholding tax on capital and savings income of EU citizens. This was increased to 20% since 2008, and 35% since 2011. 75% of the retention tax collected would go back to the EU and its member states while Switzerland would keep the remaining 25%.[26]

Under this scheme, Switzerland got to keep its banking secrecy while earning 25% of the withholding tax. Clients could protect their wealth information by paying a fixed rate, and the EU could collect some taxes that were previously uncollectible. This seemed like a win-win-win situation for everyone involved. What could possibly go wrong?

Asset rich, ethics poor

"I think they were a tax avoidance and tax evasion service. I think that's what they were offering. They knew full well that people come to them to dodge their tax liabilities." – Richard Brooks, former HMRC tax inspector[27]

Clever manipulation of Swiss banking laws can set the stage for tax evasion. However, it takes two to tango, and HSBC Suisse's questionable practices had to share the stage. HSBC Suisse exploited the freedom accorded by the Swiss laws and took advantage of a loophole within the Swiss-EU Savings Tax Agreement to initiate and aggressively market a "device" to its clients.[28]

The withholding tax agreed on only applied to individual savings and not corporate funds.[29] Armed with this knowledge, HSBC Suisse allegedly began offering "Tax, Trust and Real Estate Planning" services to its clients. Clients were advised to circumvent the withholding tax by depositing their funds into shell companies. HSBC would provide the necessary paperwork and incorporate the companies for an annual fee.[30] A complementary service which allowed clients to withdraw huge amounts of foreign currencies in Switzerland came packaged with the deal.[31]

Huff and puff and blow your house down

"Most Swiss banks do have a whistle-blower program, but they use it to punish those who avail themselves of it" – Hervé Falciani[32]

HSBC's Employee handbook outlines the company's definition of wrongdoing at work, and the avenues that employees can avail themselves to make a "protected disclosure".[33] HSBC Chairman, Douglas Flint, asserted that firms should "encourage the calling out of bad behaviour" and reward and praise "those who escalate their concerns even if they are sometimes wrong".[34]

The recent cases of Everett Stern[35] and Nicholas Wilson[36], however, offer a different viewpoint. Both raised concerns over suspicious transactions and illegal practices only to see them fall on deaf ears, despite reporting to HSBC via proper channels.

Being ignored is rarely the only repercussion whistle-blowers face, particularly in Switzerland which is in the midst of tightening its law on whistle-blowing.[37] In Falciani's case, Swiss authorities are in the midst of indicting him for qualified industrial espionage, unauthorised obtainment of data, and violation of banking secrecy.[38]

The apple doesn't fall far from the tree

"We deeply regret and apologise for the conduct and compliance failures highlighted which were in contravention of our own policies as well as expectations of us" – Douglas Flint, CEO HSBC Holdings PLC[39]

While HSBC apologised and accepted responsibility for its failures within its Swiss subsidiaries, it took due care to stress that its Swiss arm had not been fully integrated into HSBC after its purchase and was therefore run in a more "federated way" with decisions "frequently taken at a country level".[40] This allowed "significantly lower" standards of compliance and due diligence to persist.[41] A quick peek into HSBC annual report, however, showed that "the integration of the former Republic and Safra businesses went smoothly during 2000".[42]

It is worth noting that this was not the first time HSBC had claimed poor integration. Douglas Flint, Chairman of HSBC Group, made a similar claim when HSBC's Mexican subsidiary was exposed for money laundering back in 2012. Flint claimed that it was "impossible for board members to know how the bank's different businesses were operating" unless issues were raised.[43] Stern and Wilson, however, harshly rebuked this claim by alleging that their reports of compliance failures fell on deaf ears.

Gulliver's troubles: Stuart's little problem

"Being in Switzerland protects me from the Hong Kong staff. Being in Panama protects me from the Swiss staff" – Stuart Gulliver, CEO, HSBC[44]

It soon emerged that HSBC's CEO Stuart Gulliver had private Swiss and Panamanian bank accounts. Apart from that, Gulliver was found to be registered as a non-domiciled citizen of the UK.[45] Additionally, Gulliver's role as CEO of HSBC Holdings PLC was merely a secondment from the Dutch-headquartered HSBC Asia Holdings.[46] All these conferred tax advantages which allowed Gulliver to limit his tax exposure in the UK.[47]

Gulliver issued statements maintaining that he had "never paid less than the marginal UK tax rate".[48] He further justified his assertions by emphasising that he had openly declared his Swiss account to UK tax authorities over the years. These claims were supported by Flint who openly backed Gulliver by stating that "there is absolutely no story here. There is nothing Stuart has done that is not absolutely transparent, legal and appropriate".[49]

Fair weather ahead?

"I can assure you that we had no evidence of tax evasion" – Rona Fairhead[50]

Rona Fairhead, Independent Non-Executive Director of HSBC Holdings PLC, joined Gulliver at the centre of the furore when she insisted that no evidence of tax avoidance had surfaced during her tenure.[51] She blamed HSBC Suisse's relationship and domestic managers for the failings.[52] However, her status as "independent" non-executive director was called into question due to concerns over her remuneration of £847,000 in 2014.[53] Her plea of reliance on internal auditors, FINMA, and on strict internal controls were refuted as she was criticised for her passive regulation of the bank and gross incompetence which led the court to call for her resignation.[54]

Hide and seek no more

The practices that HSBC was decried for is by no means exclusive to the bank itself. Other players in the private banking industry, such as UBS, Julius Baer, RBS[55] and BSI[56] have been either convicted or are under investigation for the same transgressions.[57] In the wake of these incidents, private bank managements are scrambling to inspect and eradicate tax evaders from their client lists.[58]

Following a growing global outcry regarding corporate tax compliance, a framework for the crackdown on global tax avoidance has been released by the Organisation for Economic Co-operation and Development (OECD) and supported by more than 60 governments.[59] The framework aims at creating global guidelines for tax reform and reporting, as well as exercising pressure on specific countries to address and correct commonly exploited tax loopholes.[60]

As part of the OECD's efforts, Switzerland has budged slightly on the international front and committed to the automatic exchange of information about individual accounts, taxes, assets and income, subject to reviews and rules of confidentiality.[61] The proposed timeline for full implementation by 2017 or 2018 and has been hailed as the final nail in the coffin for banking secrecy.[62]

A Franc disclosure

"I would say that a number of us, myself included, think that the practices at the Swiss private bank in the past are a source of shame and reputational damage to HSBC." – Stuart Gulliver[63]

As of February 2015, HSBC has neither confessed nor denied any of the tax evasion allegations. Instead, in a statement released by HSBC on 8 February 2015, they maintained that individuals themselves exploited Swiss banking secrecy laws to circumvent tax obligations and that such problems were prevalent throughout the entire industry.[64]

When quizzed about a recurrence of the scandal, Gulliver asserted that HSBC had put in place controls, systems and compliance functions to reduce the risk of recurrence to an "absolute minimum", and to uphold the "highest or most effective standards across the group to combat financial crime".[65] However, he carefully noted that he could not "absolutely guarantee that it (would) not happen again".

In a bid to win back investor confidence, a new management team has been established to lead HSBC Suisse and implement a host of new reforms, such as reviewing clientele and refusing service to those who did not manage to pass, or enforcing a new tax transparency policy.[66] This comes in line with a major restructuring of HSBC's control and management, where MWM Consulting was appointed to facilitate the sourcing and engagement of non-executive directors for the Board. Analysts have described this as the most sensational change in the management of Britain's largest bank. In addition, prior to the exposure of the tax scandal in its Swiss arm, HSBC announced that it would do away with its age old tradition of nominating the next chairman from its internal pool of talent.[67]

The repercussions for HSBC have been financially and reputationally damaging. In light of the recent scandals, almost a third of its shareholders refused to back the proposed remuneration for top management at the 2015 Annual General Meeting and called for the resignation of key management figures who were heavily involved in the tax scandal.[68]

Au Revoir

"Can I know what every one of 257,000 people is doing? Clearly I can't"
– Stuart Gulliver[69]

Following allegations that the company had become "too big to manage", HSBC has been scaling down its international operations by divesting businesses in less profitable countries.[70] In doing so, HSBC, the world's local bank, may be laying an epitaph on the slogan that it worked so hard to be synonymous with.

Discussion questions

1. Comment on the effectiveness of HSBC's whistleblowing policy.
2. Based on your answer in Question 1, evaluate the implications of having a poor internal whistleblowing environment. When whistleblowers have to resort to exposing their organisation to external parties, what impact does it have on the organisation?
3. Falciani's whistleblowing differed from most other cases due to his questionable motives. Discuss whether the eventual result of whistleblowing necessarily justifies the means, in this instance theft and an intention to monetise the stolen data.
4. HSBC stressed that its failure to integrate its Swiss arm was the underlying reason for its low ethical standards. How should acquiring companies integrate their subsidiaries and what are the implications for corporate governance?
5. The HSBC parent bore the brunt of the public scrutiny and criticism for the subsidiary's misdeeds. To what extent should the parent board of a multinational company be held responsible for the actions of its subsidiary?
6. The HSBC case brought up an increasingly pertinent issue of tax governance. How should companies integrate the tax function within their corporate governance framework?
7. Directors have a fiduciary duty to act in the best interest of the company and have an obligation to maximise shareholder value. To what extent does this justify using legally permitted structures to shift profits to low tax jurisdictions in order to minimise tax? Or do directors have a broader ethical obligation to society to ensure that the company pay its fair share of taxes?

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PETROBRAS: NOT YOUR TYPICAL CARWASH

Case overview

On 20 March, 2014, the former refinery chief of Petroleo Brasileiro SA Petrobras ("Petrobras") was arrested during "Operation Carwash", under allegations of money-laundering during his term at Brazil's largest company. In a bid to obtain concession from the prosecutor, Paulo Roberto Costa agreed to a plea bargain. This led to a divulgence of insider information that included many alleged elaborate kickback schemes between Petrobras, its corporate partners and some members of Brazil's top political leadership echelons. Since then, Brazil has been embroiled in the largest corruption scandal the country has ever faced.

This objective of this case is to facilitate discussion on issues such as bribery and corruption; the role of public governance in companies; corruption risk in countries with poor public governance; and the effectiveness of anti-corruption programs in business environments where corruption is rampant.

Petrobras - Powering Brazil's future, once upon a time

"The economics are just so poor at Petrobras, that we really have called it a scheme, not a stock," – Jim Chanos, founder of Kynikos Associates LP[1]

This is the abridged version of a case prepared by Goh Jia Han, Lim Hui Ying, Lim Kai Ting Grace and Ng Xu Hao under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Ang Qun Yun under the supervision of Professor Mak Yuen Teen.

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At its peak, Petrobras had been the symbol of Brazilian pride and envy of the world. Today, its tainted reputation has become a source of public ridicule and mockery. What had once been heralded as the gold standard of global energy producers has since plunged into the doldrums.

Petroleo Brasileiro SA Petrobras, Que Saudade!

Petrobras was founded in October 1953 by Brazil's former president, Getúlio Vargas. Headquartered in Rio de Janeiro, Petrobras was a major player in the oil and gas industry. It sought a public listing on the Sao Paulo Stock Exchange in 1997 and listed as a depository receipt on the New York Stock Exchange thereafter. In 2011, Petrobras was ranked the fourth largest energy company worldwide and the largest company in South America.[2]

Petrobras' operations can be segmented into five divisions: exploration and production; refining, transportation and marketing of oil and natural gas; petrochemicals; distribution of derivatives, electrical energy, biofuels; and other renewable energy sources.[3] Through these segments, Petrobras aims to deliver a variety of quality products processed from the energy it produces.

Board of Directors

Chairing its Board of Directors between 2003 and 2010 was Dilma Rousseff, before her win at the 2011 Presidential Elections. It was a historic moment for Brazil as the Office of the President was held by a woman for the first time. In January 2012, Maria das Graças Foster was appointed Chief Executive Officer (CEO) by the controlling shareholder (i.e. the Brazilian Government).[4] She also sat on the Board of Directors.

The Board at Petrobras comprised 10 directors, each elected for a one-year term, with re-election allowed. Seven of these directors had been appointed by the controlling shareholder, one by the minority common shareholders, one by the preferred shareholders and one by the employees.[5] Four out of the 10 directors were considered independent.

Shareholdings

Petrobras issued two classes of shares – Common and Preferred, with the latter class having no voting rights and being offered primarily to investors. As at February 2015, the Brazilian government had control of more than 50% of the voting rights. A further 11% was controlled by entities over which the government had effective control. Additionally, the government also retained veto power over major decisions concerning the company.[6]

New money, suit and tie

"To end corruption is the supreme goal for one who has not reached power."
– Paulo Roberto Costa[7]

Costa had it all, or so he thought. He led an upscale lifestyle, owned luxurious cars, and had bank accounts loaded with billions.[8] As he rose through the ranks at the energy giant, he frequently indulged in the company of high society and their world of merry-making. It was a world where individual profit-making was encouraged and self-interests were advocated.

Eventually, blinded by greed, Costa turned a deaf ear to his conscience and eventually went down the wrong path. In his 35 years with Petrobras, he channelled a significant amount of wealth from the company into his pockets through an elaborate corruption and bribery scheme. Little did he know that the cheating would soon come to an end, as would the extravagant living.

From handshakes to handcuffs

The 20th of March 2014 seemed like any ordinary day, except that it was not.

On that fateful day, Costa was apprehended by the federal authorities from the comfort of his luxurious gated community to assist in investigations concerning money laundering malpractices. The arrest had been unexpected, and had sent Costa's daughters and sons-in-law into a packing flurry, as they filled suitcases and bags with cash, incriminating documents and a laptop in a bid to hide them from the prosecutor. Unfortunately for the Costa family, however, a security camera had taped the entire episode, and the footage was handed over to the judge presiding over the case.[9]

Spilling the beans

Between 2004 and 2012, Costa held the appointment of Chief of Refining and Supply at Petrobras. Evidence showed that at the peak of his career he had acted as an intermediary for money launderers and the state. The notorious Alberto Youssef formed the other half of the criminal duo. He had acted as the black-market currency dealer for the scheme and had been caught earlier on 17 March, 2014. Previously, Youssef had been arrested nine times for laundering more than R$10 billion.[10]

On 27 August, 2014, Costa appeared in the Parana federal court and pleaded for leniency. As part of the plea bargain, he spilled the beans on Petrobras' illegal activities which had been going on for almost a decade, dishing out the names, bank accounts, political connections and contacts of all those involved. Youssef did likewise, unravelling the details of the biggest corruption scandal to date in Brazil.[11] Over a period of at least seven years, Costa and several others had embezzled kickbacks amounting to millions from companies to whom Petrobras had awarded inflated construction contracts. In addition, they had given bribes to politicians through intermediaries to ensure they voted in line with the ruling party.[12] During a recorded court hearing, Costa described the kickbacks he received from the companies as a "three percent political adjustment" which equated to tens of millions of dollars.[13]

Greasy palms, troubled nation

According to Brazilian law, the commencement of investigations against congressmen and top figures of the executive branch was subject to the approval of the Supreme Court. Subsequent criminal charges or trials against these persons must also be approved and judged by the highest court. As a result, legal proceedings concerning such persons implicated in the Petrobras scandal were expected to span at least a few years.[14]

Upon investigation, the Federal Police found 750 construction and public works implicated in the scandal.[15] Costa divulged a total of 54 names to the Attorney General, many of whom were members of Rousseff's Workers Party (PT) and its coalition allies in the Congress.[16] Although Rousseff chaired the board of Petrobras when the kickback scheme was still in operation, she vehemently denied any knowledge of it. Eventually, her name was cleared by the prosecutors.[17] However, opinion polls revealed that most Brazilians believed she knew of the scheme.[18]

As investigations continued, more dirty secrets and dishonourable acts were uncovered. A further probe revealed that nine of the biggest Brazilian infrastructure and construction companies had been involved in the scheme.[19] Prominent corporations such as Rolls Royce, and Singaporean companies such as Keppel Corporation, were also accused of paying bribes to Petrobras in exchange for favourable treatment.[20] Three political parties made the headlines for allegedly receiving benefits from the state-owned enterprise – PT, Brazilian Democratic Movement (PMDB) and the Progressive Party (PP). On 6 March, 2015, 12 senators and 22 congressmen were formally held under investigation.[21]

On 14 October, 2014, Petrobras took another blow as PricewaterhouseCoopers (PwC), the company's external auditor since 2012, refused to sign off the third-quarter earnings and threatened to bring the case to the United States authorities.[22] Petrobras admitted that it was "impracticable to measure in a correct, complete and definite manner" its losses from the corruption scandal.[23] The accounting firm refused to comment and demanded further investigation.

On 24 November, 2014, Petrobras received a subpoena from the US Securities and Exchange Commission requesting for access to documents which were needed in an ongoing investigation. Petrobras duly obliged. Petrobras was also separately investigated by US Department of Justice for potential violations of the US Foreign Corrupt Practice Act. Probes by the United States authorities were said to be ongoing since start of 2014.[24]

Mired in financial turmoil

On 21 October, 2014, in light of the corruption scandal and its huge amount of debt, Moody's Investors Service (Moody's) downgraded Petrobras' global foreign currency and local currency debt ratings from Baa1 to Baa2.[25] Coupled with falling oil prices and a weakening local currency, the future of Petrobras seemed bleak. Despite the negative outlook, Rousseff managed to emerge victorious at the Brazilian presidential elections by a narrow margin, securing 51.6% of the votes. However, the news was not well-received by investors – Petrobras stock fell 16.4% on 27 October, 2014.[26]

After being left in the lurch by PwC, Petrobras released its unaudited 2014 third-quarter results on 27 January, 2015. The company's shares fell 11.6% to US$6.59 the following trading day in reaction to the news.[27] On 29 January, 2015, Moody's downgraded all ratings for Petrobras. This included a downgrade of the company's senior unsecured debt from Baa2 to Baa3 and Baseline Credit Assessment from ba1 to ba2.[28]

To aggravate matters, the company was simultaneously facing a dozen class-action lawsuits in the US including a lawsuit from Ohio's pension fund on the basis that it had violated US federal securities laws.[29]

As if things were not bad enough, on 25 February, 2015, shares of Petrobras fell more than eight percent to US$6.29 following Moody's further downgrade of the company's long term debt rating from Baa3 to Ba2 (junk status).[30] The firm offered a probable explanation of the downgrade to its stakeholders – concerns over the corruption investigations and potential liquidity pressures, as well as Moody's negative outlook on Petrobras' ability to reduce its significant debt levels in the following years.[31]

The scandal took a huge toll on Brazil's economy and few have managed to emerge unscathed. With the cancelled contracts and delayed payments, many construction companies are facing credit downgrades and bankruptcies. The oil industry bore the brunt of the fallout with thousands of workers dismissed, worsening the unemployment situation in the country.[32]

Easy come, easy go

Back in 2012, Foster's appointment as the CEO of Petrobras had been met with some resistance. As Foster and Rousseff maintained a close relationship, many questioned if Foster would have a potential conflict of interest maximising firm value and catering to Rousseff's political agenda. Although not accused of direct involvement in the scheme, Foster was reported to have ignored internal whistleblowers about the corruption scandal. Venina Velosa da Fonseca, a former Petrobras manager, said that she had warned several directors about inflated contracts in 2008, including Foster who was then the head of the gas and energy division. However, Foster vehemently denied all knowledge of the scheme.[33]

On 4 February, 2015, Foster tendered her resignation. This move was generally accepted by the markets but investors were concerned about the government's failure to name her replacement immediately. Together with Foster, five other Petrobras top executives also resigned from their positions.[34]

A leadership vacuum

"We have seen today an episode of disrespect for the board of directors of Petrobras. Once again the controlling shareholder (the government) has imposed its will over the interests of Petrobras, ignoring the appeals of long-term investors." – Mauro Cunha, Petrobras' Representative Director for Minority Shareholders[35]

Following the mass resignations, Rousseff used her personal connections to search for replacements for the key management positions at Petrobras. The five executive positions were filled two days later on 6 February, 2015, all of them by employees of the company who had considerable experience in engineering and the oil and gas industry.[36]

Additionally, Rousseff nominated Aldemir Bendine, head of state-owned Banco do Brazil, as Petrobras CEO. However, the independent directors were not consulted and the appointment was not supported by the full board, which was unsurprising given that he possessed neither experience nor expertise in the oil industry.[37] Furthermore, Bendine's appointment was met with disappointment given his close relationship with Rousseff, and Banco do Brazil's status as a major lender to Petrobras and its contractors. As expected, the stock market reacted negatively – Petrobras' shares fell by nine percent.[38]

A change in board leadership, again

Guido Mantega, Brazil's former finance minister, had been chairing the board since March 2010 before the baton was passed to Murilo Ferreira, CEO of Vale SA, a Brazilian multinational corporation engaged in metals and mining. It was hoped that Ferreira would be able to "replicate this story in Petrobras", referring to how he had "corrected a very serious problem of capital allocation" at Vale SA.[39] Moreover, Ferreira's appointment, along with two other executives from Vale, were seen as a departure from the tradition of appointing cabinet ministers and allies of the Brazilian government.[40]

However, less than eight months into his appointment, Ferreira vacated his position on 30 November, 2015. Neither Petrobras nor Vale's press department provided any reason for Ferreira's departure, but it was believed that Ferreira had clashes with Bendine, and that fundamentally, they had "disagreed on how to conduct business".[41] Taking his place was acting chairman Luiz Nelson Guedes de Carvalho, who was subsequently re-elected on 28 April, 2016.[42]

In a surprising turn of events, Rousseff was forced to step down as Brazil's president amid impeachment trials, for allegations that she had "illegally manipulated fiscal accounts".[43] Michel Temer, who assumed the role of acting president, proceeded to appoint new heads for state-run banks such as BNDES and Banco do Brasil, as well as Petrobras, "as part of a broad shuffle of top government jobs."[44]

Pedro Parente, chairman of BM&Fbovespa SA, the operator of Latin America's biggest securities exchange, succeeded Bendine and became Petrobras' third CEO in less than two years. Even though Parente had never managed an oil company, his experience in business and government garnered praises from investors, as he had led Brazil out of a national crisis when he oversaw energy rationing during his term as an energy minister in a 2002 drought.[45]

Blessings in disguise?

Industry experts predicted that as Petrobras and other implicated companies were blacklisted from further work, opportunities may arise for medium-sized and global construction and engineering companies that had previously been unable to contract for large projects in Brazil as the "political shield often blocks public bids".[46]

On 20 March, 2015, Petrobras' executive board approved a project to be led by Aldemir Bendine to revise its corporate governance and management rules. This project aimed to "adapt the company's governance to a new business environment and a revised investment plan."[47]

Amidst the troubles plaguing Petrobras, some investors remained hopeful. For instance, Skagen AS, a Scandinavian employee-owned investment manager,[48] continued investing in Petrobras' shares, as it anticipated that Petrobras would be in a stronger position after the corruption probe. In the short term, cash flows were seen to be improving due to decreasing oil prices and fixed retail product prices in Brazil.[49]

Tougher rules, greater enforcement

Prosecutors who had uncovered the scandal appealed for tougher prison sentences and greater legal authority to clamp down on "rampant graft that costs taxpayers more than the annual budget for education and health."[50] As the scandal unravelled, more executives and directors of Petrobras, even politicians from the Workers' Party, were arrested and prosecuted.[51]

Evidently, some believe that the corruption scandal will lead to better governance in Petrobras and even in the country in the long run. However, much remains to be seen and the world watches on with keen eyes as the saga unfolds.

Discussion questions

1. What are the existing measures in place to combat corruption and bribery in Petrobras? Are they effective? If no, what else can be done?

2. It was reported that bribery and corruption schemes have been occurring within Petrobras during Dilma Rousseff's term as Chairman. Discuss the roles and responsibilities of the Board in preventing such situations. Has she fulfilled her responsibilities as the Chairman?

3. It has been reported that Keppel Corporation and Sembcorp Marine have business dealings with Petrobras. If you are on the Board of Directors or in the management team of these companies, what are some issues you would be concerned with?

4. What should the board and management of companies such as Keppel Corporation and Sembcorp Marine do to minimise bribery and corruption risks when doing business overseas?

5. As former Vice-President and Controller of the World Bank, Jules Muis, puts forth, "the public and the private sectors are the two wings of one plane". Using Petrobras as an example, to what extent does a country's public governance affect the corporate governance of companies resident in that country?

6. Transparency International provides a report on "Exporting Corruption" yearly since 2005. This report gives an assessment on the status of enforcement in 41 signatory countries. When local enforcement is weak, does this mean that the risk of being caught for corruption is very low? Explain.

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SANOFI: DISPENSING THE DRUG LORD

Case overview

In September 2008, Sanofi welcomed its first non-French CEO, Christopher A. Viehbacher. The appointment of German-Canadian Viehbacher marked a cultural shift in the French pharmaceutical company, who introduced a series of revamps in an attempt to revive the ailing drug empire. However, despite the stock market's positive response to Viehbacher's reforms, Sanofi's board of directors, headed by Serge Weinberg, was clearly displeased with their non-French leader. On 29 October, 2014, the abrupt firing of Viehbacher shocked the market and left a question mark over one of the world's largest pharmaceutical companies. Why was Viehbacher fired? Who would be coming on board next? The objective of this case is to faciliate discussion of issues such as board-management relationship; CEO succession planning; qualities of a good CEO; cultural differences; and hiring and firing of a CEO.

Sanofi: The pharmaceutical empire

Sanofi is the world's fourth largest pharmaceutical company in terms of sales, with an annual revenue of €33,770 million.[1] Formally incorporated in France in 1994, Sanofi gradually expanded into the global markets over the decades. It was first listed on Euronext Paris, and later, on the New York Stock Exchange. Sanofi takes pride in its rich heritage and longstanding history of French innovation through mergers and acquisitions of established pharmaceuticals such as Laboratories Midy and Synthélabo.[2]

This is the abridged version of a case prepared by Isabella Ow Dan Wei, Koh Hui Wen Michelle, Liu Jun Yao, and See Jun Jie under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Chua Chloe under the supervision of Professor Mak Yuen Teen.

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Conseil d'Aministration

Sitting on Sanofi's board are 15 Directors, comprising Chris Viehbacher, four non-independent directors, and 10 independent directors. Helming the board is Chairman and independent director Serge Weinberg, who took over the reins in May 2010. A majority of the directors (10 out of 15) are French.

One of the board committees is the Appointments and Governance committee, which evaluates the composition and performance of the Board, its committees and its executive management. Before November 2014, the committee was led by the Chairman Serge Weinberg.[3] The committee is composed of four directors, three of whom are independent. All the directors on the committee are French.[4]

The drug lord

Christopher A. Viehbacher was head of GlaxoSmithKline's North American Division before joining Sanofi as Chief Executive Officer (CEO) in September 2008. Having worked in Canada, Europe, and the United States, Viehbacher had a wealth of international business experience. His appointment as Sanofi's first non-French CEO evoked speculation of major changes at France's second-largest listed company.[5]

Cure to the ailing Sanofi

The market speculated that Viehbacher's appointment signified a cultural shift in the company in its attempt to make Sanofi more international by encouraging it to move away from its traditional French and European strongholds.[6] Before Viehbacher's appointment, Sanofi had been a European-centred company typically behaving "as if the American market were an afterthought".[7] Sanofi's European-centred management style had hindered the company's expansion into the US and international markets. Right before Viehbacher's appointment, Sanofi had experienced a major failure with its weight-loss drug Acomplia in the United States.

To make matters worse, Sanofi was also facing the pending expiration of six of its major patents which accounted for 40% of its revenue. As a result, Sanofi was falling behind its European competitors, with analysts calling it "a laggard of the European pharmaceuticals sector".[8] Sanofi was thus left ill-prepared to deal with new competition and potential rivalry from generic pharmaceutical manufacturers.

When Viehbacher took over the company, he introduced a series of revamps that was a "breath of fresh air for the company".[9] He focused on strengthening Sanofi's research and development, and steered Sanofi towards the international markets. He initiated a massive program of layoffs which included cutting more than 40% of the organisation and selling off non-core assets because he "just didn't believe in those projects". Viehbacher's revamps were well received by investors, with the share price steadily rising from $25.62 when he first took over in 2006, to a peak of $56.43 just a few days before his dismissal in 2014.[10]

Concocting his own disaster

Despite Viehbacher's contributions to the company, his tenure as CEO was a bittersweet period for Sanofi. Viehbacher's distinct management style and the cultural clash created conflict and dissatisfaction amongst the board members.

Viehbacher had a reputation for his aggressive and uncommunicative management style, which did not sit well with Sanofi's board of directors. During his term as CEO, Viehbacher had adopted a solo decision making approach – preferring not to consult the board when making major decisions for the company. Sanofi's directors more often than not felt ill-informed about his plans. Despite general confidence in the turnaround strategy he was pursuing, his management style created increasing tension between him and the board members. In an interview with Fortune, Weinberg revealed that "the board was dealing with a CEO who had a 'willingness not to communicate', [and] the situation only grew worse, 'trust diminished and it was very difficult'".[11] He also said that the board collectively felt that "the management style in a company that is big, international and complex needs to be much more inclusive".[12]

The cultural differences between the non-French CEO and the French-dominated board further aggravated the already tense situation. Not a native to the French culture, Viehbacher adopted an Anglo-Saxon style of management that was heavily questioned by the board. In June 2014, Viehbacher's decision to relocate to Boston, US, further fuelled concerns from the French government that Sanofi was shifting its focus away from home. Despite Sanofi's claim that this was a personally-motivated decision which would have no impact on Sanofi's operations,[13] it was clearly a debatable decision made by Viehbacher as Sanofi was one of France's biggest companies, and its operations were extremely embedded in the country's corporate and political life.[14]

Burning side effects: Project Pheonix

At the end of May 2014, Viehbacher's secret project to sell off several of Sanofi's mature drugs which were suffering from low growth to Bloomberg was leaked to the press. It was the first time Sanofi's board had heard about the undertaking, dubbed "Project Phoenix", which Viehbacher had worked on without consulting the board. The board was alarmed, and Weinberg was quoted saying, "The board found out about the project in the press, and would have nixed it had they known." Viehbacher was reported to have denied the project's existence when questioned by Weinberg.[15]

Three weeks later, in June 2014, there was another leak of a project document by The General Confederation of Labour, a French national trade union centre, to the media. The 25-page document detailed a plan presented to Sanofi's investment committee on 6 May, discussing the potential sale of Sanofi's portfolio of matured and low growth drugs valued at over €6.3 billion.[16] Given the backdrop of France's high rate of unemployment at that time, the initiative, which affected six manufacturing and distribution sites, and 2,600 staff in Europe, was seen as "tactless and hurtful"[17] and "very sensitive in France."[18] When Weinberg questioned Viehbacher yet again about the undisclosed plan, the then-CEO downplayed the colossal initiative, calling it a "local project."[19]

The growing dissatisfaction Sanofi's board had with Viehbacher led the board members to consider Viehbacher's departure from the firm in July 2014. This evolved to Weinberg discussing transition plans directly with Viehbacher in early September 2014.

Without me, the company falls

Two months after the unsettling Project Phoenix, Viehbacher caught a whiff of the discontentment stirring within Sanofi's board of directors. This prompted him to write a letter to the board, stating reasons why he should retain his position as CEO of the company[20], as well as revealing his wariness of Weinberg.[21] The letter, dated 4 September 2014, stated, "It has come to my attention, first through rumour, that the Chairman of the Board is actively seeking a successor to me as Chief Executive Officer."[22] Through the dispatch, Viehbacher also pressed for further clarification from the board regarding the issue. However, Viehbacher's quest for answers was not addressed and he threatened the board with legal action.[23]

The contentious letter, along with the private opinions expressed by Viehbacher, was made public on 27 October 2014 in Les Echos, a French newspaper[24], resulting in the company's dirty laundry being aired in public. It was suspected by Weinberg that the letter was leaked by Viehbacher himself, as he reasoned that only the CEO had a copy of the circulated unsigned letter; all board members had received signed copies of the letter.[25]

Private matter no more

In September 2014, a month prior to Viehbacher's dismissal, Weinberg and Viehbacher reached a "mutual" agreement on succession[26] where there would be a smooth leadership transition once Viehbacher stepped down as CEO. The agreement seemed concrete, up until the leaked letter on 27 October 2014. Weinberg perceived this leak as a malicious attempt on Viehbacher's part to confuse matters and to turn his back on the gentlemen's agreement.[27]

Any chance of a smooth succession was clearly thrown out the window. The leak further drove a wedge between the CEO and the board, resulting in additional cracks in an already thinning degree of trust between the two parties, where any chance of collaboration for a succession agreement was out of the question. In light of this, the board was led to believe that the CEO "doesn't want to collaborate in a natural, trusting way", and thus, in the words of Weinberg, "the board had to act".[28]

On 27 October 2014, the very same day the leaked letter was published, Viehbacher once again sought clarification on his future at a meeting at Sanofi's headquarters, only to be declined information by Weinberg, who claimed that the CEO's succession was not on the agenda.[29]

On 28 October 2014, Sanofi's directors were notified of an emergency meeting.[30] This special board meeting held in the morning of 29 October 2014 led to Sanofi's board unanimously deciding to remove Viehbacher, who had been with the pharmaceutical firm for six years. This was in stark contrast with the board's previous statement two days before, raising questions over the sudden change of mind.

Coup d'État – D-Day Viehbacher

On 29 October 2014, Viehbacher's long-standing tussle with Sanofi's board came to an end, with the 15 board members unanimously deciding to fire him as CEO. Following Viehbacher's shocking departure, Sanofi's board was left without a successor. The appointment of Chairman Weinberg as the interim CEO signalled only one thing - the board had neglected its key duty of succession planning. In an article by Fortune magazine, Weinberg conceded that "the board was not happy with how Viehbacher had to go, especially without a succession plan in place."[31]

Sanofi's Board Charter explicitly stated that the one of the main roles of the Appointments and Governance Committee was to "ensure that there is adequate succession planning for the Company's executive bodies, in particular through the establishment of a succession plan for the Chairman and the Chief Executive Officer so that replacement solutions may be proposed in the event of unplanned vacancies."[32] Why then did Sanofi not have a succession plan in place for Viehbacher?

There were attempts by the board to create a CEO succession plan. For three years since Viehbacher's appointment as CEO, the board had requested for a succession plan to be put in place.[33] However, the efforts by the board were stonewalled by Viehbacher, who clearly had no interest in identifying any potential successors.

Although it may seem that a well formulated succession plan was not a top board priority, Weinberg defended Sanofi in an interview with Fortune magazine, asserting that "In Europe, boards are often slow to act, as there is this view of the 'almighty CEO'" and that Sanofi, compared to other European boards, addressed the matter in a more timely manner.[34]

Repercussions

The sudden dismissal of Viehbacher as CEO unnerved investors. It triggered a ripple effect, resulting in Sanofi's shares falling 4.5% on the fateful day itself. Sanofi's share price hit rock bottom on the Paris Stock Exchange and NASDAQ on 29 October 2014. The plunge came one day after Sanofi's largest single-day drop in share price in nearly 20 years, which was a result of its announcement that the sale of its bestselling drug 'Lantus' – a treatment for diabetes that accounts for 18% of the company's sales revenue – would be flat in the following year due to a price war.

A new leader

Sanofi's four month search for a new CEO came to an end in February 2015, when Olivier Brandicourt, who was then Chairman of the Management Board at Bayer's HealthCare AG, was selected to be Viehbacher's successor.[35] The appointment of Paris-educated Brandicourt was clearly to the satisfaction of the board, with Weinberg saying Brandicourt had a "deep knowledge of the markets where Sanofi is present," and the "right personality" for the job.[36] He further added in an interview that he desired "a team player, someone capable of communicating . . ." as well as "someone from the industry and someone with knowledge of the US market"[37], insinuating that in the board's eyes, 'management style' was one area in which Viehbacher had failed.

With Brandicourt, Sanofi has selected a French citizen with considerable international experience. As well as reviving its international growth plans, Brandicourt will have to consider redefining and communicating the company's strategy at home, where Viehbacher's Anglo-Saxon management regime has ruffled more than a few feathers among the French officials and Sanofi's French-dominated Board of directors.[38]

Discussion questions

1. Based on the events that have transpired, identify the contributory factors leading up to the firing of Christopher Viehbacher. Evaluate the factors in terms of cultural differences and the relationship between Sanofi's board and the CEO.

2. What kind of relationship should be maintained between the Board and C-suite executives?

3. What are the roles and responsibilities of a CEO? What qualities should a good CEO possess? Based on these criteria, was Viehbacher an effective CEO during his term with Sanofi?

4. What were the reactions to the sudden firing? How well do you think the process leading up to the firing was handled?

5. What elements constitute a good succession plan? Why is a clear succession plan important to corporate governance?

6. What is the role of the nominating committee (in this case, the Appointments and Governance Committee) in succession planning? Did Sanofi's committee carry out its duties appropriately?

7. To what extent do you think the blame should be put on the CEO? Who do you think is ultimately responsible for the whole fiasco?

8. Put yourself in the shoes of Serge Weinberg as the Chairman of the Board and the Appointments and Governance Committee. How would you have dealt with the issues of an uncooperative CEO with regards to information sharing and succession planning?

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SCA: THE HUNT FOR ETHICS

Case overview

In November 2014, Swedish daily newspaper Svenska Dagbladet published an investigative article detailing potential corporate excess at Svenska Cellulosa Aktiebolaget (SCA), a Swedish multinational corporation.[1] The controversy, based on SCA management's use of the organisation's corporate jet and lavish Henvålen hunting lodge, sparked a huge uproar in egalitarian Sweden. Over the following few months, the scandal led to internal investigations, followed by the departure of key executives from SCA and related companies. The objective of the case is to allow the discussion of the extent to which corporate governance policies can tackle corporate excesses; the governance role of the board of directors; business ethics; and the effectiveness of Sweden's highly regarded corporate governance model of active ownership.

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Sweden's lumberjacks: The business of SCA AB

Svenska Cellulosa Aktiebolaget AB (SCA) was founded in Sweden in 1929 and was listed on the Swedish stock exchange in 1950.[2] It has since evolved into a company with three core business areas, namely personal care, tissue, and forest products. SCA is Europe's largest private owner of forests, with 2.6 million hectares of forest land[3], which it holds in order to meet the demand of its largely European market, while meeting its environmental sustainability objectives.[4] SCA has won numerous sustainability awards, and is listed on the FTSE4Good Global Sustainability Index and the Dow Jones Sustainability Europe Index.[5]

Power to the shareholder

Sweden possesses a unique model of corporate governance that has "become the object of international attention and admiration".[6] The responsibility for corporate governance in Sweden rests on the shoulders of the shareholders[7,8], in direct contrast to the market-controlled corporate governance models in the UK and the US.[9] Under the Swedish model of active ownership of companies, shareholders are encouraged to be agents influencing change within the companies and actively participating in the management of their companies through legal provisions provided by the Swedish Companies Act[10] and Code of Corporate Governance. It has been argued that concentrated, activist ownership "promotes long-term thinking" as it creates a climate of stability where companies can learn from their mistakes.[11]

That being said, critics have questioned the use of some important aspects of the Swedish model of corporate governance – including a concentrated activist ownership, a shareholder-led nominating committee, and a greater involvement of external auditors – by SCA's management.

Concentrated activist ownership

In Sweden, concentrated ownership in companies is common[12], with Industrivärden AB and Investor AB controlling more than half of the Swedish stock market.[13] As a result of concentrated ownership, greater responsibility can be vested in shareholders in the Swedish model, relative to corporate governance models in the US or the UK. This was no different in SCA.

As of 31 December 2014, the two largest shareholders of SCA by voting rights were Industrivärden AB (29.52%) and Handelsbanken (Handels) (14.3%).[14] A complex cross-ownership network has been put in place between SCA, Industrivärden, and Handels through the use of foundations and funds.[15] Dual class shares, in combination with cross-ownership arrangements, allowed Industrivärden to consolidate 29.52% of voting rights in SCA, despite having only a 10.06% effective economic interest.[16]

The sharing of directorships across various related company boards was equally complex. The system allowed Anders Nyrén, as SCA's board member, to approve SCA Chairman Sverker Martin-Löf's SCA flight claims, while Martin-Löf, as Industrivärden Chairman, could approve the claims of Nyrén in Industrivärden.[17] As such, the senior management and board members of the Swedish group of companies could sign off for one other while working within the same system.

Shareholder-Led nomination committee

Relative to corporate governance models in the US and the UK, Sweden's corporate governance model of active ownership gives shareholders a greater degree of influence during shareholders' meetings, promoting a greater balance of power between owners, boards and executive committees.[18]

Under the Swedish corporate governance structure, a committee of shareholders deals with nomination and remuneration matters; their roles include making recommendations during the Annual General Meeting (AGM). Following this model of active ownership, SCA's shareholder-led Nominating Committee had the responsibility of recommending board members and company auditors, as well as their respective remuneration. The committee is either appointed directly at the shareholders' meeting or through a procedure specified by the meeting. To ensure the Nominating Committee acts bona fide, restrictions are placed on the number of non-independent persons in the Nominating Committee.

SCA's Nominating Committee comprised of representatives from the largest shareholders based on voting rights, as well as ex-SCA Chairman Martin-Löf.[19] Industrivärden and Handels representatives constituted a significant portion of the Nominating Committee. Over the years, SCA's Nominating Committee have been passing proposals allowing prominent directors to be re-elected, including Martin-Löf, who had been Chairman since 2002.[20]

Role of external auditors

Swedish auditors generally report directly to shareholders, having been recommended by the Nominating Committee and appointed during the annual shareholders' meeting. They are also conferred additional responsibilities by the governing body of the Swedish auditing profession, FAR SRS.

In Sweden, the auditor's role includes examining the management's administration of the company.[21] PwC, SCA's external auditor since 2000, had been tasked to provide assurance on the administration and proposed appropriation of the company's profit and loss, in addition to providing assurance on financial statement information and compliance with legal and regulatory requirements. Furthermore, Swedish auditors are required to make recommendations on whether to report and discharge liability of the board and/or CEO to the shareholders at the AGM. The obligation to make a recommendation on such a discharge from liability occurs when the board has acted in ways which has caused the company significant liability or damages.[22] Granting a resolution for a discharge from liability implies that the company waives the right to sue the board members and managing directors for matters covered in the resolution.[23]

SCA's corporate excesses

As the owner of massive tracts of forested land, SCA had put in place hunting policies to help ensure the sustainability of its forested land. As part of these policies, Henvålen was a 9,400 acre plot of land that SCA invested into for hunting. According to SCA CEO Jan Johansson, "it is important for SCA to have its own facility that can be used year-round"[24] and Henvålen was the place to "invite customers, partners, hunting and conferences for employees."[25] In 2011, SCA made an investment of SEK50 million into the Henvålen hunting facility owned by Maths O. Sundqvist, a friend of SCA Chairman Martin-Löf.[26] In 2012, SCA's top management started formally hosting hunts in Henvålen, often inviting many of their business partners to hunt alongside them.[27] It has been estimated that SEK100 million had been invested into Henvålen, which was located on prime elk-hunting land.[28] The hunting trips have also been associated with high expenditures, and the share of internal participants was significant.[29]

Additionally, SCA's executives have been reported to take their families on SCA's aircraft flights. For example, Johansson and his daughter used SCA's corporate jet to fly to the 2014 FIFA World Cup, which cost approximately SEK5 million.[30] While SCA policy allowed employees to take passengers along with them, it required relatives' names to be recorded on the trip invoice, to ensure that employees would be charged for their relatives' flight expenses. However, it was revealed that in many cases, only the employees' names were present on the invoices, despite reports of employees' family members being on board company flights as well.[31]

Additionally, Martin-Löf was accused of using SCA's jet to shuttle between Stockholm and his weekend house in Östersund, for "emergency meetings". Such "emergency meetings" between 2010 and 2014 had cost SCA an estimated SEK4.9 million.[32]

An Egalitarian utopia?

With an extremely low Gini co-efficient of 0.27 in 2012[33], Sweden is staunchly egalitarian and has often been used as a model for social redistribution. Against this backdrop, a scandal involving the questionable use of corporate funds by senior management and directors has put Industrivärden and related companies under heavy fire.[34] It has also led critics to question the validity of Swedish corporate governance as a model for other countries.[35,36] In defence of the actions of SCA's board and senior management, Nyrén, Chairman of Industrivärden, claimed that Sweden is "a very small country", and that the people capable of running companies on SCA's scale were in "a close-knit sphere with a lot of influence".[37] Moreover, CEO Johansson had a reputation of "laying golden eggs"[38], as evidenced by record profits in 2014 despite such dubious corporate expenditure.

"Tell the truth or someone will tell it for you"

Following the news release in November 2014, SCA's board of directors commissioned 500 accountants to undertake two independent audits in SCA.[39] Both reports held that SCA had "acted in compliance with Swedish law and the company's policies".[40] Although PwC gave SCA the all-clear, it noted an "inadequate treatment" as SCA's policy was not fully complied with – only 36% of trips were billed and paid for since investigations started.[41] The audit firm also commented that the "emergency" meetings had been planned long before, raising the possibility of "overexploitation" by Martin-Löf.[42] Subsequently, after the second audit conducted by Svenska Dagbladet (SvD) Business, SCA revamped its policy, disallowing employees' relatives to utilise the company's planes.[43]

Spring cleaning: Revamping SCA's Board

On 22 January, 2015, SCA announced that Martin-Löf, who had spent 29 years on SCA's board, would not be seeking re-election.[44] Pär Boman, CEO of Handels and a member on the boards of SCA and Industrivärden, took over as SCA Chairman and replaced Nyrén as the Chairman of Handels.[45] Less than a month later, on 10 February, 2015, Johansson resigned as CEO, claiming that the investigations had diverted his attention from managing the company.[46] He was soon followed by the vice-president of SCA, who had been accused of flying with his wife on the company jet.[47]

Finally, on 27 April, 2015, Nyrén, the CEO of Industrivärden then, received a shock as shareholders withdrew their support for him to take over the Chairman role in Industrivärden, which was recently vacated by Martin-Löf. Instead, they terminated him as CEO and elected Fredrik Lundberg – a majority shareholder and industrialist, who was a former board member of Industrivärden – as the new Chairman of Industrivärden. Martin-Löf described the firing of Nyrén as "a coup-like seizure of power by Lundberg's side".[48] It was reported that the instigators of his dismissal were Lundberg himself and Pär Boman.[49] The latter replaced Nyrén as the Chairman of Handels earlier in the year, while taking on the position of Chairman of SCA and cleaning up SCA after its jet scandal.[50]

The hunt continues?

Boman has consolidated a significant amount of power due to his positions in SCA and related corporations, arguably greater than any of his predecessors.[51] In addition to being the CEO of Handels, Boman currently sits on the boards of Handels, Industrivärden and SCA, of which he holds the position of Chairman for both Handels and SCA. He has also installed Lundberg, his right-hand man, as the new Chairman of Industrivärden. Lundberg is also Vice-Chairman of Handels and sits on the board of SSAB, another company in the group. Both board members have been on Handels' board since 2002 and 2006 respectively.[52] However, Boman is reportedly a man of principles, who embodies Handels' values of thrift, hard work and responsibility.[53] Would this arrangement improve the corporate governance in the group, or would the hunt for good corporate governance continue?

Discussion questions

1. What are the main reasons which allowed corporate excesses in SCA to go unnoticed? Evaluate the effectiveness of SCA's corporate governance system in the prevention of such practices.

2. In light of the changes in the board of directors and key management personnel, comment on the effectiveness of the changes in preventing similar incidents. What are other possible steps that can be taken?

3. What role does an external auditor play in the overall corporate governance framework of a listed company in your country? Compare the scope of responsibilities of the external auditors in SCA's case with that for external auditors in your country. Which do you prefer?

4. Discuss the key characteristics of the Swedish corporate governance system and its suitability in your own country.

5. Consider the number of board memberships and senior management positions which Pär Boman and Fredrik Lundberg held respectively. What are some corporate governance concerns that would arise due to such an arrangement?

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SIKA AG: AVALANCHE IN THE ALPS

Case overview

In December 2014, Saint-Gobain, a French rival of Sika, struck a deal with the founding family, the Burkards, to acquire their 16.1% stake in Sika for CHF2.75 billion. The bid included a premium for superior voting rights afforded by the equity stake, which would give Saint-Gobain 52.4% of the total voting rights in Sika despite owning merely 16.1% of the company's outstanding equity. A provision within Sika's articles of association allowed investors to circumvent a mandatory takeover offer when an investor gained more than one-third of the voting rights in a company. As such, Saint-Gobain would not be required to initiate a full takeover offer for Sika despite having acquired a majority of the voting rights in Sika through the acquisition. This forced the management, directors and shareholders of Sika to initiate an intervention to protect the interests of the company and its shareholders. The objective of this case is to discuss the pros and cons of a dual-class share structure, differences in dual class shares in different countries, impact of institutional and legal environments on the suitability of dual class shares, and the impact of opt-out provisions with regards to the interest and rights of different stakeholders.

This is the abridged version of a case prepared by Lee Mei Hui Cheryl, Ng Shi Jui, Nina Wang Jia Xin, Ong Jia Ling and Wee Guang Jude under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

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Ending the family business

Founded in 1910 by Kasper Winkler, Sika AG ("Sika") is a specialty chemical company headquartered in Switzerland. Over its century-long history, it has expanded its operations to areas in Europe, South America and Asia.[1] The heirs of Sika are currently the fourth generation members of the Burkard family. A holding company, Schenker-Winkler Holdings (SWH), was set up by Romuald Burkard to maintain the family's controlling stake in Sika. The Burkard family was able to control the company through dual class shares, whereby they held 16.1% of the shares but had 52.4% of the voting rights.[2]

With waning interest in the company, the heirs of Sika decided to sell their stake in the company to their French rival, Saint-Gobain, for a 78% premium over the market price.[3] The decision raised strong opposition among Sika's management and the minority shareholders of Sika. Some believed the takeover made no strategic sense while others felt it was unfair to shareholders who were left out of the Saint-Gobain offer.[4] Should the management and directors of Sika be unable to overturn the decision, they would be taken over by one of their largest rivals. This prompted Sika's board and management to take action in an attempt to reverse the decision.[5]

The battle begins

The key point of contention between both parties was a clause embedded within Sika's articles of association. In Switzerland, this clause is provided to exempt potential investors from the requirement to bid for the entire company after securing more than one-third of its total outstanding shares.[6] This particular clause had been adopted by Sika in its articles of association in 1998.[7]

Following the announcement on 8 December, 2014 that Sika's board and management did not support the change of control, shares of both Sika and Saint-Gobain plunged.[8] Sika's management also made it clear that they would collectively step down should the planned acquisition succeed.[9] In response, on 10 December 2014, SWH made a request for an Extraordinary General Meeting (EGM) to be held before Sika's Annual General Meeting (AGM), with an intention to remove Chairman Paul Hälg and two other independent directors, Monika Ribar and Daniel Sauter, – all of whom were opposed to the sale of shares – from Sika's board.[10]

Defending Sika at all cost

To tackle the situation, Sika's management came up with their own agenda for the upcoming AGM, scheduled to be held on 14 April, 2015. They attempted to prevent SWH from exercising its full voting rights by restricting it to five percent, on the basis of them having a major conflict of interest. On top of that, a shareholder's resolution was filed on 23 December, 2014, for the deletion of the opting-out clause from Sika's articles of association, claiming that the provision was overly disadvantageous to minority shareholders. In a media statement released in January 2015, Sika announced that shareholders representing over 35% of Sika's total capital had expressed their support of the board and management in their efforts to protect the interests of the company and its stakeholders.[11]

On 26 January, 2015, the board passed a board resolution to restrict the voting rights of SWH to the statutory limit of five percent, with the intention of preventing Saint-Gobain from indirectly passing resolutions to their advantage at Sika's AGM.[12] This was due to the presence of a provision within Sika's articles of association, which prevented registered shareholders from holding more than five percent of all registered shares. In the past, the Burkard family had been exempted from this provision due to their history with the company. However, that privilege was nullified, together with the right to call for an EGM, due to the de facto transfer of voting rights to Saint-Gobain.[13]

Validity of opting-out clause

The position of Sika's board and management was supported by a number of shareholders. One group of shareholders, which included the Bill and Melinda Gates Foundation Trust and Cascade Investment LLC, took it upon themselves to ascertain the validity of the opting-out clause by sending a request to the Takeover Board of Switzerland.[14] On 5 March, 2015, the Takeover Board ruled that the clause was valid in principle but were doubtful as to whether Saint-Gobain could invoke the clause in its transaction.[15] However, on 1 April, 2015, the eventual decision by the Takeover Board reinforced Saint-Gobain's position on the transaction; it confirmed that the opting-out clause applied to the proposed acquisition of SWH, and that Saint-Gobain was not required to submit a public offer to the shareholders of Sika. In addition, the Takeover Board also concluded that Saint-Gobain's acquisition of Sika's voting rights was not abusive.[16] The decision was subsequently confirmed by a higher authority, namely the Swiss Financial Market Supervisory Authority (FINMA) on 4 May, 2015.[17] This led to the group of shareholders filing an appeal with the Federal Administrative Court (FAC) against the FINMA decision.[18]

Combating restrictions

In light of the recent rulings that were not in their favour, Sika's board of directors was determined to restrain SWH and Saint-Gobain's influence on the company. During the AGM held on 14 April, 2015, Sika's board of directors sought to use the provision to restrict the voting rights of SWH regarding certain items on the agenda. This included the re-election of existing members of the board, namely Monika Ribar, Paul Hälg, Frits van Dijk, Daniel Sauter, Ulrich Suter and Christoph Tobler; the election of SWH's proposed new candidate, Max Roesle, to the board; the re-election of the chairman of the board of directors; and the re-election of members to the nomination committee and compensation committee, with the exception of Urs Burkard, a family representative.

A group of Sika's shareholders also pursued their own agenda. The shareholder group's requests for a special audit to be conducted with regards to the takeover, as well as the appointment of a special expert committee to supervise the future conduct of the board of directors to safeguard the interests of the public shareholders, were approved during the AGM.[19] The removal of the opting-out clause, however, was not approved.[20]

In response, SWH directly appealed to the superior court in Zug, Switzerland in June 2015, to lift the restriction on their voting rights with regards to the agenda proposed during the AGM, and applied for an ex parte order to prohibit any restrictions of their voting rights at the upcoming EGM to be held on 24 July, 2015. The superior court denied the appeals.[21] Previously, SWH had been unsuccessful in its application for such an ex parte order with the Supreme Court and Cantonal regarding the AGM held in April 2015.[22]

Following the AGM, FINMA announced the rejection of the appeal sent in by Bill and Melinda Gates Foundation Trust and Cascade Investment in early May 2015. FINMA further reinforced the decision made by the Takeover Board on the matter of the applicability of the opting-out clause to the acquisition of Sika, allowing Saint-Gobain to carry on with the transaction without any obligation to submit a public tender offer to the rest of Sika's shareholders.[23] Unsatisfied with the verdict, the shareholder group appealed to the FAC against FINMA's decision.[24]

After the AGM: EGM results

Despite the European Commission's acceptance of Sika's acquisition by Saint-Gobain before the EGM[25], the failure to obtain the ex parte order from the courts proved to be detrimental to the pursuit of SWH's agenda during the EGM on 24 July, 2015. Sika's board of directors successfully reduced SWH's voting rights to five percent during the EGM and denied SWH's proposal to oust the current chairman, Paul Hälg, and two other independent directors, who opposed the takeover deal.[26] Due to the vote restrictions that reduced SWH's voting rights to 5%, a whopping 86% of the total shareholder votes cast during the EGM were against the removal of the three board members.[27] Hälg was impressed by the strong support by Sika's shareholders displayed for the board's actions, commenting that "never was there such wide resistance against the transaction as today from foreign and local investors, politicians and managers".[28] After SWH's proposal had been blocked, the Burkard family released a press statement reinforcing their stand that they would remain committed to selling its $3 billion-stake in Sika.[29]

On 1 September, 2015, Switzerland's FAC ruled that Saint-Gobain's purchase of a minority stake with majority voting rights did not give rise to the obligation of issuing an offer for all outstanding shares of Sika, in light of the opting-out clause in Sika's articles of association.[30] In its statement release, FAC emphasised that the ruling was final and could not be appealed.[31] Two weeks later, on 15 September, 2015, the Swiss Competition Commission (COMCO) authorised Saint-Gobain's acquisition of Sika.[32]

The future of Sika

On 12 April, 2016, at Sika's annual meeting, Chairman Hälg once again restricted voting rights of the founding Burkard family to five percent, resulting in the re-election of six directors to Sika's board for another year.[33] The move has been disputed in Swiss courts[34], though the two parties involved have shown no sign of backing down. In an attempt to garner support for its offer, Saint-Gobain promised Sika employees to accelerate Sika's development without retrenching employees, and that Sika's headquarters and stock market listing would remain in Switzerland.[35] Meanwhile, Sika's minority shareholders, which include the Bill and Melinda Gates Foundation Trust and Cascade Investment LLC, continue to express their support for Hälg, against Saint-Gobain's takeover offer. Justin Howell, representing the Bill and Melinda Gates Foundation Trust said that they "want to set a precedent for Switzerland and more broadly across the world that we will stand up for good corporate governance and will not be pushed around."[36]

Sika's fate currently lies in the hands of the Swiss courts, which is expected to decide before the end of 2016 on the legality of the board's move to limit the Burkard family holding company's voting rights on crucial decisions that greatly impact the future of the company.[37] Until then, the takeover battle for Sika continues, with no clear winner in sight.

Discussion questions

1. Sika is a large family firm with dual-class shares. What are the pros and cons of having dual-class shares? Discuss.

2. Compare the dual-class share structure in Sika with those in Facebook and Google with respect to the ability to transfer superior voting rights to external investors. Which do you prefer? Explain.

3. Comment on the effectiveness of the actions taken by Sika's stakeholders. Could they have taken any other form of action to protect their interests?

4. Should Singapore allow dual class shares? Why or why not? Are there differences in the legal system and institutional environment between Singapore and other countries like the U.S. and Switzerland that may affect the suitability of dual class share structures?

5. "Due to the issues arising from the opting-out clause, Ethos Foundation launched a support group to garner support for the removal of the clause. In response, the Swiss Federal Council has decided to include a limitation of the scope of the opting-out clause in the Stock Exchange Act." Consider the role of shareholder activism and its effects in general.

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TESCO AND THE ACCOUNTING BLACK HOLE

Case overview

In September 2014, Tesco PLC ("Tesco") admitted to an estimated £250 million profit black-hole in its books after a whistle-blower exposed the issue. Further independent investigations by Deloitte raised the misstatement to £263 million, uncovering past years' manipulations of commercial income, a subjective area of accounting in the grocery retail industry. The objective of this case is to allow discussion of issues such as board composition, particularly the skills, knowledge and competencies of the board; the governance role of the board; the role of regulators; shareholder litigation; and accounting for commercial income in the grocery industry.

This is the abridged version of a case prepared by Karen Soh Hui Ying, Lai Shi Ting Vanessa, Ooi Qui Wen and Pamela Boo Wan Yi under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

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Warren Buffett's £427 million grocery bill

There he sat, arguably the world's most famous investment guru, reflecting on his decision to invest in Tesco. Seated across the interviewer in the CNBC building, the third-largest shareholder of Tesco admitted his "huge mistake".[1] This came in light of the eruption of the accounting scandal the previous Monday. Tesco had admitted to unaccounted profits estimated at a whopping £250 million, sending shockwaves through the stock market. The share price plunged, wiping £1.1 billion off the retailer's market value.[2] Later that month, Buffett dumped 245 million shares, effectively halving his stake in the retail giant. In the process, he suffered a loss of £427.2 million.

Tesco PLC

Prided as a British national asset, Tesco PLC is a British multinational grocery and merchandise retailer listed on the London Stock Exchange (LSE). It is also a constituent of the FTSE 100 Index. Tesco is Britain's largest retailer and the second-largest retailer in the world by revenue.[3] Founded in 1919 by Jack Cohen, Tesco began growing rapidly in the 1950s through expansion and acquisitions. Tesco has since engaged in geographical and product diversification. Its products include books, clothing, electronics, financial services, telecommunications and internet services.

The space race

For the past decade, Britain's 'big four' supermarkets – Tesco, Asda, J Sainsbury and Wm Morrison – had been undertaking an aggressive expansion strategy, opening an unprecedented number of new stores[4] against the background of a sharply declining supermarket industry. Factors contributing to the industry's decline included a raging price war, the falling cost of food commodities, stiff competition from growing discounters Aldi and Lidl and up-market grocer Waitrose, and the growth of online and high street convenience stores.[5] Other factors included the advent of online retailers and consumers' lifestyle preference for low-cost products.[6] As such, supermarkets struggled to maintain profit margins in the weak market.

Board composition

In 2014, Tesco had a board consisting of 12 directors, including two executive directors – Chief Executive Officer (CEO) Philip Clarke and Chief Finance Officer (CFO) Laurie McIlwee, who were also the only individuals on the board with a background in the retail industry. The other 10 board members, including Chairman Richard Broadbent – who had worked previously at HM Treasury, Schroders and HM Customs and Excise before joining Tesco in 2011 – had no prior experience in retail. Three board members had a background in banking and finance, one in telecommunications, one in glass manufacturing, and two in the government.[7] There were also two board members with a background in audit – Ken Hanna, a non-executive director and the Chairman of the audit committee, who was previously the CFO of Cadbury[8], and Mark Armour, another non-executive director, a former partner at PricewaterhouseCoopers (PwC). Among the non-executive directors, only Hanna and Patrick Cescau had a 'consumer bent'.[9] The shortage of retail experts on the retail giant's board of directors led to concerns regarding the lack of knowledge and skills on the board relating to the grocery retail industry.[10]

Early warning signs

Tesco issued a series of profit warnings in 2014. Its first profit warning came on 9 January, 2014 due to poor Christmas sales, with an announcement that projected profits might be up to £150 million below expectations.[11] Deterioration of sales continued into April, despite Clarke's efforts to revive the business. On 5 April, 2014, McIlwee, who did not see eye-to-eye with Clarke, resigned.[12] Consequently, Clarke was the only remaining executive director on the board, and the only director with retail experience.[13] McIlwee assumed the role of CFO emeritus for the following six months to help with "transition activities" while Tesco searches for his successor. During this period, he continued to receive his salary of £886,420 and a potential bonus valued at twofold of his remuneration for the half-year period. Upon his departure from Tesco in October 2014, McIlwee received a £970,800 golden goodbye.[14]

In May 2014, PwC, Tesco's auditor for 30 years since 1983[15], informed Tesco in its latest audit report about its concern regarding how income from commercial deals with suppliers had been recognised.[16] Citing the "judgment required in accounting for the commercial income" and the "risk of manipulation of these balances", PwC noted the issue as a specific area of focus.[17] In response, Tesco's audit committee said it did not consider it a "significant area for disclosure in its report."[18] Nevertheless, this did not impact the unqualified opinion of PwC.

The curious case of commercial income

Commercial income is defined as promotional fees, discounts and rebates from suppliers. Suppliers routinely contribute a percentage of the promotional costs. In effect, suppliers pay retailers back a portion of their lost income. Such negotiations between retailers and suppliers usually take place a year in advance; hence cash is often received much earlier than when actual sales are made.[19] This time lag results in room for interpretation with regards to the timeliness of the booking of relevant profits and costs. While Generally Accepted Accounting Principles (GAAP) advocate the matching of revenues and costs, profit accruals may be recognised earlier while cost accruals may be delayed, effectively overstating profit for the period.[20] In reality, such grey areas are prevalent in the accounting of many retailers, including Tesco.

There is difficulty in estimating exactly when retailers would reach the sales target triggering the rebate; hence the ambiguous timing on the booking of rebates that were earlier received.[21] While there had been no clear guidance on the matter, the sheer size of Tesco's accounting misstatement and persistence of profit warnings, coupled with PwC's earlier warning, indicate a lack of sustainability of early profits stemming from Tesco's earnings management.

Profit warnings continue

On 21 July, 2014, Tesco issued a second profit warning, stating that sales and trading profits would be lower than previously expected, which contributed to brewing negative sentiments among shareholders against Clarke and Broadbent. This prompted Cescau, Chairman of Tesco's nominating committee, to succumb to shareholder pressure and oust Clarke on the basis of a lack of improvement in financial performance.[22] Subsequently, Dave Lewis was appointed as his successor and he was expected to join the retail giant's board in October that same year.[23] In response to this management change, Tesco's share price rose by 2.8% to 292.80p within the first hour of trading, despite the profit warning.[24]

On 29 August, 2014, Tesco issued yet another profit warning – its first-half year profits were to be £400 million less than expected.[25] This triggered a more than £1.3 billion decline in Tesco's value, as its shares dived nearly seven percent to 230p, its lowest level in 11 years.[26]

On 1 September, 2014, incoming CEO Dave Lewis started his job at Tesco one month earlier than had been arranged for, amidst doubts of his capability.[27] In early trading hours on the same day, Tesco shares fell by 1.9% to 225p.[28]

Whistleblowing

On 22 September, 2014, Lewis revealed that Tesco has uncovered issues with its accounts that had boosted profits by £250 million in the first half of the year.[29] The problem had been brought to the attention of the general counsel in Tesco by a whistleblower, who had approached Lewis with a report. This immediately triggered an investigation.[30] It was alleged that the same whistleblower had earlier in July 2014 attempted to alert Carl Rogberg, the UK finance director of Tesco, regarding the accounting error but was ignored for months.[31] The news raised questions about the effectiveness of Tesco's board in its oversight role.[32] Broadbent later commented that he could not be sure that £250 million was the limit of the overstatement.[33] Tesco further admitted that they had had a vacant CFO position for five months leading up to the scandal. The shares tumbled 11.3% to 203.5p – a new 11-year low – in early Monday trading on 22 September, 2015, in response to the revelation.[34] Broadbent said that he would not resign in the wake of the profit accounting scandal, but will "always listen to shareholders".[35] Tesco also suspended four executives immediately after the discovery of the profit misstatement.

Here comes another: The series of investigations

Pursuant to the announcement of the accounting misstatement, Lewis concurrently alerted the Financial Conduct Authority (FCA), the City regulator of UK, and appointed audit firm Deloitte and law firm Freshfields for an internal review concerning the accounting misstatements.[36] This led to a gruelling series of investigations into Tesco's inflated commercial income. On 23 September, 2014, a new finance director, Alan Stewart, was brought in two months ahead of schedule to help a team of external investigators to get to the bottom of the profit misstatement.

On 1 October, 2014, the FCA launched an investigation to examine whether Tesco had breached financial disclosure rules and released misleading statements to the stock exchange.[37] At this point, Tesco's shares had lost half of its value from the previous year.[38] Just three weeks later, on 23 October, 2014, Deloitte's inquiry pointed to a shocking overstatement of £118 million in Tesco's 2014 financial half-year, £70 million in the 2013/14 financial year, and £75 million in the prior year[39], effectively extending the period and the amount of misreported profits. In response to Deloitte's report, Broadbent announced his departure from the board so as to draw a line under the entire affair.[40]

On 29 October, 2014, an investigation commissioned by the Serious Fraud Office (SFO) – the organisation which "probes the gravest of financial crimes"[41] – took over the ongoing investigation by the FCA. The wide scope of investigations uncovered unfair payments and complex transactions underlying supplier-retailer relationships.

With the largest drop in sales in four decades, the fifth profit warning of the year was issued on 9 December, 2014. Lewis announced that annual profits would not exceed £1.4 billion, down from the earlier consensus of £1.94 billion. In response, Tesco's share price plunged by 16% to 156p, reducing Tesco's market value by another £2 billion.[42] By 18 December, 2014, a total of nine executives were suspended.[43] Meanwhile, the Financial Reporting Council joined the ongoing investigation on 22 December, 2014 to investigate the conduct of Tesco's auditor, PwC.[44]

Two months later, on 5 February, 2015, the Groceries Code Adjudicator (GCA) also joined the investigations, based on "reasonable suspicion" that Tesco had breached the Groceries Supply Code of Practice. Critics, however, argued that the GCA alone was not strong enough to force supermarkets like Tesco to change their ways due to its lack of legal powers to impose penalties.[45] This prompted drastic changes to be implemented in the UK grocery retail scene. On 4 February, 2015, the UK government submitted new rules to Parliament to hand powers to the GCA to fine supermarkets for poor treatment of suppliers.[46] The new legislation was approved, allowing the GCA to impose penalties on large supermarkets of up to one percent of their total annual turnover.[47] However, the new powers were only limited to breaches from 6 April 2015. As a result, Tesco would not be affected by the change in legislation.

We want our share: Shareholders' reaction

The accounting scandal sent a ripple of rage through its shareholders with its £263 million black hole in profits. With the majority of Tesco being owned by large pension funds and institutional investors, Tesco had to brace itself for a series of long legal battles by angry investors chasing compensation. On 9 November, 2014, numerous US law firms such as Scott and Scott LLP, were in talks with European institutional investors over the filing of legal claims.[48] Subsequently, a class-action lawsuit was filed in the US by Tesco's shareholders. On 25 November, 2014, Stewarts Law attempted to bring together major shareholders who owned at least 10,000 shares with a value of more than £20,000, to launch a lawsuit in the UK, where there exists no legal provision allowing for thousands to come together to file one big claim.[49] The claim, which was funded by Bentham Ventures B.V., was premised on the argument that Tesco's directors and senior management "knew or were reckless as to whether Tesco's statements to the market were untrue or misleading", which was in breach of the UK Financial Services and Markets Act.[50]

The Tesco Shareholder Claims, a non-profit group funded by Scott+Scott, was also set up in the US on 25 March, 2015, to rally institutional shareholders' support to bring an action against Tesco.[51] The group was also determined to extend the claims to institutional investors in the UK through representation by McGuire Woods. With the group's argument that Tesco's shares had lost between 50p and 70p of their value per share, Tesco was thus set to face a claim of £5.6 billion with its eight billion outstanding shares.[52] On top of hefty legal claims, Tesco's CEO, Lewis, had to grapple with a loss in shareholder's confidence as Tesco's shares hit a 14-year low during the series of investigations.[53]

Unlike in the US, there are currently no legal provisions in the UK for class-action lawsuits, and the use of the Financial Services and Markets Act by investors to lodge civil claims in the UK is relatively rare.[54] Hence, the Tesco scandal marks one of the rare recent cases of shareholder class action in the UK and may set the tone for future shareholder action against irresponsible large corporations.[55]

On 8 January, 2015, Lewis announced a turnaround plan for Tesco in a bid to regain its competitiveness in the market and to cut costs significantly to save £250 million a year.[56] As part of the cost-cutting measures, Lewis abolished dividends for the second half of 2014. Tesco's share price surged by more than 15% after the announcement, closing at 209.25p at end of the day.[57]

Too little, too late?

Since the commencement of the investigations, Tesco's board has experienced major restructuring in response to criticisms of its board composition. On 1 November, 2014, the board was joined by two non-executives with retail experience: Mikael Ohlsson, the former chief executive of Ikea, and Richard Cousins, the former chief executive of food services firm, Compass Group.

Two female non-executive directors, Olivia Garfield and Jacqueline Tammenoms Bakker, resigned on 26 February, 2015, leaving only one female director remaining on the board. This left Tesco far short of the government's recommendation on female board representation. New Chairman John Allan mentioned that "we are committed to a balanced, representative board and the composition of that board continues to evolve".[58] On 5 March and 7 April, 2015 respectively, Gareth Bullock and Patrick Cescau retired from the board.[59] Gareth Bullock still remained on the board of Tesco Bank. Tesco's board was joined by Byron Grote, a former BP chief financial officer, on 1 May, 2015.[60]

As investigations proceed, only time will tell whether the future of Tesco will improve with board changes and turnaround plans.

Discussion questions

1. Comment on the composition of the Tesco Board before the accounting scandal. Discuss how this has changed throughout the accounting scandal.

2. Discuss the key similarities and differences in board composition recommendations in the UK and Singapore corporate governance codes. Which do you think provide for better standards of board composition?

3. CFO Laurie McIlwee left right before the accounting scandal blew up, leaving with a golden parachute. What do you think about this remuneration policy? Are there any other noticeable deficiencies in Tesco's succession planning?

4. Evaluate the effectiveness of the regulators in dealing with the scandal and in protecting the interests of minority stakeholders.

5. Compare the legal system in the US and UK with respect to shareholder litigation. Which system do you prefer? Explain.

6. Comment on the general industrial practice of accounting for commercial income. Given the wide scope for interpretation, how do you think companies in the industry should comply with accounting standards?

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VOLKSWAGEN: THE EMISSION SCANDAL

Case overview

On 20 September, 2015, Martin Winterkorn, the Chief Executive Officer (CEO) of Volkswagen Group, issued a statement admitting that Volkswagen had cheated on emission tests for many years by installing "defeat devices" in its diesel cars. The statement was made after the United States Environmental Protection Agency (EPA) and the California Air Resources Board (CARB) revealed Volkswagen's manipulations that violated the legal emission standards. Volkswagen had initially been given a chance to remedy the issue when EPA first made contact, but they chose instead to continue cheating on the emission tests. Preliminary investigations revealed that a Volkswagen technician had blown the whistle internally on the deception in 2011. However, the warning call went unanswered. The objective of the case is to allow a discussion of the corporate governance issues such as the two-tier board structure in Germany; diversity and independence of the supervisory board; employee and state representation on the board; boardroom infighting; the role of regulators in the emission scandal; the culture created by the top management within Volkswagen; and the effectiveness of the whistleblowing system in Volkswagen.

This is the abridged version of a case prepared by Geraldine Cheng, Goh Liquan, Han Xiaoming, Loke Yi Liang and Phoon Tzin Wai under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Sarah Ho under the supervision of Professor Mak Yuen Teen.

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Volkswagen – The people's car

Volkswagen is a car manufacturing company headquartered in Wolfsburg, Lower Saxony, Germany. To date, it is the second-biggest automaker in the world, boasting sales in over 150 countries, with 119 production plants in 31 countries all over the world. In 2014, Volkswagen made profits of over €11 billion and produced 10.2 million vehicles worldwide. Notable brands under the Volkswagen Group include Bentley, Bugatti, Lamborghini, Audi, Porsche and Škoda.

Home of Volkswagen: The German state of Lower Saxony

Lower Saxony, the German state where Volkswagen's Wolfsburg headquarters was located, was a significant shareholder of Volkswagen. The state held the second largest stake in Volkswagen in terms of voting power (20.2%).

Despite not being a majority shareholder, Lower Saxony was granted various privileges, including the ability to veto decisions such as shutting down or relocating assembly plants as well as business acquisitions. This was because the Volkswagen Law stipulated that voting on major shareholder meeting resolutions required 80% agreement. In 2008, Porsche, which owned 31% of shares, wanted to gain the majority stake in Volkswagen. They sought to amend the statutes to have a freer hand over Volkswagen. However, even though Volkswagen's directors welcomed Porsche's interest in increasing their stake in Volkswagen[1], Porsche's plans were thwarted due to Lower Saxony's opposition.[2]

In 2005, the European Commission took action against Germany on grounds that the Volkswagen Law restricted the movement of capital across European borders, and the Law was amended in 2008. However, the rule requiring 80% majority support was maintained and Lower Saxony's 20% stake remained high enough to block any decision that needed shareholder approval, such as a takeover.[3] Under normal German corporate law, companies needed at least 25% of votes.[4]

Despite further attempts by the European Commission to revoke the Volkswagen Law, Ferdinand Piëch, the chairman of Volkswagen's supervisory board at that time, managed to obtain the support of Chancellor Angela Merkel. She made sure that 80% majority rule was preserved even with the amended Volkswagen Law.[5] The maintenance of the 80% majority rule resulted in a win-win situation, with Piëch remaining at the helm of the board and Lower Saxony retaining influence in Volkswagen through its veto power.

Ferdinand Piëch: Dominance or doom-inance?

Prior to becoming the chairman of the supervisory board in 2002, Piëch, a stellar automotive engineer, was the CEO of Volkswagen since 1993.[6] During his nine-year tenure as CEO, he guided Volkswagen to overcome its inefficiencies and turned a loss of €1 billion into a profit of €2.6 billion. He had also spearheaded Volkswagen's expansion into a 12-brand entity that produced a wide range of vehicles such as fuel-efficient cars and 40-tonne trucks.[7]

Piëch's vision was to transform Volkswagen into the world's biggest and best carmaker.[8] Being a member of the Porsche-Piëch family – which controlled 51% of Volkswagen's voting rights – Piëch was able to hand-pick executives he favoured and terminate those he disliked. [9, 10] Piëch's autocratic management style made many engineers and executives in Volkswagen fear him as they knew that they might be fired instantly if he was displeased.[11]

In 2012, Piëch succeeded in installing his fourth wife, Ursula Plasser, previously a kindergarten teacher, to the company's supervisory board. Although many shareholders protested her lack of competence and independence, they had minimal influence as the Porsche-Piëch family held a majority of the voting shares.[12] Furthermore, the appointment was supported by David McAllister, the state Premier of Lower Saxony, who mentioned that Plasser was well-versed in Volkswagen's inner workings and had close ties with Lower Saxony after living there for a decade.[13]

Volkswagen's two-tier board structure

Under German company law, it is mandatory for all public companies to have two boards – a supervisory board and management board. The supervisory board is composed of 20 members, and the board appoints and oversees the members of the management board, and authorises major business decisions. The Co-Determination Act of 1976 stipulates that companies with more than 20,000 employees must have 20 seats in their supervisory board.

"Harmonious" labour relations: Co-determination

Labour representation at the board level of German companies is governed mainly by the One Third Participation Act and the Co-Determination Act. It is almost exclusive to Europe, and to Volkswagen in particular, where employees are highly empowered to influence top management decisions. The Co-Determination Act applies to Volkswagen as the company employs more than 2,000 employees. Under this Act, the supervisory board of Volkswagen must consist of an equal number of shareholders' and employees' representatives or in other words a 50/50 co-determination.[14]

In addition, the Works Council[15], formed to protect and defend employee interests, elects employee representatives onto the supervisory board.[16] Members of the works council are elected only by employees for a term of four years [17], with most of them also being trade union officials or members.[18]

Are employees kings?

10 of the 20 seats on Volkswagen's supervisory board were held by employee representatives. Being the chairman of the Works Council and a member of the board, Bernd Osterloh was a decisive figure. According to a source close to the supervisory board, none of the employee representatives would vote against Osterloh in a shareholder's meeting.[19]

In August 2014, employee representatives forced management to dismiss McKinsey & Company ("McKinsey") who were previously engaged to advise on a €5 billion cost-savings plan introduced by Winterkorn. Osterloh was concerned that McKinsey would propose a plan that mainly focused on headcount reduction in Germany rather than curtailing spending on surging research and development costs. This move was major setback to Winterkorn's plans to close the profit gap with its rivals.[20]

Back in 2008, it was revealed that managers at Volkswagen had endorsed payments for high-class prostitutes, sponsored cash gifts for the mistresses of trade union officials, and even provided free supplies of Viagra. Klaus Volkert, a former chairman of the Works Council, was found to have received about €2 million in unauthorised bonuses and to have paid vacations for his Brazilian mistress. Piëch, who had been CEO when the alleged offences took place, referred to the scandals as mere irregularities. An insider revealed that such inappropriate use of company's resources had spanned over a decade but no action had been taken from within.[21]

How German uncovered the German scandal

It was John German, together with his colleague Peter Mock, who uncovered one of the biggest corporate scandals in history. German was an American engineer who co-led the International Council on Clean Transportation (ICCT), a small, non-profit organisation that assisted in the reduction of vehicle emissions by providing scientific and technical analyses to environmental regulators.[22]

Volkswagen had been struggling to establish a strong presence in the United States (US), the second largest automobile market in the world. To appeal to increasingly environmentally-conscious Americans and boost sales, Volkswagen promised "clean diesel" vehicles.[23] When German and Mock carried out emission tests on US cars under normal driving conditions on roads instead of simulated laboratory tests, the pair detected irregularities in the emission levels of the Passat and Jetta models.[24] The Passat and Jetta models emitted dangerous levels of toxins of up to 25 and 35 times higher than the legal limit respectively. They informed the EPA and CARB, which thereafter launched an official investigation into the matter.

After several months of talks between Volkswagen and the regulatory bodies, Volkswagen claimed that it had identified the reasons behind the high emissions and subsequently recalled over 500,000 US vehicles in December 2014.[25] However, further investigations thereafter showed that the emission levels still violated the standards, and both EPA and CARB threatened to withhold certification for Volkswagen's 2016 diesel models.

On 3 September, 2015, Volkswagen finally admitted to cheating on US diesel emission tests.[26] This subsequently led to the uncovering of the fact that Volkswagen had installed a "defeat" software since 2007 to drastically reduce nitrogen oxide emissions when the automobiles were tested by the EPA in laboratories.[27] Shortly after the news broke, Winterkorn announced his resignation as the CEO.

Green or grim car of the year?

Volkswagen had a reputation for producing fuel-efficient and environmentally-friendly cars. In 2009, its first diesel car, the Jetta model, won the "Green Car of the Year" at the Los Angeles auto show. The same title was also awarded to its Audi A3 model in 2010.[28]

Volkswagen's commitment to sustainability had always been strongly emphasised by the supervisory and management board. Winterkorn and Osterloh regarded the sustainability report as the group's business card. In 2014, Volkswagen held a leading position in 11 international ratings and relevant indexes, and was ranked highly as a sustainable automaker in the Dow Jones Sustainability Index, which is a renowned benchmark for measuring the development of the world's most sustainable corporations.[29]

However, Volkswagen was stripped of its accolades after the scandal surfaced. The company was also removed from the rankings of the Dow Jones Sustainability Index on 6 October, 2015.[30]

Winterkorn: A sweet corn or a prickly thorn?

Winterkorn was Piëch's former protégé who had a strong background in engineering with a doctorate in metal physics. In 1993, he joined Volkswagen as the head of group quality assurance and was heavily involved with the technical development, both at Volkswagen and its Audi subsidiary before becoming CEO in 2007.[31] He had a similar goal to Piëch, which was to make Volkswagen the world's largest automaker by 2018.[32] As CEO, Winterkorn led the company to record profits[33] and the company achieved the title of the world's best-selling automaker in 2015, surpassing Toyota, three years earlier than originally expected.[34]

Winterkorn had a reputation of being a micro-manager who paid extremely close attention to detail.[35] He continued to retain control over engineering details that many other CEOs would relinquish fully to deputies.[36] His micro-management style had been criticised because it delayed model launches and hampered the company's ability to adapt to local markets.[37] Several times a year, Winterkorn would also personally test drive new vehicles during Volkswagen's group approval drive.[38]

Board games

Over time, Piëch became increasingly disappointed with Winterkorn as he felt that Volkswagen's performance had failed to break the dominance of Ford, General Motors and Toyota in the US market.[39] Volkswagen's market share in the US had declined from three percent in 2012[40] to 1.9% in 2015.[41] Piëch subsequently bypassed the supervisory board and told Der Spiegel, a German magazine, that he was distancing himself from Winterkorn.[42] This open display of animosity revealed Volkswagen's infighting and drama to the media.

Back in November 2006, Piëch had successfully ousted Bernd Pischetsrieder, who had succeeded Piëch as Volkswagen CEO in 2002. The move came as a surprise to many as the board had just extended Pischetsrieder's contract for five years in May 2006.[43] Prior to ousting Pischetsrieder, Piëch had undermined his successor in two notable ways. First, he imposed a new human resources director against the wishes of Pischetsrieder and most of the board members. Second, he openly expressed his disagreement regarding the extension of Pischetsrieder's contract.[44]

Ferdinand had come to an end

Piëch launched an attempt in April 2015 to oust Winterkorn as CEO but his attempt failed. This time, Lower Saxony, members of the Porsche family and majority of the supervisory board, including Osterloh, backed Winterkorn. They decided that the infighting had to come to an end. Piëch acquiesced, and agreed to keep Winterkorn. Soon after, Piëch was given an ultimatum by key shareholders and stakeholders to either resign or suffer the humiliation of being kicked out in a board vote as they had lost confidence in him as chairman. Piëch and his wife then resigned from their positions on the supervisory board.[45] [46]

After Piëch resigned, the supervisory board chairmanship was temporarily transferred to deputy chairman, Berthold Huber.[47] Huber was the former chairman of IG Metall, one of the largest unions in the world, where virtually all Germany's car workers are members.[48]

Whistle fell on deaf ears

Robert Bosch GmbH, one of Volkswagen's key suppliers, had warned Volkswagen in 2007 that the engine-control software it supplied to Volkswagen should only be used for company test purposes and not for rigging emission tests. However, Volkswagen proceeded to modify the software so that it could turn the vehicle's emission control system on during emission tests, substantially lowering the levels of exhaust pollutants like nitrogen oxides released, and turn it off when the vehicle was on the road to allow for maximum engine performance.[49]

Four years later in early 2011, a Volkswagen technician blew the whistle and reported that the company was violating emission laws by concealing the real emission levels of its diesel vehicles.[50] An internal audit revealed problems with Volkswagen's diesel engines, but no further action was taken.

Problems in Volkswagen continued to snowball and eventually, the fact that Volkswagen had been cheating on emission tests was discovered by the EPA and CARB. Up to 11 million Volkswagen diesel vehicles around the world that were equiped with the emissions cheating software had to be recalled.[51]

Financial implications on Volkswagen

The day after the scandal was uncovered, Volkswagen's share price plunged by over 16.7% and wiped out more than €20 billion off its market value. It also faced fines amounting up to a maximum of more than US$18 billion for its violations, and a criminal investigation by the US Department of Justice.[52] The firm had to set aside €6.5 billion in provisions to cover potential costs related to the emission scandal.[53]

Road block ahead

The emission scandal prompted authorities in the US, Europe and South Korea to launch their own investigations into the matter.[54] Customer confidence was severely shaken and many affected drivers became frustrated because of the lack of information about how their cars would be repaired. Furthermore, a recent survey conducted in the United Kingdom found that more than half of the Volkswagen customers had no intention of buying a Volkswagen diesel car in future.[55]

Less of the same

In October 2015, Volkswagen appointed Thomas Sedran, former General Motors Co. manager, as head of group strategy, and Christine Hohmann-Dennhardt, a former judge from Germany's top court, to head its legal and compliance division.[56]

Moving forward, Volkswagen announced that it would cut annual investments made by the group's brand division by over €1 billion alongside its plans to continue manufacturing environmentally-friendly cars such as electric cars and plug-in hybrids.[57]

All eyes on Müller

The industry's attention was now focused on Matthias Müller, the newly appointed CEO of Volkswagen, to see how he would steer Volkswagen out of this crisis. Failure to deliver its promises on providing clean diesel had severely tainted its reputation as a green company.[58] With the odds clearly stacked against the company, only time will tell how long it will take for Volkswagen to regain the trust and confidence of the public in their brand.

Discussion questions

1. Under German company law, all public companies are required to have two boards – a management board and a supervisory board. Discuss the advantages and disadvantages of adopting a two-tier board structure, and draw a comparison with the one-tier board structure.

2. Comment on the composition of the supervisory board in Volkswagen. Piëch became the chairman of the supervisory board right after he stepped down from his position as CEO. Are there any corporate governance issues that could arise from such a transition? Explain.

3. What responsibility does the regulator EPA have in the emission scandal? To what extent can blame be put on the EPA?

4. In 2011, a Volkswagen technician blew the whistle on how the company was cheating on emission tests, but the warning went unanswered. Given that the cheating had begun in 2007, what are the possible reasons for the truth only being uncovered in 2015?

5. Going forward, how can Volkswagen improve its corporate governance to prevent a similar crisis from recurring?

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THE MEXICAN WAL

Case overview

US-based Wal-Mart Stores Inc. ("Walmart"), the world's largest retailer, is listed on the New York Stock Exchange. In 2005, it was alleged that its Mexican unit, Wal-Mart De Mexico ("WalMex"), was involved in bribery, and that there was a subsequent cover-up. A former executive from WalMex had informed Wal-Mart International's general counsel of the dealings. It was claimed that the then-WalMex Chief Executive Officer had been the "driving force" behind the bribery payments. A preliminary investigation unearthed evidence of bribes amounting to US$24 million. However, the investigation was allegedly quietly halted in 2006 with "no evidence of bribery". The issue resurfaced in December 2011, when Walmart disclosed in its SEC filings that it was performing internal investigations into possible infringements of FCPA regulations. In April 2012, New York Times published a Pulitzer Prize-winning investigative story revealing the allegations of bribery in Mexico. The news caused Walmart shares to plunge. A series of lawsuits by shareholders followed. Regulators then intervened to investigate the alleged bribery.

The objective of this case is to allow a discussion of issues such as the risks associated with bribery and corruption; accountability of holding companies for the actions of subsidiaries; the adequacy of the board's reactions; whistleblowing; and corporate governance failures that possibly facilitated bribery and corruption.

This is the abridged version of a case prepared by Au Hoe Sun Norman, Bay Zeng Lin, Dylan Lim Jun Yong and Philip Michael Yung Yunren under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Nie Yuanqiu under the supervision of Professor Mak Yuen Teen.

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Crossing the borders

Walmart de México y Centroamérica ("WalMex") was established in 1991 and was Walmart's first venture outside of the United States. Eduardo Castro-Wright ("Castro-Wright") was a high-flyer who had joined WalMex as Chief Operating Officer (COO) in 2001.[1] He shortly became the President and CEO of WalMex. Under his helm, the division's net profit grew by 36% in a single year.[2] Within a decade, the division had become the largest private employer in Mexico. It controlled 30% of all supermarket food sales, and had even more business than Mexico's entire tourism industry. Castro-Wright was praised for his stellar performance, and it was not too long before he became the President and CEO of Walmart.[3]

The rattlesnake shakes his tail

In September 2005, Sergio Cicero Zapata ("Cicero"), an in-house lawyer at WalMex, notified Walmart International senior general counsel Martiza Munich ("Maritza") of prevalent bribery within WalMex.[4] Cicero claimed that he had information regarding corrupt practices by senior WalMex officials, and accused them of bribery and false accounting practices.[5] Cicero also alleged that Castro-Wright was the driving force behind the deals. Castro-Wright set "very aggressive growth goals" which put pressure on WalMex executives to do "whatever was necessary" to open new stores in record time.[6] The bribes were "purified" in accounting records as simple legal fees, and Walmart's management across the border were kept out of the loop.[7]

Maritza brought the accusations to several senior executives in Walmart. Soon after, Walmart hired Willkie Farr & Gallagher, a law firm with considerable experience in Foreign Corrupt Practices Act (FCPA) cases, to investigate the issue.[8]

The law firm planned to conduct an extensive investigation that would span a period of four months. However, Walmart's senior executives opted to conduct a shorter and limited "preliminary inquiry", and tasked Walmart's Corporate Investigations Unit to undertake it instead.[9]

Corporate Investigations Unit (CIU), I see you

The CIU had fewer than 70 employees and only four people were specifically assigned to corporate investigations. Walmart's director of corporate investigations described in a confidential memo that the number was "wholly inadequate for an organisation the size of Walmart". The unit, however, managed to obtain approval to hire four "special investigators" who, according to their job descriptions, would be assigned the "most significant and complex fraud matters".[10]

The role and independence of the CIU had been questioned before. In one of the previous internal investigations, the CIU had been in charge of investigating an allegation concerning one of Walmart's senior vice presidents. However, John Menzer, Walmart's then vice chairman, intervened and removed CIU from their role as investigator. He then passed the investigator role to a subordinate of the executive being investigated. Eventually, the senior vice president was cleared by the subordinate.[11]

Small "Gestores" go a long way

The CIU began work in November 2005, and uncovered 441 instances of gestores payments dating back to 2003.[12,13] Cicero singled out two prominent gestores who had received payments amounting to US$8.5 million and the CIU noted that payments to these two gestores had halted when Castro-Wright left WalMex to join Walmart in 2005.[14]

An internal WalMex audit in March 2004 had highlighted the gestore payments and recommended notifying Walmart of the issue.[15] However, WalMex's chief auditor, who was implicated by Cicero, altered the recommendations and sacked the internal auditor shortly after.[16]

In December 2005, the CIU proposed ramping up investigations on grounds that there was "reasonable suspicion to believe that Mexican and USA laws have been violated"[17] An anonymous tip was also sent to three senior officials in Walmart – Lee Scott, Mike Duke and Rob Walton – alleging that WalMex executives were receiving kickbacks.[18]

The briber searches for his own bribes

Following the preliminary investigations, Walmart leaders rewrote the protocol for internal investigations to allow them to hand control of the investigation over to José Luis Rodríguezmacedo Rivera ("Rivera").[19] Rivera was WalMex's general counsel, and had been implicated in the scandal. After four weeks, Rivera exonerated the implicated executives and closed the case. He stated that there had been "no evidence of bribery" and accused Cicero of trying to defraud WalMex.[20]

The issue would not come to light again until December 2011 when Walmart made a disclosure with the SEC.[21]

Bad times for Walmart

In December 2011, Walmart disclosed in its SEC 10-Q filing that, during the year, they had begun a voluntary internal review into possible contravention of the FCPA.[22]

Five months after the disclosure, The New York Times (NYT) published an investigative report alleging widespread corruption in WalMex, and implicating several key executives in both Walmart and WalMex, including then-CEO Lee Scott ("Scott"), former head of Walmart International Mike Duke ("Duke"), and chairman of the board Rob Walton ("Rob").[23] Castro-Wright was identified as the driving force in Mexico, while the top brass in Walmart were accused of burying the matter.

Concerned with violations of the FCPA and the cover-up by top officials in the company, two US Congressmen, representatives Elijah Cummings and Henry Waxman, began a congressional investigation into the allegations.[24]

In response to the report, David Tolvar ("Tolvar"), a company spokesman, issued a statement highlighting Walmart's non-tolerance towards non-compliance with the FCPA, and stated that it was working closely with the SEC and the US Department of Justice (DOJ) in its investigations.[25]

Chipping away at the Wal of silence

It was later discovered that Walmart had been involved in a lobbying campaign against the FCPA.[26] The lobbying group had been pushing to weaken anti-bribery laws. The congressional investigations then expanded to include Walmart's involvement in the campaign.[27]

Shareholders from CtW Investment Group revealed an internal Walmart memo showing that in 2005, Walmart's long-serving auditor, Ernst & Young LLP (EY), had known about the possibility of bribery in Mexico.[28] The group accused EY of violating Public Company Accounting Oversight Board (PCAOB) rules and auditing standards, as well as US securities laws.[29]

It was also revealed that there were concerns about Walmart's internal control system back in 2005. A letter from four major shareholders was sent to Roland Hernandez ("Hernandez"), the then-chairman of the Walmart's audit committee.[30] It urged the company to appoint a special committee of independent directors to review the company's internal controls. Hernandez rejected the idea.

A second exposé by the NYT was published in December 2012, detailing the extent of Walmex's reach in Mexico.[31] The report focused on a store that was opened near Elda Pineda's ancient pyramids despite zoning restrictions and public protests. It further alleged that bribes were used in connection with the opening of 19 different stores, and that WalMex had even influenced public policy to further their agenda.[32]

Shareholders attack The Great Wal

The report was followed by backlash from Walmart's shareholders. Several major shareholders sued Walmart over a range of issues.[33] Some claimed that Walmart executives had failed to respond to the red flags of unethical conduct in Mexico; others mentioned that Walmart executives had suppressed internal investigations.[34]

One shareholder group, the Indiana Electrical Workers Pension Trust Fund (IBEW) sued Walmart demanding that they release documents related to the bribery probe.[35] The Delaware Chancery Court later held that the shareholders were only entitled to the documents related to the initial investigation in 2006, and that they were not privy to those linked to the subsequent investigations in 2011.[36]

Regulating the regulators

In November 2014, law firm Robbins Geller sued the SEC for improperly withholding documents related to the investigation. They also claimed that the SEC had yet to translate and review many of the documents despite having possessed them for over 40 months.[37]

Confidence low, votes show

Two influential proxy advisory firms, International Shareholder Services and Glass Lewis & Co, recommended that shareholders vote against several of Walmart's key executives and directors including Scott, current CEO Duke, and Christopher Williams ("Williams"). [38] Williams had been a member of the audit committee at the time of the scandal, and was the current audit committee chairman.[39] At the same time, some prominent institutional shareholders said that they would be voting against several Walmart's directors.[40]

At the general meeting in June 2012, Walmart's shareholders still voted largely in favour of re-electing Walmart's existing directors. However, unlike the 2011 re-elections where re-elected directors received 98% or more of votes, most received approximately 10% fewer total votes.[41]

Shareholders continue to fight for a glass Wal

Shareholders continued to fight for greater transparency about whether Walmart clawed back remuneration from its executives for violating laws and tarnishing the company's reputation.[42] An investor coalition with a cumulative shareholding of US$3.1 billion filed a proposal titled 'Request for Annual Report on Recoupment of Executive Pay.[43]

At Walmart's annual meeting held in 2014, there was an increase in the percentage of votes on this issue from 32% in 2013 to 38%.[44]

Rebuilding the great *Wal*

Since the publication of the NYT report, Walmart has taken steps to enhance its global compliance program. These include the institution of compliance officers in each division, the implementation of a common compliance system, regular risk assessments, and increased training.[45]

Walmart has also extended its Anti-Corruption Policy to associates and third parties that engage government officials on the company's behalf.[46] The company reiterated disciplinary measures for non-compliance. Senior executives' compensation has also been tied to the achievement of compliance objectives, and their annual cash incentives could be slashed if they fail to meet the Audit Committee's expectations.[47]

During Walmart's annual international employee pep rally in 2012, executives addressed several thousand employees and emphasised that employees and managers must comply with the law even "when no one is watching".[48] The use of the whistleblower hotline was also encouraged.[49]

The Wright response

On 24 April 2012, Castro-Wright resigned from the Board of MetLife, where he was previously a member of the Governance and Corporate Responsibility Centre.[50] Subsequently, in July 2012, Castro-Wright resigned as vice chairman of Walmart.[51]

Adios Amigos

A series of leadership changes occurred after the NYT exposé. In 2013, Rivera voluntarily resigned from Walmex.[52] Duke stepped down from his role as CEO but continues to sit on the Board today. The Board also lost three independent directors in the same year, causing the percentage of independent directors to fall from 71% to 64%. In 2014, Williams and Scott stepped down from the Board.[53] In 2015, Rob stepped down from his long-standing post as Chairman of the Board, and his son-in-law Greg Penner, took over the post. Shareholders had been pushing for an independent director to chair the board.[54]

Currying favour in India

In October 2015, the Wall Street Journal ("Journal") reported that the DOJ's investigation was largely complete[55], and that the extent of the scandal in Mexico was not as serious as it had initially been perceived to be. The investigation also uncovered a vast number of small bribes linked to Walmart India that collectively amounted to a few million dollars. According to insiders interviewed by the Journal, Walmart was likely to receive a fine, and its executives were unlikely to face criminal charges.

Discussion questions

1. To what extent should top management and the board of Walmart be held accountable for bribery cases especially in cross border situations?

2. Given Mexico's reputation for corruption, how should Walmart have assessed the risk of doing business and what preventive measures should it have taken to curb illegal practices? How should incentive plans be designed for employees in these low integrity regions? How should the issue of bribery be communicated? What about Singapore companies operating in foreign jurisdictions?

3. Was the whistleblowing policy effective in the case of Walmart?

4. Evaluate the adequacy of Walmart's responses to the alleged bribery.

5. Were there red flags that should have raised concerns with investors?

6. Do you think that Walmart should have given in to the demands of the shareholders? Was there an infringement of shareholders' rights? Explain.

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WYNN-WYNN SITUATION

Case overview

Wynn Resorts, Limited is a developer and operator of high-end casinos and hotels. It was co-founded by Elaine Pascal Wynn ("Elaine") and Stephen Alan Wynn ("Steve") and became publicly listed in 2002. The Wynn couple divorced after two short-lived marriages and parted with the arrangement that neither party could sell their shares without the other's consent. Thereafter, allegations of Elaine selling shares and engaging in insider trading tainted Elaine's credibility as an independent director. On 24 April, 2015, Elaine was removed from the Board by the shareholders. The objective of the case is to allow a discussion of issues such as director independence, conflict of interest, insider trading, and gender diversity on the board.

Wynn Resorts: Most "public and awkward" proxy battle

"While I am certainly disappointed by the result of today's vote, I am hopeful that I have once again served as an agent for change and improvement for this company, which I love so deeply." – Elaine P. Wynn[1]

The battle finally came to an end at the annual general meeting on 24 April, 2015. Elaine Wynn ("Elaine"), co-founder and third-largest shareholder of Wynn Resorts, Limited ("Wynn Resorts") had lost her seat on the board after the company considered that her recent actions had not been in the company's best interests.

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At that time, she was the only female director serving on the board and had arguably contributed significantly to the US$13 billion valuation of the company.[2]

"I vow to Honour the shareholder agreement"

"He was so different. He wasn't sexy, but I could sense his personal power just from that first date." – Elaine P. Wynn [3]

Elaine and Steve met each other on a blind date set up by their parents and got married in 1963. In 2002, the couple co-founded a luxury resort and casino, Wynn Resorts. However, the union was short-lived as the couple underwent two marriages that still ultimately ended in divorce. The second marriage ended amicably in 2010, with the court-imposed agreement that Steve was to split around 46% of his stake in the publicly traded shares of Wynn Resorts with Elaine. The split amounted to more than US$740 million.[4] In addition to the split, a shareholder agreement was put in place to restrict the Wynns from selling any shares without the other party's consent, and required the two to vote their shares in consent together.[5]

The odds: Who's in control?

"There's a better way to do it." – Stephan Chang, Shareholder [6]

Sale of shares

On 19 June 2012, Elaine filed a lawsuit against Steve to amend the shareholder agreement and grant her the power to sell shares at her will. The motivation behind this was twofold: one, to support charitable causes that she was involved in; and two, for estate planning purposes to protect the value of her investment for her children.[7]

Under the original agreement, any sale of shares worth more than US$10 million had to be approved by her ex-husband. If Elaine were to win this lawsuit, she would be granted the freedom to liquidate as many shares as she wanted, and this would potentially trigger a shift in control.[8]

Based on the potential consequences, the Board determined that Elaine had made the decision solely to advance her personal interests and thus had lost her credibility as a director. Even so, based on Elaine's word that the dispute would not interfere with her duties, the Corporate Governance committee recommended a re-nomination, and Elaine was re-nominated as a director for another three years in September 2012.[9]

Compensation package

In 2014, Steve's employment package was restructured to reduce the reliance on cash-based annual incentive awards by reducing his annual base salary from US$4 million to US$2.5 million, and increasing the variable portion of performance contingent equity awards.[10]

However, this restructuring was subject to terms in the shareholders' agreement which stated that each party's sale of shares had to be consented to by both Elaine and Steve. Therefore, to implement the enhanced compensation, the Compensation Committee requested for Elaine's consent to exclude performance-related shares from the restriction in the shareholders' agreement. Elaine, however, sought an amendment to the shareholders' agreement regarding the number of shares that she could sell instead.[11]

Elaine's actions led the Board to determine that she had placed her personal interests before her directors' fiduciary duties, and hence was not acting in the best interests of the company.

The black-out

"Those shares are my property, but I don't really feel like they are my property because I'm not free to exercise judgment on them." – Elaine P. Wynn[12]

In 2015, the Board claimed that Elaine had failed to comply with insider trading laws. They speculated that under Elaine's approval, her charitable foundation had sold US$10 million shares during a "blackout period" ahead of the company's earnings release to avoid the loss of six percent.[13]

The foundation had neither notified the company of the proposed timing of the sale, nor pre-cleared the sale with them. On the Board's inquiry, Elaine rebutted that her personal foundation was not subject to the Company's policy of sales restrictions during a "blackout period". Given the facts, she argued that her foundation had acted within its rights.

Is independence a title?

"As co-founder of the Company, my connection to the company is so established that a title is unnecessary." – Elaine P. Wynn[14]

On 26 February, 2015, the Board held a meeting to vote to nullify the re-nomination of Elaine, on grounds that she had not acted as an "independent director". While maintaining office at the headquarters, Elaine was still conducting activities that were comparable to those of a managing director such as developing the brand of Wynn Resorts, Limited, and the look, feel and culture of the properties. Due to her substantial and ongoing operational involvement with the company, she had effectively been an inside director, rather than an independent director, since 2002.[15]

I really did not know...

"Because I had no such knowledge, I had no reason to recuse myself from any Board discussions regarding this land." – Elaine P. Wynn[16]

In addition, the Board raised another concern against Elaine regarding a potential conflict of interest or lack of impartiality in connection with the purchase of land the company was still negotiating. Elaine's nephew had a similar interest in the land deal and Elaine had neither disclosed nor excused herself from the Board's discussions. Elaine rebutted the Board that at the time of the discussion of a possible land acquisition, she was not aware of any plans by her nephew, Andrew Pascal, to purchase that same piece of land. The Board felt that her actions might have helped her nephew to purchase the land. Elaine felt wrongly accused, arguing that she had no financial interest in the purchase of the land by her nephew.[17]

The Last Vegas fight: "White" vs. "Gold"

"I know the right questions to ask, and I am not afraid to ask them. More than any of my fellow directors, with the exception of Steve, I have a vested interest in the success of Wynn Resorts. I have skin in this game." – Elaine P. Wynn[18]

In the next re-election during the shareholders' meeting on 24 April, 2015, the Board decided not to re-nominate Elaine. This decision was reached after numerous incidents in which Elaine was considered to have posed a potential threat to the company. Her interests were in frequent conflict with the company's, her independence as a director was questionable, and she had an ongoing lawsuit with Steve. At the 2015 re-nomination of Elaine as a director, shareholders were given a choice to fill either the "white" or "gold" proxy card to vote.[19]

Wynn Resorts (White)

Prior to the shareholders' meeting on 24 March 2015, Wynn Resorts emailed a letter to the Company's shareholders in connection with the Company's 2015 Annual Meeting on 24 April, 2015.[20]

The Board had felt that Elaine's proxy statement did not accurately describe the risks created by her legal claims. Furthermore, Elaine's litigation with Steve could have effectively impaired her ability to act independently as a director.[21] In view of all the concerns, the Board voted not to re-nominate her.[22]

Hence, the Board recommended that shareholders vote on the "White Proxy Card" for the election of two Class I directors, John J. Hagenbuch and J. Edward Virtue, to serve until 2018, and not to re-nominate Elaine as director.[23]

Elaine (Gold)

On the very next day, Elaine released a letter to all shareholders outlining her rebuttal to the insinuations by Wynn Resorts' Board of Directors.[24] She felt that the issues raised by the Board distracted the shareholders from the real issues. She sought clarification in her own proxy statement.

Elaine argued that she was an independent voice who could make a meaningful contribution to the company and the Board, and that regardless of whether she satisfied the independence standards laid down by NASDAQ, she could still provide an independent voice that was not beholden to the management in the boardroom.[25]

Elaine was also confident that her industry experience, long history of serving Wynn Resorts, and extraordinary relationship with Steve would allow her to provide meaningful input and evaluations of future proposals. With these arguments, Elaine urged shareholders to vote for her using the "Gold Proxy Card".[26]

The aftermath

"This has been very upsetting to me, how the board ousted her from the board. I really think it's terrible. You have to have a woman's perspective." – Ellyce Rumick, Shareholder[27]

However, shareholders voted to remove her as a director. After the announcement of Elaine's removal, Wynn Resorts' share price rose 3.6% from US$125.50 to US$130.09.[28] However, it was not long after her departure from the company that Wynn Resorts suffered a multi-year decline in the company's stock price,[29] with the stock price dropping to its lowest at US$51.71 in 2015.[30]

Lack of gender diversity

As the sole female director for 13 years, Elaine had arguably made numerous important contributions that had helped the rise of the company. She therefore contested that the decision to remove her from the Board would potentially be a symbolic misjudgment that an "appalling lack of diversity" on the Board would suffice.[31]

In contrast to Wynn Resorts, MGM Resorts International, a fellow gambling company with similar market capitalisation, had three women on its Board. The three women were of diverse ethnic backgrounds, and included an African-American and a Latino.[32] Elaine argued that being in the hospitality industry, it was important to have women on the board as they were more service-oriented. As Erik Gordon, a corporate governance expert at the University of Michigan, said, "It may resonate as an important issue because there are so few women on boards and the standard reason is that there aren't women who have been in executive positions in whatever industry for 30 years or so, but in this case you have a woman with such exceptional experience".[33]

In response to this issue and the claim by Elaine, the Board of Wynn Resorts assured shareholders that the nomination committee would be prioritising women and diverse candidates for appointment to the Board by the end of 2015, in recognition that "gender diversity is important for the Board, not only to make sure that the Board and the Company benefit from diverse perspectives, but also to set the right tone at the top".[34]

"This proxy contest was a success in that it brought to light critical corporate governance concerns at Wynn Resorts, such as independence, expertise and diversity in the boardroom and the impact they have on key issues that our company is facing including compensation practices and succession planning."
– Elaine P. Wynn [35]

Epilogue

On 24 April 2015, proxy adviser Egan-Jones wrote an email report voicing his disapproval of the way the company had handled Elaine Wynn's removal from the Board and his opinion that the removal of Elaine could have been what led to the multi-year stock price decline of Wynn Resorts. This is in view of the contributions made by Elaine as a long-standing and sole female director.

With regards to the promise the Board made to the public to prioritise women and diversify their candidates, Wynn Resorts appointed Clark T. "Sandy" Randt, Jr. and Patricia Mulroy to its Board on 15 October 2015.[36] With the addition of the two directors, the Board now consisted of nine Directors, seven of whom were independent. The addition of Patricia has added diversity to the Board and allowed the Board to show that it had honoured its commitment.

Discussion questions

1. Should Elaine Wynn be considered as an independent director? Explain.
2. Based on NASDAQ listing rules, Elaine does not satisfy the requirements of "independence". Compare and contrast this with Singapore listing rules on her independence.
3. Do you think that Elaine's actions were contrary to the company's interest, as the Board has argued? Explain.
4. Elaine Wynn was eventually ousted from the Board of Directors at the Annual General Meeting on 24 April, 2015. Explain whether you think that the board's decision not to re-nominate her was appropriate?
5. The board mentioned that they will take steps to increase board diversity after Elaine's departure. Do you think the steps undertaken by the Board were sufficient?
6. Do you believe that gender diversity on boards is important for companies generally, and for Wynn Resorts specifically?

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