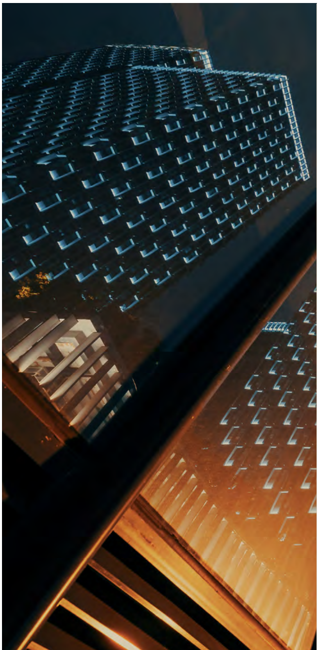
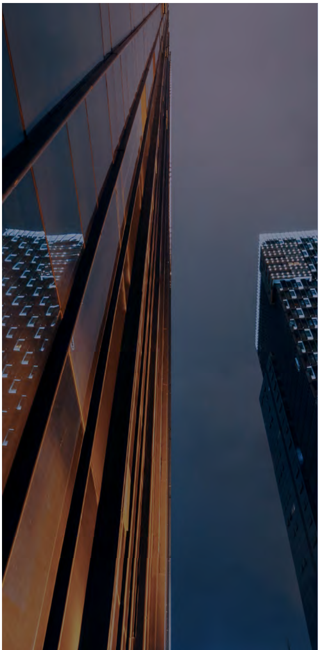
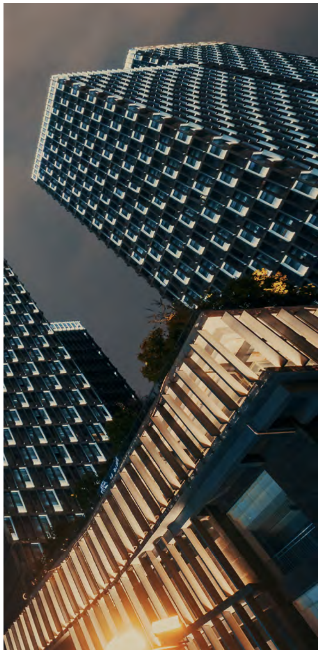

VOLUME 10

CORPORATE GOVERNANCE

CASE STUDIES

Edited by Prof Mak Yuen Teen

CPA AUSTRALIA

Corporate Governance Case Studies

Volume 10

Mak Yuen Teen, PhD, FCPA (Aust.)

Editor

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OTHER GLOBAL CASES

Foreword

Over the past decade, there have been many efforts by regulators, industry and professional bodies to raise corporate governance standards. Some positive results have emerged, as evidenced by the examples of improved governance practices in this collection of corporate governance case studies.

However, a new challenge for boards and management is how best to infuse the ideals of sustainability into governance arrangements as climate change comes to the fore. At the same time, they must also steer their companies through a fast-moving digital revolution while enhancing public trust.

Against this complex backdrop, CPA Australia is pleased to publish this 10th edition of the Corporate Governance Case Studies series.

The previous nine editions have been valuable in facilitating discussions on corporate governance issues. Educators around the world have used these cases in their teaching curriculum. CPA Australia has also incorporated a number of the case studies into our CPA Program study guides.

We hope this edition will continue to play a key role in enhancing discussions about governance and contribute to advancing corporate governance standards in Singapore and internationally.

This series of case studies has been made possible by our enduring partnership with Professor Mak Yuen Teen FCPA (Aust.) of the National University of Singapore Business School. We thank Professor Mak for his significant efforts in writing and editing the case studies, and his students for their work in researching the cases.

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October 2021

Preface

When Volume 1 of the Corporate Governance Case Studies was published in 2012, little did I realise that we would be able to keep it going yearly for 10 years. But here we are – celebrating the 10th anniversary of this publication.

The seed for this series was planted in 2007 when I was nearing the completion of my report titled "Improving the Implementation of Corporate Governance Practices in Singapore", commissioned by the Monetary Authority of Singapore and Singapore Exchange (SGX). During a roundtable discussion with a group of directors on my preliminary findings and recommendations, we touched on directors' training, and the need for local case studies on real-life boardroom issues was raised.

In early 2010, I developed and started teaching a new third-year course on corporate governance and ethics for accountancy students at the NUS Business School. A requirement for students to work in groups to write a comprehensive case study was part of the assessment. I approached CPA Australia to collaborate to turn the best cases into a collection for publication, which I will edit.

The ten volumes, including this latest volume, contain a total of 219 cases – 76 Singapore, 53 rest of Asia-Pacific, and 90 rest of the world. In 2020, with my colleague A/P Richard Tan as co-editor, we also published a special edition comprising 22 cases relating to the financial services industry. Five cases were published for the first time in this special edition. Therefore, in all, 224 cases have been published.

Two Chinese editions were also published in 2016 and 2018. They comprised 38 cases which have been previously published, translated into both simplified and traditional Chinese. In addition, the first three volumes, containing 58 cases, have been translated into Vietnamese in 2017 and 2020 in collaboration with the stock exchanges in Vietnam.

I personally use many of the cases for teaching at NUS, and in external training for directors, regulators and other professionals in Singapore and overseas. They are available for use free of charge and have been very well received. Over the years, many universities and professional bodies around the world have requested for permission to use them.

This 10th anniversary edition includes 22 cases - six Singapore, five Asia-Pacific and 11 rest of the world. We decided on a slightly different approach for this edition. In the past nine volumes, nearly all the cases deal with organisations that have been embroiled in major corporate governance scandals or lapses. For this volume, we decided to include four cases with a more positive theme.

Some of these cases involve organisations which have demonstrated strong corporate governance or corporate responsibility over long periods of time, resulting in significant value creation and/or strong reputation. The cases on the Ayala Group in Philippines, Micro-Mechanics in Singapore and the Norwegian Oil Fund fall into this category. It does not mean that they have adopted all the best practices or are completely free of controversies, but they "walk the talk" through their actions.

Take the case of the Ayala Group. In 2010, I was in Manila running a workshop for directors and senior management of the Group when I heard the tragic news that an Ayala employee had been killed in a worksite accident. One of the senior managers told me that, in such situations, the family, including the children's education, will be well provided for by the company.

Ten years later, at the onset of the COVID-19 pandemic in March 2020, the Ayala Group announced an emergency response package of about PHP 2.4 billion (US$48 million) to support the extended workforce of the Group's partner employers affected by the COVID-19 pandemic. Ayala Malls would also not be collecting rent for the period that tenants cannot carry on business while Globe Telecom set aside PHP 270 million (US$5.4 million) to ensure continuity in salary payouts for its staff and vendors. The Group's own staff were provided financial support and could be granted loans at less than market rates. Employees even received their mid-year bonuses. It was not a government dictate. At that time, many companies were thinking of the impact of this unprecedented event on themselves, but Ayala was thinking about how it can help others. I would encourage readers to visit the website at https://chronicle2020.ayala.com/ which was created to celebrate the stories through the eyes of Ayala employees from the beginning of this pandemic to date. It shows how Ayala cares for its employees and how employees care for the Ayala brand.

The Ayala case study provides other examples of how the Group considers the interests of stakeholders beyond just shareholders in its decisions. The Group has not only survived more than 180 years but has grown from strength to strength. It is now run by the seventh generation of the family, with the eighth generation being trained to take over.

I call Singapore-listed Micro-Mechanics, the subject of another positive case study, the "little giant" in corporate governance because it consistently punches above its weight, outshining many large companies. Some companies are transparent only in good times but Micro-Mechanics has been consistently transparent. I have attended its AGM as an observer and seen its engagement with shareholders. It continues to practise full quarterly reporting voluntarily after SGX decided to discontinue it for most companies. Each year, the company releases its latest Q1 results before the AGM so that shareholders have up-to-date information about the company's performance and can ask questions about the latest results. Micro-Mechanics is unlike most other companies which do only what is required.

Some years ago, I gave a presentation where I provided suggestions on how companies can improve their stakeholder communications beyond the minimum guidelines that are prescribed. After my presentation, one of Micro-Mechanics' executive directors came up to me and said that they had not thought of some of those measures and the company would implement them.

Micro-Mechanics has had to deal with disruption and uncertainty from the SARS and COVID-19 pandemics, trade wars and other business challenges. The company believes that the importance it places on good corporate governance and transparency has helped it navigate these challenges. Today, its market capitalisation is nearly S$440 million compared to about S$100 million in Q3 2007. Shareholders who invested in the company during its IPO in 2003 would have seen a total return of about 19 times.

The case study on the Government Pension Fund Global (GPFG) of Norway, more commonly known as the Norwegian Oil Fund, is our first ever case study of a sovereign wealth fund (SWF). In my view, it is the best in class in corporate governance and transparency for SWFs, far ahead of its peers. The Fund has clear accountability, high transparency about its investments and internal practices, and exercises strong stewardship over portfolio companies. A recent controversy with the appointment of its current CEO shows how accountability, corporate governance and transparency are supposed to work. That controversy was soon behind it.

The case study on Hitachi is about a Japanese company trying to be differentiate itself from its Japanese peers. Japan is often considered a laggard in corporate governance in Asia and many foreign investors have expressed frustration about Japanese companies being resistant to implementing good corporate governance practices. Past volumes have covered scandals in a number of Japanese companies, including Kobe Steel, Nissan, Olympus, Takata, Tepco and Toshiba. The Hitachi case study describes what Hitachi is doing differently to be lauded as a company with governance which can be the best model for major companies in Japan.

The other 18 cases involve mostly companies that have recently been involved in significant corporate governance controversies. Some are fundamentally well governed but have overlooked or under-estimated certain risks.

The latest volume continues the trend in recent volumes in having more cases with an ESG focus. The Ayala and Norwegian Oil Fund cases can be viewed through ESG lens. Other cases on BooHoo, Gucci/Kering, Top Glove, Trafigura and Vale also have a strong ESG theme.

The case on the U.S. company, Nikola Corporation, is the first case involving a Special Purpose Acquisition Company (SPAC), which the Singapore Exchange has now allowed as an alternative means for companies to go public. It is a cautionary tale of what can go wrong in listings through SPACs, at a time when there are more scandals involving SPACs in the U.S.

The Singapore case on the Hin Leong Group is the first involving Singapore private companies, covering events leading up to its collapse and the filing of charges against the founder and a family member. It raises questions as to whether large private companies should be subject to stricter rules. This question also applies to Trafigura, a monolith in the commodities industry which is privately owned.

I would like to thank some key people for making this "10-year series" possible: Isabella Ow, who has been my editorial assistant since volume 6, and previous editorial assistants Amanda Aw, Chloe Chua, Kellynn Khor and Lau Lee Min; all the NUS accountancy students who wrote the initial cases, and student assistants who helped with editing; Melvin Yong at CPA Australia for his tireless support and Sheryl Koh and Joanna Chek who have superbly managed the publication process for volumes 1 to 5 and 6 to 10 respectively; and my wonderful wife Linda for always supporting what I do and allowing me to have this 10 year-old "child".

Professor Mak Yuen Teen, PhD, FCPA (Aust.)
Professor (Practice) of Accounting
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AYALA: A POSTER CHILD FOR FAMILY CONGLOMERATES?

Case overview

Ayala Corporation (Ayala), the publicly-listed holding company of the diversified businesses of the Ayala Group, has established itself as one of the best managed companies in the region. Despite being 187 years old and the oldest business house in the Philippines, Ayala has found continuous success and flourished over its seven generations of leadership. Each generation took the company to new heights, making the company one of the most admired, diversified and professionally-managed conglomerates.

The Ayala leadership is unfazed by the fact that it faces challenges unique to a family business, nor by the fact that it is situated in a country rife with corruption. With a score of 35/100, the Philippines ranked 115 of 180 countries in the Corruption Perceptions Index by Transparency International. Ayala has taken those challenges in its stride, setting itself apart as a shining example of good corporate governance in the country. Its longstanding commitment to adopting good corporate governance practices has not gone unrecognised. Over the years, the Ayala Group has won multiple accolades, cementing its reputation as one of the best governed group of companies in the country.

The objective of this case study is to facilitate a discussion of issues such as the corporate governance practices of family-controlled conglomerates; the implications of having overboarded directors; the concept of independence of directors in interlocked boards within a conglomerate; the challenges of international diversification; and environmental, social and governance (ESG) issues.

The legacy of the forefathers

The story of Ayala Corporation (Ayala) began in 1834. Two individuals, landowner and entrepreneur Domingo Roxas and his industrial partner Antonio de Ayala, established Casa Roxas, which was primarily invested in a distillery, as well as in agriculture, manufacturing, trading, and mining.[1,2]

This case study is based on an initial case study prepared by Karan Haresh Mirpuri, David Wang Zi Rui, Pang Qi En, Arushi Parashar and Timothy Wong. It was updated and re-written by Tan Yi 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 organizations named in the case, or any of their directors or employees. Comments from Ayala management on this case are much appreciated. However, the editor is responsible for any errors.

By the family's third generation, Ayala's expansion into new businesses characterised its evolution as a modern holding company. The family increased their interests in the first bank of Southeast Asia (SEA), El Banco Espanol Filipino de Isabel II, where they had been involved since its inception in 1851. Jacobo Zóbel y Zangroniz, a forefather of the present-day Zóbel family, founded the first mass transportation system in the Philippines.[3]

In the 20th century, the different generations continued to be pioneers in various industries such as insurance, banking, and real estate development. In 1948, Ayala was responsible for the transformation of Makati as the premier financial, commercial, and residential district of Manila and the country. From a family partnership, Ayala was officially incorporated in 1968 and became a publicly listed company in 1976.[4]

Today, Ayala has core interests in real estate, banking, telecommunications, and power. It has a growing presence in healthcare and is beginning to make forays in logistics. It also has solid investments in water distribution infrastructure, industrial technologies, and transport infrastructure. In addition, Ayala's corporate social responsibility programs are managed under Ayala Foundation, Inc. (Ayala Foundation).[5]

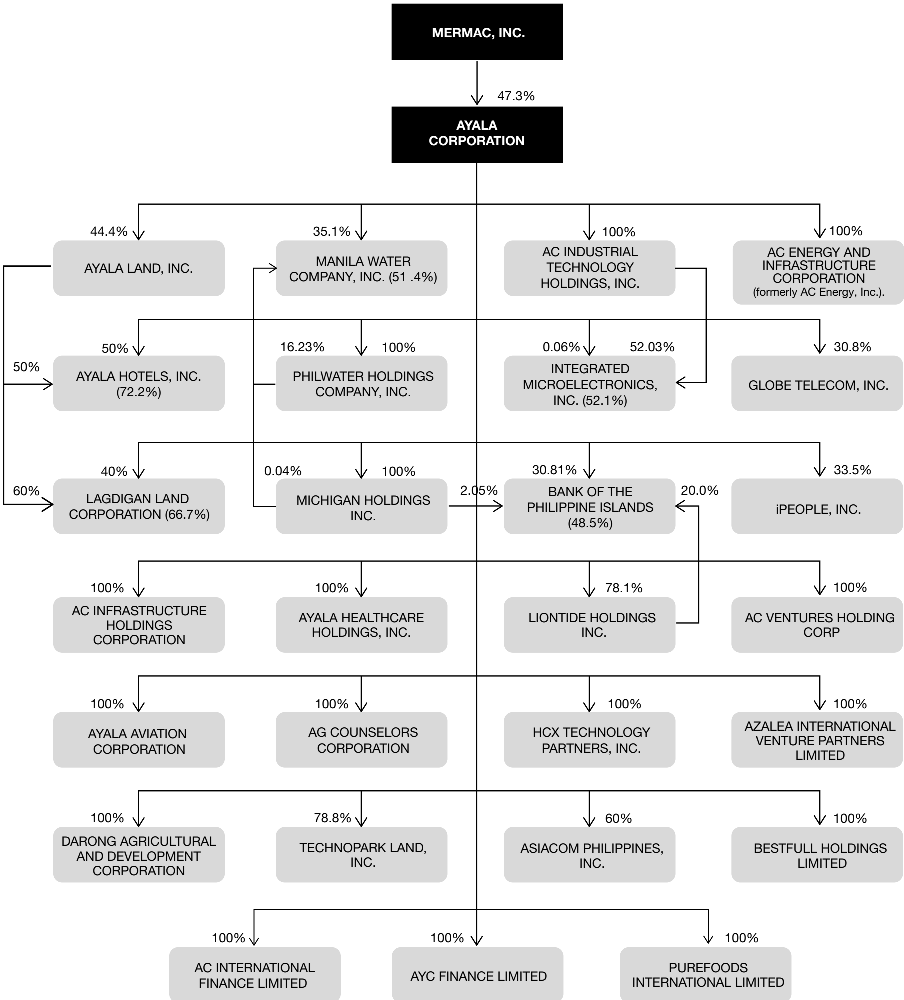
Ayala's listed units account for about 20% of the Philippine Stock Exchange Index's market cap.[6] Today, Ayala is one of the most reputable family business conglomerates in SEA and touches the lives of many Filipinos, being an employer many dream of working for.[7]

The Ayala Group continues to invest in new projects across the country to enrich and elevate the lives of the country's citizens.[8] Not resting on its laurels, the current leadership under Jaime Augusto Zóbel de Ayala (Jaime Augusto) and Fernando Zóbel de Ayala (Fernando) are eager to keep building on the successes of their predecessors. Through its commitment to sustainability and national development, the Ayala Group continues to be the shining beacon of development for the Philippines.

Corporate structure

The Ayala Group has a complex corporate structure comprising numerous subsidiaries under the holding company, Ayala Corporation, as seen in Figure 1. The Ayala companies are involved in a diverse range of businesses closely connected to the daily lives of Filipinos.

AYALA CORPORATION AND SUBSIDIARIES
Map of Relationships of the Companies within the Group
As of December 31, 2020



Legend:
% of ownership appearing outside the box - direct % of economic ownership
% of ownership appearing inside the box - effective % of economic ownership

Figure 1: Corporate structure of Ayala conglomerate as of 31 December 2020[9]

One of the key companies within the Ayala portfolio is Ayala Land, Inc. (Ayala Land), which is involved in the real estate industry.[10] It is the largest property developer in the Philippines with a solid track record in developing large-scale, integrated, mixed-use, and sustainable estates that are now thriving economic centers. With 12,483 hectares in its land bank, 30 estates, and presence in 57 growth centers across the country, it offers a balanced and complementary mix of residential developments, shopping centers, offices, hotels and resorts, and strategic investments. Construction and property management services are led by subsidiaries Makati Development Corporation and Ayala Property Management Corporation, respectively. The company adheres to standards and practices that reflect the value placed on sustainability in all its developments, aligned with its vision of "enhancing land and enriching lives for more people".[11]

Another major company is the Bank of the Philippine Islands (BPI). The pioneer financial institution in the Philippines and SEA, BPI is a universal bank providing financial services such as consumer and corporate banking and insurance services.[12] It has been one of the most profitable banks in the country[13] and has the capability to serve overseas Filipinos through BPI's affiliates and subsidiaries.[14] Two of Ayala's holding companies, Michigan Holdings, Inc. and Liontide Holdings, Inc., have a 2.06% and 20.1% stake in BPI respectively.[15]

Ayala is also involved in the telecommunications industry through Globe Telecom, Inc. (Globe). Globe is a leader in providing technology solutions that enrich the lives of Filipinos – from mobile services to home internet, enterprise data to managed services. It has a portfolio of companies spanning fintech, digital marketing, VC funding, e-commerce, telehealth and entertainment. The company currently serves nearly 82 million mobile subscribers (prepaid and postpaid) and around 4.2 million home broadband customers. The major shareholders of Globe are Ayala Corporation, Singapore Telecommunications Limited (Singtel) and Asiacom Philippines, Inc.[16]

AC Energy Corporation (ACEN) is the listed energy platform of the Ayala Group and is one of the fastest growing renewable energy companies in the region. ACEN has grown from 100 MW of renewables in 2016 to 2,600 MW of renewables capacity in 2021, with a renewable share of capacity of 80%, among the highest in the region. The exponential growth was enabled by (1) working with several industrial partners, (2) leveraging strong banking relationships, and (3) expanding into new markets such as Vietnam, Indonesia, India and Australia in addition to the core / home market Philippines. ACEN's aspiration is to be the largest listed renewables platform in SEA, with a goal of reaching 5,000 MW of renewables capacity by 2025.[17]

AC Infrastructure is a holding company with principal business in developing and investing in strategic projects to address the growing infrastructure needs of the public and private sectors in areas such as mass transportation, urban mobility and logistics services.[18]

Manila Water Company provides water treatment, sewerage and sanitation, distribution and pipework services for residential, commercial and industrial users.[19] Specifically, it has the exclusive right to provide water and used water services to the East Zone of Metro Manila and Rizal Province through the East Zone Manila Concession Agreement.[20] Beyond Philippines' borders, Manila Water Company has also ventured into Vietnam, Indonesia, Thailand and Saudi Arabia.[21] Two holding companies within the Ayala Group – Philwater Holdings Company, Inc. and Michigan Holdings Inc. – have a 16.23% and 0.04% stake in Manila Water Company respectively.[22]

The Ayala Group also includes other portfolio investments in social infrastructure, and the industrial and technologies industry. The Group is committed to improving and investing in the social capital in the Philippines through its minority investment in iPeople, Inc. (iPeople).[23] iPeople is the holding company under House of Investments, Inc. (HI) and the Yuchengco Group of Companies. It also represents Ayala's investments in education, which has since expanded to new institutions, such as Mapua University and Malayan Colleges Laguna, after 2019.[24]

Ayala Healthcare Holdings, Inc. (AC Health) is the holding company for all healthcare-related initiatives of Ayala. AC Health was established in 2015 as a wholly-owned subsidiary of Ayala Corporation. With its establishment, Ayala goes back to its roots in healthcare, when it first began as Botica Zobel, 180 years ago.[25] It aims to address the fundamental gaps in the accessibility, affordability, and quality of healthcare that exist for many Filipinos today and works towards building an integrated healthcare ecosystem with its four pillars: pharma, clinics, health tech, and hospitals and specialty centers. AC Health envisions linking every patient to a seamless healthcare experience. Its portfolio of companies includes Generika Drugstore, Healthway Philippines, QualiMed Health Network, Vigos Health Technologies, HealthNow, IE Medica and MedEthix Incorporated.[26]

In industrial technologies, Ayala formed AC Industrial Technology Holdings (AC Industrials) in 2016 as its platform for its interests in the space. AC Industrials manages and operates three main business lines – global manufacturing, enabling technologies, and automotive distribution and retail.[27] It builds on the collective strengths of AC Motors, one of Philippines' largest multi-brand vehicle distribution and dealership groups, and PSE-listed Integrated Micro-Electronics, Inc. (IMI), a leading global manufacturing solutions provider, ranked 21st in the world in terms of electronics manufacturing revenues.[28]

In addition, AC Ventures Holding Corp. (AC Ventures), in partnership with Globe's Kickstart Ventures, aims to lay the foundation for Ayala amid the fast pace at which disruptive changes are taking place. It is Ayala's platform for peeking into new technologies and business models that are relevant.[29] AC Ventures currently holds a 44.7% stake in Zalora Philippines and a 5.9% stake in Mynt, a fintech venture with Globe and Ant Group.[30]

Finally, the remaining companies within the Ayala Group operate in an assortment of industries: Ayala Aviation Corporation provides aircraft charter rental and leasing services;[31] AG Counselors Corporation provides shared legal and consultancy services to the companies within the Ayala Group;[32] HCX Technology Partners, Inc. works with partners such as Oracle and Mobile HR to provide innovative solutions and services to its customers' core business units and human resource units;[33] Azalea International Venture Partners Limited is an offshore investment vehicle for Ayala Corporation for its various investments in the business process outsourcing, technology and other sectors;[34] and Darong Agriculture and Development Corporation manages and facilitates the sales of land for agricultural activities and facilities in Darong, Philippines.[35]

The remaining subsidiaries – Bestfull Holdings Limited,[36] AC International Finance Limited (institutional brokerage services),[37] AYC Finance Limited,[38] and Purefoods International Limited[39] – are primarily holding companies that serve financing functions within the Ayala Group.

Overall, the majority of Ayala's companies have a presence in the Philippines. This is not surprising, as the Ayala Group ultimately aims to meet the evolving needs of Filipinos by providing "practical solutions that balance quality and affordability".[40]

However, Ayala has begun expanding its global footprint – especially in its manufacturing, water infrastructure, energy, and property businesses – through its subsidiaries since 2018.[41] For instance, Ayala has geographic presence in countries such as Mexico, India, China, Singapore, France, and Serbia.[42]

Performance

Ayala's four core businesses, Ayala Land, BPI, Globe and AC Energy, as well as its portfolio investments Manila Water Company and iPeople are publicly-listed.[43] Another publicly-listed company, IMI, is a subsidiary of another wholly-owned Ayala subsidiary, AC Industrials.

In the past five financial years, a majority of the listed companies have reported an increase in net profits attributable to equity holders of the companies, except for FY2020 due to the COVID-19 pandemic. However, despite the major disruptions caused by the pandemic, most of the companies still managed to report positive net profits in FY2020.[44,45,46,47,48,49,50,51,52,53,54,55,56,57,58]

Nevertheless, most of the companies have not been stellar performers in terms of share price over the five-year period from FY2016, with most showing declines in the first few months of 2021.[59,60,61,62,63,64,65]

Business environment

It is no secret that the political climate of a country may give rise to complications while conducting business. The Philippines has a reputation for having a corrupt business climate.[66] According to Business Anti-Corruption Portal,[67] corruption plagues the administration, and fraud routinely occurs. The legislative framework for fighting corruption is scattered and not effectively enforced by the enforcement agencies. The rampant corruption in the country makes it difficult for businesses to keep themselves clean while keeping their business profitable.[68]

Corporate governance in Philippines

An updated Code of Corporate Governance for Publicly-Listed Companies released by the Securities and Exchange Commission of the Philippines (SEC) came into effect from 1 January 2017.[69] The code is applicable to all publicly listed companies and follows a 'comply or explain' approach, giving companies flexibility in following the code.[70] Any area of non-compliance with the code needs to be disclosed and justified.[71] The updated code recommends all companies to establish strong and suitable whistleblowing policies providing heightened protection to employees. The SEC is highly prescriptive in the Philippines and requires all companies to submit a Manual on Corporate Governance documenting the company's governance policies, programs and policies.

In 2019, the Code of Corporate Governance for Public Companies and Registered Issuers, which is different from the Code of Governance for Publicly-Listed Companies, was introduced and one of the major reforms was institutionalising corporate governance provisions while strengthening shareholder protection.[72] The current Philippines government had been actively campaigning for ease of doing business in the Philippines and this code is seen to go a long way in increasing the competitiveness of the Philippines as an investment destination.[73]

Despite the difficulties and temptations surrounding the Filipino business climate, Ayala has strived to uphold its principles and values. It has continued to be early adopters of new standards.[74] With its corporate ethos of "doing the right thing", Ayala states that it is committed to empower its people to make ethical and upright decisions for the company and the society.[75]

Ayala's efforts in maintaining strong corporate governance practices have been consistently recognised. At the 2019 ASEAN Corporate Governance Scorecard Awards held on 29 January 2021, Ayala Land and Globe were ranked among the top three publicly listed companies in the Philippines, while a total of four Ayala companies were given the ASEAN Asset Class Awards.[76] Ayala Corporation also came out on top as the Best Managed Company in Philippines in Finance Asia Asia's Best Companies 2020 survey.[77] Furthermore, Ayala Corporation and one of its subsidiaries, Globe, were the only two Philippine companies which received the Best Corporate Governance Award in Asia and Australasia at the Ethical Boardroom Corporate Governance Awards 2019.[78]

Surviving the test of time

"It is a name synonymous with visionary leadership, exemplary management and innovative business practices — the very same values Ayala Corporation was founded on 180 years ago."

– Tatler Philippines[79]

There is a saying that wealth never lasts for more than three generations: the first generation creates the wealth; the second generation grows the wealth and the third generation spends the wealth. This age-old Chinese saying highlights the difficulty of maintaining a family business over many generations.

A major problem facing family businesses arises from the insular nature of their operations.[80] Leadership of the company gets passed from the head of the family to another, leaving little space for other executives outside of the family to take charge and influence decision making.[81] The succession of leadership often creates many problems. Many families struggle to produce successful heirs who have the same business acumen and interest in growing the company as their forefathers.[82]

The Ayala Group has defied the norms. Growing from strength to strength after more than 180 years since its founding, the Group is currently helmed by its seventh generation of leaders with the eighth generation being trained up in various businesses and to rise from the ranks.[83] Each generation has brought with it innovation and new ideas, allowing Ayala to continue to thrive despite the challenges of time. So, what has Ayala done to succeed as a family business that has allowed it to overcome the challenges facing family businesses to a publicly-listed, diverse and professionally-run conglomerate?

The family

As Jaime Augusto from the seventh generation, says, "From the earliest days, we made sure that we stayed unified as a family,[84] organised ourselves effectively, and remained attuned to the changing needs of the business."[85] The effort put into moving forward as a cohesive family unit and to steward the company in the same direction has allowed decisions to be quick, and harmonious to the business and the family as a whole.

"We try to ensure that the next generations know that they are not merely owners but also stewards of business. Each new generation should know early on the difference between ownership and stewardship. Ownership is like possession, stewardship is a fiduciary role."

– Jaime Augusto Zóbel de Ayala, Chairman of Ayala Corporation[86]

This "stewardship" principle is ingrained in each Zóbel de Ayala since young by the older generation. The youths know the family's history and their legacy by heart, and understand the impact their actions can have on the business and the people around them. More importantly, understanding their importance as stewards gives the family members a sense of purpose to continue contributing to the family and business, even if they are not involved in executive roles.

"Family members potentially have roles in either the governance or executive side of the corporation, or even both. However, no institution can grow, be relevant and keep progressing on the back of only family executive leadership. It must be combined with progressive professional leadership. We have regular family council meetings that are separate from the Ayala board meetings, so that we decouple issues that are family oriented from issues that are business oriented."

– Jaime Augusto Zóbel de Ayala, Chairman of Ayala Corporation[87]

The separation of business and family, as well as the sense of belonging and ownership that comes with stewardship has given each member a sense of mission to be united and amicable in their family affairs.

One does not need to look far to see the amicability among members of the family. The beginning of Jaime Augusto and Fernando's succession was a very equitable experience.[88] They decided very early on to co-manage the business together and act like equals. They provide a shining example of what it means to be family within the Ayala household.

Leadership of the family

Eighteen consecutive family members have been at the helm of the Group. Each generation has left its mark, introducing new businesses and entering new industries, developing new business models and building strategic alliances and partnerships that turned Ayala into an international player with leadership positions in its various businesses.[89]

The importance of being able to chart their own course and decide on their own legacy has been a defining trait of every generation of Ayala leaders. The focus on innovation and pioneering has allowed the leaders to venture into areas not previously explored and create new value for shareholders and the community in ways that have not been done before. It is a challenge by the predecessors for the successors – to never rest on their laurels and trailblaze their own story.[90]

Career progression

Ayala has always been very deliberate as far as career progression of the next generation is concerned. Healthy transitions between the generations are encouraged where the next generation are initiated into the business to inject ongoing dynamism into the company while learning from industry experts and business professionals within the corporation.

With the seventh generation at the helm, the eighth generation of the family has already slowly stepped into the fray to have a taste of managing different industries. Mariana E. Zóbel de Ayala (Mariana), daughter of Jaime Augusto and Elizabeth Eder, is currently VP and Deputy Head of Marketing for BPI after serving as Deputy Head of Ayala Malls in Ayala Land. Their son, Jaime Alfonso is Head for Business Development and Innovation at Ayala Corporation. Jaime Z. Urquijo (Jaime Urquijo), son of Jaime Augusto's and Fernando's sister Beatriz Susana is AC Energy's Assistant Vice President for Business Development, International.[91] All three serve as board members of different organisations within the group. Over the next few years, they will continue to be exposed to the various segments of the sprawling business and be mentored by the best professionals the company has.[92]

Nothing taken for granted

Every generation of the Ayala family knows that the responsibility for the family's business does not come naturally.

Mariana, Jaime Alfonso and Jaime Urquijo, the eighth generation from the Ayala family, fully understand the need to prove themselves. After graduating from Harvard College at 21, Mariana spent two years in Wall Street's cut-throat environment in an investment bank, JP Morgan. She also had a brief stint in the Philippines' Department of Finance.[93] Prior to joining Ayala, she had to rely on herself and build her business acumen from the ground up without getting any preferential treatment.[94] Similar to Mariana, Jaime Urquijo has had to chart his own path. After graduating from Notre Dame University, he worked as an analyst on Wall Street while juggling time playing for the Philippines rugby national team. Jaime Urquijo also showed his own entrepreneurial spirit early in his education,[95] establishing an entrepreneurship club with his friends while at university. Jaime Alfonso is a Harvard graduate and was elected director of Ayala Land in 2020. Additionally, he also holds a position as a management associate of Globe.[96]

Ayala and its stakeholders

The numerous accolades that the firm has received serve as a testament to the capabilities of the leadership in managing relationships with its various stakeholders. Ayala has done much to improve the livelihood of its stakeholders which include its shareholders, employees, business partners, customers and the communities in which it operates.

Ayala's foray into sustainability

Although extremely crucial in the long term, many corporations lack a holistic view on sustainability.[97] Many corporations, including large ones, still see sustainability as a form of compliance and "box-ticking" against regulations.[98] In contrast, Ayala has taken sustainability very seriously.

In an effort to drive business growth responsibly, the institution has started to integrate risk and sustainability factors into its strategies. The Group's current Chairman, Jaime Augusto, was also chosen as a UN Sustainable Development Goals (UN SDGs) Pioneer for Sustainable Business Strategy and Operations, an unprecedented nomination in the Philippines and the first in SEA.[99]

What were some of the initiatives set up by Ayala in the pursuit of sustainability? How was it able to remain economically viable while achieving its green agenda?

Ayala Land

Ayala Land was named the best overall company at the 2019 Sustainable Business Awards for its outstanding performance on environmental and social sustainability.[100] This is demonstrated by the company's integration of sustainability practices in day-to-day operations; its goal to become carbon neutral by 2022; and by aligning its sustainability programs with the UN Sustainable Development Goals. Project development and operations are guided by four focus areas, namely site resiliency, pedestrian and transit connectivity, eco-efficiency and local economic development.[101]

The company has promised to grow 586 hectares of land as carbon forests. Carbon forests are essential in regulating the Earth's atmospheric carbon. The forests, which are spread over 6 sites across the Philippines, are expected to hold an estimated 90,000 metric tons of carbon dioxide by 2022.[102] Ayala Land is already a leading developer in multi-purpose sustainable estates that are eco-friendly, allow for easy access to public transport and are supportive of local businesses.[103]

AC Energy

ACEN's commitment to sustainability is linked to its corporate strategy and vision, and aligned with the UN Sustainable Development Goals. Guided by its Environmental & Social (E&S) Policy, the company's sustainability framework is built on three focus areas embedded across its business operations, governance, and culture: having a low carbon portfolio by 2030, protecting the environment and investing in communities.[104]

ACEN started to develop targets and measures to help drive its sustainability agenda across the organisation and with its business partners. Sustainability is fully integrated in the company's strategy. In March 2020, ACEN announced the board approval of its E&S Policy, incorporating sustainability in its business and organisation. At the core of the policy is the company's transition to a low carbon portfolio and divestment of its coal plants by 2030.[105]

ACEN also established a management system that incorporates global best practices in biodiversity management, circular economy, community relations, and organisational diversity, well-being, and safety.[106]

By embracing the renewables technology and prioritising sustainable energy, ACEN took on a leading role in the energy transition process and has integrated its decarbonisation strategy into its business model as well as capital raising strategies.

1. In 2019, the company divested approximately 500 MW of thermal coal assets, worth US$574 million, and re-invested into renewable energy developments.

2. In 2019, ACEN made its debut in the debt capital markets and raised US$410 million in Green Bonds, the first publicly syndicated U.S. dollar Green Bonds in Southeast Asia which were CBI-certified, a sign of best practice in the market in terms of ESG commitment. The International Finance Corporation and the Asian Development Bank are anchor investors. The issuance has since been increased to US$470 million. During the latter part of the year, ACEN had another offering – the world's first U.S. dollar-denominated perpetual fixed-for-life green notes at an aggregate principal amount of US$400 million certified under the ASEAN Green Bonds Standard and successfully listed in the Singapore Exchange.[107]

3. In March 2020, the company announced the board's approval of its E&S Policy which highlights the company's transition to a low carbon portfolio. Divestment from existing coal generation assets shall be implemented, to achieve full divestment from coal generation assets by 2030.[108]

4. Most recently, AC Energy successfully issued U.S. dollar-denominated senior perpetual fixed-for-life (non-deferrable) green bonds at an aggregate principal amount of US$300 million as part of a liability management deal. This represents the first Philippine fixed-for-life perpetual bond offering since November 2019 and the first public green bond out of the Philippines in 2020.[109]

Not lip service

The above two examples reflect the alignment of the SDGs and the values and goals of the Ayala Group. The Ayala Group started publishing its Integrated Report in 2016, the first in the country. The report is a response to investors' requests rather than a regulatory requirement as this was prior to the Philippines Securities and Exchange Commission requiring listed companies to include a sustainability report as part of the annual report. Former Chief Finance Officer (CFO) of Ayala Corporation,[110] Jose Teodoro Limcaoco, has mentioned that the company will continue to "boldly challenge the status quo to engage in climate action" because it "[recognises] its role as a driver of consumer behavior and sustainable development".[111] Ayala's sustainable practices and emphasis on ethical actions show a consistent effort from the ground up to do good and be good to the society around them.

Ayala's affinity with society

Ayala has not forgotten to give back to society and has continued to drive a social purpose throughout communities in the Philippines. It has ensured that it addresses the socioeconomic development goals of the country alongside meeting its financial targets. The Chairman of Ayala Corporation, Jaime Augusto, has claimed to "dedicate about 15-20% of [his] personal time to the nonprofit sector as a way of building trust with broader communities", indicating the Group's commitment to its civic duty.[112]

The Ayala Foundation

The Ayala Foundation is the social development arm of the Ayala Group. Committed to community development, the foundation works closely with the conglomerate as well as its program communities to identify compelling developmental needs and providing suitable solutions with measurable outcomes. Working under the principle of stakeholdership, program partners, including the Ayala group, commit resources (financial, time, human resources, among others) to implement programs that benefit the greater community. It has programs under three themes – sustainable livelihood, love of country, and in particular, education.[113,114]

One of its longest-running education programs is CENTEX, which initially worked with two public elementary schools to provide children from economically disadvantaged families to gain access to quality education. To expand its footprint, CENTEX also gives priority to the continuing training and mentoring of teacher as well as the provision of volunteer and livelihood opportunities for parents, knowing that a child's development is the result of the collaborative work of a community, and those involved in it can benefit from continuing empowerment.[115]

Technology also figures significantly in the implementation of the foundation's education initiatives, through programs like ProFuturo, <code/it>, and the Ayala Museum's and Filipinas Heritage Library's continuing efforts to promote Philippine art, history, and culture.[116]

In partnership with Spain's ProFuturo Foundation as well as the Department of Education, Ayala Foundation implements the ProFuturo program in the Mimaropa region, providing access to digital tools for the use of public school teachers and students. Since its launch in 2017, ProFuturo has expanded its reach from 94 schools to 126 schools.[117]

For its part, the digital education project provides public elementary school students access to basic computer science and programming education as part of their educational curriculum, preparing them for the "workplace of tomorrow." Working closely with the Department of Education, local government units, and private funders, the program was piloted in 12 schools in 2019, and has continued to expand to more regions, even through the COVID-19 pandemic.[118]

Meanwhile, art and cultural education remains a priority for the Ayala Museum and Filipinas Heritage Library, done through exhibits as well as onsite, offsite, and online programs – be they in the form of educational videos, provision of digital resources, and others.[119,120]

The Ayala Foundation's two other program themes – sustainable livelihood and love of country – also have strong training components, both within and outside the formal education setting. These include the leadership and program management training for community youth provided by the Leadership Communities program; the livelihood training assistance for communities in Calauan, Laguna and El Nido Palawan; and the promotion of nationalism and respect for national emblems through the Maging Magiting program.[121]

Dealing with COVID-19

The COVID-19 pandemic continues to impact countries all around the world. What began as an unknown pneumonia-like illness has mutated into a global pandemic that has threatened health systems and economies alike.[122] Ayala's stakeholders have also been badly hit by the effects of COVID-19.

In an effort to alleviate the impact of the virus on its stakeholders, in March 2020, the Ayala Group announced an emergency response package of approximately PHP 2.4 billion.[123] This package consisted of wages, bonuses, leave conversions and loan deferments meant for the extended workforce of the Group's partner employers to ensure that they would still receive their salaries during the quarantine period in the Philippines. Of this sum, 25% was dedicated to paying workers who could not continue working in the construction and retail arms of Ayala, Makati Development Corporation and the Ayala Malls Group.[124] In addition to that, Ayala Malls would also not be collecting rent for the period that tenants cannot carry on business.[125] Globe has also set aside PHP 270 million to ensure continuity in salary payouts for its staff and vendors. Meanwhile, the Group's own staff were guaranteed financial support where feasible and could be granted loans at less than market rates. Employees even received their mid-year bonuses.[126]

Ayala also worked with other top tier corporations in the Philippines to provide grocery support to individuals who had to stop work due to the enhanced community quarantine (ECQ) of Luzon City.[127]

Together with Caritas Manila and the Philippine Disaster Resilience Foundation, Ayala spearheaded Project Ugnayan, which raised over PHP 1.7 billion worth of food vouchers and in-kind donation, benefitting over 14 million individuals in the most vulnerable barangays of Greater Manila Area.[128] At the helm of this program is Fernando, the current Chief Executive Officer (CEO) of Ayala Corporation. He stressed the importance of the spirit of "Bayanihan" – a Filipino term for community – amongst the country's corporations and business families in the success of this operation, another reminder of the group's civic mindedness.[129]

Ayala continues to support the government in its development and implementation of the Philippine National Vaccine Roadmap. It has helped to strengthen the country's anti-pandemic capabilities by constructing isolation centers and testing laboratories, donating vaccines, testing equipment and PPEs and assisting in the roll-out and deployment of vaccines.[130]

#AyalaforTaal

On 12 January 2020, the Taal volcano, located in the island of Luzon, erupted and caused several earthquakes, lava fountains and volcanic lightning. As a result, over 400,000 residents in the vicinity were evacuated over a 14-kilometer radius.[131] Masks had sold out after the Philippine government released an advisory stating that residents should wear masks if they wished to step outside of their homes. The capital's airport, Ninoy Aquino International Airport, was shut after clouds of volcanic ash blew towards Manila.

At the forefront of relief operations was none other than the Ayala Group. The Group had stepped in to send aid to those who were impacted by the volcano's eruption. Manila Water Company, along with the disaster relief team had sent a convoy of 30 water tankers to various evacuation sites along with 37,840 litres of bottled water.[132] Ayala Land waived parking charges and provided free Wi-Fi connectivity in their malls for those whose cars had been rendered immobile by the volcanic ash fall. Ayala Malls Solenad in Sta. Rosa, Laguna opened the ground floor of its cinema building to customers who were in need of shelter and charging stations. Makati Development Corporation (MDC) distributed PHP 1.5 million worth of goods to 235 families in Paaralang Elementarya ng San Antonio in Sto. Tomas, Batangas. Relief goods included food, hygiene kits and sleeping mats. MDC's in-house medical team also conducted free medical check-ups and distributed medicines.[133]

Globe ensured that its network was up and running at full capacity in all affected areas. It also set up several Libreng Tawag (Free Calls) and Charging Stations around Cavite and Batangas to help keep people connected during the disaster. Globe also provided free and unlimited GoWifi internet connection in select malls in Laguna, Cavite, Batangas and in all four terminals of the Ninoy Aquino International Airport, which cancelled hundreds of flights due to the risk from volcanic ash.[134]

AC Health's Generika drugstore and Healthway (formerly FamilyDOC) clinics remained open, including branches in affected areas in Cavite and Laguna, to provide medicine, medical supplies, first-aid, medical consultation and assistance.[135]

Bank of the Philippine Islands delivered relief goods including masks, blankets, sleeping mats, slippers, non-perishable food, clothes, water, medicines and hygienic items and distributed to about 500 families and 3,000 individuals from Lemery, San Nicolas and Agoncillo, who were relocated to Bauan, Batangas.[136]

AC Motors cancelled its scheduled media thanksgiving party and allocated the funds to purchase and transport relief goods via a 30-vehicle convoy to different evacuation sites in Batangas. The subsidiary also donated 10 brand new KIA K2500 Kargo vehicles to the local authorities to use in the delivery of aid.[137]

In coordination with the Batangas provincial government and the municipal health office, the Ayala Group also sent a medical mission organised by Ayala Foundation with AC Health, MDC and the Ateneo School of Medicine & Public Health to attend to evacuees, most of whom were residents in "locked down" towns of Lemery, Agoncillo and Laurel in Batangas, who have been housed at the Municipal Covered Court of Alitagtag. The evacuees were in need of medical assistance for treatment of common cough and colds, muscle pains, hypertension, diarrhea, diabetes and other skin care concerns. A number of patients also required nebulisation services and wound treatment.[138]

AC Energy also donated 300 solar lamps to help families without access to electricity in Ibaan, Batangas.[139]

Ayala Foundation in coordination with the different Ayala business units and partners spearheaded several relief operations for evacuees staying in the different evacuation centers in Batangas. Ayala companies also independently organised their own employee fund raising activities and relief initiatives for the affected communities.[140]

As much as PHP 11.4 million was mobilised by the Ayala Group to provide immediate relief for 4,000 families or 20,000 individuals adversely impacted by the eruption of Taal Volcano in January 2020.[141]

Stakeholder capitalism

The examples described above are just some of the more recent snapshots of the Group's efforts in contributing back to society. The Ayala Group has consistently put its money where its mouth is, and has consistently dedicated time and resources to improving the lives of stakeholders. It is dedicated to the community and strive to be ethical in its dealings. Chairman Jamie Augusto foresees a future where every Filipino would have access to essentials such as education, healthcare, affordable water and even to financial services.[142]

Ayala's board governance: boon or bane?

Although the Ayala Group has developed a strong reputation for its corporate governance and environmental and social responsibility, it has some corporate governance practices which are common in family conglomerates that do not align with conventional best practices. There are questions as to whether directors who are deemed as independent directors (IDs) should be considered independent.

Within the board of Ayala Corporation, all the directors hold more than one directorship within the Group. Ayala Corporation's Chairman, Jaime Augusto, is also the Chairman of Globe, BPI and IMI and and Vice Chairman of Ayala Land and AC Energy.[143] The current President and CEO of Ayala Corporation, Fernando, is also the Chairman of Ayala Land and AC Energy, director of BPI, Globe, Manila Water Company and IMI. Outside of the Ayala Group, he is also an ID of Pilipinas Shell Petroleum Corporation.[144] These are just a few examples of the numerous positions these two Ayala directors hold in other subsidiary companies.

Interlocked independent directorships

In Ayala Corporation and its subsidiaries, it is usually the case that the two brothers (Fernando and Jaime Augusto) and a handful of interlocked directors run the board of directors. Apart from the brothers, IDs of Ayala Corporation also serve in other companies within the Ayala Group simultaneously.

For example, Ayala Corporation owns a 44.5% stake in Ayala Land and a 35.1% stake in Manila Water Company. There are related party transactions between the parent and subsidiaries.[145] Both the subsidiaries also have board structures that are interlocked and have IDs who sit on the parent and subsidiary boards simultaneously. Rizalina G. Mantaring is the lead independent director (LID) of Ayala Land and an ID of Ayala Corporation,[146] while Sherisa P. Nuesa (Sherisa Nuesa) is an ID of Ayala Land and the LID of Manila Water Company.[147]

Sherisa Nuesa is the most interlocked ID within the Ayala Group, holding directorships across four different companies. In addition to being the LID of Manila Water Company, she is also the LID of ACEN.[148] She is also an ID of IMI and Ayala Land.[149] Sherisa Nuesa is no stranger to Ayala. One of her earliest roles within the Group was Vice President of Ayala Land, held between 1989 and 1999.[150] Subsequently, she served as the CFO of Manila Water Company from 2000 to 2008, and as the CFO and Chief Administrative Officer of IMI from January 2009 to July 2010.[151] She was also the managing director of Ayala Corporation until 2011.[152]

Another highly-interlocked director within the Ayala Group is Rex Ma. A. Mendoza (Rex Mendoza). Together with Sherisa Nuesa, Rex Mendoza serves as ID of Ayala Land.[153] Rex Mendoza is also the LID in another two Ayala companies – Globe and Ayala Land Logistics Holding Corp., a subsidiary under Ayala Land.[154] Similar to Sherisa Nuesa, Rex Mendoza had also served in several Ayala companies, especially in subsidiaries of Ayala Land. He was previously the Senior Vice President, and Chief Marketing and Sales Officer for Ayala Land, as well as the Chairman of Ayala Land International Sales, Inc., another subsidiary of Ayala Land.[155] He was also the former President of Ayala Land Sales, Inc. and Avida Sales Corporation, both of which are subsidiaries of Ayala Land.[156]

Busy senior executives and directors

Senior executives within the Ayala Group hold multiple directorships across different companies and their related subsidiaries. For instance, Bernard Vincent O. Dy, the President and CEO of Ayala Land, has a total of over 40 directorships in companies within the Ayala Group. He is heavily involved in a substantial number of subsidiaries of Ayala Land, such as being the Chairman of Ayala Property Management and Alveo Land Corporation.[157]

The five senior executives with the highest number of directorships in companies within the Group all have more than 20 directorships.[158,159,160,161] Jaime Augusto from the founding family currently holds more than 20 board membership in the Ayala Group.[162] His brother, Fernando, holds over 30 board memberships in Ayala-related companies.[163]

Synergistic or conflicting?

The interlocked boards and busy senior executives and directors within the Group may raise concerns about weak oversight and conflict of interest. However, their attendance rate for board meetings averaged more than 90%.[164,165] The fact that the Group has survived and thrived over seven generations may mitigate concerns about its unconventional corporate governance practices.

Further, there have not been many major corporate governance mishaps that have happened to the Group over the past decade although some of the Ayala companies have recently received some negative publicity. In June 2020, it was reported that BPI was involved in the Wirecard accounting scandal.[166,167] A junior officer in BPI was alleged to have issued a fraudulent document indicating that Wirecard is a client of BPI.[168] Then President and CEO of BPI, Cezar Consing, had to subsequently clarify that none of the missing funds of Wirecard entered BPI, as Wirecard was not a client of the bank.[169] BPI has since strengthened its policies and programs to promote good conduct and practices of its employees.[170]

In another unrelated case, BPI also came under scrutiny in 2019 after its remittance partner in Australia, Westpac, was embroiled in a massive money laundering scandal.[171] It was alleged that money used for child exploitation was transferred through an online remittance platform, LitePay – a partnership between Westpac and BPI.[172] BPI has since cut ties with Westpac.[173] Additionally, BPI was found to have operational lapses arising from human error, which led to a two-day internal glitch and downtime in its online and automatic teller machine platforms.[174] This also resulted in inaccurate account balances being reflected in its customers' accounts.[175]

A few other companies within the Ayala Group have also previously come under the spotlight. In January 2019, Globe mishandled the personal data of its subscribers and sent personal information to the wrong recipients during the registration process of a promotion.[176] Email addresses, names and postal addresses of over 8,000 customers subsequently reached the hands of the wrong individuals.[177]

In January 2020, Philippine President Rodrigo Duterte claimed that there was massive corruption in the state-run Light Rail Transit (LRT) contract with the Light Rail Manila Corporation (LRMC), a consortium formed between AC Infrastructure and two other infrastructure companies.[178] In addition, he approved an investigation into an alleged improper deal between the University of the Philippines and Ayala Land.[179]

In spite of these negative publicity, the Ayala Group states that it remains committed to good corporate governance, a testament to its 187 years of existence in the Philippines.

Ayala's venture into the golden land

Although it is largely a Philippines-based conglomerate since its founding, Ayala has set its sights on global expansion in recent years. The Group has established its presence in China, Bulgaria, Serbia, Germany, Mexico and the U.S. through its majority-owned subsidiary, IMI,[180] and AC Industrial's acquisition of MT Misslbeck Technologies GmbH (MT) and Merlin Solar.[181] Ayala Corporation Chairman Jaime Augusto said that the conglomerate is in "expansion mode" and expects to increase its equity earnings from countries beyond the Philippines by three percent.[182]

In November 2019, Ayala announced its entry into Myanmar through the acquisition of a 20% stake in Singapore-listed Yoma Strategic Holdings (YSH) via subscription to shares and 20% of First Myanmar Investment (FMI) through a convertible loan.[183] Not long after, Myanmar's peace icon, Aung San Suu Kyi, found herself at the International Court of Justice denying allegations of genocide committed by the military against the Rohingya Muslim minority.[184]

Reputational damage for Ayala?

The author of Myanmar's Enemy Within, Francis Wade, describes the resentment against the Rohingya in Myanmar as "toxic and combustible".[185] Many countries including the U.S., Australia, Canada, and the European Union have imposed sanctions on the Burmese military leaders.[186] By venturing into a country which has poor human rights records, is Ayala risking its reputation as a group with a strong social conscience?

There is also the issue of corruption. The Financial Action Task Force (FATF), an intergovernmental watchdog agency, has "grey-listed" Myanmar as a state that is susceptible to money laundering and terrorism financing. For instance, a tax amnesty introduced under the 2019 Union Tax Law, which took effect on 1 October 2019, legalised the mobilisation of underground assets, in hopes of boosting the economy and its troubled real estate and banking sectors.[187] Companies involved in illegal activities such as drug trafficking and jade extraction are also exempted from punishment by Burmese law.[188] A recent survey conducted by Myanmar's Anti-Corruption Commission (ACC) also revealed the prevalence of corruption in Myanmar; 90% of participants expressed difficulty in engaging in business deals with the government without bribing government officials.[189]

Lack of adequate infrastructure

Myanmar is also known for its poor transportation infrastructure. Almost 60% of the country's highways are in poor condition.[190] While many living in rural Myanmar lack basic access to roads, traffic congestion is a common sight in Yangon due to ill-disciplined motorists and pedestrians that do not comply with road etiquette. Roadside hawkers further worsen the situation.[191] Hence, for businesses that rely on transportation and logistics to support their operations, the lack of proper transportation infrastructure is a huge drawback.

In addition, Myanmar lacks adequate technological infrastructure. The average internet speed in Myanmar and bandwidth per user are ranked 124th in the world according to speedtest.net,[192] and is frequently disrupted by unreliable electricity. To make matters worse, the development of infrastructural support continues to be a challenge due to natural disasters such as flooding, as well as corruption.[193]

Ayala is optimistic

Jaime Augusto believes in the growth potential for ASEAN countries. In an interview with Forbes, he explained, "You take a country like Myanmar where half the population are young and going through this economic growth spurt, there is no doubt that consumption will continue to grow and products and services will evolve".[194]

This sentiment echoes that of many others, as Myanmar has been dubbed by many investors as "Asia's final frontier".[195] The country has a substantially large youth population[196] with a median age of 29 years,[197] providing a potentially large pool of low-cost labour. The country's population of about 60 million also offers a large and untapped consumer market.[198] Myanmar is also rich in natural resources such as oil and gas and offers attractive mining opportunities with one of the world's largest depositories of precious stones.[199] The country also has an advantageous geographical location in being close to China and India,[200] allowing access to the fastest-growing consumer markets in the world.

Partnership with Yoma

Ayala invested a total of US$237.5 million in the Yoma Group,[201] representing Ayala's first foray in Myanmar.

Tycoon Serge Pun leads both YSH and FMI as the Executive Chairman. His son, Melvyn Pun, was appointed as CEO of YSH in 2016. Serge Pun is also the Executive Chairman of Yoma Bank, one of the largest banks in Myanmar with 80 branches.[202] He holds the appointment of Chairman of the SPA Group, which is the parent company of FMI and Yoma Bank. The SPA Group is an investment holding and operating company involved in financial services, real estate development, trading and distribution, the service industry, automotive, agriculture, hospitality and transportation.[203]

Although Myanmar is known for its widespread corruption due to decades of military rule, the younger Pun said that his father has held true to his principles.[204] Serge Pun has been referred to as "Mr Clean",[205] due to his adherence to clean business practices. His landmark project to develop Yoma Central, which would potentially house Yangon's most luxurious hotel and world-class residences, experienced significant delays between 2012 and 2016 due to excessive bureaucracy. He was reportedly determined to ensure compliance and said that "good governance always has a price to pay and the price we are paying is a delay", and hence he was fine with taking the "red-tape road".[206] Melvyn Pun also said that the Group's anti-corruption business ethics are a "competitive strength" and that they have no reason to compromise on it.[207]

In a country where corrupt practices are rampant, many foreign businesses have chosen Serge Pun and his companies as their preferred partner.[208] Companies under the Puns do not face international sanctions unlike many other Burmese businesses. American fast-food chain KFC and Indonesian healthcare operator Lippo Group are some of the many international businesses that have formed partnerships with him.[209] Recently, despite Myanmar's "grey-listing", the World Bank's International Finance Corporation (IFC) and Singapore's sovereign wealth fund GIC have also made significant investments in Yoma Bank.[210]

Ayala said that it decided to partner with the Yoma Group to "participate in Myanmar's growth story", because of the latter's "solid, decades-long reputation as a business house" and its "expertise in multiple sectors such as real estate, banking, automotive, health care, power and tourism, among others".[211]

Following the investment, Ayala Corporation's current President and CEO Fernando was nominated to the board of YSH and FMI. Plans to establish a 50:50 joint venture to develop around 200 megawatts of renewable energy have been in progress since the formation of their strategic partnership. The joint venture hopes to gain control of Yoma Micro Power (S) Pte. Ltd., a micro power plant and mini-grids builder in Myanmar, in 2021.[212]

Ayala believes that there is much potential for Myanmar's untapped market and hopes to "improve the lives of people in Myanmar through purposeful business" through its partnership with Yoma.[213]

Maintaining optimism amidst the coup

In an unfortunate turn of events, Ayala had to deal with a double whammy of the COVID-19 pandemic and a military coup following its investment in Myanmar. On 1 February 2021, Myanmar's military leaders declared a one-year state of emergency after arresting Aung San Suu Kyi and other government leaders. The crackdown on the protests that followed left hundreds of protestors dead, with local businesses and foreign investments severely impacted by the disruptions caused by the political unrest.[214]

In its 2020 Integrated Report, Ayala recognised the problems it faced in Myanmar. Yoma Group's businesses have been affected by telecommunication disruptions.[215] YSH's share price also plunged to its lowest level since May 2020 just two days after the state of emergency was declared.[216] YSH's board of directors has since announced that it will continue to "assess the situation in Myanmar".[217] YSH has continued to acknowledge the negative impact caused by the "uncertain operating environment in Myanmar" in its half-yearly report in May 2021.[218] Likewise, FMI's shares fell 7.2% on 3 February 2021,[219] while its Annual General Meeting originally scheduled on 6 February 2021 had to be postponed due to internet connectivity issues.[220]

During Ayala's full-year earnings conference call held on 11 March 2021, shareholders voiced concerns about the deteriorating situation in Myanmar. When asked about Ayala's investments in Yoma Group, then-CFO of Ayala Corporation, Jose Teodoro Limcaoco, stated that its investments in Myanmar are for the long-term, and he is hopeful that the "situation resolves itself sooner rather than later".[221] Limcaoco was also committed to completing Ayala's investment in Yoma Group,[222] as the subscription of the second tranche of US$46 million of primary shares was due by 11 May 2021.[223] However, the long stop date was further extended to 30 September 2021, as announced by YSH on 30 April 2021.[224]

Separately, other senior executives and directors have also voiced similar views about the crisis in Myanmar in April 2021. Ayala managing director, Eric Francia, remarked during an online media briefing that the Group views the Myanmar investments "from a long-term perspective".[225] Ayala head of corporate strategy, Paolo Borromeo, also expressed concern about the Myanmar coup, emphasising that Ayala will ensure the safety of its partners' employees, while the "most prudent thing to do is to wait and see".[226] When Ayala invested in Yoma Group in 2019, it had described Yoma as a "long-term investment…with values that align with ours [Ayala]".[227]

With its continued expansion into new sectors and geographies, and continuing focus on ESG issues by investors, is it time for the Ayala Group to reconsider its corporate governance model? Or should it persist with it as it has served it well over seven generations?

Discussion questions

1. What are the key corporate governance challenges and risks in family-controlled companies that can affect the performance and rights of minority shareholders? How can such companies address these challenges? What are some key corporate governance practices that can help mitigate the risks faced by minority investors in such companies?

2. What has Ayala done in the face of the challenges typically associated with family-controlled companies and conglomerates that have set it apart and allowed it to survive and thrive over seven generations?

3. How would you describe Ayala's model of corporate governance? Evaluate the relationship that Ayala has with its stakeholders and cite examples that demonstrate the model that it is following. Should other companies emulate Ayala? Explain.

4. What are the concerns about the interlocked boards and busy senior executives and directors in the Group? Do you believe that Ayala has been able to overcome these concerns? Are there any benefits from such unconventional corporate governance practices? Explain.

5. Should corporate governance rules impose restrictions on interlocking directorships and number of directorships? Should exceptions be allowed for conglomerates such as the Ayala Group? What would be the basis for any such exceptions, if so?

6. The diversification of a business, especially in a foreign country or different industry, comes with risks. What factors should a company consider when diversifying into different industries or venturing overseas? What role should the board of directors play in such decisions and how should it exercise oversight?

7. From an ethical standpoint, do you think the Ayala Group should have invested in Myanmar given the issues in the country even before the military coup began in February 2021? Explain.

8. Is there anything that you think the Ayala Group should change in terms of corporate governance practices to ensure its continuing success? Explain.

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HITACHI: BREAKING THE MOULD?

Case overview

After World War II, traditional Japanese corporate governance systems with complex corporate cross-shareholdings, also known as the keiretsu, became the dominant partnership network of modern Japanese businesses. These interconnected businesses not only exchanged ownership stakes, but also a wide myriad of corporate executives and directors, strategic schemes, and policies in order to assert maximum control and performance. Together with a large board size and a lack of outside directors, it was a uniquely Japanese business structure. After the 2008 financial crisis, Hitachi, Ltd. (Hitachi) decided that there was a need for change and embarked on a series of reforms to improve its corporate governance and management practices. Will Hitachi be able to overcome the corporate governance problems that have recently affected other major Japanese corporations such as Kobe Steel, Nissan, Olympus, Takata, TEPCO and Toshiba? The objective of this case study is to facilitate a discussion of issues such as corporate governance in Japan; the impact of Japan's business landscape on governance matters; board composition; board committees; risk management; crisis management; and restructuring of large multinational corporations.

The awakening

Hitachi, Ltd. (Hitachi) experienced an important turning point following the 2008 financial crisis. Similar to many Japanese multinational companies (MNCs), it had been operating a wide range of businesses, with 404 subsidiaries in Japan, 22 of which were listed on the Tokyo Stock Exchange. Many of these subsidiaries did not have a strong business rationale and this created multiple levels in its structure and delayed decision making.[1] With increasing raw material prices, a falling demand for exports such as cars and computers which adversely affected Hitachi's sales in the semiconductors and automotive systems businesses,[2] and the Japanese Yen (JPY) being at a 13-year high,[3] Hitachi experienced a drastic decline in earnings.[4] Further, Renesas Technology Corporation, a joint venture company owned by Hitachi and Mitsubishi Electric, was expected to post a loss of JPY 206 billion for the financial year ended March 2009, which would significantly affect the performance of Hitachi.[5] The most adversely affected businesses were flat panel displays, automotive and semiconductors. These businesses were later split off from Hitachi and holding shares were transferred to other companies such as NEC Corporation.[6] Having previously projected a JPY 15 billion profit, the company saw a loss of JPY 787 billion for the financial year ended March 2009.[7]

This case was prepared by Ishaan Vinod Dulhani, K.S. Farhana, Natalie Poh Siya, Ong Lei Xuan, Poh Sing Wei Angeline and Tan Siang Yu, and edited by Evangeline Lim 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 organizations named in the case, or any of their directors or employees.

Hitachi's response

The losses during the 2008 financial crisis triggered prompt action from the leadership at Hitachi. Kazuo Furukawa stepped down and Takashi Kawamura took over as the President, Chief Executive Officer (CEO) and Chairman in 2009, and put together a plan for the company to recover financially and set the course for long-term profitability. The plan was in the form of a series of initiatives named "Strengthening the Base '08-'09", aimed at creating a foundation for the transformation of Hitachi through improvement in the company's structure and governance. Hitachi aimed to cut fixed costs by JPY 200 billion by March 2010. This meant deferring capital expenditure, reducing inventories, and expediting the collection of accounts receivables. The company decided to split its automotive systems and consumer business groups as part of restructuring efforts. Hitachi was also looking to re-evaluate its business portfolio, exit unprofitable businesses and create a robust business structure which would generate long-term profits.[8] The announcement of these measures in March 2009, combined with the expected losses for the year, led to the share price of Hitachi closing down 6.7% at JPY 294.[9]

This marked the start of Hitachi's restructuring plan which led to a gradual decrease in the number of subsidiaries in the Group, as seen in Figure 1. Hitachi continuously evaluated its businesses for consolidation and disposal, reducing the number of listed subsidiaries from 22 to just two.[10]

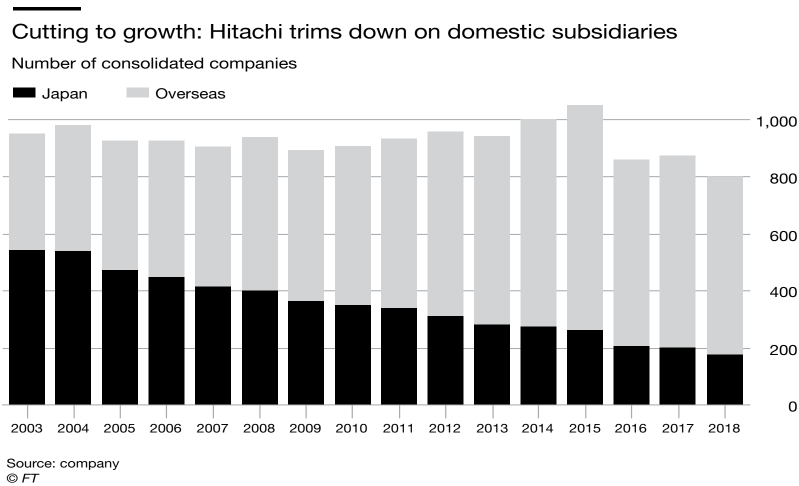

Figure 1: Hitachi's domestic subsidiaries over the years[11]

According to Akira Kiyota, the representative executive officer of the Japan Exchange Group, Hitachi was transformed in the last decade “by its decision to make governance a greater priority”.[12] Kawamura and his establishment of a “Last Man” in making final decisions and taking responsibility for these decisions led to quicker decision-making as it introduced the “in-house company” system in October 2009.[13] This system divided the internal functions into six virtual in-house companies and defined the responsibility and authority of each in-house company.[14]

Each “in-house company” had a leader acting as a CEO and the “Last Man” in taking decisions for that virtual company. Through this, Hitachi aimed to have a clearer and more independent view of profitability for each “in-house company”, encouraging management to exhibit authority, responsibility, and accountability. This was also expected to promote more timely decision-making and a greater sense of business ownership across functions.[15]

Following these reforms, Hitachi saw a healthy recovery in earnings in the financial year ended March 2010. According to a Financial Times article,[16] the corporate governance reforms introduced by Hitachi were “pioneering in Japan” but were quite conventional as compared to corporate governance in other developed markets. Hitachi saw its share price more than double in October 2019 compared to 2009.[17] The 2008 financial crisis was the turning point that kickstarted Hitachi’s next decade of transformation.

Not sunny in the land of the rising sun

For some years before the global financial crisis, Japanese companies had lagged behind their counterparts around the world, especially the West, in terms of profitability and return on equity (Figure 2). For example, companies such as Apple Inc. of the U.S. and Samsung Group of South Korea were outperforming them significantly. The conservative culture of Japanese companies was seen to be detrimental to financial growth. One consequence of such a culture was that many companies were sitting on growing piles of cash instead of investing them to expand their businesses, or returning the excess cash to investors so that they can reinvest the money in other businesses.[18]

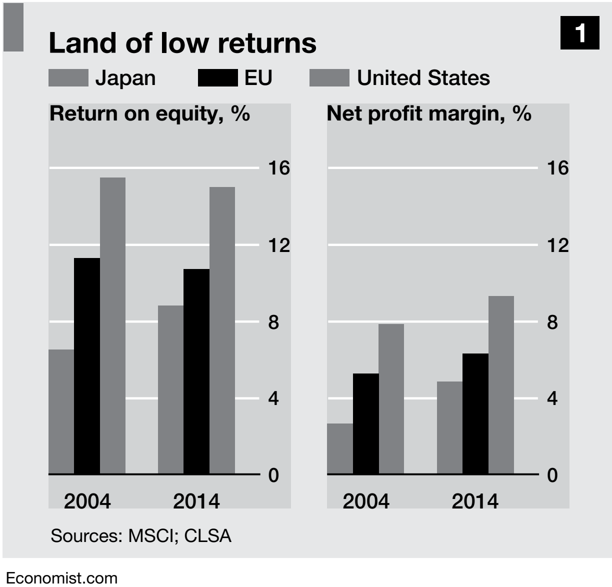

Figure 2: Return on equity and net profit margin of Japan, EU, and the U.S.[19]

Falling behind global competitors in profitability was not the only indicator that signalled a need for change in Hitachi's corporate governance. During the 2000s, a growing proportion of shares in Japan's listed companies were owned by foreigners, as shown in Figure 3. This increased the pressure on Japanese companies to reform their outdated corporate governance systems.[20] Shareholder activists – which included individuals, private equity funds and institutional investors – were actively seeking to replicate the governance transformations they had brought about in Europe and the U.S., to Japan. One of the largest of these shareholder activists was the California Public Employees' Retirement System (CalPERS), which actively sought change in Japanese companies.[21] Several key changes were made by Hitachi as a result.

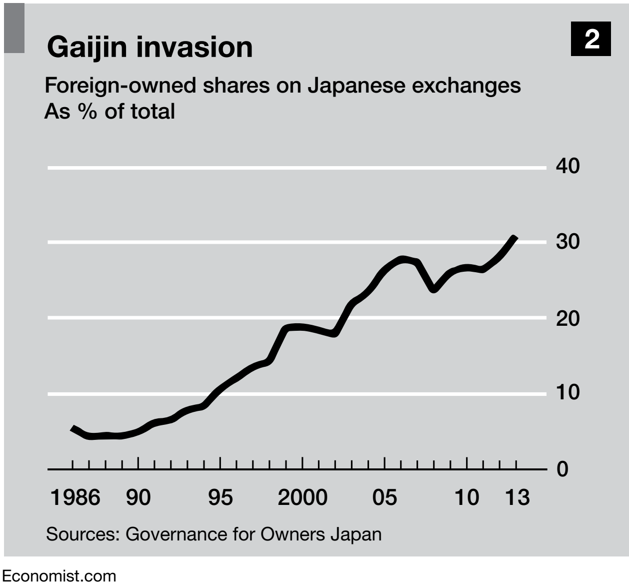

Figure 3: Foreign-owned shares in Japan stock exchanges as a percentage of total shares in Japan stock exchanges from 1968 to 2013[22]

Ganbatte Hitachi! – Road to a better corporate governance system

After the 2008 financial crisis, Hitachi adjusted its strategy and corporate governance system frequently to ensure that it was constantly improving. In 2012, several plans were introduced. Firstly, there was an emphasis on the social innovation business – a fusion of social infrastructure and IT, materials and key devices. Secondly, there were global growth strategy plans to move from "defence" to "offense", indicating a change from cost competitiveness and reinforcement of financial positions to active investments in key business areas, expansions, and cooperation with local and overseas partners with Japan as the base. Thirdly, there was a plan to develop environmental and integrated technology services.[23]

Oversight was strengthened through the committee system, which involved three statutory board committees – namely the Nomination Committee (NC), Compensation Committee (CC) and Audit Committee (AC). The number of outside directors on the board was also increased and accounted for the majority of the board in 2012.[24]

In 2015, Hitachi's social innovation business was further developed by providing solutions with integrated products, services, and highly sophisticated IT functions. Innovation through cloud-based services was also introduced to facilitate expansion of the social innovation business globally. Hitachi also sought to simplify its group structure to minimise waste and improve clarity.[25]

Earlier in 2012, Hitachi had developed and published its own Corporate Governance Guidelines,[26] outlining the responsibilities of directors and criteria for director nomination. In particular, Hitachi set criteria to ensure that outside directors were independent and also highlighted the importance of appointing outside directors who have experience in related fields.[27] In 2015, Japan introduced a Corporate Governance Code.[28] Hitachi was in favour of the measures to strengthen its corporate governance.

Other initiatives to strengthen corporate governance included clearer reporting of corporate governance strategies, better board qualifications and improved remuneration policies. There was also a clearer implementation of the principles of the 2015 Corporate Governance Code of Japan.[29]

In 2018, there was a shift in focus on digitalising the social innovation business. Industry innovation was encouraged to realise more convenient, comfortable and eco-friendly lifestyles. With the fusion of IT, operations control, and products and systems, Hitachi had hoped to drive growth in the Internet of Things age.[30] That same year, its corporate governance reporting was also updated in accordance with the revised 2018 Corporate Governance Code of Japan.[31]

Top management changes

Hiroaki Nakanishi stepped up as President of Hitachi in 2010 while Kawamura remained as Chairman. Nakanishi went on to succeed Kawamura as Chairman and CEO in 2014.[32] In 2016, Toshiaki Higashihara was appointed as the new CEO while Nakanishi remained as Chairman.[33]

Hitachi also recognised the importance of diversity and appointed its first foreign executive officers, Alistair Dormer and Jack Domme, as Vice President and executive officers of Hitachi in 2015.[34] Hitachi's executive officers form Hitachi's top management and are appointed and answerable to the board.[35] Hitachi also continued to refresh its management personnel, with eight new executive officers appointed in 2018.[36] As at 12 May 2021, there are 32 executive officers, of which four are foreigners.[37]

Restructuring of the board

Hitachi's board of directors has also seen multiple changes. In general, Hitachi has limited its board size to a maximum of 12 directors. Hitachi also sought to improve board diversity. Prior to 2012, the board was mostly made up of Japanese directors. Further, in 2011,[38] only four out of 13 directors were outside directors. One of the major changes to the board occurred in 2012 when Hitachi increased the number of non-Japanese directors and moved to a majority of outside directors.[39] In 2012, out of the 12 directors, seven were outside directors.[40] Since then, Hitachi's board has comprised mainly outside directors. [Note: As the company explains in its FY2020 annual report, outside directors in Japan are directors who fulfil the qualification requirements to be outside directors as provided for the Companies Act of Japan. Independent directors are outside directors who also meet the independence criteria defined by the Company and those provided by Japanese stock exchanges where the Company is listed.][41]

Restructuring businesses

Hitachi continued to actively restructure its business, which has resulted in it being less diversified and better able to focus and specialise in certain industries.

Besides the in-house company system, Hitachi also introduced a new management structure in 2012[42] to consolidate related businesses together into five main domains – the information and technology systems group, infrastructure system group, power systems group, construction machinery group, and high functional materials and component group. Through this, Hitachi aimed to increase its focus on each specialisation and improve decision-making efficiency. As part of the new management structure, Hitachi also appointed a CEO for the Asia Pacific region based in Beijing, China to help strengthen Hitachi's relationship with China in the hope of expanding its business in the mainland.[43]

In 2013, the management structure was restructured[44] into six main domains. The new domain – automotive systems group – was established to meet the growing demand in the automotive industry as well as to meet Hitachi's goal of becoming a major global player in the industry.[45]

Hitachi's in-house company system was subsequently further improved in 2016 with the introduction of 12 front business units (FBUs) to enhance the front-line functions and to strengthen customer relationships.[46]

In 2019, Hitachi embarked on its 2021 Mid-term Management Plan, aiming to transform the business to focus on five key growth domains – Mobility, Smart Life, Industry, Energy, and IT – representing yet another change in its management structure.[47]

Data falsification scandals

However, while Hitachi's stock price experienced a steady increase amidst ongoing reforms to its corporate governance and business practices, it could not avoid similar scandals that had afflicted some other major Japanese corporations. In late June 2018, news surfaced regarding Hitachi falsifying data in quality tests of lead-acid batteries for industrial use. These falsified tests were found to have occurred over more than seven years, impacting 60,000 products shipped to 500 companies.[48] In October 2018, another scandal involving Hitachi's subsidiary, Hitachi Chemical Co., Ltd. (Hitachi Chemical), regarding falsified testing of a material used in semiconductors, came to light. This was reported to be widespread across all of its factories in Japan and estimated to impact 1,900 businesses and almost 30 products used in cars and consumer electronics. Hitachi's shares plummeted by 15.6%.[49]

Suspicions regarding the accuracy of quality controls at Japanese companies had grown as other large manufacturers such as Kobe Steel, Subaru and Mitsubishi Materials also admitted to misrepresentation of quality test results or provision of falsified documents.[50]

In response, Hitachi once again sought to strengthen its corporate governance system. The company tightened oversight of five core businesses including industrial machinery. At its first Environmental, Social and Governance (ESG) briefing in September 2019, Hitachi announced that it had appointed executives as “executive auditors” to manage the internal audit of each of the five growth sectors.[51] This was to increase the effectiveness of the overall internal audit by getting business units in each division to share information with the parent company’s auditing section to prevent any deviations.[52,53]

Hitachi Chemical also provided regular updates on the investigation into the root cause of its false testing. In November 2018, it revealed measures that would be implemented to prevent a recurrence. Four main changes were to be made: improving senior management’s quality-orientated approach and initiative to change attitudes within the company; changing attitudes of all employees toward quality assurance; improving its quality assurance system; and strengthening the operating base, quality assurance-related audits and internal whistle-blowing system.[54]

The three committees

In 2003, Hitachi changed its corporate governance to the “three committee” system, with the establishment of three board committees – namely the NC, CC, and AC. Each of these committees oversaw significant changes in corporate governance practices under their responsibilities.

Compensation Committee

The CC has the authority to determine compensation policies for its directors and executive officers. It comprises four directors, of whom three are independent directors. The committee reviews compensation policies, assesses compensation amounts and evaluates progress towards individual targets.

The CC oversaw major changes to Hitachi’s compensation system. The executive compensation system is benchmarked to major global companies with the goal of creating value for shareholders. In FY2020, a restricted stock unit (RSU) compensation structure for non-Japanese officers was implemented to promote shared values between senior management and shareholders.[55]

The 2015 Corporate Governance Code provides that compensation should include incentives that reflect mid to long term business results and potential risks, as well as promote healthy entrepreneurship.[56] Accordingly, Hitachi's compensation structure for executive officers consists of three components – basic compensation as fixed pay, as well as performance-linked short-term incentives and medium-term and long-term stock-based compensation as variable pay. These three components follow a standard 1:1:1 ratio, but are adjusted to allocate a higher proportion of variable pay for executive officers who hold higher positions. The short-term incentives are within a range of zero to 200% of a basic amount set according to specific positions and adjusted to reflect financial results and individual performance,[57] as shown in Figure 4.

Evaluation items		**Proportion of evaluation item**	
		Executive officers that constitute the Senior Executive Committee	Other executive officers
Performance-linked component	Company performance	80%	30%
	Division performance	-	50%
Individual target-linked component		20%	20%

Figure 4: Executive short-term incentive compensation structure[58]

The four performance indicators used to evaluate company performance are revenue, adjusted operating income, earnings before interest and taxes, and net income attributable to shareholders.[59] In contrast, directors receive only fixed pay, which is adjusted according to factors such as their position, responsibility and required travel from place of residence.[60]

Under new laws introduced in 2010 by the Financial Services Agency, Japan's financial regulator, companies in Japan are required to disclose names of executives and the breakdown of their compensation when their annual pay exceeds JPY 100 million. Companies are also required to state how they assess performance and how they decide on the method used in calculating compensation.[61] For FY2019, Hitachi reported the required information by including names of directors and executives with compensation exceeding JPY 100 million and their compensation breakdown.[62]

Moving forward, Hitachi aims to remove one of Japan's most well-known practices – seniority-based pay – and instead reward employees based on performance and job responsibilities. Although many Japanese firms such as Toyota, Panasonic and Hitachi consider such old-school practices to be no longer applicable and have thus partially adopted merit-pay remuneration policies, seniority-based pay still remains the norm.[63] According to Chairman Nakanishi, merit-based pay is more in line with Hitachi's transformation from a hardware-focused manufacturer into a services business after the 2008 global economic crisis.[64]

Furthermore, after the merger with ABB Ltd's power grid business in 2020, more than half of Hitachi's 310,000 global workforce consisted of overseas employees. Hence, given the need to align compensation for its employees in overseas operations, Hitachi developed job descriptions for its domestic workforce to utilise the performance indicators to assess employee performance and determine the pay of local employees.[65]

Audit Committee

Hitachi's AC is responsible for auditing the execution of duties by directors and executive officers, and also decides on proposals submitted to the shareholder general meetings regarding election and dismissal of auditors. The Chairman of the AC, Hiroaki Yoshihara, possesses substantial financial and accounting knowledge from his extensive experience in accounting and other business practices at Big Four accounting firm, KPMG.[66]

The primary focus of the AC includes enhancing collaboration and promotion of information sharing through tripartite audits undertaken by the AC, internal auditors and external auditors, and the establishment and evaluation of internal control systems to ensure adequate risk management. Committee members also attend senior executive meetings and other important internal conferences like the budget meeting to keep themselves informed of information discussed by the management.[67]

To enhance audit effectiveness, Hitachi implemented an "executive auditor system" in each of the five growth sectors – Mobility, Smart Life, Industry, Energy and IT – in 2019. Although chief auditors are not legal agents under Japan's Companies Act, they do assume responsibility for governance in each sector and function as the reporting line for statutory auditors.[68]

The 2015 Corporate Governance Code of Japan states that external auditors and companies should recognise the responsibility that external auditors owe towards shareholders and investors and take the appropriate steps to ensure the proper execution of audits.[69]

By adopting a risk-based approach, the external auditors of Hitachi determine the scope and method of the audit, formulate the audit plan and perform audit on each of the five sectors. During the audit process, if the external auditors uncover risks that could potentially impact future financial statements significantly or cause large qualitative effects, they are required to share the relevant information regarding the risks and the progress on response from the relevant divisions with the AC and internal audit section. The external auditors also submit management letters comprising points of concern and improvement suggestions. Moreover, to improve efficiency of checks on the accuracy of financial information, IT systems are used to investigate all cases, instead of performing test-checking via sampling.[70]

With increasing global expansion, Hitachi believes that the establishment and maintenance of appropriate audit systems is critical. To achieve sustainable growth in corporate value, Hitachi's AC and internal audit collaborate with external auditors to strengthen tripartite auditing, with the aim of increasing internal control effectiveness. With the AC taking the lead, all three parties work closely together to share risk information and assessments concerning risk response and the evaluation of the group audit system, while maintaining transparency and adequate checks and balances.[71]

Nominating Committee

The third committee, the NC, has authority over proposals submitted to the shareholders' meeting regarding the election and dismissal of directors.[72] The NC sets transparent criteria and procedures which are guided by the company's corporate governance guidelines regarding board composition, directors' qualifications and independence.[73]

Strengthening risk management

Over the years, Hitachi introduced various committees and initiatives to strengthen its risk management system. In 2017, it established the investment strategy division to minimise risks and enhance the quantitative risk management of its investments. That same year, the executive sustainability division was launched to address social and environmental issues, and to identify potential business opportunities.[74] In April 2020, Hitachi established the new post of Chief Risk Management Officer to formulate and execute risk management policies for the entire Group. To ensure all Hitachi executives and employees comply with corporate ethics, the "Hitachi Group Corporate Ethics and Compliance Code"[75] was established.[76]

With rising geopolitical risks around the world, Hitachi believes that a robust risk management system is indispensable for seizing growth opportunities while controlling risks. Thus, Hitachi aims to maintain a clear understanding and analysis of the operating environment, by taking into account social issues, competitive advantages, and business management resources. Hitachi's risk management approach allows it to identify the many quantitative and qualitative risks the Group should be prepared for, including opportunities for growth.[77]

Understanding quantitative and qualitative risks

Hitachi statistically calculates the maximum risk (value at risk) based on price movements over a specified period of time. Considering the total consolidated net assets and other factors, Hitachi determines the surplus capacity of growth investments in order to assess growth opportunities and ensure risks do not outweigh risk tolerance. By analysing risk conditions by country and sector and the outlook for future trends, Hitachi gains a quantitative understanding of risk concentrations in given countries and sectors, relative to profitability. Identified risks are reported to executives and finally reflected in the Group's management strategy.[78]

Focusing on global political and economic events, Hitachi utilises research from external organisations to analyse potential risks and opportunities and leverage on such research to improve corporate value. The investment strategy division examines investment projects and large orders with respect to the identified qualitative risks, by taking into account quantitative factors such as Hitachi's past performance in the business, as well as current market conditions and trends.[79]

Responding to risks and opportunities

With the identification and understanding of the potential risks and growth opportunities, Hitachi establishes clear and appropriate actions to be undertaken. An example is the company pulling out of a large nuclear power project in the U.K. in September 2020. The project, which was valued at almost JPY 3 trillion, was part of Hitachi's plan of becoming a "global company". However, the project was halted for over 20 months when Hitachi decided to opt out since it had set a deadline for resolving the issue within 12 months. The company cited the "investment environment due to the impacts of COVID-19" becoming "severe"[80] as a reason why financing the project would become difficult.

International relations may be also a possible future risk for Hitachi, especially since Japan and local companies face the possibility of being caught in a dilemma between China and the U.S., as China-U.S. trade tensions increase.[81] The impact might be exponential due to the fact that Hitachi is a MNC and has stakes in both the U.S. and China. An example of a high-profile international collaboration is the multiyear deal between Hitachi and Microsoft Corporation (Microsoft).[82] The collaboration with Microsoft enabled Hitachi to accelerate its customers' digital transformation and continue to deliver social, environmental and economic value to the market.[83]

However, in light of the COVID-19 pandemic, Chairman Nakanishi pointed out that "if we are totally reliant on one specific country and they have a lockdown, there will be huge consequences".[84] Hitachi hence plans to be an ally of the U.S., while keeping China as a key business partner. In its future projects with either side, Hitachi may have to revise or create new contingency plans, as well as revise its risk management plans and key risk indicators (KRIs) to allow prompt identification and recovery of any potential losses.[85]

Staying at the forefront

"In a sense, Hitachi has become a company with governance which can be the best model for major companies in Japan."

– Akira Kiyota, President of Japan Exchange Group, Inc (JPX)[86]

The slow pace of change in Japanese corporate governance practices highlights the fact that Hitachi is a leader in Japan. In contrast to Japan's traditional corporate governance system of a Kansayaku board, where statutory auditors are nominated by shareholders and are responsible for auditing directors and management regarding performance of their duties,[87] the alternative system of three committees has long been practised outside of Japan. It was only in 2003 that Japan revised its Commercial Code to provide Japanese listed companies the option of adopting a system of three committees under the title of "Companies with Committees".[88] This was to promote greater compatibility and coherence with overseas governance structures.[89] That same year, Hitachi, Toshiba Corporation (Toshiba) and Sony Corporation (Sony) were the few Japanese MNCs that became notable forerunners in adopting this three-committee model.[90]

However, before Hitachi's major financial slump in 2008, outside observers and institutional investors had criticised the company despite the implementation of a three-committee model. As the term "independent" was only first addressed in Tokyo Stock Exchange Listing Rules in 2010, the definition of an "outside director" pursuant to Japan's Companies Act[91] was inadequate in establishing whether a director from a parent company was genuinely independent.[92] Hitachi focused on strengthening management coordination and unifying decision-making over its subsidiaries,[93] but failed to improve monitoring and external oversight,[94] as "78% of the "outside directors" of Hitachi group companies (were actually) from Hitachi Ltd"[95] as of September 2003 - and thus their independence was compromised. Further, when it adopted the three-committee system in 2003, the 13-member board did not consist of any non-Japanese director and only included four outside directors.[96]

Fast forward to 2012, Hitachi had completed an overhaul of its board of directors. Compared to its industry peers at that time, Hitachi was seen to have made evident progress in embracing the true spirit of corporate governance.[97] As of 2012, Hitachi's board had a majority of outside directors including non-Japanese directors.[98]

In comparison, only four of Toshiba's 14-member board were outside directors.[99] Even though Toshiba fulfilled its obligations required of a three-committee system on paper, Toshiba's board in 2012 lacked independent oversight – its composition in terms of outside directors remained largely unchanged from 2003 when its three-committee system was first implemented.[100] The insufficient external oversight, together with Toshiba's large board, outside directors with no financial or accounting expertise, and a profit-driven hierarchical culture, were seen to be major factors that led to its accounting scandal in 2015.[101,102,103]

Another industry peer, Olympus Corporation (Olympus), also had a positive recovery from its scandal in 2011. Unlike Hitachi and Toshiba, Olympus was managed under a Kansayaku board. At the time of its scandal, Olympus' 15-member board was stacked with inside directors, having only two genuinely independent outside directors.[104] However, in 2012, Olympus revamped its board to include a majority of six outside directors out of a total of 11 directors.[105] In June 2019, Olympus also changed to a three-committee system with 12 board members, with nine outside directors, of which eight are independent.[106]

Hitachi also continued restructuring its business through the divestment of non-core businesses and consolidation of business divisions, similar to Sony's recent restructuring efforts. After recording a JPY 457 billion net loss in 2011, Sony's new President, Kazuo Hirai, made similarly bold structural reforms including consolidation of manufacturing sites, sale of its chemical products business in 2012,[107,108] and selling off its personal computer division in 2014.[109] With a new strategic focus on its mobile and high-end television business,[110] Sony eventually recorded a two-decade high operating profit in 2018 after five years of restructuring.[111]

Where is my train?

Despite Hitachi's efforts in improving its corporate governance, the next lapses turned out to be just around the corner. In April 2021, cracks were found during maintenance works of Hitachi's Class 800 trains, which are part of the U.K.'s Great Western Railway (GWR).[112] The cracks were said to be due to metal fatigue[113] and the trains were taken out of service for repair. This fleet had started running in 2017[114] as part of the intercity express programme, for which Hitachi had won the tender in 2011.[115]

However, on 8 May 2021, Hitachi took all of its Class 800 trains out of service as further cracks were found in them. This affected the GWR, London North Eastern Railway (LNER) and other routes, causing massive railway service disruptions.[116] The U.K.'s minister of state for transport, Chris Heaton-Harris, asked Hitachi to come up with a comprehensive plan to "identify the extent of the cracking and outline a long term repair strategy"[117] to ensure that Hitachi's trains can continue running safely.

The CEO of Hitachi Rail, Andrew Barr, apologised for the disruptions and Hitachi Rail maintained its firm stance that safety is its "number one priority".[118] After stringent checks and inspections on the fleet, the train services resumed after clearing safety checks.[119] On 13 May 2021, Hitachi Rail, train operators and the U.K. government agreed to a service recovery plan to safely resume train services.[120]

Time to say goodbye

On 12 May 2021, Nakanishi stepped down from his position as Chairman after serving in the post for seven years due to deteriorating health. Higashihara took over as Chairman while Vice President Keiji Kojima took over as President.[121] Nakanishi is known as "a proponent of aggressive corporate governance reform"[122] and was seen to have successfully transformed Hitachi. His success with Hitachi led to his appointment in 2018 as Chairman of Japan's influential business lobby, Keidanren, where he was seen as the "powerful reformist voice from the top of corporate Japan".[123]

Moving forward

“Other major Japanese companies are now following suit. So, Hitachi’s success is extremely useful for the penetration of corporate governance in Japan.”

– Akira Kiyota, President of JPX[124]

Hitachi’s transformation has helped pave the way for a new corporate governance era for Japan and more Japanese companies can be expected to follow suit. Hitachi’s leadership in corporate governance has been recognised in its Institutional Shareholder Services (ISS) governance quality score, which provides an indication of a company’s governance risk across four categories: audit and risk oversight, board structure, shareholder rights and takeover defences, and compensation.[125] The scores for each category ranges from one to ten, with one indicating a relatively higher quality governance system and lower governance risk and ten being lower governance system quality and higher governance risk.

Hitachi’s scores as of May 2021 were one, one, four and four respectively.[126] While it has done well especially in the first two categories, there is still room for improvement. Corporate Japan and the rest of world will be watching Hitachi with interest to see if will truly achieve corporate governance standards comparable to the best in the world.

Discussion questions

1. Identify the key issues relating to Hitachi’s corporate governance system and business practices highlighted by the 2008 crisis and evaluate the subsequent changes. Did the issues prior to 2008 contribute to Hitachi’s poor performance? Explain.
2. Evaluate Hitachi’s board composition before and after the 2008 crisis. How did the inclusion of outside directors improve Hitachi’s corporate governance? Discuss the motivation behind its enhanced board diversity.
3. In 2010, Hiroaki Nakanishi was appointed Chairman and CEO of Hitachi. Would the separation of the position of CEO and Chairman of the board necessarily mean better governance in a company? Why or why not?
4. Discuss the motivation behind Hitachi’s shift away from seniority-based pay to merit- based pay. Compare and discuss any pay practices adopted by corporations in Singapore today that may similarly have restricted the progress of these corporations.
5. Does adopting a three-committee system guarantee effective governance? What other changes are necessary? Explain.
6. The reforms brought by Hitachi were said to be ground-breaking in Japan but were quite conventional compared to other developed markets. What do you think explains the differences in corporate governance practices between Japanese corporations and those in other developed markets? Suggest other improvements that Hitachi can explore to truly make its corporate governance world class.

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MICRO-MECHANICS: THE LITTLE GIANT IN CORPORATE GOVERNANCE

Case overview

Micro-Mechanics (Holdings) Ltd (Micro-Mechanics) has expanded from a small factory in Singapore into a publicly listed company with a global customer base over the years. Despite being a small cap company, it has continually punched above its weight, outshining much larger companies in its corporate governance. It has won many accolades and is well loved by investors. The company's share price and market capitalisation have grown steadily over the years, as it has consistently delivered strong financial performance in an industry that is cyclical and vulnerable to macroeconomic shocks. It has also paid healthy dividends over the years.

The objective of this case study is to facilitate a discussion of issues such as corporate governance of small cap companies; board composition; business continuity planning and risk management; navigating the COVID-19 pandemic; and shareholder engagement.

A challenging industry

Micro-Mechanics (Holdings) Ltd (Micro-Mechanics) was founded in Singapore in 1983. It is in the business of designing, manufacturing, and marketing high precision parts and tools used in the semiconductor industry.[1]

The onset of the global industry downturn in late 2018 led to the semiconductor industry suffering its worst year in almost two decades, with semiconductor revenue falling 12.1% to US$412.1 billion in 2019.[2] For FY2019, Micro-Mechanics' revenue decreased 7.3% to S$60.3 million from a record of S$65.1 million in FY2018, reflecting the cyclically slower conditions in the global semiconductor industry.[3] According to the Semiconductor Industry Association, global chip sales fell 14.5% in the first half of 2019.[4]

"Amid a confluence of factors, including ongoing global trade unrest and cyclicality in product pricing, worldwide sales of semiconductors were down considerably in 2019."

– John Neuffer, Semiconductor Industry Association President and CEO[5]

This case was prepared by Benedict Liew Weng Chee, Choy Yu Yong, Deepa Syaama Arul, Eunice Lim Yixin, Kaoru Shigeno, Shaun Pua and Yeo Yong Xin Natalie, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. The case was developed from published sources and based on an interview with Mr Chow Kam Wing, executive director and Chief Financial Officer of Micro-Mechanics (Holdings) Ltd 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 organizations named in the case, or any of their directors or employees.

The situation was made worse by trade tensions between the U.S. and China. As one of the six core industries in President Trump's 'America First' agenda, semiconductor companies have been facing a significant risk as electronic products exported from the U.S. to other countries face increased tariffs if those products contain Chinese-made components.[6] As a result, World Semiconductor Trade Statistics (WSTS) expected worldwide chip sales to contract by 12.1% to US$412 billion in 2019[7] amidst growing global economic and geopolitical uncertainties. Given that Micro-Mechanics' largest market is China (29% in FY2020),[8] the increase in prices of U.S. electronic exports would lead to falling demand and thus reduced sales for Micro-Mechanics' products.

Initial projections from WSTS indicated an increase in annual global chip sales of 5.9% in 2020 and 6.3% in 2021.[9] However, things took a turn for the worse. On 9 January 2020, the World Health Organisation (WHO) reported the first outbreak of a novel coronavirus in Wuhan, China.[10] At the end of the same month, it declared the COVID-19 outbreak "a global emergency".[11] A few months later, a global pandemic ensued and countries worldwide went into lockdown, causing a global health and economic crisis that persisted beyond 2020. As a result of the COVID-19 pandemic, research firm Gartner, Inc. forecasted that global semiconductor revenue would decline 0.9% in 2020 after falling 12% in 2019.[12]

Micro-Mechanics' share price fell from S$1.95 on 2 January 2020 to S$1.33 on 23 March 2020 during the market crash arising from the COVID-19 pandemic. However, it has risen steadily since then to hit a 52-week high of S$2.79 on 20 October 2020 and later, a record high of S$3.91 on 22 January 2021.[13] Despite its numerous challenges, Micro-Mechanics defied expectations in FY2020 and achieved exceptional financial results with a 6.4% increase in revenue. The company's recovery was even more impressive considering how it managed to maintain a healthy cash balance with no bank borrowings as at Q3 2020, and increased its dividend payout ratio to 114% in FY2020.[14]

The mechanics behind Micro-Mechanics

Micro-Mechanics designs, manufactures and markets high precision parts and tools used in process-critical applications for the wafer-fabrication and assembly processes of the semiconductor industry. It also makes consumable tools and parts used in the back-end semiconductor process, in particular, die attach and wire bonding, and manufactures precision parts and assemblies on a contract basis for original equipment manufacturers (OEMs). More recently, Micro-Mechanics has also started to build up capabilities to serve the front-end of the semiconductor industry through its U.S. operations. The Group's strategy is to relentlessly pursue product and operational improvements while providing fast and effective local support to its customers worldwide.[15]

Peak performance

From 2012 to 2017, Micro-Mechanics experienced a steady increase in revenue from S$38.79 million to S$57.23 million, representing a compound annual growth rate of 8.1%. Earnings increased at a much higher rate – at a cumulative average growth rate (CAGR) of 28.5% – due to an increase in net profit margin from 10.9% to 25.8%. It also has a high and growing ROE.[16]

"Companies that have no debt can't go bankrupt."

– Peter Lynch, Chairman of the Lynch Foundation[17]

Besides its exceptional growth over the years, Micro-Mechanics has also maintained a strong and healthy balance sheet. With no debt since 2011, the Group has managed to run and expand its business with internal funds alone.[18]

"If our shareholders invested in Micro-Mechanics during IPO in 2003, the total return will be about 19 times. Including dividends, the total return is more than 20 times."

– Chow Kam Wing, CFO of Micro-Mechanics[19]

Micro-Mechanics was first listed on the then SESDAQ of the Singapore Exchange (SGX) in Singapore in June 2003. The company's share price and market capitalisation have increased significantly since then, with the latter increasing year-on-year from about S$100 million in Q3 2007[20] to nearly S$440 million today.[21] Although Micro-Mechanics experienced a slight dip in its market capitalisation in FY2019 and FY2020, it managed to recover and reach greater heights in FY2021. Meanwhile, the company's share price has increased by over ten-fold since its upgrade to the SGX Mainboard in July 2008.[22] The movement in Micro-Mechanics' share price over the years is shown in Figure 1.

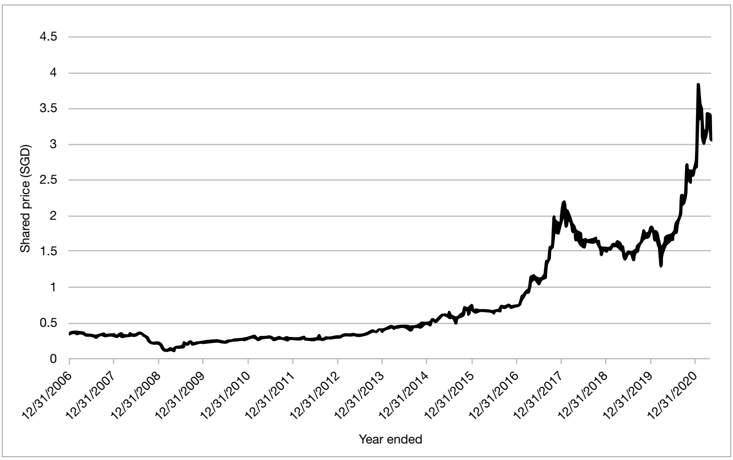

Figure 1: Share price of Micro-Mechanics[23]

Risk management: ahead of the curve

In 2003, the SARS outbreak led to a pandemic, resulting in Asian countries suffering an estimated loss of about US$12 to US$18 billion.[24] While the outbreak did not cause Micro-Mechanics to suffer major losses, it served as a wake-up call regarding the importance of Business Continuity Planning (BCP) and the need to implement appropriate measures to prepare the company for future crises. This move proved beneficial in the face of the COVID-19 pandemic – Micro-Mechanics was able to minimise the damaging impact arising from the pandemic through reducing interruptions in its business operations.

"Amid the unprecedented market and operating conditions caused by the COVID-19 outbreak, the Group still performed admirably well in 3Q20."

– Christopher Borch, CEO of Micro-Mechanics[25]

Micro-Mechanics had established a Pandemic Response Plan (PRP) as part of its BCP in 2018,[26] just two years before COVID-19 pandemic. The PRP was put in place to ensure that the company's businesses are able to remain viable in the event of a pandemic outbreak, whether on a regional or global scale. As part of the PRP, annual training was implemented to equip employees with a comprehensive understanding of individual roles and duties in the event of a disaster, pulling cases from past pandemics such as SARS and MERS.[27]

At the start of the COVID-19 pandemic, corporations across the globe experienced severe disruption to their production levels, especially for companies with major production facilities in China. This created major problems in the supply chain as governments across the world imposed strict restrictions for business and individuals, such as social distancing, and factories had to be shut down to curb the spread of the virus.[28,29] However, Micro-Mechanics was able to restore operations relatively quickly.

Business as usual

In January 2020, news of an unknown virus outbreak in Wuhan, China broke. Micro-Mechanics took immediate action to prepare itself for an imminent pandemic crisis. With staff trained in BCP and PRP, it was able to effectively take precautionary measures and implement stringent protocols such as halting of business travel and minimisation of visitors. Micro-Mechanics also conducted briefings to its employees on the precautionary measures relating to COVID-19, and had internal checks to ensure the availability of clinical masks and sanitisers in its facilities.[30]

On 29 January 2020, Micro-Mechanics temporarily closed its factory in Suzhou, China, which primarily served its customers in China.[31,32] As the highly infectious virus continued to spread across the world, factories in countries such as Malaysia and the U.S. also experienced disruption in their operations.[33] An increasing number of countries began to impose lockdowns and restrictions as corporations scrambled for alternative production solutions.

On 18 March 2020, Malaysia implemented a two-week movement control order nationwide, which included an immediate shutdown of all non-essential business premises. This impacted

Micro-Mechanics as one of its factories was in Penang, primarily serving local customers which accounted for 16% of its total revenue.[34] Similarly, in the U.S., with effect from 17 March 2020, California announced a legal order for residents to limit activities solely to those which are essential. Micro-Mechanics' factory in Morgan Hill, Santa Clara which primarily catered to American customers and which contributed to around 20% of the Group's revenue, was also affected.[35]

As its factories fell under exemption orders, the majority of Micro-Mechanics' factories were permitted to perform basic operations, although at significantly reduced levels. With the strong BCP and PRP in place, Micro-Mechanics was able to implement plans to ensure the smooth running of operations with reduced personnel to maintain its essential operations. A diversified supply chain and multiple factories also reduced the impact of the strict COVID-19 measures implemented by various countries' governments. Thus, the company made an announcement to reassure stakeholders that reduced operations in Penang and the U.S. were "not expected to affect its customers in other markets as they will continue to be served by the Group's factories in Singapore, the Philippines and China which is now fully operational".[36]

The company's commitment to BCP and certification also resulted in robust measures being put in place to protect workers in such a pandemic. Such efforts paid off as Micro-Mechanics was one of the first companies to be allowed to re-open its manufacturing operations in China after the lockdown in China in 2020.

Throughout the COVID-19 pandemic, Micro-Mechanics continued to be accountable to its shareholders by closely monitoring the situation and keeping shareholders informed of any material developments as and when they arose.[37]

Earlier in 2008, Micro-Mechanics had also recognised the need for BCP in areas apart from pandemic crises that could also impact business activities. The company invested S$3 million to implement Enterprise Resource Planning (ERP), which is a web-based platform where employees are able to access company information and input data. The system allows for operational processes, such as quotations and goods finished, to be recorded. Micro-Mechanics then phased out the use of desktops and equipped its employees with laptops to allow a seamless transition to work from home arrangements. Had this not been carried out, the company would have suffered greatly in a crisis situation such as the COVID-19 pandemic where employees were not allowed to physically be in office to work. With the use of the ERP system, employees were able to continue working – whether from Singapore or elsewhere – with minimal interruption, and continue serving customers.[38]

Striking the balance

"The essence of BCP is to have a backup for all essential operations of the company. However, from a business point of view, it is not practical to have everything with a backup because of the costs involved."

– *Chow Kam Wing, CFO of Micro-Mechanics*[39]

While Micro-Mechanics' BCP plan has served it well during the pandemic crisis, could it have done any better? From a business perspective, BCP is about having backup plans. However, Chow Kam Wing, Chief Financial Officer (CFO) of Micro-Mechanics, highlighted that it is not feasible for the company to have backups for every essential operation due to the extensive additional costs that will be incurred.

When Micro-Mechanics hired a BCP consultant, it was recommended to build a back-up factory in case the main factory breaks down or has to be closed permanently. This was not a feasible recommendation based on a cost and benefit analysis, and the company rejected it. To Micro-Mechanics, it was about treading the fine line between ensuring a proper BCP and ensuring that additional costs associated with implementing plans are justified.

Micro-Mechanics issued its first sustainability report in its 2018 annual report, which focused on its Singapore operations.[40] Subsequently, in the following year, the report was expanded to include its subsidiaries across the U.S., China, Malaysia, and Philippines. The report discloses various procedures used by the company to ensure sustainability, with a section on standards, certificates and management plans. The report also outlines detailed policies and initiatives to ensure the sustainability and continuance of business operations.[41]

Not just a pandemic

In 2012, Micro-Mechanics' Singapore operations attained its first certification as an ISO22301 Business Continuity Management Company. This was then subsequently renewed in 2019 to ensure that all its employees were aware of the company's Emergency Response Plan. Aside from its ISO22301 certification, annual training is carried out for all staff to check their readiness for such events. The company is fully committed to make BCP and crisis management an integral part of its business to minimise any potential negative impacts on its customers, maintain the public's confidence in it, as well as protect the interests of all its stakeholders. Micro-Mechanics also places emphasis on its capability to maintain or restore its critical business functions within 48 hours based on their BCM plans in the event of a crisis.[42]

The company's commitments made as part of the ISO certification requirements also extended to ensuring that customers received adequate support with regard to the stringent quality control of its products. As the tools produced by Micro-Mechanics often play an important role in its customers' own business operations, any defects or contamination of products will negatively impact other businesses.

Furthermore, Micro-Mechanics ensures that its products are compliant with international environmental standards such as the Restriction of Hazardous Substances (RoHS), and Registration, Evaluation, Authorisation and Restriction of Chemical Substances (REACH).[43]

As of 2020, Micro-Mechanics Singapore was the only BCM-certified company in the wider Group, as some of the locations of the subsidiaries did not have the ISO certification. In order to ensure the same standards across all companies in the Group, Micro-Mechanics

Singapore shared its templates with its subsidiaries. The ISO certification generally "specifies requirements to implement, maintain and improve a management system to protect against, reduce the likelihood of the occurrence of, prepare for, respond to and recover from disruptions when they arise".[44] Hence, such sharing of documentation and checklists will provide structure and standardisation in the Group. Micro-Mechanics acknowledged that is not always applicable due to the varying sizes and industries of companies in the Group. As such, it is only implemented for companies that are similar to Micro-Mechanics Singapore in terms of business and situations.[45]

One size does not fit all

With regard to BCP, one significant difficulty which Micro-Mechanics encountered was having to account for its factories in various parts of the world. As it has five factories in Asia and the U.S., each location posed different risks, geo-political issues, and cultural gaps. Instead of formulating specialised plans for each factory, Micro-Mechanics made the decision to manufacture similar products, standardise machinery, and put in place standard operating procedures for its operations. This proved beneficial in April 2020, when its factory in the Philippines was under curfew and lockdown due to the COVID-19 pandemic. Micro-Mechanics was then able to shift manufacturing operations to Singapore and purchase its supplies to minimise disruption to its customers in the Philippines.[46] The lack of differentiation in its factories and the presence of backups among the Asian companies in the Group was one notable way in which Micro-Mechanics implemented its BCP.

However, this backup could not be applied to the fifth factory located in California, U.S. as the factory's products are completely different from those produced by the Asian factories. The situation was also exacerbated by the factory's location in an earthquake-prone area. Due to these factors, Micro-Mechanics does not have an extensive backup plan in place for this particular factory. It instead notifies investors and stakeholders of this potential risk in its annual reports, ensuring transparency and keeping them well informed.[47]

However, it has been noted that not every requirement of the ISO certification should be followed to the letter. Micro-Mechanics has diverged from the requirements of the ISO certification of BCP by running its business digitally. While this is not mandatory according to the requirements, "without digitalizing the operations, we may not turn around the business so quickly during COVID-19 pandemic and support our people working from home seamlessly."[48]

Continuous learning

"BCP is a kind of continuous improvement and forward-looking process…It is all about the management who must have vision with proactive action. It is not about the system itself. It is about people."

– Chow Kam Wing, CFO of Micro-Mechanics[49]

To Micro-Mechanics, BCP is a forward-looking process of continuous improvement. It involves learning from past experiences, such as the SARS outbreak in 2003. The extensive planning by Micro-Mechanics' management, as well as the implementation and installation of said plans as an integral part of its business operations is evident in its handling of the current COVID-19 situation. Micro-Mechanics has attributed this success to the proactive actions taken by its management in response to the crisis instead of the certification of the BCP.[50]

The keys to success

While key-person risk is a concern for all companies, it is especially critical for companies for which shareholder value relies heavily in the trust that investors have in its management. According to research by investment research firm Ycharts Inc., it is observed that share prices of companies fall an average of 4.19% relative to the S&P 500 after 30 days following the departure of a Chief Executive Officer (CEO).[51] It is therefore critical that companies have robust succession plans to mitigate such risks.

Micro-Mechanics recognises that the departure of key personnel is an unavoidable risk and hence takes active measures to prepare for such an event. According to Micro-Mechanics' CFO Chow, the board discusses and reviews succession plans for the board and key management annually.[52] Micro-Mechanics does not focus on identifying specific personnel to take on certain positions in the future, but instead has a robust system in place to groom all potential leaders. The company believes that this will ensure that it has employees who are trained and ready to step up and take on management positions if needed. Additionally, each key management personnel is supported by a core team. This means that when a key personnel leaves the company, the successor will have several deputies and a team who are familiar with the role, allowing for a smoother transition. Since the company's Initial Public Offering (IPO), it has managed the departure of several facility heads with little disruption to the Group's operations.[53]

In addition, from 2019 onwards, the CEO, CFO, and Chief Operating Officer (COO) – who are also executive directors – have agreed to serve as mentors for one year following the cessation of their respective executive roles. Micro-Mechanics' annual report explains that this ensures a seamless handover of the directors' duties and responsibilities to successors and allows Micro-Mechanics to continue tapping on their wealth of knowledge and experience in managing the company.[54]

As for independent directors, successors are sourced externally to ensure true independence. Micro-Mechanics has stated that any person identified for future succession as an independent director must be a person whom management is familiar with, which may be considered by some to contradict the requirement of independence. Upon retirement of an independent director, the company will look for a replacement through third parties such as the Singapore Institute of Directors, or the Institute of Singapore Chartered Accountants for Audit Committee members. The management of Micro-Mechanics believes that unlike key management personnel, independent directors are not as critical to business operations, and hence they do not warrant specialised succession plans.[55]

Transparency is paramount

"Although it (quarterly reporting) entails more work, we think it is the right decision especially after the fast-moving events that we witnessed recently."

– *Chow Kam Wing, CFO of Micro-Mechanics*[56]

Micro-Mechanics values its transparency to shareholders, striving for the highest level of communication with them. While the CFO has said that Micro-Mechanics does not specifically strive to maintain a high level of corporate governance, the company's belief in doing the right thing and putting itself in its shareholders' shoes is what allows it to achieve such a high level of transparency as a company.[57]

In January 2020, SGX Regco announced that it would require quarterly reporting only for companies associated with higher risks.[58] Other companies will only have do semi-annual reporting. This was a significant change from the previous requirement, under which companies with market capitalisation of over S$75 million were required to issue quarterly reports, with 70% of SGX-listed companies meeting the quarterly reporting threshold. Under this new rule, which started from 7 February 2020, just over 100 companies were required to continue with quarterly reporting.[59]

This is a potential problem for investors. Based on a survey quoted by Professor Mak Yuen Teen and Chew Yi Hong, over 88% of investors surveyed indicated the use of quarterly reporting in some form for their investment decisions.[60]

Micro-Mechanics' board unanimously decided to continue with quarterly reporting, despite the time and costs involved. The company's CFO said the company believes that it is important to provide timely and clear performance metrics to enhance accountability to stakeholders. Micro-Mechanics believes that prioritising transparency and reporting to shareholders outweigh the time and costs involved. This will allow stakeholders to make the best possible investment decisions. While there is still some cost involved, it mainly consists of management's time and the costs of having the CEO fly in for board meetings to discuss quarterly results.[61]

CFO Chow does not hold the view that quarterly reporting will create "shortermism", and states that Micro-Mechanics thinks of long term sustainable profit instead. He also feels that quarterly reporting reduces insider trading risk and that small companies with not as much coverage by analysts will benefit from quarterly reporting. Further, full quarterly reports provide the Micro-Mechanics board with information beyond monthly management accounts, and the company has found board meetings to discuss the quarterly reports to be helpful.[62]

While some other companies look to save costs in discontinuing quarterly reporting, Micro-Mechanics has identified the importance of quarterly reporting in continuing its culture of transparency and putting its investors at the forefront.[63]

The company's transparency is also evident in other ways. Since its listing on the then SESDAQ on SGX in June 2003 and its subsequent transfer to the SGX Mainboard in July 2008, Micro-Mechanics has been queried only once, consistent with its desire to communicate well with shareholders and to remain transparent. The SGX query was issued on 23 October 2014 with regard to a deviation from paragraph 9.3 of the Code of Corporate Governance 2012, where Micro-Mechanics failed to disclose the total aggregate remuneration paid to the top five key management personnel (who are not directors or the CEO), as recommended by the Code.[64]

The company responded promptly the next day and clarified that it had complied with most of the disclosures in paragraph 9.3 of the Code regarding individual remuneration disclosures, but inadvertently overlooked disclosing the aggregate total remuneration. It also promised to make this disclosure in future and ensure compliance with the Code in all respects.[65]

Engaging with investors

Micro-Mechanics has an "open-door" policy with regard to questions raised by investors or analysts, and commits to responding to questions within three working days. It provides an email address and contact details of its investor relations consultants for investors to contact the company.[66]

Its Annual General Meetings (AGMs) have been highly engaging and interactive in recent years. A large part of time in the agenda is allocated to shareholders who have questions about the company's operations or finances.

In 2020, pursuant to the COVID-19 measures, Micro-Mechanics held an online AGM.[67] It posted the responses to shareholders' questions the day before the AGM[68] and the minutes of the AGM 17 days after the AGM.[69]

"It is our practice to provide opportunity for shareholders to ask questions on the spot with the most updated financial information. We hold IR briefing for financial analysts and media for our half year and full year result. We think that the AGM is the right time for us to hold IR briefing for our shareholders."

– Chow Kam Wing, CFO of Micro-Mechanics[70]

Unlike most companies which only discuss the annual results even though Q1 results would be announced soon after the AGM (when they were practising quarterly reporting), Micro-Mechanics has been disclosing its Q1 results at the yearly AGMs since its IPO. Investors were not only briefed on the previous financial year performance but were able to also know the current quarter performance, allowing them to obtain a clear outlook for the rest of FY2021.[71] This is yet another indication of the company's belief of keeping investors informed in a timely manner, rather than merely blindly following rules.

You can almost see through them

Another key feature of transparency ingrained in Micro Mechanic's corporate culture is the frequent and prompt disclosure of major changes in business operations. When the COVID-19 pandemic affected its manufacturing operations in 2020, Micro-Mechanics was quick to announce the impact of the pandemic on its manufacturing facilities across the world. This included the temporary closure of its Suzhou factory announced in January 2020,[72] as well as the reduced level of operations in its factories in Malaysia and the U.S. in March.[73] The timely announcements provided shareholders with information on how the company was coping with the situation and gave shareholders the assurance that business is still ongoing.

Micro-Mechanics also has clear disclosures with regard to its interested person transactions. When Micro-Mechanics entered into an agreement with Sarcadia LLC (Sarcadia) in 2018, it made sure to disclose the transaction as an interested person transaction as Sarcadia was a family trust set up by Micro-Mechanics' CEO, Christopher Reid Borch.[74] This provided full transparency for shareholders in terms of knowing the controlling person behind the party whom the company was dealing with.

The level of transparency and quality of corporate governance of Micro-Mechanics has been recognised through the multiple awards it has received over many years. Since the company received the "Most Transparent Company (SESDAQ)" award in 2005 by the Securities Investors Association Singapore (SIAS), Micro-Mechanics has received more than 30 awards from SIAS, the Singapore Corporate Awards, and the Asiamoney Corporate Governance Poll.[75]

Notable awards include the Best Managed Board Gold Award in 2012 and 2017 as well as the Best Investor Relations Gold in 2017. In the 2020 Singapore Governance and Transparency Index (SGTI), Micro-Mechanics climbed four ranks from 2019 to rank 13th out of 578 listed companies (excluding REITs). The company's CEO has also received due recognition – CEO Borch was awarded the Best CEO Award in 2018, while CFO Chow was awarded the Best CFO Award in 2008.[76]

In terms of performance, Micro-Mechanics has also received two awards for its productivity granted by the Singapore Business Federation in 2017 and Singapore Precision Engineering and Technology Association in 2018.[77]

The "software" of Micro-Mechanics

Bearing in mind the need for an optimal board size in view of its current stage of growth, the need for effective decision making, and its strategic imperatives, Micro-Mechanics has a current board size of six members as at FY2020.[78] The board is led by a female Chairman, Sumitri Mirnalini Menon @ Rabia, who is an independent non-executive director. The other members of the Micro-Mechanics board comprise three executive directors – Borch (founder and CEO), Chow (CFO and company secretary), and Low Ming Wah (President and COO) – as well as two other independent directors, namely Lai Chin Yee and Kenny Kwan. None of the board members are related to one another.[79]

"The composition of the board is diverse and our board members are of different genders and nationalities and possessing different skill sets and experience. We are satisfied with the composition and size of the board."

– *Chow Kam Wing, CFO of Micro-Mechanics*[80]

The company has a board diversity policy approved by the board on 28 August 2019, focusing on key areas of board diversity which are independence, gender, nationality and ethnicity, skills and experience, as well as age.[81]

The company has a history of having a larger proportion of women's participation on boards compared to the 100 largest primary-listed companies on the SGX, with one-third of the board comprising female directors from FY2015 to FY2018 and in FY2020, as well as 28.6% of the board comprising female directors in FY2019. This surpassed the 16.2% average percentage of female directors based on statistics provided by the Council for Board Diversity as at 31 December 2019.[82] Two independent directors, Chairman Menon and Kwan, are senior practising lawyers with different sets of core expertise. Lai, an independent director, is a finance director of a listed company. With regard to the executive directors, CFO Chow has audit and accounting expertise, while CEO Borch and COO Low have decades of experience in engineering.[83]

From FY2003 to FY2020, Micro-Mechanics has had eight independent directors in total. Five have retired or otherwise ceased service while three are serving as of FY2020. The independent directors who have left were Chan Fong Chee Caroline, (who was sadly one of the victims during the tsunami in Thailand in 2006), Pao Ning Yu who served four months, Howard Duane Wadsworth who served three years, Ng Beng Tiong who served 11 years, and Girija Prasad Pande who served 10 years on the board. The independent directors who served short tenures did not raise any concerns when they resigned or retired after short tenures. For example, in the case of Pao, it was stated that his resignation was "due to personal reasons that arose recently and are unrelated to any board, committee or company matters".[84] In Micro-Mechanics' 2019 annual report, it was stated that Pande had served on the board for nine years and "decided to not stand for re-election in observance of the nine-year rule on independent directors as part of board renewal".[85]

Kwan, Lai, and Menon – the independent directors who are currently on board – have served for one year, six years and 17 years respectively.[86] The company's 2020 annual report stated that Menon "shall be serving as independent director for the seventeenth year". The reason for the exception is that she is deemed by the rest of the board to remain objective in discharging her duties as an independent director. The board is "confident that she has the ability to continue exercising strong independent judgement" and "have requested that she continue for the ensuing year". She was excluded in the decision making of the board regarding her continuation of service.[87]

According to CFO Chow, the Chairman may need to stay for a longer period of time on the board to ensure a balance of power and checks and balance as the longer tenure equips the Chairman with more knowledge and stature. However, he agrees that other independent directors should not stay beyond nine years. For the Chairman, he is of the view that a two-tier vote is an acceptable way to allow the Chairman to stay on and remain independent.[88]

The adequacy of the structure, size and composition of the board is periodically reviewed by the Nominating Committee (NC). The NC provides recommendations to the board for all board appointments and re-appointments. Every member of the NC abstains from discussing and voting on any matters in which he or she is interested. The NC reviews board performance and compiles a consolidated report based on evaluation forms completed by the board members and submitted to the NC. It implemented a recommendation that all directors are encouraged to have at least eight hours of training and development each financial year to better discharge their duties as directors.[89]

In addition, the NC reviews directors' conflicts of interest to ensure that the directors do not hold other positions with conflicting interests in Micro-Mechanics. Each director is restricted to at most four directorships in listed companies, including Micro-Mechanics.[90]

Departures from "best practices"

Micro-Mechanics does not strive to comply with all recommended "best practices" as it feels that some of these practices may not be relevant to the company. One of the departures from "best practices" is having the CFO as a member of the board.

"Without the CFO on the board, there might be some decisions made without his knowledge which may not be justifiable from the CFO's perspective,"

– *Chow Kam Wing, CFO of Micro-Mechanics*[91]

One of the members of the board of Micro-Mechanics is the CFO. CFO Chow joined the company in 1996 and was cited as having played a key role in the company's IPO on SGX back in 2003. He was recognised as the "Chief Financial Officer of the Year" at the Singapore Corporate Awards in 2008. Chow has served on the Micro-Mechanics board since 2003.[92]

The company believes that having Chow on the board adds great value to decision making by the board. He is considered to have a solid understanding of the Code of Corporate Governance as well as the SGX Listing Manual.[93]

Prior to being appointed as a board member, Chow acted as a check for the board's decisions when he was called upon to analyse whether certain strategic decisions were justifiable from the perspective of the CFO – based on his knowledge of the financial figures of the company, as well as his understanding of internal control, risk management and IT governance. The board came to the view that having the CFO merely as a subordinate of the CEO was insufficient and that it was important that the CFO has equal authority on the board to provide a substantial check and balance in the decisions they were making.[94]

The practice of Micro-Mechanics in this regard is different from most other companies. In an article published by The Business Times, "Should CFOs have a seat on the board?", it was stated that in 2012, less than one percent of companies listed on SGX have their CFOs sitting on the board.[95] For Fortune 500 companies, The Wall Street Journal reported that only 19 have their CFO as a board members in 2012.[96]

These reports explained the tangible benefits of having the CFO on the board such as having a board member who has the accountability of producing the financial statements that the board approves, a stronger fiscal oversight of the company, and having another individual in the decision making process who probably has the next best understanding of the company – only second to the CEO. At the same time, they also highlighted an independence issue, which arises from having an additional executive director on the board, and stated that if a board is ever in a situation where it requires sound financial analysis, the CFO could simply be called up for advice instead of allowing him to be part of the board.[97]

Chow explained one of the reasons why the CFO should be on the board in a company such as Micro-Mechanics: "For those large cap or blue chips, they may not need a CFO on the board because they may have a strong professional team to back the board such as in-house counsels. For those small cap companies, due to limited resources and many of the executive directors (especially those from family business) with less knowledge running a listed company, they may need a qualified and experienced CFO on the board." He added: "Our CEO invited me to join the board to indicate his intention to have good corporate governance – as a check and balance. He believes that the CFO should have an independent say on the board, rather than just be an assistant to CEO, especially in terms of risk management. My personal opinion is that if I were not on the board, I may not openly and independently express my views during board meetings."[98]

Chow added that he is also the company secretary. Because of this position, he has the opportunity to work with the board and committee chairmen directly on agendas and board/ committee papers. This helps the board/ committee chairmen understand more about the business and be well prepared before the meetings.[99]

Remuneration practices

Micro-Mechanics adopted a remuneration structure which is made up of a fixed basic salary and variable components comprising a performance bonus incentive (PBI) scheme, special bonus, sales incentive scheme (SIS) and the performance share plan. The PBI is applicable for all employees and is linked to performance of the relevant subsidiary. For executive directors, the PBI is linked to the performance of the Group. However, the SIS is only relevant to the sales and marketing teams structured on predefined targets.[100]

An overriding principle strictly followed by Micro-Mechanics is that no director is to be involved in deciding his or her own remuneration. The Remuneration Committee (RC) reviews the remuneration packages of executive directors and key management personnel on a yearly basis and assesses if they are in line with the directors' performance. Total remuneration comprises a fixed base salary and variable bonuses to align performance with the company's objectives.

With regard to full disclosure of the specific remuneration of each executive director, Micro-Mechanics took the stand that it is not in the best interests of the company and shareholders due to the sensitivity of the matter. However, it provides the breakdown of the level and mix of remuneration of each director and key executive. For the executive directors, the upper and lower remuneration band, together with the name of the executive director, are disclosed, in addition to a breakdown into the directors' fees, salaries, bonuses and benefits. For the independent and non-executive directors, total remuneration is entirely in the form of a director's fee and is disclosed on an individual basis. The aggregate remuneration paid to the key management personnel is also disclosed. In addition, Micro-Mechanics also made known the remuneration paid to the eldest son of the CEO, who is an employee of one of Micro-Mechanics' subsidiaries.[101]

Does good governance pay?

"Literally, we do not strive to maintain a high level of corporate governance. We are just humbly doing the right things as a listed company, whether today or the next 10 years. We just put ourselves in the shareholders' shoes – what they want from a company they have invested in..."

– Chow Kam Wing, CFO of Micro-Mechanics[102]

As at 12 August 2020, Singapore's recession deepened with the worst ever quarterly contraction of 13.2%. Chan Chun Sing, Singapore's Minister for Trade and Industry, said: "... we are not returning to a pre-COVID world, recovery will be some time yet and recovery is not likely to be smooth".[103] In addition, McKinsey & Company's research on the semiconductor industry concluded that the industry is expected to experience a negative year-on-year revenue growth.[104] Micro-Mechanics' share price performance tells a whole different story amidst the COVID-19 pandemic, with strong growth since March 2020.[105]

While it is possible to retrospectively link a company's failure to poor governance or risk management, it is more difficult to link strong corporate governance with better performance.[106] Although the importance of corporate governance has been recognised by many and has become a key focus area for numerous companies, recent studies have been inconclusive.[107]

In the case of Micro-Mechanics, good corporate governance and transparency seem to be very much part of the company's DNA – not a conscious drive to tick boxes in corporate governance or comply with "best practices", but just doing the right thing and setting its shareholders as top priority. This has helped the company not only garner many accolades and maintain excellent relationships with its shareholders and other stakeholders, but also enable it to deliver consistent financial and share price performance.

It is truly a little giant when it comes to corporate governance.

Discussion questions

1. Critically evaluate Micro-Mechanics' corporate governance and transparency since its IPO as a small-cap company. Do you believe that its corporate governance has contributed to its financial and stock market performance? Explain.
2. Do you think it is more difficult for a small-cap company, as compared to a large-cap company, to maintain a high level of corporate governance? Should the Code of Corporate Governance differentiate between small and large companies? Explain. What are some areas where it may be justifiable for smaller companies to deviate from "best practices" of large companies?
3. Do you think all companies should be required to practise quarterly reporting? Alternatively, should it be voluntary, based on a risk-based approach as is currently practised on the SGX, or based on company size? Explain.
4. Analyse the composition of the board of directors. What does it reveal about the level of corporate governance in Micro-Mechanics?
5. Should the CFO be a member of the board of directors? In Micro-Mechanics' case, do you think it is justified for the CFO and COO to be board members? Explain. How can a company balance having more executive directors with ensuring that the board exercise independent oversight over management and operations?
6. Evaluate the adequacy of Micro-Mechanics' succession planning. How effectively has the company mitigated its key-person risk?
7. Discuss and evaluate how Micro-Mechanics has prepared for and handled the impacts arising from the COVID-19 pandemic and the extent to which its Business Continuity Planning, Pandemic Response Plan, Enterprise Resource Planning, and digitalisation have contributed to its effectiveness in doing so. Do you think Micro-Mechanics has done enough to deal with threats it may encounter in the future? Explain.

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BLACK GOLD GOVERNANCE: THE NORWEGIAN OIL FUND

Case overview

It all started in 1969 – on the day before Christmas Eve – in Norway, when one of the world's largest oilfields, Ekofisk, was found. The wealth from the oil was enormous and Norway's economy grew exponentially. It was then decided that prudent management of the oil revenue was needed to avoid economic imbalance. To support this, legislation was passed by the Norwegian government in 1990 through the creation of the Government Pension Fund Global (GPFG), more commonly known as the Norwegian Oil Fund. This allows the Norwegian government to transfer capital from petroleum revenue to the fund and support the long-term management of the revenue. Through the fund, the government has the flexibility to adjust its fiscal policy when oil prices drop or during economic downturns, helping the country's ageing population to manage its financial challenges. As it is only a matter of time before the oil runs out, the fund was designed to allow it to be drawn only when required, ensuring long-term sustainability to safeguard the future of the Norwegian economy. As of October 2019, the fund was valued at more than US$1 trillion.

The objective of this case study is to facilitate a discussion of issues such as corporate governance of a sovereign wealth fund; accountability of a sovereign wealth fund to the government and other stakeholders; board selection and composition; disclosures; investor stewardship and engagement; and Environmental, Social and Corporate Governance (ESG) investing.

The gold standard

History provides many examples of "problematic" sovereign wealth funds (SWF), such as those of Nigeria[1] or Venezuela. Often, they are fraught with poor governance and become vessels for corruption. There have not been many examples of successful sovereign wealth funds. The Government Pension Fund Global (GPFG) of Norway is often cited as an exception and it is one of the few SWFs that is fully compliant with the Santiago Principles.[2,3]

The Santiago Principles encompass 24 Generally Accepted Principles and Practices (GAPP) setting out best practices for the operation of SWFs. It was developed in response to the rising concerns of investors and regulators about inadequate transparency, independence and governance.[4,5]

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Governance structure

The GPFG has a multi-tiered governance structure with a clear delegation of duties and effective systems for control and supervision as shown in Figure 1.

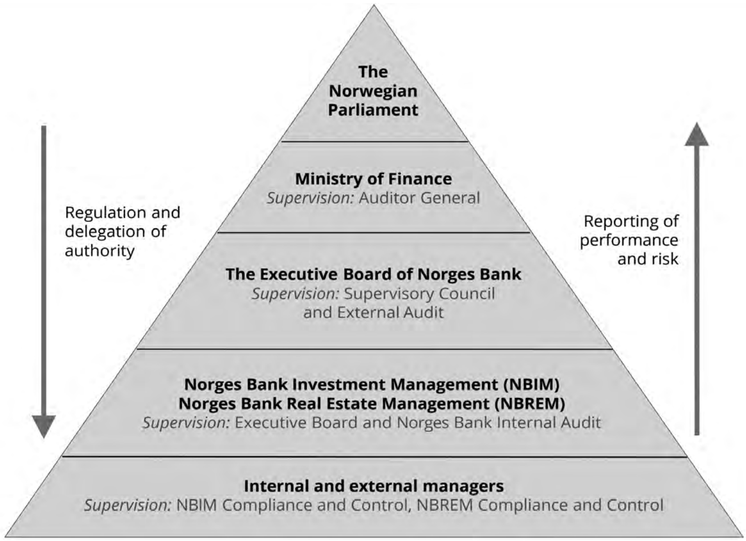

Figure 1: Governance structure of GPFG[6]

The governance structure of the GPFG includes the Norwegian government and relevant governing bodies of the funds in the decision-making process, with regard to cash flows in and out of the funds and any investment made.

The fund is owned by the Storting, the Norwegian Parliament, on behalf of Norwegian citizens. Since its establishment in 1996, the Norwegian Ministry of Finance has been tasked with the formal responsibility of the management of GPFG. In turn, the Ministry has delegated responsibility for operational aspects of GPFG to Norges Bank – the central bank of Norway – through the latter's investment arm Norges Bank Investment Management (NBIM), a wholly owned subsidiary of Norges Bank. The Ministry and NBIM have a written agreement for shared responsibility to manage GPFG.[7]

The current governance model of GPFG is based on a clear delegation of roles and responsibilities from one level to another involving the Storting, Ministry of Finance, Norges Bank's executive board and NBIM. The nature of the responsibilities can be viewed as two separate parts.

The first part involves the formulation of the general policy. Currently, the legislative basis is determined by the Storting in the Government Pension Fund Act while the Ministry of Finance is responsible for drafting the management mandate that is then issued to Norges Bank.[8] This detailed and prescriptive mandate serves as an important tool in ensuring that management of funds is in line with its objectives, by setting out the general investment framework for the fund and stipulating requirements with regard to risk management, along with institutional management principles. Some guidelines in this management mandate include the Principles for Responsible Investment Management in Norges Bank[9] and the Principles for Risk Management in NBIM.[10]

The second part relates to the operational management of the GPFG which NBIM is put in charge of. At the NBIM, the management is again divided into four main sections of the executive board, committees, CEO, compliance and senior managers' leadership group. Together with the Ministry of Finance, the executive board sets guidelines for investment thresholds for GPFG regarding the size and risk of investment deals in the mandate.[11] The general investment strategy is therefore largely determined by the mandate as it sets out the benchmark index and tracking error limits as well as impose constraints on the fund's investment.[12] Thus, while managers of NBIM are independent from the Ministry of Finance in pursuing opportunities and making investment decisions independently of the Ministry, it has limited room for determining the overriding investment strategy due to the need to adhere to the investment mandate in comparison with other large public investment funds.

As can be seen, the governance model and principles the fund has built itself upon are such that duties and authorisations are delegated downwards in the system, while reporting on performance and risk are made upwards. Important changes have to be submitted to the Storting for approval. Additionally, at all management levels of the fund, sound controls and supervisory bodies are put in place.[13]

The world's most transparent SWF?

While the Santiago Principles encompass a total of 24 different criteria, two important overarching principles relate to transparency and accountability in managing SWFs. For such funds like GPFG, this becomes especially vital to instill trust and confidence in the investment management by the relevant bodies. Generally, common reasons for inefficiency in funds relate to the lack of clear rules and operations. Funds should instead be transparent, supported by rigorous mechanisms put in place to ensure accountability and prevent resource misuse.[14]

Due to its extensive reporting, the GPFG has a reputation of being one of the world's most transparent SWFs, with few able to match it in terms of public disclosure of assets, returns, and performance.[15] This is because the GPFG is operated under far more rigorous reporting requirements based on the mandate from the Ministry of Finance and investment criteria, compared to those in other countries.

Norges Bank provides regular and timely reports of all investment activity as well as clear communication of the role of the funds to the public. This includes comprehensive annual reports detailing the management of the fund. These public reports explain how the GPFG is managed and includes a list of companies the fund invests in. Information on the investment view and the selection process for the external managers is publicly available as well. Quarterly reports concerning main revenue and cost data are also published.[16]

The Ministry of Finance presents a separate annual white paper about the management of the GPFG which includes the annual report by Norges Bank to the Storting. These reports, which pertain to general issues regarding the management of the fund capital or the proportion of oil revenue to be spent for the following year, are also made public. In addition, the Office of the Auditor General of Norway monitors the Ministry's exercise of authority in relation to Norges Bank and audits the GPFG line item in the government accounts. The findings are then reported directly to the Storting.[17,18]

On behalf of the executive board, the internal audit unit ensures that adequate and effective risk management as well as appropriate and satisfactory internal controls are in place. It also issues independent statements and provides advice regarding improvements in the risk management and control systems. The internal supervisory function within the asset management unit is carried out by the NBIM and NBREM (Norges Bank Real Estate Management) compliance and control unit. These units have the authority to report independently to the executive board when necessary.[19]

The overall image of the GPFG is thus characterised by a high degree of transparency and accountability.[20]

Who's on the board?

The executive board of Norges Bank is made up of a Governor, two Deputy Governors and six external board members. There are also two board members appointed by and from among the employees to participate in the deliberation of administrative matters.[21]

Name	Position	Educational background
Øystein Olsen	Governor of Norges Bank & Chair of the executive board	Economics
Jon Nicolaisen (resigned on 4 December 2020)[22]	Deputy Governor of Norges Bank & Deputy Chair of the executive board	Economics
Ida Wolden Bache	Deputy Governor of Norges Bank & Deputy Chair of the executive board	Economics

Karen Helene Ulltveit-Moe	Board member	Economics
Kristine Ryssdal	Board member	Law
Arne Hyttnes	Board member	Economics and business administration
Hans Aasnæs	Board member	Economics
Benedicte Schilbred Fasmer	Board member	Finance
Nina Udnes Tronstad	Board member	Chemical Engineering
Mona Helen Sørensen	Employee representative	Economics and administration, and management
Kjersti-Gro Lindquist	Employee representative	Economics

Figure 2: The executive board of Norges Bank in FY2020[23]

With great power comes great responsibility

"Responsible investment is an integral part of the fund's investment strategy. Our aim is to identify long-term investment opportunities and reduce the fund's exposure to unacceptable risks."

– *Norges Bank Investment Management*[24]

Keeping the long-term investment horizon of the fund in mind, NBIM recognises that the fund's returns are highly dependent on sustainable long-term growth, well-functioning markets and good corporate governance, and hence actively involves itself in responsible investing.[25] This form of investing involves the consideration of Environmental, Social and Governance (ESG) issues in its investing approach. Environmental issues consider how a company performs as a steward of nature; social issues examine how it manages relationships with employees, suppliers, customers, and the communities where it operates; and governance deals with a company's leadership, executive pay, audits, internal controls, and shareholder rights.[26] NBIM thoroughly considers these issues when screening companies to invest in.[27]

Over the years, the "highest possible long-term return with an acceptable risk" investment strategy of the fund has generated a net annual return of 4.6%.[28] According to NBIM's website, the aim is "to have diversified investments that bring a good spread of risk and the highest possible return" subject to the constraints set out in the investment mandate from the

Norwegian Ministry of Finance. This mandate specifies the markets the fund can be invested in and sets limits for allocations to different asset classes. A benchmark index is set out by the Ministry, which comprises an equity index based on the FSTE Global All Cap stock index[29] and a bond index based on various Bloomberg Barclays Indices. Returns are measured against this benchmark for market and currency risk. NBIM constructs a portfolio that differs from the actual benchmark index so as to make full use of the fund's advantages and characteristics, manage the portfolio in a more cost-effective manner, as well as to satisfy certain requirements of the mandate, including environment-related investing.[30]

NBIM's approach to responsible investing is based on three main pillars: establishing principles, exercising ownership, and investing sustainably.[31]

Establishing principles

As a global fund invested in 71 countries, NBIM recognises a set of internationally agreed standards and principles which provide a framework for companies and shareholders it works with worldwide. Within this framework, NBIM also sets out expectations of companies to comply with. These standards and expectations are voluntary, non-statutory recommendations, but the companies NBIM invests in are expected to strive to meet them.[32,33]

In the management mandate laid out by the Norwegian Ministry of Finance, three standards from the OECD and United Nations (UN) are specified as a framework for NBIM's responsible investment management. These standards are the OECD's G20/OECD Principles of Corporate Governance, OECD Guidelines for Multinational Enterprises, as well as the UN Global Compact. Additionally, in its own principles for responsible investment, NBIM references two other UN standards – the UN Guiding Principles on Business and Human Rights, and the UN Principles on Promoting Responsible Sovereign Lending and Borrowing.[34]

NBIM is also an active contributor to the development of international standards, drawing on its experience as an investor in 71 countries and its in-depth knowledge of its portfolio companies. NBIM participates actively in consultations – it responded to 16 consultations relating to responsible investment in 2019 – and regularly engages with international organisations and regulators, such as the OECD, UN Global Compact, European Commission, International Accounting Standards Board, as well as national standard setters in key countries.[35]

Since 2008, NBIM has also been publishing expectation documents of companies it invests in. These include clear expectations on anti-corruption and human rights. NBIM believes that the onus is on the companies' respective boards to address environmental and social challenges, and integrate related material risks into the companies' strategy, risk management and reporting.[36] This in turn assists investors like NBIM in analysing the risks and opportunities that are related to their investments.

Exercising ownership – "Responsible shareholder"

It is NBIM's ambition to become a responsible shareholder, and despite small ownership stakes in each company it invests in, NBIM recognises that ownership, regardless of size, confers upon it rights and influence. In view of this and to protect its interests, NBIM takes its ownership responsibilities seriously, constantly raising ESG issues and pushing for good corporate governance of companies worldwide.[37] In 2014, NBIM's Chief Investment Officer for equities, Petter Johnsen, said that the GPFG had around 2,500 meetings with companies yearly and aimed to vote at all annual meetings if practically feasible.[38]

In the past, the GPFG was not a very active investor. It was difficult for it to actively influence its investee companies regarding their corporate governance matters, given the size of the fund and the number of companies it invested in. This changed in 2013 when the fund set up its corporate governance advisory board, which was tasked to advise the fund on becoming a more active investor.[39] The former CEO of NBIM, Yngve Slyngstad, acknowledged the fund's responsibility in promoting good governance in portfolio companies and the market as a whole, calling the new advisory board "a sounding board for both long-term ownership matters as well as specific issues".[40] However, despite the effort, the GPFG did not often publicly express views about the corporate governance of its investee companies.[41]

This approach drew some criticism to the fund, especially in markets which placed great emphasis on corporate responsibility. In 2015, the GPFG came under attack in Sweden for its lack of oversight, after one of Sweden's largest corporate scandals involving Swedish papermaker Svenska Cellulosa AB, a company in which the fund had an eight percent stake.[42] The Chief Executive of Sweden's shareholder association, Carl Rosén, commented that "NBIM has not done a good job [in terms of corporate governance in Sweden]. We want them to become more professional owners".[43] At the same time, fellow sovereign fund managers in Sweden have called for greater involvement in corporate governance oversight by NBIM. The Chief Investment Officer of Sweden's AMF Pensionsförsäkring AB, Peder Hasslev, said that he would "welcome greater involvement from NBIM".[44] In the fund's defence, former NBIM CEO Slyngstad said that silence to the media should not be mistaken with a lack of action.[45]

The GPFG has since taken steps to become a more active investor and promoter of good corporate governance. It began to reveal its voting intentions at portfolio companies' annual meetings, issue "position papers" setting out its corporate governance principles, as well as place representatives on a number of the boards of its key portfolio companies. The last initiative is in line with the Nordic model of governance whereby a company's largest shareholders often sit in the Nomination Committee.[46]

In February 2016, NBIM revealed that it had been in a company dialogue with German carmaker Volkswagen AG (Volkswagen) since 2008 to discuss issues such as board independence and capital allocation.[47] In 2015, Volkswagen was involved in the emissions scandal in the U.S.[48] In May 2016, the GPFG publicly declared that it would take legal action against Volkswagen over the scandal.[49]

In 2018, the GPFG published three papers detailing its position on various issues related to companies' board of directors.[50] These issues include: a limit of five concurrent board memberships for directors;[51] the separation of Chairman and CEO roles;[52] having a majority of independent directors with industry knowledge and at least two independent directors with industry experience.[53]

"Sitting as a director in a board has become a much more demanding job than 10 to 20 years ago", said NBIM's then CEO Slyngstad, while emphasising that these principles were some of the most important ones ever created by the fund.[54]

Voting and having one-to-one meetings with companies are two of the most important ways for NBIM to influence the corporate governance of its portfolio companies. In 2020, NBIM voted at 11,871 shareholder meetings – or 98.0% of all shareholder meetings of its portfolio companies. At these meetings, NBIM voted against only 4.9% of company resolutions. Some of these instances related to director elections. Of the 45,966 votes cast for resolutions relating to board candidates in 2020, NBIM voted against recommendations in 5.4% of director elections, mainly due to a lack of independence on the board or board committees in those companies. A significant example was Alphabet Inc. (Alphabet), where NBIM voted against seven resolutions in 2020. The subject of the resolutions rejected related to the board, remuneration, and shareholder protection.[55]

In 2020, NBIM held 2,877 company meetings with its portfolio companies[56] – down from 3,412 company meetings in 2019.[57] Issues discussed in 2020 include sustainability, effective boards, executive remuneration, capital allocation, climate change and the environment, human rights, anti-corruption, and tax.[58]

NBIM expects its portfolio companies to contribute constructively to solving challenging issues for the world, and these expectations are largely in line with the UN Sustainable Development Goals. Key issues which NBIM has highlighted to its portfolio companies include children's rights; climate change; water management; human rights; tax and transparency; anti-corruption; and ocean sustainability.[59]

Investing sustainably

In 2020, NBIM had invested 98.9 billion kroner in environmental investments. The returns from its environmental investments in the equity portfolio amounted to 34.3%. NBIM considers climate issues in its investment decisions and assesses companies' impact on the environment and society before investing in them, choosing not to invest in certain companies due to sustainability or ethical reasons.[60,61]

The sustainable investment strategy undertaken by NBIM comprises the following three steps:[62]

1. Risk assessment

NBIM aims to understand the full range of risks affecting companies and how these risks affect long-term fund-level risk and return.

As part of risk management and investment decisions, NBIM assesses sustainability issues and monitors its investments closely. In 2020, it analysed sustainability risks in 1,300 companies in emerging markets in the externally-managed portfolios. NBIM has a framework in place to map sustainability risks at companies in high-risk sectors and pick up investments in companies with exceptionally high long-term sustainability risks. In this regard, it identified 114 serious sustainability incidents – including breaches of laws, regulations or norms, or accidents caused by negligence – in 2020. NBIM also carries out an annual review of the portfolio against its expectation documents in order to identify portfolio companies which could have substantial adverse impacts on the environment or society, and to take steps to reduce the risks from investing in these companies.[63]

2. Investment

NBIM identifies long-term investment opportunities by analysing companies' operations and the impact they have on the climate and the environment. It utilises governance and sustainability data to identify long-term investment opportunities. Such data is obtained from companies' own reports and from external data providers, including external specialists where required.[64]

Investments are made in three main areas, aligned with the UN Sustainable Development Goals for climate, clean energy and resource management. In order to be considered as an investing opportunity to NBIM, companies must minimally have 20% of their business in one of these areas: low-carbon energy and alternative fuels, clean energy and energy efficiency, and nature resource management.[65]

3. Divestment

Based on its definition of sustainable economic growth, there are certain sectors and companies which NBIM does not invest in. The GPFG's approach towards environmental sustainability is to divest in certain industries and businesses such as coal and energy companies.[66] Generally, it divests its investments in companies that violate fundamental ethical norms or operate a business which is incompatible with long-term sustainability. NBIM makes divestment decisions based on recommendations by the Council on Ethics, an independent council set up by the Norwegian Ministry of Finance to make ethical assessments of companies. Divestments may be due to product-based or conduct-based considerations.[67]

Before a decision is made to exclude a company, NBIM will take into consideration whether other actions or measures – such as active ownership – might be more appropriate to reduce the risk of ethical norm violations.[68]

Risk-based divestments

A number of companies have been excluded from the fund due to risks of severe environmental damage. For example, Elsewedy Electric Co S.A.E. was blacklisted as a result of its participation in the development of a hydropower project in Tanzania, and Vale S.A. was excluded due to a series of dam breaches which had caused devastating environmental and social impacts in Brazil.[69] However, the GPFG has retained its stakes in large integrated companies, such as Royal Dutch Shell plc and BP plc, as it believes that these companies will invest heavily into renewable energy in the future.[70]

In 2020 NBIM divested from 32 companies after the assessment of ESG risks. NBIM integrates the analysis of ESG issues in its risk management process, and risk analysis is comprehensively conducted at the country, industry and company levels. NBIM also takes a systematic approach to risk-based divestment due to the nature of its diversified portfolio. According to NBIM's 2020 responsible investing report, "divestment as a form of risk management is used primarily for relatively small investments where other actions are not considered suitable".[71]

In 2019, GPFG was placed among the 25 most responsible asset allocators by the Responsible Asset Allocator Initiative (RAAI), an initiative under the World Bank that ranks the world's sovereign funds and pension investment funds.[72]

Greenwashing

At the end of 2019, Morten Balterzen, head of Norway's Financial Supervisory Authority, commented that ESG investments have resulted in the creation of a new risk. In a bid to meet investor demand, many companies have begun overstating their green credentials – otherwise known as greenwashing – while investors do not actually know what they are investing in, because there is no policing of whether the companies' claims are indeed true. This, coupled with the lack of standardisation across ESG classifications, approaches and definitions used in companies' sustainability reports, has become a problem for investors like NBIM.[73]

Risky business

At the start of 2020, the GPFG lost 1.3 trillion kroner (US$125 billion) as markets collapsed due to the COVID-19 pandemic.[74] In managing its risk, NBIM aims to have a plan which is customised to its specific responsibilities while recognising its distinctive relationship with the Norwegian government. Risk management should be systematic and structured, and integrated in NBIM's strategic planning, business processes, and decision making. There should also be a reasonable balance between risk and return in the management of the GPFG. Additionally, the plan should be compliant with legal and regulatory requirements.[75]

NBIM emphasises the segregation of duties in managing the risks relating to the GPFG. The Principles for Risk Management published by NBIM specifically states that segregation of duties should be present between its three lines of defence, which are operational management activities (first line of defence), the risk management and control functions (second line of defence) as well as Norges Bank's internal and external auditors (third line of defence).[76]

To identify the potential risks associated with the fund, NBIM requires all new investment activities to undergo a comprehensive and documented risk assessment process. In each case, the risk assessment must provide an overview of the relevant issues, such as measurement of return and valuation, together with the controls and management of these risks.[77]

Unlisted investments are subjected to due diligence. The process includes relevant risk assessments (including operational risk, counterparty risk, liquidity risk, legal risk, market risk, technical risk and tax risk), assessments of ESG risk factors as well as risks regarding the handling of various stakeholders relating to the investment. Lastly, there is also an assessment to check whether sufficient and appropriate systems and procedures are in place. All these assessments are documented, with unlisted investments requiring formal approval.[78]

Three risk classes

The framework which governs enterprise risk management considers strategic risk, investment risk and operational risk as NBIM's three main risk classes. Reputational impact is a consequence across all three classes.[79]

1. Strategic risk

NBIM defines strategic risk to be "the risk of not achieving strategic objectives set out in the strategic plan". By implementing enterprise risk management, NBIM is able to evaluate the risks and opportunities under strategic objectives. NBIM identifies, assesses, and monitors strategic risks, and ensures that they are within specified limits and thresholds.[80]

2. Investment risk

NBIM defines investment risk to be "the risk of events that affect the return on [its] investments". This includes market risk, credit risk and counterparty credit risk. Furthermore, NBIM assesses and incorporates ESG risks into the investment management process. Other additional considerations include activities such as leverage, use of derivatives, securities lending and shorting.[81]

3. Operational risk

NBIM defines operational risk to be "the risk of an unwanted operational event with financial or reputational impact". Well-structured and systematic, NBIM's operational risk management is included in its decision-making processes and supports continual improvement of all processes. In addition, NBIM has a policy statement for operational risk management which is supported by a framework based on internationally recognised standards and frameworks. NBIM regularly assesses its exposure to operational risks and such risks are to be mitigated by the implementation of applicable internal controls or other actions to reduce the risk level.[82]

Tax risk management

NBIM makes a point to manage risks related to tax. It complies with all local laws, considers standards published by appropriate bodies and aims to follow market practices. It also emphasises transparency regarding tax matters and the need to keep abreast of global tax changes. NBIM implements processes to ensure that tax risks related to investments are properly assessed and managed in accordance with its risk management framework.[83]

Internal controls

NBIM defines internal control to be "all measures and processes, effected by the executive board, administration and employees, designed to provide reasonable assurance that NBIM's objectives related to operations, compliance, and reporting will be achieved". NBIM's processes related to risk reviews and internal controls are based on the Regulation on Risk Management and Internal Control in Norges Bank, as issued by the Norwegian Ministry of Finance. NBIM also has processes in place to ensure that control activities are performed on an ongoing basis and are properly documented. NBIM also regularly evaluates its risk management and internal control framework.[84]

Risk reporting

Reports on risk management in NBIM are presented to the executive board, in line with reporting requirements. Assessment of reputational impact from all three risk classes will also be reported to the executive board. Furthermore, critical and major operational incidents, including breaches of mandates of the executive board or Norwegian Ministry of Finance shall be reported to the executive board.[85]

You see what you get and pay for

The GPFG's market value is publicly available real-time on NBIM's website, and stands at around 11.7 trillion krone (US$1.36 trillion) as at 30 June 2021.[86] GPFG invests in more than 9,000 companies around the world,[87] which it fully discloses. Anyone is able to access all of the fund's investment information through an interactive map, which discloses the value invested in each single company over time, the fund's ownership percentage, and the fund's voting rights.[88] The fund's full voting records in its portfolio companies' annual meetings are fully disclosed.[89]

In terms of portfolio performance, GPFG publishes all information relating to its returns on its website. It publishes both the annual return of the fund, as well as that of each asset class – equity, fixed income, and real estate. On top of annual figures, returns for the fund and different asset classes are also published in 5-year time periods. Furthermore, with regard to unlisted real estate investments, GPFG discloses how its performance compares to the MSCI Global benchmark.[90]

The remuneration amounts for the executive board of Norges Bank, as well as senior executives of NBIM, are published in Norges Bank's annual reports.[91] It is disclosed in Norges Bank's 2020 annual report that the bank's executive board is responsible for setting the limits for the bank's salary and remuneration schemes and monitoring how they are put into practice. Norges Bank also engages external consultants to perform annual comparisons of salaries with other peer groups. The salaries of the Governor and Deputy Governors of Norges Bank are determined by the Norwegian Ministry of Finance. In addition to gross salary and other benefits, they also receive pension benefits, based on the existing pension plan for members of the Storting and the Norwegian government.[92] The remuneration of Norges Bank's executive management team in FY2020 is disclosed in Figure 3 below.

Amounts in NOK millions		2020			
	Name	Gross salary	Value of other benefits	Pension benefits earned	Employee loan
Governor	Øystein Olsen	2 524 121	163 647	269 977	-
Deputy Governor	Ida Wolden Bache	1 538 299	13 408	243 109	-
Chief Executive Officer – NBIM	Nicolai Tangen	2 216 666	2 432	133 240	-
Chief of Staff / Deputy Chief Executive Officer – NBIM	Trond Grande	4 713 889	7 688	342 921	-
Executive Director, Norges Bank Administration	Jane Kristin Aamodt Haugland	1 996 058	9 217	348 320	1 812 296
Executive Director, General Secretariat	Birger Vikøren	1 795 363	9 041	378 415	-

Figure 3: Remuneration to the Norges Bank executive management team in FY2020[93]

Norges Bank's executive board also lays down the principles for NBIM's salary system. The leader group receives only a fixed salary. In addition to a fixed salary, employees of NBIM whose work directly involves investment decisions, and certain other NBIM employees, will be entitled to performance-based pay. Performance-based pay is calculated based on the performance of the GPFG, group and individual, which are measured against set performance goals.[94] The remuneration to senior executives in NBIM for the FY2020 is detailed in Figure 4.

Amounts in NOK millions		2020				
	Name	Gross salary	Gross performance pay	Value of other benefits	Pension benefits earned	Employee loan
Chief Executive Officer	Nicolai Tangen	2 216 666	-	2 432	133 240	-
Chief of Staff/Deputy Chief Executive Officer	Trond Grande	4 713 889	-	7 688	342 921	-
Chief Technology Officer	Age Bakker	3 801 524	-	8 554	410 981	-
Chief Operating Officer	Birgitte Bryne	814 555	-	2 536	89 114	-
Chief Real Assets Officer	Mie Caroline Holstad	742 145	-	2 837	62 997	-
Chief Risk Officer	Dag Huse	4 561 828	-	7 296	578 352	-
Chief Governance and Compliance Officer	Carine Smith Ihenacho	4 091 916	75 934	90 456	409 192	-
Chief Equities Officer	Petter Johnsen	8 438 073	-	110 216	843 807	
Chief Real Assets Strategies Officer	Geir Øivind Nygård	4 521 252	351 680	7 296	241 751	-

Figure 4: Remuneration to senior executives in NBIM in FY2020[95]

NBIM also publishes the compensation principles of its employees. It states that an employee's compensation is closely tied to his competencies, responsibilities and performance and must be aligned with local market compensation practices. For NBIM, variable components of an employee's compensation cannot exceed 100% of the fixed component. Of the variable component, at least 50% will be deferred and paid over a period of at least three years.[96]

Another side of the story?

Despite the fact that the GPFG is commonly seen as a model of governance and transparency, it has faced criticism.

Growing politicisation

"This is the time for thinking 20 years ahead and getting the structure right. I feel that the proposals are going in the wrong direction."

– Knut Kjaer, former CEO of NBIM[97]

Knut Kjaer, who was CEO of the GPFG from 1998 until 2007, wrote a formal letter to the Norwegian Parliament in 2019 arguing against a government proposal on the governance of the fund. Kjaer, together with a group of experts, were against the idea of placing the fund under the Norges Bank. In his view, the proposed structure would "pulverise accountability". Thus, he believes that the fund should be an independent organisation with its own dedicated board instead.[98]

Lack of investment expertise

"Monetary policy and investment have two completely different skill sets."

– Knut Kjaer, former CEO of NBIM[99]

Placing the fund under the management of the central bank has also led to concerns about the lack of investment expertise. The investment decisions relating to the fund have to be submitted to the board of directors of Norges Bank, which also runs the country's monetary policy. Meanwhile, asset allocation policy is mostly set by the Norwegian Ministry of Finance and approved by politicians "with little financial experience". Kjaer pointed out that the skill sets involved in monetary policy and investment are very different, and believes that changes are required to establish "a much more professional board".[100]

Governance hiccups

On 30 October 2019, a few days after the GPFG's value reached 10 trillion kroner (US$1.08 trillion), Slyngstad – who had been the CEO of NBIM since 2008 – stepped down from his position as CEO.[101,102] He took on a new role in the fund, which involves building a unit to invest in "unlisted infrastructure projects" such as renewable energy.[103]

Under Slyngstad's leadership, the GPFG had seen a five-fold increase in value.[104] He turned the fund into an activist investor, tackling issues such as board composition, executive pay and climate change disclosure at its investee companies worldwide.[105]

Some believe that Slyngstad's departure was caused by the straining of ties between the Norwegian Ministry of Finance and the GPFG under Slyngstad's leadership. According to Espen Henriksen, associate professor at BI Norwegian Business School, "The person who is appointed CEO must be able to reset the relationship and rebuild trust with the Ministry of Finance. During the past few years, the relationship has soured and trust has eroded."[106] Financial Times reporter Richard Milne echoed this sentiment, saying that there has been "a growing debate over political influence in the fund".[107]

New blood

"I want to be CEO of the oil fund, and have only one objective: creating wealth for future generations,"

– Nicolai Tangen, CEO of NBIM[108]

On 26 March 2020, NBIM announced that Nicolai Tangen has been appointed as the new CEO and would take over the reins in September 2020.[109] The central bank's executive board was unanimous in selecting Tangen for the role.[110] The Governor of Norges Bank and Chair of NBIM's executive board, Øystein Olsen, expressed strong trust in him, saying in a press release: "The executive board feels confident in Nicolai Tangen being the best candidate to manage the Government Pension Fund Global. Tangen has built up one of Europe's leading investment firms and has delivered very good financial results as an international investment manager. He has extensive experience with equity management, which is the fund's largest asset class."[111]

In 2005, Tangen had set up AKO Capital LLP (AKO),[112] an investment management firm which has approximately US$24 billion in assets under management.[113] AKO's flagship European fund has had an annual return of 10.1% since its launch, as compared to 3.4% for the market. In the first quarter of 2020, although the market had a return of negative 21.8%, the fund still managed to attain a positive return of almost one percent.[114]

Roadblocks

"I will only have one hat, and that will be the oil fund hat."

– Nicolai Tangen, CEO of NBIM[115]

Tangen's road to becoming CEO of NBIM turned out to be a bumpy one. Norges Bank had allowed Tangen to keep a controlling stake in his firm and his own personal finances. However, the parliamentary Finance Committee took issue with this, saying that the CEO "cannot have assets or interests that create, or could appear to create, conflicts of interest that could weaken confidence in the reputation" of the fund. In response, Tangen promised to reduce his stake in AKO to 43%, and to place his assets into a blind trust.[116] However, this was deemed inadequate by the Finance Committee. To satisfy the demands of the committee, Tangen transferred his stake in AKO to a charitable foundation, the AKO Foundation, and restructured his other investments. Tangen estimated the value of his forfeited hedge fund holdings at US$1.15 billion.[117] As a result, he no longer has any ownership interest in AKO. He also disclosed that after the planned conversion of his personal fund investments into bank deposits,[118] he would have bank deposits of about US$778 million.[119]

Norwegian parliamentarians also took issue with the manner by Tangen had been appointed – allegedly without being on the candidate shortlist, and after correspondence with then CEO Slyngstad.[120] However, Tangen said he was first contacted by a head-hunting firm about the role in December 2019.[121] To add fuel to the fire, it was reported that Tangen asked Slyngstad for a favour via email – to inform him "what the job involves in terms of political guidance, opportunities and the like".[122] This came weeks after Tangen paid for Slyngstad's private flight from Philadelphia to Oslo after an all-expenses-paid closed conference in the U.S. organised by Tangen. In his defence, Tangen said that he had planned the seminar for years and extended an invitation to Slyngstad over a year prior in May 2018. Tangen fervently denied that the seminar or Slyngstad's attendance was a deliberate attempt to "smooth his way" into the job of CEO of NBIM.[123] The GPFG had also said that Slyngstad was not involved in the process to select his successor.[124]

Following a media furor over contact between Slyngstad and Tangen before his appointment, Norges Bank disclosed details of its recruitment process and correspondences between Tangen, Slyngstad, and NBIM. This quickly escalated to queries raised by the parliamentary Supervisory Council of Norges Bank and a warning that Tangen's appointment "carries the risk of violations of laws, rules and guidelines".[125] In August 2020, Norges Bank defended its selection of CEO at a hearing in Norway's parliament. Although Norges Bank previously admitted to being too slow in releasing Tangen's name as part of a public list of applicants for the role – which is mandated by law – Norges Bank Governor Olsen firmly defended the bank's decision, stating that "in a thorough process to recruit a new CEO of NBIM, Nicolai Tangen emerged as the decidedly strongest candidate".[126]

As a public servant, Tangen's new annual salary would amount to US$672,400, a modest amount compared to what he would have earned had he not switched jobs. He would also likely pay significantly more in annual wealth tax in Norway as compared to London, where he was previously based.[127] Although it had cost Tangen over US$1 billion to finally obtain his dream job, he said that he had no regrets about giving up his previous job to manage the GPFG.[128]

A new era

Despite the numerous roadblocks, Tangen started his job as CEO of NBIM and manager of the GPFG on 1 September 2020.[129] The new strategy document published by NBIM in April 2021[130] under its new CEO shows "a change towards more active management". NBIM would no longer automatically invest in small companies which were included in the index. Karin Thorburn, professor of finance at Norwegian School of Economics, noted that NBIM's goal – "to achieve the highest possible return" – is very much like a hedge fund as compared to "the highest possible risk-adjusted return net of cost," which is what an index fund strives towards.[131]

With Tangen's extensive experience, GPFG's enhanced financial influence, and three priorities for GPFG – return, communication and talent development[132] – it seems that the SWF is ready for a new era of investor stewardship.

Discussion questions

1. While the multi-tiered governance structure that the GPFG utilises can be an effective system, discuss possible drawbacks if it is not regulated properly by drawing similarities to the relationship between a company's shareholders, board and management.

2. Evaluate the board structure of Norges Bank. Are there any improvements that can be made to strengthen it in order to improve the overall governance of the fund?

3. Evaluate the GPFG's approach in exercising its stewardship. Discuss in relation to the specific approaches NBIM is taking and the corporate governance issues that have surfaced in their portfolio companies.

4. Discuss the extent of stewardship shareholders should practise for companies they own shares in.
5. Evaluate the risk management practices of NBIM.
6. Evaluate how its status as a sovereign wealth fund affects GPFG's governance. To what extent does political influence play a role in its governance? Compare and contrast the GPFG's governance with that of Singapore's Temasek and GIC, or a sovereign wealth fund in your country if there is one.

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CHIP ENG SENG: FAMILY FIRST

Case overview

Chip Eng Seng Corporation Ltd (CES) started out as a building sub-contractor in the 1960s and today, it has expanded into various sectors with operations in several countries. In October 2018, new controlling shareholders – Gordon and Celine Tang – emerged after they acquired 29.73% of the company's shares from members of the founding family. The following year, the company undertook a rights issue which increased the Tangs' stake to 39.1%. The initial acquisition of shares by the Tangs and the manner in which the rights issue was structured came under intense scrutiny. Observers felt that the spirit of the mandatory general offer rule in the Singapore Code on Take-overs and Mergers might not have been fully complied with. The company's corporate governance – in particular, its board composition, remuneration policies and disclosures – also came under the spotlight.

The objective of this case study is to facilitate a discussion of issues such as corporate governance of family-controlled companies; board structure; remuneration policies and disclosures; responsibilities of directors in change of control situations and decisions relating to acquisitions, divestments and diversification; application of takeover rules; and the role of regulators.

From humble beginnings

Chip Eng Seng Corporation Ltd (CES) is listed on the Mainboard of the Singapore Exchange (SGX). It operates in several countries, with businesses in construction, civil infrastructure, precast technology, property development and investment, hospitality, and education.[1]

CES was founded by Lim Tiam Seng (LTS) in the 1960s as a building sub-contractor for landed properties. In 1982, it was appointed as main contractor for its first Housing Development Board project in Singapore. Over the years, it diversified into the construction of private condominium and executive condominium projects, as well as precast fabrication.[2]

In the 1990s, it scaled up the property value chain to undertake property development and investment projects. Today, its property development and investment portfolio spans across shop houses, residential, commercial, industrial and mixed-use development projects.[3]

This initial case study was prepared by Ng Peng Soon Joel, Ng Pin Hui Carolyn, Ong Xin Min, Nguyen Minh Anh and Dinh Duc Trong, and edited by Sheethal Shanbhogue under the supervision of Professor Mak Yuen Teen. It was substantially rewritten by 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 organizations named in the case, or any of their directors or employees.

It further diversified into the hospitality industry in 2015 and into the education sector in 2018. In 2019, CES started its civil infrastructure business with the acquisition of an established design and build construction service provider to augment its construction business. Currently, the Group operates in a number of countries in the Asia Pacific region, including Singapore, Malaysia, Vietnam, Australia, New Zealand, and the Maldives.[4]

A board that ticks most boxes

In FY2015, the board had nine directors, including five executive directors (EDs), four of whom were related family members – Executive Chairman LTS, Executive Deputy Chairman Lim Tiang Chuan (LTC), ED and Group CEO Chia Lee Meng Raymond (RC), and ED Dawn Lim Sock Kiang (DL). LTS and LTC are brothers, RC is LTS's son-in-law, while DL is RC's sister-in-law.[5] The fifth ED, Hoon Tai Meng (HTM), was an independent director (ID) for 12 years before his appointment as an ED. He holds an undergraduate commerce degree in accountancy and an honours law degree, and was previously a partner in a law firm.[6]

The four IDs on the board were lead ID Ang Mong Seng (AMS), a former Member of Parliament (MP) who joined the board in March 2003; Goh Chee Wee (GCW), former MP and Minister of State for Trade and Industry, Labour and Communications, who was appointed in November 1999; Cheng Heng Tan (CHT), a former senior partner of Ernst & Yong LLP, who was appointed in July 2011; and Ung Gim Sei (UGS), a director at a law firm who was appointed in April 2015.[7]

The company said that the roles and responsibilities of the Chairman and CEO were held by separate individuals "to ensure that there is an appropriate balance of power, increased accountability and greater capacity of the Board for independent decision-making".[8]

The 2012 Singapore Code of Corporate Governance recommends that in situations where the Chairman is not an ID, at least half of the board should comprise IDs. This particular guideline became effective for financial years starting from 1 May 2016.[9] In FY2016, CES duly complied with this recommendation.[10] The Executive Chairman stepped down from his role to become Honorary Chairman and advisor, and half of the board comprised of IDs. The lead ID AMS had, however, served on the board since 2003. The company said the board had subjected his independence to a "particularly rigorous review" and was satisfied that he was truly independent. Additionally, GCW, who had been on the board since 1999, retired as ID that year. His successor was Lui Tuck Yew (LTY), who was previously MP, Minister for Transport and Minister for Information, Communications and the Arts.[11]

Subsequent to LTS' retirement in April 2016, RC took over as Executive Chairman. After the handover, even though the company had a single person holding both the Executive Chairman and CEO positions, the company represented that "the board is of the view that there is sufficient safeguard and checks".[12]

On 2 February 2018, CES appointed a new ED, Tan Tee How (TTH), who formerly held the positions of principal private secretary to the then Prime Minister and permanent secretary of the Ministry of National Development, among other public sector positions. It also appointed a new ID, Abdul Jabbar Bin Karam Din (AJ).[13] With another ED on its board, the company would require another ID to meet the Code's guidelines with regard to the proportion of IDs.[14]

AJ is a partner with Rajah and Tann Singapore LLP (Rajah and Tann) and "advises companies on corporate governance, compliance and regulatory matters". Rajah and Tann has been a long-time provider of company secretarial services to CES, where AJ had been joint company secretary since 2004.[15] He resigned as joint company secretary on 31 January 2018, and the next day, CES announced that he was appointed as an ID with effect from 2 February 2018.[16]

Later that year, Celine Tang (CT), who had recently become the controlling shareholder of CES, was appointed as Non-Executive Chairman and non-independent, non-executive director. RC became ED and Group CEO, and all his family members, together with HTM and CHT, left the board. Another new ID, Lock Wai Han (LWH), was appointed. LWH is the ED and CEO of SGX-listed OKH Global Ltd, which is controlled by CT.[17]

Family-friendly remuneration

On 24 April 2019, CES announced that it had received a query from SGX the day earlier regarding the disclosure of remuneration in its FY2018 annual report. SGX's query states: "We refer to the company's FY2018 annual report. As required by Rule 1207(12) of the Listing Manual, please make disclosures as recommended in paragraph 9.2 of the Code or otherwise explain the reason(s) for the deviation from the following Code recommendations. The company reported that it did not disclose directors' remuneration in the nearest thousand dollars as it is commercially sensitive. The top band for directors was stated as 'above S$1,000,000' without an upper limit. Please provide an upper limit to the band."[18]

The company's reply said: "Mr Chia Lee Meng, Raymond ("Mr Chia") is the executive director and Group Chief Executive Officer of the company, a key management officer of the company and its subsidiaries (collectively, "the Group"). The board had decided not to disclose the upper limit to the band of Mr Chia's remuneration in view of the sensitive and confidential nature of such disclosure. The board believes such disclosure would pose as a disadvantage to the Group as it operates in a highly competitive environment. Such information was accordingly not disclosed in the FY2018 annual report to protect the interests of the Group."[19]

There was no follow up to the company's reply by SGX. Further, in the company's FY2018 annual report, there were three EDs whose remuneration was disclosed within the 'above S$1,000,000' band, but the company only referred to the Group CEO in its reply. The annual report also stated that "poaching of employees by competitors is fairly common".[20]

An article published in The Business Times estimated that while RC's remuneration was disclosed as "above S$1,000,000", he was actually paid a minimum of S$4,368,000 and up to S$4,968,000.[21]

CES was even less transparent when it came to the remuneration of its top five key management personnel. It did not even disclose the total remuneration earned by the top five key management personnel, saying that this was “in the interest of maintaining good morale and a strong spirit of teamwork within the Group”.[22]

CES did, however, disclose the remuneration of five employees who are immediate family members of a director in bands, as recommended by the Code. Between FY2015 and FY2018, there were five immediate family members who were employees in the company and drawing remuneration ranging from a band of S$150,000 to S$199,999 to a band of S$600,000 to S$649,999.[23,24,25] The only exception was in FY2017 when LTS was paid between S$2,400,000 to S$2,450,000, including “a one-off gratuity payment in recognition for this lifelong contributions to the Company” after he became Honorary Chairman and advisor to the company.[26]

For the non-executive directors, including IDs, their individual remuneration was disclosed as “below S$200,000”.[27]

Interested person transactions

CES disclosed interested person transactions (IPTs) in several of its annual reports. These were often related to sales of residential units from properties developed by CES. For instance, there were sales of two residential units in High Park Residences to two family members amounting to a total of just over S$1 million in FY2015; [28] sales of four Grandeur Park Residences units to five family members amounting to just over S$5.8 million in FY2017;[29] and the sale of one Park Colonial residential unit to a family member for S$1.25 million in FY2018.[30] According to the company, directors and employees of the Group are entitled to a three percent discount off the list price of the units. There were also other IPTs relating to interest paid for, or redemption of, term notes issued by the company.[31]

New controlling shareholders emerge

On 4 October 2018, CES received a trading query from SGX Regco after its share price had increased from slightly over S$0.80 in early September to as high as S$0.965 on increasing volumes. Despite the query being issued at 4.27pm, the company only requested a trading halt the following day prior to the start of trading.[32]

The next day, the company announced that it had received notification from its major shareholders that they had sold approximately 29.73% of the company’s issued shares at S$1.08 per share. The seven selling shareholders were all related and, with the exception of one, held various senior appointments in the Group. Three days later, on 8 October 2018, the company clarified that two sisters, Lim Sock Joo (LSJ) and DL, would retain 1.55% and 0.38% of the company’s shares respectively. The other five shareholders would no longer hold any shares of the company. LSJ is the wife of the then Executive Chairman and Group CEO, RC. DL resigned as ED three days later on 11 October 2018.[33]

The new CES shareholders were husband and wife, Gordon Tang (GT) and CT, who jointly held 26.98% of the shares, with another 2.75% held by a company in which CT is a director. The new controlling shareholders therefore had direct and deemed interests amounting to 29.73% in the company, a whisker below the 30% threshold which would trigger a mandatory general offer.[34]

Change of control or not?

The first general principle of the Singapore Code on Take-overs and Mergers (Takeover Code) states that persons engaged in a take-over or merger transaction must observe both the spirit and the precise wording of the general principles and rules. More specifically, the fifth general principle states that a general offer to all other shareholders is normally required where effective control of a company is acquired or consolidated by a person, or persons acting in concert.[35]

For the purpose of the Takeover Code, effective control has been set as a holding, or aggregate holdings, of shares carrying 30% or more of the voting rights.[36] Except with the Securities Industry Council's (SIC) consent, any person who acquires shares which carry 30% or more of the voting rights of a company, or any person who holds between 30% and 50% of the voting rights, and acquires within any period of six months additional shares carrying more than 1% of the voting rights, must make a general offer to other shareholders. This includes shares acquired by persons acting in concert. Rule 14 of the Takeover Code covers the conditions and circumstances relating to a mandatory offer. Unless the contrary is established, a director is assumed to be acting in concert in a transaction.[37] In CES' case, RC was and continues to be a director. He did not sell his 1.78% stake even though his wife's stake was pared down from 3.15% to 1.55%.[38]

Rule 14(6) appears especially relevant to the CES situation because it governs the partial sale by a vendor "particularly where an acquirer wishes to acquire under 30%, thereby avoiding an obligation under this rule to make a general offer". The Takeover Code states that the SIC will assess if a significant degree of control exists over the unsold shares. One point the SIC would consider is a very high price being paid for the voting rights as it would suggest that control over the entire holding was being secured.[39]

Using the average undisturbed price of S$0.815 in August 2018, the new controlling shareholders effectively paid a premium of S$0.265 (or approximately 33%) to the founding family members for a controlling stake of 29.73% – this translates to a control premium of approximately S$49 million.[40]

Another point mentioned by the Takeover Code is that "a significant degree of control over the retained voting rights would be less likely if the vendor was not an 'insider'". LSJ and DL continue to retain stakes in CES. If either of the two sisters had not done so, the new controlling shareholders would have crossed the 30% threshold.[41]

Questions were raised about the possible applicability of Rule 14(6) to the CES case, such as the 33% premium paid by the new controlling shareholders and the retention of stakes by the two Lim sisters.[42] Further, the share sales triggered a change in control under the company's note covenants (which specifies 25% as the threshold). Together with wholesale changes to the board, a commentary argued that "it would appear crystal clear to most market participants that 'effective control' has been achieved by the new controlling shareholders".[43]

Was rights issue a backdoor?

On 22 August 2019, CES announced an underwritten one-for-four rights issue at an issue price of S$0.63 per share.[44] This came shortly after the company had invested S$30 million in a distressed real estate development project in Jiangsu, China in June. The project is a 51:29 joint venture between CES and Haiyi Shantou Investment Group Co. Ltd. (Haiyi Investment)– an associate of the Tangs – with the remaining stake held by a newly incorporated entity controlled by a shareholder from China.[45] The rights issue and the haste in executing it was surprising to observers.[46]

On 29 August 2019, CES issued a notice for an Extraordinary General Meeting (EGM) to pass three resolutions, regarding (a) the proposed rights issue (Resolution One), (b) a proposed payment of the sub-underwriting commission to the controlling shareholders (Resolution Two), and (c) a proposed whitewash resolution (Resolution Three). Each of these resolutions is "inter-conditional upon the approval being obtained at the EGM for each of the other resolutions".[47] In other words, the rights issue would not proceed unless all three resolutions were passed.

One of the motivations cited for the rights issue was that it would serve to lower the company's net debt-to-equity which had risen to 1.8 times as at 30 June 2019.[48] However, it was pointed out that higher leverage is actually common among companies in property development during the early stages of their projects. As these projects approach completion, their gearing ratios often improve quite significantly. CES' high existing leverage was due to its portfolio of investment properties, the recurring income from which should improve the company's financials in the foreseeable future.[49]

Further, the method used by the company to estimate its cost of equity capital and the company's statements hinting that the cost of equity was cheaper than the cost of debt were questioned, as they were used by the company to justify using the rights issue as opposed to using debt.[50]

An article in The Business Times said:

> "…the cost of equity was obtained by taking the last dividend of 4 cents per share and dividing by the closing price of 68 cents. This is a highly simplistic computation of the cost of equity. The "textbook" dividend capitalisation model uses future dividend divided by the share price and then adding on the growth rate of dividends. Modern corporate finance revolves around future earnings and prospects…The company stated in the same breath the 5.88% cost of

equity and the 6% cost of borrowing, seeming to hint that the company's cost of equity is cheaper than its cost of debt – which may in turn support the use of a rights issue to raise more capital. However, a fundamental principle in corporate finance is that cost of equity is higher than the cost of debt as equity holders are compensated for taking on more risk since they only have residual claims. This is rarely invalidated, if ever. A quick Bloomberg check shows that the estimated cost of equity for CES is 9.8%. Further, if the cost of those two sources of finance is to be compared, the after-tax cost of debt should be used as there are tax benefits on the interest payments."[51]

Unattractive rights issue price

It was argued by observers that the subscription price, which was S$0.05 below the closing price on the day of the announcement – or a 5.97% discount to the ex-rights price of S$0.67 – was unattractive and would not encourage shareholders to exercise their subscription rights. The discount was less generous than 13 out of 14 comparable rights issues over the previous 12 months.[52]

Moreover, after the announcement of the rights issue, CES' share price steadily fell, closing at S$0.645 the day after the announcement, and continued to drop, closing at S$0.625 on 2 September 2018. This rendered the subscription price of S$0.63 even less appealing to investors. In fact, it was observed that since the Tangs replaced the founding Lim family as the largest shareholders, many shareholders had been selling their shares in CES.[53]

Under the terms of the rights issue, the Tangs and CEO RC had made irrevocable undertakings to subscribe for their pro-rata entitlement to the rights shares, which accounted for 31.51% of all shares offered. Furthermore, the sub-underwriting agreement also guaranteed that the Tangs would subscribe for all the underwritten rights shares not successfully subscribed for under the rights issue.[54]

Subsequently, despite the passing of the resolutions, the rights issue was met with an unenthusiastic response from minority shareholders who in aggregate subscribed for only 21.64% of all shares offered.[55]

As the total number of shares taken up by virtue of the irrevocable undertakings and by minority shareholders only amounted to 53.15% of all shares offered, the remaining unsold shares – 46.85% of all the rights shares issued – were bought by the Tangs in fulfilment of the sub-underwriting agreement. As a result, the Tangs successfully raised their shareholding to 36.35%, from 29.73% prior to the rights issue.[56]

Slam dunk sub-underwriting agreement?

In essence, the Tangs effectively underwrote the entire rights issue as the underwriter and manager, United Overseas Bank (UOB), could pass on all the risks to the Tangs as the sub-underwriter. It was further disclosed in the company's letter to shareholders that UOB would not underwrite the rights issue without such a sub-underwriting agreement.[57] This meant that the underwriter would enjoy a risk-free underwriting commission spread of 0.5% of the gross proceeds from the underwritten rights share.[58]

When questioned by a shareholder on the need for such an underwriter when the Tangs could directly underwrite the issue, ID and former CES company secretary AJ replied: "For us to enter into such an arrangement with the family is an IPT… Then, instead of a whitewash resolution, we would be passing different kinds of resolutions so that would complicate matters."[59] As for why UOB was chosen, he reasoned that it offered the lowest underwriting fee of all the banks approached by CES. He also explained that the choice to engage the Tangs as the sub-underwriter was made by UOB.[60]

As the sub-underwriter, the Tangs stood to receive a sub-underwriting fee of 1.5% of the gross proceeds from the underwritten rights share. Based on the aggregate gross proceeds from the issue of approximately S$67.5 million, the commission to be paid by UOB to the Tangs would be approximately S$1 million, even if minority shareholders were to take up their rights fully. This amount represented approximately 0.12% of the audited net tangible assets of the Group as at 31 December 2018.[61] As the rights issue was in fact poorly received by minority shareholders, the Tangs actually secured S$1 million to carry out the rights issue that would eventually enable them to increase their shareholdings above 30% without triggering the mandatory general offer. [62]

Whitewash waiver

Note 1 of the notes on dispensation from Rule 14 of Takeover Code states that the SIC would waive the obligation to make a general offer under this rule in cases involving the underwriting of an issue of new shares where there is an independent vote at a shareholders' meeting for the whitewash waiver. An independent vote means a vote by shareholders who are not involved in, or interested in, the transaction in question.[63]

On 26 July 2019, the SIC granted its approval for a waiver to the new controlling shareholders and parties acting in concert, subject to the standard conditions imposed on companies seeking a whitewash waiver.[64] SIC required the whitewash resolution to be separate from other resolutions. Under paragraph 2.1 of Practice Note 8.2 of the SGX Listing Manual, CES was also required to obtain specific shareholders' approval for the payment of the sub-underwriting commission to the controlling shareholders by passing a separate shareholder resolution.[65]

Accordingly, the company tabled the three resolutions relating to the rights issue at its EGM. However, the three resolutions were inter-conditional. This was questioned by an article which said the following: "While the company may reason that this is to ensure the success of the rights issue, there is no doubt that it will further strengthen the control of CES by the new controlling shareholders. Is this in the spirit of making the sub-underwriting and the whitewash waiver resolutions separate from other resolutions?"[66]

RC was considered independent and did not abstain from voting. In the same undertaking to subscribe for his pro-rata entitlement to the rights shares issued, he also gave an irrevocable undertaking to vote in favour of all three resolutions prior to the EGM.[67]

With the whitewash waiver, the Tangs could successfully raise their stake in CES at a significantly lower price (S$0.63 per share) through the rights issue than they would have had to pay if they were required to make a general offer at the price they had paid the Lim family (S$1.08 per share).[68]

Despite the controversy, all three resolutions were passed at the EGM held on 13 September 2019, with 78.11% voting for Resolution One on the proposed rights issue, 78.33% voting for Resolution Two on the payment of the sub-writing commission to the controlling shareholders, and 83.41% for Resolution Three on the whitewash waiver. Out of a total issued share capital of 626 million shares, which includes 186 million shares belonging to the Tangs and their associate, Senz Holdings Limited – which abstained from voting – only 110 million shares took part in the voting.[69] Following the completion of the rights issue, the Tangs stake increased to 39.1%.[70]

On 18 September 2019, it was reported that the SIC was looking into the acquisition of shares by the Tangs. However, no further news has been reported on the SIC inquiry.[71]

Who are the Tangs?

The Tangs were listed by Forbes as the 28th richest family in Singapore with a net worth of S$1.3 billion.[72] They were reported to have used their wealth to forge ties with a number of American politicians and in 2019, were said to be under investigation for making contributions through a U.S.-based company, American Pacific International Capital (APIC), to support former presidential hopeful Jeb Bush, who ran as a Republican in 2016.[73] Federal law in the U.S. prohibits foreign nationals from contributing to U.S. political campaigns and the Tangs had to pay a US$550,000 fine.[74]

GT also owns a controlling stake in Singapore-listed property developer SingHaiyi Group Ltd. (SingHaiyi), while CT is the Group managing director. SingHaiyi is chaired by Neil Bush, brother of Jeb Bush and former U.S. president George W. Bush.[75] Besides SingHaiyi, the Tangs also have stakes in various SGX-listed property issuers such as ARA US Hospitality Trust, Eagle Hospitality Trust and OUE Commercial Reit.[76]

The Tangs were also reported to be close to Yingluck Shinawatra (Yingluck),[77] the former prime minister of Thailand. Yingluck had served as the Chairwoman and legal representative of Shantou International Container Terminals Ltd (SICT).[78] It was said that its major shareholder had been changed to one owned by Pacific International Capital Ltd, which has a similar name to APIC mentioned above, although the link was not confirmed. Further, SICT is 70% owned by Hutchison Port Holdings, at which CT was one of the directors.[79] The relationship between the Shinawatra family and the Tangs, as well as their business relationships, remain largely unclear.

In 2013, SingHaiyi confirmed the rumours which were raised in the early 2000s regarding the smuggling investigations in Shantou for which GT was investigated.[80] However, while several members of his staff were convicted of crimes and some of his business assets were seized, GT himself was not punished.[81]

Branching out

As of 2015, the geographical reach of CES included Malaysia, Singapore, and Australia, mainly in the property and hospitality sectors.[82] Over the next two years, the company further diversified into Vietnam, Maldives, and New Zealand.[83] After CT took over as Non-Executive Chairman in late 2018, CES has diversified further into different countries for various sectors.[84] Between October 2015 and May 2021, it made numerous acquisitions and disposals.[85]

In June 2019, CES' wholly-owned subsidiary, CEL Property Development Pte. Ltd. (CEL), entered into a joint venture with Haiyi Investment, investing RMB153 million (approximately S$30 million) into a China-based property,[86] Taicang Jianianhua Real Estate Development Co. A total of RMB240 million would be contributed to the joint venture, with CEL and Haiyi Investment holding a 51% and 29% stake in the entity respectively.[87] The remaining 20% of the equity interest would be held by Ren Weimin, the effective controller of the project company, through a newly incorporated entity. The investment was planned to be made in four stages and would enable the project company to "discharge its outstanding liabilities such that its assets will be unsealed" and restart a project involving the development and construction of a residential development. The project was to enable CES to establish a presence in the Yangtze River delta area.[88]

This joint venture saw CES "stepping out of [its] circle of competence by going to China," as pointed out and questioned by a shareholder of CES.[89] In response, RC acknowledged that the real estate business in China is "very, very difficult" and justified that "playing 'white knight' [would allow] CES to go to China to do real estate in a very quick way". He also clarified that the project had been initiated by CES' own staff and that the company had only subsequently approached GT because of his presence in China.[90]

Taicang City is considered to be one of the most competitive county-level cities in China. With respect to the Yangtze River Delta area, authorities in China had integration plans for the region. Accordingly, at about the same time the joint venture was formed, many provinces and cities such as Shanghai, Zhejiang, Jiangsu, and Anhui, came up with a three-year action plan spanning from 2018 to 2020, to increase the region's competitiveness. This would mainly be accomplished through the Yangtze River Economic Belt and enhanced infrastructure development. The latter encompasses the Hangzhou-Taizhou expressway and a deep-water channel, which decreases the travelling time between two cities and strengthens Nanjing as a logistics centre respectively.[91]

In October 2019, following the rights issue, CES announced that the company would also be heading into a joint venture with Tropical Developments Pte. Ltd. (TDPL) to acquire a lagoon in the Maldives,[92] under which an initial investment of US$7 million would be contributed by CES to develop the lagoon into a five-star resort. TDPL is incorporated in Singapore and is affiliated to the current lessee of the lagoon and Amin Construction Pvt Ltd. The latter was the main developer and contractor for CES' first hospitality project in Maldives. According to CES, the lagoon acquisition presents an opportunity for the company to further establish its presence in the hospitality sector in Maldives.[93]

Let's educate

In July 2018, a sale and purchase agreement was signed by a subsidiary of CES with an affiliate of private equity firm Navis Capital to acquire 70% of White Lodge Education Group Services (White Lodge) for S$13.3 million in cash. White Lodge operates a chain of pre-school centres in Singapore and Malaysia.[94]

Two months later, CES announced its plan to expand into China's education market with an investment of RMB100 million in Guangzhou Yuanda Information Development, an education software business. The investment was said to be in line with the long-term plan of diversifying into the education sector.[95] This was just a month before founding family members of CES decided to sell nearly all their shares to the Tangs.[96]

On 3 July 2019, CES' wholly owned subsidiary CES Cambridge (CESC) "entered into an agreement with The Perse School Cambridge International (TPSCI) to set up an elementary school in Singapore by early 2020".[97] The elementary school will "cater to students from six to 11, and may extend into a secondary school". Further, as part of the agreement, CESC and TPSCI "granted each other a mutual exclusivity for 30 years not to establish and operate elementary schools in Singapore using a British brand". CESC will also be paying a fixed fee to the company's shareholders and an annual fee calculated based on a percentage of total revenue of the operation of the elementary school for each academic year.[98]

CES also acquired Tarneit West Childcare's childcare centre in Tarneit, Australia for A$3.5 million (approximately S$3.3 million) on 1 August 2019.[99] CES mentioned that with the existing presence of the company's property development and hospitality segments already established in Australia, coupled with the "country's stable economy and sound legal system", the acquisition would enable it to expand into the education sector in Australia, particularly in childcare. CES engaged White Lodge for the management and operation of the childcare centre, with the reason that "the business would benefit from the extensive experience and expertise of the incumbent management of White Lodge, accumulated from over two decades of operating pre-school centres in Singapore and Malaysia".[100]

CES Education then acquired Raffles Campus (Malaysia) for S$24.4 million on 12 December 2019.[101] Raffles Campus (Malaysia) is the holding company of two wholly owned entities in Malaysia, with one owning a plot of freehold land while the other owns and operates Excelsior International School on the land itself. Since September 2013, the school has catered to students from kindergarten to high school.[102]

In September 2020, CES made a further investment into Invictus International School Pte Ltd (Invictus) through its wholly-owned subsidiary CES WL Pte. Ltd. Following this investment, CES' effective interest in Invictus increased from 70.06% to 86.83%.[103] CES first invested in Invictus in April 2019 when White Lodge bought a 64.64% stake in Invictus.[104] CES said that an increase in the stake in Invictus would enable the company to capture a larger share of the future value of Invictus. It said that since the company's initial investment into Invictus in April 2019, Invictus had embarked on rapid expansion plans, including the establishment of schools in new markets such as Hong Kong and Cambodia, and the extension of its curriculum from only a primary school segment to the full scope of K-12 education. Invictus would also enter into licensing arrangements to allow the company's joint venture vehicle in China to use and further license the Invictus brand to schools in certain territories in China.[105]

More board changes

From 2019 to 2021, there were a number of board changes. In April 2019, 79-year old ID UGS did not seek re-election at the company's Annual General Meeting (AGM), having served for four years.[106] This was followed by the resignation of LTY in October 2019 "to pursue other work commitment", after serving just over three years on the board.[107] On 1 November 2019, it was announced that he had been appointed as Singapore's ambassador to the China.[108] Finally, in April 2021, lead ID AMS, who had served on the board for 18 years, retired at the company's AGM. AJ was appointed as the new lead ID.[109]

CES appointed three new IDs to replace those who left. In December 2019, it appointed Professor Low Teck Seng (TS) and Professor Neo Boon Siong (NBS). TS is a professor in both the National University of Singapore (NUS) and Nanyang Technological University (NTU), as well as CEO of the National Research Foundation under the Prime Minister's Office of Singapore. At the time of his appointment, he served on the boards of two other SGX-listed companies. TS was on the board of Singapore Post Limited but left in 2016 during the board overhaul following the disclosure lapse and conflict of interest involving the lead ID of the company.[110] NBS was a former Dean and Professor of Business at the Nanyang Business School, NTU, and is currently a professor in the Lee Kuan Yew School of Public Policy at NUS. He has served as an ID in several listed companies.[111] He was on the board of Keppel Offshore and Marine Ltd (KOM) for several years until FY2010.[112] In December 2017, KOM paid a US$422 million settlement under a deferred prosecution agreement for bribery in Brazil over the period from 2001 to 2014.[113]

In February 2020, CES also appointed Professor Yaacob Bin Ibrahim (YBI), a Professor of Engineering and advisor at the Singapore Institute of Technology. YBI was previously the Minister of Communications and Information and is currently Professor of Engineering and advisor to the President of Singapore Institute of Technology. CES was the first board of a publicly-listed company he served on.[114]

CES also appointed Yam Ah Mee (YAM) as a non-independent non-executive director in December 2019.[115] YAM is the CEO of Sembcorp Design and Construction Pte Ltd, which was acquired by CES that month.[116,117]

What does the future hold?

The COVID-19 pandemic has hit CES particularly badly. In the year ended 31 December 2020, it reported a net loss of S$78.5 million, down from a net profit of S$32.6 million the previous year. Revenue fell from S$1.06 billion to S$674.6 million.[118] However, its deteriorating performance was not solely due to the pandemic as its net profit in FY2019 had fallen from S$80.3 million the previous year.[119] Meanwhile, its share price, which had climbed to more than S$1 in the first half of 2018, had fallen to S$0.44 by 28 May 2021.[120]

Will the diversification of CES pay off? With its recent board changes, will its corporate governance improve or will questions continue to flood in? Will SIC clarify the application of the Takeover Code in situations such as CES, or will the market continue to wonder if only the letter but not the spirit of the code matter?

Discussion questions

1. Critically evaluate the board structure of Chip Eng Seng in FY2015, after the departure of the family members from the board, and after the most recent changes. Is the reported background of the Tangs a cause for concern? Are there concerns about the independence of some of the independent directors? Explain.

2. Critically evaluate the remuneration disclosures for Chip Eng Seng and the remuneration payments to family members before the change of control. How should remuneration policies for family members in a family-controlled company such as Chip Eng Seng be determined? Do you believe that the remuneration practices at Chip Eng Seng are prejudicial to minority shareholders? Explain.

3. Chip Eng Seng has been changing its business through a series of acquisitions and disposals and is diversifying into new markets and sectors. What are the responsibilities of the board in this situation? What due diligence should be done when companies make acquisitions and divestments?

4. Discuss whether the Tangs should have been required to make a general offer following their acquisition of shares from the Lims and in light of the rights issue.

5. Discuss the responsibilities of directors in change of control situations like in Chip Eng Seng's case. What do you think independent directors should do to ensure that the interests of minority shareholders are safeguarded in such situations?

6. Critically evaluate the effectiveness of the rules and regulations in ensuring good corporate governance and protection of minority shareholders.

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HC SURGICAL SPECIALISTS: FAR FROM SERENE

Case overview

In January 2017, Serene Tiong, a business development manager at Thomson Medical Centre, entered into an extramarital affair with Dr. Chan Herng Nieng, a senior consultant psychiatrist at the Singapore General Hospital. This all came crashing down after their vacation to Eastern Europe in April 2018. While Dr. Chan was asleep, Tiong was horrified to find WhatsApp messages between him and his close surgeon friend, Dr. Julian Ong, from HC Surgical Specialists (HCSS), a company listed on the Catalist Board of the Singapore Exchange (SGX). The messages allegedly showed that the two doctors were colluding to take sexual advantage of female patients. Outraged, she took screenshots of the chats and eventually publicised them. Tiong also made complaints to the Singapore Medical Council (SMC) against the two doctors. Dr. Ong sued Tiong for defamation. Although Tiong initially won, Dr. Ong won his suit on appeal. Tiong then decided to pursue a statutory derivative action against the CEO of HCSS alleging breach of director duties, which she lost.

The series of events dragged HCSS into the spotlight and its decision to increase its stake in the practice owned by Dr. Ong in the midst of the scandal drew scrutiny from SGX Regco, the regulatory arm of SGX, and from commentators. Meanwhile, the SMC itself faced public criticism on its disciplinary process as it has been more than three years since Tiong first made her complaints.

The objective of this case study is to faciliate a discussion of issues such as board composition; directors' responsibilities in making acquisition decisions; the tradeoff between profits and ethics for listed medical companies; the role of regulators; and the challenges of profit guarantees and put options in protecting shareholders' interests while ensuring compliance with ethical guidelines for listed healthcare companies.

An affair gone awry

From January 2017 to May 2018, Serene Tiong, a business development manager at Thomson Medical Centre, and Dr. Chan Herng Nieng, a senior consultant psychiatrist at the Singapore General Hospital (SGH), were involved in an extramarital affair. Tiong was still legally married but was intending to divorce her husband. The affair came to an abrupt end after a trip they took together to Eastern Europe.[1]

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While vacationing in Prague, Tiong accessed Dr. Chan's phone without his knowledge or consent. She then took screenshots of several WhatsApp messages between Dr. Chan and Dr. Julian Ong, his close surgeon friend from HC Surgical Specialists (HCSS), detailing the men's sexual exploits. The WhatsApp messages contained extremely salacious content, with Dr. Chan revealing that he had been engaging in sex with other women, and Dr. Chan and Dr. Ong boasting about their past "conquests" (which included their colleagues), while casually labelling the women whom they have had sex with as "sluts".[2] The screenshots included messages where Dr. Ong made reference to anal sex with a patient, and shared a patient's contact with Dr. Chan while egging him on to meet her.[3]

Tiong allegedly confronted Dr. Chan later and threatened to make the screenshots public. According to a police report filed by Dr. Chan in May 2018, Tiong had allegedly demanded S$10,000 from him, failing which she would send screenshots of the WhatsApp messages to his parents. When Dr. Chan did not accede to her demand, Tiong purportedly sent the screenshots of the WhatsApp messages to his parents and younger sister.[4]

Sexual exploits go public

Tiong made good on her threat to make the screenshots public. She first filed a complaint with the Singapore Medical Council (SMC) via letters on 13 and 19 June 2018, alleging that she had suffered various side effects from medication that Dr. Chan had prescribed her, and that she had become addicted to the medication. She further claimed that Dr. Chan had then taken advantage of her emotional instability that arose under the influence of the medication.[5]

Subsequently, between 19 and 23 June 2018, Tiong sent various emails to multiple colleagues of Dr. Chan's, both in SGH and in private practice. Dr. Chan testified that these included at least six senior doctors at SGH, including the head of the psychiatry department.[6] The emails contained statements which were also included in the complaint, as follows:[7]

1. "I found out that he has been colluding with Dr. Ong, a surgeon from the private practice to take advantage of other vulnerable woman patients";
2. "I suspect Dr. Chan uses his reputation as a platform, together with Dr. Ong to 'source' and 'groom' the patients turned victims"; and
3. "Both doctors exchanged potential patients and colleagues who are deemed to be easily taken advantage of to satisfy their immoral desires".

Dr. Chan discovered the emails when some of the recipients forwarded them to him, which he then informed Dr. Ong about. Dr. Ong took swift legal action, instructing Dentons Rodyk & Davidson LLP to write a letter to Tiong demanding that she cease publication of the defamatory allegations against him. Undeterred, Tiong continued to send such emails. This included an email to one Dr. P, who was a colleague of Dr. Chan, informing Dr. P that she was the subject of one of the WhatsApp messages between Dr. Ong and Dr. Chan. This led Dr. Ong to commence legal proceedings against Tiong on 4 July 2018, alleging that the aforementioned statements contained in the email were defamatory.[8]

A doctor defamed...?

Dr. Ong sought damages for libel, and an injunction to restrain Tiong from publishing or causing to be published the three offending statements (listed above) or other words similarly defamatory of Dr. Ong. However, according to Dr. Ong, Tiong continued to send emails containing the defamatory allegations to Dr. Chan's colleagues, even after the commencement of the defamation suit.[9]

Tiong did not dispute the defamatory nature of the statements made in her email. Instead, she pleaded the defence of justification – that the allegedly defamatory words were substantially true.[10] She succeeded at the District Court level, and on 3 April 2020 District Judge Lynette Yap dismissed Dr. Ong's action with costs, finding "the main charge to be substantially true" (judgment hereinafter known as SGDC Defamation Decision).[11]

Earlier on 6 January 2020, Dr. Ong had obtained a protection order which prohibited Tiong from communicating with Dr. Ong, HC Surgical Specialists Limited (HCSS), as well as officers and employees of Julian Ong Endoscopy & Surgery Pte Ltd (JOES). On 16 January 2020, the police administered a warning to Tiong in lieu of prosecution for the offence of attempted extortion, after completing investigations into the police report made by Dr. Chan.[12]

Dr. Ong appealed against the District Court decision. At the High Court, the decision hinged on whether there was substantial truth to the allegation that Dr. Ong and Dr. Chan had colluded by using their positions as medical professionals to take advantage of and/or to attempt to take advantage of "vulnerable woman patients" (judgement hereinafter known as SGHC Defamation Decision). Since the only patients named were a female patient 'K' and Tiong herself, the Court had to determine if Dr. Ong and Dr. Chan could have been said to have colluded to take advantage of Tiong.[13,14]

Ultimately, Dr. Ong succeeded on his appeal on technical grounds on 2 October 2020. Justice See Kee Oon found that while Dr. Ong and Dr. Chan did take advantage of patient 'K', Tiong was not considered a patient of either Dr. Chan (due to the nature of their affair) or Dr. Ong and was therefore not considered a "vulnerable woman patient". Since Tiong's defamatory allegations referred to "vulnerable woman patients" in the plural form, the Court found that there was no substantial truth to Tiong's allegations.[15]

Nonetheless, Justice See took pains to highlight that while Dr. Ong succeeded in his appeal, there was "no moral victory" that he nor Dr. Chan could lay claim to. The fact still stands that Dr. Chan and Dr. Ong took advantage of a female patient 'K', and have blatantly treated women like sex objects. In the Court's view, regardless of the outcome of the case, the professional reputations of Dr. Chan and Dr. Ong have been sullied.[16]

The defamation case and allegations against Dr. Ong cast the spotlight on HCSS, which had in February 2017 acquired 51% of Dr. Ong's practice, JOES.[17] When news of the SGDC Defamation Decision broke, the share price of HCSS fell by as much as 10.5% to S$0.34.[18]

HCSS is a medical services group primarily engaged in the provision of endoscopic procedures, including gastroscopies and colonoscopies, and general surgery services with a focus on colorectal procedures across a network of clinics around Singapore.[19] Incorporated on 1 September 2015, HCSS was listed on the Catalist Board of Singapore Exchange (SGX) on 3 November 2016.[20]

No big deal?

HCSS first became privy to the allegations against Dr. Ong in June 2018 when Dr. Ong voluntarily revealed to Dr. Heah Sieu Min – HCSS' executive director (ED) and Chief Executive Officer (CEO) – about the allegations of sexual misconduct by Tiong against him and the commencement of the defamation suit against Tiong. Dr. Heah told Dr. Ong to "keep him updated".[21]

In February 2019, SMC formally notified Dr. Ong of the complaint lodged against him (SMC Complaint).[22] When Dr. Ong relayed this to Dr. Heah and Dr. Chia Kok Hoong – HCSS' medical director and ED –at the end of the same month, he reiterated that Tiong's allegations were "one-sided" and "groundless".[23] Nevertheless, HCSS made inquiries about the nature of the complaint. Additionally, Dr. Heah and Dr. Chia had internal discussions and counselled Dr. Ong.[24] Both EDs reached a similar conclusion that as SMC is the professional regulatory body, it was in the best position to make findings of the misconduct. Further, even if the allegations were true, they would not pose a significant financial impact on HCSS, as that was a matter of Dr. Ong's personal affairs.[25]

The duo then took the following actions: (i) they reminded Dr. Ong of his obligations under SMC's Ethical Code & Ethical Guidelines (ECEG); (ii) they made it clear to Dr. Ong that the SMC's findings could have implications to HCSS; and (iii) they continued to monitor Dr. Ong's conduct.[26] They updated the HCSS board, and the board once again agreed to "let due process run its course",[27] saying that it was "impractical" to further investigate Dr. Ong before SMC provided its findings.[28]

It later transpired that neither the WhatsApp messages nor the detailed content of the SMC Complaint were made known to the HCSS board, until the written grounds of judgement was provided at the conclusion of the SGDC Defamation Decision. HCSS said that this was because "Dr. Ong wanted to keep matters relating to the suit private as it related to defamatory statements".[29]

Let’s have more of JOES

HCSS had intended to acquire 100% of the shares in JOES since 2017. The Group acquired the first 51% for S$2.2 million on 1 February 2017,[30] via a sale and purchase agreement (SPA 1). Under the terms of SPA 1, HCSS agreed to purchase the remaining 49% of the issued share capital of JOES by 1 April 2021, at a price which is ten times of JOES’ audited profit after tax (PAT) for the financial year ended 31 May 2020. Dr. Ong was to provide two guarantees (the Profit Guarantees) for the initial 51% and subsequent 49%. In the event the amount attributable to HCSS falls below the guaranteed sum, Dr. Ong will be liable to pay the shortfall within 30 days of notice.[31]

Unfazed by the ongoing allegations, the HCSS board decided to acquire an additional 19% of shares in JOES in September 2019 (the 19% acquisition).[32] In July 2019, Dr. Heah first proposed to the board that the Group should use part of the net proceeds from an investment agreement with Vanda 1 Investments Pte Ltd (Vanda 1 Investments) to fund this acquisition.[33] Thus, through a second sale and purchase agreement dated 3 September 2019 (SPA 2), HCSS’ stake in JOES was boosted from 51% to 70%. The consideration amounted to S$3,795,000, comprising S$2,846,712 in cash and 1,760,000 new HCSS shares.[34] This consideration was based on a multiple of 10 times of JOES’ PAT for the financial year ended 31 May 2019.[35]

Under SPA 2, the Group also agreed to buy the remaining 30% of JOES’ shares by 31 October 2021, at a price which is 10 times of JOES’ audited PAT for the financial year ended 31 May 2021. Further, the Profit Guarantees in SPA 1 were replaced by a Put Option, which would require Dr. Ong to repurchase HCSS’ 70% or 100% stake in JOES in the event that Dr. Ong’s employment with the Group was terminated.[36] The Singapore Medical Association (SMA) had in April 2017 stated that profit guarantees are incompatible with the profession’s ethical guidelines.[37]

The decision to acquire the remaining stake was chiefly motivated by JOES’ profitability and growth potential since Dr. Ong started his employment on 1 April 2017. When the Group acquired the first 51% interest in JOES, JOES’ PBT was approximately S$660,000. This increased to approximately S$1.79 million for the financial year ended 31 May 2018 and S$1.88 million for the financial year ended 31 May 2019, contributing 17% and 13% to HCSS Group’s revenue and profits respectively for the half year ended 30 November 2019.[38] As such, the HCSS board was confident that JOES’ profits would continue to grow and the 19% acquisition will thus be in the interest of HCSS. Ultimately, the board explained that the additional 19% stake in JOES will “motivate” Dr. Ong and that the acquisition will “continue to enhance the working relationship upon which Dr. Ong, coupled with the Company’s resources, will be able to further improve the profitability of JOES”.[39]

These decisions were made despite the ongoing SMC investigation and the fact that the outcome was still uncertain. Given Justice See’s severe criticism of Dr. Ong’s behaviour and his comment that the successful appeal in the defamation case was “no moral victory”,[40] it was far from clear that Dr. Ong will not face serious sanctions from the SMC. The 19% acquisition by the board despite its knowledge of the allegations and the SMC investigation raises questions as to whether the issue of medical ethics was properly considered in the decision to enter into SPA 2.[41,42]

The HCSS board was not done yet. On 31 December 2020, HCSS announced that it was proposing to acquire the remaining 30% of JOES. The total consideration for the balance shares shall be "an amount that is ten times the audited profit after tax of JOES, after adjustments to exclude the expenses incurred in the form of the facility management fee and Dr. Ong's profit-share under the terms of his employment contract, if any, for the one-year period commencing from the month after the outcome if Dr. Ong's registration is not suspended or the month after the end of the suspension period, as the case may be, multipled by 0.30".[43] HCSS said that it had delayed the acquisition of the balance shares due to the investigation. However, it decided to proceed after taking into consideration that Dr. Ong had won his defamation suit against Tiong and the agreement of Dr. Ong to extend his employment with the company.[44]

The completion of the acquistion was to occur one year after the outcome of the investigation or, if any, the suspension period. Where Dr. Ong's medical registration is suspended for up to three years, the company will purchase the balance shares after one year from the end of the suspension period at the purchase consideration. Where Dr. Ong is not allowed to continue his medical practice or his medical registration is suspended for more than three years, the company has the right to consider its options, which includes the right to exercise the Put Option.[45]

The put option – an illusory safeguard?

After local newspaper The Straits Times published an article on 10 April 2020 titled "Surgeon loses defamation suit as judge upholds woman's claim that he took advantage of vulnerable patients",[46] SGX issued a series of queries to HCSS.[47,48,49,50,51] The responses provided by HCSS to the queries raised by SGX faced criticism from commentators.[52,53,54]

One of the issues raised was the potential financial implications for HCSS in light of the SMC investigation. In response, HCSS replied that the Put Option was sufficient to safeguard the Group's interest. The Group explained that if Dr. Ong was found guilty for dishonest or serious or persistent misconduct, his service agreement could be terminated. Upon termination, the Group would exercise the Put Option. HCSS asserted that the minimum consideration from the Put Option would be more than the total amount paid for the 70% interest in JOES.[55]

However, it was unclear what the exact terms of the Put Option were. It was only disclosed that the consideration to be received would be a percentage of what the Group paid for the 19% acquisition. This percentage would decrease with each year of Dr. Ong's employment, on the basis that Dr. Ong would be making significant contributions to the Group.[56]

Questions were raised about the effectiveness of the Put Option in safeguarding HCSS' interest.[57,58,59] The Put Option was exercisable between the 30th and 48th month of Dr. Ong's employment. The 48th month fell on 31 March 2021.[60] Despite the proximity of the expiration date, HCSS had expressed no intention to postpone the exercise period, even though the SMC investigation was still ongoing. In fact, on 27 September 2020, HCSS said that it was unlikely that Put Option would be exercised.[61]

There was also the question of whether the Put Option was any more compliant with the medical profession's ethical guidelines than Profit Guarantees.[62]

There are "no other complaints"

After the news about the SGDC Defamation Decision broke, Parkway Group Healthcare Pte Ltd (Parkway), a private healthcare provider, suspended Dr. Ong's accreditation and clinical privileges at Gleneagles, Mount Elizabeth, Mount Elizabeth Novena and Parkway East hospitals from 20 April 2020, until and unless the SMC Complaint was dismissed.[63] If the SMC Complaint was not dismissed by 1 July 2021, Dr. Ong's accreditation and privileges at the said hospitals would completely cease.[64]

However, Dr. Ong was still permitted to practice at HCSS Group's heartland centres.[65] Is HCSS sending a message that lower standards of conduct apply to the heartland centres?

When questioned on why the HCSS board felt that Dr. Ong should be allowed to continue practising as a key specialist of the Group before SMC investigations were concluded, it said that it had determined that "notwithstanding his personal indiscretions, Dr. Ong is a surgeon who has continued to provide quality medical services to his patients", and that his professionalism had not been affected by his personal conduct.[66] HCSS said that neither Dr. Ong nor the Group had received any other complaints, and that patients were generally satisfied with his professionalism. Further, it stressed that despite the news, none of Dr. Ong's patients have decided to consult another doctor.[67]

HCSS said that it had asked Dr. Ong to inform all his patients of the SMC Complaint, and to obtain each of their consent prior to any consultation.[68] Dr. Ong voluntarily provided SMC with an undertaking that whilst the investigation remains ongoing, he will: (i) refrain from contacting his female patients for purposes that are outside the scope of his medical practice; (ii) comply fully with the provisions of SMC's ECEG, and (iii) refrain from conduct which brings disrepute to the medical profession.[69] The Interim Orders Committee (IOC) of the SMC subsequently imposed an interim order on Dr. Ong for a period of 18 months or until the conclusion of the proceedings against Dr. Ong, whichever was sooner.[70] As of 31 July 2021, the SMC has yet to complete its proceedings against Dr. Ong – more than three years after Tiong first made her complaint[71] and more than one year after SMC announced that the complaint will progress to a disciplinary tribunal.[72]

No serenity yet

After HCSS announced its decision to acquire another 19% of JOES on 3 September 2019,[73] Tiong took matters into her own hands to communicate with HCSS. She called and informed the company's Chief Financial Officer (CFO) of the ongoing lawsuit between Dr. Ong and Tiong and about his alleged act of "sending nude photos of his female patients around".[74] Tiong also requested a meeting with Dr. Heah to brief him about the defamation case and legal correspondence. Following the call, Tiong took to emailing the Group's investor relations firm to bring the defamation case and her SMC Complaint to its attention.[75]

The investor relations firm informed Tiong that the management "was aware of the case and will follow due (sic) with this". Dr. Heah also did not see the need to meet up with Tiong as Dr. Ong had already informed him of the matter.[76]

Tiong bought 100 HCSS shares the day before the company's Annual General Meeting (AGM) scheduled for 26 September 2019 with the intention of attending and voicing out her concerns about the 19% acquisition. However, the registration was not effected in time and she was denied entry to the AGM. Nonetheless, Tiong spoke to the CFO and Dr. Heah after the AGM, and was informed by both that the 19% acquisition was a commercial decision made by management. Tiong also revealed her intention to document the meeting for sharing with journalists.[77]

Lone ranger

On 29 April 2020, Tiong's solicitors wrote to HCSS seeking information on the board's and Dr. Heah's knowledge of the SMC Complaint and the defamation action at the time of the 19% acquisition, as well as the steps to be undertaken by HCSS given what had been brought to light. HCSS' CFO responded by referring her to the company's response to SGX's queries.[78]

A few days earlier, HCSS issued two responses to SGX queries on 24 April 2020 and 27 April 2020.[79,80] The responses did not directly address the question with regard to knowledge at the date of the 19% acquisition even though the chronology of events in the first response to SGX query indicated that Dr. Heah and Dr. Chia were aware of the SMC Complaint and the defamation suit before the discussions commenced on the purchase of the additional 19% stake in JOES. It also showed that when the acquisition was discussed at a board meeting on 25 July 2019, there were discussions on the complaint and the suit.[81]

The second response to the SGX query said that the HCSS board and Nominating Committee were of the view that, notwithstanding his personal indiscretions, Dr. Ong "has continued to provide quality medical services to his patients". With regard to future steps, the response said that the board had requested that "Dr. Ong inform all his patients of the matters alluded to in the Complaint prior to any consultation and obtain the consent of each patient to act as their physician if they should so agree, save for any emergency consultation". The company added that as SMC was still looking into the complaint, "the board notes the importance of allowing due process to run its course and will take into consideration the findings of the SMC Complaints Committee and determine if any further action needs to be taken".[82]

Following HCSS' response, Tiong's solicitors asked if the company was prepared to take action against Dr. Heah for breaching his director duties to exercise reasonable diligence with regard to the 19% acquisition, especially as he had dealt with the acquisition in light of the defamation action and the SMC Complaint "in the most perfunctory manner".[83]

One week later, the company rejected Tiong's allegations of breach of director duties by Dr. Heah. That same day, Tiong gave notice of her intention to apply to the Court under Section 216A(2) of the Companies Act, to commence a derivative action in HCSS' name against Dr. Heah. The claim was filed on 27 May 2020. In the claim, Tiong alleged that Dr. Heah had breached his director duties by failing to demand relevant documents from Dr. Ong, failing to commence an internal investigation, allowing Dr. Ong to be released from the Profit Guarantees under SPA 2, and failing to recuse himself from the decision of the 19% acquisition. The claim said that had Dr. Heah demanded information and conducted an internal investigation, he would have realised that the misconduct allegations in the SMC Complaint were true and this would have affected HCSS' decision to proceed with the 19% acquisition, as the company would have considered the risks associated with the SMC Complaint on the business.[84]

End of the road

On 28 September 2020, Tiong's derivative action against Dr. Heah was dismissed in full by the Singapore High Court (judgement hereafter known as SGHC SDA Decision). As such, Tiong was ordered to pay costs and reasonable disbursements to HCSS and Dr. Heah.[85]

In arriving at its decision, the Court found that it was not in the interest of HCSS to bring an action against Dr. Heah. The Court felt that the decision for the 19% acquisition cannot be said to have ignored Dr. Ong's misconduct allegations when there was no suggestion that Dr. Ong did not disclose the relevant information to the board. The Court also concluded that the board had not ignored the risks as it had proceeded on the basis that the complaint might be true. This was "abundantly clear from the fact that Dr. Heah and the board satisfied themselves that there were sufficient safeguards in place to protect the Company in the event of any adverse finding by the SMC". Dr. Heah and the board were of the view that the Put Option served as sufficient safeguards.[86]

Additionally, the court did not find that Tiong provided any credible reason why Dr. Heah should have recused himself from the 19% acquisition decision. The Court emphasised that it was not its role to interfere in corporate decisions as long as the decision was made in good faith.[87]

The Court also found that Tiong had not been acting in good faith in bringing the action. The Court believed that Tiong was not concerned about the interests of the company, as she was not concerned with the commercial aspects of the 19% acquisition. Instead, she was more concerned with documenting the meeting and sharing it with journalists. The judge opined that Tiong's objective in trying to stop the 19% acquisition was solely to punish Dr. Ong, and she had wanted to hold Dr. Heah responsible when she had failed to achieve her objective. The judge said that Tiong's personal vendetta as a victim clouded her judgement.[88]

In light of the Court's decision, HCSS reiterated its view that personal disputes between Tiong and Dr. Ong should have been resolved in the appropriate forum – that is, without involving the company.[89]

Tiong subsequently appealed the decision in the Court of Appeal. On 7 April 2021, HCSS announced that her appeal was dismissed in full and she was ordered to pay costs of S$15,000 to the company and S$30,000 to Dr. Heah.[90]

The watchmen

The board of HCSS comprised five male directors. It is chaired by Chairman and independent director (ID) Chong Weng Hoe. Chong was appointed to the board in September 2016. He has an Bachelor of Engineering (Electrical) from the National University of Singapore and a Master of Business Administration (Accountancy) from Nanyang Technological University. Chong is the Executive Vice President of TÜV SÜD Asia Pacific Pte Ltd and serves on the boards of two other listed companies.[91]

Dr. Heah, a colorectal surgeon, is ED and CEO. He is also the controlling shareholder of HCSS, holding 42.36% of the company's shares. The other ED is Dr. Chia, an accredited renal transplant surgeon, who is the medical director of HCSS. Dr. Chia was an elected member of the SMC from October 2016 to October 2019. Dr. Chia holds a 23.01% stake in the company. Both EDs have extensive experience as medical professionals.[92]

There are two other non-executive directors (NEDs) – Ooi Seng Soon, who is independent, and Lim Chye Lai, Gjan, who is non-independent. Ooi was appointed in September 2016 and has over two decades of experience in banking and finance. He has served as an independent director of two SGX-listed companies. Lim has a Diploma in Electronics from Temasek Polytechnic and has worked in the medical equipment industry for more than 18 years. He has not served on the boards of any listed companies.[93]

There are three committees – Audit Committee, Nominating Committee, and Remuneration Committee. All committees comprise three members each. Ooi chairs the Audit Committee while Chong chairs both the Nominating Committee and Remuneration Committee, with the other IDs and NEDs serving as members in committees which they do not chair. There is no mention of any committee responsible for ethics, clinical governance or risk management, although the corporate governance report states that the board "sets the tone for the Group in respect of ethics, values and desired organisational culture".[94]

Diversity or lip service?

On 1 July 2020, Dr. Goh Minghui, a female surgeon who was previously a consultant surgeon in the department of colorectal surgery at SGH, began her practice at HC Ming Endoscopy & Piles Centre in Camden Medical Centre and Tampines Endoscopy & Surgery Centre.[95]

In its response on 4 May 2020 to SGX queries regarding whether the existing arrangements were sufficient for safeguarding shareholders' interests and whether the board was satisfied that it had put in place necessary measures and safeguards in the event that the outcome of the SMC investigations' impact on Dr. Ong's ability to continue practising, HCSS said that the addition of Dr. Goh would instil confidence in the Group and that it promotes gender diversity, "which is in line with HCSS Group's long-term strategy".[96] Dr. Goh is not a member of the board of HCSS.

Stitching deals

On 5 July 2019, HCSS entered into an agreement to dispose a 51% stake in the Group's subsidiary HMC Medical Pte Ltd to Singapore Paincare Holdings Pte Ltd (SPHPL),[97] which later successfully listed on the Catalist Board on 30 July 2020.[98] HCSS said that the transaction was part of the Group's plan to participate in pain management services, which potentially unlocks additional value for the Group.[99] Following the transaction, HCSS holds a direct interest of 3.67% and a deemed interest of 4.91% in SPHPL.[100] HCSS' independent Chairman, Chong, became an ID in SPHPL on 17 June 2020.[101]

In October 2020, HCSS entered into a memorandum of understanding (MOU) with Healthcare Essentials Pte Ltd (HEPL) to subscribe for new ordinary shares amounting to 20% of HEPL's equity.[102,103] HEPL is a Singapore-based company specialising in retail sales of pharmaceutical and medical goods and provision of management consultancy services. This constitutes an interested person transaction (IPT) under Catalist rules as HEPL is wholly owned by HCSS' NED, Lim.[104] A month earlier, Catalist-listed MediNex Pte. Ltd. (MediNex), also entered into a non-binding MOU with HEPL for a proposed subscription of another 20% of HEPL's total issued share capital.[105] HCSS is the controlling shareholder of MediNex, owning more than 32% of its shares.[106]

The proposed consideration for the subscription was 20% of an amount that is double the net tangible asset value of HEPL as at 31 August 2020, and was subject to the completion of due diligence and the entry into a definitive agreement. According to the HCSS board, the subscription will enable the Group to acquire an interest in a medical-related company as part of its inorganic growth plans.[107]

Ethics or profits?

Healthcare is, at its core, a moral enterprise.[108] The vulnerability of patients within the doctor-patient relationship, and the implicit trust that patients place in healthcare providers to give them the best care, requires high ethical standards to be upheld. As a medical company, HCSS faces both the business imperative of running a profitable business and delivering returns and dividends to shareholders, and the ethical standards expected of the medical profession.

Profit guarantee – does it undermine ethics?

Under a profit guarantee, the target of an acquisition guarantees the buyer a certain profit over a certain period of time.[109] For corporate deals that take place in Singapore, profit guarantees have frequently been used, including by other companies in the healthcare industry such as the Q&M Dental Group.[110] When HCSS acquired its initial stake in JOES, the SPA included Profit Guarantees which required Dr. Ong to pay the Group any shortfall within 30 days after written notice from HCSS, if the targets are not met.[111]

Profit guarantees help protect acquirers from the potential downside risk of poor financial performance. However, they have long been discouraged under medical ethics guidelines. As early as 1998, the SMA passed a resolution stating that profit guarantees heighten the risk of unethical behaviour as the patients' interests are no longer the medical practitioner's foremost consideration.[112] The financial obligation would potentially pressure the doctor to overcharge or provide inappropriate treatment.[113] The 1998 resolution has also been supported by the SMC.[114] More recently, the Handbook on Medical Ethics, published on 13 September 2016 by the SMC and which came into force on 1 January 2017, provides guidelines on profit guarantees. In Section H3.1(c), it is explicitly stated that medical practitioners should be careful "not to allow any financial arrangement that commits you to give a revenue or profit guarantee to a third party to influence how you manage patients. [He] should avoid such arrangements as a matter of good practice as the pressures on [him] to meet [his] financial obligations would be great."[115]

On 25 April 2017, SMA reiterated that ethical guidelines for the medical profession prohibit profit guarantees for healthcare services as the financial imperative they impose is incompatible with the guidelines.[116]

Nevertheless, the use of profit guarantees is still prevalent for acquisitions in the healthcare industry. In 2014, the acquisition of Foo & Associates Pte. Ltd. by SGX Mainboard-listed Q&M Dental Group included a profit guarantee of at least S$5.25 million over a period of 10 years.[117] In 2016, ISEC Healthcare Ltd. (ISEC Healthcare), a SGX Catalist-listed healthcare company, also utilised profit guarantees in its acquisition of four JL Medical Group clinics.[118] Responding to SGX's query about its 2019 results in relation to the profit guarantees, ISEC Healthcare defended its position, stating that the sellers had reiterated that patients' interests were their top priority and thus, profit guarantees "should not and will not affect the way they practise medicine and treat their patients".[119]

Does the put option provide adequate safeguards?

The Profit Guarantees in SPA 1 were removed by HCSS when it entered into SPA 2 with JOES.[120] The Profit Guarantees were instead replaced with a Put Option. In other cases, medical companies such as the Singapore Medical Group (SMG) had also sought to comply with the ethical guidelines regarding profit guarantees. For SMG, an initially agreed five-year profit guarantee of at least S$2.3 million per year for the acquisition of two paediatrics clinics in July 2017 was removed before the acquisition was completed.[121]

HCSS did not extend the exercise period for the put option for the 70% sale shares under SPA 1 and SPA 2 despite the ongoing SMC investigations which had no timeline for a decision. Concerns were also raised regarding whether the terms of the Put Option were too loosely worded, creating uncertainty about its enforceability.[122]

In its 4 May 2020 response to SGX's queries, HCSS provided more clarity on the termination clause and the enforceability of the Put Option.[123] The service agreement with Dr. Ong contains a termination clause which allows the Group the option to terminate Dr. Ong's employment "under certain circumstances, including but not limited to, Dr. Ong being guilty for dishonesty or serious or persistent misconduct, whether or not in connection with his employment, if Dr. Ong does anything which may bring serious discredit with any group company or if Dr. Ong is struck off the register of doctors".[124] In the event that the service agreement with Dr. Ong is terminated, the Put Option can be exercised by HCSS.[125]

The company said that the minimum consideration that it would receive from exercising the Put Option would be more than the amount paid by the company for the acquisition of the 70% interest in JOES.[126] However, it did not say how that consideration would be determined, which raises the question as to whether it is dependent on the profits that have been made by JOES and therefore incorporated an implicit profit guarantee.

Changing the watchdog

On 25 October 2019, HCSS announced a change of continuing sponsor and appointed Novus Corporate Finance Pte. Ltd. (NCF) as its new continuing sponsor, replacing PrimePartners Corporate Finance Pte. Ltd. (PPCF).[127] It stated that there were "commercial reasons" behind the change,[128] though these reasons were not disclosed in detail. NCF was the advisor for the remaining 30% acquisition in JOES.[129]

In a report on Catalist Board sponsors, it was found that NCF, one of the newest Catalist sponsors, was the most successful in gaining new clients between January 2018 and July 2020, being appointed as a new sponsor for 29% of all Catalist issuers that changed sponsor during that period. This is a high percentage considering that there are 20 continuing sponsors on the Catalist Board for companies to choose from.[130]

The report also discussed how competition for business could induce some sponsors to lower the standard of their work, so as to offer more attractive prices and gain more clients.[131] NCF was in the spotlight in the 2020 scandal involving the Bellagraph Nova Group and Axington Inc., as it was the continuing sponsor for Axington.[132] In August 2020, SGX Regco said that it had "engaged" with NCF over how it assessed the "experience, expertise, character and integrity" of Axington Inc.'s Non-Independent, Non-Executive Chairman Evangeline Shen Che.[133]

SMC = Slow Moving Council?

Medical professionals are regulated by SMC[134] and are expected to observe stringent rules. In particular, SMC's ECEG sets out principles regarding violation of propriety and sexual boundaries (Principle C4) and prohibits doctors from having personal relationships with patients and parties close to them (Principle C12).[135]

One way that SMC enforces the ECEG is through complaints from members of the public through an independent Complaints Committee (CC). According to SMC's website, regular complaints usually require at least nine months for investigations to be completed, while complex ones could take more than a year.[136] The CC's independence from SMC and the confidentiality of proceedings mean that SMC is unable to update complainants until the investigations have concluded.[137]

After the SGDC Defamation Decision, SMC secured signed undertakings from Dr. Chan and Dr. Ong to refrain from contacting female patients for non-medical purposes. SMC released its first press statement on the matter on 22 April 2020 to inform the public of the undertakings.[138]

Two months later, on 22 June 2020, SMC released its next official statement, which shed light on its procedure of investigating the complaint. SMC stated that it had appointed the IOC to determine if it was in the public's interest or necessary for the protection of members of the public for both doctors' registrations to either be suspended or subjected to restrictions.[139]

On 18 June 2020, the IOC ordered that the two doctors' registrations be conditional for a period of 18 months, or until the conclusion of disciplinary proceedings, whichever was earlier. The doctors were barred from sending patients' personal data to others and contacting any female patients for non-medical purposes unless necessary, although they were still permitted to communicate with female patients directly for medical purposes if they were seeking treatment at their respective hospitals or clinics.[140]

With regard to Tiong's complaint, the time between SMC receiving the complaint and informing Dr. Ong about it was eight months. Meanwhile, SMC's investigations continued for more than a year before the SGDC Defamation Decision triggered a more urgent response from the SMC following public criticism of its slow response.[141,142] In May 2020, SMC stated that the CC had referred this case to a disciplinary tribunal.[143] As of September 2021, there has still been no outcome from the case.

SMC gets called out

Among SMC's critics was Salma Khalik, senior health correspondent of The Straits Times, who asserted that the lack of disciplinary action potentially "erod[es] confidence in the medical profession",[144] criticisms which SMC addressed in its initial April press statement.[145] Professor Mak Yuen Teen, a corporate governance advocate, also criticised the SMC.[146] He published an article on his website analysing the time that SMC took to investigate complaints. He concluded: "SMC should assess whether its current disciplinary process is in good health. The current case involving the two doctors is almost certainly going to put that to a stern stress test."[147]

The Association of Women for Action and Research (AWARE) also voiced its concerns in a forum letter in April 2020,[148] calling the messages between the two doctors "deeply misogynistic" and a "betrayal" of the medical profession and their Hippocratic Oath. AWARE also criticised SMC's handling of the case, stating it was appalled by the fact that the doctors were not being suspended outright.[149] This prompted SMC's IOC to state in June 2020 that its mission is to assess the "risk of harm to members of the public, as well as what is in the public interest and what is in the medical practitioner's interests" and not to "make any judgement on the merit of the criminal charges".[150]

Reactions of other stakeholders

Not in our hospitals!

After the SGDC Defamation Decision, Parkway suspended Dr. Ong's accreditation and clinical privileges, preventing him from admitting patients or using any of the clinical services at all its hospitals.[151] This is especially significant given that Dr. Ong's private practice is situated within Mount Elizabeth Novena Specialist Centre, which is under Parkway's management.[152] The suspension did not extend to Dr. Ong's private practice, allowing him to continue practising from his clinic.

Further, if there is no clear dismissal of the SMC Complaint by 1 July 2021 (when his accreditation will expire), his accreditation will not be renewed and thus lapse entirely. Additionally, Parkway stated that it has the right to "convene any form of inquiry or investigation deemed appropriate, and to take further action following any SMC or judicial findings involving the professional performance and conduct of the doctor".[153] Following Parkway's announcement, the company requested Dr. Ong to transfer his existing patients to other doctors to ensure that they continue to be cared for.[154]

Changing investor sentiment?

Around the time of the SGDC Defamation Decision, Vanda 1 Investments, managed by Heliconia Capital Management Pte. Ltd. (HCM), which is a wholly-owned subsidiary of Temasek Holdings Limited focusing on investing in growth-oriented Singapore companies,[155] made a sudden request for early redemption of its investment in HCSS bonds.[156]

HCSS and HCM first entered into an investment agreement in July 2019, whereby HCM invested S$5 million via a three-year 5.5% convertible bond.[157] On 17 April 2020, however, HCSS announced that both parties had agreed to an early redemption "on amicable grounds".[158,159] HCSS stated that it hoped to maintain a "cordial relationship" with HCM for potential future cooperation, whilst highlighting that this early redemption served to reduce HCSS' overall financing costs.[160]

Since the early redemption happened just two weeks after the SGDC Defamation Decision, was HCM's decision influenced in any way by the scandal? HCSS did not provide a definitive answer when pressed on this issue. It disclosed that the investment agreement gave HCM the right to redeem the bonds at 116.5% of the principal (less interest paid) if "any entity within the Group or any of its medical staff are deemed to be liable in any suit, proceeding or similar action that could result in a material adverse effect on the financial condition, earnings, reputation or assets of the company".[161]

Ever-strong business ties

Not all stakeholders reacted adversely to the scandal. For example, insurance provider AIA Singapore Pte Ltd, which appointed HCSS as the exclusive provider of colorectal cancer screening for its eligible insured clients from 2019 onwards, did not change the arrangement.[162]

In October 2020, HCSS entered into a framework agreement with another insurance company Prudential Assurance Company Singapore Ltd,[163] under which HCSS will provide "high-quality and cost-efficient health services" for eligible insured Prudential customers.[164]

Meanwhile, all eyes are on SMC to "move out of slow lane"[165] and not drag the case any further.

Discussion questions

1. Critically evaluate the structure and composition of the HCSS board. Are there any potential conflicts of interest that may affect its oversight of operations and management? Explain.

2. Critically evaluate the HCSS board's actions from the time when Dr. Ong first confided in Dr. Heah, including its decision to leave the investigations of alleged misconduct to the Singapore Medical Council, the safeguards it put in place, allowing Dr. Ong to continue practising in heartland centres, and its decision to increase the company's stakes in JOES, the practice owned by Dr. Ong. What could HC Surgical have done better?

3. To what extent should corporate decisions take into account ethical considerations? Is there a difference for medical companies such as HCSS compared to companies in other sectors? Do you think companies in the medical industry should be permitted to be listed? Are there certain industries for which a listing may not be appropriate from an ethical standpoint? Explain.

4. Serene Tiong lost her application to commence a statutory derivative action against the CEO of HCSS. Explain what a statutory derivative action is and the procedure for initiating such an action. Under what circumstances can such an action succeed? In HCSS' case, do you think the CEO and the board have adequately discharged their duties? Explain.

5. Profit guarantees are commonly used in acquisitions. What is the purpose of profit guarantees and how effective do you think they are in protecting the acquirer's interest? With profit guarantees being barred in the medical profession, how can medical companies protect their interests when they make acquisitions? Is the put option used by HCSS a good substitute for a profit guarantee? Explain.

6. Critically evaluate the role of the regulators in ensuring good corporate governance. Do you think the regulators, including the Singapore Medical Council, in this case have done a good job?

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HIN LEONG IS NOT O.K.

Case overview

In April 2020, Singapore's oil trading colossus, Hin Leong Trading (Pte.) Ltd. (HLT), filed for bankruptcy protection. Founded by Lim Oon Kuin – who is widely known as O.K. Lim – HLT was one of the largest oil traders in Asia and was listed among the top 16 commodity trading firms worldwide, alongside big players like Vitol and Noble Group. Together with other companies owned by O.K. Lim and his family, the Group's oil business spanned across importing, refining, storing, ship chartering and management, bunker delivery and trading of oil.

Trouble began for HLT in early April 2020 when major banks from JPMorgan Chase & Co. to HSBC Holdings Plc demanded the immediate and urgent repayment of hundreds of millions of dollars in loans. Its collapse sent shockwaves through the oil trading industry.

The objective of this case study is to facilitate a discussion of issues such as corporate governance and regulatory framework for private companies; corporate governance of family-controlled and family-managed companies; role of banks; roles of external auditors and regulators; and alleged accounting fraud.

The family armada

In 1955, Lim Oon Kuin (LOK), more widely known as O.K. Lim, came to Singapore from a small town in Fujian province, China, as a twelve-year-old boy.[1] At the age of twenty, he began working as a "one-man-one-truck" oil dealer and was famously known as the man who drove a single truck delivering diesel to taxi companies, bus companies, and fishing boat operators.[2] Some knew LOK as a keen poker player[3] who would either go big or go home. In 2014, he was ranked 14th richest in Forbes list of Singapore's 50 Richest.[4]

Hin Leong Trading (Pte.) Ltd. (HLT) was incorporated in Singapore in 1973 as a private company under the Companies Act, with its address at 1 Playfair Road. LOK owned 75% of HLT, while his son Lim Chee Meng (LCM) owned 15.4%, and his daughter Lim Huey Ching (LHC) the remaining 9.6%. Since HLT has only three individual shareholders with no corporate shareholders, it is an exempt private company (EPC) under section 4 of the Singapore Companies Act.[5]

The initial version of this case was prepared by Anysia Yong Ann Hui, Ho Kar Yern, Quek Aik Xin, Tan Ser Wei Gina and Yap Yan Pheng. This version has been extensively re-written by Professor Mak Yuen Teen, and further edited by Isabella Ow under his supervision. 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 organizations named in the case, or any of their directors or employees.

In August 1975, Hin Leong Marine International Pte Ltd (HLM), a bunker supplier, was incorporated as a private company, with 54.55% owned by HLT, and the rest by LOK and LCM. Unlike its parent company, HLM is not an EPC as one of its shareholders is HLT, a corporate shareholder. Less than three years later, another bunker supplier, Ocean Bunkering Services Pte Ltd (OBS), was incorporated as a private company and became a wholly-owned subsidiary of HLT. Like HLM, OBS is not an EPC. That same day, the family incorporated Ocean Tankers (Pte.) Ltd. (OTPL) as a private company, which charters and operates tankers. It is jointly owned by LOK and LHC. OTPL is an EPC because it is not owned through another company and has only two individual shareholders.

In April 1989, Xihe Investment Pte Ltd (XHI), an investment holding company, was incorporated as a private company and became another wholly-owned subsidiary of HLT. The following year, Xihe Holdings Pte Ltd (XHH), a ship-owning company, was incorporated as another private company. Like OTPL, it is an EPC, owned by LOK and LCM. In September 2017, yet another ship-owning company, Xihe Capital Pte Ltd (XHC), was incorporated. Again, it is an EPC, owned by LOK and his two children.

The directors of all the companies in the Group comprise of LOK and/or his two children. Under XHH and XHC, there are many subsidiaries which are private ship-owning companies. Most of these companies are 90%-owned by XHH and XHC, with the Lim family members usually owning the other 10%.

Figure 1 shows the main companies owned by the Lim family.

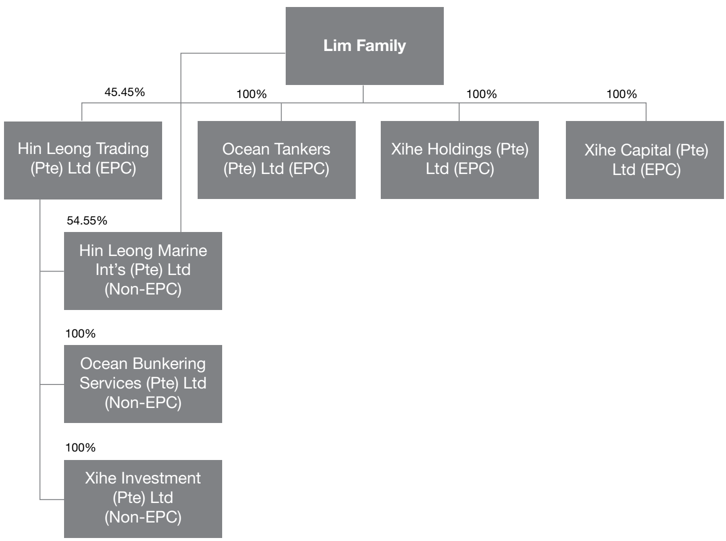

Figure 1: Major companies under the Hin Leong Group[6]

The Lim family also expanded into the oil storage business with the building of Universal Terminal, which became commercially operational in January 2008. Universal Terminal is owned by Universal Terminal (S) Pte Ltd (UTS), a private company which is 41% owned by the Lim family through another private company, and Singapore-incorporated companies owned by PetroChina and Macquarie Bank holding the remaining 59%.

The structuring of the business allowed the family to take on significant risks, while enjoying the limited liability protection of the corporate structure. Many of these companies operate within a regulatory framework based on minimal disclosures and lower auditing standards applicable to EPCs.

"Hin Leong is a company that likes risk…But this time the risk became too big."

– Jorge Montepeque, a veteran oil market executive who knows O.K. Lim[7]

The growth spurt

"Hin Leong was instrumental in helping the growth of Singapore as an oil hub and bunkering location,"

– Jean-Francois Lambert, a commodity industry consultant[8]

By the end of the 1980s, the Group was widely recognised as one of the major oil traders in the international petroleum trading arena and was awarded the Global Traders Program status by International Enterprise Singapore.[9]

After the 1997 Asian financial crisis, HLT grew in parallel with Asia's recovery. As Indonesia, Malaysia and others rebounded, so did the demand for diesel and fuel oil – the staples which HLT traded in. Back in 1997, HLT had taken a bet by buying 30 million barrels of jet fuel and diesel in the key Singapore market – worth nearly US$800 million – over a three-month span.[10] As China's growth accelerated over the following decades, more ships stopped in Singapore for fuel due to the country's unique position,[11] and HLT soon became a giant of the industry.

An early sign of trouble?

In 2012, the Monetary Authority of Singapore (MAS) fined Lim Oon Cheng (LOC), LOK's brother, for insider trading in the shares of Singapore Petroleum Company Limited and Keppel Corporation Limited, along with LOK's other daughter, Lim Huey Yih (LHY). LHY was the Senior Vice-President of Business Development at HLT. LOC had made a profit of S$3.818 million on his insider trades and paid a civil penalty of S$9.597 million, while LHY earned S$896,340 and paid a civil penalty of S$2.241 million. LOC's civil penalty was the largest penalty ever handed down for insider trading in Singapore.[12] Was this an early sign that all is not as it seems in the Lim household?

Sticky situation

"The country's Trade and Industry Minister Chan Chun Sing said in a Bloomberg TV interview last week that he doesn't think Hin Leong's collapse would affect the wider market, and that he doesn't think the case has dented the country's reputation at this point."

– Bloomberg[13]

When HLT collapsed, it sent shockwaves through the industry. HLT was a colossal firm, with total Group revenues of US$20.3 billion and total comprehensive income of US$83 million for the year ended 31 October 2019.[14] Total assets amounted to US$4.6 billion.[15] HLT's total revenue was almost identical to the 2019 total revenue of China Aviation Oil (Singapore) Corporation Ltd (CAO). CAO, whose businesses are in jet fuel supply and trading, trading of other oil products and other oil-related assets, is listed on the Singapore Exchange (SGX). It had a market capitalisation of about S$855 million, and was ranked as the 96th largest listed company on SGX as at 31 December 2019, a ranking which includes large secondary listings.[16] HLT's sister company, OTPL, had revenues of US$723.9 million and a total comprehensive loss of US$105.9 million for the year ended 31 March 2019.[17]

The oil industry is highly exposed to macroeconomic factors such as commodity prices, currency fluctuations, interest rate risk and political developments.[18] It has been riddled by accounting frauds and scandals, and the lack of transparency in the industry makes matters worse. Shortly after HLT imploded, a number of other scandals relating to companies in the sector or related sectors became public. One of these involved Inter-Pacific Petroleum Pte Ltd (IPP),[19] where Goh Jin Hian (GJH), the son of Singapore's former Prime Minister, Goh Chok Tong, was a director. GJH was sued for breach of director's duties, which he has denied. The lawsuit was funded by two of IPP's bank creditors – Maybank and Société Générale – which sought to recover losses resulting from GJH's alleged negligence.[20]

What started the fire?

"You see Singapore showing up in the commodity problems because they have gone out and provided aggressive financial incentives for people to locate these commodity trading businesses in Singapore. So you have a higher propensity for those businesses to be in Singapore."

– Michael Dee, former senior managing director at Temasek Holdings Pte Ltd[21]

Due to the COVID-19 outbreak, oil prices collapsed, crushing the demand for crude oil.[22] This was seen to be a catalyst for frauds to come to light.

As Singapore is often ranked as the leading oil trading hub in Asia, this industry is especially critical and receives considerable support from the government, including financial incentives to encourage commodity trading businesses to relocate to Singapore. Some observers have cited this as a contributing factor to the problems in the industry.[23]

Playing foul on Playfair Road

"They presented a vastly misleading picture of its financial health to external parties and deceived its lenders into extending financing even though Hin Leong has been insolvent since the financial year ended Oct 31, 2012."

– Goh Thien Phong, judicial manager from PwC[24]

The report issued by the interim judicial managers, PricewaterhouseCoopers Advisory Services Pte. Ltd (PwC), extensively discussed the alleged fraud at HLT, including "account manipulation, forged documentation and fictitious profits, including the overstatement of derivatives trading gains and inventories".[25]

Swimming with futures and swaps

LOK admitted in court documents that he was fully aware of the estimated futures trading losses amounting to approximately US$808 million, which was accumulated over ten years.[26] In order to conceal the losses from futures trading, HLT allegedly created fictitious derivatives and trading gains. The company only used two clearing members to execute futures transactions through Intercontinental Exchange. LOK and his son, LCM, were the only persons in the company who traded in futures, and LOK was said to be the principal futures trader for the company. However, the interim judicial managers uncovered a list of persons authorised to trade in futures via an unnamed clearing member. Further, there were five traders under the 2017 List of Authorised Traders who were not employees of the company, and it was unclear whether these employees executed any trades on behalf of the company.[27]

For swaps trading, HLT traded with about 24 counterparties from 1 November 2018 to 31 October 2019. Of these, 19 were handled by LOK alone, and transactions with these counterparties were believed to be fictitious. There was no usage of the "Paperswap Email Account" to transact or confirm the purported deals with these counterparties which was used for the other five counterparties. Instead, physical documents found appear to be confirmations of supposed swaps deals with these counterparties. These were purportedly copied to the Paperswap Email Account. Furthermore, eight of the 19 counterparties said they did not enter into such transactions. To keep up pretences and support purported gains from the fictitious swap transactions, it was alleged that documents such as bank inward remittance advices were meticulously forged to disguise inter-bank transfers between the company's own bank accounts as third party cash receipts.[28]

Rising levels of accounts receivables

LOK also allegedly instructed that the finance department cover the losses in HLT's books to reflect positive equity instead of ensuring proper bookkeeping and the disclosure of losses. The company was said to have systematically manipulated its account receivables and possibly inflated its value by at least US$2.23 billion as at its financial year ending 31 October 2019.[29]

This was made possible through fictitious sales, dissipation of inventory, and inter-bank transfers among HLT's various accounts to give a false impression that the company did not need to record a provision for bad debts. There were sharp decreases in its accounts receivables starting from the month following the reporting date and the abnormal figures in the recovery account, an account which was opened immediately after reporting date.[30]

HLT allegedly falsely recorded non-existent cash received from accounts receivable into control accounts through normal accounting double entries. Subsequently, it would transfer the balance in the control accounts, which included the inflated amounts, to the recovery account. This enabled the company to inflate the value of its account receivables balance and give the appearance of legitimacy by ensuring that its accounts receivables were kept current.[31]

Going overboard with inventory

"Hin Leong's total oil inventory stood at US$212 million as of May 20, less than a third of the US$646 million owed to banks that provided inventory financing facilities."

– Interim judicial manager PwC[32]

HLT was also said to have potentially overstated its inventory by at least US$0.8 billion through the inclusion of a substantial amount of inventory that might not have belonged to the company. There were significant discrepancies between the inventory records used for HLT's audited financial statements for the year ended 31 October 2019 and the inventory records maintained by OTPL. These discrepancies were from the inventory onboard the floaters Chang Bai San, Wu Yi San and Sea Coral. Further, the inventory records used for the audited financial statements included inventory stored on board various vessels which were not chartered by the company. Moreover, HLT allegedly did not purchase the inventory on these vessels as at or around 31 October 2019. This was said to be further confirmed by one of the rightful owners of the inventory, the Sea Latitude charterer.[33]

One of HLT's finance staff, who was in charge of monitoring the movement of the company's inventory for operational purposes and maintaining records of the physical inventory onboard the vessels by location, was questioned by the interim judicial managers on the discrepancies. She said she was given a handwritten list of vessels which included vessels not in the records. She was assigned to allocate the excess quantity to the vessels set out in the handwritten list despite being unable to explain the basis of the allocation and unable to provide any details or records to support the quantity of inventory on these vessels.

Further, HLT allegedly obtained inventory financing facilities by pledging cargo it did not own or that did not exist, and by inflating the quantity of cargo it owned. It also sold inventory that was intended to be held as collateral for another party. It was revealed that based on LOK's instructions, HLT sold a substantial part of its inventory and used the proceeds as the general funds of HLT. This occurred even if the inventory was the subject of inventory financing provided by bank lenders. All these actions contributed to the huge shortfall in the company's inventory as compared to the figures reported in the audited financial statements for the financial year ended 31 October 2019.[34]

More gold required

As constant liquidity was needed to conceal accumulated losses over the years, HLT obtained financing from banks through financing schemes structured around the sale and repurchase of cargo at a loss. Such schemes appeared to have no commercial benefit for HLT apart from the generation of additional funding.

The process of "teeming and lading" – a process whereby "amounts received from a subsequent debtor are allocated to an earlier debtor's account so that the accounts receivables balances always appear to be current" – continued repeatedly and the constant need to obtain funds from banks through discounting or other forms of financing remained important, on top of its oil trading and blending business model. HLT often used fabricated documents on a massive scale such as bank remittance advices, bank statements, bills of lading, sales contracts, sales invoices, swap trade confirmation, swap trade tickets, deal settlement slips, and inter-tank transfer certificates to mislead banks into extending financing. One of the forged documents stated that HLT had transferred more than one million barrels of oil to CAO[35] to secure more than US$56 million in trade financing.[36]

It was also uncovered that HLT was granted financing under 273 outstanding letters of credit facilities from 23 banks to fund purchase of cargo from various suppliers, which contributed to the hefty liability of US$3.5 billion.[37]

Law at sea[38]

"To me, one of the major problems here is that even though it is very large with more than US$20 billion in revenues, it could still be considered an exempt private company because it has fewer than 20 shareholders and no corporate shareholders. To me, that is a big gap. The family has the protection of limited liability of a company with very few safeguards. A recipe for disaster."

– Professor Mak Yuen Teen, corporate governance advocate[39]

Under section 18 of the Companies Act in Singapore, a private company is one whose constitution restricts the right to transfer shares and limits the number of shareholders to no more than 50. Under section 4 of the Companies Act, an EPC is a private company in which no beneficial interest is held directly or indirectly by a corporation and which has not more than 20 shareholders. It also includes any private company that is wholly owned by the Singapore government which the Minister of Finance, in the national interest, declares by notification in the Gazette to be an EPC.[40]

There are differences in certain provisions in the Companies Act between private and public companies, and between exempt private companies and other private companies. For example, section 199(2A) states:[41]

"Every public company and every subsidiary company of a public company shall devise and maintain a system of internal accounting controls sufficient to provide a reasonable assurance that—

(a) assets are safeguarded against loss from unauthorised use or disposition; and

(b) transactions are properly authorised and that they are recorded as necessary to permit the preparation of true and fair financial statements and to maintain accountability of assets."

EPCs are not required to file annual accounts as long as they are solvent. Therefore, stakeholders which may have dealings with EPCs, such as suppliers, would not have access to their accounts.

Under XHH and XHC, there were 62 private ship-owning companies and 10 single-purpose ship-owning private companies. XHH and XHC usually owned 90% of these companies while the Lim family owned the rest.[42]

Did the fact that the regulatory framework for private companies and EPCs allowed the Lim family to take significant risks while enjoying limited liability protection of the corporate structures without certain safeguards contribute to its collapse?

Auditor independence

All the companies controlled by the Lim family are not public interest entities (PIEs) because they are not listed companies, financial institutions, large charities, or institutions of a public character. The Accounting and Corporate Regulatory Authority Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities (ACRA Code) differentiates between the standards that apply for PIEs and non-PIEs in a number of important areas. These include an audit partner joining an audit client after leaving the audit firm; partner rotation and cooling off periods; provision of certain non-audit services; and safeguards that apply when fees from non-audit services exceed certain thresholds. Therefore, while the Hin Leong Group companies were subject to audits, the independence standards that apply to these audits are lower than for audits of PIEs.

The ACRA Code does encourage public accountants and accounting entities to consider applying stricter requirements to entities not specifically included under PIEs. Section 290.26 of the Code says:

"Firms and member bodies are encouraged to determine whether to treat additional entities, or certain categories of entities, as public interest entities because they have a large number and wide range of stakeholders. Factors to be considered include:

(a) The nature of the business, such as the holding of assets in a fiduciary capacity for a large number of stakeholders;

(b) Size; and

(c) Number of employees."

Both Deloitte & Touche LLP (Deloitte) and KPMG LLP (KPMG), who were the auditors for HLT and OTPL respectively, confirmed compliance with the ACRA Code, but did not say if they had applied the higher standards applicable to PIEs. For example, they did not disclose if they provided certain accounting, tax, valuation, internal audit or other services which would not have been permitted for PIEs, or how much non-audit services were provided.[43]

Auditors adrift[44]

For the seven main companies in the Hin Leong Group, there were four different auditors. HLT and one of its wholly-owned subsidiaries, OBS, were audited by Deloitte. OTPL was audited by KPMG. The other two subsidiaries within the Hin Leong Group – HLM and XHI – together with XHH, were audited by a smaller accounting firm, Smalley & Sims PAC, while XHC was audited by another smaller accounting firm, Singapore Assurance PAC.

For listed companies, the SGX Rulebook states that significant subsidiaries "must engage the same auditing firm based in Singapore to audit its accounts, and its Singapore-incorporated subsidiaries and significant associated companies" unless "the issuer's board and audit committee are satisfied that the appointment would not compromise the standard and effectiveness of the audit of the issuer; or the issuer's subsidiary or associated company, is listed on a stock exchange".[45]

For the companies owned by the Lim family, there is no independent board or Audit Committee to review the decision to use different auditors. Nevertheless, for the four companies within the Hin Leong Group, there is an auditing standard (SSA 600)[46] that deals with special considerations in the audits of group financial statements (including the work of component auditors). This helps to ensure that there is communication and cooperation between the different auditors, even if practical challenges do arise.

However, this would not be the case for auditors auditing companies that are not part of the Hin Leong Group – that is, KPMG which audits OTPL, and Singapore Assurance PAC which audits XHC.

It was explained that for the majority of trades done by HLT, OTPL was nominated for the performance of the contracts. OTPL had issued bills of lading for the trades and is liable for these bills of ladings. However, the cargoes under the bills of lading had been discharged against instructions or letters of indemnity issued by HLT. Banks have provided inventory financing activities to HLT where the inventory is stored in facilities operated by OTPL. Bills of lading naming the bank lenders as consignees have been issued by OTPL. However, much of the inventory has been sold by HLT and can no longer be delivered to the holders of the bills of lading.

Would the above problems be less likely to happen if the same audit firm was auditing both HLT and OTPL – especially with the same audit partner in charge – or if OTPL was part of the Hin Leong Group?

Missing the icebergs

Deloitte and KPMG issued unmodified opinions for HLT and OTPL respectively. Since they are not listed companies, there are no key audit matters highlighted in the auditors' reports.

OTPL had blamed its difficulties on HLT's financial woes. OTPL's audited financial statements show the losses for the years ending 31 March 2018 and 31 March 2019 to be US$145.2 million and US$105.9 million respectively; and operating cash flows to be negative US$113.7 million and negative US$99.1 million respectively. As at 31 March 2019, the accumulated losses for OTPL totaled US$534.4 million, and its equity was less than US$6 million, compared to total liabilities of US$126 million. Furthermore, this was after a US$300 million share subscription by the family shareholders in February 2019.

OTPL did not look to be in the best of health either – but like HLT, it received an unmodified opinion and was not required to file audited accounts as an EPC.

Leaky risk management[47]

Note 4(c) of the financial statements of HLT and its subsidiaries for the year ended 31 October 2019 describes the financial risk management policies and objectives.

> "By its nature, the Group's activities are principally related to transacting crude oil, petroleum and related by-products. These activities expose the Group to financial risks arising from its operations and the use of financial instruments. The key financial risks include market risk (including price risk, interest rate risk and foreign currency risk), credit risk, and liquidity risk.
>
> Risk management at the Group is a multi-faceted process with oversight that requires constant communication, judgement and knowledge of specialised products and markets. The Group operates a number of centralised financial, operational, compliance and legal risk management functions in order to monitor, manage and mitigate overall risk exposure, within approved guideline. The Group's senior management takes an active role in the risk management process and has developed policies and procedures that require specific administrative and business functions to assist in the identification, assessment and control of various risks. In recognition of the increasingly varied and complex nature of the global financial markets, the Group's risk management policies and procedures are evolutionary in nature and are subject to ongoing review and modification."

Note 20 of the financial statements of OTPL for the year ended 31 March 2019 similarly describes the financial risk management for the company.

"Overview

The Company has exposure to the following risks arising from financial instruments:

- market risk
- credit risk
- liquidity risk

This note presents information about the Company's exposure to each of the above risks, the Company's objectives, policies and processes for measuring and managing risk, and the Company's management of capital.

Risk management framework

The Company has no formal risk management policies and guidelines, which set out its overall business strategies, its tolerance for risk and its general risk management philosophy. It has however established informal processes to monitor and control such risks on a timely and accurate manner. Such policies are monitored and undertaken by the directors.

Risk management is integral to the whole business of the Company. The management continually monitors the Company's risk management process to ensure that an appropriate balance between risk and control is achieved. Risk management policies and systems are reviewed regularly to reflect changes in market conditions and the Company's activities."

Beyond the disclosures in the notes, there is no information on adoption of any formal risk management framework, such as COSO, or details about different lines of defence. There are no indications that the Hin Leong group of companies had any internal audit function. Further, as private companies, they are not subject to corporate governance requirements in listing rules or codes of corporate governance despite their size. For example, there is no separation between the board of directors and management as the Lim family members are the only directors on the boards of the Group companies and are also closely involved in management. There are no independent directors and no Audit Committee.

Banks on the rocks

The Hin Leong Group had large amounts of bank loans to finance their businesses. Some of their larger lenders included HSBC Holdings (HSBC), DBS Bank (DBS), OCBC Bank, Bank of China, Société Générale, and Standard Chartered Bank. HSBC allegedly has the largest exposure, at approximately US$600 million.[48,49]

The onset of the COVID-19 pandemic led to the collapse of crude oil prices. Brent crude plunged from more than US$70 a barrel in early January 2020 to US$21.65 a barrel in late March 2020.[50] Banks started having concerns about HLT's ability to repay debt and decided to freeze credit lines to the company.

On 14 April 2020, HLT made a last attempt in obtaining credit from banks. The company held talks with its lenders but was unable to reach an agreement, according to various media reports. In a presentation to its creditors, HLT estimated the debt recovery rate at 18 cents in the dollar, indicating massive potential losses for banks.[51,52]

A few days later, LOK's son, LCM, who is a director of OTPL, filed an affidavit in the High Court of Singapore on behalf of OPTL in support of its application for a six-month moratorium relief pursuant to section 211B of the Singapore Companies Act.[53] The revelations disclosed in the affidavit shocked the corporate community.[54] It was revealed that HLT was obtaining financing and loans from banks by engaging in illegal practices such as selling cargo to another party and immediately repurchasing it at a lower price. In instances where multiple companies were involved, HLT would sell the cargo to one trading company then repurchase the same cargo from another.[55] Despite being loss-making, each of the transactions would produce another injection of liquidity through financing extended by the banks.

One specific incident of a fraudulent transaction occurred in March 2020, where HLT managed to obtain financing from Société Générale to sell 780,000 barrels of oil to trading giant Glencore, which would be repurchased immediately by HLT. HLT received letters of credit supporting the two transactions, which were issued by Rabobank and DBS.[56]

Where was the corporate governance?

"Part of why Hin Leong still managed to get bank loans was because of their status as an established company. So they were able to negotiate with the banks, and made the banks slightly afraid of HL. In the end they would just give them the loan without proper checking of collateral assets."

– Anonymous insider source

Banks are arguably the most strictly regulated of all companies when it comes to corporate governance. The fact that the Hin Leong Group was able to obtain loans from banks despite what appears to be a massive fraud over many years has raised questions about the corporate governance, risk management, and internal controls of the banks involved. Did the banks consider the concentration of power in the hands of the Lim family, and the resultant lack of checks and balances? Was there a lack of effective oversight by the board and management of the banks in managing credit risk? Did the boards lack knowledge and experience in the oil and gas industry? Was there inadequate monitoring of ongoing market developments and potential impacts on the banks by the banks' respective boards and management-level risk management committees, given the sharp fall in oil prices in early 2020 along with the onset of the COVID-19 pandemic?

In terms of risk management, was there a failure to identify high risks of lending to the oil and gas industry?[57] Even though the banks involved were well-diversified by industry in their loan portfolios, it appears they did not factor in the high credit risk arising from the nature of the business of the Hin Leong Group. Did the risk management team fail to perform a rigorous analysis of credit risk involved in providing loans to customers such as the Hin Leong Group and put in place measures to mitigate these risks?

On the issue of internal controls, was there a lack of internal controls in checking for the existence of items held as collateral by HLT, authenticity of invoices and collaterals pledged? HLT had forged documents in order to secure financing from banks.

The Hin Leong fraud is certainly a big wakeup call for banks.

Salvaging the shipwreck

On 17 April 2020, HLT filed an application to the Singapore High Court for a six-month debt moratorium as it sought to restructure debts of almost US$4 billion.[58] It was revealed that 23 banks had exposure to Hin Leong's financial troubles, including Singapore's three local banks – DBS, OCBC and UOB – which had a combined exposure of at least US$600 million.[59] Following objections by bank lenders, HLT withdrew the application on 21 April 2020 and sought to have PwC appointed as interim judicial manager.[60] The Singapore High Court appointed Goh Thien Phong and Chan Kheng Tek, partners from PwC Singapore, as interim judicial managers of HLT.[61]

On 12 May 2020, OTPL was placed under interim judicial management by the Singapore High Court.[62] The judicial manager of OTPL, Ernst & Young (EY), also sued LOK, LCM, and LHC for allegedly transferring more than US$19 million from OTPL's bank account to the trio's bank accounts days before the company filed for the debt moratorium. EY was seeking a court order for full restitution of the US$19 million to OTPL.[63,64]

On 13 August 2020, the Singapore High Court appointed Grant Thornton Singapore as interim judicial managers for XHH,[65] which was owned by LOK and LCM. This came after OCBC Bank successfully applied for interim judicial management, citing a strong distrust of the firm's current management after a total of US$208.1 million was transferred from Xihe Group to HLT "for no valid commercial purpose."[66]

On 14 August 2020, LOK was charged with abetment of forgery for the purpose of cheating.[67] The following month, another charge of abetment of forgery for the purpose of cheating was added.[68] These offences carry a maximum punishment of up to 10 years and a fine.[69] In April 2021, a further 23 charges were filed against him.[70] LOK was charged for yet another 105 cheating and forgery offences in June 2021 and his bail was raised from S$3 million to S$4 million.[71]

PwC, the judicial managers of HLT, also filed a suit against LOK and his children, LCM and LHC. The trio was alleged to have breached their fiduciary duties as the directors of HLT and its subsidiaries. A total claim of US$3.5 billion was filed against the trio as well as another US$90 million which was paid out to them as dividends throughout the years.[72]

In their bid to recover US$3.5 billion of debt, in May 2021, the judicial managers of HLT successfully applied to the Singapore High Court to freeze the Lim family's assets worldwide.[73] Asset sales have also started. Earlier in March 2021, Jurong Port completed the purchase of the Lim family's 41% stake in Universal Terminal for an undisclosed sum. In 2016, the whole terminal had been valued at more than US$1.5 billion.[74] OTPL also closed a US$36 million sale of lube assets to Gulf Oil International, a unit of Indian conglomerate Hinduja Group, in July 2021.[75] In the same month, LOK's bungalow in Bukit Timah – one of the nine properties in Singapore and Australia under the court-ordered asset freeze – was reported to have received an offer of S$28.5 million.[76] However, recovering the huge debt owing is likely to be a long drawn out process and it remains to be seen exactly how much can be recovered.

The painful lessons from the collapse of the Hin Leong Group and other commodity traders have led banks to tighten their commodity lending practices.[77] Banks have significantly scaled back their lending to the commodities sector in 2020. A number of banks were said to be exiting the trade and commodity finance business, in large part due to the commodity trading scandals in Singapore.[78]

The fallout from the Hin Leong empire collapse may be much bigger than some have initially thought. The impact on other players in the supply chain and the long-term reputational damage to Singapore as an oil hub[79] have yet to be fully considered. Will the Singapore authorities address the regulatory lacuna for large private companies or will it be back to business as usual?

Discussion questions

1. "The tone at the top significantly influences a company's corporate governance." To what extent is this related to the fall of the Hin Leong Group? Explain.
2. To what extent did the regulatory framework and auditing standards contribute to the Hin Leong scandal? Explain. What other factors contributed to its collapse?
3. Should private companies such as the Hin Leong group of companies be subjected to certain minimum corporate governance standards? If so, what are the key critical areas for private companies compared to public listed companies?
4. Should Singapore continue to allow companies to be exempt private companies? Explain. If so, what additional safeguards, if any, would you propose?
5. Based on the four lines of defence model, what measures should a company such as Hin Leong Trading have put in place to avoid the problems that it faced?
6. Are the external auditors and regulators also responsible for the collapse of the Hin Leong Group? Explain.
7. Why do you think so many banks failed to notice the risks in the Hin Leong Group? Do you think it is indicative of systemic weaknesses in banks? Explain.

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LESSONS FROM RAFFLES EDUCATION

Case overview

To an outsider, Oei Hong Leong (OHL), a billionaire and one of the richest individuals in Singapore, and Chew Hua Seng (CHS), Raffles Education Corporation Limited's founder, Chairman and Chief Executive Officer (CEO), seemed like close friends. However, on 12 October 2017, OHL served a notice of requisition to convene an Extraordinary General Meeting (EGM) to remove CHS from his positions in the company. The following year, he filed a lawsuit against CHS. OHL claimed that CHS had failed to fulfil an agreement to find a buyer for his shares. CHS responded that it was merely a "friendly agreement". While OHL lost that lawsuit, his battle against CHS was far from over as he continued to build up his stake in the company, question the board, threaten legal action and requisition for EGMs.

The objective of this case study is to facilitate a discussion of issues such as the role of major shareholders, minority shareholders and the board of directors in the corporate governance of companies; dual roles of CEO and Chairman; board composition; duties and roles of independent directors; due diligence in acquisitions and investments; regulatory compliance; shareholder rights and activism; and the role of regulators.

The early years

Raffles Education Corporation Limited (REC) describes itself as a premier private education group and established its first college in Singapore in 1990. It has since grown to operate 22 colleges in 12 countries in the Asia-Pacific and Europe.[1] Its stated aim is to educate and empower youths by providing quality education that affords graduates a well-rounded hands-on experience which is relevant to the industry.[2,3]

REC was listed on the SGX SESDAQ (now known as Catalist) in 2002 and moved to the SGX Mainboard in 2005.[4] It was ranked amongst the top 200 Asia-Pacific companies on Forbes Asia's "Best Under a Billion" list from 2006 to 2009.[5]

This case was prepared by Anuja Anant Shukla, Benson Leom Meng Suan, Han Xin Yi, Heng Shi Ning and Janalyn Pang Jia Yi, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. It was substantially re-written by 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 organizations named in the case, or any of their directors or employees.

The principals

REC's founder, Chew Hua Seng (CHS), was featured in Forbes Magazine as one of the wealthiest individuals in Singapore in the early 2000s. As the son of a fisherman, he came from a humble background, which motivated him to work hard since he was young. In the 1970s, he graduated with a degree in business administration from the then University of Singapore. However, CHS did not manage to get a job post-graduation, prompting him to set up his own company in the business of shipping and timber broking and "be his own boss". Over the years, he moved on from his initial venture in timber trading to establish his own successful private education group.[6]

CHS's wife, Doris Chung Gim Lian, is a senior management in the Group and manages a number of schools in Malaysia and Thailand.[7] His elder son, Chew Han Wei is the vice president in charge of the operations of colleges in Italy and India, and serves as the company's IT director.[8] His second son, Chew Han Qiang, was appointed assistant vice president for the Group's operations in Thailand in 2018.[9]

As of 25 September 2020, CHS and his wife held 43.5% of the ordinary shares of REC.[10] CHS is also the Non-Executive Chairman of Sitra Holdings (International) Limited (Sitra), a distributor of wood-based products and lifestyle outdoor furniture, which is listed on the Catalist Board of SGX. CHS held 32.49% of Sitra's shares as of 19 March 2021, while his brother, Chew Ah Ba George, had a 16.85% total interest.[11] On 4 October 2019, Sitra acquired a 54% interest in BVI-incorporated Mapur Rocky Resort Limited from CHS's spouse, Doris Chung, and his son, Chew Han Wei.[12]

CHS's brother, Patrick Chew Hwa Kwang, was co-founder and CEO of Midas Holdings Limited (Midas), which was listed on both the SGX Mainboard and Stock Exchange of Hong Kong. On 9 February 2018, trading of Midas' shares was suspended[13] and Patrick Chew resigned on 22 March 2018, citing health issues.[14] It emerged that there was a massive fraud involving Midas' subsidiaries in China. On 26 April 2018, Mazars LLP, which had been Midas' auditors since 2012, issued a letter to Midas' board stating that its auditor's reports for FY2012 to FY2016 may no longer be relied upon.[15] About a month later, the Securities Investors Association (Singapore) (SIAS) withdrew its Most Transparent Company Award from Midas, which had been awarded to Midas every year from 2012 to 2016.[16] While CHS was not implicated in this scandal, Midas' Executive Chairman, Chen Wei Ping, and CEO Patrick Chew were both at Raffles LaSalle Limited (Raffles LaSalle) prior to taking up their roles in Midas. Raffles LaSalle is a subsidiary of REC. Chen Wei Ping had held the position of executive director (ED) from 1998 to 2003 in Raffles LaSalle. Prior to his appointment as ED, he was a marketing manager in 1997.[17,18]

Where is the teacher?

Despite winning numerous academic accolades, questions were raised about REC's quality of education. Operational issues within REC led to concerns being expressed online. One former employee's account in particular stood out.

Joana S. Kompa, an ex-programme director for digital media design and visual communication design who previously worked in Raffles International College Bangkok (Raffles Bangkok), shared her experience and opinions openly on her blog page. She asserted that REC failed to emphasise employing good quality educators. According to her, Raffles Bangkok had seven different college directors over the period from 2006 to 2017. Frequent changes in college directors were said to have hindered the establishment of a consistent education policy for students, diminishing the quality of education at Raffles Bangkok.[19]

Kompa also shared that REC did not develop qualification programmes to improve and hone the basic teaching skills of its staff. Teachers were said to have to reproduce their own learning conditions learnt elsewhere. Many untrained part-time teachers had no prior training to execute basic classroom management. Practices such as replicating materials from the internet, releasing answers in advance, and filling classroom time with YouTube videos or other superfluous activities became commonplace. Moreover, as REC classes were organised as intensive four-hour teaching blocks, teachers were often tempted to rely on these counterproductive practices to fill up excess time.[20]

The content taught to students was also allegedly outdated. For instance, even though Adobe Flash was no longer used on the web due to vulnerability issues, students were made to learn the application as part of their multimedia classes. Newer and more relevant skills such as developing mobile applications or coding were not integrated into the curriculum. Additionally, learning tools and equipment such as video editing suites, audio equipment, broadcast-level digital cameras or related software were apparently non-existent in the school.[21]

Kompa may be far from the only unhappy former employee. Glassdoor shows an average rating of 1.9 out of 5 based on 84 reviews, with many of the comments raising concerns about how REC is managed.[22]

Accreditation issues

"The Company has a department, known as Raffles University Systems, directly responsible for academic quality assurance, including accreditation."

– REC's response to a query raised by Securities Investors Association (Singapore)[23]

REC offers programmes for diploma, degree, and masters qualifications. While laws on education differ across countries, there is a common requirement to have higher education programmes accredited by the relevant authorities in the respective countries. To manage business risks relating to accreditation and operating compliance, REC set up a corporate unit called the Raffles University System. The Raffles University System is stated to be "responsible for all academic matters and adheres strictly to a rigorous reporting and audit system to ensure quality standards and assurance, as well as operational compliance".[24]

According to the company's response to a query raised by the SIAS, the Raffles University System also "advises senior management and the Audit Committee of risks, if any, that would affect the accreditation or continuing accreditation of [its] colleges and university".[25] However, despite setting up the Raffles University System, REC faced accreditation issues for various programmes across its campuses, including those in Thailand, Sri Lanka, and Australia.

Thailand

In 2010, the Raffles Design Institute (RDI) in Bangkok was found to be operating without the permission of Thailand's Office of Higher Education Commission (OHEC). It was reported that criminal proceedings were launched against RDI by the Thai authorities for its failure to cooperate. A RDI spokesperson claimed that there was a misunderstanding and that the school would meet with the OHEC to clarify the matter.[26] However, according to Kompa, RDI had yet to acquire a valid international college license as of November 2017.[27]

Sri Lanka

On 16 June 2013, REC's unit in Colombo, Sri Lanka – Raffles Design Institute Pvt. Ltd – was accused by local newspaper, The Sunday Leader, of misleading students by claiming that it had recognition from the country's Higher Education Ministry for its diploma programmes, even though such recognition had yet to be confirmed. It was reported that the company was only registered with the Board of Investment of Sri Lanka as a business venture without any degree awarding status conferred yet either by the Higher Education Ministry or the University Grants Commission.[28]

REC responded to The Sunday Leader's report on 23 June 2013 as follows:[29]

> "We, Raffles Education Corporation Limited, are a reputable education provider listed on the Main Board of the Stock Exchange of Singapore. The article comprises allegations that are absolutely false and misleading. It is written with a malicious intent and is, without question, calculated to ridicule and injure the reputation of Raffles Education Corporation Ltd. and its college in Colombo, Sri Lanka."

In the response, the company also addressed the issues raised on its Thailand college:[30]

> "The truth is Raffles is not banned in Thailand and in fact we are in the process of being upgraded to university college status by the Thai authorities."

Additionally, REC refuted The Sunday Leader's allegation that the private education provider had claimed to be recognised by the Sri Lanka's Higher Education Ministry "only to attract more students to follow their courses". It said that it had already obtained approval from the Tertiary and Vocational Education Commission (TVEC) of Sri Lanka for its advanced diploma courses. It further asserted that an application had been made to the country's Higher Education Ministry for degree awarding status, for which "in-principle approval" was already granted.[31]

The Sunday Leader included a reporter's note when it published REC's response. The reporter described how he posed as a parent to inquire about the "in-principle approval" and was informed by the company's sales and marketing executive that approval from the Higher Education Ministry had already been granted. However, he received a contradictory response from the Higher Education Ministry when he called the authority to inquire about the same issue. The Higher Education Ministry said that REC's application was still being evaluated.[32]

Australia

In June 2015, the company's Australian campus, Raffles College of Design and Commerce (RCDC), lost its accreditation granted by Australia's Tertiary Education Quality Standards Agency (TEQSA) for undergraduate programmes as it had failed to meet certain requirements of the Education Services for Overseas Students Act and the National Code of Practice for Providers of Education and Training to Overseas Students. Further, TEQSA said that RCDC "[did] not have the capacity to provide education of a satisfactory standard".[33,34]

In June 2017, REC attempted to re-register with Commonwealth Register of Institutions and Courses for Overseas Students (CRICOS) to allow the private education provider to offer its higher education courses to overseas students.[35] RCDC expressed confidence that CRICOS re-registration would be obtained in 2018 and conveyed this multiple times to its investors.[36,37] However, in a turn of events, REC applied to TESQA to withdraw its registration as an Australian higher education provider on 26 November 2018.[38] Approval to withdraw was granted by TEQSA on 20 December 2018 with certain conditions imposed.[39]

Financial performance

"We will continually seek an optimal mix among our three growth engines – Education Provider, Management of Education Assets & Facilities and Education-Linked Real Estate Investment & Development – and balance our assets portfolio and resources both geographically and across sectors for sustainable growth."

– Chew Hua Seng, Chairman and CEO of REC[40]

The principal activities of the parent company of the REC Group are described as investment holding and the provision of business and management consultancy services, while its subsidiaries are largely involved in the education and property management industries.[41] The Group's business strategy seems to have undergone some changes over the years.

In the company's 2012 annual report, it was stated that the principal activities of the REC subsidiaries were wholly in relation to education and education-related services, except for one entity which was in the business of providing utilities management services. The investment properties under REC were held under four subsidiaries, namely Oriental University City Limited (OUC), Raffles Assets (Singapore) Pte Ltd, Raffles Assets (Thailand) Co., Ltd, and Raffles Iskandar Sdn Bhd. It was further disclosed that OUC owned and leased out these properties to colleges within its self-contained campus while Raffles Assets (Singapore) Pte Ltd leased out the properties in Singapore for commercial office purposes. The land under the last two subsidiaries remained vacant as of 2012.[42]

However, over the past few years, the Group seemed to have become more involved in property investments. Based on its 2019 annual report, the principal activities of three REC subsidiaries were listed solely as "property investment", compared to none in 2012. Moreover, the type of properties owned by the Group has evolved. The following is an extract from REC's 2019 annual report:[43]

> "OUC owns and leases out investment properties to colleges within its self-contained campus. The land under [Raffles Iskandar Sdn Bhd], [Mandurah Resort Pty Ltd] and [Raffles Asset (Private) Limited] are vacant as at 30 June 2019. [Raffles K12 Sdn. Bhd.] has utilised part of the land for cafeteria and boarding facilities rental. Building construction on the land of [Trophy Land Global Limited] is ongoing. [Raffles Assets Australia Pty Limited] owns a commercial building and leases out to various tenants. [Raffles Siviez 1750 Pte. Ltd.] owns a commercial building. [4Vallees Pte. Ltd.] owns a hotel and facilities ("Hotel") and seven commercial units ("commercial units"), of which six are rented out."

The above extract indicates that a larger number of the REC subsidiaries generated revenue from investment properties, including rental and utility income through renting their investment properties for different business purposes, which includes a hotel.[44]

REC shareholders who expressed concerns about the company's diversification into property back in 2014 were apparently rudely dismissed. Mano Sabnani, Chairman and CEO of Rafflesia Holdings, an investment company he founded, wrote this after the AGM:

> "CEO lost his cool…calling shareholders "Oii..you're ridiculous!!" and telling them to sell their shares if they are not happy with the company. But how can they? Shares at 35c are one fifth of price five years ago! CEO Chew says co has three businesses now with two legs in property development and management. Result: co has lost focus on education and survives on periodic sale of land. Shareholders want better focus on education and recurrent earnings. It's not likely he will listen… Sigh. Question that irritated CHS related to loss of focus and need to refocus in education. His point is group has already diversified. So take it or leave it. A lot of bad news is IN the price. Stock is trading at multi-year low. Student enrolment which has been declining past few years is stabilising now. I would NOT be a seller at this point. Balance sheet has improved through land divestment and will improve further with flotation of OUC in China."[45]

In FY2018, REC's revenue from investment properties was 18.4% of the total revenue. The Group's investment properties amounted to S$520.3 million and represented 41.3% of the Group's total assets. The company's net profit before tax of S$42.4 million for FY2018 was largely attributable to the fair value gain on investment properties of S$64.9 million from its investment properties in Thailand, Australia and China.[46] For FY2019, net profit before tax of S$28.1 million was bumped up by a gain on disposal of subsidiaries amounting to S$37.4 million.[47]

Based on the FY2020 annual report, REC recorded an increase in revenue to S$100.5 million, up from S$97.9 million in the previous year. However, the company fell into the red, reporting a net loss attributable to shareholders of S$16.4 million – a sharp fall from the net profit of S$40.2 million in the prior year.[48,49] These figures were a far cry from those reported in its heyday – for example, REC's net profit for the FY2007 and FY2008 amounted to S$49.3 million and S$98.8 million respectively.[50] Analysts back then expected the company's profit growth to average 35% per year through 2010.[51]

Figure 1 shows that revenue for REC has generally fallen over the ten years from FY2011 to FY2020, with revenue relatively flat in recent years. Net profit after tax attributable to shareholders has been highly volatile with FY2012 reporting a loss of more than S$66 million and generally on a downward trend from FY2011, except for FY2014 when a profit of S$55.4 million was reported, and with reported profits of S$10.7 million and S$40.2 million in FY2018 and FY2019 respectively. Cash flows from operations have also deteriorated considerably over the past 10 years, except for an increase in FY2019.

(in S$ thousands)	**FY 2011**	**FY 2012**	**FY 2013**	**FY 2014**	**FY 2015**	**FY 2016**	**FY 2017**	**FY 2018**	**FY 2019**	**FY 2020**
Revenue	146,353	131,135	128,377	127,390	119,895	111,030	96,220	96,832	97,854	100,477
NPAT attributable to shareholders	41,917	(66,261)	26,672	55,374	16,983	15,818	(1,853)	10,667	40,213	(16,426)
Cash flow from operations	29,331	13,768	9,009	12,354	4,167	815	(5,515)	(10,707)	16,438	8,847

Figure 1: Financial performance of REC from FY2011 to FY2020[52]

In its announcement of its FY2020 financial results, REC cautioned that the "challenging global education environment, currency volatility, increasing competition and the COVID-19 pandemic continue to impact the Group". In particular, its recruitment and retention of foreign students has worsened from border restrictions and lockdowns implemented as part of worldwide COVID-19 measures. The company also reported a loss per share of 1.19 Singapore cents for FY2020, compared with an earnings per share of 2.92 Singapore cents for FY2019.[53,54]

Share price performance

REC's share price has been on a downward trend since its heyday in the mid-2000s. During its prime, the company was known to have an aggressive acquisition strategy and a generous dividend policy, which made it a 'darling' of the Singapore bourse.[55]

The company had previously carried out 2:1 stock splits on 10 November 2006 and 13 March 2008 respectively.[56] On 29 March 2011, the company carried out a share consolidation exercise, which resulted in every three existing shares being consolidated into one consolidated share. There were in aggregate 874,401,361 consolidated shares on issue (including treasury shares) following the share consolidation exercise.[57]

In March 2009, the CEO of REC's associate company, Oriental Century Limited, admitted to have inflated the company's sales and cash balances, prompting a suspension of its shares on the SGX.[58] REC announced that the company was "not materially affected" by the development.[59] However, its share price had already taken a hit and fell as much as 19%.[60] On 8 June 2010, REC's shares fell to their lowest level since March 2009 after AIF Capital Asia III LP – a Hong Kong based private equity group – pulled out from a non-binding agreement to buy a 10% stake in Oriental University City due to poor global economic and market conditions.[61] In March 2011, some analysts attributed the fall in REC's share price by 24% to "the rising tension in the Middle East and the unfolding nuclear crisis in Japan".[62]

As the company's financial performance worsened, so did the performance of its share price.[63]

Figure 2 shows the movement in REC's share price across the years.

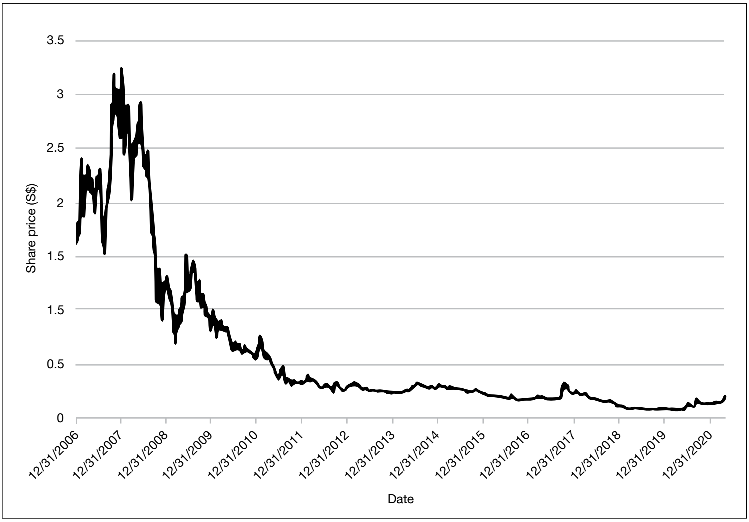

Figure 2: Share price of REC[64]

Absent dividends

REC had consistently paid dividends between 2006 and 2009. In 2007 and 2008, the company distributed dividends ranging from S$0.0065 to S$0.013 four times a year. However, when its financial performance started deteriorating, the dividend payouts slowed down and eventually stopped. REC's last dividend declared was in October 2015 at S$0.01 per share.[65]

No dividend was declared by REC for FY2020 "due to the COVID-19 pandemic and on a prudence basis".[66] Meanwhile, the company's reason for not paying out a dividend for FY2019 was due to the lack of accumulated profits to declare a dividend.[67] There was also no dividend declared in the previous financial years.[68,69]

Board of directors

Back in 2012, the REC board comprised of eight directors – four independent directors (IDs) and four EDs. Chew held the dual roles of Chairman and Chief Executive Officer (CEO), while Chew Kok Chor, who is unrelated to Chew, served as ED and Deputy CEO. They were joined by lead ID Henry Tan Song Kok (TSK), three other IDs, and two other EDs.[70] The IDs were actively involved in Singapore's business and public sectors, with numerous credentials and extensive professional experience.[71]

TSK was the Chairman of the Audit Committee (AC) and joined the board on 1 September 2000.[72] Prior to joining REC, he set up his own accountancy firm in 1993 with Member of Parliament Sitoh Yih Pin.[73] Their business has since grown into what is known as Nexia TS Public Accounting Corporation – one of Singapore's top mid-tier accounting firms.[74] TSK has also served on numerous boards of directors, often holding the positions of lead independent director and AC Chairman.[75]

Of the three other IDs, Dr Tan Chin Nam (TCN) and Teo Cheng Lok John (TCL) were appointed on 24 October 2008 while Lim Tien Lock, Christopher (LTL) joined on 19 November 2008.[76] TCN is a notable figure in the public sector with over 30 years of distinguished service in the Singapore Civil Service, holding key positions such as Permanent Secretary of the Ministry of Manpower and managing director of Singapore's Economic Development Board.[77]

An experienced accountant, TCL is a co-founder and was a former senior partner of Baker Tilly TFW LLP (Baker Tilly).[78] He was in public accounting until 2010. Prior to 2017, REC's annual reports stated that its "internal audit function is outsourced to a firm of certified public accountants" but did not mention the name of the firm. However, the annual reports from 2017 to 2020 stated that Baker Tilly is doing the internal audit for REC.[79] Since TCL is a member of the AC which oversees the internal audit function, this raises concern about a conflict of interest. In its response to questions from shareholders for its 2020 AGM, the company said that Baker Tilly was appointed as internal auditor in January 2015, about five years after TCL had retired from the firm.[80]

LTL has a strong background in business, including being group ED of Hotel Properties Limited and previously, Head of Corporate Finance of N M Rothschild & Sons (Singapore) Limited.[81]

Each of the IDs chaired one of the four committees – the AC, Nomination Committee (NC), Remuneration Committee (RC), and Risk Management Committee (RMC). Directors were often invited to participate in the meetings of committees that they were not part of as well. This included CHS, who attended AC and RC meetings on multiple occasions, despite only being a member of the NC.[82,83] In FY2018 and FY2019, in addition to being part of the NC, Chew became a member of the RC and RMC as well.[84,85] This is despite the Code of Corporate Governance recommending that the RC should only comprise of non-executive directors. As CHS is the Chairman and CEO, and several family members hold management positions in the Group, his membership on the RC raises concerns about conflict of interest in setting his remuneration and those of his family members. On 15 November 2019, there was a further change in the composition of the board committees as CHS resigned from the RC and RMC.[86]

Recent changes

In late 2017 and early 2018, REC saw several resignations from its board of directors. LTL resigned on 30 November 2017, citing "relinquishing directorships in companies which are not related to Hotel Properties Limited" as the reason.[87] On 19 December 2017, the company announced that ED and Deputy CEO Chew Kok Chor was stepping down from his positions from 2 January 2018 due to "personal reasons".[88] On 6 March 2018, lead ID TSK also resigned, citing "to facilitate renewal of the board".[89]

To replace the directors who left, REC first appointed Lim How Teck (LHT) as ID on 6 March 2018. He became the lead ID and Chairman of the AC. LHT holds directorships in more than 10 listed and unlisted companies, including ARA-CWT Trust Management (Cache) Ltd and NauticAwt Ltd, which are both public listed companies. Furthermore, he is on the board of directors of Heliconia Holdings Pte Ltd and Heliconia Capital Management Pte Ltd, which are wholly owned subsidiaries of Temasek Holdings.[90] LHT has also served as AC Chairman in many of his board directorships.[91] He was previously Chairman and lead ID of SGX-listed Swissco Holdings Limited, before the company went into judicial management in 2017.[92] Other previous directorships in SGX-listed companies include Eng Kong Holdings Ltd, Mewah International Inc, ARA Asset Management Ltd, and Rickmers Trust Management Pte Ltd.[93] LHT has in-depth knowledge of the shipping industry – having been with NOL Group for over 25 years including holding the position of ED, Group CFO, Group COO and Group Deputy CEO – as well as experience in business finance and accounting.[94]

On 25 April 2018, Gan Hui Tin (GHT) was appointed as an ID. She is the managing director/advisor, business development in Southeast Asia, at BNP Paribas. She was previously the country head for HL Bank Singapore from 2001 to 2016 and has more than 30 years of experience in the banking industry. In considering her nomination, the board was also of the view that female representation would add diversity to the board.[95,96]

Subsequently, TCN retired from the board on 29 October 2018.[97] Joseph He Jun (JHJ), who is a partner in the corporate mergers & acquisitions and the capital markets practices, as well as Head of the China Practice, in Wong Partnership LLP – a large law firm in Singapore – was appointed to the board as a non-independent and non-executive director on 5 November 2018.[98] In REC's 2019 annual report, it was disclosed that JHJ had previously acted for Hebei Oriental Zhuyun Property Development Co., Ltd. – a REC subsidiary – in the divestment of four land parcels in the Langfang Development Zone, Hebei Province, China.[99] As at the date of appointment, he held 20 directorships in various listed and unlisted companies, including BRC Asia Limited, which is listed on the SGX.[100]

On 15 November 2019, Liu Ying Chun (LYC) was appointed as a non-independent and non-executive director. He is the CEO of Oriental University City Holdings (H.K.) Limited (OUCHK), a subsidiary of REC a company which is listed on the Hong Kong Stock Exchange. LYC is registered as a valuer with the China Appraisal Society, and is a qualified auditor accredited by China's National Audit Office.[101,102] However, after less than a year, he retired and did not seek re-election at the company's AGM on 30 October 2020.

In the 2018 annual report, LYC appeared for the first time among the list of top 20 shareholders, with a 2.84% stake as of 24 September 2018.[103] As of 25 September 2020, he held a 2.86% stake.[104] LYC's stake in REC was to become one of the major flashpoints in the battle between OHL and CHS.

On 25 February 2021, Ng Kwan Meng (NKM) was appointed as ID. NKM is Chairman and a non-executive director of SP Group Treasury Limited, non-executive director of British and Malayan Holdings, British and Malaysian Trustees and Tasek Jurong, and a director of Singapore Power. He had formerly held management positions in entities in the United Overseas Bank group.

TCL, who had served on the board as an ID since October 2008, resigned on 1 July 2021, with REC citing "the board's renewal and rejuvenation process" as the reason.[105] In his place, Lim Siew Mun (LSM) was appointed as an ID and member of all the four board committees.[106] LSM has never served as a director of a listed company and is required to attend training prescribed by SGX. She is a mental health professional, the Governor of the Cheshire Home, a member of the Living Waters Methodist Church, and serves on various committees of the Home and the Church.

With these board changes, the 'new' REC board of directors now consists of six board members, with CHS as Chairman, four IDs and one non-executive director.[107] CHS is the only remaining member of the REC board that was in place in 2012.[108]

Remuneration

REC's annual reports state that "the Group advocates a performance-based remuneration system that is directly linked to corporate and individual performance, both in terms of financial and non-financial, and the creation of shareholder wealth by incorporating appropriate key performance indicators." The RC is responsible for the establishment of a framework for attracting, retaining and motivating senior management staff through competitive compensation and progressive policies; the annual review and approval of the remuneration for directors and senior management staff; and the administration of the company's employees' share option scheme and performance share plan. It is disclosed in the annual reports that the RC has access to expert advice from external remuneration consultants where required.[109]

Remuneration details

REC's director remuneration is disclosed in bands of S$250,000 in its annual reports. Between FY2012 and FY2020, company directors apart from CHS and the other EDs received director fees of below S$250,000.[110] For FY2020, REC only disclosed CHS's remuneration in a band of S$500,000. This is not compliant with the Code of Corporate Governance which recommends disclosure of the remuneration of individual directors in exact amount, and for FY2020, the remuneration band for CHS has also widened compared to the past few years. Over the most recent four financial years, CHS's remuneration comprised solely of salary, which is likely due to the poor performance of REC resulting in no variable remuneration.

REC's disclosure of the breakdown in remuneration of individual directors is also arguably not in compliance with the Code as it shows percentage breakdown in three components of "fees", "salary" and "others", with no further breakdown of the "others" component. CHS was not paid "fees".

CHS's remuneration across the years is summarised in Figure 3.

Financial year	Remuneration	Band disclosed in REC's annual report
2012	• 100% salary	Between S$750,001 and S$1 million
2013	• 38% salary • 62% others	Between S$2 million to S$2.25 million
2014	• 14% salary • 86% others	Between S$5 million to S$6 million
2015	• 47% salary • 53% others	Between S$1.75 million to S$2 million
2016	• 63% salary • 37% others	Between S$1.50 million to S$1.75 million
2017	• 100% salary	Between S$1 million to S$1.25 million
2018	• 100% salary	Between S$1 million to S$1.25 million
2019	• 100% salary	Between S$ 850,000 to S$900,000
2020	• 100% salary	Between S$1 million to S$1,500,000

Figure 3: Chew's remuneration between FY2012 and FY2020[111]

Between 2013 and 2016, up to 86% of CHS's total remuneration was disclosed under "others". The remuneration sections of the company's corporate governance statement say that his remuneration includes "a variable bonus as well as share option elements", which would have been disclosed under "others". He is not eligible to participate in the performance share plan. From the directors' reports in the company's annual reports since 2012, no additional options were granted to CHS after FY2012. In other words, the remuneration under "others" from 2013 to 2016 includes a variable bonus but not share-based remuneration. The company did not disclose whether there are benefits that are included under "others". However, in response to questions from shareholders for the 2020 AGM, REC disclosed that none of the directors were paid benefits and that the "others" remuneration for CHS refers to his incentive bonus in his service agreement.[112] It is unclear whether is there any cap on his incentive bonus.

The company also did not disclose what CHS's variable bonus is linked to but it appears to be closely linked to the annual profits of the company. In FY2012, REC reported a huge loss of S$66.3 million, CHS received remuneration in the range of S$750,001 to S$1 million. The following year, in FY2013, his remuneration increased by more than 100% as the company's profit recovered to S$26.7 million. However, profit was still well below FY2010 and FY2011. In FY2014, his remuneration more than doubled again to the range of S$5 million to S$6 million as the company's profit increased to S$55.4 million. The profit in FY2014 was only slightly higher than FY2010. In FY2020, his remuneration – which was 100% in salary - increased to the range of S$1,000,000 to S$1,500,000, compared to S$850,000 to S$900,000 in the previous year, even as the net profit attributable to shareholders of more than S$40 million in FY2019 turned into a net loss of more than S$16 million.

CHS's remuneration increased considerably over a period when cash flow from operations deteriorated considerably and the share price continued to fall. Further, between FY2013 and FY2016 when CHS was receiving a variable bonus, shareholders only received dividend of 1 cent per share for two of those years, and none for the other two years.

In FY2015, the company said that the RC had reviewed CHS's remuneration package with the assistance of Hay Group, an external management consulting company. Following the review, the RC proposed a revision of the CEO's remuneration package which was approved by the REC board.[113]

Meanwhile, ED and Deputy CEO Chew Kok Chor received between S$500,001 to S$750,000 between FY2012 and FY2016, and between S$250,001 to S$500,000 in FY2017, before he resigned from the company on 2 January 2018.[114] The company disclosed that he is not related to CHS.

Remuneration of family members

The amounts received by CHS's spouse and his sons for their roles in the group have increased over the years but declined in FY2020. Their remuneration is summarised in Figure 4.

Financial year	Doris Chung (spouse)	Chew Han Wei (eldest son)	Chew Han Qiang (second son)
2013	Between S$100,000 to S$150,000	-	-
2014	Between S$250,000 to S$300,000	-	-
2015	Between S$250,000 to S$300,000	-	-
2016	Between S$250,001 to S$300,000	Between S$50,001 to S$100,000	-

2017	Between S$250,001 to S$300,000	Between S$150,001 to S$200,000	-
2018	Between S$250,001 to S$300,000	Between S$200,001 to S$250,000	Between S$50,001 to S$100,000
2019	Between S$400,000 to S$450,000	Between S$200,000 to S$250,000	Between S$150,000 to S$200,000
2020	Between S$350,001 to S$400,000	Between S$151,000 to S$200,000	Between S$100,001 to S$150,000

Figure 4: Remuneration of Chew's spouse and sons between FY2013 and FY2020[115]

Remuneration of key management personnel

Although the Code of Corporate Governance recommends that the remuneration of at least the top five key management personnel (who are not directors or the CEO) be disclosed – including the names, amounts and breakdown of remuneration in bands no wider than S$250,000,[116] REC's board is of the opinion that such a disclosure "would compromise confidentiality and may affect the retention of competent personnel".[117]

The growing presence of Oei Hong Leong

OHL, a Singaporean billionaire businessman, is one of Singapore's richest individuals. The bulk of his wealth is derived from a corporate bond portfolio and real estate assets. OHL is an avid Buddhist art collector and owns the private Nei Xue Tang museum in Singapore with over 50,000 items. Many of these items are rare and valuable antiquities dating to the Chinese Tang, Song and Ming dynasties. He has been listed on the Forbes billionaires list and Singapore's 50 richest list. OHL's net worth as at May 2021 is estimated to be US$1.9 billion.[118,119]

OHL started his acquisition of REC's shares on 29 April 2011 at S$0.665 per share. On 12 September 2012, he purchased more than 11.5 million shares at S$0.326 per share. This increased his stake from 4.79% to 6.14%, making him a substantial shareholder of REC.[120] The next day, through a series of open market purchases, OHL's stake in the private education company grew further to 7.18%.[121] Given his public status as one of Singapore's wealthiest individuals, his purchases resulted in a huge spike in activity.[122] In March 2014, OHL purchased another 1.222 million shares, while his investment vehicle, Oei Hong Leong Museum, bought 8.337 million shares, raising his direct and deemed interest in REC to 83.137 million shares or 8.11%.[123]

In September 2017, OHL once again increased his stake in REC by purchasing approximately 6.5 million[124] and 6.1 million shares through two transactions, raising his total shareholding to 12.77%[125] and making him the second largest shareholder of REC after CHS. Later that same month, OHL purchased another 12.2 million shares and increased his stake further to 14.04%.[126,127] OHL's accumulation of REC shares seemed to have some influence on the company's share price, which rose to a 12-month high of S$0.335 on 26 September 2017.[128]

Following a private placement of shares that was completed in October 2017, OHL's direct and deemed interests were diluted from 14.04% to 12.88%. OHL continued to increase his stake in REC. On 8 September 2020, there was an unusual share price movement in the company's stock, which prompted queries from SGX.[129] This was due to OHL increasing his stake from 12.9% to 13.05% through market transactions. This was followed by a further increase to 13.14% the following day,[130] and two further market transactions that same month which increased his stake to 13.53%.[131,132] By 30 April 2021, OHL had increased his stake back to 14%.[133]

Sparks that started a flame

On 28 September 2017, REC proposed a placement of 95 million shares – representing 8.96% of enlarged capital –at a price of S$0.30 per share to raise net proceeds of S$28.2 million. The placement price represented a discount of about 9.04% to the volume weighted average price of S$0.3298 on 27 September 2017. A majority of the proceeds would be used to settle loans and borrowings, while the remaining would be for working capital purposes.[134,135]

Two weeks later, on 10 October 2017, the placement shares were allotted and issued.[136] After the share placement, CHS and his wife jointly held a 33.58% stake – a drop from 36.88% prior to the share placement.[137,138] Despite having recently bought 1.07 million shares for S$0.3379 per share from the open market[139] prior to the share placement, OHL's direct and indirect interest was diluted from 14.04% to 12.88%.[140]

For the placement, REC entered into a placement agreement with RHB Securities Singapore Pte. Ltd. Rule 810(2) of the SGX Mainboard Rulebook requires the following information to be disclosed "where no placement agent is appointed or where a placement agent is appointed but is subject to any restrictions and directions imposed by the issuer regarding the identities of and/or the allocation to the placees identities of the placees and the number of shares placed to each of them": "(a) the identities of the placees and the number of shares placed to each of them; (b) details on how the placees were identified and the rationale for placing to them; and (c) the restrictions and/or directions imposed on the placement agent by the issuer regarding the identities of and/or the allocation to the placees, where applicable".

Since REC appointed a placement agent, it was not required to disclosed the placees and chose not to do so. OHL later alleged that LYC, who became a top 20 REC shareholder sometime between 7 September 2017 and 24 September 2018,[141] acquiring a 2.84% stake, was either one of the placees or had acquired the shares from the placees. According to OHL, LYC is a nominee of CHS and his acquisition of the REC stake allowed CHC to increase his stake beyond the limits imposed by The Singapore Code on Take-Overs and Mergers without triggering a mandatory general offer.[142]

Big David takes on not-so-mighty Goliath

Under Section 176 of the Companies Act, shareholders with at least a 10% stake can requisition a company to convene an EGM, which must be held within two months.[143]

On 12 October 2017, OHL and his investment vehicle Oei Hong Leong Art Museum served a notice of requisition to REC to hold an EGM to remove CHS from his position as Chairman and director of the company, terminate his employment with the company, and appoint an ID as a Non-Executive Chairman. In relation to REC's placement of 95 million new shares two days prior,[144] OHL also asked for the disclosure of the identities of the places and the number of shares placed to each of them.[145,146] The EGM was scheduled for 29 November 2017.[147]

OHL's intent to remove CHS came as a surprise as the market had thought that the two were friends. This move placed CHS under the spotlight, and shareholders demanded explanations for undelivered promises and net losses suffered by REC at its Annual General Meeting (AGM) on 13 October 2017. CHS urged shareholders to provide him with their continual support. To alleviate shareholders' concerns, he said during the AGM that "this year I can already tell you that our numbers are positive".[148] This mirrored the company's 2016 AGM, where shareholders voiced concerns over how the company was planning to "start making real earnings from education". CHS was quoted saying, "We're trying to focus and expand at the expense of bringing in revenue." Lead ID TSK added, "There's nothing to be proud of in terms of current performance and share price, but it's not as if we've just been sitting there."[149]

In a surprising turn of events, on 16 November 2017, OHL withdrew his earlier requisition notice dated 12 October 2017.[150] REC's share price dropped by 7.8% to S$0.295 per share after the withdrawal.[151]

Growing tensions

OHL filed a lawsuit against CHS in June 2018, suing him for S$15 million in losses for allegedly breaching an agreement to find a buyer for OHL's REC shares.[152]

According to the lawsuit, on 16 October 2017, OHL had offered to buy out CHS's stake and make a mandatory general offer for REC. However, citing REC as a family asset, Chew turned down the proposal. CHS had counter-offered that he would find a buyer for OHL's shares at S$0.44 per share within one month. OHL then agreed to withdraw his requisition notice at CHS's request.[153]

OHL said that, on or around 25 October 2017, CHS informed him that he had found a potential buyer – a businessman from China known as Peng Yusen. OHL declined the deal as the buyer wanted to make payment in Chinese yuan instead of Singapore dollar.[154]

However, CHS had a different version of what had happened on 16 October 2017. He said that OHL asked him to find a buyer at the price of S$0.44 per share. CHS said that he had agreed due to their longstanding friendship, but further cautioned OHL that it would be difficult to find a buyer at that price, as it was significantly higher than the market price at that time. CHS claimed it was a "friendly agreement",[155] although each of them have a handwritten copy of the meeting's record signed by both parties.[156]

In February 2020, the Singapore High Court dismissed the lawsuit brought by OHL against CHS. It concluded that the note which detailed the agreement between the two individuals on 16 October 2017 was not intended to be legally binding. The judge went on to say that, given that OHL and CHS were experienced businessmen, the S$60 million transaction would not have been completed without the negotiation of details and the involvement of lawyers. The judge also accepted CHS's testimony that the note was drafted merely to capture the essence of both parties' "amicable solution" at the informal meeting.[157,158]

Unsatisfied with the verdict, OHL filed an appeal against the judgement.[159] However, the Singapore Court of Appeal dismissed his appeal against the judgment in August 2020.[160]

Further power struggle

On 6 December 2018, REC announced a renounceable rights issue which would raise up to S$27.44 million to primarily repay loans owed to CHS.[161] The company's share price fell from S$0.137 on the date of the announcement to close on 11 December 2018 at S$0.099.[162] OHL served another notice of requisition on 13 December 2018 to require REC to convene an EGM to vote on the following resolution: "That the proposed rights issue of up to 275,858,734 new ordinary shares in the company with the rights issue proceeds to settle the company's Chairman and Chief Executive Officer, Mr. Chew Hua Seng's loans to the company as announced by the company on the 6 December 2018 be terminated immediately."[163] CHS had previously extended interest-free shareholder's loans to REC for working capital purposes, and the outstanding amount was approximately S$16.37 million.[164]

Following the notice, REC sought legal advice and was advised that the proposed resolution was invalid and/or would be ineffective in light of the share issue mandate approved by shareholders at the previous annual general meeting held on 29 October 2018.[165] It issued a response to the EGM requisition which highlighted that "the Requisitionists may not seek to circumvent the Share Issue Mandate (which was carried with 94.81% votes at the annual general meeting held on 29 October 2018 and remains in force) by way of the proposed resolution."[166] REC did not convene the EGM.

Share issue mandate – a tool to be used in good faith

At the crux of the abovementioned conflict was the "Share Issue Mandate" that was approved by shareholders during the earlier AGM.[167,168] Under Rule 806 of SGX Mainboard Listing Rules, a "general mandate" is used to confer authority to the board of directors to issue shares or other convertible securities either unconditionally or on specified conditions. Approval by the company's shareholders for share issuances within the terms of the general mandate would not be required if shareholders had, by ordinary resolution in a general meeting, given a general mandate to the directors.[169] General mandates thus provide companies with greater flexibility and allow companies to swiftly respond to business opportunities and challenges by raising the necessary capital through the issuance of shares.[170]

At the AGM held on 29 October 2018, REC had passed an ordinary resolution for a Share Issue Mandate with 94.81% of total votes.[171] In line with SGX Listing Rule 806(2), REC was limited to issuing "not more than 50% of the total number of issued shares excluding treasury shares and subsidiary holdings in each class, of which the aggregate number of shares and convertible securities issued other than on a pro rata basis to existing shareholders must be not more than 20% of the total number of issued shares excluding treasury shares and subsidiary holdings in each class".[172]

REC had planned to raise up to S$27.44 million in net proceeds by issuing up to 275.86 million new ordinary shares at an issue price of S$0.10 for each rights share on the basis of two rights shares for every 10 existing shares. The issue price represented a discount of approximately 27% over the last transacted price of the company's shares on 6 December 2018. CHS and his wife had intended to subscribe for their entitled allotment and the cost would offset against the loan extended by CHS.[173]

Given the weak performance of REC in late 2018,[174] doubts emerged about the motivation behind the share issuance. A share issuance also possesses dilutive effects if existing shareholders choose not to subscribe for the new shares.[175] However, this proposed rights issue was subsequently cancelled on 5 March 2019 as the market price of the shares fell below the proposed issue price.[176] The company's share price fell to S$0.088 per share that same day, down by 2.2%.[177]

OHL holds his ground

The power struggle in REC continued to play out in 2020.

Round one

On 17 August 2020, REC received another notice of requisition from OHL, requesting that the company hold an EGM and table six resolutions for shareholders' approval. The resolutions once again included the removal of CHS from all his appointments in the Group, and the appointment of a Non-Executive Chairman. Further, in relation to the placement of 95 million new shares issued and allotted on 10 October 2017, OHL once again requested that the company discloses the identities of the placees and the number of shares placed to each of them. Furthermore, he called for the appointment of an independent special auditor to conduct a special audit on the circumstances surrounding the 2017 share placement and the rights issue in April 2018.[178,179]

In response, REC said it had obtained legal advice and was advised that the requisition request was without merit. It said that based on the provisions of the Companies Act and the company's memorandum and articles of association, the proposed resolutions concerned subject matters which fell outside the province of the shareholders at the general meeting. As such, it declined to convene an EGM.[180]

Round two

On 31 August 2020, several shareholders, including Indian edtech businessman Shantanu Prakash and OHL, issued yet another notice of requisition.[181] Six of the seven resolutions proposed in the latest requisition notice were the same as those listed in the earlier 17 August notice issued by OHL.[182] The additional resolution called for the appointment of a special auditor to review the circumstances surrounding REC's joint venture with Educomp Solutions Limited (Educomp) – Educomp-Raffles Higher Education Limited (ERHEL) – on concerns of wrongdoing, which included alleged forgery as well as extortion. Educomp is an education company in India founded by Shantanu Prakash and is listed on the National Stock Exchange of India.[183]

The shareholders also asked that the auditor look into whether there were any "irregularities" committed by REC's directors, as well as whether there were any corporate governance failures such as allegations of corruption. The former was in relation to Shantanu Prakash's complaint lodged with Singapore's Commercial Affairs Department (CAD). The complaint related to whether CHS, his wife and elder son, as well as other REC directors, had "colluded and conspired to fraudulently fabricate and forge documents towards extortion of Mr. Prakash for land grabbing in India".[184] In response, CHS said that there was no CAD investigation into him or his family members.[185] He also noted that Shantanu Prakash and Educomp were in the midst of a probe by India's investigation agency for major corporate fraud.[186]

REC announced on 19 September 2020 that it had obtained legal advice on the contents of the notice, and was advised that the requisition request was without merit. The underlying reasons were the same as those provided previously to reject OHL's earlier notice of requisition dated 17 August 2020. As such, it declined to convene an EGM. REC also addressed the additional resolution in respect of Shantanu Prakash and ERHEL. It disclosed the background facts and circumstances surrounding ERHEL and confirmed that the board was unaware of any alleged investigation commenced by the CAD to-date.[187]

In May 2008, ERHEL was set up as a 50:50 joint venture by REC and Educomp to launch the Raffles-Educomp brand of green field campuses and learning centres or institutions in India. Between then and 2015, REC increased its investment in the joint venture to 52.18%. Due to the positive performance of ERHEL, REC wanted to acquire the remaining stake in the joint venture to "consolidate and expand its business in India".[188] However, the acquisition was not completed by Educomp despite the issuance of written reminders and the service of a Notice to Complete dated 2 September 2015 by REC.[189] In November 2016, it was reported that the Raffles design institute, which is branch of REC, had shut down, leaving 160 students in a fix.[190]

In April 2017, over a year and a half after the initial suit was launched in September 2015, REC was awarded damages of 163.2 million rupees (S$3.52 million) plus 5.33% interest by an arbitration tribunal in India for breaches by Educomp in respect of the share purchase agreement.[191] The tribunal concluded that Educomp had breached the agreement by failing to complete the sale and purchase transaction by Raffles Education Investment (India) Pte Ltd and Raffles Design Pvt Ltd for the 41.82% equity interest of ERHEL from two Educomp entities. The two REC subsidiaries held the remaining 58.12% stake in ERHEL. Thereafter, REC initiated enforcement proceedings in India to recover these sums. The company also initiated a lawsuit in Singapore against Shantanu Prakash with regard to the arbitration award.[192,193]

Business in China

In October 2007, REC announced that it was buying a campus in Langfang city in Hebei province near Beijing from Oriental University City Development for S$392 million.[194] Through this deal, REC would acquire the land and two of the 19 schools, and be the landlord to the other 17 colleges on the campus. CHS said that the acquisition would "leapfrog Raffles Education to be the largest foreign provider of education in China" and REC would be able to intensify the land use by building more schools. It said it planned to add five more colleges and one university in four years, with further plans to add new courses and programmes, while improving existing ones. Payment for the deal will be through four instalments over four years.

An investigation by Mark Laudi of Investor Central in May 2011 questioned whether the deal was really about education or whether it was in fact a property deal.[195] A visit to the campus found a lack of students. Within a few short years, the number of students had halved and the number of schools had fallen from 19 to 14. REC blamed the change in the quota system for the decline in student numbers. The investigation said that Oriental University City was no longer just a university campus and that REC had been trying to sell some of the land in order to build residential units. Based on its accounts, REC had made around S$10 million profits from the sale of land and a potential S$50 million from the realisation of assets assuming all of the units they have developed are sold. It seems that what started purportedly as an acquisition in the education business was now a property transaction.

In 2013, REC's subsidiary, Langfang Tonghui Education Consulting Co., Ltd. (Tonghui), entered into a framework agreement for the sale of land and buildings in the Oriental University City Development to Langfang Heying Real Estate Development Co., Ltd. (Heying). The land and buildings to be sold to Heying had earlier been transferred to Tonghui in 2012 as part of an "internal reorganisation" of the Group.

Tonghui and Heying then incorporated Langfang Hezhong Real Estate Development Co., Ltd (Hezhong) in 2014 as a joint venture (JV) company between Tonghui and Heying, with the two JV partners contributing 70% and 30% respectively to the registered capital of Hezhong. Hezhong's principal business is property development and property leasing. It has a registered capital of RMB318.8 million, and its assets primarily consists of land with a total area of 332,833m^2.[196] Tonghui's contribution was in the form of the land and buildings valued at 233.33 million yuan, while Heying's contribution was cash of 100 million yuan. Heying's role as a JV partner was to procure the conversion of the land from educational use to residential and mixed development use. However, efforts to convert the land to commercial and residential land titles over the past six years had been stalled by "numerous protracted challenges" and had not been successful.[197]

On 16 July 2020, REC announced its plans to take control of Hezhong after Tonghui entered into a sale and purchase agreement with Heying to raise its stake by 35.9% for RMB254 million (S$49.2 million) in cash. As at the date of the announcement, Tonghui had a 34.1% stake in Hezhong while Heying held the remaining 65.9% stake. As the proposed acquisition was considered a "major transaction" under Chapter 10 of the SGX Listing Manual, it was subject to shareholder approval.[198] REC's share price closed at S$0.11 on the date of the announcement, down by S$0.005, or 4.4% from prior to the announcement.[199]

REC rationalised that the proposed acquisition would allow it to "obtain majority control over [Hezhong] and thereafter rationalise the land for development and use as education facilities". The company also said that the acquisition would "create revenue streams complementary to the Group's businesses of providing education consulting and other education related services".[200] It said that Langfang City, being strategically located between Beijing and Tianjin, is "well poised to cater to the demands for educational facilities of higher education institutions". According to REC, the acquisition would result in an increase of net tangible assets per share from S$0.3715 to S$0.3790.[201,202]

REC Education set the date of the EGM for shareholders to vote on the proposed acquisition to be 30 September 2020.[203] It was duly approved, with 78.61% of the shares voting for it.[204]

A puzzling deal[205]

The proposed Hezhong transaction raised a number of questions.

Tonghui and Heying had also entered into an option agreement which gave Tonghui the right to require Heying to buy Tonghui's 70% interest in the JV for 700 million yuan, which was based on the then prevailing value of the land. In 2014, the two JV partners entered into supplementary agreements to amend the shareholders' agreement and the option agreement.

Tonghui later exercised its option but Heying paid only 460.83 million yuan instead of 700 million yuan. Heying now owned a total beneficial interest of 65.9% in the JV. Both parties agreed to waive any claims against each other under the shareholders' and option agreements. The settlement agreement was announced in June 2019.

The EGM was for REC shareholders to approve the sale back to Tonghui of the additional 35.9% beneficial interest, which Heying acquired following the exercise of the option.

The net tangible asset value and book value of the sale shares based on the latest management accounts for the year ended 31 December 2019 was 290.34 million yuan. An independent valuation commissioned by Tonghui undertaken by Jones Lang LaSalle Corporate Appraisal and Advisory Limited valued the sale shares at 295.97 million yuan as at 30 June 2020.

On the surface, it did not seem like a bad deal. After all, Heying had paid 460.83 million yuan for the stake, which it was now selling back to Tonghui for 254 million yuan. The sale price was also below the net tangible asset value and book value in Hezhong's management accounts and the valuation by Jones Lang LaSalle. However, these values may not be relevant given that the land will now be used for educational purposes. Jones Lang LaSalle also emphasised that with COVID-19, "values may change significantly and unexpectedly even over short periods".

On 21 September 2020, OHL sent a letter to REC attention to its lead ID, LHT, regarding the proposed transaction.[206] The letter requested that REC make the relevant agreements and supplemental agreements available for inspection. It also raised a series of questions, including inter alia, why REC did not pursue a claim against Heying for the breach of shareholders' agreement; reasons for continuing with a JV with a defaulted partner; and rationale for entering into the option settlement agreement and agreeing to buy back shares rather than pursuing a claim for a breach.

The EGM was to be conducted by virtual means under the COVID-19 measures introduced by the regulators, which require issuers to answer shareholders' substantial questions before or at the shareholder meeting. REC only responded to the questions from OHL on 29 September 2020 at 5.30pm. This was after the deadline for voting, which was 10am the day before.

This was heavily criticised by a commentator, who said "In REC's case, the concerns and further questions raised by REC's responses could also have influenced how other shareholders vote. It is simply unacceptable for REC to post its responses to the shareholder's questions the day after the voting deadline, when the questions were sent eight days earlier."[207]

Game far from over

OHL was far from done in his battle with CHS. He continued to send letters to the company demanding answers and to regulators urging action.

One of these letters was an open letter dated 8 February 2021[208] relating to the lawsuit OHL filed against CHS in June 2018 which alleged that CHS reneged on an agreement to buy OHL's shares in REC. In his open letter, OHL alleged that CHS "tried to hide highly relevant documents from the Court to prevent them from having all the facts", was caught and was then directed by the Court to produce the documents. OHL also alleged that CHS created the false impression of a buyer for his shares and also suggested a fictitious transaction be entered into in order to enable CHS to avoid making a general offer for REC's shares. According to OHL, CHS's plan involved OHL selling his shares to CHS and then disguising the payment of the deposit as payment by CHS's wife for the purchase of a property in Switzerland belonging to OHL's sister. If true, this would clearly be a very serious allegation made by OHL. OHL in his open letter also alleged that CHS's lawyers "drafted and submitted their [CHS's and his wife's] affidavits to the court which misled and misrepresented the court into believing that the discussion with me was informal and friendly….and they had no intention to create legal relations".

On 12 April 2021, OHL sent another letter to the REC board in which he claimed to have discovered through their own investigations that CHS had "engineered the [2017] placement of up to 95 million new ordinary shares" and that at least one of the placees is LYC, a former member of the board.[209] The letter listed several circumstances pointing to LYC being a nominee of CHS, enabling the latter to circumvent his obligations to make a mandatory general offer by using LYC to acquire more shares. These circumstances include LYC being CEO of a REC subsidiary and having a long association with this subsidiary; CHS's wife being an alternate director of LYC on the board of an Australian-listed property developer; and LYC's filings with the Accounting and Corporate Regulatory Authority listing a property owned by CHS as LYC's registered address.

OHL gave notice that if the REC directors fail to investigate and/or commence action against CHS and LYC within 14 days of the letter, he would proceed with legal action against REC and both parties under section 216A of the Companies Act.

That same day, he also sent a letter to RHB Securities Singapore, the placement agent for the 2017 placement, putting RHB on notice to preserve all documents, records and correspondence relating to the placement.[210]

This was followed by another letter to the board on 23 April 2021 questioning the company's response to his letter and its announcement on SGX.[211] OHL claimed that, contrary to the company's claims, RHB had said that the placement was actually arranged by CHS and all the placees were in fact introduced by CHS. OHL also raised the question as to how LYC would have the financial means to pay S$11.7 million for the 39 million shares he bought when his annual salary disclosed in the annual report of the REC subsidiary disclosed his annual salary of about S$65,000 as CEO. A subsequent letter dated 28 April 2021 asked further questions, including inter alia, how the IDs conducted the investigation into the placement and whether independent special auditors were appointed to carry out the investigations. OHL offered to "underwrite the reasonable cost of independent special auditors if their report reveals that our allegations are not supported".[212]

REC has thus far refused to disclose the placees for the 2017 placement.

A shocking revelation[213]

On 29 July 2021, 5.39 pm, REC announced that the company and two of its subsidiaries in Malaysia, had been served with writs and statements of claims filed by Affin Bank Berhad (Affin Bank) on 27 May 2021 in the High Court of Malaysia. Affin Bank sought the immediate repayment of the entire outstanding amount of RM410 million – or approximately S$131 million – under facilities entered into by REC's two subsidiaries. This amount was more than half of REC's market capitalisation of about S$220 million just before the announcement. Not surprisingly, REC's share price went into free fall the day following the announcement, closing at S$0.10 compared to the previous day's closing price of S$0.16 – a fall of 37.5%. It fell to as low as S$0.08 on 2 August 2021, before closing at S$0.09 on 6 August 2021, down 43.8% compared to the price just before the announcement of the writs.

REC said that the announcement was issued "further to discussions between the company and Singapore Exchange Securities Trading Limited ("SGX-ST") and at the request of SGX-ST". Professor Mak Yuen Teen, a corporate governance advocate, said that "there is simply no excuse for the writs not to be disclosed on 27 May – and arguably before that when presumably letters of demand would have been received before the filing of the writs and statements of claims".

The board attempted to justify not disclosing the writs earlier by saying that the two subsidiaries "have had discussions with Affin Bank prior to and immediately after its receipt of the Writs and had also sought advice from Malaysian legal counsels on the Writs (including the merits). Having regard to the foregoing, the board is of the view that the actions brought, and claims, under the Writs are unmeritorious."[214]

Therefore, the board seems to believe that disclosure is at its discretion or is a matter of business judgement. According to Professor Mak, the board is wrong. He argued that it is clear that disclosure is mandatory under Chapter 7 on "Continuing Obligations" and Appendix 7.1 Corporate Disclosure Policy of the SGX Rulebook. According to him, there is nothing in Chapter 7 or Appendix 7.1 which states that even if information should be disclosed pursuant to the rules, the issuer still has the discretion as to whether to disclose or not.

It turns out that the REC board had indeed chosen to interpret the rules as if it has the discretion to disclose. On 23 July 2021, OHL had written to the board highlighting the failure to disclose the lawsuit after he got wind of it. He has since posted the letter on the "Save Raffles Education" website.[215]

The REC board, in its reply to OHL on 28 July 2021, said: "…the board formed the view, based on the exercise of business judgement as well as legal advice from its Malaysian legal counsel, that the claims in the Litigation cannot be proceeded with and/or sustained. As you are aware, if a legal action taken against the company could reasonably be characterised as being bound to fail, disclosure of the same may not be necessary. The company had amicably settled this matter with Affin Bank".[216]

Professor Mak pointed out he was not aware that the SGX rules allow the board to exercise its discretion even when the information is clearly required to be disclosed under the rules. He said that Affin Bank is a reputable bank in Malaysia and is unlikely to file unmeritorious claims that are “bound to fail”.

He also questioned the disclosure of the litigation by REC on 29 July 2021, where the company had said:

> “The board wishes to further update that the company and the borrowers have reached a settlement with Affin Bank on the amicable resolution of the matters under the Writs and understand that the Writs will be withdrawn upon the formalisation of such resolution….The company will make further announcements as and when there material developments on the above matter, including if and when there is a formal withdrawal of the Writs by Affin Bank”.

Professor Mak noted that while the board had told OHL in its reply that the company has amicably settled the matter with Affin Bank, the company’s announcement on 29 July 2021 indicates that there is no formalised resolution yet and Affin Bank has yet to withdraw the writs.

On 30 July 2021, OHL sent a further letter to the REC board and raised a number of queries.[217] Professor Mak felt that SGX should direct the company to respond to the queries, saying that the market is clearly unnerved by the very late announcement that indicates that there is no certainty that the matter will be formally resolved. Further, he said this latest lapse adds to the concerns that have already been raised about how REC is governed and managed, and about its financial condition and prospects.

Professor Mak called for SGX Regco to act decisively and quickly, and take action for “the clear and serious breach in the listing rules by REC”. He said that the Monetary Authority of Singapore “should also investigate whether there are breaches of the Securities and Futures Act with respect to the continuous disclosure requirement, and whether prior information disclosed by the company in light of this latest disclosure may be false or misleading”.

Professor Mak added that investors who have bought shares from 27 May until before the company’s announcement – and arguably even before that, when letters of demand may have been issued – may understandably feel aggrieved. He said that they may well have a basis for a civil liability action against those responsible for the lack of timely disclosure.

How will it end?

It is clear that OHL has no plans to back off in his tussle with CHS. He has continued to increase his stake in REC, with recent market acquisitions taking his stake back up to 14%.

The REC case is unlike other cases in corporate Singapore where a minority shareholder with limited resources finds himself pitted against a controlling shareholder with the financial muscle to thwart and sometimes intimidate the minority shareholder into submission. In this case, the roles of David and Goliath are reversed.

Discussion questions

1. Critically evaluate the corporate governance of Raffles Education based on its compliance with the Singapore Code of Corporate Governance, and other applicable corporate governance rules and good practices. Include an evaluation of the composition of the board of directors and changes in the composition over the years.

2. What is the intention of the requirement for a mandatory general offer under the Singapore Code of Take-overs and Mergers? How might companies circumvent this requirement? Cite examples of recent cases where this may have occurred. Do you think Oei Hong Leong has a reasonable basis for his allegations that Chew Hua Seng has avoided his obligations to make a mandatory general offer? Explain.

3. Critically evaluate the effectiveness of Rule 810(2) in the SGX Rulebook relating to the placement of shares. Do you believe that companies should be required to disclose the identity of major placees regardless of whether a placement agent is used? Explain.

4. Critically evaluate the actions of the board of directors, particularly the independent directors, in response to the allegations and questions raised by Oei Hong Leong.

5. Oei Hong Leong requisitioned for an EGM to terminate the rights issue proposed by the company pursuant to the general mandate for the issue of shares approved by shareholders at the AGM. The company's view was that it was not a valid resolution since the general mandate has already been approved by shareholders. Do you agree with the company's view? Explain.

6. Explain the background to the joint venture Hezhong in China. Are there concerns and red flags relating to the proposed acquisition of the additional stake in Hezhong from the joint venture partner. Explain. What are the responsibilities of the board of directors in merger and acquisition decisions, such as in the case of the proposed acquisition of the additional Hezhong stake?

7. A recent EGM and AGM of Raffles Education were conducted by virtual means under Covid-19 measures introduced by Singapore regulators. Critically evaluate these measures and whether the virtual meetings conducted by Raffles Education disenfranchised minority shareholders. Should fully virtual meetings be allowed post-pandemic? What measures should companies have to put in place when they conduct shareholder meetings by virtual means?

8. Do you think that regulators have acted effectively in the Raffles Education case to ensure good corporate governance, transparency and protection of minority shareholders?

9. Critically evaluate the quality of investor protection in your market and the rights and ability of minority shareholders to hold directors of companies accountable.

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SINGAPORE POST: BACK FROM THE ABYSS?

Case overview

On 4 July 2016, Singapore Post (SingPost) pledged to adopt the recommendations of the special audit and corporate governance review after an "administrative oversight" in 2015 led to an exposé of its corporate governance shortcomings. The revelations of the lapses occurred shortly after the sudden departure of its Group CEO and were soon followed by the high-profile departures of its Chairman and most of the other directors and members of the senior management team. While SingPost implemented numerous measures to address past shortcomings, ghosts of its past continued to linger.

The occurrence of service lapses in 2018 and 2019 reignited a public outcry that threatened to derail SingPost's progress. Changes in business conditions – most prominently, a continuing decline in demand for postal service – also presented ongoing challenges to its business and profitability. However, there are positive signs that it was putting its past behind it as it refocused its long-term strategies towards the Asia-Pacific region, implemented leading corporate governance practices, improved employment conditions and practices, embraced greater use of technology, and embarked on a sustainability journey – hopefully laying the groundwork for a brighter future.

This case study reviews the numerous challenges which continued to afflict a company with significant corporate governance lapses and which contributed to a significant decline in profitability, share price and dividends, and the actions taken by a company to address the lapses. The objective of this case study is to facilitate a discussion of issues such as the long-term consequences of poor corporate governance; board and management transformation; implementation of leading corporate governance practices; board composition; role of the board in dealing with disruption, overseeing changes in strategies, and ensuring proper due diligence in mergers and acquisitions; the importance of focusing on stakeholders such as employees in driving long term performance; and the board's role in guiding a company's sustainability journey.

This case was prepared by Ang Peng You Presley, Dion Lim Kang Kai, Lai Jin Hoe, Soh Xin Yi, Yang Xinyi and Yeo Jun Kang Jason, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been significantly re-written by 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 organizations named in the case, or any of their directors or employees.

Reading the mail

Since its humble beginnings as a local post office in 1819,[1] Singapore Post Limited (SingPost) has grown to become a SGX-listed company with a vision of being a global leader in e-commerce logistics and trusted communications. SingPost's current business model is centered on three main thrusts: post and parcel, logistics, and property.[2]

First, SingPost envisions a "Future of Post" five-year program to deploy smart urban logistics in Singapore and entrench its market dominance.[3] This will be achieved through investing in nationwide delivery infrastructure and repositioning its post and parcel network to gain a larger e-commerce market share, such as through the installation of "smart letterboxes".[4] It also aims to develop Singapore into the "global e-commerce distribution superhub".[5]

Second, SingPost plans to build a strong integrated B2B2C network to capitalise on the growing demand for integrated supply chains due to the e-commerce boom.[6] This includes the creation of a "second home base" in Australia,[7] which possesses high growth potential in the e-commerce industry.[8] With the earlier acquisitions of a number of Australian e-commerce logistics companies, such as CouriersPlease[9] and G3 Worldwide Aspac Pte. Ltd.[10] (now known as Quantium Solutions International Pte. Ltd.),[11] it aimed to create a strong revenue-earning platform for SingPost and enhance its existing supply chain operations in Australia.[12]

The final thrust hinges on a renewed focus on properties to optimise and grow returns for SingPost. Through unlocking the value of important property assets such as SingPost Centre located in Singapore's Paya Lebar neighbourhood, the potential increase in returns can in turn fund SingPost's planned growth strategies.[13]

Old mail

Back in 2015, SingPost found itself engulfed in a major corporate governance scandal. There were questions surrounding board competencies, independence of directors, board renewal, the segregation of board and management, conflict of interest, and questionable acquisitions.[14]

Too many postmasters?

In financial year 2015, SingPost's board of directors consisted of 12 directors, with eight independent and four non-independent directors. Apart from the CEO, the remaining 11 directors on the board were non-executive. There was only one female independent director.[15] SingPost's board size was considered unusually large compared to other government-linked companies. For example, Singapore Telecommunications Limited (Singtel), which at that time owned 23% of SingPost[16] and had a market capitalisation 16 times larger than SingPost, only had nine directors.[17]

The board had several long-serving independent directors, with the Chairman and lead independent director both having served for 17 years on SingPost's board. Several of these independent directors, including the two longest serving ones, were over 70 years of age. Questions were raised as to whether the long-serving directors had the necessary skill sets and competencies for the new strategies that SingPost was pursuing, such as its expansion into the e-commerce business, and whether they continued to be independent.[18]

Inexperienced supervisors

In February 2011, SingPost appointed 36 year-old Austrian Dr. Wolfgang Baier as its CEO (International).[19,20] Prior to joining, Dr. Baier had worked with SingPost on major initiatives over the previous five years while he was a partner at McKinsey & Company (McKinsey). McKinsey was instrumental in advising SingPost on its regionalisation and diversification initiatives. Dr. Baier's entire past work experience had been with McKinsey in both Singapore and Austria. On 5 October 2011, he was appointed as Group CEO and a member of the board.[21]

The following month, SingPost announced the appointment of 33 year-old German, Dr. Sascha Hower, as Chief Operations Officer. Dr. Hower was previously a junior partner of McKinsey in Germany, where he had spent his entire career.[22]

SingPost also appointed several other former McKinsey consultants to senior management positions, including Chan Kiat, who was then executive vice president (investments, group strategy & business development).[23,24]

Conflicting interests in the mailroom

With SingPost's move towards e-commerce and logistics, it undertook numerous acquisitions.[25] Among the acquisitions were the "Famous acquisitions" comprising Famous Holdings Pte Ltd (FHPL) in 2013, FS Mackenzie Limited (FSML) in 2014, and Famous Pacific Shipping (NZ) Limited (FPSL) in 2015.[26] SingPost's lead independent director, Keith Tay Ah Kee, was concurrently the Non-Executive Chairman and a major shareholder of corporate finance advisory firm Stirling Coleman Capital Limited (Stirling Coleman), which was headquartered in Singapore. Tay owned 34.5% of Stirling Coleman's shares.[27] Stirling Coleman disclosed on its website that it was the "arranger" for the FHPL deal and "financial advisor to the seller" for the deals involving FSML and FPSL.[28] It neither had representative offices in the U.K. nor New Zealand where FSML and FPSL are located.[29] In respect of SingPost's acquisition of FSML, SingPost's initial company announcement had stated that none of its directors or controlling shareholders had any interest in the said acquisition. However, that statement was later found to be inaccurate due to Tay's involvement, and when questioned by SGX, SingPost said that the mistake was attributable to "administrative oversight".[30,31]

In December 2015, Dr. Baier's resignation from SingPost shocked the market and led to scrutiny of the company's corporate governance by Professor Mak Yuen Teen, a corporate governance advocate. He also raised the possibility of a "conflict of interest and perception issues" regarding the involvement of Stirling Coleman as "arranger" or "financial advisor" for the seller, given Tay's position as the Non-Executive Chairman and a major shareholder of Stirling Coleman, and his role as lead independent director of SingPost.[32]

This led to a special audit and corporate governance review being ordered by SingPost, which identified a number of issues, such as lack of timely disclosure of a director's interests to the board.[33] Law firm Drew & Napier LLC and accounting firm PricewaterhouseCoopers LLP were engaged by SingPost to review whether the company's constitution, internal policies and procedures, and legal obligations were complied with in connection with the Famous acquisitions.[34] Meanwhile, the corporate governance review was conducted by leadership consulting firm Heidrick & Struggles and local law firm Lee & Lee.[35] Eventually, most of the directors resigned or did not seek re-election and almost the entire senior management team was replaced.[36]

New mail

Over the last few years, SingPost has taken many steps to improve its corporate governance and operations. However, as the write-offs from major investments, disputes relating to acquisitions, and operational issues since 2015 show, the road to recovery has not been easy. SingPost's profitability, dividends, and share price are still a long way off from its heyday before 2015.

Corporate governance reforms

Following the special audit and corporate governance review, the board swiftly introduced a new Code of Business Conduct and Ethics for its board of directors on 16 June 2016. The Code aims to provide guidance to directors on areas of ethical risk and to create a framework for an environment where integrity and accountability are of utmost importance.[37] Apart from the Code, two new policies were unveiled: one on directors' conflicts of interest and the other on board renewal and tenure. Directors can serve for a maximum of two terms, totalling no more than six years. However, a director may serve for an additional three year period as the board determines is necessary, to accommodate phasing, giving due regard to critical skill sets needed.[38] It also dissolved the Executive Committee (Exco) – a committee that had wide remit and was perceived to have overstepped its oversight role.[39]

On 4 July 2016, SingPost released the findings and recommendations of the corporate governance review to the public and promised to substantially implement the recommendations over the next three months. These recommendations focused on five broad areas: 1) Board processes and merger and acquisitions (M&A); 2) Market disclosures; 3) Board composition and structure; 4) Board culture and dynamics; 5) Board partnerships with management.[40]

It also announced the establishment of a new Finance and Investment Committee to replace the defunct Exco, but with a limited terms of reference focusing on M&A matters, finance and investments.[41]

On 10 October 2016, SingPost provided a further update and reported that it had substantially implemented all the recommendations.[42] The selection process for directors was also enhanced to consider the extent to which the directors fulfilled factors detailed in a board composition matrix, key expertise criteria, and leadership competency criteria.[43] On 29 December 2016, the law firm Lee & Lee, which was engaged to conduct an independent review of the implementation of new corporate governance policies, indicated that SingPost's new measures comprehensively addressed the recommendations of the corporate governance review.[44]

Industry observers expressed support for the reforms. Joyce Koh, executive director of the Singapore Institute of Directors, commented that the reforms relating to conflicts of interests, director's code of conduct and board renewal were extremely comprehensive, with some even going beyond existing leading practices.[45]

Policy on directors' conflicts of interest

The special audit concluded that there were insufficient disclosures, as well as delays in disclosing conflicts of interest regarding lead independent director in the Famous acquisitions. The audit also indicated that SingPost lacked prescribed policies and procedures governing the disclosure of directors' interests. For example, SingPost lacked a standard documentation to update directors' external appointments. Furthermore, the company did not have a process requiring directors to assess and declare their interests in potential transactions undertaken by SingPost.[46]

Under the new policy, directors may make conflict of interest disclosures by completing prescribed standard forms which contain conflicts of interest and the nature of the conflicts and giving notice to the company secretary, who would then disseminate information to the board in a timely manner. It was also emphasised in the policy that the duty to disclose conflicts of interest as soon as is practicable lies with the directors. For greater clarity, the policy also provides guidance on identifying actual and potential conflicts of interests.[47]

Reforms in mergers and acquisitions

The special audit report on the Famous acquisitions revealed that SingPost lacked a prescribed policy to evaluate and to approve M&A transactions. Instead, the process was based on broad internal guidelines and the M&A team's own work experience.[48] These findings from the special audit report were reinforced in the findings of the Corporate Governance Review, which observed that SingPost's M&A guidelines were inconsistent and confusing. There were two separate proposed M&A guidelines which made no reference to one another and were, in some cases, contradictory. Moreover, many of the broad guidelines were implemented based on the commercial experience of those working on each M&A transaction, "with varying interpretations and applications of the principles and guidelines".[49]

The special audit report also proposed a series of changes in SingPost's M&A policy, stating that SingPost should review its guidelines, delegation matrices and checklists holistically to adopt a properly documented M&A policy, as well as set out clear procedures to identify and disclose potential conflicts of interests or interested persons transactions as soon as possible.[50] The formal M&A documentation which sets forth the necessary actions and approvals required during the M&A process should cover the M&A process itself, the management evaluation checklist, the M&A delegation matrix, dealing with conflicts of interests and interested persons transactions, and the board approval process.[51]

Changing of the guard

At the time of the scandal, the SingPost board consisted of eleven men and only one female director, with an average age of more than 59 years. Three of the independent directors were above seventy years old, with two of these serving for 17 years.[52]

Five years on, all except one director – Chen Jun, who is a non-executive director nominated by substantial shareholder Alibaba – had stepped down from the SingPost board. As at mid-2020, the board has been reduced to nine directors, five of whom are independent directors. The average age of the board also fell to about 57 years. Additionally, gender diversity had improved substantially, with the number of female directors increasing to four.[53]

Today, the SingPost board is chaired by Simon Israel,[54] who also served as the Chairman of Singtel until his retirement in July 2020.[55]

Logistics veteran Paul William Coutts was appointed as the new Group CEO in June 2017. Coutts has significant global experience in the logistics and postal industries. Before his appointment, he was the CEO of Toll Global Forwarding, an international freight forwarding and supply chain management services provider. He has over 20 years of experience in senior management positions at major global logistics and postal companies, including DHL.[56,57] Professor Mak welcomed Coutts' appointment as CEO, commenting that he was glad that SingPost had "finally found a replacement CEO that does have the appropriate experience".[58]

In October 2016, the company also appointed new independent directors with legal, finance and accounting expertise, areas of expertise identified by the corporate governance review.[59] One of the new directors appointed was 34 year-old Elizabeth Kong, who was then a director at Morgan Lewis Stamford LLC[60] and who has since joined Clifford Chance Pte. Ltd. as a counsel. Kong has wide-ranging experience in areas such as M&A and corporate finance.[61] Another new female director who was appointed to the SingPost board was 66 year-old Fang Ai Lian,[62] who was the first woman to run an Ernst & Young office worldwide.[63] A qualified chartered accountant, she was previously with the Big Four accounting firm for 37 years, and was also a former director of Singtel and Oversea-Chinese Banking Corporation Limited. Another newly appointed independent director was Bob Tan Beng Hai, 64, a chartered accountant who has served on the boards of various companies such as SMRT Corporation Ltd and Sembcorp Marine Ltd. He is also a fellow at the Singapore Institute of Directors.[64,65] The other three non-executive directors who have since joined the SingPost board are Chu Swee Yeok, CEO of EDBI Pte Ltd; Steven Robert Leonard, CEO of Singularity University and former founding CEO of SGInnovate, a private company wholly owned by the Singapore Government; and Lim Cheng Cheng, the Group CFO of Singtel.[66]

There was also an overhaul of SingPost's senior management team. The table below shows the names, prior experience and education background of the members of the new management team who were appointed.[67]

Name	Role	Prior experience	Educational background
Lai Tak Loi Richard	Group CFO	• More than 27 years of experience in the financial, property and banking industries • Key roles in M&A and logistics • CFO of several SGX-listed companies including GuocoLand Limited and Tee International[68] • Worked in several banks such as Standard Chartered Bank	• Bachelor in Economics (Honours) with a major in Accounting and Finance from University of Manchester, U.K. • Member of Malaysian Mensa Society
Phang Heng Wee Vincent	CEO, Postal Services and Singapore	• 20 years of regional experience in supply chain, logistics, industrial and manufacturing industries in Asia • Group CEO of ST Logistics and executive vice-president of global logistics in Toll Group[69]	• Master in Engineering (First Class) in Aeronautical Engineering from Imperial College, U.K. • Advanced Management Programme at Harvard Business School
Puar Huan Kiap	Group Chief Information Officer	• Head of Information Systems and Technology at Mapletree Investment Pte. Ltd. • Senior roles in IT across industries such as fashion, retail and electronics	• Bachelor of Engineering from University of Aberdeen, U.K. • Master of Management Technology from University of Singapore (now known as National University of Singapore)
Lim Jui-I	CEO, Quantium Solutions	• Group Chief Transformation Officer of SingPost • Director of Strategy & Development of Toll Global Forwarding	• Master of Engineering and Bachelor of Science in Applied & Engineering Physics from Cornell University, U.S.
Linda Hoon Siew Kin	Group general counsel and Group company secretary	• 32 years of legal, compliance and company secretarial experiences • Served as the Group company secretary for listed companies such as DBS Group Holdings[70] and SembCorp Industries[71]	• Bachelor and Master's in Law (National University of Singapore) • Master's of Science in Management (Essec Business School)

Figure 1: Details of SingPost's key executives[72]

SingPost received recognition for the reforms implemented, which have been well-received by stakeholders and analysts alike. In 2019, SingPost was runner-up for both the Most Transparent Company Award in the industrials category and the Diversity Award at the Securities Investors Association (Singapore) (SIAS) Investors' Choice Awards. The following year, it won silver for Best Crisis/Reputation Management at the PR Awards 2020.[73] SingPost's ranking in the Singapore Governance and Transparency Index (GTI), which had fallen from 14 in 2015 to 328 in 2016 following the scandal, rose to 32 in 2018 and 2019, and to 12 in 2020.[74]

Not plain sailing

However, even as SingPost improved its corporate governance and management from 2016, legacy issues from the past and continuing service lapses were reminders that the road back is not an easy one.

Poor acquisitions

SingPost made over 20 acquisitions between 2011 and 2015,[75] in most cases paying a considerable premium relative to the net asset value of the target companies.[76]

To expand its e-commerce business in the U.S., it acquired TradeGlobal Holdings, Inc. (TradeGlobal)[77] and Jagged Peak, Inc (Jagged Peak) in 2015.[78] In the case of TradeGlobal, the purchase consideration was S$236 million, with goodwill amounting to S$176 million. As for Jagged Peak, the purchase consideration was S$34 million, with goodwill of S$33 million. For both acquisitions, SingPost cited expected synergies for its e-commerce business. With the integration of both entities with its existing eCommerce capabilities in Asia, SingPost aspired to provide integrated eCommerce logistics solutions to customers across the U.S. and Asia Pacific.[79]

However, in 2017, SingPost recognised impairment charges of S$185 million for TradeGlobal,[80] while S$98.7 million of impairment charges were subsequently recorded for TradeGlobal and Jagged Peak in 2019.[81] These resulted in the entire value of these investments being written down.

In September 2019, SingPost announced that both U.S. units had sought bankruptcy protection after a failure to find buyers.[82] In December 2019, it was announced that these subsidiaries of SingPost had sold substantially all of their assets, with no financial impact from the sales as they had already been written off and deconsolidated.[83] An independent review of the TradeGlobal acquisition by law firm WongPartnership LLP, which was commissioned by SingPost's board, concluded in July 2017 that due diligence was neither observed nor properly carried out before the acquisition.[84]

More hangovers from acquisitions and investments

On 30 March 2020, SingPost divested Postea, Inc. (Postea), a U.S. e-commerce logistics company.[85] At the time of SingPost's investment in May 2009, Postea was said to be a rising star in the postal, courier and logistics markets.[86] Following the investment, Michael James Murphy, the founder and CEO of Postea, joined SingPost's board as a non-executive, non-independent director in August 2009.[87]

Postea was a developing technology company that needed to find its footing. Unfortunately, the technology of Postea's competitors soon outpaced Postea's technology. In 2011, SingPost's investment in Postea was written down by S$10.3 million.[88] In February 2017, Murphy resigned from the SingPost board "to assume new responsibilities on other boards".[89] Postea was eventually divested by SingPost in March 2020. The sale price for the 27% stake was just S$145,000, a sliver of the S$43.1 million that SingPost had paid for its acquisition.[90]

In a separate incident, SingPost announced that Tan Ho Sung @ Taufiq Tan (Tan) had commenced arbitration against the company in June 2020. This pertained to disputes between the company and Tan in respect of a share purchase agreement and shareholders' agreement in relation to FHPL and its subsidiaries. The disputes centered on the transfer of Tan's remaining 37.5% shares in FHPL to SingPost, following the exercise of his put option for those shares.[91]

Earlier in 2013, SingPost had acquired 62.5% of FHPL from Tan, with the consideration for the remaining 37.5% stake to be determined based on the final valuation of the FHPL Group. There were differences in understanding between the two parties on the final valuation. The arbitration tribunal issued its partial award and dismissed Tan's various claims against the company. It also ruled in the company's favour on material accounting and computational issues under the share purchase agreement. The tribunal directed the parties to see if they could agree on the final amount payable for the transfer of the 37.5% stake to the company.[92] This has yet to be resolved as of July 2021.

The disappointing Santa Claus

In 2016, many overseas mail packages were lost and could not be tracked, even when they were registered. Customers would call SingPost's customer care hotline to get more detailed information about the expected time of delivery of their parcels. However, poor customer service standards led to further disappointment on their end. Customer representatives gave different excuses and would transfer the calls to other representatives in the same office, with no concrete resolution. [93]

As SingPost outsources its customer call centres to lower-cost countries, another common complaint was that customers could not understand the customer care officers and vice versa. This was despite SingPost's claim that it only works with highly-ranked call centres.[94] Additionally, communication between cross-border offices was ineffective. Despite multiple requests, customer representatives from the overseas call centres would not direct customer calls to local staff members even when the overseas call centres were unable to address customers' issues. In addressing complaints sent by email, customer service staff used generic email addresses and there was no direct point-of-contact whom customers could reach out to.[95]

In 2018, there was a high-profile incident involving a postman who was caught on video discarding mail meant for residents of the Reflections at Keppel Bay condominium. Soon after, he was sacked by SingPost. The lapses of SingPost's standards were magnified when Singapore's Infocomm Media Development Authority (IMDA) revealed that SingPost had 20 incidents of non-compliance in 2018, compared to nine in 2017. Consequently, SingPost was fined S$300,000 for failing to meet standards on the delivery of local letters and international registered mail.[96]

In response to the service lapses, SingPost issued an apology to customers and explained that its deterioration in service levels was due to the "tremendously busy" peak period in November and December 2018 that was "beyond forecasts and expectations".[97] SingPost's postmen had to make an average of an extra 20 doorstep deliveries each day. As a result, the postmen had to work beyond their usual hours.[98] This explanation was questioned as seasonal surges in demand are "recurrent in nature in the business of mail delivery" and management should have had the foresight to allocate the necessary resources to meet the increased seasonal demand.[99]

In January 2019, the company was hit by another bombshell when a viral Facebook post showed photos of unopened letters and parcels found in a rubbish bin. According to the post, this was not an isolated event, sparking public outrage again.[100]

IMDA steps in

"The recent service lapses by SingPost indicate gaps in SingPost's processes and we require them to implement measures urgently to meet the public's evolving postal needs,"

– Aileen Chia, IMDA's Deputy Chief Executive and director-general (telecoms & post)[101]

In light of the repeated service failures, IMDA cautioned the company and warned of firm action if it contravened postal license requirements. IMDA expressed "grave concern" [102] in SingPost's lapse in service standards and urged the national postal service provider to take urgent steps towards improving its service standards and restoring public confidence in its postal services. IMDA also issued an advisory to SingPost, emphasising its obligations to safeguard mail integrity and security as well as to train and educate its staff to perform their tasks in an appropriate manner.[103]

The service lapses also prompted a series of questions from several Members of Parliament (MPs) during a parliament session on 11 February 2019. Lee Bee Wah, then MP for Nee Soon group representation constituency (GRC), raised questions on the number of complaints SingPost has received about missing mails in 2018 and how many of these missing mail cases were successfully resolved. Ang Wei Neng, MP of Jurong GRC, observed that 90% of SingPost's profits came from its postal services business, and questioned if SingPost was under-investing in its postal services by focusing on diversifying its business.[104] Similar sentiments were shared by Professor Mak. He suggested that a "focus on increasing revenue through non-core operations may have led SingPost's mail to suffer" and "there was not enough consideration of the risks of this diversification to chase profits and its impact on core operations".[105]

In a public apology on 7 February 2019, SingPost's Group CEO expressed contrition for its lapses and said: "We deeply apologise to our customers for our service failures. We have heard their complaints and feedback; we feel their frustrations and seek to win back their trust".[106] The apology followed SingPost's announcement of immediate measures to improve service quality. These measures included hiring an additional 100 postmen and redeploying 35 mail-drop drivers as full-time postmen to increase the postal delivery workforce. Delivery slots were also extended to weekday evenings and on Saturdays to reduce missed deliveries.[107]

Continuing challenges in the business environment

Decline in postal services

As the national postal service provider in Singapore, SingPost faces a postal services market that has been declining for many years. Its FY2019/20 profit from posts and parcels decreased by 23.2% year-on-year.[108] This decline in postal profits is not just a local Singapore phenomenon. Globally, a McKinsey report predicted that the global volume ratio of letters to parcels is expected to reach 1:1 parity by 2025, based on its decline from 13:1 in 2005 to 4:1 in 2015.[109] Against the backdrop of the decline in mail, SingPost is designated by IMDA as a Public Postal Licensee and thus it would be required to perform a set of "universal service obligations" determined by IMDA, such as compulsory service to deliver letters when requested, and the provision and maintenance of post boxes and post offices all around Singapore.[110]

The decline in postal revenue has several contributing factors, one of which is the emergence of the "paperless" trend, such as digital bank statements. Companies are switching to eco-friendly e-statements and emails, resulting in less physical mail. [111]

SingPost acknowledged that one of its key strategic risks relates to overreliance on revenue generated by its postal business unit and its products. In FY2019/20, post and parcel services contributed approximately 89% of the Group's operating profits, with only a mere 11% from logistics, property, and other segments.[112]

Pushing the envelope

Recognising that the mail delivery market is increasingly untenable, the company has since pivoted to a "Future of Post" strategy. The new strategy is underpinned by one major thrust: to be a player in the last mile delivery services.[113] As part of this strategy, SingPost has ventured beyond the familiar terrain of postal service into the foreign space of last-mile delivery. The term "last mile" describes the last leg of a journey comprising the movement of items from a transportation hub to the buyer's door. It is both the most expensive and time-consuming part of the shipping process.[114] This comes with its own set of challenges as SingPost needs to attain sufficient expertise and resources for the various programmes and services to be rolled out.[115]

The e-commerce market in ASEAN is predicted to grow to S$120 billion in less than a decade since 2018, and the demand for last mile delivery services is expected to follow suit. It is no wonder that service providers such as Lalamove, Ninja Van and CJ logistics are vigorously jostling for market share. SingPost has to play catch-up with its peers who are ahead in the last-mile delivery space.[116] Acknowledging the challenges, SingPost disclosed that it faces stiff competition from the young upstarts and other service providers which disrupt the industry through the use of new technology and innovative product offerings.[117]

SingPost's closest rival in the domestic e-commerce space,[118] Ninja Van, presents especially stiff competition. Ninja Van brands itself as a technology-enabled express delivery company and has become one of the region's largest last-mile logistics companies. Like SingPost, Ninja Van has set its sights on the heated Southeast Asia market, a region where both local and domestic players wrangle to be the last-mile delivery provider of choice to consumers.[119] To reap economies of scale, Ninja Van collaborated with Grab in 2019 to increase its collective outreach and customer base.[120] Through the collaboration, Ninja Van offered logistics services to Grab's users. In May 2020, Ninja Van raised US$279 million to fund developments in the business-to-business sector and grow its existing services.[121]

Performance struggle continues

SingPost's shares were trading as high as S$1.92 per share in 2015, but has since declined to as low as S$0.61 before increasing slightly to more than S$0.70. As at 16 July 2021, SingPost's share price closed at S$0.705.[122]

SingPost's financial performance continues to struggle. Its latest full-year results for the year ended 31 March 2021 showed some promising trends, including revenue increasing 6.9% largely led by strong e-commerce volume growth in logistics, domestic post and parcel segments, with e-commerce-related revenue rising to 34% of total domestic post and parcel revenue, up from 21% the previous year. However, there was a decline in profit from continuing operations to S$47.0 million from S$100.3 million the previous year, while underlying net profit declined from S$100.2 million to S$60.1 million with COVID-19 disruptions leading to a sharp increase in international conveyance and line-haul costs. Pre-COVID-19, underlying net profit has already seen a sharp decline from S$153.6 million in FY2015/6 to just over S$100 million in FY2018/9.[123]

Dividends have been cut from S$0.07 per share in FY2015/6 to just S$0.027 in FY2019/20 and S$0.011 in FY2020/21.[124]

Light at end of tunnel?

As SingPost continues to address legacy issues and current challenges, it has stepped up efforts to address some of these issues by harnessing a greater use of technology.

SmartPost app

Previously, postal staff were overwhelmed during seasonal peak periods, which led to "service deterioration",[125] and complaints of subpar delivery service. To rectify this, in November 2018, SingPost introduced the SmartPost application amongst other new "digital initiatives designed to bring greater convenience, flexibility and control to customers".[126] With the mobile application, users can deliver and electronically sign-over registered mail, increasing the efficiency and reducing the workload of its postal staff. The mobile application uses wireless and digital technology to help postmen keep track of deliveries made through their smartphones, while letting customers track their deliveries. Customers can also schedule the collection of missed mail articles from the post office. Furthermore, the mobile application provides operational information about SingPost's mail products and services to address users' queries.[127]

Smart Letterbox

To deal with the accelerating decline in domestic letter mail volume, SingPost looked to re-engineer the postal business with smart urban logistics. In December 2020, SingPost rolled out a year-long public trial of PostPal, a smart letterbox with automated mail sorting and delivery technology. With PostPal, customers are notified upon the arrival of mail in their letterboxes via the SingPost mobile application. They will then scan a QR code to retrieve their mail. The new system is an alternative to registered mail, which requires a signature from the recipient to acknowledge receipt. Expressing confidence in PostPal, Vincent Phang, CEO of Postal Services and Singapore, said "The PostPal trial has the potential to fundamentally transform and refresh the HDB letterbox infrastructure from a simple, letter-oriented lock-and-key structure to a cutting-edge digital system with capabilities beyond mail delivery, while significantly alleviating labour constraints."[128]

MyPostman

SingPost has strived to improve public opinion about it through campaigns such as MyPostman. Through the microsite, customers can read a short biography of their neighbourhood postmen and leave ratings and comments. In conjunction with other initiatives, this was set up "in a bid to win back the public's trust after a spate of service lapses".[129] The company has also expanded its social media presence with short films and paid partnerships with local media brands like SGAG and The Smart Local.[130] It also has stickers with QR code on HDB letterboxes to expedite letterbox-related issues and improve the service standards of its postal staff. SingPost believed that while the main aim of the MyPostman campaign was to increase its service standards, it also hoped that it would facilitate a sense of community amongst residents.[131]

Improvements in SingPost's service standards have not gone unnoticed. Commenting on the company's service standards, Minister for Communications and Information, S. Iswaran, acknowledged the "early signs of improvement" in the national postal service provider.[132]

Service from the heart

Improving employee welfare and efficiency

Changes were not just restricted to the utilisation of technology to improve service efficiency. SingPost also increased its efforts on improving employees' welfare and efficiency. As a start, the company promised to review its employees' pay to reflect the changes in job scopes. It also revamped mail processing and delivery protocols with the aim of enhancing postmen's operational efficiency while reducing unnecessary workload.[133] One significant change was the revamp of its package categories and postal products in October 2019. In view of the high demand for small package deliveries in Singapore and as part of this change, small packages of up to two kilograms are delivered to recipients' letterboxes. This would help lighten postmen's workloads and reduce missed deliveries by customers, making it a win-win situation for all stakeholders.[134]

To boost morale and create a sense of camaraderie within the company, an internal campaign with the credo "Every delivery counts" was initiated. The campaign sought to instil pride in SingPost employees for their contributions towards Singapore's postal service.[135] New uniforms were also launched in October 2020 with the aim of encouraging all employees "to feel a sense of pride when wearing their new uniforms".[136] SingPost engaged and involved its employees in designing the uniforms, considering their comfort levels when carrying out their duties. The new uniforms included over 10 different garments, including shirts, outerwear, aprons and headgear, for various job roles.[137]

Employee training

In May 2019, SingPost became one of the first companies to establish the Company Training Committee (CTC) in the trade and connectivity sector, in partnership with Union of Telecoms Employees of Singapore and NTUC's e2i (Employment and Employability Institute). The CTC aims to strengthen employee skills through various courses and training programmes, embed learning mindsets and support employees in their career growth, all while the company undergoes business transformations.[138]

Additionally, SingPost has provided training to over 500 frontline staff and sought to train another 1,500 frontline staff between 2020 and 2022. The training sessions would focus on areas relating to digital proficiency and customer service excellence, in the hope of offering a "distinctive and delightful experience" to the wider community. As part of building leadership capabilities at the middle management level, emphasis would also be placed on developing leaders through the company's supervisor learning roadmap to equip supervisory level staff with the necessary skills to facilitate effective teams and respond to service challenges.[139]

Continuing focus on corporate governance

In respect of corporate governance, SingPost is not resting on its laurels. It has continued to review its corporate governance framework and has made key changes to its remuneration, risk management and whistleblowing policies in recent years.

Remuneration policy

To keep its remuneration policy and practices up to date, SingPost has engaged remuneration consultants Mercer (Singapore) Pte Ltd and Willis Towers Watson Consulting (Singapore) Pte Ltd to advise on market practices and benchmark data.[140]

SingPost has in place a claw back provision in its remuneration policy. Under the provision, SingPost can recover certain incentive components of remuneration previously paid out to the Group CEO and key management personnel in the event of – amongst other missteps or misdeeds – an inaccurate assessment of financial targets and performance achieved, or misconduct leading to financial loss to SingPost.[141]

According to SingPost's corporate governance report, it adopts a remuneration strategy that supports a pay-for-performance philosophy. The variable component of the Group CEO and key management personnel's remuneration is closely linked to the achievement of corporate targets such as financial outcomes, business initiatives, operational efficiency and leadership. This is designed as such to support SingPost's business strategy and shareholder value creation. In addition, management is also assessed based on their demonstration of SingPost values as part of a blended qualitative assessment.[142]

Whistleblowing policy

SingPost's whistleblowing policy seeks to "sets out the guidelines under which [its] employees, stakeholders and members of the public are able to raise concerns about possible matters of improprieties or wrongdoings in confidence". The whistleblowing channel published on the company website is accessible at any point of time, and whistleblowing reports can be made via email or post. SingPost committed that all whistleblowing reports would be reviewed by the Audit Committee (AC) to ensure independent investigations are carried out to facilitate the resolution of issues.[143]

Risk management

SingPost adopts the four lines of defence in its risk governance structure. Risk managers and management make up the first and second lines of defence, internal and external audit form the third line of defence, and the board of directors – together with Board Risk and Technology Committee (BRTC) and the AC – form the fourth line of defence. The SingPost board, through the BRTC, has an overall responsibility for risk governance and ensuring that management has in place a robust system of risk management and internal controls to safeguard stakeholders' interests and the company's assets and resources.[144]

In its risk appetite statements disclosed in the FY2019/20 annual report, SingPost has stated that in terms of sustainability and growth, it "aims to strengthen its market position in Singapore and the rest of Asia Pacific by taking measured risks that balances risk and reward in line with its strategic objectives and initiatives. The Group will also proactively seek to diversify its business while actively managing its risks." As for its strategic direction, SingPost "is committed to upholding its reputation as a trusted organisation while placing customers at the core of its business".[145]

SingPost's material risks are identified and its risk profile is categorised into strategic, financial, operational, compliance and informational technology. Some of the identified key risks and corresponding risk management strategies are shown in Figure 2 below.[146]

Risk identified	**Risk management strategy**
Strategic risk: Declining letter volume	Commercial sale integration and reviewing of incentive schemes to optimise sales opportunities and customer relationship management.
Financial risk: Credit management	Being highly selective of the type of customers to which the Group is prepared to provide credit to through credit analysis and robust screening of such customers to ensure credit worthiness.
Operational risk: Workplace safety and health	Establishing a workplace safety and health committee to review the workplace safety and health performance of each business and support units, and also reviewing near misses, investigating incidents and mapping action plans for improvements.
Compliance risks: Governance	Maintaining a zero-tolerance policy and "tone from the top" towards fraud, bribery and corruption, conducting trainings and company-wide fraud awareness seminar, as well as annual declaration exercises by all senior officers and managerial grade employees in respect of code of ethics and compliance to anti-bribery and corruption policy.

Figure 2: SingPost's key material risks and corresponding risk management strategies[147]

Open sesame! Unlocking new opportunities with Alibaba

In respect of its e-commerce business, SingPost continued to build on its strategic partnership with e-commerce giant Alibaba Group (Alibaba). In 2014, Alibaba invested S$312.5 million for a 10.35% stake in SingPost. Three years later, in 2017, Alibaba raised its stake in SingPost to 14.4%, making it the second largest shareholder in the postal company after Singtel.[148] The collaboration allows SingPost to scale up its regional e-commerce logistics operations, providing a foothold for SingPost to enter the e-commerce industry.[149]

First announced in 2015, Quantium Solutions International (QSI) is a joint venture between SingPost and Alibaba after the latter invested a further S$86.2 million in 2016 for a 34% stake in QSI. The collaboration focused on "strengthening QSI's end-to-end e-commerce logistics network, building scale for future profitability" by providing a full suite of end-to-end e-commerce solutions to customers in 11 markets.[150] The partnership also resulted in Lazada, an international e-commerce company owned by Alibaba, migrating its warehouse operations to the SingPost regional e-commerce logistics hub. The integration of Lazada's e-commerce platform and SingPost's end-to-end integrated warehousing and delivery hub allows both organisations to enjoy "scale and efficiencies".[151] Looking ahead, SingPost hopes to capture the opportunities from the e-commerce boom and to expand its warehouse fulfilment footprint to meet its customers' growing needs. It also looks to expand its services into the B2B2C space, which it deemed "a relatively untapped space that presents much potential".[152]

Response to COVID-19 pandemic

Revenues increase amidst pandemic

Domestically, SingPost said at the end of 2019 that it hoped to attain a 50 to 60% share of the e-commerce delivery market, after "seeing its share improve from 20 to about 46% in the last two years". In this regard, Group CEO Coutts said that SingPost was "well-positioned" to capitalise on the region's booming e-commerce market.[153] In June 2020, SingPost saw a significant e-commerce volume growth of 52% in the quarter ended June for its domestic post and parcel business, with e-commerce volume standing at slightly less than 10% of all domestic deliveries.[154]

However, increasing revenue from rising e-commerce volume was offset by rising costs in its other segments. Costs rose because COVID-19 disrupted and delayed international out-bound air freight and increased conveyance cost. SingPost also incurred increased costs as a result of health and safety arrangements in light of COVID-19, such as through the provision of temporary housing for its Malaysian employees in Singapore.

In 2020, the increase in cost arising from supply chain disruptions due to the COVID-19 pandemic led to its Group profit halving to S$22 million in the first fiscal quarter. While SingPost acknowledged that the Job Support Scheme defrayed some of the costs, the COVID-19 had an "adverse impact on the Group's customers and doubtful debt provisions", and there remains "significant uncertainty" in the e-commerce and postal operating environment arising from COVID-19. Nonetheless, Group revenue increased 12% to S$360 million despite the tumultuous global economic situation, and the company "remains committed" to its transformation efforts, and showed a further increase in FY2020/21.[155,156]

Corporate governance

Beyond the bottom line, the COVID-19 global pandemic also has a significant impact on companies' corporate governance. There are various pressures and demands from various stakeholder groups. There are greater demands by boards of directors for company updates from management, as well as heightened expectations for societal engagement and corporate citizenship.[157] COVID-19 has been labelled a "crash test" of a company's corporate governance, as well-governed companies are better prepared for crises and are generally much faster in incorporating and implementing robust risk management strategies.[158]

In light of the COVID-19 pandemic, SingPost implemented mandatory procedures that all employees must follow in Singapore, such as temperature and health declarations, work segregation by teams, proper social distancing, and regular equipment wipe-downs. The company also provided mail-processing staff with gloves, earphones and masks, and monitored teams to ensure compliance with company guidelines.[159] When it was uncovered that staff members at its packet-processing facility were diagnosed with COVID-19 in March 2020, SingPost swiftly suspended operations at the packet-processing facility for disinfection as a precautionary measure.[160]

Acquisitions re-start

After a nearly five-year pause in acquisitions following the acquisition of TradeGlobal at the end of 2015, SingPost announced on 19 October 2020 that its wholly-owned subsidiary had entered into a conditional sale and purchase agreement with existing shareholders of Freight Management Holdings Pty Ltd (FMH) and a share subscription agreement with FMH to acquire a 38% equity interest in FMH. FMH is described as a "leading 4th party logistics service company incorporated in Victoria, Australia". SingPost was to pay S$84.1 million in cash in two tranches. An independent valuation as at 31 July 2020 by PricewaterhouseCoopers Securities Limited gave FMH a midpoint valuation of S$196 million.[161]

On 31 December 2020, SingPost announced the completion of the acquisition and the payment of the first tranche.[162] On 6 May 2021, the company announced that the payment of the second tranche is expected to take place on or about 12 months following the payment of the first tranche.[163]

The approach to the acquisition of FMH, including the payment of the consideration, appears to be rather prudent, perhaps indicative of a more formalised M&A process and extensive due diligence following the implementation of new policies and procedures.

Sustainability journey

SingPost announced on 4 February 2021 that it had established a Board Sustainability Committee (BSC) in recognition of the growing importance of environmental, social and governance (ESG) factors to its purpose in society and the communities it serves, and the sustainability and long-term well-being of SingPost.[164]

The BSC is chaired by the Chairman of the board, with the Group CEO and two other independent directors as members. It will work with management to accelerate the company's ESG transformation and journey.[165]

Epilogue

In a surprising turn of events, Group CEO Coutts resigned on 31 May 2021[166] after four years at the helm to "pursue other opportunities". He would stay with SingPost until 31 August 2021 or earlier to assist with handover duties. Despite the announcement of his departure, SingPost said that it "will continue to execute its strategic road map, and the board has confidence in the remaining leadership team to do so".[167]

It was disclosed in SingPost's announcement that "In February 2021, it came to the attention of the board that there were indications of lapses in internal procedures and protocols relating to the engagement of an advisor for certain Australian and New Zealand subsidiaries of the SingPost Group, which occurred in 2020 during the tenure of Coutts as the Group Chief Executive Officer."[168] However, after a Group internal audit, it was concluded that there was "no dishonesty, fraud or criminal activity" in connection with the engagement of the advisor.[169]

On 14 July 2021, a day prior to its 2021 Annual General Meeting, SingPost released its responses to shareholder questions, including some which related to the matters of the outgoing Group CEO.[170] The company elaborated that the board was informed of the "lapses in internal procedures and protocols" by an anonymous whistleblower, which mainly revolved around gaps in internal approvals required prior to the engagement of the unnamed advisor. In response to the whistleblower's complaint, a comprehensive internal review by Group internal audit was quickly initiated. Although the review found that there were indeed "deficiencies" in the engagement approval process, it also confirmed that the advisor engaged had the necessary qualifications and experience, and his compensation was within Australian benchmarks. There was also no familial or non-professional relationships between the unnamed advisor and Coutts. After the conclusion of the review, SingPost assured shareholders that the lapses in approval process were "neither systemic nor material in the context of the Group as a whole", and informed shareholders of its commitment to improve its operational and communication processes. The Group has also continued working with the said advisor.[171]

On 13 August 2021, the search for a new CEO finally concluded when Vincent Phang was selected as Group CEO and executive, non-independent director of the board, effective 1 September 2021. The "extensive global search" was said to have considered both internal and external candidates.[172] Phang has over 20 years of experience in the supply chain, logistics, industrial and manufacturing industries in Asia. Prior to his appointment as Group CEO, he was SingPost's CEO for Postal Services and Singapore. Before joining SingPost, Phang was Group CEO of ST Logistics and Executive Vice-President of Toll Global Logistics Singapore. Since joining the company in April 2019, he was said to have played a significant role in repositioning SingPost's postal business, having spearheaded the "Future of Post" vision to transform Singapore's postal landscape.[173]

The news in late September 2021 that its strategic investor, Alibaba Group, has been added as a new investor in the late stage funding round of its competitor, Ninja Van, is a blow to SingPost. This new funding raised a total of US$578 million from Alibaba and existing Ninja Van investors.[174]

SingPost's experience is a lesson to all companies not only about the importance of corporate governance but the long road back when poor corporate governance leads to serious lapses, destruction of shareholder value and a breakdown in investor trust.

How SingPost's foray into the e-commerce logistics sector pans out, and whether it is able to leverage on its new business model to eke out a competitive advantage in the highly competitive parcel delivery industry, remains to be seen. The company is crafting a new business strategy to remain profitable amid decreasing demand for postal services.

While SingPost appears to have made progress in improving its service quality and rebuilding the trust it has lost, the recent departure of its Group CEO, Coutts, may make stakeholders wonder whether there may be turbulence ahead again.

Has the board truly learned the lessons from 2015 or will we see history repeating? It may be difficult for SingPost to come back from the abyss twice.

Discussion questions

1. Identify and evaluate the key reforms implemented by SingPost from 2016 to address the issues that surfaced in the 2015/2016 saga. Are the measures adequate? Are there other steps that it should take? Explain.
2. Evaluate SingPost's current leadership (both the board and management) compared to the previous leadership in 2015.
3. In your opinion, explain whether the 'new' leadership should be fully responsible for the service lapses or whether they are truly legacy issues as suggested in the case.
4. Discuss the current challenges faced by SingPost and their potential implications on SingPost's business model and corporate governance. Comment on the actions taken to address these challenges.
5. Do you think SingPost's remuneration, risk management and whistleblowing policies are appropriate and adequate? Explain.
6. Discuss the importance of stakeholder engagement and the actions taken by SingPost to improve its stakeholder relations.

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TOP GLOVE: TIP-TOP OR TOPPED OUT?

Case overview

Top Glove Corporation Bhd (Top Glove), the world's largest natural rubber glove maker, saw its share price surge by more than 250% in the first six months of 2020. The company reported its highest ever net profit for the quarter ended 31 August 2020, as it benefited from the significant increase in demand for gloves due to the COVID-19 pandemic. However, within a short period of just a year, it faced a huge reputational fallout from the treatment of its employees.

Allegations regarding forced labour, excessive overtime, debt bondage and passport confiscation first surfaced in 2018. However, Top Glove did not fully address these issues. In July 2020, the company once again found itself in the spotlight for migrant worker exploitation. The U.S. Customs and Border Protection banned products from two of Top Glove's subsidiaries, accusing the companies of excessive overtime, as well as abusive working and living conditions.

Worse was to come when the Teratai cluster originating from workers' dormitories of Top Glove became the largest COVID-19 cluster in Malaysia in late 2020. Once crowned a COVID-19 hero, it ended up being the single largest contributor to the nation's spread of the virus. In December 2020, Top Glove came under a government probe for the provision of unsatisfactory accommodation for its workers in their dormitories. A whistleblower who exposed the overcrowding and lack of proper ventilation in the worker dormitories was fired, resulting in further outrage.

Major institutional investors publicly criticised the Top Glove board for its lack of oversight over the company's labour practices and voted against the re-election of the directors at the 2020 Annual General Meeting.

The objective of this case study is to facilitate a discussion of issues such as the corporate governance practices of founder-controlled companies; board independence; duties and responsibilities of directors; risk management during a pandemic; whistleblowing; and environmental, social and governance (ESG) issues.

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The beginnings of Top Glove

Established in 1991 and headquartered in Malaysia, Top Glove Corporation Bhd (Top Glove) is the world's largest natural rubber glove maker, producing latex and nitrile gloves for health care providers, manufacturers, and households. The company was founded by its current Chairman, Tan Sri Dr. Lim Wee Chai (Dr. Lim), a former salesman, and his wife, Puan Sri Tong Siew Bee (Tong), amidst a thriving glove manufacturing industry when rubber prices were low.[1] Despite its humble beginnings as a local business enterprise with only a single factory and one glove production line, Top Glove quickly grew, accounting for 26% of the global market share for rubber gloves as of 2020, with manufacturing operations in Malaysia, Thailand, Vietnam, and China. With around 21,000 employees and operations in 750 production lines worldwide, the company exports to over 2,000 customers in 195 countries.[2] Top Glove has since expanded to offer a more comprehensive product range, including a non-glove segment comprising face masks, condoms, dental dams, exercise bands and household products, successfully targeting both the healthcare and non-healthcare market sectors.[3]

In March 2001, Top Glove was listed on the Second Board of Bursa Malaysia. It was subsequently promoted to the Main Board in May 2002. On 28 June 2016, the company obtained a secondary listing on the Mainboard of the Singapore Exchange.[4] Top Glove has shown consistently stellar growth, achieving a compound annual growth rate of 23.1% for revenue and 28.2% for profit after tax in the past 20 years. It became a component stock of the MSCI Global Standard Index, FTSE Bursa Malaysia KLCI Index, FBM Top 100 Index, FBM Emas Index, FBM Hijrah Syariah Index, and FBM Emas Syariah Index.[5]

Riding on its vision of "continuously striving for improvement and innovation", together with its progressive efforts in research and development and marketing, the company was bestowed with the Enterprise 50 Achievement award for nine years from 1998 to 2007.[6] In addition, being located approximately 10 kilometres away from Malaysia's largest international port, Port Klang, Top Glove has an additional logistical advantage over its competitors. With an aim of becoming a Fortune Global 500 Company by 2030, Top Glove is determined to expand its business scope and look out for merger and acquisition opportunities in similar industries.[7]

Who owns Top Glove?

Top Glove's ownership is mainly split between the general public, institutions and individual insiders. The Executive Chairman, Chief Executive Officer (CEO) and founder of Top Glove, Dr. Lim, has the largest shareholdings in the company – as of FY2020, Dr. Lim's stake in the company amounted to 25.68%.[8] In addition, his wife, Tong, a non-independent non-executive director (NINED), holds a 0.27% stake in the company, while his brother, Lim Hooi Sin (LHS), an executive director (ED), holds 1.38% of the shares.[9] Dr. Lim's son, Lim Jin Feng (LJF), who is part of the senior management team, also holds 0.001% of the shares.[10]

The next largest shareholder, Firstway United Corp., holds a substantial 6.82% in Top Glove.[11] Dr. Lim and his wife are deemed to have interest in the shares held by Firstway United Corp.[12] Thus, the Lim family has total direct and deemed interest in Top Glove of 34.15%.

Among the 53.48% of Top Glove's shares held by Malaysian institutions, the Employees Provident Fund Board (EPF) of Malaysia holds 5.67% of the shares as of FY2020.[13] However, on 5 January 2021, EPF disposed of 40 million shares in the company, reducing its shareholding to below five percent.[14] Top Glove's shares are also held by international fund managers such as UBS Asset Management, The Vanguard Group, Inc. and BlackRock, Inc. (BlackRock).[15]

Tip-top performance

The economies of many countries, including Malaysia, have been hit hard by the COVID-19 pandemic. According to Malaysia's then Prime Minister Muhyiddin Yassin, the country has lost RM2.4 billion in revenue every single day, after the movement control order (MCO) was imposed to curb the spread of the virus.[16] However, Top Glove experienced a surge in demand for its products, due to its role as a leading manufacturer of essential goods used by healthcare workers. Unlike other businesses that were forced to shut down their operations, Top Glove's production utilisation increased from 85% to nearly 100%, and its factories were operating at almost full capacity by June 2020.[17]

The spike in demand meant that Top Glove's financial performance was significantly boosted. In 2020, the company's share price surged by more than 255%, as shown in Figure 1.[18] Additionally, Top Glove recorded a 366% year-on-year jump in net profit to RM347.9 million for the quarter ended May 2020, a jump that was almost equivalent to the full-year income the year before.[19] Monthly sales volume also increased by about 180%.[20] The company reported net profit of RM2.87 billion for the quarter ending February 2021 – a record 2,380% increase compared to a year ago.[21]

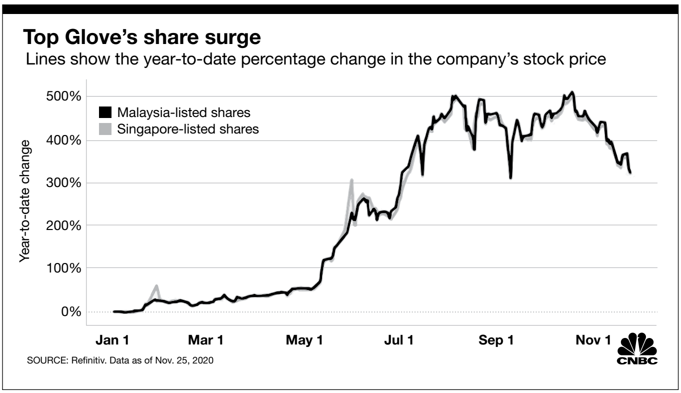

Figure 1: Year-to-date percentage change in Top Glove's share price in 2020[22]

The growth in demand of gloves was estimated to be 20% in 2020, 25% in 2021 and 15% post-pandemic.[23] In view of a positive business outlook, Top Glove allocated RM8 billion for capital expenditure over the following six years, which would be invested in several key areas such as new capacity, enhancement of existing manufacturing facilities, and workers' facilities.[24]

In September 2020, Top Glove announced plans for a second primary listing[25] on the Stock Exchange of Hong Kong by 2021.[26] This was to expand its investor base and allow the company to raise capital to fund potential strategic mergers and acquisitions to create synergistic effects, enabling the company to expand its operations beyond glove manufacturing and into other strategic businesses.[27] However, plans to list in Hong Kong have since stalled, as the import ban on Top Glove's products imposed by the U.S. Customs and Border Protection (CBP) due to forced labour practices remains unresolved.[28]

Employees needed a helping hand

"When I wake up every morning I am filled with dread. I think: 'How can I get through the next 12 hours of working? I don't know if I can do it anymore."

– A 22-year-old Nepalese worker in Top Glove's production line[29]

Top Glove mainly hires workers from countries such as Bangladesh, India, Myanmar, and Nepal.[30] Its hiring process is heavily reliant on recruitment agencies and sub-agents in these countries. Intermediary agencies located in Malaysia may also be used to source for workers.[31] However, these agencies are not paid significantly for sourcing new workers. Instead, the agencies would make workers bear the relocation costs.[32] These costs range from US$800 to over US$5,000, for work-related expenses such as international passports, visas and flights.[33]

However, mounting debt would only be the beginning for these workers, as the conditions in these factories were said to be atrocious. The Malaysian Human Resources Minister S. Saravanan likened the workers' living conditions to "modern slavery".[34] Experts agreed that Top Glove's working practices showed signs of forced labour as defined by the International Labour Organisation (ILO), which included abuse of vulnerability, deception in recruitment, payment of recruitment fees and abusive working conditions.[35] Workers would have their passports confiscated, making it difficult for them to return to their home countries.[36] The excessive amounts payable to these recruitment agencies also meant that workers would be stuck at the company in order to repay their debts.

Employees at Top Glove were also alleged to have clocked in longer hours than what was allowed under Malaysian laws.[37] According to the local labour laws, Malaysian employees can only work a maximum of 104 hours of overtime per month and should be given a minimum of one day of rest per week.[38] However, it was reported that during the pandemic, employees were collapsing and suffering from seizures after being overworked for six days a week.[39] Back in 2018, the company had already been reprimanded when employees were caught doing excessive overtime, although Top Glove claimed that the workers had done so voluntarily.[40] Following that incident, Dr. Lim said during a press conference that Top Glove would "continue to improve" its labour standards.[41]

In an article published in 2018 accusing Top Glove of forced labour, employees interviewed by The Guardian lamented that they were told to work seven days a week for at least 12 hours a day, with only one day off a month.[42] Working conditions in the factories were also said to be unsafe, with workers reportedly having lost limbs in workplace accidents,[43] and temperatures in the factory reaching highs of 40 degrees Celsius while workers were clad in heavy protective gear.[44] Based on payslips, employees at Top Glove only received overtime pay for four out of the 12 hours they worked on their rest days.[45]

Daily glove production targets were also extremely high. Workers were expected to pack around 15,000 gloves daily, with one employee interviewed by The Guardian claiming that his daily target had increased 400% within a year. It was alleged that if targets were not met, workers' monthly pay would be reduced.[46] Interestingly, one of Top Glove's business goals is "to earn two healthy dollars and spend one efficient dollar".[47] Could efficiency have come at a cost of ethical treatment of employees?

However, Top Glove refuted these accusations. Regarding the high working temperatures in its factories, the company stated that these high temperatures were necessary to ensure that there was no contamination during its manufacturing process.[48] The company conceded that the excessive working hours put in by employees was an issue, but argued against allegations that the factories did not meet workers' rights standards, bringing up the fact that the company has won plenty of human resources awards and has complied with local laws.[49]

As for the withholding of passports, the company contended that the passports were not confiscated. Rather, they were taken for "safekeeping" in lockers.[50] Top Glove further explained that these measures were part of a passport safekeeping policy and workers were notified of this clause in the consent form that they had previously signed.[51] However, anecdotal reports from employees seemed to suggest that Top Glove's policies were not implemented at all – employees were allegedly only given temporary locker keys and forms to sign on the spot when an auditor visited a Top Glove factory.[52]

Apart from poor working conditions and contractual issues, investigations into Top Glove's premises showed that the workers' accommodation was not up to standard.[53] Dormitories failed to meet the minimum standards set by Malaysia's Labour Department under the Ministry of Human Resources.[54] The living areas lacked proper facilities, were cramped and not well-ventilated. In one case, a single bathroom was shared among 25 workers, taking them collectively two to three hours in the morning to get ready for work.[55]

A round of applause for Top Glove!

The forced labour allegations came as a surprise, as Top Glove had received many accolades over the years. For instance, Top Glove was recently named Best Employer Brand Graduates' Choice Awards 2021 in the category of manufacturing.[56] Other awards include ASEAN Corporate Governance Award 2018 and 2019 from the Minority Shareholders Watch Group (MSWG), HR Asia's Best Companies to Work for in Asia 2019, and CSR Malaysia's Company of the Year 2019 in the manufacturing of gloves category.[57]

Top Glove was also included in the Dow Jones Sustainability Index (DJSI) for emerging markets, which consists of companies that "have recognised that sustainable business practices are critical to generating long-term shareholder value".[58,59]

Yet another award – Top contributor to COVID-19 cases

Although the Malaysian government ordered employers to take preventive measures and test every migrant worker, only construction workers and security guards were eventually tested at the start of the COVID-19 pandemic.[60] Malaysia then introduced new regulations in September 2020 in the form of the Workers' Minimum Standards of Housing and Amenities Act, which specifies the minimum standards that must be met for accommodation provided by employers or centralised accommodation providers.[61]

Top Glove reportedly did take some basic measures to protect employees from COVID-19 early on, such as providing masks, face shields, and sanitisers. There were also markers placed on the factory floor to remind workers to practise social distancing.[62] However, social distancing was not strictly enforced as workers often had to physically work closely together in the production line.[63] Despite these lapses, Malaysia's Ministry of Health said in May 2020 that it was very satisfied with Top Glove's COVID-19 preventive measures, although the company could have distributed more hand sanitisers and better enforced social distancing.[64] However, employees interviewed by Reuters highlighted that the canteens and entrances to the factories were still often packed, and that up to 20 people were living in each poorly ventilated room in the dormitories.[65]

With subpar living and working conditions, it was unsurprising that there was a surge in COVID-19 cases in locations where Top Glove factories and dormitories were located. In November 2020, it was reported that out of 5,800 workers who were tested, 2,453 were COVID-19 positive.[66] This led Malaysian authorities to announce that Top Glove would reduce operations in 28 plants in stages.[67] Following the announcement, Top Glove shares fell by 7.5%.[68] Within a few weeks, the total number of COVID-19 cases in Top Glove doubled to 5,147 cases.[69] This made Top Glove the top contributor to the number of COVID-19 cases in Malaysia in late 2020.[70] Although the spread of COVID-19 in foreign workers' dormitories had occurred earlier in April 2020 in Singapore – after it was initially praised for its ability to tackle the virus at its early onset –[71] it seemed that Top Glove did not take heed to prevent the same thing from happening in its dormitories.

As many of Top Glove's employees continued to test positive for COVID-19, Malaysia's Labour Department began examining Top Glove's dormitories. After conducting enforcement operations, Asri Ab Rahman, director-general of the Department of Labour Peninsular Malaysia, concluded that Top Glove's dormitories were cramped, poorly ventilated, and lacked proper areas for resting and cooking.[72] The authorities then suggested filing charges against Top Glove. In response, Top Glove stated its commitment to improving the workers' accommodation standards by 31 December 2020 to meet the new requirements which came into force from 1 September 2020.[73]

The torn glove

In November 2020, Top Glove's dormitories in Ipoh – the capital city of the state of Perak – were raided by Malaysia's Labour Department.[74] It was charged in March 2021 in the Sessions Court in Ipoh for breaching the Minimum Standards of Housing, Accommodation and Employee Facilities Act 1990 (Act 446).[75] The company faced 10 counts of "providing accommodation that did not meet the minimum standards for housing", as laid out by the Labour Department.[76] Based on the charges, 10 of the accommodation facilities in the state of Perak did not receive a certification from the Labour Department. Each charge carried a potential fine of RM50,000. Top Glove, however, pleaded not guilty to all the charges.[77] A second mention was set for 28 April 2021.

While each country has its own regulations for workers' accommodation, the ILO aims to "advance social and economic justice through setting international labour standards".[78] Based on ILO's R115 – workers' housing recommendations,[79] Top Glove was likely to have breached multiple recommendations, such as the lack of sleeping space and overcrowding in a single room.[80]

Khadka blew it!

It was reported that months before the Malaysian authorities cracked down on the unsatisfactory living and working conditions at Top Glove, the company had already learnt of these issues through complaints from employees themselves. Yubaraj Khadka (Khadka), a Nepalese employee of Top Glove for eight years, had blown the whistle in May 2020.[81] He was then terminated after he shared two photographs depicting the poor working conditions and the lack of physical distancing in Top Glove's factories.[82] He said that he did so out of worry for the safety of his fellow workers and himself.[83] Other employees also highlighted the lack of COVID-19 protection for workers – despite the safety regulations imposed in factories – to Reuters.[84] Fearing for his job security, Khadka sent the photos to a workers' rights campaigner, Andy Hall (Hall), in Nepal instead of speaking directly to the management of Top Glove. Hall subsequently sent them to Top Glove and the Malaysian government, without disclosing Khadka's identity.[85]

The government did not respond to Hall.[86] However, it was reported that Top Glove made use of closed-circuit television (CCTV) footage to identify Khadka as the whistleblower.[87]

Following his firing, Khadka revealed in an interview that he was subjected to an 11-hour "counselling session" after being identified as the whistleblower.[88] Khadka's mobile phone was also confiscated "from 10am until about 9pm" by his employers, who looked through all of his messages.[89] The reason provided in Khadka's termination letter was that his actions were an act of misconduct, since he did not seek prior approval from management for taking and sharing the photographs.[90] Khadka had to pay out of his own pocket US$400 and US$70 respectively for his flight back to Nepal in October 2020 and a COVID-19 swab test.[91] Despite these consequences, Khadka said he believed he did the right thing and that Top Glove's management was at fault.[92] Top Glove's shares dipped by 5.7% to reach a three-month low after news of the whistleblower's termination was published.[93]

Top Glove later told Reuters that it had resolved matters with Khadka peacefully but declined to comment on the issues raised in his photos.[94] The company's managing director Dato' Lee Kim Meow (Lee) claimed that Khadka admitted he had intentions to distribute the pictures to Hall to discredit Top Glove.[95] Subsequent to Khadka's termination, on 23 December 2020, Lee shared that Top Glove had engaged consultants on the "right thing to do" with regard to whistleblowers, and that "if this incident happens today, the termination will not happen".[96] In addition, Lee announced on the same day that Top Glove had established three helplines to handle worker complaints.[97]

Who protects the whistleblower?

In 2010, Malaysia passed the Whistleblower Protection Act (WPA) to combat corruption and provide a safe avenue for whistleblowers to disclose improper practices to authorities in good faith.[98] The law protects the identity of the whistleblower, allowing the informer to be immune to civil and criminal implications.[99] However, there are certain requirements which the whistleblower must satisfy to receive protection under the WPA. For instance, the whistleblower's identity will be kept confidential if the whistleblower makes a "disclosure of improper conduct to any enforcement agency based on his reasonable belief".[100] These enforcement agencies include the Malaysian police, Malaysian Anti-Corruption Commission (MACC), Securities Commission and Companies Commission of Malaysia.[101] However, under the Act, the whistleblower's protection can be revoked by the enforcement agency under several circumstances, such as if he had participated in the reported improper conduct, or when the disclosure contains a false material statement.[102]

In the case of Khadka, he had disclosed the unsafe practices at Top Glove to a worker's rights campaigner from a non-profit organisation in his home country of Nepal,[103] instead of reporting them to enforcement agencies in Malaysia. As a result, Khadka was not protected from wrongful termination by Top Glove under the WPA. In an earlier Malaysian case, whistleblowers were similarly unable to seek protection under the WPA because they did not make the disclosure to an enforcement agency.[104] The key question in Khadka's case is whether migrant workers were fully aware of the legislative requirements of a foreign country, and whether they would be comfortable disclosing malpractices to the authorities of a foreign country.

Although Khadka was unable to receive protection under the WPA, it was possible for him to report his unlawful termination to the director-general of Malaysia's Department of Industrial Relations, under the Ministry of Human Resources, based on the Industrial Relations Act (IRA), since he was deemed to be acting in the best interests of the company.[105] However, it was alleged that there was an intent to discredit Top Glove through Hall, based on Khadka's oral representation with Lee.[106] Hence, it was difficult for Khadka to be protected under IRA as well.

A silent whistle?

With effect from 1 June 2020, Bursa Malaysia made whistleblowing policies mandatory for all listed companies.[107] Listed companies must publish whistleblowing policies and procedures on their websites, which act as additional anti-corruption measures for companies to promote "better governance culture and ethical behaviour".[108] Companies should conduct reviews to assess the effectiveness of these measures at least once every three years.[109] Further, under the Malaysian Code on Corporate Governance (MCCG) 2017 and now the MCCG 2021, companies are expected to implement policies and procedures on whistleblowing, which include the reporting of concerns relating to health and safety.[110]

Top Glove's website provides a form for whistleblowers to report bribery, fraud or other misconduct.[111] The whistleblower may also choose to submit a mailed disclosure through an external whistleblower provider, who will in turn bring the anonymous complaint to the Whistleblowing Committee. The committee is made up of senior independent non-executive director (INED) Dato' Lim Han Boon (LHB); the head of internal audit, Jack Lim; and Lee.[112]

Top Glove provides assurance that the information provided by whistleblowers will be "treated confidentially in accordance with the law" under the WPA.[113]

The company's Whistleblowing Policy and Procedure (WBPP) can also be found on the company website.[114] The WBPP promotes internal whistleblowing for issues such as acts that endanger the health or safety of any individual. According to the WBPP, no action will be taken against the whistleblower in accordance with the Companies Act and the WPA.[115] In particular, the WBPP states that whistleblowers will be protected against reprisals and adverse employment consequences.[116]

Khadka was not protected even though a complaint was lodged about the company's workplace environment which endangered the health and safety of employees. The WBPP stipulates that "whistleblowing reports must be made in the best interest of the company and not for any personal gain", otherwise disciplinary action may be taken against the employee.[117] Having worked at Top Glove for eight years,[118] Khadka could arguably be genuinely concerned about the safety of the company's employees. However, he faced disciplinary action and was subsequently terminated.

Institutional investors put on their gloves

The events at Top Glove led some institutional investors to question the board and management. During the Annual General Meeting (AGM) on 6 January 2021, some institutional investors voted against the re-election of six INEDs.[119] The six INEDs up for re-election were LHB, Tan Sri Rainer Althoff, Lim Andy, Datuk Noripah Kamso (Kamso), Datuk Dr. Norma Mansor (Dr. Mansor) and Sharmila Sekarajasekaran (SS).[120]

Among those who voted against the re-election of the INEDs was BlackRock, a global investment management firm which had previously publicly stated that it would vote against the re-election of the six directors, as well as against the separate resolution to retain LHB, who had served nine years on the board, as an INED.[121] BlackRock Institutional Trust, a BlackRock unit, has a 1.07% stake and is the tenth biggest shareholder.[122] BlackRock believed that the board had failed to manage risks, especially those regarding worker health and safety issues. Given that these issues existed since 2018, Blackrock attributed the woes arising from COVID-19 to the failure in oversight by the board, suggesting "ineffectiveness" of the current directors.[123] It also announced its intention to vote against the re-election of the other directors at future meetings to hold them accountable.[124]

Norges Bank Investment Management (NBIM) was also reported to have voted against the re-election of the directors, without providing reasons for its decision.[125] Norway's Government Pension Fund Global, the world's largest sovereign wealth fund, holds a 0.89% stake in Top Glove through NBIM as of 31 December 2020.[126] Despite the investor backlash, the six INEDs were re-elected with between 72.3% and 86.5% of the shareholder votes. LHB was also retained as INED.[127]

At the AGM, Top Glove's board answered various questions posed by shareholders. The EPF, MSWG, Kumpulan Wang Persaraan (KWAP) and various individual shareholders raised their concerns to the board, especially regarding the poor living conditions of employees.[128] Senior INED LHB reassured shareholders that the board is equally concerned and has been working closely with management to resolve the issues raised.[129]

Floored by U.S. authorities

Prior to the outbreak of COVID-19 in the workers' dormitories and the revelation of the termination of the whistleblower, Top Glove had already faced consequences for the treatment of its employees after shipments of its products were issued detention orders in July 2020 in the U.S. by the CBP.[130] With negative workplace practices capturing headlines during the COVID-19 pandemic, the CBP increased its enforcement of withhold release orders (WRO), which are placed on goods suspected of being made with forced labour to prevent them from entering the U.S.[131] Suspicions of withholding employee passports, as well as debt bondage, were some of the key reasons provided for detaining the products exported by Top Glove.[132] This was a blow to Top Glove's performance, as the North American region provided 24% of total sales in the first nine months of FY2020.[133]

Another glove maker, WRP Asia Pacific Sdn Bhd (WRP Asia Pacific), was previously in the crosshairs of the CBP as it was also issued with WRO.[134] However, WRP Asia Pacific rectified the situation with remedial action, resulting in the subsequent lifting of the WRO.[135] As Top Glove denied making use of forced labour, it was left with only two options: to re-export the goods to other countries or provide evidence to the CBP that its goods were not produced with forced labour. Top Glove decided to take remedial action and began paying remediation fees to its employees.[136]

In December 2020, Top Glove publicly announced the measures it had taken to improve its labour practices, such as blacklisting two recruitment agencies that employed unethical practices to source for workers.[137] It added that it was working closely with 11 "principled" recruitment agencies and that it had implemented a "zero-cost" recruitment policy since January 2019.[138] This means that Top Glove fully bears the cost of recruiting foreign workers. Top Glove had also begun paying foreign workers for their hefty recruitment fees and would continue to do so until July 2021. The total remediation payments amounted to RM136 million.[139]

The company expected the WRO to be lifted by the end of 2020.[140] However, on 29 March 2021, the CBP published a statement concluding that disposable gloves imported into the U.S. were produced "with the use of convict, forced or indentured labour", thereby extending the ban to all disposable gloves manufactured in Top Glove factories in Malaysia.[141] This led to a five percent drop in Top Glove's share price.[142]

On 5 April 2021, the CBP directed Top Glove to make additional amendments to improve its labour practices.[143] The company said that it had been working with Impactt Limited, an independent consultant, since July 2020 to resolve issues relating to ethical trade, human rights, and fair labour practices under the ILO's forced labour indicators. Top Glove's ED Lim Cheong Guan shared that the company has resolved six out of 11 of the indicators identified by ILO – specifically, the abuse of vulnerability, restriction of movement, excessive overtime, abusive working conditions, isolation, and withholding wages.[144] While there were still five outstanding indicators yet to be resolved in early April 2021, Impactt Limited said that all 11 indicators had improved since the first round of assessment done in August 2020.[145] Shortly after, at the end of April 2021, Top Glove issued a statement indicating that all 11 ILO indicators of forced labour were resolved.[146]

"I think it is a good lesson for us to learn and to improve. As a growing company and industry, I think we have to learn quickly and improve quickly because we have been in business for 30 years. There are things we know and things we do not know. So, we need to learn quickly, things we do not know."

– Tan Sri Lim Wee Chai, Top Glove Chairman[147]

Top Glove's management team stated that it remains committed to resolving outstanding issues with the CBP and believes that the glove industry in Malaysia will improve as a whole.[148] However, despite the company's efforts, two shipments of latex and disposable gloves were once again seized by the CBP in May 2021,[149] while the WRO has yet to be lifted as of June 2021.[150]

The top of Top Glove: A family affair?

Currently, the 12 directors sitting on the board of Top Glove consist of four EDs, one NINED and seven independent directors (IDs).[151] The directors have diverse backgrounds and experiences, ranging from innovation technology to public relations.[152] Apart from Dr. Lim, two other directors – Lee (managing director) and LHS (ED) – have experience in the glove manufacturing industry. Lee has been in the rubber glove industry for over 20 years, serving as a board member of the Malaysian Rubber Export Promotion Council and the Malaysian Rubber Board, and was the President of the Malaysian Rubber Glove Manufacturers Association. Similarly, LHS, the founder of TG Medical (U.S.A), Inc., has over 20 years of experience in the U.S. glove market.[153]

LHS is one of the two directors with family ties to Dr. Lim – he is the brother of the Chairman. Tong, the only NINED on Top Glove's board, is the wife of Dr. Lim. Both LHS and Tong are classified as non-independent.[154]

Additionally, the son of Dr. Lim, LJF, is part of Top Glove's senior management team, serving as the deputy general manager of marketing. Another family member of Dr. Lim is Lew Sin Chiang, the brother-in-law of both Dr. Lim and Tong, and he serves as a member of the executive committee.[155]

Independent directors

Practice 4.1 of MCCG 2017 and Practice 5.2 of MCCG 2021 state that large companies should have a majority of their boards comprising IDs.[156,157] Top Glove complies with this as seven of the 12 directors on its board are independent.[158] The MCCG also states that the tenure of IDs should not exceed a cumulative period of nine years, although the director can continue serving in a non-independent capacity after nine years.[159] Shareholder approval should be sought through a two-tier voting process in order for an ID to remain independent after 12 years under MCCG 2017,[160] and after nine years under MCCG 2021.[161]

The respective tenures of the IDs on the Top Glove board fall below nine years, with the exception of senior ID LHB. He was first appointed as an ID on 21 February 2011 and was redesignated as senior ID on 8 January 2019.[162] Top Glove has a policy to limit the tenure of IDs to nine years, although the Board Nomination and Remuneration Committee (BNRC) can assess and recommend to shareholders to retain an ID beyond nine years.[163] At the company's AGM held on 6 January 2021, shareholders' approval was sought to retain LHB as an ID.[164] This resolution was passed with 81.54% of shares voting in support.[165]

Welcome on board

In the past six years, there were several changes to the board of Top Glove, including among the IDs. Based on Practice 4.6 of MCCG 2017 and Practice 5.6 of MCCG 2021, boards should utilise "independent sources", instead of "solely rely[ing] on recommendations from existing board members, management or major shareholders", when identifying potential candidates to be appointed as directors.[166,167] In MCCG 2021, it is stated that if boards rely on "recommendations made by existing directors, management or major shareholders, the Nominating Committee should explain why these source(s) suffice and other sources were not used".[168] In Top Glove's 2020 corporate governance report, it was disclosed that potential IDs are sourced "from independent sources such as 30% Club Malaysia and Institute of Corporate Directors Malaysia", apart from candidates from the existing directors' connections.[169]

On 18 March 2015, Arasaratnam Sekarajasekaran (AS) retired as an ID of Top Glove. He has an engineering background. That same day, his daughter, SS, took over as ID, an appointment she currently still holds.[170] A lawyer by training, she serves as a consultant in the legal, operations and industry development departments of the RIM Group, and as a partner of Jerald Gomez & Associates.[171]

On 8 January 2019, when former corporate and central banker Tan Sri Arshad Ayub (Ayub) retired as ID, his daughter, Azrina Arshad (Arshad), was appointed as his replacement.[172] Arshad has a background in architecture and is currently a freelance project architect and manager of Focus Architects, Urban Designers & Planner Sdn. Bhd., and the project manager and director of Zalaraz Sdn. Bhd.[173]

At Top Glove's AGM on 8 January 2020, the MSWG of Malaysia questioned the failure of the company to appoint an "outsider" to replace Ayub.[174] In response, Top Glove's directors clarified that the decision was made based on the recommendation of Ayub. After a review of the credentials of Arshad by the BNRC, the board agreed that she would be able to continue her father's legacy by carrying out her duties proficiently and support the growth of the company as a reputable businesswoman.[175] In response to the question of how her architectural expertise is relevant to the company, the board explained that Arshad's working experiences in the architecture field and rapport with various local authorities would contribute to Top Glove's objectives in growing its market share through its factory expansion plan.[176] Moreover, with her keen interest in environmental, social and governance (ESG) issues, she would be able to guide Top Glove to achieve the Green Building Index certified status and other best practices for its building and factory developments for the company's expansion plans.[177]

Gender diversity

With the launch of the Board Diversity Policy in 2012, Bursa Malaysia outlined a vision for companies to achieve at least 30% of women's participation on the boards in the corporate sector.[178] For Top Glove, four out of the five new directors appointed since March 2015 are female, including SS and Arshad.[179] Meeting the gender diversity target was also a reason cited by Top Glove for the appointment of SS.[180] Currently, five out of 12 directors on the board are women. This surpasses the target set by Bursa Malaysia and satisfies the newly updated Practice 5.9 of MCCG 2021, which states that boards should comprise at least 30% of women directors.[181] Besides increasing the level of women participation on the board, three out of seven of Top Glove's board committees – the Board Risk Management Committee (BRMC), Board Sustainability Committee (BSC) and BNRC – are being chaired by women as of FY2020.[182]

Malaysia boleh: The "short squeeze"

In January 2020, before COVID-19 was declared a global pandemic, Top Glove was trading at around S$0.50 (RM 1.50), as shown in Figure 2.

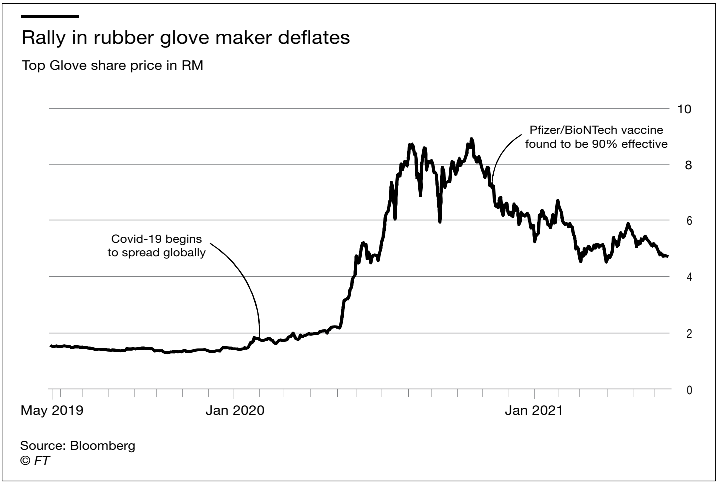

Figure 2: Top Glove's share price[183]

As the virus continued spreading around the world, the company's share price reached a peak of S$3.00 (RM 9.00) around August 2020, as the demand for protective equipment was expected to continue to rise.[184] However, in November 2020, the announcement of the development of vaccines reversed the trend. The decline also coincided with the forced closures of the company's dormitories. As of 31 May 2021, Top Glove shares closed at S$1.65 (RM 5.16), approximately a 45% decline from its all-time high.[185]

At the beginning of 2021, the rally in GameStop shares in the U.S. from the "short squeeze" spurred Malaysian retail investors to attempt their own "short squeeze" on Top Glove shares, creating a boost in its share price.[186] A Reddit community, Bursabets, was formed following the GameStop phenomenon and had over 8,000 members.[187] Bursabets was set up to support Top Glove after it became one of the most shorted stocks on Bursa Malaysia. It was inspired by WallStreetBets, the Reddit community consisting of six million members that pushed GameStop's stock up 16-fold as small investors went on a "short squeeze" against short sellers.[188] Bursabets zeroed in on Top Glove after information of its net short position showed that it was close to three percent of its float, the highest recorded in Malaysia.[189]

However, unlike the situation in the U.S., where regulators were said to be "scrambling to find the appropriate response to the GameStop saga", the Securities Commission Malaysia and Bursa Malaysia issued a joint statement stating that they are "closely monitoring the local stock market".[190] Malaysian investors were advised to be "cautious of social media chat rooms that try to influence investors to buy or sell certain stocks based on speculation or rumours".[191] Retail investors were warned that they may face similar issues that investors on the Robinhood trading platform faced, with trading restrictions imposed for shares like GameStop.[192]

Malaysian retail investors flocked to BursaBets to discuss buying up Top Glove shares due to their dissatisfaction about the fall in share price in early 2021, even as the firm's profits grew. For instance, although Top Glove reported a record profit in December 2020, its share price fell by about 40% from its peak after vaccines for COVID-19 became available.[193] Furthermore, some analysts have reduced their target prices despite maintaining a "buy" recommendation on Top Glove's shares, while others have advised investors to "accumulate [Top Glove's shares] at lower levels".[194]

Malaysia gLOVEs you

Despite the global pushback against Top Glove's practices, the company continues to find admirers back home. Telegram chat groups, such as "TOP Glove Investors Discussion!" and "Malaysian GLOVE Union", which aimed to promote Top Glove's shares, have surfaced and gained followers.[195]

The nationalistic sentiment is also evident in the case of Top Glove's termination of Khadka, the whistleblower. A number of Malaysians on an online forum highlighted that the termination of Khadka and his allegations are simply conspiracy theories.[196] Some believed that the media was looking for ways to tarnish Top Glove's reputation due to its success during the pandemic, suggesting that the workers themselves are being dishonest.[197]

Back to the top?

Top Glove remains the world's largest glove maker today. Analysts have described the recent decline in its share price to be "unjustified", given that the demand for disposable gloves is projected to increase by an average of 15% annually for the next five years, with glove prices likely to remain above pre-COVID-19 levels.[198]

In FY2021, Top Glove has continued to produce stellar financial results – it reported a 12.8% increase in revenue from the first to second quarter, notwithstanding an increase in global vaccination rates.[199] In the third quarter of FY2021, Top Glove also recorded a net profit of RM2.04 billion, a six-fold increase from the previous financial year.[200] Analysts such as DBS Bank have continued to maintain a "buy" recommendation on its shares, with a target price of RM7.25 on 10 June 2021.[201]

However, Top Glove's plans to raise US$1 billion in its Hong Kong listing remains on hold, as it continues to try to resolve the U.S. import ban.[202] This proposed third listing has raised concerns about Top Glove's plans to continue raising funds despite forecasting a weaker outlook, and that the new listing will dilute earnings per share.[203] On 26 August 2021, the company announced that its application for the proposed listing in Hong Kong had lapsed but it intends to renew the application as soon as possible.[204]

In March 2021, Top Glove was crowned as one of the "Best Companies to Work for in Asia 2020" for the fifth year in a row.[205] Top Glove said it remains committed to further improve its ESG practices. On 9 June 2021, the company declared 2021 as the "year of ESG".[206] This entails the implementation of various initiatives, such as investing in green energy, implementing robust water management systems, and investing in new accommodation for foreign workers.[207] Ironically, just one week later, Bursa Malaysia announced that Top Glove has been removed from three indices which are based on ESG factors, namely the FTSE4Good Bursa Malaysia Index, ASEAN 5 and Emerging Markets Index.[208] UOB Kay Hian analysts opined that the removal of Top Glove from these indices was due to the unresolved WRO issued by the CBP.[209]

Will Top Glove be able to overcome its setbacks to truly become an ESG darling? There was good news for the company when it announced on 10 September 2021 that it has been cleared to resume exporting and selling its products to the U.S. after the ban by the CBP was lifted.[210]

Discussion questions

1. What are the pros and cons of having the founder of Top Glove as its Executive Chairman? Is having family members – who collectively hold a controlling stake in Top Glove – as directors and management of Top Glove good for the company? How should a family-controlled company balance family involvement while ensuring good corporate governance and performance?

2. Critically evaluate Top Glove's board composition in terms of independence and diversity. What are your thoughts on the appointment of the two independent directors who are family members of retiring independent directors? Do you think they should be deemed to be independent? Explain.

3. To what extent do you believe that the board composition of Top Glove has contributed to the issues it has faced? What improvements do you think Top Glove should make to its nomination process for directors? What skills and experience do you think are particularly relevant for independent directors who are appointed to Top Glove's board?

4. To what extent is the board of directors responsible for the alleged labour abuses and spread of COVID-19 in the foreign workers' dormitories? Especially in light of how Singapore experienced a surge in the number of cases in their workers' dormitories early in 2020, what should the board have done from a risk management standpoint? What risk management lessons can one draw from the issues faced by Top Glove both in Malaysia and the U.S.?

5. Laws and requirements in different countries differ with regard to ESG. How should a company approach such differences? What is the role of the board and senior management in this regard?

6. Evaluate the effectiveness of the whistleblowing policy of Top Glove and whistleblowing legislation in Malaysia. Did Top Glove handle the whistleblowing case adequately and if not, what should it have done differently? How can whistleblowing policies of a company be improved to protect migrant workers, who may be unfamiliar with the laws and language of a foreign country?

7. With a strong commitment to improve its ESG practices, Top Glove declared 2021 as the year of ESG. What are some changes you would recommend to Top Glove to improve its ESG practices?

8. BlackRock and Norges Bank Investment Management unsuccessfully voted against the re-election of six directors. How can minority shareholders hold directors accountable for their oversight in companies with controlling shareholders? Should regulators better protect these minority shareholders in such companies? Explain.

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WESTPAC: WASHING MONEY IN THE PACIFIC

Case overview

Australian banking giant, Westpac Banking Corporation (Westpac), one of the four major banks in Australia, was rocked to its core after it was uncovered in 2019 that the bank had breached anti-money laundering laws a record 23 million times, with some of these breaches relating to transactions potentially involving child exploitation. This came hot on the heels of another similar money laundering scandal which ensnared the Commonwealth Bank of Australia (CBA) back in 2017. However, the scale of breaches by Westpac was far greater than that of CBA.

The multiple breaches were outlined by the Australian Transaction Reports and Analysis Centre (AUSTRAC) in its statement of claim submitted to the Federal Court. The bank was accused of having a poor corporate and regulatory environment where key management and directors had been accused of being asleep at the wheel. As AUSTRAC alleges, despite senior management being aware of "long-standing non-compliance", the bank failed to make it a priority to resolve the problem. Given the sizeable influence that Westpac holds in the international financial market, the scandal caused shockwaves both in the domestic market and worldwide.

The objective of this case study is to facilitate a discussion of issues such as corporate governance of financial institutions; corporate culture; money laundering; compliance; remuneration; risk management; and regulatory oversight and enforcement.

Westpac – the pioneer bank

Westpac was established in 1817 as the Bank of New South Wales before a change to its current name, Westpac Banking Corporation (Westpac) in 1982.[1] As Australia's oldest bank, it is also one of the four big banking organisations in Australia and one of the largest banks in New Zealand. Westpac provides a broad range of consumer, business and institutional banking and wealth management services through a portfolio of financial services brands and businesses. Through a unique portfolio of brands such as Westpac, St. George, Bank of Melbourne, BankSA, BT and RAMS, Westpac serves over 13 million customers.[2] As at 31 July 2021, Westpac has a market capitalisation of about A$92 billion.[3]

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Breaches galore

"The failure to pass on information about international fund transfers to AUSTRAC undermines the integrity of Australia's financial system and hinders AUSTRAC's ability to track down the origins of financial transactions, when required to support police investigations,"

– Nicole Rose, AUSTRAC CEO[4]

In 2011, Westpac experienced a bungled computer systems update affecting the recording of bank transactions. This meant that automatic reporting was not switched on, affecting transfers between multiple banks including Citibank, Standard Chartered Bank and Wells Fargo. Six years later, on 22 May 2017, junior staff in Westpac realised that money transfers with Standard Chartered Bank were missing and went unrecorded in the system. This prompted Di Challenor, the then head of Global Transaction Services at Westpac, to request for an urgent review in early August that year. The review uncovered a number of problems, including the fact that there were similar problems experienced with Citibank. However, the findings were neither shared with Challenor nor any of the bank's executives. The situation was also not reported to the Australian Transaction Reports and Analysis Centre (AUSTRAC) – Australia's financial crime fighting agency.[5,6]

It was only around mid-2018 that Challenor realised the severity of the breaches. She worked together with Amanda Wood – the head of anti-money laundering, corruption, and bribery – to piece together what exactly happened.[7] In July 2018, Wood notified the Westpac regulatory disclosure forum of the breaches. The Westpac regulatory disclosure forum, chaired by Chief Compliance Officer Jamie Kelly, is a committee responsible for deciding when Westpac should inform regulators or law enforcement agencies that it may have broken the law.[8] Subsequently, in August 2018, AUSTRAC was informed of failed money transfers and the Westpac board was notified of the breaches.[9]

Silencing the alarm?

After Wood informed the Westpac regulatory disclosure forum of the breaches, she was tasked to oversee Westpac's response to the investigation by AUSTRAC, which spanned over 10 months during which she worked with managers from the global transaction business to understand what happened and to provide explanations to AUSTRAC. However, she was subsequently told that she did not have the required skills and was offered a transfer to a more junior role, after being informed that the bank wanted a money-laundering reporting officer "who had more international experience". She chose to take a redundancy payout rather than the more junior role.[10]

It was reported that Wood felt that Westpac's executives were "more worried about reputational damage than fixing the problem". She also voiced out that the bank had failed to see compliance as a social good and viewed it as more of a "hindrance", signifying the lackadaisical attitude towards compliance. Wood asserted that "the talk around the executive table was that it was small value, low-risk transactions and it's not as bad as CBA".[11]

AUSTRAC takes action

On 20 November 2019, slightly over a year after AUSTRAC got wind of the Westpac's extensive breaches, AUSTRAC applied to the Federal Court of Australia for civil penalty orders relating to "systemic non-compliance with the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (AML/CTF Act)" against Westpac.[12,13] AUSTRAC alleged that Westpac failed to report over 19.5 million international funds transfer instructions over a period of nearly five years, and failed to carry out proper due diligence on suspicious transactions in Southeast Asia which included transfers related to potential child exploitation. Furthermore, AUSTRAC accused Westpac of contravening the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (AML/CTF Act) on more than 23 million occasions. Each breach of money laundering laws may result in a civil penalty of between A$17 million and A$21 million, which cumulatively amounts to a maximum potential fine of A$391 trillion for Westpac.[14,15]

Bank for the unbankable

"These contraventions are the result of systemic failures in its control environment, indifference by senior management and inadequate oversight by the board…"

– *AUSTRAC*[16]

Documents filed by AUSTRAC with the Federal Court of Australia in November 2019 depicted the bank as one which for years has failed to take money laundering and terror finance risks seriously.[17] AUSTRAC discovered that Westpac did not have a proper automated detection system in place until 2018 to swiftly detect and report suspicious activities and transactions which might point to illegal activities such as child exploitation.[18] Banks and other financial institutions should have in place such systems and processes to prevent it from becoming an accomplice to crime and terrorism.[19]

AUSTRAC alleged that Westpac's failure to comply with anti-money laundering and counter-terror financing laws permitted one customer to make bank transfers to an individual in the Philippines who was later arrested for child sex trafficking and livestreaming child sexual abuse,[20] and another who had previously been jailed for child exploitation to open several bank accounts to make payments to the Philippines.[21] Furthermore, Westpac was accused of failing to carry out proper due diligence on twelve customers who made numerous transactions "consistent with child exploitation typologies". These involved "customers with no apparent family ties to the Philippines/Southeast Asia, frequently remitting small sums of money to multiple beneficiaries in the Philippines/South east Asia within short timeframes".[22] Further control and security measures were also not undertaken by Westpac with regard to business dealings with offshore banks which operated in high-risk or sanctioned countries.[23]

Investigations deepen

After AUSTRAC sounded the alarm about Westpac's failure to adhere to reporting rules, the 'twin peaks' – Australian Prudential Regulation Authority (APRA) and Australian Securities and Investments Commission (ASIC) – stepped in as well. Australia's financial regulatory system follows a 'twin peaks' model.[24] APRA is the prudential or financial safety regulator,[25] which supervises institutions across banking, insurance and superannuation and is tasked to maintain the safety and soundness of financial institutions.[26] ASIC is the conduct regulator,[27] responsible for maintaining, facilitating and improving the performance of the financial system, promoting confident and informed participation by investors and consumers, and administering the law effectively and with minimal procedural requirements.[28]

On 21 November 2019, ASIC commenced an investigation "concerning possible breaches of legislation it administers arising from AUSTRAC's actions in relation to Westpac".[29] It was reported that ASIC could look at a Corporations Act duty to act "efficiently, honestly and fairly" and to take the care and diligence expected of a reasonable person.[30] Meanwhile regulators and government agencies in the Philippines also commenced investigations into the suspicious payments via Westpac that were linked to child exploitation in the country.[31]

On 17 December 2019, APRA officially launched investigations into Westpac for potential breaches of Australia's Banking Act of 1959.[32] APRA mentioned that among other things, its investigations would involve a comprehensive review with a focus on the risk governance of Westpac. These reviews would cover risk management, accountability, remuneration and culture. APRA mentioned that it would also look into steps undertaken by Westpac to strengthen its risk governance in recent years.[33] It would also look into whether the acts committed by Westpac transgressed the Banking Executive Accountability Regime (BEAR) – heightened standards of accountability among authorised deposit-taking institutions established in July 2018.[34] Furthermore, Westpac was to set aside an extra A$500 million in capital with immediate effect to reflect the increased operational risk profile of the bank. This was on top of the additional A$500 million in capital that was imposed by APRA on Westpac in July 2019.[35]

Highlighting the gravity of the breaches, APRA Deputy Chairman John Lonsdale remarked that "AUSTRAC's statement of claim in relation to Westpac contains serious allegations that question the prudential standing of Australia's second largest bank … Given the nature of the matters raised by AUSTRAC, the number of alleged breaches and the period of time over which they occurred, this will necessarily be an extensive and potentially lengthy investigation."[36] Notably, the prudential regulator would be conducting the investigation using powers that were strengthened after another money laundering scandal affecting the Commonwealth Bank of Australia (CBA) – Australia's largest bank – just two years earlier in 2017. In a statement filed to the stock exchange, Westpac reiterated that the breaches were unacceptable and that it would fully cooperate with APRA in its investigations.[37]

Taking the fall

On 25 November 2019, just days after AUSTRAC applied for civil penalty orders against it and ASIC started a probe into its operations, Westpac announced the resignation of Chief Executive Officer (CEO) Brian Hartzer, who would step down from his role on 2 December 2019. He was given a notice of 12 months and his fixed salary of A$2.7 million would be paid in full.[38] Hartzer would not be paid any short-term and long-term bonuses.[39] The ouster of Hartzer followed a string of casualties in Australia's finance sector, where top executives in other banks were forced to leave following numerous scandals.[40] Hartzer joined Westpac in 2012 as head of the Australian financial services unit before being promoted to Managing Director and CEO in 2015.[41] Although he had initially promised to stay and "fix" the issues faced by Westpac,[42] strong political pressure forced him to step down.[43,44]

Chief Financial Officer (CFO) Peter King was selected to take over as acting CEO after Hartzer stepped down. King has been Westpac's CFO since 2014 and an employee of the bank since 1994.[45] He was officially appointed CEO in April 2020.[46]

Chairman Lindsay Maxsted was not spared either. Maxsted, who had served as Chairman since 2011, announced that he would bring his retirement forward to the first half of 2020. Ewen Crouch, Risk and Compliance Committee Chairman and board member since 2013, would not seek re-election at the 2019 Annual General Meeting (AGM).[47,48]

Angry shareholders

Westpac's share price took a hit in light of the investigations by the various financial regulators and did not recover even after the resignation of the bank's top executives.[49] It plummeted eight percent in the first three weeks after the suit launched by AUSTRAC, resulting in an A$7.7 billion drop in its market value.[50] It further fell by 0.78% on the day APRA announced that it had commenced investigations.[51] In addition, for the first time in a decade, Westpac announced a reduction in dividends.[52]

AUSTRAC's investigation into Westpac further fueled the fury of shareholders, leading to multiple class action lawsuits.[53] Phi Finney McDonald – a specialist class action law firm[54] – was one of the first law firms which represented the affected shareholders. It accused Westpac of breaching its continuous disclosure obligations and failing to monitor account transactions which suggested potential child exploitation. It also alleged that Westpac's share price was artificially inflated due to its breaches and misleading representations.[55] Principal lawyer Tim Finney said that Phi Finney McDonald had been contacted by hundreds of concerned retail and institutional investors with regard to AUSTRAC's claims.[56]

Shortly after being served its first class action lawsuit from Phi Finney McDonald, Westpac faced yet another class action lawsuit from New York-based Rosen Law Firm over the money laundering and child exploitation scandal. It was looking to seek damages for investors in the U.S. who purchased Westpac securities on the New York Stock Exchange between 11 November 2015 and 19 November 2019.[57] Former CEO Brian Hartzer and current CEO Peter King were named as defendants in the Rosen Law Firm class action lawsuit. On 13 March 2020, Westpac was hit by a third shareholder class action lawsuit by Melbourne-based corporate law firm Johnson Winter & Slattery.[58]

Deja vu

Westpac's money laundering and child exploitation scandal shares a number of similar characteristics with CBA's money laundering scandal which was uncovered in 2017. CBA was harshly criticised for countless "serious and systemic" breaches of anti-money laundering and terrorism financing laws.[59] On 3 August 2017, AUSTRAC launched civil proceedings in the Federal Court alleging that CBA breached the law on 53,700 occasions. In CBA's case, the breaches related to intelligent deposit machines (IDMs) between November 2012 and September 2015, where "deposits are automatically counted and instantly credited to the target account which can be located domestically or internationally",[60] which can potentially aid in money laundering causes. Furthermore, CBA did not monitor transactions on 778,370 accounts to check for money-laundering red flags[61] and failed to report cash transactions of above A$10,000 and suspected money laundering to AUSTRAC, as required by anti-money laundering laws.[62] It was later reported that the money laundered through CBA included proceeds of drug and firearms importation and distribution syndicates.[63]

Systemic industry failure

Commissioner Hayne's report

"There can be no doubt that the primary responsibility for misconduct in the financial services industry lies with the entities concerned and those who managed and controlled those entities: their boards and senior management,"

– Commissioner Hayne[64]

The groundbreaking CBA case was one of many reports into the failures in the Australian financial services sector by Adele Ferguson,[65] a prominent investigative reporter for the Australian Broadcasting Corporation. Ferguson's reporting over the years eventually drew the attention of the Australian government, and on 14 December 2017, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was established.[66,67]

On 4 February 2019, Commissioner Hayne's final report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was released to the public.[68] The report found extensive failures of corporate governance and regulation in the Australian financial services industry. According to Russell Marks – a lawyer and honorary research associate at La Trobe University – these failures suggested a culture of systematically ignoring legal obligations within the banks in Australia.[69]

The report includes 76 recommendations and emphasises the key principles of good governance to be practised by the boards and senior management. Hayne also affirmed that the Australian regulators have an important role to play in the supervision of culture, governance and remuneration in the financial sector.[70]

Commissioner Hayne's comments on regulators

"Compliance with the law is not a matter of choice…Negotiation and persuasion, without enforcement, all too readily leads to the perception that compliance is voluntary. It is not."

– Commissioner Hayne[71]

In light of the series of scandals plaguing the Australian banking and financial sector, Commissioner Hayne lambasted both regulators, saying that the law "has not been enforced effectively" and the accountability of both regulators needs to be strengthened. Commissioner Hayne's report stated that "both ASIC and APRA recognise that their approach to enforcement must change. That change cannot be effected by the passing of legislation. It must come from within the agencies." Furthermore, it was mentioned in the report that both ASIC and APRA should co-operate with one another and share information as much as possible.[72]

One key recommendation in Commissioner Hayne's report states that a new oversight authority, unrelated to the government, should be established to oversee APRA and ASIC and to regularly "assess the effectiveness of each regulator in discharging its functions and meeting its statutory objects, the performance of the leaders and decision-makers within the regulator, and how the regulatory exercises its statutory powers".[73]

In particular, ASIC was slammed for treating the banks like "clients" even though it is charged with enforcing financial services laws on behalf of the community.[74] The report recommended an overhaul of ASIC's culture – the regulator was recommended to always first question if a court should determine the consequences of a breach. It was also told to only issue infringement notices when the matter was with regard to administrative breaches and that it should take further steps to strengthen enforcement when dealing with larger firms and to separate their employees from engaging in matters unrelated to enforcement with the companies that they were overseeing.[75] Another key recommendation of the report is for ASIC to be granted new powers to enforce the BEAR alongside APRA – powers which ASIC had always welcomed. In response to the report, ASIC Chairman James Shipton acknowledged that there is a need to change ASIC's culture.[76]

Commissioner Hayne's report also called on APRA to have greater oversight on non-financial metrics. It highlighted that APRA should play a central role in underpinning improved behavioural standards and stronger accountability, and thus it should increase the breadth and depth of its supervision. In response, APRA said that it is reviewing its enforcement strategy – including when to hold individuals to account – alongside an independent expert panel. APRA Chairman Wayne Byres further commented that Commissioner Hayne's report is "a considered and fair assessment of failings in the financial system and a helpful roadmap for reform".[77]

In an earlier government-commissioned capability review concerning APRA, which concluded in June 2019, APRA was found to have a "culture of conformity" and was deemed slow to act and not being firm in addressing potential breaches.[78] The regulator also had a preference for doing things "behind the scenes" with the entities it oversees, which "limits its impact and authority".[79] The report concluded that "APRA's internal culture and regulatory approach need to change".[80] One of the core recommendations in the report was that "The Government should consider providing APRA with a non-objections power to veto the appointment or reappointment of directors and senior executives of regulated entities. This would bring it into line with international regulators and strengthen its capacity to pre-emptively regulate [governance, culture and accountability] risks."[81] APRA was also asked to review its existing strategies to deal with potential breaches to ensure a strong regulatory environment in the Australian financial sector. Additionally, the report stated that it should use "more strategic and forceful use of communication to ensure that it maximises its impact with regulated entities".[82,83]

In December 2019, Westpac's money laundering and child exploitation scandal saw APRA launching an official investigation for the first time under the BEAR legislation, which had been effective since July 2018. This legislation provides APRA with the ability to disqualify directors and executives in its own capacity.[84]

Westpac's reaction to Commissioner Hayne's report

In response to Commissioner Hayne's report, Westpac provided an implementation progress update in November 2019, stating its commitment to "proactively and transparently" implement the recommendations of the Royal Commission. Westpac disclosed that of the 76 recommendations in Commissioner Hayne's report, 49 applied to Westpac. It further elaborated that 11 recommendations have been implemented, 11 are in the midst of being implemented and 27 require legislative or regulatory action before implementation work can commence. Westpac also assured that its response to Commissioner Hayne's report was part of a "broader set of initiatives … within Westpac to address root causes of issues, rebuild trust and drive better customer outcomes."[85]

Governance, Accountability and Culture Self-Assessment

The CBA scandal also prompted Australian regulators to demand greater commitment to corporate governance by financial institutions in Australia. After the issuance of the final report on APRA's Prudential Inquiry into the CBA scandal, APRA wrote to the boards of 36 authorised deposit-taking institutions, insurers and superannuation licensees, requesting them to conduct a Governance, Accountability and Culture Self-Assessment. APRA then examined the self-assessments to assess their quality, identify common themes across financial institutions, and challenge institutions' findings, where applicable. On 22 May 2019, APRA published its key findings and proposed solutions in an information paper to assist financial institutions in understanding and addressing the challenges of embedding effective risk governance frameworks and practices.[86]

Don't bank on the corporate culture

In 2018, Westpac set out 45 recommendations in its self-assessment of governance. Subsequently, APRA ordered for a reassessment as it was concerned that Westpac "was not tackling the root causes of its failings". The latest findings of Westpac's Culture Governance and Accountability reassessment report released on 17 July 2020[87] found that Westpac was still "overly complex, which results in confusion around accountability and challenges in execution" and alleged a lack of non-financial risk management capabilities. Westpac said that it recognised that the changes it has been making had been "incremental" and conceded that the "culture, governance and accountability program" established in January 2019 to implement the reforms detailed in the 2018 self-assessment "has not delivered sufficient momentum".[88] Later, in December 2020, APRA notified Westpac of its findings, commenting that the bank's non-financial risk culture was "immature and reactive", and that it had "unclear accountabilities, capability shortfalls and inadequate oversight".[89]

Remuneration and consequence management

One of the key points the earlier 2018 self-assessment had identified was that "Westpac had "taken action to enhance and simplify remuneration frameworks and practices", and several "strengths" were identified in these enhancements, but "a range of shortcomings and opportunities to enhance frameworks and practices were identified to bring about and report the desired risk-based remuneration consequences."[90]

Addressing the above, the 2020 reassessment report stated that "While accountability for group executives is clearer as a result of formal changes such as implementation of BEAR and strengthening of remuneration frameworks, more guidance is needed on how accountability applies in practice for employees at all levels."[91] The report further proposed, among other improvements, there should be emphasis placed on remuneration and consequence management in the direction and tone set by the Westpac board and group executives. It elaborated that the outcome of this would be:[92]

> "Consequence management and remuneration adjustment frameworks work together to reinforce positive, and deter negative, risk behaviours and are used effectively and consistently in practice to achieve their goals.
>
> Expected behaviours are reinforced through remuneration and performance management policies and practices."

Money, money, money

For the years 2018 to 2020, the CEO and group executives' total remuneration consisted of fixed remuneration – set based on benchmarks within the financial services industry – a short term variable component, and a long-term variable reward plan. The fixed remuneration comprises cash salary, salary sacrificed items, and superannuation contributions. For the short-term variable reward (STVR), 50% of the STVR is awarded in cash and 50% is deferred into equity in the form of restricted shares. Performance is assessed against a balanced scorecard which contains financial and non-financial measures such as customer service transformation. Meanwhile, the long-term variable reward (LTVR) is awarded in performance share rights which vest after four years, subject to the achievement of financial performance indicators, continued service, and adjustments. The CEO and Group Executives are required to maintain a minimum Westpac shareholding within five years of their appointment. The requirement supports alignment with shareholders' interests.[93,94,95]

During the 2018 AGM, Westpac's disgruntled shareholders handed the bank its first strike on executive pay and made it known to the board that the bonuses being paid out were not sufficiently cut.[96] Over 64% of shareholders voted against Westpac's remuneration report.[97] Under Australian corporate rules, if over 25% of shareholders vote against a pay proposal for two consecutive years, they can call for the removal of the board of directors. This is known as the 'two-strikes' rule.[98]

Westpac had already taken the 2018 events into account when arriving at the decision to reduce short-term executive bonuses by 25%.[99] CEO Hartzer's cash bonus was reduced by approximately 30% to A$1.04 million for a year. His total realised remuneration had fallen by 9.4% from A$5.46 million to A$4.94 million.[100]

Chairman Maxsted defended the bank's remuneration structure but said that the bank would respond to the concerns raised by the shareholders.[101] He had also acknowledged that Westpac's board was aware that there were concerns that the board had not gone far enough in reducing the STVR paid to the CEO and other executives, and responded by saying "the board takes your feedback very seriously".[102] He also promised to "reach out to more shareholders this year to fully capture and understand [their] views."[103]

On 24 June 2019, Westpac released a letter to shareholders in response to the protest vote by shareholders during the 2018 AGM, where it acknowledged that the 2018 cuts to executive bonuses did not go far enough.[104] In the letter, Maxsted expressed his disappointment that the board did not meet the expectations of shareholders and that it was determined to do so in 2019. It stated that shareholders could expect that upcoming changes would include "more effectively capturing non-financial risk elements of performance in executive remuneration, improving the transparency of remuneration decisions, and applying discretion where circumstances warrant".[105]

Deeper cuts

In Westpac's 2019 annual report, Maxsted noted that the bank's remuneration decisions in 2018 were "not in line" with shareholder expectations, and the board had cut back various payments, including the reduction of director fees by 20% for 2019.[106] He further stated that Westpac "had consulted extensively to better understand shareholder views and act on their feedback…We met with groups of individuals with the help of the Australian Shareholders' Association and we held a number of meetings with institutional shareholders and advisory groups."[107]

A number of notable changes were made. Firstly, CEO Hartzer did not receive any STVR and there was no increase in his base pay. Secondly, group executives received between 0% and 83% of their STVR. Thirdly, the board applied downward remuneration adjustments to two group executives and two former group executives in response to material risk and compliance matters that impacted the Group. The two former group executives did not receive any STVR in 2019. There were also downward adjustments made to a portion of deferred STVR for two former group executives. Lastly, no LTVR was vested for the CEO and group executives in 2019 as performance hurdles were not met.[108]

Maxsted also disclosed: "Changes have also been made to 2020 remuneration structures including the removal of fair value allocation methodology (and moving to face value) to determine the number of performance share rights issued under the LTVR to the CEO and Group Executives. This change contributes to a reduction in the total target remuneration of the CEO and Group Executives by 23% and 12.5%, respectively."[109] He concluded by stating that Westpac will continue to take into account shareholder feedback and new APRA requirements when assessing its remuneration approach.[110]

Is the second strike the end for the board?

On 12 December 2019, Westpac held its 2019 AGM. Against the backdrop of the money laundering scandal which added fuel to the fire, Westpac's shareholders delivered a second strike which automatically led to a motion to spill the board – where the shareholders will vote at the same AGM to determine whether the entire board will need to stand for re-election.[111] Around 35% of shares voted against the remuneration report in 2019 – down from about 60% in 2018.[112] Fortunately for the Westpac board, the spill was averted as the bank managed to secure the backing of major investors such as Australia Council of Superannuation Investors, with 91% of votes cast against dismissing the entire board of directors.[113]

Doing what is right

After the emergence of its money laundering scandal and the subsequent ‘two strikes’ scare from its angry shareholders, Westpac has made substantial investments on improving its anti-money laundering compliance by upgrading its digital systems and retraining employees.[114] It took some immediate steps to fix the issues and disclosed future corrective actions as part of its remedial plan. The immediate fixes comprise the following:[115,116]

- Close the relevant Westpac Australasian cash management product – the technology platform at the core of Westpac’s failure to identify and report on international fund transfer instructions (IFTIs) to AUSTRAC
- Remediate and analyse all unreported IFTIs to AUSTRAC
- Close the LitePay international funds transfer system
- Implement updated child exploitation filters into screening for the SWIFT payment channel to additional jurisdictions
- Lookback screening of customer transactions – a further review of all child exploitation transaction types for the Philippines over the past 12 months
- Review and action highlighted customers
- Increase financial crime resourcing – with plans to add 200 more people to its internal resourcing dedicated to financial crime

It also volunteered to match funding for the International Justice Mission and the Australian government’s SaferKidsPH partnership to raise awareness about and expand initiatives to put an end to the online sexual exploitation of children. Furthermore, Westpac committed to convene an expert advisory roundtable to develop a program to support the prevention of online child exploitation and provide funding of up to A$10 million per year for three years.[117]

Paying the price

“To maintain public confidence in Australia’s financial system and prevent future non-compliance, AUSTRAC will not hesitate to take action when these obligations are not met. This is aligned with AUSTRAC’s role and community expectations.”

– Nicole Rose, AUSTRAC CEO[118]

In October 2020, the Federal Court ordered Westpac to pay a A$1.3 billion penalty – which dwarfs the A$700 million fine paid by CBA[119] – for its breaches of the Anti-Money Laundering and Counter-Terrorism Financing Act 2006. The penalty imposed is the highest civil penalty in Australian history, and according to AUTRAC, “reflect[s] the seriousness of compliance failings by Westpac”.[120] Federal Court judge Jonathan Beach further said that “the integrity of Australia’s financial system depends upon Westpac and other major banks having first class, compliant, risk-based systems to address anti-money laundering and terrorism financing risks”, thus highlighting the need for banks to understand the importance of compliance and the severity of the consequences associated with even the smallest of breaches of the law.[121] No Westpac banking executive was jailed or charged with any criminal offence.[122]

There are many learning opportunities in light of the scandals that have surrounded the two largest banks in Australia in recent years. Commissioner Hayne's report identified red flags in financial institutions which suggest that many have taken the stance that strict compliance with the law is optional.[123] AUSTRAC has since clarified that such breaches and anti-compliance are strictly intolerable especially when it comes to cases involving money laundering.[124] This has helped to push Australian banks to change their operations and systems "to reflect their harsh new operating environment".[125]

Calls have also been made for stricter penalties to be imposed for major breaches of the law. The Australian Greens treasury spokesman, Peter Whish-Wilson, said that "CEO resignations aren't enough. It's time for tougher measures like jail sentences for any white-collar crime and for bank executives to have their ridiculous salaries capped by parliaments and by extension the Australian people".[126] According to columnist Jennifer Hewett, "the dynamics of the demand for accountability to accompany those big pay packets have permanently changed".[127]

Discussion questions

1. What were the key contributory factors to the Westpac scandal? Rank them in order of significance and explain.
2. Evaluate how Westpac's remuneration policies and structures may have affected the behaviour of management and employees in the context of the scandal.
3. Using the four lines of defence for risk management, explain how effective risk management can help mitigate risks of money laundering such as those that occurred at Westpac?
4. Comment on Westpac's handling of the problems that contributed to the scandal and its response to it. Could the bank possibly have prevented the large number of breaches? Are its remedial efforts sufficient to prevent a recurrence?
5. Discuss the key findings and recommendations of Commissioner Hayne's report. Would implementing his recommendations have helped prevent the Westpac scandal?
6. Explain the operation of Australia's 'two strikes' rule and compare with 'say on pay' requirements in U.S. and U.K. Do you think 'say on pay' or 'two strikes' rule should be implemented in Singapore? Explain.
7. Do you think the Australian regulators were effective in dealing with the Westpac scandal? Explain.
8. Compare and contrast the regulatory framework and key regulators for financial institutions in Australia and Singapore. Are there changes you would recommend to the Singapore regulatory framework for financial institutions? Explain.

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YES BANK, NO GOVERNANCE

Case overview

On 5 March 2020, the Reserve Bank of India (RBI) suspended and superseded the country's fifth largest bank, Yes Bank Limited (Yes Bank), by imposing a 30-day moratorium. RBI cited serious deterioration in the bank's financial health, underreporting of non-performing assets and the absence of a credible revival plan. The next day, the RBI announced a rescue plan, under which the State Bank of India would acquire a 49% stake in Yes Bank and Yes Bank's board of directors will be overhauled. This sent depositors and investors into widespread confusion and panic. Two days later, Yes Bank founder Rana Kapoor was arrested under charges of money laundering.

The objective of this case study is to facilitate a discussion of issues such as corporate governance issues in banks; fraud and money laundering; concentration of power; risk management; corporate culture; India's corporate governance system; and the importance of regulatory oversight.

Beginnings of Yes Bank

Yes Bank Limited (Yes Bank) is one of India's largest private sector banks headquartered in Mumbai, India.[1] Its beginnings started in 1999, when three successful Indian bankers – Rana Kapoor, Ashok Kapur, and Harkirat Singh – joined forces to float a non-banking financial company. Kapoor was previously the corporate finance head of ANZ Grindlays Bank, Kapur was the former country head of ABN Amro Bank, while Singh was the ex-country head of Deutsche Bank. Kapur was also previously managing director (MD) of Rabo India and led a management team to partner Rabobank Netherlands to set up Yes Bank.[2] The three bankers had a combined stake of 25% in the corporation, while the remaining 75% was owned by Rabobank, a Dutch multinational banking and financial services company headquartered in Netherlands. On 21 December 2003, Yes Bank was incorporated as a public limited company in India. In the same year, Singh left the bank due to disagreements on the influence exerted by Rabobank in the appointment of Yes Bank's CEO and Chairman.[3,4]

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On 21 January 2004, Yes Bank acquired its certificate of commencement of business. The following year, on 15 June 2005, Yes Bank launched its Initial Public Offering (IPO) and listed on the National Stock Exchange of India.[5] The bank's shares were oversubscribed by 8.27 times.[6] The company made slow but steady progress in its early years. Kapur took on the role of Chairman of Yes Bank, while Kapoor acted as the MD and Chief Executive Officer (CEO).[7] Kapur's professional relationship with Kapoor eventually turned into a personal one when the sister of his wife married Kapoor and they became brothers-in-law.[8]

In November 2008, Kapur was killed by terrorists at the Oberoi Trident Hotel in the 26/11 Mumbai terrorist attacks.[9] After Kapur's death, Kapoor tried to exclude Kapur's family from the management of Yes Bank and attempted to project himself as the sole founder of Yes Bank. During a company function in 2012, Kapoor reportedly did not mention Kapur's name in the company history. This angered Kapur's family, who had inherited a 10.29% stake in the company – only slightly less than Kapoor's 11.77% stake. In retaliation, the late Kapur's daughter attempted to join Yes Bank's board of directors but was eventually rejected.[10]

Kapur's widowed wife and daughter dragged the boardroom battle to the court. They alleged that they were unable to jointly nominate one director to Yes Bank's board because Kapoor had been exercising full control over the bank's board. The Kapur family had also approached the Reserve Bank of India (RBI), accusing Kapoor of misusing his position and power and requesting the central bank not to allow the selection of MD and Chairman without the joint nomination of Yes Bank's co-promoters. In 2015, the Bombay high court ruled in Kapur's favour and directed that any new full-time director on Yes Bank's board could only be appointed with the consent of all the bank's promoters.[11,12]

Say 'yes' to distress

Under Kapoor's leadership, Yes Bank took steps to build its corporate lending segment and focused on sectors such as real estate, pharmaceuticals, renewable energy, and media. While Kapoor took an aggressive approach to expand the loans division, he was able to balance businesses' loan needs with the bank's requirement of prompt repayments. The modus operandi was to provide sizeable loans to those who required them but make borrowers pay a steep upfront fee of between 2% and 10% of the sanctioned amount. He also charged interest rates of up to 16% per annum, which was approximately 3% higher than the rates of competitors.[13]

However, in 2014, Yes Bank started to face struggles. Under Kapoor's management, there was a focus on increasing the bank's loan book. As at 31 March 2014, Yes Bank's loan book was ₹55,633 crore and deposits were ₹74,192 crore. Over the following five years, Yes Bank's loan book increased by four times to ₹224,505 crore as at 30 September 2019. However, deposit growth failed to match the loan book growth and increased less than threefold to ₹209,497 crore.[14] The drastic increase in loan book over a short period of time was due to the bank's strategy of handing out loans to troubled firms that were unable to get credit elsewhere due to significant stress or liquidity issues. Yes Bank began lending to distressed companies such as Anil Ambani Group, Dewan Housing Finance Corporation Ltd (DHFL), Infrastructure

Leasing and Financial Services (IL&FS), and the Essel Group. DHFL and IL&FS have since collapsed and were taken over by the Indian government for restructuring.[15]

The loans that Yes Bank sanctioned to such companies eventually fell apart and the top three largest defaulters were Anil Ambani Group (₹12,800 crore), Essel Group (₹8,400 crore), and DHFL (₹4,735 crore).[16] In July 2015, Swiss bank UBS AG issued a report on India banks[17] and found that Yes Bank had loaned 125% of its net worth to companies which were unlikely to repay their loans.[18] The UBS report stated that Yes Bank had the highest share of loans backed by unlisted shares and current assets, and further added the bank "is most vulnerable to a large corporate default".[19] Yes Bank continued increasing its loans by 309% to companies under stress over the three-year period from 2013 to 2015.[20] It was estimated that as much as 25% of all loans issued by Yes Bank were issued to three of the worst performing industries in the Indian economy: non-banking financial institutions, real estate firms, and construction companies.[21]

Yes Bank complained to the Securities and Exchange Board of India (SEBI) – India's market regulator – and requested it to investigate UBS. Many analysts viewed this as a "panicky and immature response" and chided Yes Bank for not providing facts to defend itself instead.[22,23]

Crushing diamonds

In 2014, when the Bharatiya Janata Party (BJP) came into power after the India general elections, the new ruling party started to crack down on financial institutions in the country.[24] During his three-year tenure, the then RBI governor Raghuram Rajan began a clean-up of India's financial sector and conducted an asset quality review (AQR), forcing banks to come clean on their undisclosed bad loans. He discovered that many banks were understating their non-performing assets (NPAs) – loans which did not fetch any returns.[25] His successor, Urjit Patel, delved even further into this issue. Under Patel's guidance, the RBI set up a rescue fund for Indian banks and put them under a watchlist for lending activities.[26] Following the AQR, RBI discovered repeated divergences between Yes Bank's reported NPAs and its actual figures.[27]

BJP alleged that Kapoor had "deep links" with the prominent Gandhi family of the previous ruling party, Indian National Congress (Congress), and questioned whether the latter had turned a blind eye to Yes Bank's problematic loan book. BJP noted that Kapoor had previously bought a painting from Congress leader Priyanka Gandhi Vadra for ₹2 crore, suggesting a close relationship between the two individuals.[28]

In October 2018, despite Yes Bank's plea to extend Kapoor's term as MD and CEO by three years, the RBI refused the extension against a backdrop of numerous regulatory lapses and corporate governance concerns in Yes Bank. The RBI did not mince its words in its statement and pointed to the "persistent governance and compliance failure reflected by the bank's highly irregular credit management practices, serious deficiencies in governance and a poor compliance culture" as contributing factors to the bank's dire state. It was also reported that the RBI was "very critical" of how Kapoor managed Yes Bank.[29] In the following weeks, a number of prominent Yes Bank individuals resigned, including Non-Executive Chairman Ashok Chawla; independent director and head of the Audit Committee, Vasant Guajarathi; and O.P. Bhatt, an external expert for the Search and Selection Committee[30] set up to select a new MD and CEO.[31]

In January 2019, Yes Bank announced its plans to replace outgoing CEO Kapoor with Ravneet Gill, the former head of Deutsche Bank's India operations. The bank also appointed Maheshwar Sahu, a former civil servant, and Anil Jaggia, the former Chief Information Officer of HDFC Bank Ltd, as independent directors.[32] When Gill officially took over the reins of Yes Bank on 1 March 2019, the mood within Yes Bank was uplifted with high hopes as a "rescuer" had arrived.[33] However, the bank only managed to raise one round of funds through a share sale to institutional investors under Gill, and it did not prove to be enough to save the cash-starved bank.[34]

Tipping point

On 21 September 2019, Kapoor – together with promoter group companies Yes Capital (India) Pvt Ltd and Morgan Credits Pvt Ltd – sold a 2.75% stake in Yes Bank. The move came after news that Kapoor and the promoter group companies were looking to exit the bank. After the sale, their combined stake in Yes Bank was reduced to 6.89%.[35] This was despite Kapoor saying that "diamonds are forever" just a year prior, indicating that he would never sell his stake in Yes Bank.[36]

Yes Bank's liquidity crisis due to insufficient liquid resources and its subsequent failure to raise sufficient funding to cover its potential NPAs led to a downgrade of its credit rating, which made it even more difficult for the bank to procure funds. The rapidly deteriorating financial position of Yes Bank and absence of any credible plan for injection of capital prompted RBI to impose a month-long moratorium on 5 March 2020 which ended on 3 April 2020. The objective of the moratorium was to restrict claims and withdrawals from creditors and depositors until the situation was under control.[37]

The moratorium set a permissible limit of withdrawal capped at ₹50,000 from clients' savings accounts, current accounts or other deposit accounts. However, to allow deposit-holders to continue to afford to pay for their essential expenses and pursuits, RBI allowed individuals to withdraw up to ₹5 lakh for health-related emergencies, higher education, marriage instalments, and other "unavoidable crisis".[38]

Distressed loans and other problems

Lack of transparency and misreported figures

Under Kapoor's management, there was a trend of under-reporting NPA figures in Yes Bank's financials. The senior management at Yes Bank concealed the state of its asset quality and blindsided its shareholders and the public with reassuring words. However, due to the RBI's push for banks to disclose the full extent of their asset quality stress, Yes Bank was forced to publish revised figures.[39,40]

On 27 April 2016, Kapoor and Rajat Monga – Yes Bank's Chief Financial Officer (CFO) – issued a certification stating that the financial statements ended 31 March 2016 "[did] not contain any materially untrue statement or omit any material fact or contain any statements that might be misleading".[41] However, for FY2016, the RBI's mandatory disclosure showed that the bank's gross NPAs was ₹4,925 crore, 6.6 times of the reported ₹748.98 crore.[42] Despite that, Yes Bank continued to under-report its gross NPA figures in the following years. In FY2019, Yes Bank was found to have under-reported its bad loans by ₹3,277 crore.[43]

Yes Bank's FY2019 gross NPA of 7.4% was the fourth worst among major Indian banks. As Yes Bank under-reported its gross NPA, it also made insufficient provisions to cover its deteriorating assets. In FY2019, it reported a provision coverage of 43.1%, which was significantly lower than its peers such as the State Bank of India (63.5%), and ICICI Bank (76.1%). The data suggested that Yes Bank was at a higher risk from the unexposed part of the bad debt.[44]

Inaccurate credit ratings

When Yes Bank raised ₹3,042 crore in September 2018 through the issue of listed non-convertible unsecured bonds, the bonds were rated AAA by Care Ratings, and AA+ by India Ratings and Research (Ind-Ra).[45] This implied that the bonds issued by the bank were highly secure with a low likelihood of default. Investors showed great confidence in Yes Bank as its share price hit a record high of ₹394 per share in August 2018.[46]

After the bank's crisis surfaced in 2019, Ind-Ra downgraded Yes Bank three times in a year to a long-term issuer rating of A-, due to "continued delay and inconclusive quantum of the anticipated equity infusion".[47] Internationally, Moody's also downgraded Yes Bank's long-term foreign currency issuer rating from Ba3 to B2. This was due to recognition of the insufficient capital that the bank held, indicating the significant pressure that the bank was under unless sufficient capital was raised.[48] Yes Bank's rating by Moody's was further downgraded to Caa3 in March 2020.[49]

Financial fraud and money laundering

Rana's Yes Bank

"[Kapoor] had acted as the "prima donna," "chief conspirator" and the "architect" of a scam aimed at diverting public money to create wealth for himself and his family."

– India's Enforcement Directorate[50]

On 7 March 2020, the Central Bureau of Investigations (CBI) registered a criminal case to probe the transactions between Kapoor and DHFL Group, alleging criminal conspiracy and cheating.[51,52] Kapil and Dheeraj Wadhawan were the promoters of DHFL.[53] The economic offence wing of the CBI launched its initial investigations into alleged loan transaction deals amounting to ₹5,050 crore. It was allegedly uncovered that Kapoor abused his power and influenced Yes Bank to extend large loans to DHFL and other Wadhawan-owned companies in return for undue benefits for him and his family. Between April and June 2018, Yes Bank had invested ₹3,700 crore in short-term debentures of DHFL, allegedly in exchange for a kickback of ₹600 crore from the Wadhawans under the guise of loans to companies owned by Kapoor and his family.[54]

These investigations led the CBI to file a second case against Kapoor, his wife (Bindu Kapoor), Bliss Abode Pvt Ltd, and Avantha Realty Limited.[55] The second case alleged criminal conspiracy, cheating, and obtaining illegal gratification against Kapoor and his wife. The couple was found to have acquired a 1.2-acre luxury bungalow from Avantha Realty Limited for ₹378 crore in 2017 – significantly less than the then market value – through Bliss Abode Pvt Ltd. Kapoor's wife was a director of Bliss Abode Pvt Ltd.[56] This discounted transaction was said to be an illegal kickback to Kapoor in return for not repaying loans amounting to over ₹1,900 crore, as well as for advancing other additional loans to Avantha Group.[57]

Concurrently, Kapoor was also being investigated by the Enforcement Directorate (ED) – the agency responsible for enforcing economic laws and fighting economic crime in India.[58] On 8 March 2020, Kapoor was arrested under the Prevention of Money Laundering Act (PMLA) after 30 hours of questioning by India's ED over accusations of money laundering involving ₹4,300 crore in a suspected conspiracy between Kapoor and the Wadhawan brothers. This was reportedly because Kapoor was not cooperating in the probe.[59,60] Subsequently, the ED announced in May 2020 that it had filed an official charge sheet against Kapoor, Bindu Kapoor, their three daughters – Radha, Roshni, and Rekha – and three companies linked to his family (Morgan Credits Pvt Ltd, RAB Enterprises (India) Private Limited, and Yes Capital India Private Limited).[61] Upon further investigation, the ED discovered that many other entities were involved and filed a second official charge sheet in July 2020 against 19 individuals and entities, including the eight prosecuted earlier.[62]

It was discovered that accounts belonging to more than 44 companies under 10 large Indian business groups accounted for ₹34,000 crore of bad loans sanctioned by Yes Bank.[63] These included Cox and Kings – the second high-value borrower being investigated by the ED, after DHFL.[64] In the process of granting these loans, it was alleged that Kapoor accepted illegal gratification and the monies were diverted through various companies. These proceeds had allegedly been siphoned off, laundered, concealed or layered and integrated into the main financial system through the acquisition of properties. The estimated amount of money laundered by Kapoor and his family totaled ₹5,050 crore.[65,66]

Shell companies

A complex web of over a hundred shell companies created by Kapoor and his family as vehicles for various financial manoeuvres and fund misappropriation were uncovered by the CBI and ED. Of the 102 companies identified, Kapoor and his family members had a majority stake in 78 of them.[67] In addition, the agencies also uncovered dummy directors appointed by Kapoor on the boards of these companies.[68]

While it was not illegal for Kapoor and his family to own companies without active business operations or significant assets under Indian law, Kapoor had illegally utilised these shell companies to hide the money laundering transactions instead of conducting legitimate business.[69]

How Kapoor ran a Yes Bank

"A lot of investors thought [Kapoor] was a tiger – he is going out to hunt – and people liked it. It was an environment where people put a premium on aggression."

– Fund manager at Yes Bank[70]

Kapoor was known for his flamboyant lifestyle and penchant for publicity. His belief was to grow at any cost and he was not shy about declaring his achievements. It was reported that Kapoor previously rewarded Yes Bank's top performers with "golden pin awards" and hosted extravagant parties at his residence in an upscale Mumbai neighborhood.[71,72]

Throughout his career, Kapoor built himself a reputation of being opportunistic and ruthless – he was known to be the banker who would never say "no".[73,74] After the 2008 global financial crisis – when the market was performing poorly – Kapoor opened Yes Bank's doors to companies which were in such deep trouble that all other major Indian banks turned them away. Yes Bank often held after-work meetings with troubled companies to approve loans on conditions that no other Indian bank was willing to offer. Furthermore, Kapoor was extremely ambitious. Although Yes Bank was known to be a relatively young bank, Kapoor vowed to make it India's largest bank by 2020.[75]

Ironically, during an Annual General Meeting in 2015, he gave a mantra to the bank's 11,000 employees: "Be protective and be defensive".[76] Despite preaching such a mentality to employees, he adopted a bold and aggressive approach in his management of Yes Bank. His hunger to grow Yes Bank resulted in excessive risk-taking and growth through controversial methods. Although Yes Bank grew 26 times in size since its infancy, the bank's overall risk profile and balance sheet hole also increased significantly.[77]

Ka-poor to Ka-ching

Kapoor's aggressive and bold direction propelled Yes Bank to become the fifth largest private bank in India.[78] His success in managing and leading one of India's largest banks was rewarded with attractive remuneration as shown in Figure 1 below.

	FY 2015	FY 2016	FY 2017	FY 2018
Salary, bonus, pension, LTA and medical	₹44,172,996	₹54,556,849	₹40,613,414	₹64,841,390
Value of perquisites	₹10,149,217	₹11,428,506	₹9,743,654	-
Others	₹2,395,869	₹2,732,424	₹3,154,436	-
Total	₹56,718,082	₹68,717,779	₹53,511,504	₹64,841,390

Figure 1: Kapoor's remuneration packages between FY2015 and FY2018[79,80,81,82]

After numerous breaches of corporate governance and regulations surfaced, the amount of compensation received by Kapoor suffered. However, the total remuneration package granted to Kapoor for FY2017 remained substantial at ₹53,511,504.[83] It was reported in Yes Bank's 2018 annual report that the board of directors had clawed back all the performance bonuses paid to Kapoor from FY2014 to FY2015. No bonuses were paid to Kapoor for FY2016 and FY2017.[84] This was in line with RBI's recommendations after its intervention in the bank's affairs in 2018.[85]

Even after his removal as MD and CEO of Yes Bank in 2019, Kapoor sought to rejoin Yes Bank's board and the recoupment of "crores of rupees" as compensation for lost remuneration.[86]

Yes, even if others say no

"After every storm there is a rainbow, but Rana Kapoor was faced with the biggest storm of his life after experiencing the hues of rainbow for decades."

– *Amol Dethe, The Economic Times*[87]

As the CEO of Yes Bank, Kapoor controlled the bank's decisions on loan transactions. Many of these highly suspicious transactions were being investigated by the CBI.[88] It was discovered that many transactions involved a conflict of interest between Kapoor and Yes Bank. Such transactions had to be disclosed to the board of Yes Bank and the Management Credit Committee (MCC). However, Kapoor, who was the head of the MCC, approved these transactions without disclosing them. This was a violation of Yes Bank's code of conduct and certain provisions of the Companies Act.[89,90]

In particular, the CBI flagged out the 2017 bungalow acquisition by Bliss Abode Pvt Ltd, in which Kapoor granted the approval for the issuance of a no-objection certificate from Yes Bank. Despite being a related party and having a conflict of interest in the arrangement, Kapoor violated the bank's code of conduct and did not disclose the transaction to the board and management of Yes Bank.[91] In another case, in April 2018, Kapoor had pledged shares of unlisted Morgan Credit Pvt Ltd – one of Kapoor's investment arms through which he controlled Yes Bank – to raise ₹950 crore from Nippon Mutual Fund. This price sensitive information was neither disclosed to Yes Bank's board nor the bourses, creating "an opaque layer" between him and stakeholders.[92]

Once the poster boy of Indian banking industry,[93] Kapoor is now a shadow of his former self. In September 2020, SEBI levied a fine of ₹1 crore on him for not making disclosures regarding a transaction of Morgan Credit Pvt Ltd. As Kapoor failed to pay the fine, SEBI instructed banks, depositories and mutual funds not to allow any debit from his accounts in March 2021.[94] Apart from his affairs with Yes Bank, the ED also uncovered another money laundering case involving Kapoor and PMC Bank. As a result, Kapoor – who was already in judicial custody after he was arrested in connection to Yes Bank's financial irregularities and money laundering in March 2020 – was once again arrested by the ED in January 2021.[95]

The Yes Bank board

Prior to the takeover of Yes Bank by RBI in March 2020, Yes Bank had eight directors on the board. Kapoor was on the board as the CEO and Chawla acted as the non-executive, independent Chairman of the board. Chawla was appointed to the Yes Bank board in March 2016 and subsequently took on the role of Chairman in October 2016 for a period of three years. He was previously India's finance secretary before joining the Yes Bank board.[96] The rest of the board comprised five independent directors and one non-executive, non-independent director.[97]

Apart from Kapoor and Chawla, only two of the directors – Vasant Gujarathi and Ajai Kumar – had experience in the financial services industry. The remaining three independent directors had backgrounds ranging from civil service to marketing. In total, the board established 12 committees, including the Audit Committee, Risk Monitoring Committee, Nomination and Remuneration Committee and the Board Credit Committee.[98]

Prior to stepping down as MD and CEO, Kapoor was part of eight of the 12 board committees, namely the Risk Monitoring Committee; Nomination and Remuneration Committee; Stakeholders' Relationship Committee; Corporate Social Responsibility Committee; Service Excellence, Branding and Marketing Committee; Fraud Monitoring Committee; Capital Raising Committee; and Board Committee on Willful Defaulters and Non-Cooperative Borrowers.[99]

Persistent corporate governance failure

"The action of the bank to invoke 'malus' for these executives and not to invoke 'clawback' for the MD & CEO, is indicative of the poor governance standards prevailing in the bank."

– RBI, in a letter addressed to Yes Bank[100]

When the underreporting of NPAs and money laundering scandal came to light, Yes Bank's board faced criticism for its poor internal management and inadequate board-level supervision leading to poor corporate governance within Yes Bank.[101] Despite the existence of a Risk Monitoring Committee and the Board Credit Committee, the board neither stopped the MCC from distributing and evergreening risky loans nor addressed the corporate governance issues within the bank.

Further, through an exchange of letters between Yes Bank and RBI, the two parties went back and forth on remuneration matters for individuals who contributed to the regulation breaches. In a letter sent to Yes Bank dated 11 April 2018, the RBI asked the bank's board of directors to consider clawing back the substantial bonus paid to CEO Kapoor for the FY2014 and FY2015. In a response letter dated 28 August 2018, Yes Bank informed RBI that it came to a decision that a number of Kapoor's direct subordinates would not be paid any outstanding bonuses due for previous financial years but failed to address whether any actions would be taken against Kapoor. The RBI found this unacceptable and informed the Yes Bank board that its proposal reflected the poor governance standards which prevailed in the bank. It was only after this slap on the wrist did Yes Bank agree to follow through with RBI's proposal. Dissatisfied with Yes Bank's lack of improvement in its corporate governance, RBI highlighted that the penalties were only initiated after RBI's letter and not "as compliance actions in normal course".[102]

Yes men have longer lifespans

"Rana Kapoor only liked yes men. He was the final authority and many times loan applications were rejected without giving any reason. I am not sure that the board members knew about all the dealings. But, yes, there was a feeling that all is not well with the bank."

– Former senior executive at Yes Bank[103]

It is also widely speculated that Kapoor preferred to work with "yes men".[104] As Kapoor was part of the Nomination Committee, he was able to recommend board candidates and influence hiring decisions. Most notably, Chairman Chawla was said to have a close personal relationship with Kapoor. In an effort to extend Kapoor's term as MD and CEO in Yes Bank, Chawla personally met then RBI governor, Patel, in person to try to convince him to approve the three-year extension.[105]

As a result of the blurred relationship, the board of directors was seen to have failed to act as a check and balance on Kapoor's actions. For instance, after the misreporting of financial statements in FY2017, the board failed to take corrective actions and allowed Kapoor, the Audit Committee, CFO and the auditors to continue in their respective positions. As such, Yes Bank continued to misreport its financial statements for two consecutive years, casting doubts on the accuracy of its subsequent financial statements.[106]

Behind the PR charm lay poor risk management

Yes Bank had established a clear risk management framework by addressing the three lines of defence for risk management. Based on its annual reports, the bank imposed comprehensive credit risk management and operational risk management policies to regulate their day-to-day activities. There was also delegation to management to design processes and controls to manage risks, and independent assurance with an internal audit department coupled with external auditors.[107]

At the board level, risk management was overseen by five board-level committees. They are the Risk Monitoring Committee, Audit Committee, Fraud Monitoring Committee, Board Committee on Wilful Defaulters & Non-Cooperative Borrowers, and Board Credit Committee (BCC). These committees endeavour to implement relevant policies, frameworks and systems to enhance the risk management ability of the bank.[108]

However, the policies implemented were ineffective in regulating Kapoor's actions. After the arrest of Kapoor, the ED interviewed the top executives of Yes Bank and disclosed that despite objections from the risk team to proceed with specific high-risk loans, Kapoor failed to adhere to its advice and chose to override its decisions. It was uncovered that a loan to Belief Realtors Private Limited (BRPL) – a company controlled by the Wadhawans – amounting to ₹750 crore was approved by Kapoor despite the risk team's objections. The Yes Bank risk team highlighted issues in connection with BRPL's proposal for which the loan was required, such as the majority of project approvals not being in place, the fact that slum evacuation had not started then, and the irregularity in carpet area between the letter of intent issued by Slum Rehabilitation Authority and BRPL's proposal. However, Kapoor overruled all its objections.[109]

Regulators turned a blind eye

"The RBI has a supervisory role over all banks and is responsible for enforcing banking standards and addressing red-flag issues. When, how and at what time it acts are of crucial significance to the overall health of the banking industry,"

– Sanjay Bhattacharyya, former MD of State Bank of India[110]

Many governance and accounting issues, as well as suspicious activities, in Yes Bank had already come to light in the years leading up to the collapse of the bank. The RBI faced scathing criticism from the public, who said that the regulator was slow to act.[111] They believed that RBI should have been notified of Yes Bank's problems as early as 2014, when Yes Bank's advances grew abnormally. Despite poor investment rates in India, Yes Bank's loan book multiplied by four times in the span of five years. This huge increase in loan book despite the poor market outlook should have raised alarm bells for RBI.[112] Amit Tandon, founder and CEO of proxy advisory firm Institutional Investor Advisory Services, lamented that "there should have been tighter monitoring, more timely intervention, fixing accountability early, getting the incentive structure for senior management right and, most importantly, clear communication."[113]

Furthermore, the RBI had a representative on Yes Bank's board. Rama Subramaniam Gandhi, the RBI's former deputy governor, was appointed to the Yes Bank board as an additional director in May 2019 for a two-year term after it identified significant understatements in Yes Bank's reported bad loans. However, less than a year later, Yes Bank collapsed, necessitating an expensive bailout by State Bank of India (SBI) and seven private sector banks. In this regard, observers in the industry argued that given the full access to information Gandhi had, he could have alerted RBI about the full extent of issues faced by Yes Bank well in advance but failed to do so.[114,115]

In RBI's defence, it did attempt to clean up Yes Bank in the years leading up to its collapse. In September 2018, the RBI blocked the re-appointment of Kapoor as MD and CEO for another term after an investigation had found the bank evergreening loans under his watch.[116] However, it was too little too late.

Many bankers also pointed out that it was the market's belief that Yes Bank could have pulled through on its own. This was because several large foreign financial firms such as Citax Holdings, JC Flowers and Tilden Park Capital Management were knocking on Yes Bank's door as potential investors.[117] Furthermore, RBI was aware that clamping down on a private sector bank would likely cause panic and disruption to the financial sector, preventing it from making such decisions prematurely.[118]

Whistleblowers get involved

In September 2018, an anonymous whistleblower alerted Yes Bank's management to the irregularities in the processes of the bank, potential conflicts of interest concerning Kapoor, and incorrect classifications of NPAs. In response, the bank's management – led by Kapoor – began investigating these allegations under the supervision of the board, and subsequently the Audit Committee engaged an external investigator, JLN US & Co. (JLN), to independently look into the whistleblower complaint.[119]

The special audit conducted by JLN confirmed the whistleblower's complaint that excess payments were given to employees working in close relation with Kapoor. However, JLN was unable to thoroughly investigate all the allegations raised as it had limited access to documents. In particular, data relating to transactions carried out by Kapoor's family office was not made available to JLN. The special report issued by JLN was thus inconclusive and Yes Bank's statutory auditor, BSR & Co. requested for a fresh audit into this issue.[120]

More finger pointing

Audit crisis in India

In 2018, India witnessed an audit crisis when auditors of over 204 listed firms resigned between 1 January and 17 July 2018, citing vague reasons such as lack of adequate information and preoccupation with other assignments. This occurrence could be attributed to the Indian government's moves in respect of audit firms. Various ongoing probes and forensic audits into the books of the client companies found numerous lapses in auditing by the audit firms. Thus, as a preventive measure, audit firms were increasingly cautious in their association with suspicious companies, which might give them a bad reputation.[121,122]

The exodus of auditors raised questions on the standard of corporate governance in India and demonstrated the exit route auditors could take without penalty.[123]

Credit rating agencies, wrong priorities

Credit rating agencies have also received their fair share of the blame following the unravelling of the Yes Bank crisis. In the wake of collapses of Indian companies such as IL&FS and DHFL, it was contended that credit rating agencies had repeatedly failed to alert investors about impending defaults in a timely manner and instead issued sharp downward revisions to ratings of instruments which were supposedly of high credit quality. Questions were also raised over the 'issuer pays' model, whereby credit rating agencies are paid by issuers of financial instruments for ratings of a security. The public then gets access to these ratings at no cost. Under such a model, credit rating agencies could face pressures to give favourable ratings from the issuers who paid them. This invariably results in a conflict of interest.[124,125]

In India, there are seven rating agencies, all of which are regulated by SEBI and RBI. In view of such competition, credit rating agencies have little bargaining power and might issue more favourable ratings – regardless whether the ratings were supportable – to attract business and earn more revenue. At the same time, with the variety of credit rating agencies available, companies could also engage in "rating shopping" and engage credit rating firms which are willing to give them a good rating at a lower price point. On many occasions, the credit rating agency which quoted the lowest price or promises an investment-grade rating beforehand would win the offer. This has resulted in a deterioration in quality of the assessments carried out by credit rating agencies in India.[126,127]

Regulatory enforcement – Dormant and unimportant

"India's financial sector broadly needs to raise governance standards and restore trust…The central bank's assessment of nonperforming loans for a number of banks was higher than lenders' own assessments, suggesting transparency was poor at the institutions."

– S&P Global Ratings[128]

Despite the blatant misreporting of Yes Bank's financial statements year after year, the banking and capital market regulators did not take any severe actions apart from issuing the bank a nominal fine. As a result, Kapoor and his associates continued certifying the fudged financial accounts, misleading investors into thinking the bank was in tip top shape. This led Hemindra Hazari, a specialist in Indian banking and economic research, to believe that "such actions by the regulators are merely symbolic and will instead encourage banks to repeatedly mislead investors and the public".[129]

"Dependent" independent directors

In the light of the recent cases of alleged fraud and irregularity in India, the spotlight also fell on independent directors who were seen to stay loyal to and toe the promoter's line, primarily because they are handpicked by the promoter or the CEO. Directors also frequently do not challenge the promoters as they did not have skin in the game. In the few cases where independent directors voiced their concerns, they were either booted out or did so after they issued their resignation letters. For instance, in 2016, industrialist Nusli Wadia was removed from the boards of Tata Motors, Tata Steel and Tata Chemicals after he highlighted corporate governance lapses at Tata Sons Ltd.[130] When Yes Bank director Rentala Chandrashekhar resigned from his position in November 2018, he questioned the corporate governance practices at Yes Bank in his resignation letter.[131] This was similarly echoed by Yes Bank's independent director, Uttam Prakash Agarwal, who resigned in January 2020 over "deteriorating corporate governance standards and compliance failure" at the bank.[132]

Diamonds to dust

"Yes Bank is a large private sector bank. The decision to not let it sink and the decision to revive it was taken by public sector banks and private banks together with the RBI,"

– Deepak Parekh, HDFC Bank Chairman[133]

On 6 March 2020 – one day after the 30-day moratorium was announced – RBI revealed a draft "reconstruction scheme" for Yes Bank.[134] Over just two days, RBI placed Yes Bank under a moratorium, took over its board, announced SBI as a potential buyer of a 49% stake in the distressed bank, proposed to substantially write down Yes Bank bonds, and cut its capital and share base, among other measures. Following the announcement, Yes Bank's share price fell as much as 96% from its record high of ₹394 in August 2018.[135]

As part of the rescue package, SBI procured a 49% stake in Yes Bank at ₹10 per share, representing a premium of ₹8 per share.[136] This contributed fresh funds of ₹6,050 crore into Yes Bank.[137] Seven other Indian lenders took a combined 30% stake in Yes Bank. Together, the eight banks helped to increase deposits in Yes Bank by about ₹12,000 crore to ₹117,000 crore by the end of June 2020.[138]

In July of the same year, SBI's board approved an investment of up to ₹1,760 in Yes Bank's follow-on public offer (FPO). Through the FPO, Yes Bank aimed to raise ₹15,000 crore. Although it only managed to raise ₹14,267 crore with a FPO subscription rate of 95%, SBI funded the shortfall.[139] The new capital reduced the rescuing banks' combined shareholding to 45%, with SBI's stake dropping to 30%.[140]

Under the reconstruction scheme, RBI and SBI looked to establish a new board of directors in Yes Bank. SBI would appoint nominee directors on the board of the reconstructed bank, while RBI was allowed to appoint additional directors to the board. The members of the new board would continue in office for a year, or until an alternate board is constituted by Yes Bank.[141] The first new appointment was Prashant Kumar as MD and CEO. Kumar formerly held the position of CFO and deputy MD at SBI and was designated as Yes Bank's administrator by RBI. Next, Sunil Mehta was appointed to the board as Non-Executive Chairman, armed with his past experience as Non-Executive Chairman of Punjab National Bank. Additionally, Mahesh Krishnamurti and Atul Bheda were given non-executive director roles.[142]

On 14 March 2020, India's Union Cabinet approved the Yes Bank reconstruction scheme. Finance Minister Nirmala Sitharaman said that the scheme's aim was to "safeguard depositors and ensure the stability of the financial system".[143] After the news broke, Yes Bank's share price closed at ₹25.55 per share, representing a 424% jump from a low of ₹5.65 the week prior.[144]

Additionally, Yes Bank made plans to sell some of its NPAs to different asset reconstruction companies. The bank had already made provisions of ₹24,476 crore, representing 76% of its gross NPAs. The move came after Yes Bank sold bonds held in DHFL to raise ₹500 crore.[145,146]

Is Yes Bank saying its goodbye?

The Yes Bank case is one of how India's fifth largest private bank was brought to its knees by its leader's personal greed and ambition. In light of its material accounting misstatements and CEO's money laundering scandal, Yes Bank lost the trust and confidence of many of its stakeholders.[147] Fortunately for Yes Bank, the reconstruction scheme initiated by an SBI had given the distressed bank a new lease of life. Although the worse seems to be over, the road to recovery remains long.

Discussion questions

1. What are the factors that contributed to the eventual downfall of Yes Bank? Evaluate which were the most significant factors and explain why.

2. Critically evaluate the corporate culture of Yes Bank. How did Rana Kapoor and the board of directors perpetuate this culture? What are the potential dangers of having such a culture?

3. Discuss the role and responsibilities of the board of directors of Yes Bank, apart from Rana Kapoor. Did the board of directors of Yes Bank fulfil their director duties and obligations? Explain.

4. Evaluate whether the remuneration packages awarded to Rana Kapoor from 2015 to 2018 were reasonable. Was the decision by the board to approve such substantial remuneration to Rana Kapoor justifiable? Explain.

5. Rana Kapoor had roles on multiple committees within the bank. Did these appointments lead to corporate governance issues and contribute to Kapoor's alleged involvement in money laundering and financial fraud? Explain.

6. Comment on the regulators' handling of Yes Bank's crisis. To what extent do you think they were at fault? Assuming you are a regulator in the case of Yes Bank, what else would you have done to prevent such a scandal?

7. To what extent do you think financial scandals such as the Yes Bank scandal depend on:
   (a) internal factors such as the management and company culture; and
   (b) external factors such as India's regulatory and governance landscape?

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AIRBUS: FLYING ON THE WINGS OF BRIBERY

Case overview

Airbus Group (Airbus), one of the world's leading players in the aircraft supply industry, was embroiled in a major bribery and corruption scandal that triggered probes from prosecutors worldwide. On 31 January 2020, it agreed to pay a record US$4 billion in settlement after reaching a plea bargain with prosecutors in Britain, France and the U.S. over rampant corruption and misconduct in the last 15 years. This massive bribery scheme involved many countries including Taiwan, Indonesia, Malaysia, China, Nepal, Russia, and Colombia. Huge amounts of cash incentives and luxurious gifts were transferred to the pockets of airline directors and government officials to secure deals. This was largely done under the supervision of the Strategy and Marketing Organisation, a division dedicated to securing sales in emerging markets.

The objective of this case study is to facilitate a discussion of issues such as organisational fraud and bribery; corporate culture; failure of internal controls and compliance functions; the four lines of defence; cross border challenges of doing business; and severance packages.

Welcome on board

Headquartered in the Netherlands,[2] Airbus' journey began in 1965, when the French and German governments initiated plans to develop a high-capacity, short haul jet transport company in Europe.[3] Subsequently, the European Aeronautic Defence and Space Company (EADS) was formed following the combination of three European companies: Aerospatiale-Matra, Deutsche Aerospace AG, and Construcciones Aeronáuticas SA in 2000.[4] It was then listed on the Paris Stock Exchange, Frankfurt Stock Exchange and Spanish stock exchanges in Madrid, Bilbao, Barcelona and Valencia.[5] In January 2014, EADS was renamed as Airbus Group.[6] The parent company of the Group is Airbus SE, which controls all activities within the Group.[7]

From 2004 to 2016, Airbus Group witnessed several restructurings.[8] Currently, the activities of Airbus are organised into three divisions. The bulk of its revenue comes from the commercial aircraft division, which manufactures and sells civilian aircraft to airlines. The other two divisions are the defence and space division, which manages military aircraft, satellites, intelligence and security systems used by governmental agencies; and the helicopters division, which distributes civil and military helicopters.[9]

This case was prepared by Ding Zheming, Kong Zhen Hao, Stanford, Lim Zheng Xiang, Necia Rica Coleen Ng Jia Min, Nicole See Wan Yi, and Ong Jia Hui, and edited by Sheethal Shanbhogue 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 organizations named in the case, or any of their directors or employees.

Financial performance

Airbus has generally achieved strong financial performance over the past two decades. Apart from fluctuations between 2004 and 2009, sales and profits had been increasing steadily before it suffered a net loss in 2019.[10]

Similar trends can be observed in its share price. Before the announcement of the settlement and the onset of the COVID-19 pandemic, Airbus' share price has generally seen tremendous gains in the past two decades, hitting an all-time high of €139.00 on 24 January 2020. In the following three months, its share price suddenly fell to a record low.[11] However, since mid-2020, when the COVID-19 situation started to stabilise and with governments taking actions to fight the pandemic, the company's share price has been steadily recovering, as seen in Figure 1.

Figure 1: Share price movement of Airbus SE[12]

Intense competition

Since its establishment, Airbus has developed an intense rivalry with its biggest competitor, The Boeing Company (Boeing), with the two effectively becoming a duopoly in the industry.[13] In the first two decades following Airbus' establishment, it progressively increased its market share to 30% of new orders in the early 1990s, while Boeing maintained its market share of over 60%.[14] Airbus continued acquiring market share, causing Boeing's share of new orders in 1998 to slip to 54%. This created fierce competition between both companies as they tussled for market share in the sale of commercial aircraft.[15]

Adding to the intensity of competition is the complex and time-consuming process of striking a plane deal. Former Airbus Chief Executive Officer (CEO) Jean Pierson called the courtship of clients and customers the "Dance of the Seven Veils",[16] where aircraft suppliers took turns to make their sales pitches to airlines, with each supplier attempting to sweeten the deal in its own way to stand out from others. Very often, the negotiation outcome would be unpredictable since competing suppliers have no information about their competitors' offers. There would only be one ultimate winner clinching the coveted deal, while the other suppliers leave negotiations empty-handed.[17]

Flight to the top – the shaping of Airbus' corporate culture

"He really moves the metal. He is indefatigable. When he smells a deal he will dig in until he has done it, but he is also good – he takes the trouble to understand our business."

– Cathay Pacific CEO Tony Tyler, on John Leahy[18]

John Leahy, the former Chief Commercial Officer of Airbus, was known as Airbus' "top salesman". He drove over 90% of Airbus' deliveries and played a huge role in helping Airbus close the gap on Boeing.[19] Things were, however, very different before his arrival.

When the American Chief Commercial Officer first arrived in Toulouse, France – home to Airbus' head operating office[20] – it created an extreme culture shock for the French who were very comfortable and familiar with a traditional and cordial approach of doing business. He demanded many of the office's walls be taken down to fulfil his vision of creating an open-plan office, a move that was akin to "shaking the cobwebs off" in what was described as a "gentlemen's club".[21] An extremely demanding and driven leader, Leahy set high expectations for those working under him, and was known by his French colleagues as "the hyperactive American",[22] due to the various ways in which he went about to reinvigorate the otherwise dreary and monotonous culture at the office. This included convening sales meetings over the weekend, a practice which was previously unheard of in the Group.[23]

Leahy was confident about his ability to bring Airbus to greater heights. During a board meeting in 1995, Leahy famously told the board he aimed to win 50% of the aircraft market, causing great shock and incredulity to the board, which felt that Leahy needed to "stop dreaming".[24] Nevertheless, Leahy's boss, then-CEO Pierson, also echoed Leahy's sentiment about pushing Airbus to greater heights and going head-to-head with Boeing. Pierson once remarked, "In a world market, with up to 20% you are nothing. At 20 to 40 you start to be a danger and can go to 50. We needed to get out of the 20 – 40 cave."[25]

Leahy gained a reputation for sealing many major deals through unconventional sales tactics that were previously unheard of in the industry, such as "walkaway clauses" or "buy small, think big" deals.[26] A walkaway clause was once offered to American Airlines in a deal for 25 A300 airplanes in 1987. Leahy remarked: "We knew we were as good as we were claiming, so it wasn't an enormous risk".[27]

Earlier in 1986, Leahy had also extended a deal to Northwest Airlines under which the airline could place a firm order for 10 A320 jets, but Airbus would provide them with the pricing and delivery dates for 100 jets. In Leahy's words, it was a risk that Airbus was taking, as "if [Northwest Airlines] didn't like the Airbus planes, that's it. [It's] stuck with 10. We'll take the risk on the rest of them".[28] Nevertheless, Leahy's gamble paid off as Northwest Airlines eventually bought 145 planes.[29] Such sales tactics by Leahy allowed Airbus to seal major deals that were based on much smaller initial commitments.

As such, many considered Leahy to be the most prolific salesman in the industry, and he was pivotal in lifting Airbus to the top in global sales as early as 1999.[30]

A tainted industry

In the past decade, there have been many notable cases of corruption within the aerospace industry, such as those involving BizJet International Sales and Support, Inc. (BizJet) and The Nordam Group Inc. (NORDAM). BizJet, which provides aircraft maintenance, repair, and overhaul (MRO) services, paid US$11.8 million for breaching the Foreign Corrupt Practices Act (FCPA) over alleged payments through shell companies to Latin American companies in the hope of securing lucrative contracts.[31] NORDAM, another MRO provider, agreed to pay a US$2 million criminal penalty for breaching the FCPA over alleged payments to officials of Chinese airline companies to secure MRO contracts.[32]

Companies conducting business on an international scale have to maintain greater oversight of their operations to ensure that they comply with anti-corruption and anti-bribery laws in various regions.[33] Companies in the aerospace industry face an elevated risk of prosecution and regulatory enforcement. According to global law firm Ropes & Gray LLP, the industry is the third-most investigated, prosecuted, and fined industry in the world, and is subject to enhanced regulatory scrutiny.[34]

The heightened risk of corruption in the aerospace industry is a result of various factors inherent in the industry.[35] Firstly, a high proportion of customers in the industry are government or state-owned entities.[36] Secondly, contracts for services and products generally involve huge sums of money and are extremely lucrative.[37] Thirdly, companies in the aerospace industry operate in an environment that is highly regulated, therefore subjecting them to higher scrutiny. This can motivate companies to come up with more creative ways to cover up corrupt payments.[38] Lastly, in a number of countries with high corruption risk, it is a requirement for third-party agents to play a role in the procurement process.[39] These factors increase the risk of bribes or corrupt payments paid to foreign officials or employees of state-owned enterprises during the course of conducting business, and consequently expose companies to greater risk of facing regulatory action.

In 1988, Airbus secured a deal with Air Canada for the sale of A320 aircraft. However, it was later discovered in 1995 that it paid CA$20 million in bribes to International Aircraft Leasing to secure this deal.[40] Between 1996 and 2000, Airbus was found to have offered €15 million to a former top Korean Air executive in exchange for a deal involving the purchase of 10 A330 jets. The amount was transferred through a fictitious consulting contract via a middleman.[41]

Hitting turbulence

Airbus was flying high in 2004 as commercial aircraft orders peaked and the A380 super-jumbo jet was set for its debut.[42] However, its fortunes began going downhill from mid-2005. Despite making its maiden test flight on 27 April 2005, it reported in June that year that the A380 super-jumbo jet was behind its delivery schedule due to production problems, with orders from major airlines such as Qantas, Emirates and Lufthansa delayed by up to six months.[43] In June and October 2006, Airbus announced further delays of up to a year, sending its shares tumbling in 2006.[44] These delays led to significant financial penalties and losses as the consolidated net income plunged from €1,030 million in 2004[45] to a net loss of €437 million in 2007.[46]

The series of delays also led to further controversy. Former co-CEO Noël Forgeard resigned after he was found to have sold his shares three months before the delay of the A380 super-jumbo jet was announced. Investigations by the Autorité des marchés financiers, the French stock market regulator, also revealed that 1,200 insiders had sold 10 million shares between May 2005 and June 2006,[47] which included 21 top executives of the aerospace firm.[48] Forgeard was later replaced by Louis Gallois in July 2006,[49] who was subsequently succeeded by Thomas Enders.[50]

Shortly after his resignation, Forgeard came under fire as the authorities investigated his severance package of €8.5 million as a possible misuse of company funds. This controversy was further exacerbated by how the generous severance package came during a period when the company was laying off thousands of workers.[51] Similar controversies later re-surfaced for severance packages paid to Jean-Paul Gut – the former head of strategy and marketing – and Enders, who subsequently shut down the Strategy and Marketing Organisation (SMO) which he termed "Bullshit Castle".[52]

Bribery engine

In 2008, the SMO was created to support sales across all divisions of Airbus. SMO comprised a few divisions, including SMO International (SMOI). The main role of SMOI was to supervise the Group's business development activities by ensuring that commercial intermediaries, also referred to as business partners (BPs), selected by the sales team were independent of Airbus' customers. This was done by conducting compliance risk assessments on all third-party relationships.[53]

During its existence, SMOI carried out development activities relating to the Airbus commercial division, such as the management of BPs and International Market Development (IMD) projects.[54] From 2008, an annual budget of US$300 million[55] was set aside for SMO, which ultimately facilitated the massive bribery scheme. This was done with the objective of attracting business[56] and gaining undue advantages in the industry. In addition, the defence and space, and helicopter divisions also had relationships with some of the same BPs.[57] Hence, SMOI was essentially involved in managing BPs across the entire Group.

While SMO was responsible for agreements and payments of BPs, approval to enter into formal agent relationships with BPs and IMD projects was the responsibility of the Company Development and Selection Committee (CDSC)[58] The CDSC comprised primarily the Group's Chief Compliance Officer, and SMO's head of international compliance, head of international relations, and general counsel. The composition of the rest of the committee varied between the Chief Financial Officer (CFO), Chief Strategy and Marketing Officer and SMO's head of administration and controlling at different points of time.[59] Even though they were not CDSC members, division representatives were also entitled to attend CDSC meetings.[60]

The CDSC established two subcommittees, the sub-CDSC and the pre-CDSC. The former was responsible for proposing the engagement of BPs while the latter was responsible for proposing IMD projects, both of which were validated by the CDSC. These proposals were then subsequently subjected to due diligence by the SMO before recruiting any BPs or investing in IMD projects. However, both subcommittees were helmed by the head of SMOI operations, which allowed SMO to review the work submitted by themselves.[61] It later emerged from investigations that information presented to the committees were either misleading, inaccurate, or incomplete. It was also found that SMO conducted due diligence hastily, and sometimes even ex post facto, after the subcommittees had already given their approval.[62]

In addition, the CDSC approved proposals submitted by the subcommittees without carrying out its own detailed examination of the proposed investment or terms. In several cases, proposals requiring remuneration in excess of US$15 million, which was the cap set by Airbus' internal guidelines for payments to intermediaries, were approved.[63]

Adding a coat of paint

"Compliance is buying the story, we now only need to 'justify' your past experience."

– SMOI manager (name unknown)[64]

Subsequent investigations by French Parquet National Financier (PNF), the French National Financial Prosecutor, also revealed deliberate attempts to conceal bribes paid via indirect means such as fictitious loans, which made it almost impossible to identify the nature and content of the services the intermediaries had provided to Airbus. This was done by either avoiding the preparation of detailed reports of the activities conducted, or by providing fake reports written by Airbus employees whom SMOI had specifically hired for this purpose.[65]

Additionally, some BPs were stated to be involved in sales campaigns on paper, when in reality they were not. Alternatively, they were engaged via shell companies to conceal their involvement. This was done to bypass the maximum compensation amounts of US$15 million, and to transmit funds to third parties in complete secrecy.[66]

In 2007, Airbus entered into an agreement to sell Air Arabia 34 A320 aircraft, and options for an additional 15 A320 aircraft. To fulfil the US$10 million "concealed compensation" an Airbus Middle East executive promised to pay, the pre-CDSC recommended using a financial structure like a "vehicle without capital links" to Airbus.[67] In its ruling, PNF noted that instead of questioning the principle of the transaction, the committee had sought a more discreet way to perform the transaction.[68]

In another scheme involving the Russian Satellite Communications Company, Airbus' defence and space division engaged a BP via a retroactively signed contract. A SMOI executive later admitted the intermediary's involvement was fictitious and explained the objective was "to transfer funds to ultimate beneficiaries by removing any trace of Airbus as the originator of the payments".[69] Frequent discussions also transpired between the executive and BP on how he should circumvent requests made by Airbus' compliance department on the "commercial intermediary" engagement process.[70]

Where's the money?

"I have made a commitment: all payments will be made in a manner acceptable to both parties. Our intention is also the same as yours: "do not create discomfort"."

– Chinese BP (name unknown)[71]

Over the course of the bribery schemes, Airbus also found itself repeatedly under pressure to pay its BPs.

In yet another bribery scheme, Airbus executives repeatedly delayed payments demanded by a BP which was engaged to facilitate payments to officials who approved the general term agreements relating to the sale of aircraft to the Chinese government and airlines. This led to repeated warnings that the lack of a "monetary commitment" was putting the BP "in a difficult position".[72] To resolve this impasse, another BP was brought in to wire the payments of €10.3 million to the main BP. The money was first transferred to a Lebanese bank account under the latter BP and then subsequently transferred to the original BP under the cover of a fictitious loan agreement signed retroactively. An internal SMO spreadsheet later revealed a further €13 million was due to be paid in 2015.[73]

Similarly, following the signing of a memorandum of understanding in relation to a sale of one A330 and one A320 aircraft to the Nepal Airlines Corporation in November 2009, the Nepalese administration opened an inquiry into the procurement process. In response, a BP emailed a SMOI manager, stating "the lack of effective convincing from top to bottom and left to right of the Nepalese authorities needed to be addressed". Specifically, the BP asked Airbus to "support the project" and "to urgently take the necessary steps in order to make this small project succeed".[74]

Would you like to have some fun(d) in Hawaii?

Airbus also resorted to gifts and sponsorships. In 2011, Airbus China established the China Aviation Cooperation Fund (the Fund) and made US$24.2 million worth of monetary contributions to the fund.[75] On paper, the Fund was used to support projects such as "aviation related management education, seminars and pilot educational facilities."[76] In reality, it was used to make payments to event agencies for hosting social events catering to Chinese government officials, Chinese airlines executives, and their families.[77]

According to the U.S. District of Columbia Court, Chinese officials and executives were frequently invited to travel to the U.S. to participate in all expenses-paid events in Park City, Utah, and Maui, Hawaii.[78] For instance, from 28 July 2013 to 2 August 2013, Airbus hosted an event at a luxury resort in Maui that included golf, scuba diving, snorkelling cruises amongst others, and invited Chinese officials and executives to participate in it. Aside from a daily early morning half-hour business-related presentation and side meetings with airlines, the rest of the event was dedicated to leisure and entertainment activities.[79]

Political contributions

Airbus was also found to have wilfully opted against disclosing its monetary political contributions for the sale of military aircraft to the governments of Ghana, Indonesia, and Vietnam. It therefore violated disclosure requirements under Part 130 of the International Transfer of Arms Regulations (ITAR) and the Arms Export Control Act.[80] Such failures were found to have occurred regardless of whether the BP involved in the dealings was associated with SMO.[81]

As early as September 2009, a senior compliance employee at Airbus' defence and space division circulated a memorandum entitled "Part 130 ITAR-U.S. Requirements Under the International Traffic in Arms Regulations for Providing Information on Fees, Commissions and Contributions".[82] In April 2010, the division's senior export compliance staff, which included the aforementioned employee, discussed the need to establish processes to report political contributions, fees or commissions to the Directorate of Defence Trade Controls.[83] However, these discussions did not lead to any action until 30 December 2016.[84]

Before Airbus instituted an ITAR 130 compliance policy, ITAR license applications were often signed by export compliance personnel in each Airbus business unit. Despite knowing how BPs were used, they did not personally verify the payments for political contributions and failed to inquire with sales personnel before attesting that no political contributions were paid in the sale of military aircraft. It was also found that the ITAR license applications used by Airbus had a "standard language" that no political contributions, fees, and commissions had been paid.[85]

Whistles are blown

In 2012, former military officer Ian Foxley blew the whistle on bribes amounting to millions of pounds paid by GPT Special Project Management Ltd (GPT) – a subsidiary of Airbus – to officials from Saudi Arabia. After coming across a payment for "bought in and outsourced services" which cost more than the fees GPT was paying its prime contractor, and which were provided without any service in return, Foxley obtained and submitted documents that proved "a history of bribes" dating back to 1978, to a brigadier from the U.K. Ministry of Defence (MoD).[86]

In the process, he conversed with the GPT's former financial controller, Michael Paterson, who had previously tried to blow the whistle.[87] Paterson was previously told to sign off "luxury cars and jewellery" intended to bribe government officials.[88] He raised concerns regarding these payments to his superiors and compliance officers. However, all of his concerns were dismissed and he was eventually demoted for trying to blow the whistle.[89] Subsequent discussions with his managing director, which included the director for human resources and the Saudi Princess, grew "heated" as the managing director "threatened to have him arrested for theft of confidential information".[90] Foxley quickly sensed that if the "Saudi Princess rings the police...and accuse[d] [him] of theft", he would be "dead in the water".[91] Fortunately, Foxley survived the incident.[92]

Following his return to the U.K., Foxley sent a report to the U.K. Serious Fraud Office (SFO), which opened an investigation that lasted seven years and led to charges pressed against GPT, former GPT managing director Jeffrey Cook, and the partial owner of two subcontractors, John Mason.[93] The lengthy investigation came to an end on 28 April 2021, when GPT was ordered to pay a fine of £7.5 million and hand over £20.6 million under a confiscation order. Proceedings against Cook and Mason are still ongoing as of 31 May 2021.[94]

The Guardian gets into the act

In another separate incident in 2017, The Guardian uncovered a series of suspicious transactions that occurred between two companies controlled by Airbus – Eolia, a Maltese company, and Avinco Holdings, a Dutch retailer. Leaked bank records, internal memos and financial statements showed how, in 2007, Eolia bought 26% of shares in Avinco in a transaction worth €19 million, of which a large part was then routed to a "mysterious company via a tax haven".[95]

It was further revealed that both companies presented themselves as independent entities and did not reveal any external support or backing received, despite being under Airbus' effective control. Queries from The Guardian on whether such payments could constitute money laundering led Airbus to launch an internal investigation into the possible case of corruption.[96] However, there has been no further follow-up on this incident.

More turbulence ahead

Following his appointment in 2012, Enders became aware of cases of bribery involving the SMO and pushed for the dissolution of the "Bullshit Castle". Despite his efforts, an auditor memorandum circulated to him in 2014 raised the alarm on ongoing problems, with 'investments' continually made in initiatives that were "without clear or consistent justification". It was believed these 'investments' were in effect bribes paid to owners of entities including German "wind farms" and Lebanese "office buildings" as inducements to purchase airplanes from Airbus.[97]

In September 2014, Airbus took action to review all third-party relationships and found significant breaches in compliance policies. The resulting internal corporate audit and forensic report revealed that most IMD projects did not add value to the business. In October 2014, there was a freeze on all payment arrangements to BPs and IMD projects by the commercial aircraft division. In April 2015, Airbus introduced new rules on future engagements with BPs and business development plans. The freeze was extended to the defence and space division and helicopter division in May 2015.[98]

Subsequently, a Liquidation Committee which included former CDSC members involved in or aware of the wrongdoings; as well as individuals from the commercial aircraft division, contracts and treasury department; and Group general counsel, was set up.[99] The committee was eventually replaced by the Supplemental Due Diligence Committee.[100] Further, restructuring of the legal and compliance functions was made under the leadership of a newly appointed general counsel from 1 June 2015.[101]

In April 2015, U.K. Export Finance (UKEF) identified that disclosures made to obtain export credit financing with regard to the use of intermediaries within Airbus were incomplete.[102] Later that same year, following further investigation, a more comprehensive report was made to the UKEF, in which Airbus sought to correct the information previously provided and included red flags for corruption. During this period, Airbus was informed by the UKEF that it was obliged to report any suspicion of corruption.[103]

On 1 March 2016, the SMO was closed. More irregularities surfaced when Enders initiated an internal investigation into alleged wrongdoing. Airbus and UKEF subsequently reported the issues to the SFO on 1 April 2016.[104] On 7 August 2016, SFO opened a criminal investigation against Airbus.[105]

The following year, on 31 January 2017, both SFO and PNF signed a joint investigation team agreement to conduct an investigation on the bribery and corruption conspiracy relating to Airbus, its employees, and all other third parties.[106]

On 20 December 2018, reports surfaced that the U.S. Department of Justice (DoJ) opened its investigations into Airbus in parallel with the probes by the SFO and PNF.[107] This caused Airbus shares to fall by nine percent on the same day.[108]

Cast in the spotlight

The case came to the public's attention when the PNF, SFO, and DoJ issued their decisions over allegations of bribery and corruption on 31 January 2020. After years of negotiation, Airbus reached a deferred prosecution agreement (DPA) with the three authorities for a total settlement of US$4 billion over the worldwide bribery and corruption case.[109] This was the largest-ever foreign bribery settlement for the U.S.[110] and a record-breaking settlement for the U.K. and France.[111] It is believed that "entering into a DPA is likely to be and is, in the interests of justice and that the proposed and actual terms are fair, reasonable and proportionate".[112]

Are you being charged?

Under a DPA, an organisation like Airbus may be charged with a criminal offence and prosecuted. Nonetheless, the prosecution may be suspended provided the company meets certain conditions.[113] In this case, Airbus agreed to fully cooperate with any future investigations and prosecutions, and disclose any subsequent transgressions committed by itself or its employees.[114] Therefore, Airbus has not been convicted of any crime. However, the government will go ahead with the prosecution or public trial should a violation occur again.[115] Moreover, the agreement only applies to corporations. Individuals involved in the misconduct, such as Airbus executives, may still face prosecution.[116]

Critics have expressed concerns about the difficulty and feasibility of going after individuals. As of May 2021, the SFO has chosen to discontinue criminal investigation of individuals involved in the corruption and bribery scandal. However, non-U.K. prosecutors may be able to initiate their own proceedings against them.[117] Hence, it remains to be seen whether any current or former employees of Airbus will face charges arising from the offences.[118] Critics also speculated that the DPA was used to enable Airbus to avoid prosecution for its economic offences, rather than to address a complex issue that would otherwise be difficult to work on. However, in actuality, the prosecuting authorities would have taken into account various factors such as the extent of self-reporting, cooperation with the investigation, as well as the engagement of a comprehensive remediation programme, in considering whether a DPA should be offered to Airbus.[119]

An effective tool or cop-out?

Introduced in 2010, the U.K. strengthened its anti-bribery legislation with the U.K. Bribery Act (UKBA). Pursuant to Section 7 of the UKBA,[120] any "failure to prevent bribery" provision applies to all companies conducting business in the U.K.. To date, the settlement for the Airbus case is the largest financial penalty the SFO has ever meted out. Under the DPA terms, Airbus was required to settle the financial sanction of €983,974,311 within 30 days of the issued approved judgement. The costs related to ongoing cooperation and investigations were to be borne by Airbus, which amounted to €6,989,401. In exchange, Airbus was given a suspended prosecution of three years.[121]

Under the agreement reached with the PNF, known as a Convention Judiciaire d'Intérêt Public or Judicial Public Interest Agreement, Airbus was required to pay €2,083,137,455.[122] This included a 50% discount for the additional penalty in view of Airbus' high level of cooperation and implementation of corrective compliance measures.[123] Airbus will also be subject to annual checks on the deployment of a refurbished compliance programme for a period of three years by the French Anti-Corruption Agency.[124]

Furthermore, Airbus' violation of the ITAR also resulted in the breach of anti-bribery provisions of the FCPA. Under the DPA reached with the U.S. authorities, a total fine of US$2,329,715,271 was initially imposed. However, up to US$1,797,490,796 to be paid to French authorities could be credited.[125] As a result, a total sum of US$527,224,475 was needed for settlement of which, US$294,488,085 and US$232,736,390 are attributable to breaches of FCPA and ITAR respectively.[126] In addition, Airbus was required to transfer its ownership interest of an identified bond worth €50,000,000, which is traceable to ITAR violations, to the U.S. within 10 business days following the execution of the agreement.[127]

Ripple effects

Reaching a settlement with the authorities, however, did not prove to be the last act of this scandal. As news of the settlement went public, Airbus' relationship with airlines and governments turned sour as some complained that they were not forewarned about the charges and claimed little knowledge regarding the fraudulent fleet purchases. A series of internal probes were also triggered worldwide.[128]

On 1 February 2020, Malaysia's Anti-Corruption Commission reportedly launched an investigation into the Malaysian airline group, AirAsia Berhad (AirAsia), and its unit, AirAsia X, over alleged bribery payments from Airbus. It was alleged that Airbus had paid approximately US$50 million to sponsor Catherham, a former Formula 1 racing team founded by AirAsia CEO Tony Fernandes in exchange for an "improper favour" relating to the order of 180 aircraft.[129] This caused AirAsia and AirAsia X's share price to fall by 11% and 12% respectively,[130] and forced CEO Fernandes and Chairman Kamarudin Meranun to temporarily relinquish their roles.[131] Former Malaysian Prime Minister Mahathir Mohamad also weighed in on the issue by alluding that the payments made to AirAsia were "offsets" that were commonly asked by the Malaysian government when specific equipment are bought at high prices, rather than bribes.[132]

Nonetheless, a few weeks later, on 20 March 2020, AirAsia made a filing to the Malaysian stock exchange asserting that its procurement process was "robust and justifiable" and the alleged sponsorship was "disclosed to and supported by the board of directors" of AirAsia, following an internal probe.[133] BDO Governance Advisory, the independent expert appointed to perform the review, also recommended reinstating Fernandes and Meranun, who were said to have abstained from discussions and investigations relating to the sponsorships.[134]

On 3 February 2020, Ghana reportedly launched an internal probe regarding allegations that Airbus disguised around €5 million worth of bribes to a close relative of a government official without aerospace experience,[135] as part of the sale of military equipment from Airbus to the Ghanaian government from 2009 to 2015. The probe also threw a spanner in the works for former President John Mahama of the National Democratic Congress, who oversaw the alleged fraudulent transactions, and was attempting to make a political comeback after losing to the incumbent Nana Akufo Addo of the New Patriotic Party in a 2016 election.[136] As part of the probe, English actor Philip Middlemiss, his girlfriend Leanne Davis, and Mahama's brother, Samuel Mahama, were suspected to have acted as intermediaries for the then President.[137]

Similar investigations were also triggered in Sri Lanka as President Gotabaya Rajapaksa ordered a full investigation into bribery allegations that Priyanka Niyomali Wijenayaka, the wife of the former CEO of Sri Lankan Airlines, acted as an intermediary in aircraft deals between Airbus and the airline.[138] Eventually, Wijenayaka and her husband, Kapila Chandrasena, were arrested over similar bribery allegations.[139] The scandal spurred the Sri Lankan government to look into ways to claim compensation from Airbus.[140] The UKEF also came under fire after it was revealed that the government agency took more than a year to pass on the evidence it received in relation to the bribery allegations involving Sri Lankan Airlines to the SFO.[141]

On 7 February 2020, Indonesia's Corruption Eradication Commission also announced plans to use information released in the DPA to support the prosecution of Garuda International's former CEO, Emirsyah Satar.[142]

In August 2020, Thailand's Ministry of Transport initiated a probe into Thai Airways over suspicions of corruption over a deal relating to the procurement of 10 Airbus A340 aircraft between 2003 and 2004. Subsequent investigations into the deal claimed to have unravelled "a larger scheme" involving 20 employees who were involved in alleged mismanagement of the Thai airline.[143]

The scandal also incurred the wrath of Airbus' U.S. shareholders. In August 2020, shareholder Andrew Kornecki filed a proposed class action against Airbus. The complaint sought damages for Airbus' violation of U.S. securities laws, and accused Airbus of "concealing shortfalls in its compliance controls", both of which contributed to a drop in share price. It also alleged that Airbus had misled shareholders on its "ability to avoid and manage corruption accusations" over four-and-a-half years.[144]

Paying for misconduct?

Amidst investigations carried out by the French authorities, questions were also raised about the severance package of Gut, the former head of strategy and marketing. Prior to his departure, Gut had played a major role in facilitating billion-dollar deals between Airbus and its clients. He was also known for the "connections he had built up in Gulf States" and in striking deals with corrupt countries.[145]

During Gut's departure in 2007, the company announced he had received a severance pay of €2.8 million and was also entitled to an unspecified amount of pension. However, there was controversy surrounding another point in the company's announcement, which stated that it had signed a "long-term service agreement" with Gut in order to retain his "outstanding market expertise". This implied that Gut could continue to pursue aircraft sales on a "freelance" basis.[146]

The exact amount of Gut's severance pay was also contentious. While Gut denied rumours that his severance pay was €12 million instead of the announced €2.8 million, some clues indicated that the actual figure could have eclipsed both figures. A former supervisory board member mentioned that Gut had signed a consultancy contract prior to resigning, thereby allowing him to obtain around €80 million after his departure from Airbus.[147] This was not explicitly disclosed in the company's financial statements. The 2007 annual report mentioned a consultancy contract with Gut that did not disclose any dollar amount.[148]

However, the following year, the 2008 annual report stated that the company paid €86 million to acquire rights "previously embodied under a Service Provider Agreement",[149] with no mention of Gut's name. It was, however, alleged that this statement was made with reference to the aforementioned 'long-term service agreement' Gut signed in 2007, which meant Gut was paid a sum of €86 million as part of his severance package.[150]

Shake ups

Despite the backlash from the massive fraud, Airbus was nonetheless commended for the active steps it took to implement remedial measures as it sought to improve its chances of obtaining a favourable settlement and strengthen internal compliance systems to prevent the occurrence of similar fraud in the future.

Cracking the whip

Airbus conducted an extensive internal probe that saw a crackdown on employees in the Group. Since 2015, Airbus has parted ways with 63 top and senior management employees directly or indirectly involved in the scandal – with half of them getting dismissed, and the other half retiring or voluntarily leaving Airbus.[151]

In 2018, Airbus also reportedly dismissed over 100 employees and issued more than 300 internal warnings for ethics or compliance breaches. These dismissals and warnings coincided with a sharp increase in the use of internal whistleblowing systems. However, the internal probe also led to growing complaints of a 'witch hunt' among staff, with company helplines recording around 80 cases of alleged moral harassment. The probe also triggered a wave of departures from senior executives who left despite not facing any accusations, and dampened sales as employee morale was negatively affected.[152] In 2017, the Financial Times also reported that the Group was facing lawsuits from consultants and middlemen who were dismissed as part of the Group's internal compliance review, which could lead to "material impact" on profits.[153]

The probe also saw a big shakeup in top management, as it sought to further demonstrate its commitment to change to the authorities. On 18 February 2017, Airbus announced the surprise departure of Marwan Lahoud, its former head of international, strategy and public affairs, who was also the head of SMO[154] and had earlier replaced Gut following the latter's departure. Airbus stressed that his departure was unrelated to probes relating to the scandal, but was instead a result of the successful integration of Airbus and its main commercial aircraft subsidiary that left Lahoud with a more limited role to play in Airbus.[155]

Following Lahoud's departure, the Chief Technology Officer Paul Eremenko also left the Group in November 2017 just two years following his appointment.[156] That same month, Airbus announced that Eric Schulz would take on the role of Chief of Sales, Marketing & Contracts, replacing Leahy.[157] Less than a year later, however, Schulz was replaced by Christian Scherer, an Airbus veteran.[158]

The probe also amplified an ongoing power struggle between then CEO Enders and Chief Operating Officer Fabrice Bregier, who was also the President of Airbus Commercial. Bregier sought to oust Enders by alleging that he was partly responsible for the scandal as he countersigned Lahoud's decisions, in the hope that he could take over as CEO. At the same time, questions also surfaced on Bregier's possible involvement in the scandal.[159] However, it was eventually announced on 15 December 2017 that Bregier would be stepping down the following year. That same day, Enders also announced his retirement when his term expired in 2019.[160] On 14 May 2018, it was announced that then CFO Harald Wilhelm would follow Enders out of the door.[161]

According to company filings and corporate governance firm Proxinvest, Enders' future potential share earnings and overall retirement package is worth €36.8 million.[162] This figure attracted the attention of the French government, with French Finance Minister Bruno le Maire remarking that "The figure announced regarding Tom Enders is obviously excessive and could harm the reputation of Airbus".[163]

Following the departure of Enders and Bregier, it was announced in April 2019 that Guillaume Faury was appointed CEO of the Group and Chairman of its Executive Committee.[164] Faury's previous roles in Airbus included the President of the Airbus' commercial aircraft division and the CEO of Airbus Helicopters. During the worst downturn in decades for the helicopter industry, the company managed to secure landmark deals in both the civil and defence markets under Faury's leadership.[165]

Board reshuffle

There was also a shakeup of the board of directors, with seven new directors being appointed since the launch of the probe. Lord Paul Drayson, an independent director, was elected in 2017. He has an entrepreneurial background having founded multiple companies such as PowderJect Pharmaceuticals Plc, and Sensyne Health Plc.[166]

Three independent directors were elected in 2018 – René Obermann, Victor Chu, and Jean-Pierre Clamadieu. Obermann took on the role of Chairman of the board of directors. He has an entrepreneurial background and past executive experience having founded his own business and previously holding directorships in companies like Spotify and Telenor. Chu is said to be an "extremely respected" business figure in Asia. He holds directorships in multiple companies and is a senior partner at Victor Chu & Co, a law firm. Clamadieu was the CEO of Rhodia S.A. (Rhodia) and led the successful integration of a new group following the merger between Rhodia and Belgian chemical group Solvay in 2011.[167]

After his appointment as Airbus CEO, Faury became an executive director on the board.[168] In 2020, two more independent directors were elected, namely Mark Dunkerley and Stephen Gemkow. Dunkerley has extensive experience in the aerospace industry, having previously held senior positions at British Airways and Hawaiian Airlines. Gemkow has significant management experience, and previously served on the board of Deutsche Lufthansa AG and Franz Haniel & Cie GmbH.[169]

Of the original board, only independent directors Ralph D. Crosby, Catherine Guillouard, Amparo Moraleda, Claudia Nemat, and Carlos Tavares, remained at the end of 2020. All five directors have significant management and leadership experience – Crosby was formerly the Chairman and CEO of EADs North America from 2004 to 2009, Guillouard previously served as the CFO and Group Senior Vice-President at Rexel, Moraleda was previously the Chief Operating Officer at Iberdrola SA's international division, Nemat was a senior partner at McKinsey & Company, and Tavares was President of Nissan North America.[170]

Changes to internal processes

As part of the reforms undertaken, Airbus also established a new Independent Compliance Review Panel, which comprises external independent consultants who are well-versed in compliance monitoring of large corporations, in November 2017.[171] The panel comprises:

- Lord Gold – previously known for reviewing Rolls-Royce's global anti-corruption compliance policies after it was also subjected to bribery allegations.
- Noelle Lenoir – part of the Conseil d'Etat (France's highest court in administrative and tax matters) since 1984.
- Theo Waigel – advisor to corporations and governments on compensation, governance and compliance matters since 1999.

The panel is said to be given access to all levels of the company and reports directly to the CEO on compliance processes and policies.[172]

As of 31 January 2020, the panel has issued two reports. The first report, released in 2018, noted the significant progress made by Airbus and provided 55 recommendations. The second report, released in 2019, further reiterated Airbus' commitment to stronger compliance procedures by noting that "the company is now in a very different place than it was two years ago".[173]

A rough landing

As Airbus attempts to rebuild its tarnished reputation from the bribery scandals, it was faced with the onslaught of the COVID-19 pandemic that has ravaged the aerospace industry. Despite Airbus' deliveries rising 50% in June 2020 compared to the month prior, it was reported that deliveries for the first half of 2020 still slid to a 16-year low.[174] On 29 June 2020, Faury remarked that production and deliveries would be 40% lower than originally planned for the next two years.[175] A few days later, Airbus unveiled its plans to cut up to 15,000 jobs in response to the falling demand for jets from airlines.[176] The very next day, Airbus employees in France went on a brief strike, walking out of the company's factories in Toulouse, and marching alongside an airport runway with picnic bags and banners. Over in Germany, Airbus workers staged an "empty chair" protest, taping personal photos to two thousand empty chairs to symbolise the jobs that could potentially be lost as a result of the cuts.[177]

When would the next flight be?

As the COVID-19 outbreak continues into 2021, the outlook for the aerospace industry appears bleak. Despite several countries in Asia exploring the concept of 'travel bubbles', there is still great uncertainty as to when air travel will pick up and return to pre-COVID-19 levels. Carriers in countries which have little support from governments are not expected to make it through the pandemic, according to analysis by Bloomberg.[178] Predictions by Bloomberg also indicated that there was a 12.6% chance of airlines cancelling or deferring planned deliveries from Airbus, with airlines currently undergoing restructuring posing the largest cancellation risk.[179] Amid the ongoing developments, it remains to be seen how Airbus will weather the storm and navigate out of what Faury described as the "gravest crisis the aerospace industry has ever known".[180]

Discussion questions

1. Evaluate the extent to which Airbus' corporate culture contributed to the scandal. What are other major contributory factors?
2. Examine the responsibilities of the committees, and business and support functions, involved in this case. Comment on their effectiveness and how they contributed to the bribery scandal.
3. Identify the four lines of defence in the context of this case and evaluate the roles each line of defence played in the scandal.
4. Evaluate why the bribery prevention policies in place during the scandal were insufficient to prevent the employees from committing fraud.
5. Comment on the role the business partners played in the scandal. What are some of the difficulties large multinational corporations like Airbus face in the governance of their operations?
6. What is the role of the board of directors in preventing bribery? What steps should a board of directors take to minimise the risk of bribery?

7. What actions did Airbus take to remedy the internal operational issues which facilitated the incidents of fraud? Were Airbus' remediation efforts sufficient? What further steps could Airbus take to improve its corporate governance and internal controls?

8. It has been said that in certain industries, bribery is inevitable and a cost of doing business. Do you agree? How should companies address such risks?

9. Comment on the transparency of disclosures on Jean-Paul Gut's severance pay. What inferences can you make about Airbus, based on the amount of severance payments made to Gut and other past executives? Are there any issues with such "golden handshakes"? Explain.

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BOOHOO WON'T TELL US WHO MAKES THEIR CLOTHES

Case overview

Between 30 June 2020 and 5 July 2020, Boohoo Group PLC (Boohoo) was forced into the public eye after a non-profit organisation and a media outlet ran exposés accusing the company of being complicit in modern slavery. These accusations came two months after Boohoo was criticised by a short seller for a number of questionable acquisitions as well as misrepresentation of financial information, and shortly after facing shareholder discontent over announcements regarding remuneration matters for its management and directors. The objective of this case study is to facilitate a discussion of issues such as related party transactions; remuneration of directors and management; conflict between profit generation and Environmental, Social and Corporate Governance (ESG) considerations; the link between corporate governance, and environmental and social issues; greenwashing by companies; and ESG and responsible investing.

About Boohoo

"We're not just a U.K. retailer, we're a global retailer and we really see ourselves growing into something similar like [Zara owner] Inditex Group or H&M Group. That is our ambition – to be a global online player."

– John Lyttle, CEO of Boohoo[1]

Founded in 2006 by Mahmud Kamani and Carol Kane, Boohoo Group PLC (Boohoo) is well-known in the U.K. for the sale of clothing targeted at young women on its online retail platform www.boohoo.com. Since then, Boohoo has expanded at a rapid pace to become a frontrunner in the fast-fashion scene.[2] It has 13 brands under the Group,[3] with the most recent acquisitions being Dorothy Perkins, Wallis and Burton in February 2021.[4] The acquisitions allowed Boohoo to widen its product range, with each brand differentiated to target specific consumer segments.

Boohoo's business model was centred on being ultra-fast and ultra-cheap.[5] Its company website states that its philosophy is "we don't take life, or fashion, too seriously", and markets itself as consumers' "fashion bestie" that produces 500 new items weekly to satisfy consumers' desires.[6] In March 2014, Boohoo was listed on the London Stock Exchange's junior AIM market after a successful Initial Public Offering (IPO).[7]

This case was prepared by Dean Tjahjono, Desmond Teo Wen Long, Liu Jiamin, Samuel Low Yee Kiat, Teo Wei Lie, and Thin Thi Han, and edited by Isabella Ow 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 organizations named in the case, or any of their directors or employees.

Based on Boohoo's 2020 annual report, the overall financial performance of the Group has been impressive – revenue has been on an upward trend and has increased by 44% from the previous year to reach £1,234.9 million. Similarly, its FY2020 net profit before tax has increased by 54% to £92.2 million from FY2019. The popularity of Boohoo's brands has also surged 31% to hit 13.9 million active customers.[8]

The beginning of it all

On 26 May 2020, short seller ShadowFall, a London-based hedge fund, released a 53-page report accusing Boohoo of conducting unnecessary fund-raising and questioning its intentions. ShadowFall believed the fundraising to be linked to the exorbitant price the company was paying for the potential acquisition of the remaining stake in PrettyLittleThing (PLT) – a company owned by the sons of Boohoo's Chairman, Mahmud Kamani. Further, ShadowFall alleged that Boohoo had overstated its free cash flows by £32.2 million by not including tax charges and treating PTL as a wholly owned subsidiary.[9] Boohoo's stock fell by 12% after the report was published.[10]

About PrettyLittleThing

PLT was co-founded by the sons of Mahmud Kamani – Umar Kamani and Adam Kamani – in 2012. It initially started out as an accessory-only brand with a small number of products listed on its website. However, PLT expanded its business rapidly and currently has an international presence which includes the U.S. and European markets. According to a 2017 report by Hitwise, a consumer analytics company, PLT was the fastest growing online fashion retailer, with site traffic rising by 663% since 2014. Between 2016 and 2019, PLT's annual sales skyrocketed from about US$23 million to almost US$510 million.[11,12] Adam Kamani parted ways with PLT in 2017 and Umar Kamani was left to run the company as CEO.[13]

In December 2016, Boohoo successfully acquired a 66% stake in PLT for £3.3 million.[14] Under the terms of the agreement, Boohoo was presented with an option to acquire the remaining 34% stake in PLT at its market value by 2022. The acquisition price at that point was expected to be significantly more, considering the robust growth trend in PLT's financials. Boohoo commented that this was meant to incentivise CEO Umar Kamani and the company's senior management to continue their excellent work in overseeing its operations and growing the company. However, if Boohoo were to not exercise the option to acquire the remaining 34% stake in PLT by 28 February 2022, a dividend of up to all of PLT's distributable reserves would be payable to PLT's shareholders – 66% to Boohoo and 34% to Umar Kamani.[15]

The acquisition was well received by investors as Boohoo's share price increased by 8% following the announcement.[16]

Boo to Boohoo

Boohoo's plan to acquire the remaining 34% stake in PLT was however not smooth sailing.

What is all that cash for?

According to Boohoo's financial statements, it had amassed over £240 million net cash as at 28 February 2020. On 14 May 2020, Boohoo announced that it intended to raise about £200 million to "take advantage of numerous opportunities that are likely to emerge in the global fashion industry over the coming months".[17] As a result, £197.7 million was raised through a cash call by Boohoo.[18] However, ShadowFall questioned the need for this fundraising as it felt that Boohoo already had substantial cash to fund its plans to "take advantage of numerous opportunities".[19]

Additionally, Boohoo has a history of not paying dividends to shareholders,[20] and this trend was expected to continue following the fundraising. That being said, the Shadowfall report alleged that the £200 million raised could be handed over in dividends or buyout costs to Umar Kamani.[21]

Spending too much on PLT

The ShadowFall report made a comparison between PLT and its peers such as ASOS and Zalando. It was estimated that PLT would be valued at £2,709 million in 2022, suggesting that the remaining 34% stake in PLT would cost Boohoo £921 million. ShadowFall questioned whether PLT could sustain its high growth and margin to warrant a similar valuation of 31.3 times earnings before interest and taxes (EBIT) of its more established peers in the face of fierce online retail competition. A £1 billion acquisition would be equal to fifteen times of Boohoo's free cash flows in 2020. As a result, ShadowFall expected that the acquisition of the remaining 34% in PLT would deplete Boohoo's net cash to zero and even dilute shareholder's equity should Boohoo's management decide to do another equity placement to raise cash.[22]

ShadowFall further questioned whether PLT's supernormal profit margins which contributed to its high estimated market value in 2022 was legitimate. After Boohoo acquired the 66% stake in PLT, it was noted that PLT's distribution and administrative costs had fallen significantly while that of Boohoo had increased. This led to suspicions that PLT's expenses were subsidised by Boohoo to boost its own EBIT. If this were the case, ShadowFall estimated that – assuming PLT's distribution and administrative costs were in line with Boohoo's – PLT's actual EBIT margin would be 8.3% instead of the reported 11.1% in 2019. Thus, ShadowFall warned shareholders that if Boohoo were to acquire PLT in 2022, it might be at an artificially high price, especially if PLT's valuation was based on its EBIT multiples. ShadowFall also said that shareholders should be wary that the company's high margins might not be sustainable in the long run if PLT had indeed benefitted from subsidised costs.[23]

Further, ShadowFall noted inconsistencies in Boohoo's annual filings regarding the agreed acquisition costs of PLT. In its 2018 annual filing, Boohoo disclosed that the acquisition price would be 79% of market value. However, in its 2019 annual filing, Boohoo stated that the acquisition price would be 100% of market value. ShadowFall questioned how the acquisition price could be revised when the terms of the buy-out agreement would have been fixed at inception.[24]

Painting a pretty picture: Free cash flows

ShadowFall also accused Boohoo of misrepresenting its cumulative free cash flows since 2014. All of PLT's cash was included under Boohoo's free cash flows despite Boohoo only having a 66% stake in PLT. Based on the agreement when Boohoo acquired its initial stake in PLT, it was due to distribute these earnings to PLT's NCI in 2022 if the option to acquire was not exercised. According to ShadowFall, this meant that the earnings should not be included in the calculation of free cash flows as it would be misleading to readers of Boohoo's financial statements.[25]

Lastly, ShadowFall speculated that I Saw It First (ISIF), a company owned by Jalaludin Kamani – the brother of Chairman Mahmud Kamani – would be Boohoo's next acquisition target after PLT.[26] ISIF – an online retailer for womenswear – was incorporated on 17 May 2016[27] by Jalaludin Kamani. Jalaludin Kamani is a director and majority shareholder of ISIF.[28]

A rollercoaster ride

Following the release of the short seller's report, Boohoo released a statement that it strongly refuted allegations made in the report.[29]

In respect of the valuation of PLT in the event of a buyout, Boohoo dismissed the claims by ShadowFall, highlighting that it would be paying the market value of PLT determined by a Big Four accounting firm, with a discount of up to 30% applied. Additionally, analysts from Numis – an independent institutional stockbroker and corporate advisor – estimated that the buyout would cost Boohoo £480 million, significantly lower than the amount ShadowFall had claimed.[30]

Additionally, in relation to the issue of inaccurate accounting treatment of free cash flows, Boohoo justified its accounting treatment, stating that "international accounting standards require the Group to fully consolidate its cash flows, and its treatment of this with respect to its subsidiary, PLT, reflects this conformance with accounting standards".[31] Analysts had also defended Boohoo, stating that "most professional investors and analysts would not have been confused by Boohoo's presentation of cash flows and profits".[32]

Boohoo also downplayed its relationship with ISIF, commenting that although Jalaludin Kamani has a small stake of 0.65% in Boohoo, ISIF is an "unrelated entity to Boohoo Group" and is only a "smaller competitor in a highly fragmented marketplace".[33] In this regard, analysts commented that this speculation was far-fetched and that it was "highly unlikely" that Mahmud Kamani would want to acquire his brother's business.[34]

On 28 May 2020, merely two days after the ShawdowFall report was published, Boohoo announced that it had acquired the remaining 34% stake in PLT for an initial consideration of £269.8 million, potentially rising to £323.8 million.[35] This was paid with 60% in cash and 40% in new shares.[36] Boohoo said the acquisition would create "significant value for the group's shareholders" and was an "important further step towards achieving its vision to lead the fashion e-commerce market globally by accelerating full ownership of a brand that is in high growth with enormous growth potential ahead of it".[37]

The announcement was welcomed by investors, as the acquisition cost was much lower than ShadowFall's estimates. The share price of Boohoo rose by 16% and analysts began to upgrade their earnings forecasts and price targets, believing that the deal was "value-accretive". After the announcement, ShadowFall had no choice but to retreat from its previous position, bemoaning the "scandalous" outcome.[38,39]

Boohoo's board of directors

Boohoo's board of directors is made up of eight directors, with four executive directors – including the CEO and CFO – and four non-executive directors. There are four board committees, namely the Audit Committee (AC), Remuneration Committee (ReC), Nomination Committee (NC), and Risk Committee (RiC), on which all four non-executive directors sit.[40]

Brian Small, who is also Deputy Chairman of the board and senior independent director, chairs the NC and sits on the AC, ReC, and RiC. He was previously CFO of sports-fashion retail company JD Sports plc for over a decade and has extensive financial experience in several other companies.[41]

Shaun McCabe chairs the AC and RiC and sits on the NC and ReC. He has held a number of financial roles in e-commerce and retail, including international director at online fashion retailer ASOS and CFO for Amazon Europe.[42]

Iain McDonald leads the ReC, and sits on the remaining board committees, He is the founder of Belerion Capital, a specialist technology and e-commerce company, and was an early investor in many technology businesses, including ASOS, The Hut Group, and Eagle Eye Solutions.[43]

Finally, Pierre Cuilleret is a member of all four board committees. He was previously CEO and shareholder of Micromania, a well-known video game retailer in France. He had also been on the board of discount supermarket Distribuidora Internacional de Alimentación, S.A. and fashion company Desigual as non-executive directors.[44]

Bring on the bling

In June 2020, Boohoo proposed changes to the remuneration packages of its executive management, which drew flak from shareholders due to the lack of explanation for the changes. Further, in the same month, Boohoo announced the creation of a long-term incentive plan that could reward its top management with up to £150 million, conditional on meeting performance targets. The primary objective of the new remuneration policy was to "ensure that the Group's leadership team is motivated" and the "continuation of the exceptional levels of performance that [Boohoo] has delivered since IPO".[45]

Boohoo is listed on the AIM of the London Stock Exchange. In 2018, changes were made to AIM Rule 26 whereby all AIM-listed companies are mandated to adopt and comply with an accredited corporate governance code.[46] As such, Boohoo adopted the Quoted Companies Alliance Corporate Governance Code (QCA Code), and took into account the principles of the U.K. Corporate Governance Code and other best practice guidelines such as the QCA Remuneration Guidance and the Investment Association's Principles of Remuneration.[47]

Based on Boohoo's FY2020 annual report, non-executive directors are paid a fixed remuneration which includes their fees and free shares issued as part of their fees. Executive directors are paid both fixed and variable remuneration. Components included in fixed remuneration are base salary and fees, benefits, pension, share incentive plan awards and save as you earn (SAYE) options. Variable remuneration includes an annual bonus as well as long-term incentives, which are given based on performance. Boohoo states that it puts in place frameworks to assess the performance of its executive directors to determine the amount of variable remuneration paid.[48]

For FY2021, Boohoo determined the bonuses of its CEO and two co-founders based on the achievement of financial performance indicators such as revenue and EBITDA. Meanwhile, the CEO's long-term incentive plan was based on the achievement of stretched market capitalisation growth targets measured over a five-year performance period, while the remaining executive directors' long-term share incentive awards were based on three-year performance targets.[49]

Skin in the game?

In June 2020, Boohoo proposed a £1 million pay-out to the Group's CEO, John Lyttle, and salary increases ranging from 18% to 30% for other senior executives. It also included a £50 million bonus for Lyttle if Boohoo manages to hit the target market capitalisation of £6 billion by March 2024.[50]

Following the announcement, Institutional Shareholder Services Inc. (ISS), an influential proxy advisory firm, urged Boohoo's shareholders to vote against the proposed changes to the remuneration policy,[51] stating that Boohoo did not provide sufficient explanation for the huge pay-out to the CEO and the increase in remuneration for senior executives. In its defence, Boohoo said that the £1 million pay-out to Lyttle was for the reimbursement of payments forfeited by him when he left his previous position as Chief Operating Officer at Primark[52] and that this had already been disclosed to shareholders in July 2019.[53] With regard to the increase in remuneration of senior executives, Boohoo explained that such changes were reasonably made after the company had benchmarked its remuneration policy with other similar companies.[54]

On 19 June 2020, Boohoo held an Annual General Meeting where the proposed changes to the remuneration policy was put to an advisory vote. The shareholder discontent was apparent as 34.08% voted against the new remuneration policy.[55,56,57]

A week later, on 26 June 2020, Boohoo announced the introduction of a management incentive plan which could result in a pay-out of up to £150 million to the company's senior executives depending on Boohoo's share price. Participants included Mahmud Kamani, Carol Kane, CFO Neil Catto, and Samir Kamani. The starting market capitalisation for the bonus scheme was set at £4.54 billion as of 16 June 2020 and the maximum bonus pay-out of £150 million would be distributed if Boohoo's market capitalisation increases by 66% to £7.55 billion – representing a share price of 600p – by the target date of 17 June 2023. If Boohoo's market capitalisation reached £6.29 billion by the target date – equivalent to a share price of 500p – senior executives would collectively receive a bonus pay-out of £50 million.[58] It was apparent that this management incentive plan was only based on share price performance. Boohoo commented that the use of stock price alone was "well aligned to the Group's strategy of delivering substantial and sustained returns to shareholders".[59]

Action and reaction

The announcement was met with criticism from investor advisory firm, Minerva Analytics and Share Action, as well as Boohoo's old adversary ShadowFall. The timing of the reference price was questioned as it was set at the share price a day before Boohoo published an encouraging trading update on 17 June 2020, which resulted in a share price increase of 6.6%. ShadowFall alleged that the reference price of the bonus scheme was intentionally positioned before the release of the trading update so that a lower share price reference could be used to calculate the target share price for the bonus scheme.[60]

However, Boohoo refuted this by stating that the scheme was only implemented once the company was out of the closed period on 17 June 2020 and that the target market capitalisation would not have changed regardless of the starting point used to compute Boohoo's market capitalisation.[61]

Hoo's (Whose) bonus

Boohoo's ReC considered the fact that the two co-founders of Boohoo had not participated in the Group's long-term incentive arrangements since the Boohoo's IPO in March 2014. Hence, to incentivise them to proactively take advantage of global opportunities for the benefit of all shareholders and stakeholders, and to ensure their continuous commitment towards Boohoo, the ReC decided to allocate each of them one-third of the potential pay-out stated in the management incentive plan. The maximum pay-out per individual would amount to £50 million.[62]

As for Neil Catto, who had been Boohoo's CFO since prior to their IPO, and who had been a key member of the management team, the ReC decided to allocate 6.67% of the bonus scheme pay-out to him to "incentivise him and retain his services for the Group's ongoing development, while aligning his remuneration potential with other key members of the management team".[63]

As part of long-term succession planning, Samir Kamani – CEO of menswear brand boohooMAN – had also been identified by Group CEO John Lyttle to take on a wider role across other Boohoo brands and to eventually become a key figure in the future leadership team of the fashion company. As such, the ReC decided to allocate 16.67% of the bonus scheme pay-out to him. This reflected the growing importance and success achieved to date by boohooMAN, which was the fastest growing brand in the Group then.[64]

The remaining 10% of the intended bonus pay-out would be divided among key individuals in the management team, with no individual receiving more than 3%.[65]

AIM for the gains

As Boohoo is listed on the more lightly-regulated AIM market, it was not required to put the management incentive plan to a shareholder vote.[66] The ReC felt that only a consultation with shareholders and feedback from its board of directors were necessary for its implementation. Boohoo explained its rationale, stating that it was in the shareholders' best interest that the plan was implemented immediately so that the executives were "immediately incentivised to deliver stretching share price growth for the benefit of all Boohoo's shareholders".[67]

When it rains, it pours

"There is no way that clothes can be produced at such low costs without exploitation,"

– Meg Lewis, campaign manager at Labour Behind the Label[68]

The beginning of Boohoo's biggest scandal started in late June 2020, when Labour Behind the Label (LBTL), a U.K.-based not-for-profit organisation campaigning for workers' rights in the clothing industry, accused Boohoo of continuing to source its production of clothes from Leicester-based factories, even though illegal and unethical practices had been uncovered by numerous media reports.[69]

Prior to the release of the LBTL report, it was already "an open secret" that there was labour exploitation in the Leicester factories,[70] resulting in various brands switching their clothing production elsewhere. However, according to the report, Boohoo continued utilising these factories to manufacture 60 to 70% of its products, increasing to approximately 80% in June 2020.[71]

According to LBTL, the problems with the Leicester factories included the exploitation of workers as well as poor working conditions, especially during the COVID-19 pandemic. Most of the workers were from minority ethnic groups, with an estimated 33.6% non-U.K. citizens. The lack of proper documentation meant that these workers were taken advantage of and forced to work in poor conditions while earning less than minimum wage. It was reported that some workers earned as little as £3.50 an hour. Also, due to their status as illegal immigrants, such workers were afraid and unwilling to speak out against their mistreatment as it could lead to potential investigations by the U.K. authorities and even deportation.[72]

There was also allegedly a blatant disregard for the workers' health and safety during the COVID-19 pandemic. In March 2020, Leicester factories began halting operations due to the pandemic. However, it was reported that even though some factory managers had made the decision to cease production, they received emails from Boohoo chasing work orders, resulting in workers being forced to work throughout April 2020 to fulfil orders from Boohoo and PLT. Additionally, while Boohoo asked the factories to adhere to U.K. government guidelines, no physical site inspection was conducted by it to ensure that guidelines were indeed being followed.[73]

Furthermore, LBTL received reports from the Leicester factory workers stating that there were no measures put in place to protect the workers from the coronavirus. Workers in factories were not provided with personal protection equipment (PPE), and social distancing was not enforced. Another report stated that the employers had disregarded symptoms and even positive cases of COVID-19. Workers who felt unwell were told to come to work and there were instances when workers who tested positive for COVID-19 were informed to keep it a secret and continue working. Workers who applied for statutory sick leave were told by employers that sick pay would not be awarded and that they had to work or get the boot.[74]

The exploitation of workers allegedly worsened during the COVID-19 pandemic, when reports of furlough fraud and theft of wages and benefits arose. Factory workers were told to hide previous payslips to allow employers to claim an inflated amount of furlough benefits. Also, due to the lack of transparency with regard to these benefits, a large proportion of the furlough payments went directly into the pockets of employers.[75]

LBTL attributed the occurrences of modern slavery within the Leicester factories to Boohoo's purchasing practices and fast fashion business model. Previously, Boohoo had been accused of driving down production costs by intentionally encouraging competition among suppliers, forcing them to charge lower prices to obtain orders from Boohoo. However, this potentially led to the exploitation of workers due to illegally low wages, forced overtime, and irregular working hours. Furthermore, Boohoo's fast fashion business model, where small batch orders with fast turnarounds were required, meant that unauthorised subcontracting was commonplace and suppliers would source additional production capacity from unaudited and unvetted suppliers.[76]

LBTL called for Boohoo's sales and production to be suspended by the local authorities and investigations into labour exploitation and the lack of safety measures be conducted.[77]

The scandal escalated further on 5 July 2020, when The Sunday Times ran an exposé after an investigation by an undercover reporter found that workers working for a Leicester factory which makes clothes for Boohoo were indeed paid at a rate far lower than the minimum wage and that the accusations of dangerous working conditions by LBTL were substantially true. The undercover reporter had spent two days working in the factory and was told to expect a wage of £3.50 an hour, despite the minimum wage for those aged 25 and over being £8.72. The reporter also obtained video footage of himself packing garments under the Nasty Gal brand, which is owned by Boohoo. Further, the factory was operating during the lockdown period in the U.K. without any additional hygiene or social distancing measures in place.[78,79]

Following the exposé by The Sunday Times, the share price of Boohoo plunged by around 25% on 6 July 2020.[80]

In the initial stages of the saga, more than £1.5 billion – a third of Boohoo's value – was wiped off in two days amid concerns over its questionable supply chain practices. Shareholders of Boohoo demanded answers from the company over the alleged working conditions in its Leicester factories. Boohoo announced that it was investigating the claims.[81,82]

Boohoo's official response

Boohoo subsequently released a statement that refuted all the accusations in the LBTL report, claiming that the report was factually inaccurate and emphasising that the company did not tolerate any form of non-compliance within its supply chain.[83] It said that it had complied with government guidance which did not state that factories had to halt production during the pandemic. Additionally, Boohoo explained that it made use of audio and video calls to remind suppliers to adhere to social distancing and hygiene measures, and went the extra mile to provide sufficient PPE and hygiene products free of charge to its suppliers. Once the U.K. lockdown was lifted, Boohoo immediately resumed the physical inspection of its supply chain.[84]

Boohoo also rebutted the figures provided by LBTL, which claimed that close to 80% of Boohoo's production was sourced from the Leicester factories when in fact, the percentage was approximately half of that. In response to LBTL's claims that Boohoo's supply chain was dubious due to modern slavery and poor working conditions, Boohoo defended itself by stating that the company had been making use of a third party-led compliance programme with compliance specialists who audit its suppliers and subcontractors.[85]

Lastly, Boohoo claimed that it ensured that its U.K. manufacturers have reliable and constant cash flow so that their workers were paid accordingly and in a timely manner through the introduction of 14-day payment terms, refuting LBTL's accusations of modern slavery in Boohoo's supply chains.[86]

Boohoo also released a separate statement to address the allegations made in The Sunday Times exposé. It clarified that the factory, Jaswal Fashions – which the reporter worked undercover at – was not a declared supplier of Boohoo and was no longer trading as a garment manufacturer. Boohoo speculated that it was a different company making use of Jaswal Fashion's former premises and stated that it would investigate how the Nasty Gal products ended up in that factory. It reiterated its commitment that it "will not hesitate to immediately terminate relationships with any supplier who is found not to be acting within both the letter and spirit of [Boohoo's] supplier code of conduct".[87]

Influencers and retailers dump Boohoo

Boohoo received immediate backlash as a result of the allegations made by LBTL and The Sunday Times. There was an initial exodus of prized social media influencers who previously promoted Boohoo's clothes, such as reality television star Vas J. Morgan and model Jayde Pierce.[88] Analysts commented that scathing comments by celebrities and influencers were expected to have a huge impact on Boohoo's reputation among key customer segments, as the fast fashion company relied heavily on promotion by social media marketing. Boohoo reportedly spent £90 million on celebrity endorsements in 2019.[89,90]

Furthermore, online retail platforms such as Next, ASOS and Amazon dropped all Boohoo products from their websites. This was seen as part of a "reputational fallout" for Boohoo, as such platforms were important for marketing efforts and were a signal of status.[91]

ESG investors left red-faced

According to U.S. data provider Morningstar, Inc. (Morningstar), 20 funds with a sustainable mandate, bearing an Environmental, Social and Corporate Governance (ESG) label, held shares in Boohoo. In the days following The Sunday Times exposé, Aberdeen Standard Investments (ASI) – Boohoo's third largest independent shareholder – which held Boohoo shares through three funds that aim to invest responsibly, proceeded to dispose of its entire stake in Boohoo worth approximately £80 million.[92] It said that actions undertaken by Boohoo were "inadequate in scope, timeliness and gravity".[93] In a statement, deputy head of U.K. equities at ASI, Lesley Duncan, further justified the disposal as "divestment [was] both appropriate as responsible stewards of [its] clients' capital and aligned to [its] goal of investing for better outcomes".[94]

Fund house Premier Miton Group said that it had "been in contact with Boohoo and will assess their response". Jupiter Asset Management also released a statement that it had been given "strong assurances by management that any suppliers found to be in breach of the company's strict code of conduct will be terminated immediately" and that it would continue to engage with Boohoo on the matter.[95]

Boohoo, how can you not know?

With average dress prices at £13.95[96] and 3,000 new styles introduced each week, there were significant doubts whether the ultra-fast fashion business is sustainable at all.[97] In particular, observers such as Ketan Patel of EdenTree Investment Management doubted that it was even possible to avoid the use of cheap labour at such price points.[98]

As early as 2015, a report published by the Ethical Trading Initiative found chronic, systematic and endemic abuse of workers in Leicester's textile sector. The report alleged that at least 75% of workers were paid as low as £3, well below the U.K.'s mandated minimum wage. The report also highlighted the absence of employment contracts and serious violations of health and safety codes.[99]

Between 2017 and 2019, similar allegations were made against Boohoo in a Channel 4 investigation,[100] a Financial Times exposé,[101] a parliamentary Environmental Audit Committee hearing,[102] and in a BBC documentary.[103] Alarm bells were raised on the topic of labour exploitation in all instances.

Murky waters: ESG ratings

"The fact that Boohoo ended up in so many sustainable funds shows the callous infrastructure of our investment system, and its participants."

– Martin Buttle, head of good work at ShareAction[104]

Despite the numerous allegations, Boohoo generally received excellent ESG ratings from rating agencies. Based on an average of nine major rating providers, Boohoo was ranked within the top 29th percentile in ESG ratings out of over 19,000 companies.[105] For instance, MSCI, Inc. (MSCI) – a rating and index provider which uses artificial intelligence and alternative data to assess companies – awarded Boohoo an AA rating, which was just one rank lower than its highest rating. MSCI lauded Boohoo's "relatively strong policies and practices" in respect of its supply chain, with Boohoo scoring 8.4 out of 10 for "supply chain labour standards" compared to the industry average of 5.5.[106] The exceptional AA rating placed Boohoo among the top 15% of its peer group based on ESG metrics.[107]

In light of the modern slavery accusations faced by Boohoo, commentators and analysts questioned the consistency and validity of ESG ratings. In general, ESG ratings face three major challenges.

Firstly, the lack of an agreed upon benchmark to assess ESG performance has meant that ESG ratings across rating agencies are inconsistent. Aside from the subjectivity involved in defining ESG performance, the issue is compounded by rating agencies utilising differing methodologies to measure common attributes and assigning different weights to each of these attributes to arrive at their conclusions. In a research study conducted by Massachusetts Institute of Technology (MIT), it was found that the average correlation of ESG ratings was only 0.54.[108] For instance, in the case of electric vehicle maker Tesla, MSCI awarded Tesla one of the highest ESG ratings in its industry, whilst FTSE scored it poorly.[109] In the case of Boohoo, in contrast to its inclusion in the top 29th percentile of companies in its average ESG ratings, not-for-profit Fashion Revolution's Fashion Transparency Index ranked Boohoo in the bottom 10%, with a score of zero on the issue of traceability – the focal point of the scandal.[110]

Secondly, the integrity of ESG data collection by agencies has been called into question, with the reliance on data provided by companies themselves. There have been allegations that rating agencies issue ratings based on what is made available to them and thereby ignore missing data. In this regard, companies could selectively disclose favourable data to agencies to obtain a favourable rating. Given that smaller companies may not be able to afford the extra costs that come with additional disclosures for ESG ratings, rating agencies often do not probe further. On the other hand, rating agencies may also give companies the benefit of the doubt as there may also be an issue of ignorance on the part of companies. Diane Menville, ESG head of rating agency Scope Group, commented that "a company may not know what the problems are in its own supply chain and thus cannot disclose them".[111]

Thirdly, biases in the interpretation of data also present issues in ESG ratings. The report by MIT suggested the presence of a "rater effect", where "a rater's overall view of a firm influences the assessment of specific categories". Further, such stereotyping inhibits the ability of agencies to issue fair and objective ratings.[112] For instance, the stereotype that a factory based in the U.K. or other more developed countries signified higher labour standards contributed to Boohoo's excellent ESG ratings. In its June 2020 report, MSCI explicitly stated that Boohoo had a "low reliance on supply chains in regions with poor working conditions", which contributed to its high rating.[113]

Greenwashing funds

Allegations of greenwashing surfaced due to the lack of consistency in ESG ratings and the lack of disclosure over ESG assessment methodologies, with rating agencies classifying their assessment rubrics as proprietary in nature. Joachim Klement of Fidante Partners remarked that the lack of ESG benchmarks enables asset managers to "game the system and declare a fund to be sustainable even though the managers have hardly changed their investment process compared to a traditional fund". SCM Direct, a London wealth manager, echoed similar concerns over "alarming levels" of greenwashing.[114] Observers believed that such funds invested in Boohoo as "they knew Boohoo was making money and they didn't ask any questions".[115]

Do good and profit

In recent years, the influence of ESG rating providers has grown significantly in tandem with demand for sustainable investing. Recent trends show that investors now "look for investment products that do good as well as generate returns",[116] indicating increasing interest in sustainable funds, which pulled in €120 billion in Europe in 2019 – 2.5 times the amount in the year prior. Additionally, Morningstar reported that over 360 new ESG-focused funds were created in Europe in 2019, further supporting the continued interest in sustainable funds.[117,118]

In line with the move towards sustainable investing, many asset managers and fund houses have publicly disclosed their ESG agendas. There have been over 7,000 signatories across 135 countries to the United Nations Principles for Responsible Investing (UNPRI). UNPRI signatories seek to implement six aspirational, broad-based ESG principles into their investment framework. These include the incorporation of ESG issues into their investment analysis and decision-making, and seeking appropriate ESG disclosures in companies they invest in.[119]

In the U.K., asset managers who are signatories to the U.K. Stewardship Code commit to integrating investing, stewardship and ESG issues. The Code acknowledges that ESG issues have become material issues for investors to consider when making investments and prompts asset managers to consider them in line with all other factors when making investment decisions.[120]

Turning a blind eye to ESG

In October 2020, Liz Kendall, a prominent U.K. Member of Parliament called on Jupiter Asset Management, Baillie Gifford & Co and Invesco – Boohoo's largest shareholders – to remove Boohoo's CEO and Chairman from their positions in the company. She said that it would be a "mockery of any claims to support responsible investing" if the leaders who allowed modern slavery to occur in Boohoo's supply chain were not removed by shareholders as a consequence of their actions. However, all three major shareholders declined to comment or respond.[121]

In addition, it was reported that some fund managers of ESG funds have disposed of Boohoo shares held by their ESG funds, yet maintained or increased their positions in Boohoo via other funds without an ESG mandate. For instance, Jon Hudson and Benji Dawes, fund managers of Premier Ethical Fund and Premier U.K. Growth, continued to hold Boohoo shares in the latter fund despite selling the stake in Boohoo held by the former fund in view of the modern slavery allegations.[122]

See no evil, hear no evil

Subsequent to the exposés by LBTL and The Sunday Times, in addition to setting up a £10 million investment to "eradicate supply chain malpractice", Boohoo hired Alison Levitt – who was appointed Queen's Counsel in 2008 – to conduct an independent review into the company's U.K. supply chain.[123] To no one's surprise, the findings were damning.[124]

Levitt found that Boohoo's management was aware of the "endemic" problems in its Leicester factories but turned a blind eye to them in the pursuit of revenue generation. In 2018, email exchanges between Mahmud Kamani and employees showed that he told staff to "trade faster, harder and quicker" to increase profit margins by reducing production costs, signalling a questionable tone at the top.[125]

Her investigation found that allegations of Leicester factories paying workers less than minimum wage were “well-founded and substantially true”. Her report disclosed failures in identity verification, improper recording of hours and payment of wages, health and safety violations, and occurrences of potential furlough fraud.[126] Levitt further remarked that Boohoo’s monitoring of the Leicester factories was inadequate due to “weak corporate governance”, and that Boohoo’s risk management systems were “significantly undeveloped”.[127]

However, she stated that Boohoo did not intentionally allow the poor working conditions to persist or take advantage of the situation. She was also satisfied that the company did not break any laws. In late 2019, the Audit Committee had been briefed on supplier compliance issues highlighted in an internal audit report by Edward Toogood, Boohoo’s head of internal audit. Although there were actions taken to correct such issues, it was deemed “too little too late”. [128]

Levitt concluded the review by saying that Boohoo’s problems “have arisen from a failure to appreciate that running a great company requires social responsibility as well as growth” and further provided various recommendations for Boohoo to adopt.[129]

Share price rebound

Despite the plunge in share price following the allegations by LBTL and The Sunday Times, Boohoo’s shares subsequently experienced a dramatic rebound to recover the lost ground.

Following the decline in its share price, Boohoo was touted as undervalued by analysts with favourable coverage initiated by banks such as HSBC, Société Générale and JP Morgan. Analysts broadly cited four key factors for their favourable coverage.[130] The first factor was the lack of regulatory enforcement and avoidance of any possible legal repercussions. The Gangmasters and Labour Abuse Authority found no evidence that Boohoo contravened the Modern Slavery Act. Similarly, Levitt cleared Boohoo of any criminal wrongdoing. Further, parliamentary pressure did not materialise into the tightening of any legislation that might adversely affect Boohoo. Secondly, further analysis of Boohoo’s revenue streams revealed that wholesale revenues only accounted for 4% of its total revenues. Therefore, the potential impact of online retailers dropping Boohoo’s products was expected to be minimal.[131] Thirdly, concerns of an influencer exodus abated. A decline in the number of brands working with influencers due to the COVID-19 pandemic had forced influencers to continue their relationships with Boohoo to maintain their income streams. Thus, Boohoo’s social media following recovered from its initial dip.[132] Fourthly, Boohoo reported an unprecedented semi-annual performance with a 45% increase in revenue, which had surpassed expectations. As a result, the company increased its full year growth projections from 25% to between 28% and 32%.[133]

A root and branch overhaul

In response to the independent review by Levitt, Boohoo released a statement accepting the review's recommendations in full and issued an apology for failing to "match up to the high expectations [it] set for [itself]". Group CEO John Lyttle said that it was clear that Boohoo had to "go further and faster to improve [its] governance, oversight and compliance."[134,135]

Firstly, Boohoo intended to improve its corporate governance through the appointment of two non-executive directors to provide greater independence to the board, including one who has an expertise in ESG matters. Additionally, Boohoo had constituted a Risk Committee to better identify and monitor the risks faced by the company. Under the Risk Committee, Boohoo formed a new Supply Chain Compliance Committee comprising recognised experts and led by the new director of responsible sourcing. The committee's immediate priority was to enforce supply chain compliance with regard to the COVID-19 pandemic. Furthermore, Boohoo was committed to discuss supply chain compliance at every board meeting.[136]

Secondly, Boohoo promised to improve the working conditions for factory workers and increase transparency in relation to its supply chain. Internally, Boohoo would provide education and training to its purchasing teams to ensure better understanding of its supply chain and prevent transactions with unapproved suppliers. Boohoo also engaged two external expert supply chain and compliance audit firms to conduct a full audit of its suppliers. It planned to consolidate its approved supplier list before publishing it. Furthermore, Boohoo would extend its independent audit programme to the rest of its U.K. and global supply chain.[137]

Lastly, Boohoo pledged to provide support to both workers and suppliers in its supply chain. For the workers, Boohoo would be establishing a garments and textiles community trust to ensure that the workers receive proper compensation for their work. Boohoo would also be working closely with statutory and civil society partners to ensure that the workers are educated on their rights. For the suppliers, Boohoo indicated its commitment to provide suppliers with a consistent and predictable flow of orders to facilitate effective planning, as well as give the suppliers access to technology and infrastructure when required. Boohoo further stated its intention to build a "state-of-the-art manufacturing facility based in Leicester".

Taking into consideration the actions taken by Boohoo in the aftermath of the scandal and its plans for the future, many would agree that Boohoo is indeed moving in the right direction. However, while Boohoo's plans will have a positive impact on the stakeholders in its supply chain, whether its industry peers will follow in its footsteps is another question altogether. Will Boohoo be able fulfil its promises in respect of its supply chain, or will history repeat itself and render Boohoo's efforts "too little too late"?

Discussion questions

1. What are some of the red flags relating to the corporate governance of Boohoo?

2. Conflict of interest may be inherent when families are involved in business deals as observed in Boohoo's acquisition of PLT. How can this be effectively managed to ensure that such transactions are carried out at arm's length?

3. What are the benefits and risks of listing on the AIM. Give examples indicating how AIM is more lightly regulated.

4. It has been said that "G" or governance is the glue that holds "ESG" together and that without good corporate governance, a company cannot be effective in dealing with environmental and social issues. Do you agree? Explain.

5. Comment on the steps taken by Boohoo to address the social issues pertaining to the factory workers. Is Boohoo merely paying lip service. What other improvements can Boohoo implement?

6. It was an "open secret" that labour exploitation was rife in Leicester factories. To what extent were the U.K. authorities to be blamed? Evaluate this in relation to regulation and enforcement efforts such as those under the Modern Slavery Act.

7. With an increasing interest in ESG ratings and sustainable investing, should companies set up board sustainability committees and ESG functions to address ESG issues? Explain.

8. How can investors overcome the problems with investing in companies that are engaged in "greenwashing"?

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CREDIT SUISSE: BANKING ON TROUBLE

Case overview

Iqbal Khan swore he had seen that car before. It was just a fleeting glimpse, out of the corner of his eye, as he dropped his son off at football training. It had already been several streets and still it lurked a few cars behind. He picked up speed to lose the car. There was no mistaking it now; the car, and the three men inside it, were tailing him. He floored the accelerator but his pursuers did not let up, hot on his tail as the two vehicles tore through the old town of Zurich, Switzerland. He screeched to a sudden halt and leapt out of the car. Whipping out his phone, he snapped shots of the tailing car's license plate. One of the men stepped out of the car and ran over, demanding that he hand over his phone. When the man tried to snatch it from him, Khan shouted for the police, and the three men escaped into the streets.

Khan was the former head of Credit Suisse's wealth management division and was victim of an espionage scandal that sullied Credit Suisse's reputation. The media was in an uproar over the 'culture of observance' at Credit Suisse and the chaos only intensified when it was revealed that another former executive had also been spied on. As the company reeled from the aftermath of the scandal, its reputation took a further beating when it was caught in the collapse of Archegos Capital Management and Greensill Capital. It was also implicated, albeit less significantly, in the Luckin Coffee and Wirecard scandals.

The objective of this case study is to facilitate a discussion of issues such as corporate culture; ethics; board structure and responsibilities; diversity; crisis management; corporate espionage; and risk management.

A Swiss story

Founded in 1856, Credit Suisse AG (Credit Suisse) is a financial services company serving clients through three main regional segments – the Swiss Universal Bank, International Wealth Management, and Asia Pacific.[1] It offers diversified financial services ranging from private banking solutions to discretionary asset and risk management. Credit Suisse has gained a reputation as a firm with strong global investment banking capabilities and has established itself in its home market of Switzerland.[2]

This case was prepared by Leo Ee Jayne, Patarin Pravichphibul, Rachel Ng Rui, Muhammad Syazani Bin M Aziz, Ho Yee Yuen, and Pang Jiarong, Jacob, and edited by Sheethal Shanbhogue and Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been substantially re-written by 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 organizations named in the case, or any of their directors or employees.

However, following the 2008 global financial crisis, Credit Suisse's share price has declined more than 90%.[3] The bank has since made painstaking progress, with heavy cost cutting and restructuring, to achieve more stable financials today. More recently, Credit Suisse reported a 75% increase in profits in the first quarter of 2020 to US$1.34 billion, which was its "highest quarterly results in five years".[4]

Surprising the doubters

"We all deal with the same yield curve, the same equity markets, the same volatility. Yet people were acting as if I had landed at the bank from planet Mars. Saying that it was risky for Credit Suisse to appoint a non-banker felt to me like a cheap shot."

– Tidjane Thiam, CEO of Credit Suisse[5]

Tidjane Thiam was appointed the Chief Executive Officer (CEO) of Credit Suisse in March 2015 after being the Group CEO of Prudential plc. (Prudential) since 2007. He had a plan to scale up Credit Suisse's private banking and wealth management operations in Asia, Eastern Europe, Latin America, and Africa.[6]

Initially, many both inside and outside the bank doubted Thiam's ability to lead Credit Suisse. His background in insurance at Prudential led others to assume that he would not be able to understand the complexity in the banking industry. However, Thiam was hardly a stranger to financial markets.[7]

After taking the helm, Thiam mapped out a three-year restructuring plan for Credit Suisse that was launched at the beginning of 2016, redirecting the bank's focus from riskier, capital-intensive investment banking to wealth management and emerging markets.[8] Despite sustaining losses in 2016 and 2017 due to restructuring costs, legal settlements and U.S. corporate tax changes, Credit Suisse's profits increased steadily from 2015, supported by reduced volatility of revenue streams and operating costs. In 2018, the bank reported its first annual net profit since 2014, beating analysts' expectations.[9] It continued to do well in 2019, achieving a cost-to-income ratio of 77.6% – its best since 2010.[10] Thiam was awarded Banker of the Year by Euromoney in 2018.[11] Chairman Urs Rohner credited Thiam as the reason that "Credit Suisse is standing on a very solid foundation and has returned successfully to profit."[12]

Khan versus Thiam

Thiam's stellar performance came with high expectations that not many employees were able to meet. Two bankers came through amidst Thiam's efforts to break Credit Suisse from its past. One was finance chief, David Mathers, and the other was Iqbal Khan. Mathers succeeded in winding down under-perfoming assets within record time. Khan, who was in charge of private banking, was able to reduce costs through disposals in the asset management business and restructuring, and exceeded the targets set.[13]

As Khan and Thiam worked together, they grew closer, and became neighbours in Herrliberg, the “gold coast” of Lake Zurich, when Khan bought the apartment next to Thiam.[14] However, animosity eventually developed between the two due to work on Khan’s property that spanned more than two years, which chipped away at Thiam’s patience. A cocktail party held in January 2019 soon became the talk of the company, as the tension between Khan and Thiam boiled over. Khan and Thiam had a squabble away from the guests, regarding Thiam’s trees which blocked Khan’s view of the lake. The argument escalated and required an intervention from Khan’s wife. Instead of letting it go, Khan complained to Rohner and the Credit Suisse board, widening the split between the two and creating a toxic environment at the bank’s headquarters.[15]

The final straw for Khan came when he was passed over for a promotion while two of his colleagues were promoted to the executive committee.[16] Khan was expecting more recognition and assurances from Thiam regarding his future and role within the company. The personal animosity he felt towards Thiam and a perceived lack of recognition by Credit Suisse drove Khan to leave for cross-town rival UBS.[17] Chairman Rohner’s handling of Khan’s exit from Credit Suisse aggravated the situation. When Khan approached Rohner about leaving Credit Suisse well before his actual departure,[18] he was granted a shorter than usual “gardening leave” of just three months.[19]

On 30 June 2019, Khan was still finishing the second quarter as the head of Credit Suisse’s international wealth arm. The next day, he officially handed in his resignation to Thiam and revealed the arrangements for his departure. The communication of his departure as fait accompli infuriated Thiam.[20] Credit Suisse announced Khan’s official departure on 1 July 2019.[21]

Spy who followed me

Following Khan’s departure, it was reported that Credit Suisse Chief Operating Officer (COO) Pierre-Olivier Bouée, a close deputy of Thiam, had appointed private security firm Investigo GmbH (Investigo) to follow and track the movements of Khan during the three month “gardening leave”.[22,23] In addition to following Khan’s car, private investigators from Investigo also followed him on foot on multiple occasions. They used the encrypted messenger service Threema for communication purposes, which subsequently made it impossible for Homburger, the law firm that investigated the spying scandal on behalf of Credit Suisse, to discover the full extent of Investigo’s covert surveillance.[24]

News of the spying incident broke at the end of September 2019. The Credit Suisse board announced that Bouée had been motivated by the “misguided notion” that Khan would try to poach clients as well as employees from Credit Suisse. Bouée assumed full responsibility for the matter and resigned from his position with immediate effect on 1 October 2019.[25]

Credit Suisse conceded that Khan and Thiam had “a dispute, a heated discussion”. Nevertheless, Chairman Rohner rejected any claims about Thiam’s possible involvement and said that there was “zero evidence” that Thiam had known about the spying incident despite the personal animosity between the two men. Rohner’s assertion was corroborated by Homburger’s investigation which “did not identify any indication that the chief executive had approved the observation of Iqbal Khan nor that he was aware of it prior to 18 September 2019, after the observation had been aborted”.[26]

Prior to the conclusion of Homburger’s investigation, Credit Suisse’s largest shareholder, Harris Associates, had publicly called on the board not to dismiss any executive over the incident. Harris Associates’ Deputy Chairman, David Herro, said: “These are humans; people aren’t flawless. They don’t make perfect decisions every time. And this is why, unless laws have been broken, this doesn’t seem like a case for anyone losing their job.”[27]

In December 2019, it was revealed that Credit Suisse was involved in yet another spying case targeting Peter Goerke, the former Chief Human Resources Officer. Credit Suisse admitted that private detectives were hired to follow Goerke for several days in February 2019 after Goerke had been taken off the executive team and relegated to the role of a senior advisor. The bank placed the blame on Bouée, claiming that the former COO acted on his own accord without any involvement from Thiam.[28]

The Swiss Financial Market Supervisory Authority (FINMA), which is responsible for enforcing financial regulations in Switzerland, was drawn into the incident involving Goerke.[29] However, it was reported that FINMA was not bothered by the fact that there was surveillance involved, which is legal in Switzerland. Observations are allowed for competitive intelligence or to protect the company’s interest. However, what concerned FINMA was the fact that the messages involving the surveillance were encrypted and deleted.[30,31] Enforcement proceedings by FINMA are still ongoing as of July 2021.[32]

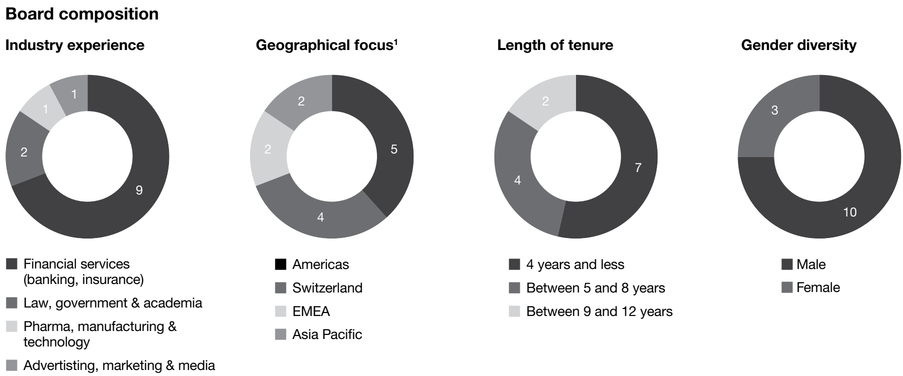
On 25 July 2021, it was reported that Credit Suisse has reached an out-of-court settlement with Khan over allegations of spying.[33]

Board of directors

Swiss company law is mainly based on the Swiss Code of Obligations. Another source of rules for listed companies is the Swiss Ordinance against Excessive Compensation in Listed Companies.[34] Other relevant regulations include the Directive on Information relating to Corporate Governance[35] – which requires companies to publish a corporate governance section in their annual reports – and the Swiss Code of Best Practice for Corporate Governance[36] which adopts a ‘comply-or-explain’ approach.[37]

Credit Suisse adopts a two-tier governance structure with a separate board of directors and executive board.[38] In this system, the board of directors is tasked with the ultimate direction and strategy of the company as well as the oversight over the executive management. Swiss law does not entitle employees to a representation on the board of directors.[39] The company's articles can provide for such a representation, but this is not the case for Credit Suisse.[40] The roles of the Chairman and the CEO are separate, with Rohner as Chairman and Thiam as CEO. Rohner chaired the board of directors while Thiam led the executive board.[41]

Swiss law also does not require directors to have any particular knowledge or qualifications and there are also no gender or diversity requirements.[42] Companies are free to incorporate such clauses into their articles of association but there are no such specifications in the case of Credit Suisse.[43] Figure 1 shows the profile of the Credit Suisse board in 2019.



1 Geographical focus represents the region in which the Board member has mostly focused his or her professional activities and may differ from the nationality of that individual.

Figure 1: Composition of Credit Suisse's board of directors in 2019[44]

In 2019, the Credit Suisse board had 13 directors who were all deemed to be independent. The independence of the board members is assessed annually by the Governance and Nominations Committee, using the independence criteria of the SIX Swiss Exchange Directive, FINMA, the Swiss Code of Best Practice for Corporate Governance and the rules of the New York Stock Exchange and the NASDAQ. Performance of the board is also assessed annually against responsibilities and objectives, including any special focus objectives for the following year.[45]

The board members had backgrounds in areas such as finance, senior management experience in financial services, government and academia. The directors included nationals from Switzerland, Americas, Asia Pacific and EMEA (Europe, Middle East and Africa). The board is committed to maintaining a good gender balance over the long term, having guidelines for representation of each gender on the board of directors and executive board of at least 30% and 20% respectively.[46]

Under Swiss law, the Annual General Meeting (AGM) must be held within six months of the end of the fiscal year, and the notice of the AGM must be published in the Swiss Official Gazette of Commerce at least 20 days prior. In 2019, the Credit Suisse board held seven meetings in person and nine additional meetings with all having over 85% attendance. In addition, the board held a two and a half day strategy session. Board members are elected at the AGM by shareholders individually for a period of one year and are eligible for re-election but have a maximum tenure of 12 years, with a special request required to extend for a maximum of three additional years. In the 2019 annual report, it was disclosed that Chairman Rohner had served for the maximum standard term limit of 12 years as of 2020 and has informed the board that he would not stand for re-election at the 2021 AGM.[47]

Boardroom battle

"I serve at the pleasure of the board, and if they decide they want to make a change, it's my duty to make that happen. I am doing that with a clear conscience."

– *Tidjane Thiam, CEO of Credit Suisse*[48]

The second spying case and investigations by FINMA further undermined Credit Suisse's reputation and placed even greater pressure on Thiam to resign.[49] The scandal also strained the relationship between Rohner and Thiam.[50]

Although Rohner said that he would not be standing for re-election at the 2021 AGM, he changed his mind a few months before that AGM and said he planned to extend his tenure. This led to unhappiness as several of Credit Suisse's top bankers had called for Rohner to step down rather than Thiam. The announcement led Blackrock – the world's largest asset manager and Credit Suisse's fifth largest shareholder – to reject Rohner's suggestion. This was a major blow to Rohner as Blackrock was one of his key supporters in the power struggle against Thiam. Blackrock had previously offered conditional support in Chairman Rohner's tussle with Thiam, provided Rohner resigned in 2021.[51,52]

A number of shareholders publicly declared their support for Thiam, including Silchester International Investors Inc. (Silchester), which owned a 3.26% stake in Credit Suisse. Silchester released a statement saying that it was not aware of any reason why Rohner and other board members were not giving Thiam their full support, and hence felt that Rohner should resign before his planned retirement date. U.S. hedge fund Eminence Capital (Eminence) went one step further and wrote to Credit Suisse's non-executive directors to warn them against pursuing a "personal agenda with respect to the CEO rather than acting in a responsible fiduciary way".[53]

Herro, from Harris Associates, which owned a 8.4% stake in the bank,[54] said that the board should remove Rohner if he still refused to show support for the CEO. He further stated that he would take matters into his own hands otherwise.[55] Herro supported Thiam as he felt that Thiam had done a great job in replenishing Credit Suisse's capital and transforming the bank into a more focused wealth manager, and that the surveillance scandal should be considered a small issue.[56] He further stated that he saw "no reason to change a successful CEO as he has not been implicated in any wrongdoing".[57] Eminence, which owned an approximately 1%

stake,[58] felt that the lack of support for Thiam would have a harmful impact on shareholder interest. Eminence called for the board to publicly reaffirm its support for Thiam. It said it would not hesitate to pursue legal action to hold Rohner and the board accountable if its requests were not complied with.[59]

Compensation

Credit Suisse's Compensation Committee is chaired by an independent director and comprises solely of independent directors.[60] In Credit Suisse's 2019 annual report, Compensation Committee Chairman Kai S. Nargolwala specifically addressed the spying incidents which he termed as "observation events". He asserted that Credit Suisse's independent investigation found former COO Bouée to be chiefly responsible for the observation events and that no other key management personnel was involved. Upon his resignation, Bouée forfeited all his outstanding deferred compensation awards. Thiam also accepted accountability for the events and had his 2019 non-financial short-term incentives (STI) score reduced to 50% from 100% a year before.[61]

In total, CEO Thiam received approximately 15% lower compensation in 2019 compared to 2018. The reduction was mainly due to the lower achievement of STI financial performance targets, a 50% score for non-financial STI, and a lower fair value of the 2019 long-term incentives (LTI) opportunity compared with the prior year LTI.[62]

The key elements of the compensation framework included both fixed and variable compensation. Base salary is based on relevant skills, qualifications, experience, responsibilities and external market factors. Pension and benefits are consistent with local market practices. For variable compensation, 2019 STI was based on equal weightage (of 33.3% each) given to adjusted income before taxes, return on tangible shareholders' equity, and non-financial criteria. In determining the 2019 LTI, equal weightage (33.3%) was given to the three-year average return on tangible equity, three-year average tangible book value per share, as well as the relative total shareholder return.[64]

With regard to variable compensation awarded, approximately 54% would be deferred. The 2019 annual report also stated that Credit Suisse neither has "golden parachute" agreements nor any other predetermined termination agreements for employees. There are also no special severance provisions to executive board members beyond the regular compensation awarded during the notice period.[65]

Thiam takes the fall

On 6 February 2020, Thiam finally resigned as CEO. The board unanimously accepted his resignation. Thiam had previously expressed his desire to stay on but was unable to subdue Rohner in an internal power struggle without the backing of the board despite the support of major shareholders. The board also unanimously decided to support Rohner to complete his full term until April 2021.[66]

Following Thiam's resignation, Credit Suisse's share price fell from US$13.06 on 7 February 2020 to a low of US$6.67 on 16 March 2020.[67] Herro did not hold back in his comments on Thiam's resignation, calling out the "poor decision-making by the board of directors" and reiterating Thiam's contribution in turning Credit Suisse around.[68]

Rohner commented that during Thiam's term, the bank "saw a deterioration in terms of trust, reputation and credibility among all [its] stakeholders".[69] Others praised Thiam's contributions to Credit Suisse's performance.[70] In FY2019, Credit Suisse achieved a 69% growth year-on-year in terms of net income. Two other key banking performance metrics – Group net new assets and assets under management – also increased from 2018.[71]

Was Thiam a victim?

"To be very frank, it seems like envy from competitors or perhaps something else given that Mr. Thiam looks a little bit different than the typical Swiss banker. Either one of these two rationales behind these attacks against him, to me are extremely distasteful."

– David Herro, portfolio manager at Harris Associates[72]

Though Thiam produced stellar results for Credit Suisse, as the sole black CEO of a large bank in a predominantly white industry and city,[73] his tenure within the Swiss bank was not smooth sailing. During his term, the first few years of restructuring required the bank to issue new shares which brought down its share price, drawing ire and disapproval.[74] Some board members criticised him for the lack of growth in the bank's Chinese arm. Furthermore, he was often viewed as an outsider in Zurich. His personality did not sit well with the Zurich public, and he received scathing, racially charged comments from bloggers and news sites – one called him a "fruits salesman" and asked him to "go home, fool!".[75] A shareholder even insinuated that he hailed from "third world" origins.[76]

Thiam was brought into Credit Suisse to improve its profitability – which he did, as he successfully stabilised the company's profits by strengthening its wealth management arm. However, he confessed to some of his close associates that he felt the board wanted him to leave since he had finished his task, a phenomenon commonly known as the "glass cliff".[77]

The racial undercurrents were present outside work as well. When he was invited to Rohner's private 60th birthday party, Thiam found himself the only black guest and watched in disbelief as a black entertainer was called onstage to dance and sweep to the music, dressed as a janitor. Thiam left the room with his partner and another couple, only to return to Rohner's friends in the midst of a performance, donned in afro wigs.[78] The bank apologised for the incident and cited "a total mischaracterisation of the evening", saying that "there was never any intention to cause offense" and that they were "sorry for any offense caused".[79]

Thiam's last news conference at the bank's headquarters was his swan song. "Every second, I've done the best I could," he said. "I am who I am. I cannot change who I am. It is the essence of injustice to hold against somebody what they are."[80]

A new team takes the helm

Thiam was replaced by a Swiss national, Thomas Gottstein, who was head of Credit Suisse's Swiss unit.[81] Meanwhile, it was reported that Rohner agreed to step down in 2021,[82] in line with the maximum term limit of 12 years. In what was seen as a surprise, the bank picked Antonio Horta-Osorio as the new Chairman succeeding Rohner. Horta-Osorio, who has dual Portuguese and British citizenship, is the first non-Swiss person to be appointed as Credit Suisse Chairman. A retail banking veteran, his position prior to taking on the role as Credit Suisse Chairman was the CEO of Lloyds Banking Group Plc.[83]

Swiss avalanche

Unfortunately, a new team at the helm seemed to bring a new set of troubles. In 2021, Credit Suisse was sued by a pension fund which claimed that investors in the bank were misled. Material defects in client companies and inadequate risk policies and oversight were allegedly concealed from investors. The bank was accused of allowing high-risk clients to take up excessive leverage, thereby exposing itself to billions of dollars in potential losses. Two such clients were U.K. fund Greensill Capital (Greensill), and U.S. investment fund, Archegos Capital Management (Archegos).[84]

The asset management team of Credit Suisse managed US$10 billion in funds that Greensill packaged based on financing it provided to companies. However, many of these companies were either not rated or had very low credit ratings. Such financing allowed these highly levered companies to hide additional borrowings with minimal accounting disclosure. Swiss regulators had previously warned the bank about the client, ordering it to set aside more capital to cover potential losses arising from companies which would default on their payments.[85] Moreover, Credit Suisse was allegedly also aware that Greensill was under investigation by the German banking regulators in July 2020.[86]

Further, two months before entering into business with Greensill, the Asian risk management team of Credit Suisse had put Greensill on a watchlist. However, according to reports, these red flags were repeatedly dismissed by the bank's leadership in Zurich, London, and Singapore. Credit Suisse continued to market the Greensill funds and went on to approve another US$160 million loan to the company. In October 2020, Lara Warner, the Chief Risk and Compliance Officer, was reported to have overruled the risk managers who predicted a default in its loan to Greensill. Warner went on to remove around 20 senior risk managers from the team.[87]

The risk management of Credit Suisse was apparently further hampered by bureaucracy. The head of the bank's Asian arm, Helman Sitohang, was responsible for many of the bank's lucrative clients. He had a strong relationship with SoftBank Group Corp. (Softbank), a significant backer of Greensill. His "salesman" nature made him extremely "risk-agnostic" and his immense support for the founder of Greensill prevented Credit Suisse from breaking ties with the company.[88]

In March 2021, Greensill lost its credit insurance coverage from Tokio Marine,[89] which refused to renew cover for the loans Greensill was making.[90] Credit Suisse also began winding down its US$10 billion group of supply chain finance funds over valuation concerns on 5 March 2021.[91] Greensill filed for insolvency on 8 March 2021.[92] In relation to the collapse of Greensill, Credit Suisse recognised US$2.3 billion worth of defaulted loans in its Greensill funds.[93]

More bad news soon came in the form of Archegos, where things went south when owner Bill Hwang's biggest wagers moved against him.[94] Hwang worked for hedge fund powerhouse Tiger Management Corp. before running his own fund, Tiger Asia Management LLC (Tiger Asia) in the 2000s. In 2012, the U.S. Securities and Exchange Commission accused Tiger Asia of insider trading and manipulation in two Chinese bank stocks. Hwang allegedly received confidential information about pending share offerings from the underwriting banks and used the insider information to make US$16.7 million in illicit profits.[95,96] Hwang was also banned from securities trading in Hong Kong for four years from 2014 due to market misconduct.[97]

Hwang started his own family office fund, Archegos in 2013.[98] At Archegos' peak, his wealth amounted to approximately US$30 billion. Hwang had built his stockpicking wagers and magnified his positions through Credit Suisse with huge, borrowed sums.[99] The bank allegedly used opaque derivatives to help Archegos place big wagers on risky companies such as ViacomCBS without being required to disclose them to regulators.[100] As Hwang's swap accounts progressively churned out cash, he accumulated additional funds to invest and increase leverage.[101]

In April 2021, some of Archego's portfolio stocks experienced a substantial dip in share price, triggering margin loan calls from lender banks. Archegos eventually defaulted on margin calls, and the lenders were forced to sell off huge chunks of its investments to recoup their money. The stock fire sale amounted to almost US$30 billion.[102] Credit Suisse was the worst hit of several global banks,[103] ending up with a loss of US$4.7 billion after it was stuck on negotiating the prices and could not sell off its investments in time. The impact of this was so significant that it led to the bank announcing an expected US$960 million pre-tax loss for its first quarter of 2021.[104]

Remedial actions

If not for the Archegos and Greensill debacles, Credit Suisse would have reported the strongest quarterly financial performance in a decade.[105] The Credit Suisse asset management division was left reeling from the Greensill collapse. The Archegos saga was the final nail to the coffin. Credit Suisse's investment banking head, Brian Chin, and Chief Risk and Compliance Officer Warner were dismissed from the bank, along with several other executives involved in the two cases.[106] Warner's predecessor, Joachim Oechslin was reinstated as the Interim Chief Risk Officer for Credit Suisse.[107]

In the aftermath of the two debacles, Credit Suisse made reductions to its bonus pool accruals,[108] to the tune of hundreds of millions of dollars. Credit Suisse also cancelled its share buy-back programme.[109]

The bank's asset management and investment banking divisions were overhauled, with many personnel changes.[110] To further address the risk management issues, it launched two independent investigations, led by third party experts, into both its investment banking and asset management operations.[111]

Credit Suisse shares lost nearly 25% of their value over a period of two months. The dividend declared was reduced to 0.10 CHF (US$0.11) per share for 2020, from the proposed 0.29 CHF (US$0.31).[112] Analysts and investors remained concerned about the Group's steps to boost capital and the upcoming quarterly earnings.[113]

Was the crisis expected, yet again?

Despite the warnings from the 2008 global financial crisis, hidden risks from opaque financial transactions have managed to destroy the reputation of a blue-chip bank, harm shareholders and risk careers, putting question marks over the financial regulation reforms post-crisis. Credit Suisse engaged in strategies which were difficult to comprehend and had escaped proper regulatory supervision.[114]

In hindsight, Credit Suisse had enough capital to fulfil regulatory requirements, and there was no warning sign alluding to any danger of an impending crisis. However, regulations for excessive risk taking were seen to be inadequate. Thomas Minder, a member of the Swiss Ständerat, said that the regulatory reforms after the 2008 global financial crisis did not address many root causes of the crisis, including outsized bonuses that encouraged excessive risk-taking by bank executives. Credit Suisse had repeatedly been accused of overcompensating its executives, with the top 1,000 executives having received bonuses worth US$1 billion.[115]

Reforms by central banks and bank supervisors include raising capital requirements, forcing lenders to invest more of their own money in transactions. With the prevailing market, it was increasingly difficult for banks to earn money through interest margins, and thus banks have been induced to take excessive risk, leading to lax risk management.[116]

The decline in the quality of risk management of Credit Suisse was not sudden. In 2020, Warner changed many reporting lines in the bank. She shifted several market risk functions to report to the head of front office technology, instead of keeping it within the independent central risk team. With this new model in place, "risk lost its independence" in Credit Suisse.[117]

Another apparent reason for Credit Suisse's poor risk management was the "co-mingling of its lending, asset management, and private wealth management functions".[118] The lack of division and independence materially reduced the bank's ability to accurately assess and manage its risk exposure to high-risk clients.[119]

Additionally, it was reported that Credit Suisse promoted salesmen and technocrats at the expense of promoting risk expertise and trading acumen. A former executive claimed this to result in "a dulling of senses" at the bank.[120]

Other misadventures

Being a global bank, the risk of being implicated in global scandals will undoubtedly be higher than for less international banks. However, it seems Credit Suisse found itself embroiled in a greater number of scandals compared to other global banks.

Luckin Coffee

Luckin Coffee Inc. (Luckin Coffee) is a coffee chain which was launched in China and became a unicorn in a short period of time. Its speedy growth from the initial funding stage to launching an initial public offering was achieved within two years, with the underwriters being Credit Suisse and Morgan Stanley.[121]

Shortly after it was listed, a shortseller's report led to the unravelling of major fraud in the company.[122] It was unveiled that Luckin Coffee had been falsifying the books over almost a year from April 2019. More than US$310 million of retail sales over this period were fabricated. Numerous other issues relating to the company's Chairman, its business model and its corporate governance were raised in the shortseller's report. The company's valuation plummeted from US$12.7 billion to US$731.5 million,[123] and its share price fell from a peak of US$50 to less than US$3.[124]

Following this accounting scandal, Credit Suisse had to bear a five-fold increase in the loan-loss provisions for the region. It set aside US$100 million to provide for the potential default of Luckin Coffee. Credit Suisse had lent millions of dollars of money to Luckin Coffee's Chairman Lu and was one of the biggest creditors for the loans defaulted by Luckin Coffee.[125]

Wirecard

Credit Suisse was also publicly criticised for several deals it arranged for another key Asian client, Masayoshi Son's SoftBank. In late 2019, Credit Suisse bankers helped Wirecard AG (Wirecard) sell US$1 billion worth of convertible bonds that Softbank had agreed to buy.[126,127] This was apparently done to establish a strategic partnership with Softbank. The deal was closed by September 2019 and helped stabilise Wirecard's volatile share price. Wirecard was already facing allegations of accounting fraud at that time.[128]

After helping sell the convertible bonds to Softbank, Credit Suisse helped Softbank cut its exposure.[129] It packaged the convertible bonds for resale to third party investors. However, in June 2020, Wirecard's stock crashed after news broke that its auditor could not account for more than US$2 billion in cash on the company's balance sheet. The convertible bonds fell to just 12% of their face value, causing huge losses to the investors, including European private banks which bought them.[130]

Although the financial losses recorded by Softbank and Credit Suisse were limited due to an insignificant exposure to the Wirecard bonds, Wirecard's collapse rebounded on many institutions that had once helped the company to establish its presence in Europe's technology scene.[131]

Is it really over?

The recent scandals that Credit Suisse found itself in – from the spying scandal to the collapse of Archegos and Greensill, and its involvement in the Luckin Coffee and Wirecard scandals – have raised issues about its corporate culture, risk management and corporate governance.

The recent scandals involving Archegos and Greensill occurred under the watch of the new Chairman and CEO. Even if they may not be totally culpable due to the recent timing of their appointments, there lies the question of whether they were at least partly responsible. After all, the current CEO, Gottstein, had said it was the right time to "capture growth opportunities" and this was seen as a signal for the bank to capitalise on the market's rally after the initial shock of the COVID-19 pandemic.[132] After Thiam stepped down as CEO, Gottstein also expanded the role of Warner to include oversight of the newly combined global risk and compliance division. Warner had reportedly pushed for risk and compliance to be "more commercial" and "aligned" with front office traders and dealmakers.[133]

While there have been some board changes in the embattled bank, the board has remained largely intact. Has Credit Suisse done enough to make sure that history does not repeat again…and again?

Discussion questions

1. What are the key contributing factors to the problems that Credit Suisse has found itself in? Rank them from most to least significant and explain.
2. Thiam stood out partly because he was the only CEO of African descent among major banks worldwide. Do you believe he should have been fired over the spying scandal or was there more than meets the eye? How can companies ensure robust diversity and inclusion policies are in place and effectively implemented?
3. Critically evaluate the board structure of Credit Suisse at the time of the spying scandal and today. Are there any improvements you would suggest?
4. Do you believe that the directors at Credit Suisse adequately discharged their duties and responsibilities in relation to the spying scandal and other major problems that the bank has found itself in? Explain.
5. Credit Suisse's share price declined sharply after the resignation of Thiam was announced. Was this indicative of a mistake on the part of the board of directors? To what extent should shareholder value dictate board decisions? Discuss how companies should handle situations where a CEO is delivering good financial performance but has faced ethically ambiguous issues.
6. Comment on how poor risk management has contributed to the problems at Credit Suisse. Identify the bank's risk management weaknesses based on the information given in the case.

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GUCCI/ KERING: DESIGNER GOVERNANCE, QUESTIONABLE FASHION

Case overview

To avoid Italy's volatile tax regime and boost bottom line profits, a rising number of companies have resorted to "tax dodging" measures in the recent decades. Italy is thought to have forfeited an estimated €150 billion a year in unpaid taxes – the third highest amount in Western Europe. In particular, fashion powerhouses like Gucci have been placed under the spotlight, with Italian tax authorities scrutinising their finances. Eventually, in May 2019, Gucci's parent company, Kering, agreed to pay €1.25 billion to settle the dispute with Italian tax authorities.

Unfortunately, the tax dispute was not the only event that has put a question mark over Gucci's blockbuster growth in the 2010s. Gucci has recently found itself embroiled in several public relations disasters, most notably the "blackface sweater" and "blue turban" controversies.

The objective of this case study is to facilitate a discussion of issues such as corporate governance of company groups; corporate culture; corporate ethics; risk appetite and risk management; crisis management; and transparency of tax structures in multinational corporations with cross-border transactions.

Kering and the House of Gucci

Headquartered in Paris, France, Kering SA (Kering) is one of the world's largest luxury goods holding companies, second only to LVMH in terms of revenue.[1] Its concept of luxury is based on "creative risk-taking and sincerity that inspires dreams and emotions" in a sustainable and responsible way.[2] The luxury powerhouse designs, manufactures, and markets luxury fashion and leather goods,[3] and has over 30,000 employees globally.[4] Most notably, Kering owns the luxury brands Gucci, Yves Saint Laurent (YSL) and Bottega Veneta.[5] It has been listed on the Paris Stock Exchange since 1988 and has a market capitalisation of €73,899 million as at 31 December 2019.[6]

This case was prepared by Chng Shu Yi, Choy Wen Qian, Emily Rachman, Foo Jen Ni and Valere Lau Hiu Tong. It was re-written and edited by Isabella Ow 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 organizations named in the case, or any of their directors or employees.

Kering's subsidiary, Gucci, is an Italian fashion label founded by Guccio Gucci in 1921. It was a luggage manufacturer in its early days, producing luxury travel goods and equestrian equipment for Italy's wealthy residents. As the fashion house grew, it became renowned for its extravagant, opulent designs and became favoured among celebrities and the affluent. In particular, it is known for its distinctive "Double-G" monogram, and its iconic Gucci stripe.[7] Today, Gucci has over 480 stores world-wide and produces leather goods, shoes, ready-to-wear apparel, watches, jewelry, fragrances, and home decor.[8]

Gucci was acquired by Kering in 1999. As one of the luxury fashion industry's top performing labels, Gucci contributes 60% of revenues and 80% of profits for Kering.[9] As Kering's crown jewel, Gucci has been the focus of brand developmental efforts in the Group.[10] Gucci's highly successful revamp under fashion designer Alessandro Michele, who is known for his maximalist designs, saw its revenues more than double between 2015 and 2019.[11]

The designer board

Kering's governance structure comprises the board of directors (BOD) – which determines the Group's strategic priorities – and the Executive Committee, which implements the Group's strategy.[12]

Board of directors

Kering's BOD determines and assesses the Group's strategic direction, objectives and performance, and ensures that its strategies are properly implemented. As at 31 December 2020, Kering's board has 14 members, with eight being independent directors. The board members have competencies in areas such as finance, marketing, law, corporate governance, and engineering.[13]

François Jean Henri Pinault is both the Chief Executive Officer (CEO) and Chairman of the board of Kering. He has held this position since 2005. After graduating from HEC Business School, he joined Kering – then known as the Pinault Group – in 1987. He was previously the Deputy CEO of Kering, during which he was in charge of the Group's digital strategy. In 2003, he was appointed the Chairman of Artémis – the holding company controlled by the Pinault family – which is Kering's controlling shareholder. Artémis owns a 41.4% stake in Kering.[14,15]

Jean-François Palus has been the Group Managing Director (MD) from 2008 and a member of Kering's BOD since 2009. As a graduate of HEC Business School, he started his career at Arthur Andersen as an auditor and financial adviser. He later joined Pinault Group in 1991. Prior to becoming Group MD, he previously held other positions in the Group, including Deputy Chief Financial Officer (CFO) for the timber division of Pinault SA, and Group CFO of Kering.[16]

Another key member of the board is Sophie L'Hélias, the lead independent director. She has served on Kering's board since 2016 and was nominated as lead independent director in 2019. She is an expert on corporate governance with a background in law. She is the co-founder of the International Corporate Governance Network, a leading international network of institutional investors for corporate governance. She also founded LeaderXXchange, which aims to promote diversity and sustainability in governance, leadership, and investment.[17] As lead independent director, L'Hélias' role in Kering is to serve as the principal liaison and facilitator between the BOD and the investors on ESG matters, as well as to "represent the interests of all shareholders with a view to creating long-term, sustainable value".[18]

Kering's board committees

Four board committees have been established by the BOD – the Audit Committee; Remuneration Committee; Appointments and Governance Committee; and Sustainability Committee.[19]

The Audit Committee is responsible for reviewing the company's financial statements and ensuring the implementation of internal control and risk management procedures, evaluating the selection and independence of statutory auditors, and reviewing the sustainability and environmental policies. The Remuneration Committee oversees the design of, and reviews, the company's remuneration policy, including the performance criteria for the variable remuneration components. The Appointments and Governance Committee's responsibilities cover the appointment of directors and evaluation of their independence, the composition of specialised committees, as well as succession plans for executives.[20]

The role of the Sustainability Committee, which was set up in 2012, is to assess the company's commitment to ethics, social, environmental and societal responsibility and guide its sustainability strategy. It reviews ethical measures, performance, and Corporate Social Responsibility (CSR) ratings. In 2020, the Sustainability Committee comprises six directors, half of whom are independent.[21] British actress Emma Watson, who joined Kering's BOD in June 2020, is the Chairman of the Sustainability Committee. Along with other campaign work, Watson is also the face of Good On You, a mobile application that allows consumers to view the sustainability credentials of fashion brands.[22]

Double service

Kering's Chairman and CEO, Pinault, is on the boards of a number of Kering Group entities, including Kering SA, Kering International Ltd., Kering Italia SpA, Yves Saint Laurent SAS, The Kering Foundation, Kering UK Services Ltd., and Kering Eyewear SpA. Apart from being Kering's director and Group MD, Jean-François Palus also holds multiple directorships in Gucci entities. He is the director of Gucci America Inc. in the U.S., Guccio Gucci SpA in Italy, and Gucci Luxembourg SA in Luxembourg.[23]

Gabe Shawn Varges, a governance expert and senior partner at HCM International AG, believes there should be careful consideration of the impact of having Group board members serving on subsidiary boards. Efficiencies in terms of cost and time have to be weighed against the potential loss of the healthy governance distance that the Group board should observe with regards to the subsidiaries. Having said that, Varges states that in certain instances, such as where a major business of the Group is carried out in a separate subsidiary, having a Group board member on the subsidiary board may help to improve alignment with the group-wide direction and oversight.[24]

The Executive Committee

Kering's Executive Committee includes the CEOs of its major fashion houses. Gucci's CEO, Marco Bizzarri, is part of this committee. Other members include Francesca Bellettini, President and CEO of YSL; Cédric Charbit, President and CEO of Balenciaga; Bartolomeo Rongone, CEO of Bottega Veneta; and Roberto Vedovotto, President and CEO of Kering Eyewear.[25]

In addition to the subsidiary CEOs, the other members of the Executive Committee comprised Kering CEO Pinault; Group MD Palus; CFO Jean-Marc Duplaix; Grégory Boutté, Chief Client & Digital Officer; Marie-Claire Daveu, Chief Sustainability and Institutional Affairs Officer; Valérie Duport, Chief Communications & Image Officer; and Béatrice Lazat, Chief People Officer.[26]

Together, the 12 members of Kering's Executive Committee implement the strategic direction of Group.[27]

Risk management in Kering

As a holding company, Kering's own operations consist of "defining and implementing its strategy, organising and managing its holdings, stimulating the development of its activities, coordinating their financing, providing support and communication functions, and defining and implementing the insurance cover policy".[28] The internal control function is decentralised at the operational level. Executive management of the operating and legal entities is responsible for managing and coordinating the internal control process, based on a common methodology and a single set of standards. Kering's organisational framework includes the setting of clear roles, responsibilities and standards, a robust risk management policy, and an IT system that makes it possible to share information about risks internally.[29]

One of the key risks identified by Kering is "image and reputation, respect for ethical rules and integrity". This risk involves the potential damage to the Group's reputation, which potentially affects its consumer demand and thus financial results. Examples of reputational risks include failing to meet the Group's rules on ethics and unethical conduct in its business dealings. The risk was deemed to be "unlikely" but has a high impact on Kering's reputation. Moreover, the impact of this risk on human capital, compliance and operational areas was assessed to be significant.[30]

Kering also identified commercial appeal risk – a strategic and operational risk – which includes the failure to comply with the Group's CSR principles and poor consideration of customer expectations and market changes. This risk was assessed to be "likely" and deemed to have high impact on finance, and significant impact on human capital and reputation. As part of its actions to mitigate the risk, Kering encourages its businesses to stay ahead of consumer trends by keeping abreast of market demand shifts.[31]

Another risk identified is compliance with national tax laws and international standards, whereby non-compliance with national and global tax standards might likely lead to investigations and disputes by the relevant authorities. This risk was deemed to be “unlikely” by Kering, with medium impact on finance and reputation. Financial risk occurs when tax authorities challenge a company’s tax position, which could lead to a reduction in cash flow. Additionally, businesses may face reputational risks when there is media coverage on well-known companies in the Group which have failed to pay their fair share of taxes or broken laws.[32]

In this regard, Kering has employed highly skilled employees in the Group’s tax department and invested in professional training to better identify and understand relevant tax issues. The roles and responsibilities of the tax department were clearly laid out by Kering. These include consolidating tax information from all Group companies; understanding and monitoring both national and international tax issues, ensuring compliance with these laws and standards; and providing technical support on tax-related matters during the preparation of consolidated financial statements.[33]

Running the Gucci business with Bizzarri

Kering has a decentralised approach to the management of each brand,[34] including Gucci, its star brand. In January 2015, Bizzarri took on the role of Gucci’s President and CEO.[35] He had one mission: to turn the brand around after sales had been stagnant and its profits took a hit due to over-aggressive expansion in China under the former CEO Patrizio di Marco.[36]

Prior to his appointment, Bizzarri played an integral role at Kering for a decade. He first joined Kering in 2005 as President and CEO of Stella McCartney. Thereafter, he was President and CEO of Bottega Veneta from 2009 to 2014. He also became a member of the Kering’s Executive Committee in 2012, and was a non-voting director of Kering from 2013. In April 2014, Bizzarri was appointed as the CEO of Kering couture and leather goods division, making him in charge of overseeing the chief executives of other Kering brands such as Bottega Veneta, Saint Laurent, and Stella McCartney.[37,38]

One of Bizzarri’s first executive decisions was to recruit Michele as Gucci’s creative director. Michele’s new vision for Gucci was to establish a more contemporary attitude for the fashion house, and was met with immediate success. The Bizzarri-Michele dream team decided to revamp the Gucci brand for the next generation and the fashion house began dressing contemporary style icons that resonate with millennials. In 2018, Gucci reported an “exceptional financial performance across the board”. It later unveiled a plan to hit a €10 billion revenue target in the following years.[39]

At Gucci, the management team has four executive pillars reporting directly to CEO Bizzarri. The four pillars are merchandising and global markets; indirect channels, outlet and travel retail; brand and customer engagement; and digital business and innovation. Together, the four pillars support Bizzarri in his mission to strengthen the Gucci brand.[40]

Gucci's corporate culture

"We are writing different chapters to try to change an organisation and culture on a daily basis – and we are not finished."

– Marco Bizzarri, Gucci's CEO[41]

Gucci has a corporate culture which is focused on people, creativity and innovation. This involves empowering its teams at all levels and encouraging them to challenge the status quo.[42] Having been widely acknowledged as one of the world's most sustainable fashion brands,[43] Gucci is also committed to a "culture of purpose, putting environmental and social impact at the heart of the brand".[44]

Positive and creative people who are not afraid to take risks

Gucci's parent company, Kering, stated in its 2020 integrated report that "We dare to take risks, think differently, and constantly propose fresh and innovative ideas that inspire emotion and enthusiasm for our exceptional products capable of expressing each consumer's distinctive personality" in a bid to meet the expectations of a new generation of customers.[45] In line with its parent company's ambition, Gucci's CEO Bizzarri also encouraged a culture of taking calculated risks in the fashion house. In an interview, he said: "I try to push everybody to take risks and make mistakes – and not kill them if they make mistakes."[46]

Additionally, Gucci believes that "a positive corporate culture helps us achieve significantly higher organisational effectiveness, because our people feel valued and part of a positive environment". As such, it continuously invests in a strong corporate culture to increase employee engagement, boost commitment, and nurture collaboration.[47] Further, as a fashion house, creativity is at the core of the Gucci brand, and is supported by its corporate values, which include "respect, happiness, passion, empowerment and inclusivity."[48]

Culture of purpose

In 2017, Gucci's launched its ten-year Culture of Purpose sustainability plan, which focuses on three broad categories: the environment, humanity, and new models. Gucci has expressed its commitment to reduce its environmental impact and removed animal fur from all its collections starting with the Spring/Summer 2018 collection. Additionally, Gucci values its employees and supporting communities – it is committed to the responsible and innovative management of the supply chain, gender equality, diversity, and inclusion. As part of its plan, Gucci is also keen on developing new solutions to improve efficiency in production and logistics, such as an incubator and start-up environment to foster greater innovation.[49]

Diversity with a capital D

Gucci is a big advocate of diversity, declaring that "diversity and inclusion are at the centre of Gucci's creative vision" and stressing the importance of equality and gender diversity in the workplace.[50] In relation to the company's 2020 to 2021 gender pay gap data, as requested by the U.K. government, Gucci submitted a report including all information regarding the U.K.

gender pay gap.[51] It was revealed that the median gender pay gap was only 1.9%.[52] This was an improvement from the 2018/2019 period, when its median gender pay gap was 4.5%. In contrast, its direct competitors Chanel and Louis Vuitton U.K. reported a median gender pay gap of 13.4% and 4% respectively.[53]

Gucci also supports the inclusion of individuals in the LGBTQIA+ community. It signed the United Nations (UN) LGBT Business Conduct Standards, which is the UN's guidelines for companies in protecting the rights of LGBTI individuals in the workplace and society. Furthermore, Gucci educates its employees through unconscious bias training on diversity and inclusion, and via workplace discussions on racial justice and issues facing the LGBTQIA+ community.[54]

Gucci also ensures a healthy representation of all generations (Boomers, Generation X, millennials, and Generation Z) and ages among its global employees. In 2020, a whopping 64.5% of Gucci's workforce comprised millennials,[55] a generation defined to be born between 1980 and 2000.[56] It was reported that the fashion house's secret weapon – a "shadow committee" of millennials under the age of 30 – who, as millennials themselves, supposedly have a good understanding of Gucci's target demographic. The shadow committee would periodically meet with CEO Bizzarri and have the opportunity to express their ideas to senior executives. Bizzarri would also spend time with these young employees and collect feedback on how to improve the company.[57]

The bigger picture

Code of ethics

Gucci does not have its own set of code of ethics. Instead, it complies with Kering's code of ethics, which is shared with all of Kering's subsidiaries and applies to all employees. Kering's code of ethics serves as an underlying framework for the Group's activities, with the aim of protecting the Group, its success and longevity. Kering's code of ethics addresses several issues such as protection of the environment, sustainability, human rights, diversity and equality. It also details the whistleblowing system in place, which comprises the whistleblowing hotline, Ethics Committees, and the Compliance Organisation – which is made up of an international network of brand compliance officers and led by a Group Chief Compliance Officer (CCO), which function is to guide employees to ensure compliance with laws and regulations. Based on Kering's code of ethics, it is evident that significant emphasis has been placed on addressing environmental, social and corporate governance (ESG) issues.[58]

Kering's sustainability strategy has been internationally recognised, having reached seventh place in the Corporate Knights 2021 Global 100 ranking of the 100 most sustainable companies[59] and being listed in the 2020 Dow Jones Sustainability Index (DJSI) World and Europe for the eighth consecutive year.[60]

Environmental, social and corporate governance (ESG)

To supplement Kering's code of ethics, Gucci has a CSR policy to sustain and promote its business growth model which "combines excellent craftsmanship with the creation of sustainable value".[61] The CSR policy states that Gucci is committed to conducting its business in accordance with principles of honesty, fairness, transparency, and integrity. Further, the policy states that Gucci will strive to fully comply with all laws, regulations, guidelines and applicable standards, as well as consider the economic, environmental and social interests of all stakeholders in its business.[62]

In 2018, Gucci launched Gucci Equilibrium, a new portal to promote Gucci's stance on the environment and social impact developments it has undertaken.[63] This is in line with Kering's commitment to sustainability, and the Culture of Purpose sustainability plan.[64]

Going green – The most fashionable colour

Gucci has expressed its commitment towards sustainability on numerous occasions. Gucci has in place a "360-degree strategy" to promote the reduction of greenhouse gas emissions and respond to climate change. Its carbon neutrality strategy takes into consideration the greenhouse gas emissions generated from its entire supply chain.[65] This has extended to its fashion shows, which have been certified according to the international standard ISO 20121 – a standard of sustainable event management from the International Organization for Standardisation.[66] Since its Spring/Summer 2020 show held in Milan in September 2019, Gucci has measured and reduced the environmental impact of its fashion shows to ensure greater environmental efficiency. This is done through measures such as using green electricity, more eco-friendly transport, and sustainable sourcing of materials.[67]

Gucci has also worked with other organisations to tackle environmental issues through its REDD+ (reducing emissions from deforestation and forest degradation) projects,[68] and obtains its raw materials "from agricultural systems that restore soils and habitats for important biodiversity".[69] Following Climate Week NYC in 2019, CEO Bizzarri has also penned an open letter to all CEOs, challenging them and their companies to take up the challenge of being carbon-neutral. He stressed that collective action is crucial for success to "create a future in which society can thrive and business can succeed, while nature is restored and protected".[70,71]

Discrimination and diversity issues

2019 was a particularly memorable year for Gucci, but unfortunately, not in a positive way. The fashion house became mired in controversy regarding questionable fashion items, drawing objections from critics and the general public on racial and religious grounds.

Controversial balaclava sweater

In February 2019, as part of its Fall/Winter 2018 line, Gucci landed in hot water for selling a "blackface sweater" – a black-knit turtleneck sweater with a cut-out red-lipped mouth that resembled offensive blackface caricatures. This product drew immense criticism from the public.[72] Prominent celebrities such as director Spike Lee and rapper 50 Cent have also spoken out about the issue, stating that the Gucci sweater was blatantly disrespectful, racist, and consisted of hateful blackface representation. The public figures also encouraged their followers to boycott the luxury brand, with 50 Cent uploading a video on Instagram burning a number of his Gucci apparel.[73,74]

In response, creative director Michele said that the inspiration behind the sweater came from performance artist Leigh Bowery, but eventually apologised for the way it had been interpreted, taking "full accountability" for the "unintentional effects".[75] As the situation escalated due to mounting pressure from the public, Gucci eventually released an apology and withdrew the sweater from its product line. The twitter apology statement read: "Gucci deeply apologises for the offense caused by the wool balaclava jumper…We consider diversity to be a fundamental value to be fully upheld, respected, and at the forefront of every decision we make."[76] Gucci also stated its commitment to increase diversity, calling the incident "a powerful learning moment".[77]

In March 2019, Gucci went one step further to launch a new global program dedicated to diversity and fostering industry change. The Gucci Changemakers program was dedicated to investing in non-profits and community-based programs supporting "the African-American community and communities of color at-large",[78] including the provision of scholarships to eligible fashion students. Gucci announced the creation of its new global program dedicated to diversity and fostering industry change. CEO Bizzarri stated that he believes in "dialogue, building bridges and taking quick action". He further added, "I believe in the promise of the next generation, and through our scholarship fund we will also create more opportunities for talented young people of diverse backgrounds to gain access to careers in the fashion industry."[79]

Bright blue turban

It was not long before Gucci was once again ensnared in another controversy. In May 2019, Gucci was accused of cultural appropriation due to the sale of a bright blue turban on Nordstrom, a luxury department store. The turban drew flak from Sikhs and other critics, who condemned Gucci for trivialising an article of faith. In Sikhism, wearing a turban "asserts a public commitment to maintaining the values and ethics of the tradition, including service, compassion, and honesty".[80]

The Sikh community took issue with the turban as it argued that the turban "is not a fashion accessory" to be monetised as a luxury good, but a symbol of faith and religious tradition considered sacred by Sikhs. Further, as turbans are "the most visible markers of Sikh identity", they contribute to the discrimination and bullying of Sikhs for expressing their religious identity. The fact that Gucci and Nordstrom would profit over it offended the Sikh community, which deemed it highly inappropriate.[81]

Nordstrom eventually removed the turban from its website and apologised. Gucci however, did not address the matter.[82]

Seeking salvation

After receiving criticism over its insensitive designs, Gucci announced the hiring of its first Chief Diversity Officer in late July 2019.[83] Renée Tirado was brought on board as part of a drive to restore Gucci's tarnished reputation and to correct its diversity shortcomings. The new role involved creating a more inclusive, diverse and equitable workplace within the company.[84] Prior to this, Tirado was the Chief Diversity and Inclusion Officer at Major League Baseball. Regarding her appointment, Tirado said, "I am in the business of making human connections that start with the foundation of inclusivity, respect, and diversity to ensure Gucci remains culturally relevant and economically competitive."[85] In a statement, CEO Bizzarri said: "This appointment is a fundamental building block to further our commitment and support the initiatives already in place."[86]

A year later, Tirado stepped down from her position in Gucci to launch her own consulting firm in New York. Although she will still continue to consult for Gucci, her responsibilities would be shared between Gucci's Chief People Officer, Luca Bozzo, and Bethann Hardison, a member of the Gucci Changemaker council. Hardison is also part of Gucci's global corporate executive committee as executive adviser for global equity and culture engagement.[87]

Mental health is not fashion

Gucci's Spring/Summer 2020 show in September 2019 opened with models clad in white straitjackets – garments historically used in psychiatric hospitals – staring bleakly ahead while rolling out on a conveyor belt. Ayesha Tan-Jones, a model who viewed that the outfits "allud[ed] to mental patients",[88] protested against the fashion brand with the phrase "mental health is not fashion" written on her palms as she walked down the runway. Tan-Jones said that "presenting these struggles as props for selling clothes in today's capitalist climate is vulgar, unimaginative and offensive to the millions of people around the world affected by these issues."[89] The model later brought the issue up again on social media, calling Gucci "insensitive" and saying that the use of the imagery of straitjackets was done "in bad taste".[90]

The saga garnered the attention of media outlets and members of the public, and caused online furor. In response to the backlash, Gucci defended its decision, stating that the intention of the show was to depict "the journey from conformity to freedom and creativity".[91] The fashion house issued a statement saying that the blank slate and straitjackets were meant to represent "the most extreme version of a uniform dictated by society and those who control it".[92] It also pointed out that the straitjacket-inspired garments were just one part of its show – the rest of the collection featured a number of colourful items that Gucci designed as "an antidote to the white utilitarian garments".[93]

Gucci's tax dispute

"In an era of mistrust of financial services, especially among the millennial generation, tax will become important for the brand,"

– PwC[94]

In March 2018, French investigative media outlet Mediapart published an article claiming that since 2002, Gucci's parent company, Kering, has avoided paying approximately €2.5 billion euros in tax on earnings.[95] Kering allegedly used its Swiss-based logistics subsidiary, Luxury Goods International (LGI), to reduce taxes paid for its Group companies – in particular, Gucci in Italy and YSL in France. Mediapart also alleged that Kering has been under investigation by the Italian tax authorities since 2017, when they raided Gucci's offices in Florence and Milan.[96] In response, Kering said it "aspires to ensure full compliance with tax regulations in the countries where it operates".[97]

The Italian tax authorities noted something amiss with Kering and could not reconcile the material amount of income tax paid in Switzerland with the substantial value added activity carried out in Italy. It considered Gucci's operations in Switzerland to be mainly "a logistics hub", while key decisions and functions of the brand are carried out in Italy. Additionally, analysts say the Group has reported a lighter tax load compared to its peer group – LVMH's average tax rate over the past seven years was 30.8%, while Kering's has only averaged about 21.2%.[98]

In January 2019, Kering announced that it could potentially incur a €1.4 billion tax bill from Italy's audit office, which claims that LGI failed to pay taxes due in Italy. Kering said that it would object to the tax claim on both "the grounds and the amount" and stated that it "is confident about the proceedings currently under way and will continue to fully co-operate in transparency with the Italian tax authorities in order to defend all its rights".[99]

Italy's volatile tax regime

Italy has a volatile tax regime – a new government can retroactively change tax laws in Italy, resulting in a high level of uncertainty in business operations. In this regard, it is not surprising for companies to seek tax arrangements outside the country.[100] In 2014, prior to the Italian tax authorities' investigations into Gucci, a new Italian voluntary tax disclosure system was implemented to encourage companies to "return from tax havens such as Luxembourg, Switzerland and Netherlands – traditional harbours for assets away from Italy's notoriously volatile tax regime".[101]

Prada – one Gucci's peers in the luxury fashion industry – was one such company which completed the process of voluntary disclosure to Italy's tax revenue agency, having repatriated its assets held in Luxembourg and the Netherlands back to Italy in 2013. Milan prosecutors opened a tax case on Prada soon after, alleging tax evasion during the decade-long period the company was based in Luxembourg.[102,103]

Tax settlement with the Italian authorities

"In terms of reputation, this is a slightly more important concern as Kering has stood up as a champion of ESG (environmental, social and governance),"

– Luca Solca, Bernstein analyst[104]

In May 2019, Kering agreed to pay €1.25 billion to settle the dispute with Italian tax authorities centered on Gucci.[105] The settlement comprised the payment of €897 million in additional taxes, and additional amounts for penalties and interest. It is the largest settlement agreed by a company with the Italian tax authorities to-date.[106] The Italian tax authorities accused Gucci of evading taxes on over €1 billion in revenues from 2011 to 2017.[107] While Kering acknowledged the Italian tax authorities' claim that Gucci had a permanent establishment in Italy during the period,[108] it denied tax avoidance allegations.[109]

After taking into account the tax settlement, Kering's effective tax rate was 69.8% for the first half of 2019. Excluding the impact of the tax settlement, the effective tax rate on recurring income was 26.4% during the same period.[110]

Apart from the hefty tax settlement, the run-in with the Italian tax authorities had an impact on Kering's reputation. Its target demographic, the millennials, might view Kering less favourably than before as they tend to be more susceptible to a reputation for social "do-gooding". A report by PwC supported this; it found that consumers were "increasingly hostile" towards companies which do not pay their "fair share" of tax – perceived or otherwise.[111]

Was the boss in on it too?

Over the second half of 2019, the Italian authorities continued to probe a number of Gucci's current and former executives over an alleged tax-avoidance scheme. In August 2019, Gucci's executives received notifications that they were being investigated over salaries received from companies in Switzerland for work done for Gucci in Italy.[112]

Gucci CEO Bizzarri was not included in the latest tax investigation as he had settled a dispute over his taxes with the Italian authorities earlier in 2017 under an amnesty programme for repatriating earnings.[113] Although Gucci's sales skyrocketed during Bizzarri's term, getting the experienced business executive on board to lead Gucci was also very costly, as he allegedly negotiated an annual salary of €8 million per year. Despite his high salary, Bizzarri was said to have only paid 13% income tax during his first few years on the job. This is a stark contrast to other high income earners in Italy, who pay a 45% tax rate. It was claimed that the tax savings were made possible by paying Bizzarri via a company based in Luxembourg and a residence in Switzerland, and thus the salaries were not recorded in Italy.[114]

Other Kering subsidiaries

Yves Saint Laurent

Founded in 1961[115] and acquired by Kering in 1999,[116] YSL is one of the most prominent luxury brands in the industry today. YSL products bring in the second highest revenue in Kering, accounting for 14% of Kering's revenue as of February 2021.[117] With regard to relevance and revenue, YSL would be closest to Gucci amongst the other fashion houses in Kering.

In 2017, YSL was embroiled in a scandal involving the advertisements for its 2017 campaign. The controversial advertisements were seen as misogynistic and degrading to women. France's advertising watchdog, the Autorite de Regulation Professionnelle de la Publicite, later requested YSL to modify two of its advertisements after receiving 50 complaints from the public. The portrayal of women in the advertisements were a breach of rules set by the French advertising industry to maintain "dignity and respect in the representation of the person." It was also highlighted that the models featured on the advertisements were "very thin", which might have a negative impact on teenage girls who aspire to be like them.[118,119]

In 2019, YSL drew flak from Malibu residents and city officials for holding its Spring/Summer 2020 menswear show on a hidden beach in Malibu. The fashion house was criticised for failing to protect Malibu's fragile environment and for violating various environmental regulations by building a boardwalk across the private beach and shoring it up with plastic sandbags.[120]

Bottega Veneta

Founded in 1966,[121] Bottega Veneta is a successful Italian luxury goods fashion house. It was acquired by Kering in 2001,[122] and is one of the top contributors of revenue to Kering, trailing only Gucci and YSL.[123]

Bartolomeo Rongone took over as Bottega Veneta CEO in September 2019.[124] Under his leadership, the fashion house does not seem to have faced any major controversy, unlike its fellow fashion houses in the Group. Bottega Veneta has its own Code of Ethics and has set up a supervisory board to monitor compliance with it.[125]

A creative future

Despite its troubles in 2019, Gucci still managed to retain its value as a highly coveted luxury brand. According to a 2019 report by marketing and consulting firm Interbrand, Gucci is one of the only two luxury companies to consistently rank among the world's most valuable brands in the past two decades. The report also stated that Gucci outpaced competitors to become 2019's fastest growing luxury company with a brand valuation of US$15.9 billion.[126] Gucci therefore appeared to have bounced back from the issues it faced.

Unfortunately, Gucci's strong recovery did not last long. In early 2020, COVID-19 took the world by storm, disrupting many industries across the world. The fashion industry as a whole has been negatively impacted by the outbreak on multiple fronts – production has ceased, retailers have closed, consumer demand has nosedived – leading to an "existential crisis" in the industry.[127] Gucci sales fell in 2020, ending years of expansion and growth as it struggled amid renewed lockdowns in Europe. The brand was also seen as too ostentatious, especially against the backdrop of the pandemic when consumers may be less keen to purchase attention grabbing products.[128] Will the Bizzarri-Michele dream team be able to overcome the threats caused by COVID-19 and bring Gucci to greater heights?

Discussion questions

1. Considering the scale, business and strategies of Kering, what would be an appropriate board structure in terms of size, leadership, composition, and committees?
2. Do you think an actress like Emma Watson is a suitable board member for Kering? What are your views on having celebrities on boards? What do you think of the "secret weapon" of Gucci – a "shadow committee" of millennials helping Gucci's senior executives understand its target demographic?
3. What are the common challenges faced in company groups, from the perspectives of the parent and subsidiaries and individuals who serve on their boards? How should parent companies in company groups govern their subsidiaries?
4. Evaluate the factor(s) that may have contributed to the ESG issues in the Kering Group, in particular the tax scandal and discrimination and diversity issues. Determine which factor played the most significant role.
5. Comment on the risk appetite of Gucci. What risk governance policies should be adopted to manage Gucci's various risks?
6. Do you think Gucci handled its controversies well? How could it have done better?
7. Gucci placed great emphasis on encouraging diversity in the company. What are some best practices to promote diversity? Do you think having a Chief Diversity Officer is effective and necessary?

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LUCKIN'S SPILLED COFFEE

Case overview

The case of Luckin Coffee Inc. (Luckin) tells the story of a high-flying and ambitious start-up which came crashing down as quickly as it had ascended. Luckin opened its first store in 2017, with a unique digitalised takeout and delivery business model and a target on Starbucks' back. In the span of 18 months, the company skyrocketed to become one of the top coffee brands in China.

However, in early 2020, the company was rocked with accusations from Muddy Waters Research LLC, which announced on Twitter that it was planning to short Luckin's shares. Along with the announcement, it released an anonymous 89-page report highlighting Luckin's flawed business model, questionable accounting practices, and various other red flags.

Despite initially defending itself against the accusations, an internal investigation subsequently confirmed that US$300 million in revenue and US$190 million in costs and expenses were indeed fabricated by the company in 2019.

The objective of this case study is to facilitate a discussion of issues such as concentrated share ownership structure; board composition; director responsibilities; the separation of roles of Chairman and CEO; the role of short-sellers; the roles and responsibilities of external auditors; due diligence by institutional investors; variable-interest entity structures; conflicts of interest; ethics; and the pros and cons of dual-class shares.

Sowing the beans

In 2017, Luckin Coffee Inc. (Luckin) was founded in China by Jenny Qian Zhiya, who later became CEO of the company.[1] She held the belief that there was great untapped potential in the coffee market in China and aspired to introduce coffee "as part of life" to the Chinese population by making coffee more affordable to the masses.[2,3]

Due to its luxury positioning, high prices, and the general perception that coffee drinking was a social activity,[4] coffee was not very popular in China, with average per capita coffee consumption of approximately five cups per annum, compared to 400 in the U.S. and over 200 in neighbouring Taiwan and Hong Kong.[5,6] However, it was rapidly growing in popularity among the younger generation in China. This was further fuelled by the population's increasing disposable income and international influence.[7]

This case was prepared by Gideon Quek Wei Han, Hariharan Jayaram Naidu, Ian Thong Wei, Lee Jin Wei, Benedict, Lee Yu Howe and Matthew Khoo Teng Lik, and edited by Isabella Ow 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 organizations named in the case, or any of their directors or employees.

In October 2017, Luckin started operations in Beijing with a single trial store, backed by an initial investment of over US$150 million from Charles Zhengyao Lu, founder of car rental company CAR Inc., and future Chairman of Luckin.[8]

Right from the get-go, Luckin marketed itself as a high-profile brand, eager to disrupt the coffee industry using artificial intelligence and big data analytics.[9] In one of the world's largest consumer markets, Luckin's digital-first strategy enabled the brand to compete against other internationally recognised companies in the industry. Through the use of a mobile application, customers were able to place their coffee orders online before heading down to a brick and mortar store to collect their orders. Unlike its direct competitor Starbucks, which offered cosy store environments for customers to relax and socialise over coffee, most of Luckin's physical stores were grab-and-go outlets consisting of small kiosks with simple interior designs and limited seating capacity.[10]

In order to gain market share, Luckin focused its growth strategy on bringing in as many users as possible onto its mobile application. Similar to business strategies used by ride-hailing and bike-sharing companies, Luckin attempted to achieve this by tapping into consumers' social circles and by offering steep discounts.[11] Consumers were given a myriad of promotional offers, such as getting a free cup of coffee for signing onto the mobile application for the first time and earning extra coupons for referring friends onto the platform. Professor Jeffrey Townsend, from Peking University Guanghua School of Management, contrasted Luckin's strategy to that of Starbucks, saying that while Starbucks' strategy was based on real estate, Luckin's was based on smartphones.[12] Since Luckin employed a digital-based strategy, the company did not have to spend as much on renovation and store maintenance expenses, thus increasing its operational cost savings. This allowed the company to set up new stores relatively easily as well as undercut its competitor by offering lower coffee prices to the masses.[13]

This led to Luckin expanding its store count at a breakneck pace, reaching 4,507 stores in China by the end of 2019. It quickly overtook Starbucks, which had opened more than 4,200 stores in China since entering the market in 1999. Not content with overtaking Starbucks in terms of the number of stores opened in China, Qian had reportedly aimed to open 10,000 stores by the end of 2021.[14]

Juicing up the coffee

Within eight months of the opening of its first outlet, Luckin was already well into its expedited expansion journey, with more than 500 stores in China.[15] In July 2018, Luckin managed to secure US$200 million in a series A financing round from venture capital firms Centurium Capital, Joy Capital, Legend Capital, and Singapore's state fund GIC.[16,17] This helped Luckin continue its rapid expansion, opening more new stores in China.

By December 2018, Luckin's store count had already grown to over 2,000 in China.[18] Growing investor confidence in the young coffee chain was evident – Luckin secured another US$200 million in its series B round from existing investors in December 2018, followed by an additional US$150 million in April 2019 from its series B+ round from other investors including Blackrock.[19]

In April 2019, with a valuation of US$2.9 billion, Luckin filed for an Initial Public Offering (IPO) in the U.S. for a listing on the NASDAQ. In its U.S. Securities and Exchange Commission (SEC) filing, Luckin announced its ambitious expansion plans, intending to open 2,500 new cafes in China by the year end.[20] On 17 May 2019, merely 18 months after it started operations, Luckin was officially listed on the NASDAQ exchange. Luckin priced its IPO at US$17 per share, valuing the company at the upper bound of US$4 billion and minting its status as a unicorn. On its first day of trading, the stock price surged nearly 50% to US$25 per share before eventually closing at US$20.38 per share.[21] Through the IPO, Luckin was able to raise US$561 million in proceeds, which it planned to use for store network expansion, customer acquisition, marketing, as well as research and development.[22] This was despite the fact that Luckin reported revenue of only US$125.3 million and a net loss of US$241.3 million in 2018.[23]

In January 2020, the company raised another US$865 million in a post-IPO offering, intending to use the funds for further expansion. At this point, Luckin already had over 4,500 stores country-wide, making it China's largest coffee chain by store count, surpassing Starbucks' 3,600 stores.[24]

Wake up and smell the coffee

"A new generation of Chinese Fraud 2.0 has emerged,"

– *Anonymous author of the 89-page report*[25]

On 31 January 2020, Muddy Waters Research LLC (Muddy Waters), an American due diligence-based investment firm, announced that it would short Luckin's shares based on an anonymous 89-page report (Muddy Waters report) it had received, which claimed that Luckin had inflated its revenue figures. It also publicly shared a copy of the report in its tweet.[26] The report examined 11,260 hours of store traffic video footage and 25,843 customer receipts to expose Luckin's questionable business practices.[27] Luckin responded that the methodology of the anonymous report was flawed and the allegations were "unsupported speculations and malicious interpretations of event".[28] Despite Luckin's strong denial, Luckin's share price plunged by about 26% on the day of the tweet.[29] It fell further from US$32.49 on 31 January 2020[30] to US$31.35 on 3 February 2020.[31]

In mid-2020, it was reported that the author behind the anonymous report was Snow Lake Capital, a Chinese hedge fund with offices in Beijing and Hong Kong. Snow Lake Capital was founded in 2009 by Sean Ma, its China-born and U.S.-educated Chief Investment Officer. The reason behind its decision to stay anonymous was not publicly disclosed. When the report was received by Muddy Waters, the short-seller decided to circulate it to the public after assessing its validity as it decided it would be a "good platform" for it.[32]

On 2 April 2020, Luckin announced that its Chief Operating Officer (COO), Jian Liu, and several employees had inflated the reported sales figures from FY2019 Q2 to FY2019 Q4 by US$310 million.[33] As a result, the coffee chain suspended Liu and employees reporting to him following initial recommendations from a special committee appointed to investigate issues in its FY2019 financial statements. The special committee consisted of three Luckin independent directors, namely Sean Shao, Tianruo Pu and Wai Yuen Chong.[34] Luckin further stated that it would take appropriate actions – including legal actions – against employees involved in the fraud.[35] On 3 April 2020, the Chinese regulator – China Securities Regulatory Commission (CSRC) – said that it would "investigate the case in line with any international investigation and strongly condemned any financial misconduct".[36]

On 5 April 2020, Luckin made direct reference to the scandal on the Chinese Weibo platform, where it issued an apology for the accounting fraud and the "bad social influence" it caused. Charles Lu – the co-founder and Chairman of Luckin – further said on social media that he was "ashamed and promised to do his best to recover the losses".[37]

The shocking news caused a 75% drop in Luckin's market value of more than US$5 billion when its closing share price fell to US$6.40 per share,[38] compared to its peak market capitalisation of US$12 billion in January 2020.[39] Trading in its shares was halted on the NASDAQ on 7 April 2020 with the status being changed to "additional information requested".[40] Luckin's stock was trading at US$4.39 a share before the trade halt – approximately 75% lower than its US$17 IPO price.[41] Trading only resumed on 20 May 2020.[42]

What's really in the coffee?

Upon further investigation, internal documents and public records uncovered that revenue was inflated as Luckin sold vouchers redeemable for tens of millions of cups of coffee that were never produced, to fake buyers – companies linked to its Chairman and controlling shareholder, Lu. Further, Lynn Liang, allegedly a procurement employee at the company who processed over US$140 million of fictitious payments for raw materials, delivery and human resources services, actually did not exist.[43]

On 12 May 2020, as more evidence of fabricated transactions appeared, Luckin fired its co-founder and CEO Qian as well as its COO Liu. Jinyi Guo, a board director and Senior Vice President, was appointed as the acting CEO.[44] NASDAQ proceeded to give Luckin two written delisting notices due to its failure to comply with listing rules. Luckin initially requested for a hearing to appeal this decision but eventually withdrew this request. Luckin was officially delisted from NASDAQ on 29 June 2020.[45]

On 26 June 2020, the majority of Luckin's board resolved to require Lu to resign as Chairman and director of the board.[46] This proposal was considered during the 2 July 2020 special directors meeting, but was not approved by the necessary two-thirds of the directors present, and thus Lu was not removed from his position.[47] However, during a shareholder's Extraordinary General Meeting (EGM) held on 5 July 2020, Lu was voted out by the coffee chain's shareholders. On 12 July 2020, Guo took over as CEO and Chairman.[48]

Although Luckin terminated the people who played key roles in the accounting fraud, its troubles were far from over. The completion of the independent internal investigation announced on 1 July 2020 discovered that Luckin's FY2019 revenue was inflated by US$300 million and expenses were inflated by US$190 million.[49,50] The Chinese market regulator fined Luckin and 44 other companies a total of US$8.98 million for the falsification of financial records and "misleading of the public".[51] Its probe found that Luckin violated Chinese laws on inappropriate competition by inflating its operational figures, and misled the public with false financial data between August 2019 and April 2020.[52]

On 16 December 2020, the U.S. SEC charged Luckin with "defrauding investors by materially misstating the company's revenue, expenses, and net operating loss in an effort to falsely appear to achieve rapid growth and increased profitability and to meet the company's earnings estimates". Luckin paid a US$180 million penalty. A number of class-action lawsuits were also filed against Luckin.[53]

Breaking down the coffee

"The misconduct is the immediate problem, but the underlying issue is Luckin's business model,"

– Brock Silvers, managing director of Adamas Asset Management[54]

In spite of Luckin's lofty ambitions to rapidly conquer the Chinese coffee market, the Muddy Waters report exposed several glaring flaws in its business model.[55]

Firstly, Luckin was in the business of selling coffee in China, a country of primarily non-coffee drinkers. Research showed that the consumption of tea was responsible for 95% of China's caffeine intake. At a level of 86mg/day per capita, overall caffeine intake levels were similar to that of other Asian countries. Given that tea is generally the choice of beverage in China, the functional demand for coffee in China was always destined to remain a niche segment of the market.[56]

Secondly, in order to maintain its aggressive growth strategy, Luckin heavily utilised generous price promotions to attract new customers. Burning through significant amounts of cash, it opened a staggering 4,500 stores in a short span of two years and distributed 20.5 million cups of coffee each month at low prices or for free. Unsurprisingly, many of Luckin's customers were highly price-sensitive and customer retention was extremely dependent on the deep discounts. Cohort analysis in the Muddy Waters report showed that many of Luckin's new customers did not continue to consume Luckin's beverages after they consumed their first cup of coffee for free. As Luckin did not have a membership program, customers had no incentive to spend more or consume more frequently. On the other hand, as part of Luckin's user retention program, customers who did not make a purchase within a certain period of time would receive various forms of coupons and discounts. This unconventional model of pricing and promotion was not sustainable in the long-term.[57]

Thirdly, Luckin's unit economics was inherently "flawed", such that there was almost no chance of profitability. The Muddy Waters report broke down Luckin's fundamental unit economics into four segments: revenue, cost of sales, store-level operating cost, and delivery subsidy. Based on its FY2019 Q2 earnings, average monthly store gross profit was RMB 50,600, store-level operating cost (including rental, labour costs, utilities and depreciation) was about RMB 61,100 per month, and delivery subsidies amounted to RMB 7,800 monthly. As such, Luckin's gross profit was unable to cover its store-level operating costs and delivery subsidy, resulting in average store-level operating losses of RMB 18,300 each month. Since operating costs were largely fixed and cost of raw materials was directly proportional to sales revenue, the daily sales volume and effective prices after discount were two key drivers of their store unit economics. In order for Luckin's store-level economics to have worked, it had to increase both its beverage prices and volumes. However, due to limiting factors of a small market size, price-sensitive customer base, and a highly fixed cost structure, it was almost impossible for Luckin to achieve those targets.[58]

Brewing the pot

The Muddy Waters report also brought to light the pervasive fraud in the company. In preparing the report, nearly 1,500 investigators were dispatched to count sales and record traffic at 600 Luckin stores. More than 11,000 hours of video were recorded and nearly 26,000 customer receipts collected.[59]

The first instance of fraud highlighted in the report was the inflation of "number of items per store per day by at least 69% in FY2019 Q3 and 88% in FY2019 Q4" based on 11,260 hours of store traffic video. Luckin's "items per order" had also declined from 1.38 in FY2019 Q2 to 1.14 in FY2019 Q4 and despite the generous "items per order", the figure still did not concur with the "items per store per day" figures reported. The 25,843 customer receipts also showed that Luckin inflated its net selling price per item by at least 12.3% to make its business model appear sustainable. Excluding free products, the actual selling price of beverages was 46% of listed price, instead of 55% as claimed by Luckin's management. Further, third party media tracking showed that Luckin had overstated its FY2019 Q3 advertising expenses by over 150%. The report argued that it was possible that Luckin recycled its overstated advertising expense back to inflate revenue and store-level profit. Lastly, "Luckin's revenue contribution from 'other products' was only about six percent in FY2019 Q3, representing nearly 400% inflation, as shown by 25,843 customer receipts and its reported VAT numbers".[60]

Doesn't smell right

In April 2020, Luckin's external auditors, Ernst & Young Hua Ming LLP (EY), said that while auditing Luckin's financials for FY2019, it uncovered that some "management personnel engaged in fabricated transactions which led to the inflation of the Company's income, costs and expenses" from Q2 to Q4 that year. This prompted EY to issue a report to Luckin's Audit Committee and the board subsequently initiated an internal investigation.[61] In April 2020, Luckin announced that the internal probe revealed that COO Liu and other employees had fabricated more than US$300 million in revenue in FY2019. This was achieved primarily by booking sizeable sales of coffee vouchers to companies linked to Chairman Lu.[62,63]

As EY had not issued any audit report on Luckin's FY2019 financial statements, the Big Four accounting firm claimed that it should not be held responsible for Luckin's FY2019 financial statements and accounting fraud. However, EY had issued a private "comfort letter" to investment banks that underwrote Luckin's stock and bond sale in January 2020. In the absence of audited financial statements, such letters are standard due diligence conducted by underwriters prior to securities offerings. In the letter, EY asserted that it had no issues with Luckin's financial results for Q1 to Q3 of FY2019. EY said that such comfort letters are not made public and do not have the effect of an audit opinion.[64,65]

AS 6101 issued by the Public Company Accounting Oversight Board (PCAOB) supports EY's statement. It states that "what constitutes a reasonable investigation of unaudited financial information sufficient to satisfy an underwriter's purposes has never been authoritatively established". Hence, only the underwriter can determine what is sufficient for his purposes. The PCAOB goes one step further to state that comfort letters are subject to limitations – such limited procedures short of an audit may only provide external auditors with "a basis for expressing, at the most, negative assurance" and do not provide assurance that they will become aware of any or all significant matters that would be disclosed in an audit.[66]

The baristas

Luckin's board of directors consisted of eight members at the date of issue of its IPO prospectus as shown in Figure 1.

Name	Position	Other Role/Relation
Charles Zhengyao Lu	Chairman	Co-founder and shareholder
Jenny Zhiya Qian	Executive director	CEO, Co-founder, and shareholder
Jian Liu	Executive director	COO
Jinyi Guo	Executive director	Senior Vice President
David Hui Li	Director	Shareholder
Erhai Liu	Director	Shareholder
Sean Shao	Independent director	-
Thomas P. Meier	Independent director	-

Figure 1: Luckin's board of directors as at 22 April 2019[67]

Lu took on the role of Luckin's Chairman in June 2018 and funded the company as an angel investor in the early days. He was also the largest shareholder, owning a 30.53% stake prior to the IPO. Lu holds a bachelor's degree in industrial electric automation from the University of Science & Technology of Beijing and an executive master of business administration degree from Peking University. He is also the founder of Chinese car-rental company, CAR Inc., and its affiliated ride-hailing company UCAR Inc. He served as CAR Inc.'s executive director and CEO from 2014 till 2016, and as its Chairman from 2014 until his resignation in 2020. He also held the positions of Chairman and CEO in UCAR Inc., which was a substantial shareholder of CAR Inc.[68,69]

All three executive directors had previously held positions with CAR Inc. and UCAR Inc. Prior to her appointment as CEO of Luckin in 2017, Qian served as the Executive Vice President and COO for CAR Inc. from 2014 to 2016, as well as COO and director of UCAR Inc. from 2016 to 2017. Liu, who served as Luckin's COO since 2018 and director since 2019, took on the role of Head of Yield Management at CAR Inc. from 2008 to 2015, and subsequently at UCAR Inc. from 2015 till 2018. Guo, who had served as executive director at Luckin since 2018 and acting CEO as at 12 May 2020,[70] was the assistant to the Chairman of UCAR Inc., Lu, from 2016 to 2017.[71]

The two non-executive non-independent directors, David Hui Li and Erhai Liu (EL), share previous associations with CAR Inc. and Lu as well. Li and EL are founders and executive members of private equity firms Centurium Capital and Joy Capital respectively. Both investment firms held significant stakes in Luckin prior to its IPO.

Prior to founding Centurium Capital in 2016, Li had served as executive director and managing director at another private equity firm, Warburg Pincus Asia LLC (Warburg Pincus) since 2002.[72] Before setting up Joy Capital in 2015, EL worked for Legend Capital Management Co., Ltd. (Legend Capital), the private equity arm of Lenovo's parent company, where he served as its managing director.[73,74] During their time at Warburg Pincus and Legend Capital, Li and EL led Warburg Pincus' and Lenovo's respective investments in CAR Inc. According to the Muddy Waters report, both Li and EL are "old friends" of Lu. The report suggested that their shared corporate history was indicative of a close "golden triangle" working relationship.[75]

Watching over the coffee

Thomas Meier had served on Luckin's board from the time of its IPO until his resignation in April 2020. He has extensive experience in the food and beverage industry, having taken on a number of key executive roles prior to his appointment at Luckin. Meier has been the CEO of candy manufacturer Ricola AG since 1 May 2019, and was previously President and CEO of Franke Coffee Systems, and managing director of Chocoladefabriken Lindt & Sprüngli AG.[76,77]

After working at Deloitte Touche Tohmatsu CPA Ltd. for about a decade, Shao went on to serve on the boards of multiple U.S.-listed Chinese companies. These companies included 21Vianet Group, Inc., UTStarcom Holdings Corp., and China Biologic Products Holdings (CBP), Inc., all of which are listed on the NASDAQ exchange. The Muddy Waters report highlighted Shao's inclusion as Luckin's independent director as one of the many red flags of the company. The report stated that out of the 18 companies where Shao took on the role as director, four of them had previously been accused of fraud, and five others went public via reverse mergers – an infamous source of fraudulent companies in the late 2000s and early 2010s.[78,79]

One notable example was Agria Corporation, a Chinese-based company previously listed on the New York Stock Exchange. In December 2018, the SEC charged Agria Corporation and its Executive Chairman with fraud. The agricultural company had concealed substantial losses from investors through fraudulent accounting, and its Executive Chairman engaged in manipulative trading in the company's American depository shares to inflate the share price.[80] Shao was an independent director of Agria Corporation from 2008 to 2017.[81] At the time when he resigned from Agria Corporation's board in August 2017, he was a member of its Audit Committee.[82]

Lighter brew

The NASDAQ listing rules on corporate governance are set out in the Listing Rule 5600 Series, which include requirements on board structure, organisation, and formation of the Audit Committee. According to Listing Rule 5605(b), the company's board of directors is required to have a majority of independent directors.[83]

However, Foreign Private Issuers are permitted to follow their "home-country practices" on certain corporate governance matters. As Luckin was incorporated in the Cayman Islands, it was allowed to adopt the Cayman Islands' corporate governance code in certain areas instead of the stronger corporate governance practices recommended by NASDAQ.[84] As highlighted in Luckin's SEC filing, it relied on this exemption and did not have a majority of independent directors.[85] Therefore, despite having only two independent directors, Luckin was still given the green light to proceed with its IPO on NASDAQ.

Too much coffee

According to Luckin's January 2020 prospectus for its post-IPO offering, there were two separate classes of ordinary shares issued: 760,687,728 Class A shares and 1,239,287,072 Class B shares. Each Class A ordinary share was entitled to one voting right while each Class B ordinary share was entitled to ten voting rights. Lu owned 484,851,500 Class B shares, which amounted to 36.86% of the aggregate voting power. Mayer Investments Fund, L.P., which is ultimately controlled by Sunying Wong, owned 196,875,000 Class B shares which amounted to 14.97% of the aggregate voting power. Although it was not disclosed in Luckin's prospectus, Wong is in fact Lu's sister.[86] Therefore, Lu effectively held 51.83% of the aggregate voting power in Luckin, making him a controlling shareholder of the company.[87] Qian was the next largest shareholder with 312,500,000 Class B shares, which equated to 23.76% of the aggregate voting power.[88]

Diluting the coffee

The Muddy Waters report uncovered that Lu, Wong and Qian had quietly pledged 30%, 47% and 100% of their respective stock holdings to secure financial borrowings – effectively "cashing out" their stakes in Luckin – despite publicly stating that they had never sold a single share of the company.[89]

Stock pledge financing – using pledged shares as collateral – is especially prevalent in Asia.[90] It creates the risk of potentially depressing the value of shares due to margin calls on those who have pledged their shares. When pledged shares decrease in value, lenders would require those who pledged their shares to provide more collateral. If they are unable to do so, a substantial amount of the shares may be sold if those shares are called as collateral. This might lead to a further depression of stock prices, forming a "negative feedback loop". Michael Puleo, assistant professor of finance at the Dolan School of Business at Fairfield University, said that "the selling causes the share price to fall further and precipitates more margin calls, which can push the price lower."[91,92,93]

The stock pledging by Luckin's management followed rising concerns about such a practice.[94] Stock price plunges arising from stock pledge financing arrangements have become increasingly common in recent years. Not all markets require such arrangements to be disclosed. For example, Hong Kong-listed Jiayuan International Group Ltd.'s share price plunged by about 89% in January 2019, driven by a margin call on stock used as collateral by its Chairman. Hong Kong's stock exchange rules state that a controlling shareholder can borrow against stock and not disclose the arrangement as long as it is for personal finance reasons rather than loans, guarantees or other forms of support for the company. The Chairman of the Hong Kong Securities Association, Gary Cheung, is of the opinion that authorities should find a balance between providing more information and protecting executives' privacy.[95]

Coffee buddies?

The Muddy Waters report further disclosed several suspicious and potentially fraudulent transactions undertaken by Lu in his capacity as UCAR Inc.'s and CAR Inc.'s CEO and Chairman.

According to the report, during Lu's tenure as UCAR Inc.'s CEO and Chairman, UCAR Inc. acquired 67% of shares in Beijing Borgward Automobile Co., Ltd (Beijing Borgward) in March 2019 from Changsheng Xingye Enterprise Management Advisory (Changsheng Xingye) for RMB 4.11 billion. This occurred just three months after Changsheng Xingye acquired the 67% stake from Beiqi Foton Motor Co. for RMB 3.97 billion in December 2018.[96] It was also noted that Changsheng Xingye was only incorporated on 3 December 2018, with registered capital of RMB 2 billion.[97,98] Further, merely three weeks before Changsheng Xingye acquired Beijing Borgward, UCAR Inc. provided a credit guarantee on Beiqi Foton Motor's shareholder loan to Beijing Borgward and directly stated that the guarantee was to "facilitate Changsheng Xingye's acquisition of target assets (i.e. Beijing Borgward)".[99] The Muddy Waters report asserted that UCAR Inc. was aware of Changsheng Xingye's acquisition of Beijing Borgward from the start. Given the relatively close timeline between events, it seemed likely that Changsheng

Xingye was formed specifically for the acquisition of the 67% stake in Beijing Borgward and its subsequent transfer to UCAR Inc.[100]

The report also highlighted the relationship between Baiyin Wang – the founder of Changsheng Xingye – and Lu. Both of them previously studied at National School of Development at Peking University where they were classmates from 2006 to 2008. Their close working relationship became even more apparent when Wang founded another company named Zhengzhe International Trade (Xiamen) Co., Ltd (Zhangzhe) on 23 August 2019. Zhengzhe's main business involved selling coffee machines and other raw materials. Zhengzhe's registered address is right next to Luckin's Xiamen headquarters.[101]

On 7 January 2020, Luckin announced plans to expand its presence by installing unmanned vending machines across various locations such as office buildings, campuses and airports to reach out to more customers.[102] Considering the close timeframe between Zhengzhe's incorporation and the announcement of Luckin's expansion plans, the close proximity of both entities' registered addresses, as well as Lu's and Wang's close relationship, the report raised the possibility that this was yet another business deal between Lu and Wang to siphon money from Luckin.[103]

Dumping the beans

Another suspicious transaction highlighted in the report occurred when Lu was the CEO of CAR Inc. From June 2015 to March 2016, Lu and three of CAR Inc.'s pre-IPO shareholders – namely Hertz, Lenovo and Warburg Pincus – disposed of a significant percentage of their shareholdings in the car rental service provider. CAR Inc.'s net profits subsequently started to take a dip – its adjusted net profit fell by eight percent in 2016 and another 25% the following year.[104]

Another report by boutique investment research firm, GeoInvesting LLC, pointed out that CAR Inc.'s profits were overstated all along as the company used a longer term of 7.3 to 9.9 years for depreciation of its vehicles, compared to the industry standard of between 4.5 and 4.8 years.[105] This resulted in depreciation expenses being understated and thus, an overstatement of the company's net profits.

Three of the four parties involved in the aforementioned dumping of shares in CAR Inc. from mid-2015 to early 2016 were also similarly involved in Luckin. Together with Lu, EL and Li held approximately 46% of Luckin's shares.[106] This, coupled with the coffee company's questionable accounting practices, led the Muddy Waters report to speculate that history could repeat itself.[107] In fact, Centurium Capital had already sold off approximately 20% of its shares in Luckin in January 2020.[108]

Chinese-style coffee

Luckin's scandal has raised questions about the corporate governance of Chinese companies listed overseas. Observers have pointed out that the culture of Chinese companies has notable differences from European or American companies, making it difficult for most foreign investors to understand Chinese corporate governance. Additionally, although China's corporate governance code is mandatory, the country does not enforce it. China also lacks an investor stewardship code. To further complicate matters, many companies included in the China A International Index are state-controlled, resulting in a lack of transparency in their business operations. On the other hand, private companies have another – possibly larger – bucket of corporate governance issues such as the concentration of power in the hands of one or a few individuals for founder or family-controlled groups, which may give rise to conflicts of interest.[109]

Moreover, many China-based companies listed on U.S. stock exchanges – including Luckin – use the variable interest entity (VIE) structure to get around China's restrictions on direct foreign ownership and to raise capital from overseas stock markets. With such a structure in place, a Chinese company will have two entities – one in China, and another holding entity located offshore (such as the Cayman Islands in Luckin's case) so that foreign investors can buy shares in the offshore entity instead of the Chinese entity itself. Meanwhile, the Chinese company – which is fully owned by Chinese nationals – would obtain business licenses and permits for its business operations, and pay fees to the offshore company using related party contracts and agreements.[110]

Analysts have commented that there are significant risks associated with the VIE structure. In China, the VIE structure falls into a "legal grey area" and has not gained any official approval from the Chinese government. As tensions rise between the U.S. and China in recent years, the legality of VIE arrangements may be scrutinised by authorities in the future. Bruce Pang, head of macro and strategy research at China Renaissance, goes so far as to say that if authorities clamp down on the VIE structure, it may lead to "businesses being shuttered and growth of the private sector being hampered in the absence of required capital".[111]

Another risk is the restriction in U.S. regulators' access to information on the Chinese companies. According to Article 177 of the PRC Securities Law, "no overseas securities regulator can directly conduct investigations or evidence collection activities within the PRC and no entity or individual in China may provide documents and information relating to securities business activities to overseas regulators without Chinese government approval". This would imply that the U.S. regulators would face difficulties in enforcing actions against China-based companies in the event of any wrongdoing. Further, there may be limitations on shareholder rights and recourse as U.S. judgments may not be recognised or enforced elsewhere.[112]

Lastly, differences between the corporate law and corporate governance rules and practices of the U.S. and other jurisdictions might give rise to greater risks and less shareholder protection. For example, U.S. stock exchanges allow exempt foreign private issuers to rely on home country corporate governance practices, which means that such companies may not be required to:[113]

- have a majority of independent directors;
- have independent audit committee members, compensation committee members, and nominating committee members;
- have independent board members meet in executive session;
- hold annual meetings; or
- obtain shareholder approval for certain issuances of securities.

There are also some differences with regard to reporting requirements between foreign private issuers and U.S. domestic issuers. For example, foreign private issuers have four months after the end of the fiscal year to file their annual reports, while U.S. domestic companies only have 60 to 90 days to do so.[114]

Picking up the spilled beans

After facing multiple lawsuits and fines, delisting from the NASDAQ, and reshuffling the board, can Luckin recover from the financial and reputational damage it has suffered?

Luckin is still the biggest coffee house operator in China, with over 6,500 coffee stores.[115] Its app remains amongst the top five most downloaded food and drink apps in China,[116] illustrating its strong customer base. Along with its innovative business model and strong revenue numbers, there is potential for Luckin to be successful in the Chinese market.

Current CEO Guo has also spoken about the growth of Luckin Tea, which separated from Luckin in September 2019.[117] Guo mentioned that tea and coffee are complementary in workplace environments,[118] and this is especially true in a predominantly tea-drinking country such as China. Nevertheless, Luckin would continue to face stiff competition from other more established tea brands such as Heytea and Nayuki Tea.[119]

In January 2021, Lu and Qian wrote a letter accusing Guo of "corruption, abuse of power to eradicate dissidents, and low capability to run the company".[120] Additionally, sources close to Luckin's own internal investigation also claimed that Lu's planned board overhaul was not purely motivated by a desire to save the company. Instead, they speculated that it served his ulterior motives of reducing the heat he was facing and hindering the investigations. This was especially because the special committee investigating the fraud was left with only one of its original three members – Chong Wai Yuen – after the board overhaul. Chong, who has an extensive background in the food and beverage industry, was introduced to Luckin by Lu.[121] While Lu was eventually removed from Luckin's board at the EGM in July 2020,[122] he had nominated two new members to the board before his dismissal, Yang Jie and Zeng Ying, potentially giving him ongoing influence at the company.[123]

Li, EL and Shao were also removed from Luckin's board. The dismissal of the "golden triangle" and a director who has been linked with many fraudulent companies seemed to signify a step in the right direction for Luckin. There were a number of other changes to Luckin's board. Pu, who was appointed on 27 March 2020, resigned less than three months after his appointment.[124] Yang and Zeng, who were appointed as independent directors after the July 2020 EGM,[125] both resigned after less than a month of service.[126]

Shao was re-appointed as an independent director in September 2020,[127] together with other leadership changes, which could improve Luckin's long-term prospects,[128] especially after Shao's role in the special committee set up to uncover the truth in the accounting scandal.[129] With his appointment, the number of independent directors on Luckin's board has increased to five, representing a majority of Luckin's board.[130]

Epilogue

On 5 February 2021, as part of the disgraced coffee chain's restructuring efforts, its Joint Provisional Liquidators (JPLs) filed a petition for bankruptcy protection with the U.S. Bankruptcy Court, in a bid to shield itself from legal action from U.S. creditors. The company stated in its press release that it was in the process of negotiating with stakeholders with respect to the company's financial obligations and desires to strengthen its balance sheet "for the benefit of all stakeholders". Luckin reassured consumers that its retail outlets remained open for business.[131,132]

Only time will tell if Luckin – once dubbed "the next Starbucks" – will be able to bounce back from its fall from grace and restore investor confidence to achieve its goal of displacing Starbucks as China's coffee powerhouse.

Discussion questions

1. What were the key contributing factors that led to Luckin's downfall?
2. Evaluate the pros and cons of companies with a concentrated ownership structure. What are some of the conflicts of interest faced by Luckin considering its shareholder composition?
3. Evaluate the composition of Luckin's board of directors. What are some problems which may arise from the close and long-standing relationship between Luckin's Chairman and management?
4. Short sellers like Muddy Waters played an instrumental part in unravelling the fraudulent activities of Luckin. How important is the role of short sellers in identifying financial fraud? Should they be more strictly regulated? Explain.
5. EY has denied any responsibility for Luckin's fraudulent financial statements. Discuss the roles of auditors and whether EY should be punished for Luckin's falsified FY2019 financial statements and the comfort note.

6. Many high-profile institutional investors flock to invest in fast-growing "unicorn" companies like Luckin, despite these companies reporting losses and in some cases arguably having "fundamentally broken" business models. What are the incentives of these institutional investors and are their interests aligned with public investors? Explain.

7. Luckin issued two classes of shares with Class A shareholders entitled to one vote per share and Class B shareholders entitled to ten votes per share. This allowed Lu to become the controlling shareholder of the company. Discuss the pros and cons of dual-class shares.

8. Luckin launched its Initial Public Offering on NASDAQ merely 18 months after it was founded, in contrast to the average time of around a decade for venture-backed start-ups to get listed. What are some corporate governance challenges faced by high-growth companies which list prematurely?

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M&C SAATCHI: TOO MUCH CREATIVITY?

Case overview

On 10 December 2019, Maurice Saatchi, co-founder of M&C Saatchi Group, an international advertising and marketing agency network, walked out of the doors of the firm named after him for the last time. In the process, he also left behind three business partners whom he had been working with for more than 40 years, namely David Kershaw, Jeremy Sinclair and Bill Muirhead. His departure followed an accounting scandal that exposed various corporate governance issues in the company. The saga, which revolved around the recognition of revenue for projects and the improper accounting treatment for assets of the firm, resulted in a series of events which almost halved the company's stock price. The objective of this case study is to facilitate a discussion of issues such as the role of the board; company structure; internal and external audit functions; and the regulatory environment in the United Kingdom.

Beginnings

The story began in 1970, when two brothers, Maurice and Charles Saatchi, founded Saatchi & Saatchi, an advertising agency based in London.[1] From its humble beginnings, the company steadily grew, acquiring large clients such as Nestle and Dunlop, before producing its first famous advertisement in the form of the "pregnant man" for the U.K.'s Health Education Council.[2] Through a merger and numerous acquisitions, the company became the biggest agency in the world by annual billings in 1986.[3] It was during this period when future M&C Saatchi PLC (M&C Saatchi) directors Jeremy Sinclair, David Kershaw, and Bill Muirhead became acquainted with Maurice Saatchi as employees of the firm.[4]

After this period of prosperity, however, the firm ran into trouble. While the firm increased its revenue, its debt had risen as well. Most notably, a bid to purchase Midland Bank in 1987 failed.[5] Charles was forced to leave the Saatchi & Saatchi board in December 1994 under pressure from angry shareholders, who accused him of destroying the firm through overexpansion.[6] Prominent shareholder David Herro of Chicago-based fund manager Harris Associates[7] also voiced his disagreement on how Maurice managed the company as Executive Chairman of the board. Amongst other matters, he disapproved of Maurice's insistence on going ahead with a new incentive and option plan as he felt that it was structured to Maurice's own benefit. He complained that the option plan, dubbed the "super option scheme", was "not formed in a fair and objective manner" and that he and other shareholders were "not only outraged by the

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gross amount of the plan, but by the very inequalities of the plan itself".[8] Under pressure from Herro and shareholders, the board dismissed Maurice in January 1995. With his departure, Sinclair, Kershaw and Muirhead – collectively referred to as "the three amigos"[9] – also left the firm.[10]

"Brutal Simplicity of Thought"

Leaving behind a company they had built from scratch and starting afresh was not an easy task. For starters, the new firm which the Saatchi brothers had set up faced expensive legal lawsuits from the original Saatchi & Saatchi over various matters such as the right to use the Saatchi name and the right for the Saatchi brothers to be able to form another agency to compete against them.[11] Despite the challenges, Charles and Maurice were undaunted. Together with the "three amigos", the five partners founded a second company, M&C Saatchi, in May 1995, along with a new motto: "Brutal Simplicity of Thought". Maurice explained in an interview that the phrase "expresses [their] distaste for waffle and vagueness and a strong preference to get to the point."[12] It was around this mantra that the new business was built.

With Charles taking a step back to focus on the creative aspect of the business, Maurice – together with the three amigos – leveraged on their past expertise and networks to grow the business. The founders were determined to depart from the previous business model employed by Saatchi & Saatchi – one that the Financial Times described as an "unrestrained debt-fueled expansion"[13] and centered around the acquisition of other companies to grow the company. They decided that the new firm would seek 'organic' growth through linking young firms to the M&C Saatchi network and supporting the entrepreneurs who ran these firms.[14] On the new Saatchi firm, Sinclair remarked, "I was genuinely interested to see whether lightning would strike twice."[15]

Remarkably, it did. When the business was finally allowed to start operations following the lawsuits, it was "pure exhilaration" and "anything less than one account win a week was disappointing".[16] By 2015, M&C Saatchi had 800 staff in the U.K. and 26 offices worldwide, and had a firm value in excess of £230 million, making it one of the major players in the advertising industry.[17] It won over several clients from the incumbent Saatchi firm, such as the David Jones account which had been held for 14 years.[18] Other significant accounts held by the firm include Royal Mail, Unilever, and British Airways.[19]

"It's easier to complicate than simplify."

"These problems did not occur overnight. Aggressive accounting will always run out of road space as the numbers will need to grow."

– Tim Bush, a spokesman for Pensions & Investment Research Consultants Ltd[20]

On 29 May 2019, M&C Saatchi's external auditor, KPMG LLP (KPMG), released its independent auditor's report. The report raised a number of concerns regarding the accounting controls in M&C Saatchi. Following the release of the report, an internal review was conducted on several of M&C Saatchi's U.K. subsidiaries, which confirmed KPMG's concerns and identified "instances of misapplication of accounting policies, mostly relating to the timing of revenue recognition and incorrect accounting of some assets and liabilities".[21] For instance, M&C Saatchi's U.K. operations practised "overaggressive" revenue recognition; treated some items such as old software and furnishings as assets on the balance sheet when they should have been written down; overstated other fixed assets such as fixtures and fittings; and understated project costs.[22]

On 12 August 2019, M&C Saatchi announced that it would take a one-off exceptional charge of £6.4 million to its 2019 annual results. The specific accounting issues were estimated to cost the firm £4.9 million. In addition, the company also decided to set aside an extra £1.5 million as a "conservative measure to provide for any potential further items arising".[23] M&C Saatchi was confident that it had "discovered the full extent of the issues",[24] but to provide additional assurance, it engaged PricewaterhouseCoopers LLP (PwC) to perform a separate targeted forensic review of the entire Group, which included the U.K. subsidiaries involved in the previous internal review.[25]

To make matters worse…

On 24 September 2019, following the independent review by PwC, M&C Saatchi released its interim results which outlined a proposed adjustment of £7.8 million. Subsequently, the company decided to revise the total adjustments by an additional £1.15 million. However, PwC then identified other issues which went beyond those announced on 12 August 2019.[26] The additional issues resulted in an additional £2.65 million added to the proposed adjustments, resulting in a total adjustment of £11.6 million as of 3 December 2019. Out of the total proposed adjustment, £9.55 million was related to 2018 and would be treated as a prior period adjustment, while the remaining £2.05 million was related to 2019 and would be treated as an exceptional item relating to the U.K. office's fixed assets. At that point of time, M&C Saatchi also highlighted that the proposed adjustments were unaudited, and that the "final confirmation of the quantum and the apportionment between the years 2018 and 2019 is subject to completion of the 2019 audit, expected in March 2020".[27]

In addition to the proposed adjustments, PwC identified that the 2018 half-year reported profit was adjusted by approximately £6.4 million, due to misstatements which included the recognition of accrued income amounting to £2.6 million that was meant to be booked only at the end of the year, understatement of costs of £3.1 million, and an inappropriate recognition of £0.7 million of intangible assets that no longer had future economic benefits. Furthermore, PwC highlighted that M&C Saatchi might have carried out such adjustments in half-year reports since 2014. In response, the company simply noted that "in each of those years, the full year audits conducted by the previous auditor had clean full year audit opinions".[28]

Regrets, Maurice

On 10 December 2019, M&C Saatchi announced the sudden dramatic resignation of three of its non-executive directors – Michael Dobbs, Michael Peat and Lorna Tilbian – as well as co-founder Maurice Saatchi, who owns about a 4.5% stake in the company. The non-executive directors were in dispute with management and the other directors over several issues. The most notable issue was accountability – the non-executive directors and management did not see eye to eye on who should be held responsible for the accounting scandal.[29] Another issue was regarding remuneration. While the non-executive directors believed that the bonuses paid should be adjusted due to the accounting scandal, the executive directors were against the adjustment.[30] The last issue was with regard to the cash position of the firm, where new financing was needed for the payment of increased dividends, which were approved by the non-executive directors based on the over-optimistic assurance over the firm's finances.[31] Furthermore, there were disagreements over whether Kershaw, the long-serving Chief Executive, should step down from his position.[32] After a series of meetings in November 2019 relating to changes in the leadership of the firm, the three non-executive directors, together with Maurice Saatchi, decided to resign. On 10 December 2019, Maurice abruptly issued a one-sentence resignation letter: "Regrets, Maurice".[33]

A terrible year for investors

After M&C Saatchi announced that it was taking a £6.4 million charge due to its accounting errors, the company's shares dropped by 22%, the biggest fall since its listing on the AIM market of the London Stock Exchange 15 years prior.[34] In its trading update, M&C Saatchi stated that its interim results would show an expected year-on-year decline in pre-tax profit due to the "unusually" strong first half in 2018.[35] However, the company expected strong performance in the second half of 2019 and that excluding the exceptional charge of £6.4 million, the board was "confident that it will meet expectations of operating profit for the year".[36] This announcement shocked investors and raised concerns over the company's accounting controls, causing M&C Saatchi's share price to drop drastically.

By the end of the year, M&C Saatchi's slump in share price was exacerbated by the announcement of a greater than expected adjustment of £11.6 million due to its accounting errors, as well as the loss of a two-decade long advertising account with National Westminster Bank, a major retail and commercial bank in the U.K. The company's share price fell from almost £4 in March 2019 to £0.79 on 4 December 2019.[37]

Shared ownership, shared objectives, shared ambitions

"With a shared ownership model, every business reaches a crossroads where there's a successful outcome or you've got to reassess the value of those shares."

– Tristan Rice, partner at SI Partners[38]

M&C Saatchi has more than 90 subsidiaries and operates on a "shared ownership" model.[39] Its expansionary business model involves acquiring subsidiaries on a "shared ownership" basis – in exchange for equity in the start-ups, the agency entrepreneurs are given funding and guidance in the running and growth of their companies, the right to use the Saatchi name, as well as the ability to tap on M&C Saatchi's networks and reputation. Further, the 2019 annual report explains: "The entrepreneurs have shares in their subsidiary companies, which at some agreed point, can be converted into more tradable shares in the Company. They can only sell (or put) all their shares when succession criteria have been fulfilled. This aligns their business success with the success of the Group as a whole. The better the Group does, the more their shares are worth."[40] The presence of "put options" allow agency entrepreneurs to sell their shares in a pre-agreed manner.[41]

While this model has been successful in driving growth, it is not without its issues. One major issue was the complicated financial reporting which arose due to the presence of numerous subsidiaries in the international network using different accounting systems.[42] M&C Saatchi also disclosed in its 2019 annual report that "the delegated structure has meant that most operational decisions are taken by local management at a local subsidiary level, rather than centrally from head office" and this "results in reduced control and oversight from the Group".[43] Another notable issue was the difficulty in keeping agency talent in view of M&C Saatchi's diving share price, as the agency entrepreneurs might wish to buy themselves out or quit.[44] In this regard, M&C Saatchi's 2019 annual report states that "the recent steep drop in the Company's share price caused by the accounting misstatements and the economic shock of the COVID-19 pandemic has resulted in some put options failing to create shareholder value, or delivering the growth intended".[45]

M&C Saatchi adopts acquisition-related remuneration and put-option accounting, which, according to Chris Boxall of specialist fund manager Fundamental Asset Management, "adds to the ambiguity" of the reported numbers in the financial statements.[46] According to M&C Saatchi's 2019 annual report, allocations and dividends paid to "conditional share award holders" have increased from £614,000 in 2017[47] to £3,106,000 in 2018,[48] and a whopping £5,841,000 in 2019.[49]

Corporate culture

In line with its organisational structure, the culture of M&C Saatchi is "highly entrepreneurial and decentralised, with local ownership being highly valued".[50] Unfortunately, one outcome of the flat, delegated organisational structure is that various agency entrepreneurs tended to only focus on their own respective operations and financials, incentivising them to under-report costs and make their revenues look good.[51] In fact, some close to M&C Saatchi insisted that its accounting figures were manipulated not for fraudulent purposes, but "done out of an eagerness to please". One insider claimed that the "people had tried to make a picture that was prettier than it was – it wasn't for financial gain".[52]

Although the Group is organised on a decentralised basis, it has implemented a number of committees – such as the diversity committee, family committee and working groups – in a bid to improve workforce engagement and reinforce its culture. Such initiatives seemed to have contributed to a positive corporate culture to facilitate collaboration amongst creative minds. In 2019, two M&C Saatchi divisions – M&C Saatchi Sports & Entertainment and M&C Saatchi Performance – were on the list of Campaign's Best Places To Work.[53,54]

Earlier in 2018, M&C Saatchi hired Sereena Abbassi as its first head of culture & inclusion. Having founded "All Here" – a social enterprise that connects individuals, brands and agencies – Abbassi has a strong portfolio in diversity and inclusion. She had also helped numerous organisations with their strategies and previously advised the U.K. Advertising & Media Industry's diversity taskforce on its strategy.[55]

Ownership

M&C Saatchi's largest shareholders as of 20 March 2018 were Octopus Investments and Paradice Investment Management. The remaining four founders of the firm each held a five percent stake in the company.[56] After the share price crashed in 2019, founders Kershaw, Sinclair, and Muirhead bought £1 million worth of shares between them in a show of support.[57]

In May 2020, technology entrepreneur Vinodka Murria and her family bought a 13.25% stake for an undisclosed price, making her the largest investor of the firm.[58] As of 4 December 2020, she was the largest shareholder of M&C Saatchi, followed by Invesco Perpetual, Octopus Investments and Paradice Investment Management.[59] On 3 March 2021, Murria joined the M&C Saatchi board as a non-executive director and Deputy Chairperson. Murria was appointed Officer of the Order of the British Empire in 2018 for services to the digital economy and has held numerous directorships in numerous companies.[60]

Corporate governance

Listed firms in the U.K. are subject to the U.K. Corporate Governance Code (U.K. Code). Similar to the approach adopted in Singapore, the U.K. Code follows the 'comply or explain' approach. Companies are given flexibility in choosing to apply the recommended practices, and in the cases where they choose not to comply, they are to provide comprehensive explanations for their shareholders' consideration.[61]

Prior to 28 September 2018, a large number of AIM companies follow either the U.K. Code or the Quoted Company Alliance Corporate Governance Code "so far as appropriate for a company of this size".[62] After that date, AIM companies are "required to adopt a recognised corporate governance code and disclose annually how it complies with that code, where it departs from its chosen code, and an explanation of the reasons for doing so".[63] In the case of M&C Saatchi, it followed the U.K. Code. However, in view of the board's size, history, structure and stage of the firm's life cycle, some provisions of the code were deemed not relevant and therefore not explicitly followed.[64] The "governance review" section of M&C Saatchi's 2019 annual report systematically sets out a point-by-point explanation on the non-compliance with specifically identified provisions of the Code.[65]

Board composition

In 2019, the board of M&C Saatchi comprised five executive directors and three independent non-executive directors. The five executive directors comprised Maurice Saatchi, "the three amigos", and Mickey Kalifa. Kalifa is a chartered accountant with almost 30 years of experience across the media, technology and gaming sectors.[66] The non-executive directors consisted of former private secretary to Prince Charles and KPMG partner, Peat; author of the House of Cards trilogy, Dobbs; and media banker Tilbian. Sinclair was the Chairman of the board since its listing on the AIM market of the London Stock Exchange in 2004, until he left the company on 31 December 2020.[67,68]

While the Code provides that at least half of the board should be non-executive directors, M&C Saatchi chose not to follow the Code, stating in its 2018 annual report that "the diversity of skills and experience which the executive directors bring to the board is more valuable at this stage of the business's development than having non-executive directors comprising at least half the board".[69]

Gender diversity

On top of the lack of non-executive directors, M&C Saatchi had an all-male board for years. Kershaw commented in 2016 that "making grand gestures like making a woman a non-exec isn't going to change the world".[70] However, in 2018, Tilbian was appointed to the M&C Saatchi board, bringing along with her 30 years of experience in the finance industry. Earlier in 2012, she was appointed head of media, corporate broking and advisory at Numis Corporation PLC.[71]

Board committees

M&C Saatchi has three board committees – Remuneration Committee, Audit Committee, and Nomination Committee.

In 2018, prior to the accounting scandal, three non-executive directors – Peat, Dobbs, and Jonathan Goldstein – sat on the Remuneration Committee, with Goldstein serving as Chairman.[72,73] On 26 March 2019, Tilbian took over as Chairman of the Remuneration Committee, a role she held until her resignation in December 2019. The Remuneration Committee is made up entirely of non-executive directors, with executive directors invited to attend committee meetings as appropriate.[74]

The Remuneration Committee has the responsibility to determine the remuneration policies of the Group. This includes establishing remuneration schemes, such as share incentive plans, that support alignment with long-term shareholder interests, business strategy, as well as M&C Saatchi's purpose and values. The Remuneration Committee also reviews the appropriateness and relevance of remuneration policies on a regular basis.[75]

In 2018, the Audit Committee was chaired by Peat. The remaining members of the Audit Committee comprised three other non-executive directors – Tilbian, Dobbs, and Goldstein – as well as executive director Jamie Hewitt (who was also the then Group finance director). Together, they oversaw the M&C Saatchi's financial reporting, internal controls and risk management systems, internal and external audit functions, and related compliance activities.[76,77]

On 31 December 2018, Goldstein resigned from the board.[78] During the same month, M&C Saatchi announced that Hewitt was stepping down from his role of Group finance director and would be succeeded by Kalifa.[79] Hewitt officially left the company on 29 March 2019, ending his nine-year term as Group finance director and director on the board.[80] Like his predecessor, Kalifa was also a member of the Audit Committee.[81]

After Peat's resignation from the board in December 2019, Colin Jones was appointed Chairman of the Audit Committee after joining the M&C Saatchi board on 3 February 2020, in view of his "recent and relevant financial experience". Jones has a wealth of financial experience, having previously spent more than 20 years as finance director of Euromoney Institutional Investor PLC. In the 2019 Audit Committee report, the new Audit Committee Chairman expressed that "the principal activity of the new Audit Committee has been the oversight of the 2019 audit including the adjustments required to the 2018 financial statements as a result of the prior year accounting misstatements".[82]

In 2018, the Nomination Committee consisted of only two directors – Chairman Sinclair and executive director Kershaw.[83] After the resignation of half of the 'old' board on 10 December 2019, the Nomination Committee was reconstituted and comprised all the remaining members of the board at the time, namely Sinclair, Kershaw, Muirhead, and Kalifa.

The Nomination Committee is responsible for all executive and non-executive appointments. It regularly reviews the size, structure, and composition of the board, evaluates the Group's leadership needs, and is responsible for creating succession plans for key personnel. According to M&C Saatchi's 2019 annual report, the Nomination Committee only meets on an ad hoc basis to deal with the appointment of new non-executive directors.[84,85]

External audit

KPMG served as M&C Saatchi's external auditors for seven years, from the financial year ending 31 December 2012 to 2018.[86] For the FY2018, a new audit partner, Adrian Wilcox, was appointed to lead the audit of M&C Saatchi, replacing John Bennett, who was said to have "provided valedictory thoughts on the Group's accounting systems and internal controls" which were "useful reference points … [and] have been considered and are being addressed with accounting system and internal control enhancements planned for 2019".[87]

In the 2018 independent auditor's report prepared by KPMG, it was mentioned that M&C Saatchi's application of the accounting standard on Revenue Recognition (IFRS 15) was "slightly optimistic", with significant errors being corrected and "significant uncorrected errors approaching materiality" with regard to Project and Media income revenue. This resulted in KPMG reporting an audit difference.[88] KPMG had also reported and corrected "significant errors" in the accounting of share-based payments for the year 2018.[89]

In September 2019, KPMG resigned as external auditors after raising red flags in its the accounting records. In a shareholder announcement released by M&C Saatchi, KPMG mentioned that the reason for its resignation was because M&C Saatchi and KPMG were "unable to agree a satisfactory commercial outcome for the 2018 audit to compensate KPMG for the additional work required over and above that originally planned".[90]

A month later, in October 2019, the M&C Saatchi board appointed PwC to perform an independent forensic view of the accounting records. Subsequently, on 4 November 2019, the troubled company also appointed PwC as its external auditor, replacing KPMG.[91] This resulted in accusations of a conflict of interest. A senior executive at another audit firm said PwC's dual role may result in it "checking its own homework". However, PwC said that it took its independence responsibilities seriously, and gave "careful consideration to matters such as these to satisfy [themselves that they] are independent before accepting a role as auditor".[92]

Internal audit

Accounting and advisory firm BDO LLP (BDO) took on the role as an internal auditor of M&C Saatchi at the end of 2014.[93] Prior to that, BDO served as the external auditor of M&C Saatchi until 2012, where it was replaced by KPMG. As M&C Saatchi's internal auditor, BDO reports directly to the company's Audit Committee, which was responsible for monitoring and reviewing the role, responsibilities and effectiveness of the Group's internal auditor.[94]

Regulators

As the competent authority for audit in the U.K.,[95] the Financial Reporting Council's (FRC) mission is to promote transparency and integrity in businesses. It sets the U.K. Corporate Governance and Stewardship Codes and U.K. standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries.[96]

In April 2021, it was reported that the FRC has made initial inquiries to determine whether KPMG's auditing had met required standards and regulatory requirements. This came at the back of three other high-profile FRC investigations. KPMG was already in hot water for its involvement in the audits of aero-engine maker Rolls-Royce Motor Cars Limited, collapsed construction and facilities management services company Carillion plc, and now defunct alcohol retailer and supplier Conviviality plc.[97]

In the U.K., the Financial Conduct Authority (FCA) is the financial regulatory body which regulates financial firms and maintains the integrity of the financial markets. Its operational objectives are to protect consumers, protect financial markets, and promote competition.[98] It has the authority to prosecute criminal offences if it uncovers any transgression of financial conduct regulations.[99]

On 31 January 2020, news broke that the FCA had commenced an investigation into M&C Saatchi's accounting errors. In response, the company said that it would cooperate fully with the FCA. Its share price closed at £1.01 that day.[100] As of July 2021, the FCA was still investigating how M&C Saatchi disclosed the accounting irregularities to the market.[101]

End of an era

On 1 October 2020, M&C Saatchi's shares were suspended as it missed a deadline to file its 2019 annual accounts on time. Under AIM rules, companies must publish their annual audited accounts not later than six months after the end of their financial year. Due to the COVID-19 pandemic, AIM-listed companies were allowed to extend the deadline by three months.[102] The trading of M&C Saatchi's shares only resumed on 7 December 2020 after a 10-week suspension, when the firm said it would publish its audited accounts.[103]

Prior to the publication of the 2019 audited accounts, M&C Saatchi disclosed that the total accounting errors in 2018 and prior years amounted to £25.8 million after PwC uncovered a further £11.3 million of adjustments to the past results.[104]

On 19 November 2020, the "three amigos" announced that they were leaving M&C Saatchi to try to draw a line under the accounting scandal. The reins of the firm will be passed to Moray MacLennan, the new Chief Executive. MacLennan has "worked with the trio since the beginning",[105] having been part of M&C Saatchi since its founding in 1995.[106] Gareth Davis, who was appointed to the board in January 2020, would succeed Sinclair as Chairman.[107]

Davis was previously the CEO of Imperial Tobacco plc, one of the world's largest international cigarette companies, from 1996 until May 2010.[108]

With the prominent founding members of M&C Saatchi saying their goodbyes, it is truly an end of an era. The firm has been handed over to a new generation of leaders – a pivotal moment in the company's history as it strives to recover from the unfortunate accounting scandal.

Discussion questions

1. What were the key contributory factors to the accounting scandal?
2. Who do you think should be held responsible for the accounting scandal? Do you think Maurice Saatchi and the three non-executive directors were too rash in resigning from the board due to their disagreements with the other executive directors?
3. Comment on M&C Saatchi's corporate governance practices and corporate culture. Are there any areas of improvement in this regard?
4. What makes a board effective? Discuss the factors which may have adversely affected the effectiveness of M&C Saatchi's board.
5. Comment on the weaknesses in the four lines of defence. How might M&C Saatchi's business model and decentralised structure have contributed to the scandal? What steps could the board and management have taken to prevent the accounting scandal?
6. KPMG and BDO served as M&C Saatchi's external auditor and internal auditor respectively. Discuss their roles and responsibilities, and whether you believe they are responsible for the accounting scandal.
7. M&C Saatchi outsourced its internal audit function. Do you think this could have contributed to the accounting scandal? Explain. What are the pros and cons of having an outsourced internal audit function and what are the considerations that should be considered in the decision to have an in-house versus an outsourced internal audit function?

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NIKOLA: FAST TRACK TO A DEAD END

Case overview

Once a rising star in the Electric Vehicle (EV) industry, Nikola Corporation (Nikola) fetched a valuation of US$34 billion at its peak, surpassing automotive heavyweights such as Ford and Fiat Chrysler. With charismatic leader Trevor Milton spearheading the company and touting its game-changing battery technology, Nikola rapidly rose to the centre of public attention. It entered into deals with reputable automotive players such as General Motors Company (GM), Anheuser Busch, Robert Bosch LLC, and Worthington. It also drew investments from top-notch institutions such as Fidelity Management & Research Company and ValueAct Spring Fund. At one point, Nikola was even seen as a force poised to rival EV market leader Tesla.

However, Nikola's fame turned into notoriety overnight. In September 2020, a huge exposé released by Hindenburg Research sparked the massive untangling of Nikola's intricately spun web of lies, tipping the company into a downward plunge. Riddled with allegations of fraud and misrepresentations of its technologies, Nikola quickly found itself buried knee-deep in lawsuits. Consequently, GM also announced its withdrawal from the company's previously agreed partnership in November 2020.

The objective of this case study is to facilitate a discussion of issues such as Special Purpose Acquisition Companies (SPACs); remuneration policies; board structure; ownership structure; accounting fraud; and the role of short-sellers in equity markets.

About Nikola

Founded in 2014 by Trevor Milton, Nikola Corporation (Nikola) – named in honour of famed inventor Nikola Tesla[1] – operates as an integrated zero emissions transportation systems provider. Nikola brands itself as a "technology disruptor and integrator" and aims to be a global leader in zero-emission transportation.[2] Through the electric truck company, Milton – described by some as an evangelical salesman – sold the idea of a future with hydrogen powered trucks on the road, all of which are leased by Nikola.[3]

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Nikola has three main business units – truck, energy, and powersports. The truck business unit aims to develop and commercialise battery-electric vehicle (BEV) and fuel cell electric vehicle (FCEV) Class 8 trucks that provide solutions to the trucking sector. The energy business unit develops and constructs hydrogen fueling stations to meet the hydrogen fuel demands of its FCEV customers. Lastly, the powersports business unit develops electric vehicle solutions for outdoor recreational activities.[4]

In January 2018, a promotional video called "Nikola One in motion" was released by Milton, showing a purportedly operational Nikola One truck driving along a desert highway. Nikola One was Nikola's prototype hydrogen-powered FCEV truck that was unveiled back in December 2016. However, the company later admitted that the truck in the video was merely rolling downhill, and was edited to mislead viewers to believe that it was fully functional.[5] This was the start of a series of untruthful representations made by the company and its founder.

Going public

In March 2020, Nikola announced its plans to list on NASDAQ via a reverse merger with VectoIQ Acquisition Corporation (VectoIQ), a publicly traded special purpose acquisition company (SPAC) led by former General Motor executives. The combined company was named Nikola Corporation and had an implied enterprise value of approximately US$3.3 billion. The SPAC merger was led by institutional investors including Fidelity Management & Research Company (Fidelity) and ValueAct Spring Fund (ValueAct). Nikola began trading on NASDAQ on 4 June 2020 after VectoIQ obtained approval from its shareholders for the merger.[6,7]

The week after Nikola's listing on NASDAQ, its stock more than doubled in value,[8] as investors continued betting on Nikola to become "the next Tesla".[9] As the IPO hype surrounding Nikola waned in the following months, an announcement of a strategic partnership with General Motors Company (GM) on 9 September 2020 saw Nikola's stock price increase by around 40%.[10] Under the partnership, GM agreed to engineer and manufacture the Nikola Badger, as well as supply fuel cells to Nikola trucks globally.[11]

A SPACtacular opportunity?

"As the boom has gone on, we suspect that more and more companies are playing . . . fast and loose with their projections in order to entice investors to commit capital."

– Jim Chanos, President and founder of Kynikos Associates[12]

Against the backdrop of COVID-19, as economic uncertainties continue to loom over the capital markets, an alternative financial vehicle has invaded Wall Street. SPACs or "blank cheque" companies have emerged as a popular means of raising capital in recent years. In 2020, over US$81 billion was raised through 250 SPAC initial public offerings (IPOs) – a figure that exceeds all previous SPAC IPOs combined.[13]

Several reasons were provided by Nikola for its decision to list on NASDAQ through a reverse merger with a SPAC. Firstly, the SPAC route to going public can be completed in a substantially shorter period of time – within two to four months[14] – as compared to a traditional IPO.[15] Nikola's Chief Financial Officer, Kim Brady, highlighted that the speed to market granted by a listing via a SPAC merger was particularly valuable to Nikola in an uncertain economic landscape. According to him, "having certainty, a strong valuation, and the ability to get the transaction done by June was very attractive compared to the IPO path".[16] Secondly, SPACs provide target companies greater flexibility to negotiate terms of the deal. Through direct discussion with investors, the founders of target companies can obtain favourable outcomes in a variety of decisions such as the composition of the board of directors.[17,18] Thirdly, there is greater certainty of proceeds earlier on in the process as compared to a traditional IPO. As funds are first raised and placed into the investment vehicle,[19] SPACs are not subject to macroeconomic shocks that may severely jeopardise the success of the listing, while in a traditional IPO, as pricing occurs the night before a company lists, it can be heavily impacted by market conditions during that period.[20]

However, the SPAC route to going public comes with reduced regulatory scrutiny, which is a double-edged sword. As SPACs are shell companies without any assets nor operations, there is hardly any financial information made available to the public.[21] The target company is also able to bypass requirements of traditional IPOs such as having a financial or operational track record.[22] As such, investors are betting on the abilities of sponsors to execute a successful acquisition. While less due diligence allows an accelerated IPO process and reduces completion risk, it may fail to uncover potential accounting irregularities.[23]

While Nikola carried the promise of transforming the automotive industry, it was not a profitable company. In fact, as at 4 June 2020, Nikola did not own a factory and had not begun manufacturing trucks.[24] Based on reported financial statements, Nikola had been incurring net losses since its incorporation. It suffered net losses of US$88.7 million and US$384.3 million for the years ended 31 December 2019 and 31 December 2020 respectively.[25] The ability of Nikola to overturn its losses was heavily contingent on the sale or lease of the Nikola vehicle platforms, which were "still in the early stages of development" as at 8 May 2020, as highlighted in the risks section of its proxy statement.[26] With the success of the company solely weighing on Nikola's hydrogen technology, and given that there was no in-house hydrogen capabilities and hydrogen partners at the time, it is questionable whether sufficient due diligence was conducted on Nikola prior to its acquisition by VectoIQ.[27]

In this regard, a lawsuit was filed against Stephen Girsky, former CEO of VectoIQ as an individual defendant, alleging that VectoIQ "falsely represented the due diligence involved with selecting Nikola as their target, effectively allowing Nikola to make a series of overstatements regarding their design, manufacturing and production capabilities resulting in false/misleading public statements".[28] Despite the accusations, Girsky said that VectoIQ "studied Nikola deeply" and "conducted a thorough process" before closing the deal.[29]

Rolling downhill

"We believe Nikola is an intricate fraud built on dozens of lies,"

– Hindenburg Research[30]

On 10 September 2020, short-seller Hindenburg Research published a 67-page report on Nikola, branding it "an intricate fraud" and accusing it of making significant misrepresentations and fraudulent claims about its technology and business to its shareholders and partners. The short-seller report included 53 questions addressed to Nikola.[31] It claimed to have "extensive evidence" that Nikola's proprietary technology was bought over from another company, and raised questions about the track record of Milton's past businesses.[32] Other significant allegations include that Nikola staged the promotional video in 2018 to disguise the fact that the truck had no operational engine, and that the company made deceptive claims about its battery development efforts.[33] Nikola's stock went into freefall over the following two days, falling by 11% on the day the short-seller report was issued, then by a further 14.5% the next day.[34]

In response to the report, the electric truck company said that "Nikola has been vetted by some of the world's most credible companies and investors. We are on a path to success and will not waver based on a report filled with misleading information attempting to manipulate our stock."[35] It fervently denied any misdeeds and said there were "dozens" of inaccurate allegations in the report.[36] Nikola's stance was that Hindenburg Research had planned to reap benefits from the resultant stock plunge by timing the release of the report with Nikola's announcement of its partnership with GM.[37]

On 14 September 2020, Nikola released a response to the short-seller report. It conceded to certain points raised by Hindenburg Research, including that it had rolled a truck downhill in its promotional video. It further defended itself by saying that "Nikola never stated its truck was driving under its own propulsion in the video", thus it did not find it deceptive. Addressing the short-seller's accusation that Nikola claims that a third-party inverter is its own technology by covering the supplier's logo with a sticker, Nikola disclosed that it "does use third-party parts in prototype vehicles, some of which may be subsequently swapped out for its own parts in production".[38,39]

Following the issue of the response, Milton resigned as Nikola's Executive Chairman on 21 September 2020, while reportedly maintaining his stake in the company. On the same day, it was announced that Girsky would succeed him as Chairman.[40] Investors reacted strongly to the news, and Nikola's stock plummeted by over 30%.[41]

A few days after the release of the short-seller report, the U.S. Securities and Exchange Commission (SEC) and Department of Justice began investigating claims that the company had misled investors.[42] Nikola CEO, Mark Russell, announced during the company's 2020 third-quarter earnings call that "[Nikola's] counsel has been in close contact with the SEC and the Department of Justice. We are fully cooperating with both in their request for information and documents."[43]

The drastic fall in Nikola's share price prompted several lawsuits from disgruntled investors.[44] This included law firm Block & Leviton LLP, which filed a class lawsuit on behalf of shareholders against Nikola and its executives for securities fraud and sought damages for the decrease in share price.[45]

In November 2020, GM retracted its plan to acquire an 11% equity stake in Nikola and announced that it would no longer help engineer and manufacture Nikola's battery-electric and hydrogen fuel cell vehicles. Instead, GM would work with Nikola on a more limited scope, agreeing to supply hydrogen fuel cells to the embattled electric truck company for use in the trucks it has been developing but yet to mass produce. Instead of becoming a "game changer deal" for Nikola, the partnership with GM was reduced to simply a "supply partnership".[46] The announcement caused Nikola's share to tank another 27%.[47,48]

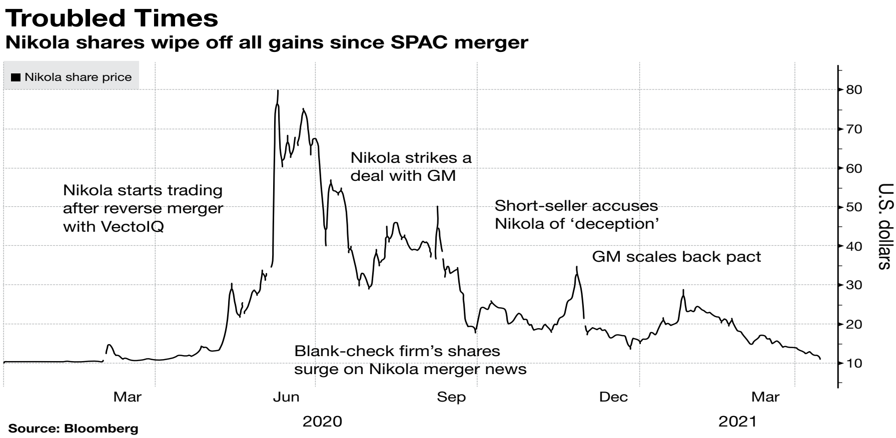

Figure 1: Nikola's share price movement since IPO[49]

Milton's background

Ranked 249 on the 2020 Forbes 400 list with a net worth of US$1.2 billion,[50] American billionaire Milton is widely known as the founder of Nikola Corporation. The college dropout was once revered for his success with Nikola and was often compared to the likes of Tesla's founder Elon Musk.[51] Today, his story serves as a cautionary tale against flamboyant claims and unfulfilled promises.[52]

Unwanted advances

Despite self-proclamations of being faith-oriented,[53] Milton faced two sexual abuse allegations. Milton's cousin, Aubrey Smith, accused then 17-year-old Milton of groping her chest in 1999. Moreover, Milton's previous office assistant for St. George Security & Alarm (his first business venture) claimed the then 22-year-old entrepreneur had groped her in 2004. Milton's former friend claimed he had "bragged" about the incident and that he said he liked "virgins" and "young girls" because they were "naive". Both victims were 15 years old at the time of the respective incidents.[54]

Past ventures – A faulty rear-view mirror?

After investors had cast doubts on Nikola's exaggerated claims on its business and technological capabilities, the spotlight was cast on Milton's history as an entrepreneur and his past ventures. His previous ventures were embroiled in lawsuits, allegations of unfulfilled promises and exaggerated misrepresentations – uncannily similar to Nikola's predicament. Some said Milton has "a long history of bending the truth" which already began during the first startups he founded. Milton allegedly "lied to boost his reputation, misled partners and coworkers about his companies' products, and claimed he and his employees built parts they bought from suppliers".[55]

Early ventures

After dropping out of Utah Valley State College, Milton set up an alarm systems business named St. George Security & Alarm. He allegedly overpromised the acquirer and exited the business for US$300,000. His fifty-fifty partner claimed he was misled into thinking that "the exit was much smaller" and had only received a cut of US$100,000.[56] In July 2009, Milton set up an online advertisements website called uPillar.com, which eventually failed. He claimed the site saw 80 million visits per month but was shut down due to a lack of capital.[57]

dHybrid

Milton's first dip into the alternative energy business began with dHybrid Inc. (dHybrid) – a company selling compressed natural gas (CNG) conversion technology for engines that ran on diesel. Within months, dHybrid got Swift Transportation Co. (Swift), one of the U.S.' biggest truckers, on board with the promise of fuel cost savings. Swift signed a contract, which was worth about US$16 million, with dHybrid to install the system on about 800 trucks. However, dHybrid only converted five trucks, and no fuel cost savings materialised.[58] In 2012, Swift filed a lawsuit claiming that dHybrid did not fulfil its obligations.[59] dHybrid also subsequently defaulted on a US$322,000 loan with Swift.[60]

In a desperate attempt to acquire more funds, Milton attempted to promote the business by inflating claims about the value and performance of dHybrid, as well as its contract with Swift. In an email to a potential investor, Milton overstated the value of the Swift contract by US$234 million and inflated the cost savings it helped achieve. In another investor presentation, the value of the Swift contract was stated as US$300 million.[61]

In May 2012, Milton clinched a buyout with Sustainable Power Group LLC (sPower). A month later, the buyer backed out and filed a lawsuit against dHybrid. In the complaint, sPower alleged significant misrepresentations made by dHybrid, including exaggerating the effectiveness of the system and fuel-savings achieved for Swift. In addition, sPower discovered during its due diligence process that, unlike what was represented to it, dHybrid had not completed development of the dHybrid system.[62]

With dHybrid up in flames, Milton and his father launched another company with a similar name – dHybrid Systems LLC – in October 2012. Milton allegedly used the similar company name to deceive prospective clients, partners and investors that the new company had a longer business track record than it actually did. In 2014, Milton sold this new business to Worthington Industries. Desperate to seal the deal, Milton was said to have "[traversed] the country in a mad dash to patch up dHybrid Systems' broken systems" and "[concealed] issues from Worthington".[63] A year later, Worthington recorded a US$2.3 million impairment on the acquisition.[64]

Nikola's engine goes up in smoke

Hindenburg Research alleged in its short-seller report that Nikola's "proprietary technology" was just cobbled-together parts acquired from other companies. Nikola's misrepresentations on its proprietary technology during its early days – when it was known as Bluegentech – helped the company clinch its initial partners, whose parts would cumulatively form its first EV truck.[65]

These misrepresentations continued as the company grew. On 23 July 2016, Nikola responded to a user on Twitter that "CNG is the way to go for power,"[66] indicating Nikola's business interest in CNG. In August 2016, Nikola declared to have engineered the "holy grail of the trucking industry"[67] and announced its aim of building trucks powered by hydrogen fuel cells. Observers found it strange that Nikola suddenly changed its tune and deserted its CNG technology without any further explanation.[68] Nikola further stated in an announcement that the hydrogen-electric Nikola One would be unveiled on 1 December 2016.[69] However, according to former partners, no such internal hydrogen capabilities existed at the time.[70]

During the unveiling event on 1 December 2016, Nikola represented that the Nikola One was fully functioning. The unveiled Nikola One had the wordings "H2, Zero Emission Hydrogen Electric" printed on its exterior.[71] However, it was later revealed in 2020 by Bloomberg that development of the truck was incomplete and only a pusher.[72] In addition, Nikola was found to fuel its truck through natural gas, instead of hydrogen as it previously claimed.[73] Over the following three years, the company's misinformation on its technological capabilities helped it secure investment capital and partnerships with renowned companies such as engineering and technology giant Robert Bosch LLC (Bosch).[74]

It was alleged that in order to prevent the mistruths from coming to light, a legal warning was issued to all former employees to "intimidate them into not discussing the company".[75]

The axle and wheels – Board and management

The board

As of 1 March 2021, Nikola had 10 directors,[76] while the average number of board members for S&P 500 boards was 10.7 in 2020.[77] Between 2019 and 1 March 2021, one executive director (ED) and one non-executive director (NED) ceased to be directors, and three new NEDs joined the board.

The NED who left – Lonnie Stalsberg – was appointed to Nikola's board in July 2017[78] but left in September 2020[79] for reasons unspecified, shortly after Nikola's IPO. The ED who departed from the board was Milton, who resigned amid fraud claims[80] in September 2020.[81] The three new directors who joined the board in the last quarter of 2020 were Steven Shindler,[82] Bruce Smith,[83] and Mary Petrovich.[84]

Before Nikola was listed on NASDAQ, Milton served the dual role of Chairman of the board and CEO. He served as Nikola's CEO from January 2014 and as Chairman from July 2017.[85] After Nikola's IPO, Mark Russell took over as CEO while Milton remained as Chairman of the board.[86] After Milton's resignation, Girsky – who was already a member of the board at the time – took over as Chairman of the board.[87]

According to Nikola's corporate governance guidelines,[88] "If the Chairman of the board is not an independent director, the board shall appoint an independent director to serve as the board's lead independent director." However, during the period where Milton was Executive Chairman, a lead independent director was not appointed.[89]

NED Michael Mansuetti has been the President of Bosch in the U.S. since 2012.[90] As per its related party transactions policy,[91] Nikola disclosed in its S-1 filing on 15 March 2021 that it had previously entered into a commercial letter agreement with Nimbus Holdings LLC,[92] a subsidiary of Bosch.[93] Moreover, Nikola disclosed that as of December 2020, it continues to have a number of agreements in place with various Bosch entities,[94] amounting to millions of dollars. Similarly, Nikola disclosed in its SEC filings that in September 2019, it had entered into an agreement with CNH Industrial N.V. (CNHI) and Iveco S.p.A. (Iveco) to establish an entity for the purposes of developing and manufacturing trucks. The initial term of agreement expires on 31 December 2030, with automatic renewals unless terminated by any party.[95] Iveco is a beneficial owner of more than five percent of Nikola's shares.[96] Furthermore, one of Nikola's NEDs, Gerrit Marx, has been serving as President of commercial and specialty vehicles of CNHI since January 2019.[97]

With regard to competencies of the board, seven[98] out of 10 of directors had experience overseeing and/or managing a listed company. Nikola's directors also had various backgrounds in automotive, renewables, manufacturing, technology, venture capital and private equity. Moreover, the directors possessed a range of skill sets required in running a business, such as law, finance, and operations.[99]

Most notably, Girsky previously served in a number of capacities at GM between 2009 and 2014, including Vice Chairman, being responsible for global corporate strategy, new business development, global product planning and program management. After he left GM, he ran VectoIQ with managing partner Mary Chan.[100] After taking over the role of Nikola's Chairman in 2020, Girsky maintains directorships on four other boards, including two listed companies – Brookfield Business Partners Limited, and VectoIQ Acquisition Corp. II.[101]

Board committees

Nikola has three board committees – Audit Committee, Compensation Committee, and Nominating and Corporate Governance Committee. It adopted a charter for each of these committees, to comply with NASDAQ listing rules.[102]

Nikola's Nominating and Corporate Governance Committee, headed by Jeffrey Ubben, is tasked to recommend candidates to serve on the board and evaluate the performance of the board, board committees and individual directors to determine whether continued service on the board is appropriate.[103] Although the company stated in its filings that it has not established any specific qualifications for the candidates to be met, it does consider "character, integrity, judgment, leadership, diversity of backgrounds, age, gender, ethnicity, independence, skills, education, expertise, business acumen, professional experience, knowledge of or experience in the industry in which we operate in, understanding of our business, the ability of the candidate to devote sufficient time and attention to the affairs of the company".[104]

Nikola's Audit Committee consists of Shindler, Mansuetti, and Sooyean Jin, with Shindler as the Chairman of the Audit Committee. Nikola highlighted that each member satisfies the independence requirements of NASDAQ and can read and understand fundamental financial statements in accordance with NASDAQ Audit Committee requirements.[105]

The Compensation Committee, chaired by Gerrit Marx and included Thompson and Stalsberg, is responsible for reviewing and approving the compensation and other terms of employment of Nikola's executive officers. On 29 September 2020, Stalsberg resigned from the board.[106]

Although Nikola does not have a Risk Committee, it believes that the board as a whole is responsible for the administration and oversight of risk management, with the Audit Committee in charge of managing financial risks.[107]

The management

Nikola prides itself as an organisation that acquires the best talents worldwide, often citing its Chief Engineer, Kevin Lynk, as a prime example. Kevin gained recognition from Milton for his efforts in designing the e-axle for Nikola's entire proposed fleet of vehicles, a task that was already complex for a single vehicle. In a promotional video, Milton credited Lynk as the sole developer of Nikola's e-axle. However, a review of Kevin's biography by Hindenburg Research revealed that prior to Nikola, he was designing oilfield products and repairing pinball machines.[108] Milton allegedly took a unique approach to hiring, and hired engineers who "had zero experience in the automotive world". Instead, his belief was that "[he] needed [people] who believed anything was possible, [people] who did not have automotive experience to limit [Nikola] by being bound to what had been done in the past."[109]

Milton also brought his brother, who was previously a concrete pourer and subcontractor, on board.[110] Travis held the title of "director of hydrogen production/infrastructure" in Nikola to oversee this seemingly critical part of the business for close to six years, from January 2015 to November 2020.[111]

Similarly, for the role of head of infrastructure development, one might "anticipate that the rollout of Nikola's coast-to-coast hydrogen production network would be managed by an individual with an extensive background in both science as well as large infrastructure developments",[112] according to Hindenburg Research. Instead, Nikola hired Dale Prows, who was previously a CEO and general manager at a residential golf course prior to being recruited.[113]

Fuel of the management machine

The ethos of Nikola's compensation design has always been to attract, retain, incentivise and reward individuals who contribute to the company's long-term success and goals.[114] Stock-based compensation is used by the company to achieve this, as seen from its 2017 stock option plan (the 2017 Plan) providing for the grant of stock options to employees, directors, and consultants, as well as from the 2020 stock incentive plan (the 2020 Plan) that became effective in conjunction with Nikola's IPO.[115] In addition to stock options, the 2020 Plan provides for the grant of share appreciation rights, restricted shares and stock units (RSUs) to employees, consultants, and non-employee directors.[116]

In light of Nikola's IPO, Nikola reviewed the remuneration plans for its executives and board of directors to align compensation with Nikola's business objectives and the creation of stockholder value. The review and development of the compensation package is exemplified by the evolution of executive compensation, in terms of the level and mix of compensation, performance measures and targets, and the termination packages for individual executive officers.[117]

Who takes the wheel for Nikola's compensation policies?

Nikola's executive compensation program is designed and operated with regard to its named executive officers. For FY2020, the company's named executive officers comprised six individuals. They were Milton, outgoing CEO; Russell, its President and CEO; Brady, its CFO; Pablo M. Koziner, the President of energy and commercial; Britton M. Worthen, Chief Legal Officer; and Joseph R. Pike, Chief Human Resources Officer.[118]

A joyride for executives

The compensation program for named executive officers before Nikola became public consisted of a base salary and incentive compensation delivered in the form of annual bonuses and stock option awards. In particular, Milton's initial base salary had been US$350,000 as CEO until 2019, when he volunteered to have his annual salary reduced to US$266,000, to offset costs associated with his airplane pilot being paid through Nikola's payroll. Milton was also eligible to receive an annual bonus upon the achievement of specific revenue milestones, beginning after Nikola reaches US$100 million or more in annual gross revenue.[119,120]

Following Nikola's merger with VectoIQ and IPO on 4 June 2020, an amendment of Milton's employment agreement reduced his base salary to US$1, along with the two other named executive officers, Russell and Brady.[121] All three named executive officers would be eligible to receive a time-vested stock award that primarily has a cliff vesting schedule of three years. A performance-based stock award is also earned upon the achievement of pre-established share price milestones – as opposed to revenue milestones – reflecting the emphasis in aligning compensation with the creation of stockholder value after the IPO.[122]

The company also introduced a one-time incentive award in the form of the 2020 performance award granted to each of Nikola's named executive officers. The performance award consists of several RSUs awarded with a three-year performance period. The scheme's primary measurement of performance is Nikola's share price. The performance award vests upon the achievement of three separate tranches of 25-, 40- and 55-dollar share price milestones. Under this scheme, the total number of performance awards granted to the CEO amounted to 4,859,000, with a total potential value of US$138,644,298.[123] The awards granted to Milton as Executive Chairman were all canceled and returned, due to his resignation. As per Nikola's S-1 filing on 15 March 2021, "none of the share price milestones have been achieved and none of the performance awards have been earned".[124]

A comfortable suspension system

Nikola's S-1 filings after the IPO disclose certain details on the named executive officers' termination packages. In the event of involuntary termination, Milton stands to receive consulting fees of US$10 million each year for the first two years after his termination, a lump sum cash payment of benefits coverage, and a full acceleration of all unvested equity awards including performance-based stock awards he holds. As for Russell and Brady, they stand to receive a single cash severance payment of US$2,600,000 and US$1,050,000 respectively upon termination, a lump sum cash payment of benefits coverage, and a full acceleration of all unvested time-based equity awards. Unlike Milton, Russell's and Brady's unvested performance-based awards do not accelerate in full upon their termination; they vest in an amount based upon the achievement of pre-established but undisclosed share price milestones prior to their termination dates and are prorated for the length of their employment during the performance period.[125]

In 2021, the termination packages were streamlined to have the same structure for all of Nikola's named executive officers. Once an executive's employment is involuntarily terminated, the executive will be entitled to receive a cash severance payment (of varying amounts depending on the executive's role), a lump sum cash payment of benefits coverage, a full acceleration of all unvested time-based RSUs, and a pro-rata acceleration of performance market-based restricted stock units.[126]

The driver's seat – Shareholder ownership structure

Nikola's shareholder ownership structure is comprised of public individual investors, public and private companies, institutional investors, and individual insiders. As of 1 March 2021, Nikola's largest shareholder is M&M Residual, LLC, wholly owned by Milton, with a stake of 21.3%. Meanwhile, the second largest shareholder, T&M Residual, LLC, holds a 10.2% stake in Nikola. Nikola's CEO, Russell, is the manager of T&M Residual, LLC, and has sole dispositive power over the shares held by it. The third largest shareholder, Iveco, holds 6.5% of the company's shares.[127] The collective shareholding of all directors and executives of Nikola, including Milton, is 44%.[128] It is notable that the general public, which collectively owns approximately 25% of Nikola, can still make a collective impact on company policies.[129] Further, since its IPO in June 2020, Nikola has amassed a significant number of institutional investors, including Fidelity, ValueAct and BlackRock Inc.[130]

Nikola's ownership structure as at 28 April 2021 is shown in Figure 2.

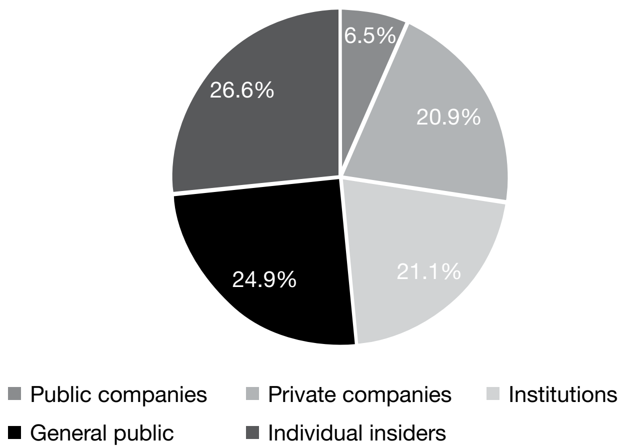

Figure 2: Nikola's Ownership Structure as of 28 April 2021[131]

High insider ownership can align the interest of company leaders with that of Nikola and its shareholders, giving them a strong incentive to engage in firm value-maximising activities.[132] Nonetheless, it gives immense power to a small group of individuals within the company, exposing Nikola to expropriation and entrenchment risks.[133]

Milton's ownership

"Milton has laid the groundwork to extract hundreds of millions from Nikola years before ever delivering on his promises."

– Hindenburg Research[134]

Upon Milton's resignation on 20 September 2020, Milton agreed to forfeit 4,859,000 performance-based stock units and the US$20 million consulting contract fees as part of the separation agreement. Nevertheless, it was reported that Milton walked away with more than 91.6 million shares in Nikola, valued at over US$3.1 billion as of 21 September 2020.[135,136]

Despite his departure from the company, Milton retains a large shareholding in Nikola, which potentially grants him a significant level of control over the company. Therefore, the company has mandated that Milton be stripped of any say in its operations, board composition, and other major decisions for three years following his departure in September 2020.[137]

In its report, Hindenburg Research heavily criticised Milton's 'golden handshake'. It highlighted that the Nikola founder "has ensured he is not going down with the ship" due to the severance terms he negotiated with the company – in the event of dismissal from the company, Milton's equity awards would immediately vest, and he would be entitled to collect US$20 million over two years.[138]

Having once been likened to Tesla CEO Elon Musk as a revolutionary in the EV industry, Milton has more recently been compared to WeWork founder Adam Neumann – another "ambitious and charismatic entrepreneur" who left his company amidst a scandal while being rewarded with a generous exit package.[139]

Nikola's wheels have fallen off

"This is a very straightforward case. Milton told lies to generate demand for Nikola stock."

– Audrey Strauss, U.S. attorney for the southern district of New York[140]

2020 was undoubtedly a rough year for Nikola. What was once a high-flying unicorn, brimming with potential to revolutionise the automobile industry, is now a company embroiled in fraud allegations, misrepresentations of its technologies, and countless lawsuits.[141,142]

After the exposé of Nikola's wrongdoings, it would prove challenging for Nikola to source for new partnerships,[143] which is a key factor in its road to recovery. The investigations by the SEC and Department of Justice, the loss of substantial outside investments, and the plummet in share price since its heyday have left the embattled electric truck company in a lurch.[144] Nikola now faces a dire lack of capital, resources and backing.[145] The volatility of Nikola's share price continues,[146] as Nikola struggles to regain the public's trust[147] and to build a solid business with its hydrogen technology.

In July 2021, Milton was charged by U.S. federal prosecutors with two counts of securities fraud and one count of wire fraud. He was alleged to have misled investors about Nikola's products and technology to convince them to purchase shares in the company. The U.S. indictment stated that Milton aspired to be among Forbes' 100 richest people and was motivated "to enrich himself and elevate his stature as an entrepreneur". The indictment charges were against Milton in his individual capacity.[148] Milton pleaded not guilty to the federal criminal charges and was released on US$100 million bail.[149]

Following the fraud charges brought against founder Milton, Nikola attempted to separate itself from its founder, stating that Milton has not been involved in the company's affairs since his resignation on 20 September 2020 and that the company "has cooperated with the government throughout the course of its inquiry".[150] It further announced on 3 August 2021 that it would deliver fewer trucks this year than planned – between 25 to 50 vehicles instead of the previously announced range of 50 to 100. It said that the trucks might lack sensors or touch screens "because of worldwide supply chain problems". As such, the vehicles' titles cannot be transferred to the buyers, and Nikola is unable to record revenue on the sales of the vehicles. Additionally, Nikola revised its revenue forecast for 2021 to US$0 to US$7.5 million, down from US$15 million to US$30 million.[151]

The journey to recovery may be a long and arduous one. Only time will tell if Nikola survives on this rocky road. Will Nikola be able to make a U-turn from its past actions?

Discussion questions

1. As Milton was the founder and keyman of Nikola, many business decisions were decided by him. What are some potential issues that could occur in founder-led companies? Did the board of directors have a role to play in this saga?

2. Nikola made many material misrepresentations about Nikola's business and technological capabilities before it was exposed by short-seller Hindenburg Research. What were some red flags in the statements made by Nikola and Milton prior to the exposé? Could these red flags have been detected earlier through proper due diligence by investors? What measures could have been put in place to avoid such misrepresentations?

3. Jim Chanos, a U.S. investment manager who is known for predicting the collapse of Enron, warned that the SPAC boom is creating "castles in the sky".[152] In view of what has happened in Nikola's case, do you think the SPAC route to going public should be allowed at all? Explain.

4. Do you think the Singapore market is sophisticated enough for SPACs? Compare the differences in the legal and regulatory environments in the U.S. and in Singapore.

5. Critically evaluate the board structure and composition of Nikola. In your opinion, were Nikola's directors truly independent?

6. Evaluate the aspects of executive and non-executive director compensation at Nikola and discuss whether it had significant bearing on the accusations brought about by Hindenburg Research. What are the advantages and disadvantages of setting share price targets in relation to executive share-based compensation?

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TRAFIGURA REACH FOR THE (NYR)STAR

"A decade on from one of the worst environmental disasters of the 21st century...Trafigura has rebranded itself, claiming it is a transparent, responsible company. This corporate giant...must not be allowed to completely wash its hands of this disaster."

– Lucy Graham, researcher at Amnesty International[1]

Case overview

On 19 August 2006, Trafigura Group Pte. Ltd. (Trafigura), the world's largest private metals trader and second largest oil trader, found itself at the centre of a toxic waste scandal in Ivory Coast. Over 100,000 people needed medical assistance and several lives were lost. Consequently, the former Chief Executive Officer (CEO) landed in an Ivorian jail for five months.

Controversies involving the company did not end there. In its 26-year history of trading, the company has been implicated in several high-profile environmental, corruption and market manipulation scandals, such as the Iraq oil-for-food scandal, the 2007 chemical explosion in Norway, a price-fixing controversy in Malta, toxic diesel trading in Africa, as well as the recent Brazilian car wash scandal that shook the world. Trafigura was also accused by the minority shareholders of its then Belgian associate Nyrstar N.V. of throttling the latter with lopsided deals that led to its collapse.

The objective of this case study is to facilitate a discussion of issues such as corporate governance of large unlisted companies; fiduciary duties of directors in insolvency situations; corporate restructuring; interlocking directorships and management teams; minority shareholder rights and activism; and the growing importance of environmental, social and governance (ESG) factors.

The Trafigura journey

In March 1993, Trafigura Beheer B.V. was born. Alongside the late Claude Dauphin – the legendary commodity trader and former Chairman and CEO of Trafigura – its founding partners were made up of a large swathe of the top brass from Marc Rich & Co, a pioneering oil-trading firm in Switzerland.[2] Trafigura Group Pte. Ltd., the Group's headquarters in Singapore, was later established in March 1996.[3]

This case was prepared by Daphne Ng Yun Ying, Hu Shuyi, Low Jun Yang Leroy, Megan Tam Yee Kwun, Tan Yi Jie and Witney Phua Yiyu, and edited by Tan Yi 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 organizations named in the case, or any of their directors or employees.

A recent book[4] explained how the rebound of oil prices near the end of the last century and the continuing oil boom propelled international commodity trading houses such as Cargill, Vitol, Trafigura and Glencore to "extraordinary financial wealth and political power".[5]

A highly qualified founding team and a few defining events in 2001 placed Trafigura on a path of accelerated growth, starting with the collapse of Enron which signalled the advent of heightened volatility in the commodities market. A low-price environment caused miners to go bust, Big Oil to transform their business models, while traders profited from managing inventories and balancing supply and demand.[6]

An acceleration in demand for energy and industrial raw materials in emerging economies led by China also called for trading houses like Trafigura.[7] The company had the ultimate secret formula to succeed in the metals market. Dauphin hired a number of individuals with new skill sets, including financial and derivatives specialist, Jeremy Weir. As Trafigura's CEO, Weir restructured the company's non-ferrous books and established an investment subsidiary, Galena Asset Management, to provide third-party investors with a platform to invest in commodity derivatives markets alongside Trafigura.[8]

Today, Trafigura is one of the largest physical commodities trading groups in the world.[9] Its core business is the physical trading and transportation of oil and petroleum products and metals and minerals.[10] Group revenues have since risen from less than US$10 billion in 2001 to US$147 billion in 2020.[11,12] Net profit was US$1.6 billion, up from US$0.9 billion in 2018 and 2019.[13]

Trafigura is exclusively owned by its management and active employees across 88 offices in 48 countries.[14] In 2012, the company shifted its main trading hub to Singapore to benefit from the city-state's low tax-regime and proximity to China.[15]

A (Figura)tive recipe for success?

Trafigura is an association of key partners – the management, together with about 850 senior employees out of the 8,000 total employees, are shareholders in the business.[16] It believes that this structure is the best system for alignment between management and shareholders as it would encourage employees to focus "on the long-term success of the business, promoting management depth and stability, and encouraging prudent risk management".[17,18]

One important aspect of the capital structure of commodity trading firms is the ownership of equity.[19] The increasing asset intensity of commodity trading firms has demanded an evaluation of ownership structure. Although Trafigura transitioned from a pure trading model to a relatively more fixed asset intensive model, the company decided to remain private. It has invoked the incentive benefits of private ownership to explain its choice, stating that "we believe an employee-owned private company is the best ownership model for our core trading business."[20]

Trafigura's current CEO, Weir, explained that many industry outsiders do not have a clear picture of the gearing of a trading company and for those in the know, "it doesn't often fit into the normal financial metrics of equity analysts for industrial companies. And they don't understand the risk profile around it."[21] His ideology is very much aligned to that of the late Trafigura founder, Dauphin. While Trafigura's competitors were dealing with the restructuring problems brought about by public listings, Trafigura continued its expansion of market share around the world by staying private.[22]

The ethics of commodity trading houses like Trafigura has been questioned over the years. As one book puts it: "Within these companies there is an extraordinary cast of characters: manically hard-working, fiercely smart, disarmingly personable, and singularly focused on making money. One thing there is not much of in the commodity trading industry is women. The commodity trading companies make Wall Street banks look progressive on gender diversity."[23] It adds: "Some of the traders we've interviewed have been remarkably blunt about the trading industry's reputation for bribery and corruption."[24] It quotes Torbjörn Törnqvist, the co-founder and CEO of oil trader Gunvor as saying: "Unfortunately this is something that has plagued the commodity industry…There's a lot of skeletons and many of them, most of them, will never be surfaced".[25]

Seven wonders of Trafigura

In 2015, Trafigura underwent a restructuring from the previous two-tier board structure – which comprised the supervisory board and the board of directors – to a unitary board structure in accordance with Singapore law.[26] The current board of directors consists of two sub-committees – the Audit Committee (AC) and the Nomination and Remuneration Committee (NRC). The Management Committee (MC), sitting below the board of directors, is separately responsible for the execution of Trafigura's business strategy. According to Trafigura, the MC is supported by the following corporate functions and committees: Finance Committee, Accounting Steering Committee, IT Steering Committee, Market Risk Management Committee, Compliance Committee, HSEC Steering Committee, Human Resources Committee, AC and NRC.[27]

Trafigura claims to have short reporting lines, flat structures, clear delineation and segregation of responsibilities, and personal accountability.[28]

As of FY2020, Trafigura's board consists of seven members. Three of them also hold key positions in the MC – Weir (Executive Chairman and CEO), Mike Wainwright (executive director and Chief Operating Officer) and Jose Maria Larocca (executive director and co-head of oil trading).[29]

One of the other four directors, Pierre Lorinet, a non-executive director (NED), used to be the Group's former Chief Financial Officer (CFO).[30] Andrew Vickerman, another NED, chairs the NRC. Concurrently, he co-chairs the HSEC Steering Committee which is one of the corporate functions under the MC.[31] Vickerman has a background in economics and spent almost 20 years with Rio Tinto Group, one of the world's largest mining companies, with the last 10 years as a member of the executive committee with responsibility for global communications and external relations.[32]

The third NED, Sipko Schat, also holds director roles in various other companies. He is an independent member of the supervisory board and Chairman of the Risk Committee for Rothschild & Co, Chairman of the supervisory board of Vion N.V., and senior independent director of OCI N.V.[33] The last NED on the board, Mark Irwin, is a U.K. qualified chartered accountant who joined Trafigura as financial controller in 1994, and was appointed as a director in 2004 "to provide support for Trafigura's corporate and IT structure".[34]

Shooting (Nyr)star

Nyrstar, incorporated in Belgium with its corporate office in Netherlands,[35] is a global multi-metal organisation[36] and market leader in the production of high quality zinc, lead and other base and precious metals[37] in Europe, the U.S. and Australia.[38] It is listed on the Euronext Brussels N.V., a European bourse.[39] After going public in October 2007, Nyrstar became the world's biggest producer of zinc metal and alloys.[40] Nyrstar was an associate company of Trafigura[41] until the restructuring of the Belgian firm, after which Trafigura became the "majority owner of the operating business of Nyrstar".[42]

From the end of 2009,[43] Nyrstar took on debt to finance its zinc mine acquisitions that subsequently underperformed. Thus, Nyrstar either had to its write down its value or sell it at a loss.[44] By 2018, Nyrstar's debt had accumulated as a result of failed acquisitions, leading to liquidity issues.[45,46] Nyrstar attributed its liquidity issues to overall unfavourable market conditions that affected zinc prices and treatment charges[47,48] and its obligation to refinance its bonds for €350 million.[49]

While Nyrstar blamed lower zinc prices in 2018 for its liquidity issues,[50] the average zinc price was reported to be higher in 2018 than in 2017.[51] Nyrstar claimed that the zinc prices "completely took us [Nyrstar] by surprise".[52] However, short seller, Iceberg Research, argued that any ordinary smelter would have hedged its exposure to commodity prices to mitigate its metal price exposure.[53] In fact, Nyrstar has consistently monitored its "Metal at Risk" on a continuous basis and hedged its metal price exposure.[54] "Metal at Risk" refers to the metal held by Nyrstar, either as work-in-progress or finished good inventory, that has been "priced-in but not priced out".[55] Hence, such metal is at risk of being "priced out" as it is exposed to fluctuations in underlying metal prices.[56] Nyrstar had also previously hedged 70% of its total "free metal" produced at the zinc smelters and North American mines in the first half of 2018 and 50% in the second half of 2018.[57]

Nyrstar further blamed low spot treatment charges for its liquidity issues.[58] According to the company, 49% of its gross profits come from treatment charges, a compensation from miners to smelters that would be deducted from the price the smelter has to pay for the zinc concentrate, which is crucial to the profitability of Nyrstar.[59] While spot treatment charges were very low in the first half of 2018,[60] Iceberg Research suggested that "no smelter would rely only on spot treatment charges as smelters are capital intensive industrial firms that need visibility on price".[61] Iceberg Research's argument was supported by a business model presentation by Nyrstar in 2017, where Nyrstar declared that spot treatment charges only constitute a maximum of 10% of Nyrstar's typical mix of zinc treatment charge terms[62] and that Nyrstar targets its treatment charges to correspond to the benchmark treatment charges in the market as it negotiate for its long-term contracts.[63] Interestingly, in 2018, Trafigura paid Nyrstar an average treatment charge of US$37.20 per tonne for a contracted volume of 500,000 tonnes of zinc concentrates. This was much lower than the US$147 per tonne agreed by Nyrstar and other smelters with miners as an annual benchmark for that year.[64]

Let Trafigura be your (Nyr)star

"We are not all friends. We come to board meetings, we act independently of each other. The board, when it is making decisions, it makes them on an informed basis and the board normally gets all the information it can get and then makes the decision."

– Martyn Konig, Executive Chairman of Nyrstar[65]

On 12 October 2019, Reuters reported that minority shareholders of Nyrstar were seeking €1.48 billion in damages from Trafigura over the restructuring of the Belgian firm.[66]

The Nyrstar minority shareholders claimed that Trafigura had influenced Nyrstar's board[67] to act against its legal duties and committed fraud.[68] The lawsuit sought to void the decision of Nyrstar's board in accepting the restructuring terms in April 2019.[69] Nyrstar was entering insolvency[70] before Trafigura stepped in to bail it out of its debt with a restructuring plan.[71,72]

Following the restructuring, Trafigura's stake in Nyrstar increased from 24.4% to 98%,[73] giving only a two percent stake to minority shareholders of Nyrstar.[74] While Nyrstar argued that the restructuring is the best outcome for all stakeholders, including its shareholders, the minority shareholders believed that the beginning of the problems lies with Trafigura's de facto control over Nyrstar.[75]

Trafigura had been Nyrstar's largest shareholder even before the restructuring exercise.[76] On 9 November 2015, Nyrstar had entered into a relationship agreement which provided a framework for its dealings with Trafigura[77] to ensure that all transactions were made at arm's length, as long as Trafigura held between 20% and 50% of Nyrstar's shares.[78] Under this agreement, both parties entered into supplier and offtake contracts and Trafigura was given some governance rights such as nominating directors constituting the minority of the Nyrstar board.[79] Trafigura said that it would not purchase more than 49% of Nyrstar's shares under the relationship agreement.[80]

However, Nyrstar signed a trade finance framework agreement (TFFA) amounting to US$650 million with Trafigura on 6 December 2018[81] as it was decided that such financing was urgently required to mitigate the possibility of insolvency. Nyrstar said that the TFFA was in the interest of the company, as assessed by Nyrstar's directors Martyn Konig, Carole Cable and Anny Fahy.[82] Nyrstar was also assisted by external experts such as Grant Thornton, Wilkie Farr & Gallagher and Argo Law in its assessment of the necessity for the TFFA.[83]

Minority shareholders of Nyrstar, however, argued that the liquidity issue could have been dealt with if Nyrstar used its available credit facilities instead of entering into the TFFA with Trafigura, which allowed Trafigura the opportunity to seize Nyrstar on non-market terms.[84] Nyrstar rebutted this, saying that given the approaching maturity for some of its debts, it was impossible to obtain new credit lines at reasonable interest rates. The TFFA was said to be necessary to avoid an insolvency, as advised by Grant Thornton and other external advisors.[85] Bloomberg subsequently reported that Trafigura had made an alleged threat to withhold from Nyrstar a US$250 million credit facility, which Grant Thornton considered as "a factor in the rapid deterioration of available liquidity" of Nyrstar which contributed to the risk of insolvency.[86]

According to Belgian Corporate Law, the decision for the restructuring lies with the board of directors, which has to take into account the interests of all stakeholders, including shareholders.[87]

Trafigura stated that restructuring was the only available option to Nyrstar and that Nyrstar would not be able to survive otherwise.[88] The Chairman of Trafigura also stated that given its long business relationship with Nyrstar, it should support Nyrstar under such circumstances.[89]

Nyrstar said that funding from others who were not already familiar with its business was impossible because of the urgent need for funds, the various restrictions placed on its existing credit facilities regarding potential terms of new funding, and the impracticality of getting waivers from its existing creditors given the tight time constraints.[90] It added that Trafigura had the requisite expertise in Nyrstar's business, and the capacity to invest a large amount of funds within a short period of time.[91]

However, Iceberg Research challenged Nyrstar's argument, pointing out that obtaining such waivers from its existing creditors was only a formality which could be settled quickly – as long as the request was reasonable – as creditors would want to avoid a liquidity crisis and instead opt to give the company more time to repay its debts.[92] Iceberg Research also argued that Nyrstar, being a publicly-listed company, is "not exactly a secretive business" and that if Nyrstar were to choose to sell its assets to raise funding, it would have been able to repay its debtors.[93]

Other events also raised further suspicions about Nyrstar's actions. Nyrstar's statutory auditor, Deloitte Bedrijfsrevisoren (Deloitte), issued a qualified opinion for FY2018 on the basis that it was unable to obtain sufficient appropriate audit evidence to ascertain the completeness in disclosures of related party transactions and the company's relationship with Trafigura.[94]

On 29 May 2020, the Financial Services and Markets Authority of Belgium (FSMA) announced an expansion of scope in its year-long investigation into Nyrstar, regarding the lack of crucial information relating to the restructuring exercise. The expansion in scope was to include information about the profitability of the Port Pirie smelter in Australia and Nyrstar's solvency and liquidity position at the end of 2018.[95] This investigation was previously initiated based on whistleblower information from the former head of internal audit services of Nyrstar, Gilbert Guinikoukou. He alleged malpractices between Nyrstar and Trafigura and filed two complaints with the FSMA.[96] It was later reported that Trafigura got the Swiss court to stop the whistleblower from discussing the matter with Belgian and Swiss authorities on the basis that he had "violated his obligations to corporate confidentiality and risked causing damage to the company that would be difficult to undo".[97] It has been alleged that Trafigura has a record of taking action against any adverse reporting of the company.[98]

Shoot down those (Nyr)stars

On 30 October 2020, minority shareholders received some further good news when the President of the Corporate Court in Belgium approved their request to nominate a panel of experts to further investigate possible wrongdoing in the restructuring of Nyrstar.[99] Some of the minority shareholders' key arguments were: (a) violation of Belgian corporate governance rules and corporate law; (b) placement of Trafigura loyalists in Nyrstar's board and management positions to gain effective control of Nyrstar; (c) approval of excessive discounts to Trafigura despite the relationship agreement to transact at arm's length; (d) disposal of mining assets at below market prices; (e) causing Nyrstar to be in a liquidity crisis which was avoidable if Nyrstar had made use of the credit facilities available to it; and (f) taking the lead in a restructuring effort where minority shareholders were effectively excluded.[100,101]

In its responses, Nyrstar claimed that its auditor, Deloitte, and external experts such as KPMG and Stonehouse Consulting had confirmed that the transactions with Trafigura were conducted on an arm's length basis.[102] Furthermore, Nyrstar rebutted the argument that it disposed of its mining assets at below market prices in 2016 and asserted that such transactions were done through normal sales processes with appropriate selling prices, as supported by managing consulting firm FTI Consulting.[103] Additionally, Nyrstar argued that the restructuring was not only on market terms, but also the most optimal option for all stakeholders, according to analyses by third party experts such as Morgan Stanley, Grant Thornton and Duff & Phelps. Furthermore, Nyrstar said that the minority shareholders would have received "zero euros" in an insolvency scenario.[104]

It was not an easy journey for minority shareholders of Nyrstar to obtain a favourable court decision. They faced multiple challenges throughout the restructuring process and their legal proceedings against Nyrstar's board. The legal system in Belgium has been described as one with "built-in impediments for swift and effective preventive action by minority shareholders when their interests are violated".[105]

Specifically, minority shareholders often lack access to established advisory and expert firms, as well as key information to present their case.[106] In fact, the minority shareholders of Nyrstar largely relied on public information or information published by Nyrstar to further their case, which lacked credibility in their view.[107] Additionally, minority shareholders usually have to bear their own legal costs, while the defendants can depend on the huge financial resources of an organisation. These circumstances thus dissuade many minority shareholders in Belgium from making claims against the majority. Nyrstar's minority shareholders therefore relied on regulatory authorities to help their claims against Trafigura, during and after the successful restructuring of Nyrstar.[108]

Nyrstar's minority shareholders previously claimed that the restructuring of Nyrstar occurred "without any information [given] to the shareholders" and that the shareholders had no say in the process, as Trafigura already had de facto control over Nyrstar.[109] Nyrstar subsequently responded in a frequently asked questions publication that the Belgium Corporate Law vests the restructuring decision with the board of directors, and shareholders are not required to vote on such decisions.[110]

On 3 June 2019, two shareholders requested Nyrstar to provide more information regarding Deloitte's report of non-disclosure by Nyrstar.[111] Nyrstar rejected the request, claiming that it had already provided sufficient information for shareholders to approve its annual accounts. The shareholders then turned to FSMA, which asked the Nyrstar board to postpone the vote on the approval of the annual accounts by five weeks.[112] However, Nyrstar's subsequent reply to the warning issued by FSMA to postpone the vote did not satisfy the shareholders. This prompted the two shareholders to submit a unilateral petition to the President of the Corporate Court in Belgium on 21 June 2019, just four days before the approval of the annual accounts was scheduled to be voted on during the Annual General Meeting (AGM).[113]

On 22 June 2019, Nyrstar agreed to delete the resolutions pertaining to the annual accounts from the agenda until the audit report is available, but announced that the AGM would still take place on 25 June 2019. Nyrstar's announcement came two days before the court granted the two shareholders' request in full.[114]

After Deloitte had issued the audit report on 27 September 2019, Nyrstar's board convened a new AGM on 5 November 2019, with the approval of the annual accounts for FY2018 and the discharge of the directors on the agenda.[115] The annual accounts were approved, albeit by "a majority against a minority".[116] Minority shareholders alleged that the meeting was organised inappropriately, given the lack of paper documents, food or drink, and the absence of interpreters after 7pm, even though the meeting ended at 8.45pm.[117]

A fortuitous absence

The attendance quorum necessary for the amendment of the articles of association was not met on 5 November 2019.[118] Nyrstar then called for an Extraordinary General Meeting (EGM) on 9 December 2019 to vote on the resolution of the board of directors in accordance with the alarm bell procedure of Section 633 of the Belgian Companies Code, which required a decision on the dissolution of Nyrstar.[119] The surprise absence of Trafigura from this EGM allowed the minority shareholders, representing only 2.83% of the total shareholders, to successfully reject the proposed continuation of activities of Nyrstar.[120] This meant the effective dissolution of Nyrstar.

The minority shareholders could not have achieved this result in the presence of Trafigura. Their rejection was a "protest vote against the restructuring", as they wanted to avoid a mischaracterisation that voting in favour of the continuation of the activities would have implied approval of the restructuring.[121]

Heading to the court

After the vote to continue the operations of Nyrstar was rejected on 9 December 2019, the board proposed to "deliberate and resolve upon the voluntary dissolution and liquidation" of Nyrstar as one of the agendas in the upcoming shareholders' meetings on 25 March 2020, in accordance with Section 633 of the Belgian Companies Code.[122] This agenda was scheduled under the second of the two consecutive EGMs to be held on 25 March 2020. A third general meeting was also scheduled to be held on the same day. However, the three meetings – one general meeting and two consecutive EGMs – were then postponed until 2 June 2020, due to the COVID-19 pandemic.[123]

On 27 April 2020, the minority shareholders brought a writ of summons before the President of the Antwerp Commercial Court, Antwerp Division. They sought to appoint a panel of company law experts to "gather evidence in order to be able to initiate an informed procedure to remedy an impairment of the company's interest, either to have it repaired or to recover the resulting damage to the company".[124]

Given the lack of physical attendance at the three meetings on 2 June 2020 due to the pandemic, as well as the pending court decision as to whether a panel of experts should be appointed, a group of minority shareholders informed Nyrstar of their intent to make additions and amendments to the original agendas and proposed resolutions for the meetings on 2 June 2020.[125]

The changes to the agendas included the postponement of the 2 June 2020 general meeting. It was suggested that the said general meeting should be included as part of the 2020 AGM, which "should be held on the last Tuesday of June" (30 June 2020).[126]

Another requested amendment related to the proposed resolution for the second agenda of the 2 June 2020 general meeting. The second agenda involved the liability claim made against both the former and current directors of Nyrstar for the errors committed in the FY2019 and FY2020.[127]

The minority shareholders also requested to postpone the second EGM scheduled for 2 June 2020.[128] They alleged that the board abused the "Corona measures to prohibit physical presence" to make "any discussion on the dissolution or restructuring of the company among the shareholders and between the shareholders and the board of directors impossible".[129] In addition, the second EGM should be postponed due to the ongoing summary proceedings brought before the Antwerp Commercial Court regarding the appointment of the panel of experts.[130]

At the same time, the minority shareholders wanted to postpone the decision on dissolution until the following conditions are met:[131]

i) Physical attendance at the general meeting is possible and/or an actual discussion can be organised at the general meeting;

ii) The consolidated annual financial statements audited by the statutory auditor have been approved until the date of closing of the restructuring on 31 July 2019; and

iii) A final decision with the authority of res judicata on the appointment of a company law expert is available.

On 18 May 2020, the newly proposed items to the agenda were added to the three meetings originally scheduled for 2 June 2020.[132]

Finally, on 2 June 2020, Nyrstar held the general meeting and two consecutive EGMs, where the various requests made by the minority shareholders regarding the changes to the agenda and proposed resolutions were put to a vote. In yet another setback for the minority shareholders, the proposed resolutions regarding the postponement of the general shareholders' meeting and the liability claim against the directors and former directors of the company were rejected[133] by 76.26% of the votes.[134] Additionally, the attendance quorum for the two EGMs were not met,[135] hence the request to postpone the EGMs was not approved and was adjourned to 30 June 2020.[136]

The conclusions arising from the various meetings on 2 June 2020 prompted the FSMA to publish a press release on the same day, as it voiced support for the postponement of the decision on the dissolution of Nyrstar "until at least three months after the court decision" has been made regarding the appointment of a panel of experts. Nyrstar continued discussions with FSMA subsequent to the press release.[137]

While discussions were still ongoing, the minority shareholders served another summons in preliminary relief proceedings on Nyrstar, before the President of the Antwerp Corporate Court, Antwerp Division. This was aimed to prohibit Nyrstar from holding the shareholders' meetings on 30 June 2020 with the dissolution of Nyrstar on the agenda of the second EGM.[138]

The minority shareholders wanted the court to order that the decision on dissolution must be postponed “until three months after a final report will have been issued by a body of experts whose appointment is requested in separate proceedings before the court, or, alternatively until three months after a final decision will have been rendered in the aforementioned proceedings regarding the appointment of a body of experts”.[139] Four days before the planned EGM on 30 June 2020, the Antwerp Corporate Court dismissed the former request but accepted the latter claim for a postponement.[140]

To comply with the court order, Nyrstar decided on 26 June 2020 to postpone the second EGM planned for 30 June 2020, which had the resolutions regarding the proposal for dissolution of the company on the agenda. The other meetings – the AGM and the first EGM – which were scheduled for 30 June 2020 did eventually occur.[141] All items on the agendas of the AGM and EGM were approved, with the exception of the second item on the agenda of the EGM relating to a change of the company name from Nyrstar N.V. to NYR Holding.[142]

Changing (Nyr)stars

Prior to the restructuring and legal challenges, there were significant changes in the Nyrstar board and management team which raised some eyebrows among observers and analysts.[143]

Since 2015, the Nyrstar board has between six and eight directors, with NEDs making up the majority of the board and the CEO usually being the only executive director. After Nyrstar entered into the relationship agreement with Trafigura in November 2015, through the latter’s wholly-owned subsidiary Urion Holdings (Malta) Ltd, Trafigura was able to nominate a predetermined number of directors to Nyrstar’s board without constituting a majority of the board.[144] This agreement was struck during the period when Trafigura’s shareholding in Nyrstar had steadily increased from 15.30% in 2014,[145] to 20.02% in 2015[146] and 24.64% in 2016.[147]

In 2014, when Trafigura increased its shareholding in Nyrstar to 15.30%, the incumbent CEO, Roland Junck, resigned.[148] Subsequently, before Trafigura increased its shareholding to 20.02% in September 2015,[149] Trafigura proposed to nominate two new directors – Martyn Konig and Christopher Cox – to Nyrstar’s board in April 2015.[150] Bloomberg reported that shareholders of Nyrstar claimed that the proposal was “unsolicited” and that the nomination was submitted too late for the AGM on 29 April 2015.[151] Trafigura disagreed with these claims, stating that it had given Nyrstar “ample time to interview and assess the candidates”.[152] Eventually, at the AGM, shareholders approved the appointment of the two new board members.[153]

The nomination of Konig and Cox to Nyrstar’s board also raised suspicions. Philip Ngotho, an analyst at ABN Amro Holding N.V., predicted that the nomination was a step for Trafigura to “gain more control over Nyrstar and … it will fuel further speculation of a potential takeover.”[154] He reasoned that the nomination would make a takeover by Trafigura “smoother and less hostile if Nyrstar’s board of directors [had] a friendlier stance”.[155] The takeover indeed became a reality.

Are the stars aligned?

There were doubts about the independence of the two new directors. Konig has been a consultant advisor, and previously Chief Investment Officer,[156] to T Wealth Management SA (T Wealth) before his appointment to Nyrstar in 2015.[157] T Wealth had only separated from Galena Asset Management, a Trafigura affiliate and the private investment arm of Trafigura Group, in June 2015.[158]

However, at an AGM on 25 June 2019, Konig clarified that he has no other relationship with Trafigura, apart from receiving an annual salary and bonus – which depended on the performance of the fund – from T Wealth, while T Wealth is "completely independent from Trafigura".[159] Yet, T Wealth is known to be the asset management fund for most of the senior management of Trafigura. Coming under severe scrutiny, Konig once again reiterated his independence, stating that joining Nyrstar's board was "the worst decision" he has made in his life.[160]

There have been several changes to Konig's role on Nyrstar's board since his nomination in 2015. During the AGM on 27 April 2016, Konig was elected as the Non-Executive Independent Chairman, one year after he had joined the board.[161] He held the position until 18 January 2019, when he took up the role of Executive Chairman. As the Executive Chairman, Konig represented Nyrstar "during negotiations with stakeholders in the capital structure review process",[162] which ultimately led to the takeover by Trafigura. After the completion of the capital restructuring process, Konig was reappointed as Non-Executive Chairman on 5 November 2019, which remains his current role today.[163]

Apart from Konig's relationship with T Wealth, his position as an NED on the board of Euromax Resources Ltd. (Euromax) since August 2012[164] also resulted in further complications. Euromax is a publicly-listed Canadian company involved in the "building and operating the Ilovica-Shtuka copper project in Macedonia".[165] In April 2018, Galena Resource Equities Limited (Galena), a Trafigura affiliate, became a shareholder of Euromax, before increasing its shareholding to 53.1% in March 2019.[166] Private placement funding was also conducted between Galena and Euromax in 2019.[167] The transactions between Galena and Euromax have thus led to a perceived lack of independence of Konig among shareholders. During the AGM held on 5 November 2019, several shareholders questioned if Konig could truly be independent if he holds a position in Euromax and contested the claim that Konig is independent.[168] In reply, Konig asserted that he is "fiercely independent", declaring that "all board decisions" on Euromax had been made independently in Nyrstar.[169]

Another board member who had pre-existing relations with Trafigura was Cox. At the time of his appointment to Nyrstar's board, he was serving on the Trafigura Supervisory Committee and was also formerly the head of the non-ferrous and bulk trading division at Trafigura. Between March and December 2011, Cox was also a member of Trafigura management board, and he was a member of the Trafigura board of directors from October 2013 to September 2014. Cox is also no stranger to the industry, having worked at Gold Fields of South Africa previously.[170] As part of the relationship agreement, Cox was considered as one of the "Trafigura Directors" who was non-independent and nominated by Trafigura in 2015.[171]

Cox held his role until 31 December 2018, when his mandate was terminated after the general shareholders' meeting for FY2018. His reappointment was not proposed at the general shareholders' meeting following the termination.[172]

Come on board!

Konig and Cox became members of the NRC of Nyrstar after joining the company's board in 2015. One of the roles of the NRC is to "make recommendations to the board of directors with regard to the appointment of directors".[173]

While Konig and Cox were members of the NRC, Jesús Fernandez was appointed as an NED on Nyrstar's board on 27 April 2016. Fernandez was the head of merger and acquisition (M&A) and sat on the board of the mining division of Trafigura Group at the time of his appointment. Fernandez also concurrently served as a board member of numerous companies, including Atalaya Mining PLC, Bowie Resource Partners, Mawson West Ltd. and various subsidiaries of Trafigura.[174] He was also a principal of the Galena Private Equity Resources Fund. Nyrstar disclosed in its 2016 annual report that Trafigura is a related party to both Cox and Fernandez, although it was stated that their various roles do not "entail a direct personal conflict of interest".[175]

After Fernandez's appointment to the Nyrstar's board, he became a member of the Health, Safety, Environment and Community Committee (HSECC), AC and NRC.[176] He remained in these committees until 2018, before his departure from Nyrstar on 25 February 2019.[177,178]

It was reported that Fernandez left Nyrstar to assist Trafigura in the negotiations regarding Nyrstar's capital structuring process and his resignation would ensure clarity and avoid any potential conflict of interest.[179] He re-joined Trafigura in 2019 and continues to be the head of M&A for Trafigura today.[180]

In 2016, in order to "further bolster performance" and "execute the current strategy" of Nyrstar, there was a shake-up of the senior management structure in Nyrstar.[181] On 13 December 2016, Hilmar Rode was appointed as an executive director on Nyrstar's board, after taking on the role of CEO in the same month.[182] This was the same year when Konig became Chairman of the board. Rode has vast experience in the metals industry, specifically in relation to the smelting business. He previously held senior management roles in other mining companies, such as BHP Billiton and Glencore. Rode also led a restructuring and business optimisation project at Glencore's Kazzinc operation in Kazakhstan, prior to joining BHP Billiton.[183]

Following the completion of Nyrstar's restructuring exercise on 31 July 2019, Rode's three-year stint at Nyrstar came to an end on 30 September 2019. Thereafter, he re-joined Glencore and subsequently Sibelco Group as CEO.[184]

Ties that bind

Apart from the close relationships between members of Nyrstar's board and Trafigura, there were also connections between members of the management team in both companies.

In 2015, Christopher Eger was appointed as CFO of Nyrstar. Prior to joining Nyrstar, Eger was a senior member of the M&A team at Trafigura. He also worked with metals and mining companies on debt and equity financing and M&A at the investment banking arm of Bank of America Merrill Lynch.[185]

Eger's appointment to the management team of Nyrstar came under the spotlight due to his ties to Trafigura. It was alleged that Nyrstar approached Trafigura to look for someone to fill the CFO position.[186] Late 2015 was also a crucial period for Nyrstar, as it was suffering from the "biggest commodity rout since the financial crisis".[187] Concurrently, Nyrstar was preparing to launch its third equity offering since 2011 to raise up to €275 million to meet a looming debt repayment. Ultimately, Trafigura agreed to underwrite part of this fundraising.[188]

Eger's appointment also caught the attention of regulators in Brussels, as they were assessing if Trafigura had taken de facto control of Nyrstar. With an impending prepayment deal between the two parties involving up to €170 million forming part of Nyrstar's refinancing package, as well as the commencement of a deal which would result in Trafigura supplying Nyrstar zinc concentrate from January 2016, there were growing suspicions about the close relationship between the two parties.[189] Eger subsequently stepped down as CFO to "pursue other opportunities" on 3 May 2018.[190]

Star awards for (Nyr)star performers

Apart from an AC, a NRC, and a HSECC, Nyrstar's board set up a Special Committee to "assist the board in the day-to-day supervising and reviewing of strategic financing matters and any capital structure review" in October 2018.[191]

The Special Committee was made up of Mike Corner-Jones, who was the Chairman of the committee, Jane Moriarty, Konig, Cable and Fahy. The committee's role involves the supervision of the recapitalisation proposal, negotiation with various creditors and the conducting of a liquidity review, among other responsibilities. The Special Committee was said to have met frequently for the "efficient operation of the Special Committee and the board".[192] In total, the committee held 70 meetings from 2018 to September 2019, a number far exceeding that of the AC (four in 2018 and 10 in 2019), NRC (three in 2018 and four in 2019) and the HSECC (three in 2018 and one in 2019).[193]

It was further disclosed that in March 2019, Fahy, Cable and Moriarty each received additional remuneration of €10,000 for being members of the Special Committee. The Special Committee was dissolved on 31 July 2019 after the completion of the capital restructuring.[194]

The restructuring of Nyrstar not only introduced a new Special Committee, but it also entailed changes to the company's remuneration structure. These changes were proposed by Nyrstar's NRC, which makes decisions on the remuneration structure by seeking independent advice from external professionals. The policies are framed and redesigned to "retain talented employees and meet shareholders expectations".[195]

In 2016, the NRC was made up only of NEDs and a majority of IDs, as per the Belgium Companies Code.[196] The Committee was chaired by Konig, while the members were Cable, Fahy and Fernandez. Konig was previously a member of the NRC for one year in 2015 and was deemed to have satisfied the requirements of having the "the necessary expertise on remuneration policy" pursuant to the Belgium Companies Code, [197] while Fahy and Fernandez were only appointed as board members in 2016.[198]

In the same year that Konig became Chairman of Nyrstar's board and Chairman of the NRC, the board submitted proposals to shareholders to make the following changes to the remuneration structure:[199]

1. Increase the remuneration paid to the Chairman of the AC from €20,000 to €30,000 due to the amount of preparatory work involved compared to other committees;
2. Remunerate certain NEDs in whole or partly in deferred share units instead of cash;
3. Renew the powers of the board of directors to pay out entitlements to beneficiaries under the annual incentive plan (AIP) in the form of Shares instead of cash; and
4. Renew the long term incentive plan for a term of 10 years.

This review was done to ensure the remuneration policies were "in line with market practice".[200]

The abovementioned changes to the remuneration structure included paying NEDs in deferred share units instead of cash. These shares will not vest immediately but will "effectively vest and be delivered on the earlier of the end of the director's mandate of the eligible director, or a change of control" over Nyrstar.[201] This was done to enable the NEDs "to link their effective remuneration to the future performance of Nyrstar and to strengthen the alignment of their interest with the interest of the company's shareholders".[202]

Two of the directors who were eligible for the deferred share units plan were Konig and Cox. The full amounts – €70,000 each – of both Konig's and Cox's remuneration, which would otherwise have been paid in cash, qualified for this scheme.[203] This change in remuneration structure was also in line with Article 556 of the Belgian Companies Code, which states that shares can be delivered upon the occurrence of a change of control over a company.[204]

The board of directors subsequently proposed to further revise the remuneration structure to remunerate certain NEDs in whole or partly in deferred share units instead of cash and to renew the powers of the board to pay out entitlements to beneficiaries (including members of the MC and directors, where applicable) under the AIP in the form of shares instead of cash.[205]

Konig continued to remain as Chairman of the NRC, except during the period when he was appointed as Executive Chairman to oversee the capital restructuring process. Moriarty replaced him as NRC Chairman during this period.[206]

The special award goes to...

Before the restructuring was completed, Nyrstar's NRC, along with the board, provided for additional remuneration incentives in view of the capital structure review process in 2018, with the "appropriate conflict of interest procedures being applied".[207]

To retain talents after the capital restructuring, it was disclosed in both 2018 and 2019 annual reports that Nyrstar paid then CEO Rode an ex-gratia payment of €221,567 in 2019. Another ex gratia payment of approximately €1.1 million was also paid to him "as the retention condition of the CEO not having resigned, nor having been dismissed for cause under Swiss law, until the earlier of (a) 31 December 2019 or (b) the successful conclusion of the Restructuring" was met by the CEO on 31 July 2019 after the successful restructuring of Nyrstar.[208]

Separately, as Konig became Executive Chairman from 18 January 2019 to facilitate the capital structure review, he was paid €119,646 in the first quarter of 2019. He received yet another ex gratia payment of €677,994 as he fulfilled a retention condition similar to Rode's.[209]

Another three members of the MC were paid an aggregate amount of €487,465 in September 2019 as part of the board's strategy to "secure continuity during the capital restructure process".[210] This condition was met by the three members.[211] However, it was not disclosed who the three members were.

Simultaneously, the interim CFO, Roman Matej, who was appointed in January 2019, was paid €206,969.[212,213] This amount was disbursed in two payments – 50% in June 2019 and a further 50% in December 2019. These payments were only given after he satisfied the condition that he had remained in Nyrstar when the payments were due.[214]

Under the ESG radar?

"It's really incredible to think that a company will use the legal and PR profession so coyly to end up making their name world famous for corporate irresponsibility. The irony is that three months ago no one outside their sector had actually heard of this firm."

– Brendan May, managing director of Planet 2050[215]

As an unlisted company with no public investors, Trafigura does not face the demands that publicly-listed companies face from institutional investors regarding their ESG performance. However, the company has been under public scrutiny after several ESG-related scandals.

Dumping toxic waste

In 2005, Trafigura purchased a large consignment of coker naphtha, an unrefined gasoline. However, it had to figure out a way to reduce its sulphur content before selling it.[216] To do so, the coker naphtha underwent caustic washing, which was completed on board of a vessel, Probo Koala.[217] 500 tonnes of toxic sulphuric waste was produced.[218]

Internal Trafigura emails revealed that the company knew even before the caustic washing commenced that there would be considerable challenges in disposing of the toxic waste.[219] Trafigura engaged Amsterdam Port Services (APS), a Dutch waste management company,[220] to deal with the waste, calling it “harmless slops”.[221] However, when treatment began, APS found the waste to be much more polluted than it initially believed, such that sophisticated treatment was required to process it. With the greater complexity of treatment required, APS raised its asking price. Trafigura did not agree to the higher cost, and brought the waste back on board Probo Koala, which transported it from Europe to Ivory Coast in West Africa.[222]

In August 2006, Trafigura engaged a newly licensed company, Compagnie Tommy, to dispose of the waste.[223] However, the contract did not specify any requirement to properly treat the waste before disposal.[224] The foul smell coming from the waste led the local dumpsite to close. Hence, truck drivers proceeded to transport and dump the waste at 18 spots around Abidjan.[225] This improper disposal of the waste allegedly led to thousands of Ivorians suffering from nausea, breathing difficulties, vomiting and diarrhoea. Furthermore, at least 10 lives were reportedly lost as a result of the improperly disposed waste.[226] The health scare led to governmental precautionary measures, such as the suspension of school activity and fishing, destruction of vegetation and culling of livestock near dumping grounds.[227]

Trafigura denied responsibility for the disposal of untreated toxic waste. It blamed Compagnie Tommy, claiming that it had appointed the waste handlers in good faith, believing it would dispose of the waste safely and properly.[228] Trafigura allegedly threatened to sue anyone who disagreed with its stance and sued the BBC for publishing material that Trafigura’s lawyers disagreed with.[229]

In 2007, Trafigura reached an out-of-court settlement with the Ivorian government to pay US$198 million for the clean-up and to support victims.[230] It paid a further US$1,546 to each of the 31,000 claimants, under a lawsuit brought by Leigh Day & Co.,[231] which was far lower than the £6,000 (US$9,764) that each victim originally asked for.[232]

Trafigura also allegedly attempted to conceal the severity of the pollution caused by its waste disposal. On 11 September 2009, Trafigura obtained an emergency super injunction to stop British newspaper The Guardian from releasing a report by Minton, Trehan and Davies Ltd, a consultancy company.[233] This report, which was later published, concluded that the waste dumped was “capable of causing severe human health effects through inhalation and ingestion. These include breathing difficulties, nausea, eye irritation, skin ulceration, unconsciousness and death.”[234] Trafigura alleged that the draft report was a general study not specific to Trafigura’s case.[235] It also claimed that the waste could only at most cause temporary low-level flu symptoms.[236]

Trafigura received backlash as critics argued that it had transported toxic waste out of Europe, and passed it on to a company that was incapable of dealing with the high toxicity of the waste which would simply dispose of it in a city dump.[237] Many argued that Trafigura should have known that extra diligence was required in the waste disposal, especially after APS found the waste to be greatly contaminated, requiring sophisticated treatment.[238]

Organisations such as Amnesty International and Greenpeace have called for transparency from Trafigura for the sake of the victims still suffering from the waste dumping 10 years on. They said that the Ivorian victims “live in fear and without basic answers about how the waste has affected their health”.[239]

In August 2012, Trafigura declined Amnesty International’s request for it to disclose the contents of the toxic waste, citing that the waste contents were disclosed in U.K. court proceedings. However, the court disclosures were based on tests conducted by a Dutch government agency well before the waste dumping.[240] Additionally, Trafigura’s claims that the most severe effect of the waste on an individual’s health was low-level flu symptoms was based on evidence which was made confidential after a 2009 court settlement.[241]

Lucy Graham, an Amnesty International researcher, pointed out that if Trafigura truly had nothing to hide, it would be transparent and disclose the full details to allow the victims to move on.[242]

Chemical explosion in Norway

Just nine months after the Ivory Coast waste disposal incident, Trafigura was involved in yet another scandal. On 24 May 2007, a tank containing waste from Trafigura exploded in Sløvåg Gulen, releasing sulphurous fumes that caused Norwegians nearby to suffer environmental and health effects,[243] such as chemically red sore throats.[244] This waste was identical to the waste that had been dumped in Ivory Coast[245] and was being handled by Vest Tank, which was engaged by Trafigura for waste disposal.[246]

Norwegian authorities accused Vest Tank of not having the appropriate permits to perform the caustic washing for Trafigura. Vest Tank insisted it had permission while Trafigura insisted it complied with government regulations when dealing with Vest Tank.[247] While Norwegian police decided not to prosecute Trafigura for the explosion, it requested multiple times to interview the Trafigura employees involved. However, Trafigura was not willing to consent to the interviews, and tried to set conditions before deciding if it would cooperate with the Norwegian police.[248] Trafigura also declined to comment on the scandal to reporters.[249]

Trading of toxic diesel in Africa

In 2016, Public Eye published a "Dirty Diesel" report after three years of research, exposing Swiss commodities companies for taking advantage of lenient African standards to sell highly sulphurous fuels in Africa.[250] These companies – including Trafigura – were found to be blending cheap but toxic petroleum products to create "African quality" fuel, which had high sulphuric content and other toxic substances, to be sold in Africa.[251] This blending technique deliberately reduced fuel quality and was done as it was cheaper and would thus increase profit margins.[252]

This "African quality" fuel, while compliant with Africa's low fuel standards, would violate European standards as its sulphur content was "up to 378 times higher than levels permitted in Europe", and contained harmful substances banned in Europe.[253] When burned, this low-grade fuel would release sulphur into the atmosphere, resulting in environmental consequences, such as air pollution and health effects including respiratory diseases.[254]

Trafigura responded to the report, citing that the onus of setting fuel standards is on national governments and that Trafigura supplies fuels that meet national standards in all its markets.[255] It also stated that it is doing its part to support human rights by being a member of the African Refiners Association (ARA) and supporting its efforts to improve fuel quality in Africa.[256]

Public Eye responded to Trafigura's claims, accusing the company of "systematically exploit[ing]" Africa's low fuel standards to increase profits.[257] It further added that it saw no reason for Trafigura's inability to deliver fuel that is of higher quality than the national standards and called for Trafigura to deliver European quality fuels to Africa.[258]

Operation Car Wash

Operation Car Wash started as an investigation on agents who used small businesses to launder money.[259] However, it was soon discovered that these agents were working on behalf of an executive from Petróleo Brasileiro S.A. (Petrobras), a Brazilian state-owned oil and gas company,[260] which eventually led to the uncovering of a vast and intricate web of corruption. The operation evolved into the biggest corruption scandal in Brazil's history, involving some of the world's biggest companies, political parties and billionaires.[261]

Global Witness, a London-based anti-corruption and investigative group,[262] raised concerns about Trafigura engaging middlemen with links to the Car Wash scandal.[263] This was mentioned in Global Witness' report published in November 2018, which was based on previously unreported court materials. In the case of Trafigura, the report highlighted that according to Petrobras, Trafigura was under police investigation in Brazil, and two of the central figures in the Car Wash scandal exchanged messages[264] about orchestrating bribes amounting to US$20 million.[265] Trafigura responded that the report was "a recycling of ambiguous commentary and conjecture, and beyond that, it provides no substantiated evidence of any wrongdoing by Trafigura".[266]

In December 2018, it was reported that Trafigura was under investigation for bribes of US$4.1 million to secure deals for trading petroleum products and rental of storage tanks.[267] In connection to this, Brazilian prosecutors accused two former Trafigura executives, Mariano Marcondes Ferraz and Marcio Magalhaes, of the wrongdoing although they were not charged.[268]

According to prosecutors, one of the bribery schemes was allegedly masterminded by former Trafigura executives Ferraz and Magalhaes, as well as Carlos Herz – a middleman for giving bribes to Petrobras officials.[269] Trafigura signed a contract hiring Herz as an agent for his "experience and networks" to "develop business opportunities".[270]

Herz regularly invoiced Trafigura for "consultancy services" from mid-December 2012.[271] However, the document trails showed that Herz passed a portion of money to a Petrobras official. In one case, Herz emailed Ferraz saying he had paid out US$200,000 to the Petrobras official, and needed to pay US$235,000 more.[272] After receiving funds from Trafigura, Herz disguised these payments. He received invoices from purported Chinese companies which allegedly turned out to be money launderers, reflecting the rough amounts that he needed to pay Petrobras – US$200,000 for "consulting services related to purchase and logistic procedures of stationery, hardware, sanitary toilets" on 4 January 2013, and US$235,200 for purported sanitary services on 24 January 2013.[273] These payments to Herz continued until 2014.[274] Trafigura claimed there was nothing improper about approving the payment to Herz and the allegation that "Trafigura's current management knew that payments to an intermediary would be used to make improper payments to employees of Petrobras is not correct".[275] Trafigura also added that it has a zero tolerance policy on bribery and corruption.[276]

The report by Global Witness also alleged links Trafigura had with Jorge Luz, who was known as the "Deacon of Bribes" in Brazil.[277] Luz and his son were allegedly planning to benefit from Petrobras's petroleum trade through an oil contract with Trafigura, getting bribes of US$20 million.[278] According to an insider, Trafigura would lend Petrobras funds under an oil-backed loan, to be repaid through a discount on future oil sales.[279] Trafigura said that such contracts for pre-payments were not uncommon in the industry and admitted there was a contract offered to Petrobras. However, the proposal did not result in any agreement as Petrobras officials rejected it. Trafigura claimed that both Luz and his son were not retained by the commodity trader to lobby the proposal to Petrobras.[280]

In May 2020, Ferraz signed a cooperation agreement to share information with prosecutors in exchange for reduced penalties. He revealed that two of Trafigura's directors, Larocca and Wainwright, approved bribes to obtain hundreds of oil fuel contracts. Ferraz also claimed that the heirs of Dauphin, the late founder of Trafigura, knew about the bribes and approved them.[281]

In December 2020, based on Ferraz's information, Brazilian investigators began pursuing the criminal probe of Larocca and Wainwright. However, neither individual has been charged to date.[282] Brazilian prosecutors also filed a civil lawsuit relating to corruption allegations involving Petrobras to seek damages from Trafigura. It was alleged that Trafigura paid US$1.5 million in bribes to former employees of Petrobras' commercial area to secure 31 irregular fuel oil purchases and sale transactions between May 2012 and October 2013.[283] Trafigura profited from this and caused losses to Petrobras.[284] The lawsuit sought more than US$77 million from Trafigura.[285] In addition, prosecutors used the information provided by Ferraz to request the freezing of US$187.55 million in assets from individuals involved, including the heirs of Dauphin.[286]

In July 2021, it was reported that the commercial arm of Mexican state oil company, Petroleos Mexicanos (Pemex), has temporarily banned new business with Trafigura, due to investigations into the latter's conduct in several countries in Latin America.[287]

Trafigura finally figuring it out…or not?

"It is disingenuous for Trafigura to tout a superficial transparency record at a time when the victims of 2006 are left in fear for their health because of its opacity."

– Lucy Graham, researcher at Amnesty International[288]

Trafigura has made efforts to rebrand itself as a socially responsible leader in the commodities industry. In 2014, Trafigura was the first commodities company to join the Extractive Industries Transparency Initiative.[289] This initiative implements the "global standard to promote the open and accountable management of oil, gas and mineral resources".[290] Additionally in 2016, it held a forum on supporting responsible trade.[291] The timeline of rebranding attempts from 2014 to 2016 coincided with Public Eye's 2016 exposé on Trafigura regarding the alleged exploitation of Africa's low fuel standards to sell cheap, toxic fuel.

More recently, Trafigura has continued to take steps to rebrand and maintain its image in the industry. On 28 September 2020, Trafigura released a press statement that it had partnered with IFM Investors to form a joint venture, Nala Renewables Switzerland Sàrl (Nala Renewables), to invest in renewable energy projects in markets that Trafigura operates in.[292]

On 6 January 2021, it was announced that Nala Renewables would invest €30 million in a project to develop battery energy storage systems at Nyrstar's zinc smelting facility. In connection with this, Nyrstar's CEO Daniel Vanin announced that Nyrstar "collaborates with partners who help make the shift towards more green energy and climate actions".[293]

However, at around the same time, it was reported that Trafigura invested €1.5 billion for a 10% stake in Vostok Oil, a giant Arctic oil project backed by Russia's President Vladimir Putin, in a partnership with PJSC Rosneft Oil Company (Rosneft).[294] Not only is the project highly controversial from an environmental point of view, Rosneft has a highly questionable reputation with very close links with President Putin through Rosneft's CEO, Igor Setchin. Both

Rosneft and Setchin are under U.S. sanctions.[295] The investment in Vostok Oil was reportedly made through a Singapore-registered special purpose vehicle called CB Enterprises, which financed the deal with debt and equity. The Financial Times report said that corporate filings in Singapore showed the €5.755 billion syndicated loan facility for the project was organised by the Central Bank of Moscow, which also has ties to Rosneft and Setchin.[296]

Epilogue

Nearly two years after the restructuring of Nyrstar was completed, Belgian regulator FSMA still has not published the outcome of its ongoing investigations. This has left Nyrstar's minority shareholders, who are highly dependent on regulatory authorities to protect their rights, disappointed and frustrated. A recent report included a fresh allegation by minority shareholders that Nyrstar hid some profits in its corrected FY2017 accounts by combining a negative accounting correction of €51 million with almost €100 million of extra profit and presenting it as a positive effect of €46 million in the metals processing division.[297] Who will prevail in the tussle between Trafigura and the minority shareholders of Nyrstar remains to be seen.

At the AGM held on 29 June 2021, several resolutions were proposed by the minority shareholders. The resolution to decide that the current directors cannot be considered independent was not approved. The proposed resolution to require the board to convene, within a period of 60 days, a special general meeting to consider the appointment of one or more independent directors, became a source of dispute between the company and the minority shareholders. According to the company, part of the resolution requires amendments to the articles of association, and quorum required for such a decision was not reached. The minority shareholders disagreed with this interpretation. The company proceeded to put to vote only the part of the resolution instructing the board to convene a general meeting within 60 days to consider the appointment of one or more independent items. This was passed. A further resolution to follow certain procedures proposed by minority shareholders for the nomination of independent director candidates was not approved.[298]

Minority shareholders decided to boycott the EGM to amend the articles of association on 23 August 2021, calling it "an unsolicited, shameless legal charade that is actually without object". They also said that Nyrstar and Trafigura have already indicated that they will not accept an independent director, therefore "making the general meeting meaningless".[299]

On 2 September 2021, the Court of Appeal in Antwerp decided to postpone the decision on the nomination of the panel of experts until 22 February 2022.

On the ESG front, it remains unclear how far Trafigura has progressed to align its ESG practices to globally accepted practices or whether it will operate on different ESG standards compared to its publicly-traded peers.

Discussion questions

1. Evaluate the ownership structure of Trafigura compared to publicly-traded commodity traders such as Glencore and how the difference in ownership structures may affect their respective corporate governance.

2. According to Nyrstar, what are the reasons which led to the restructuring plan with Trafigura? Critically evaluate the reasons offered by Nyrstar. In such a situation, what are the duties of Nyrstar's board of directors? Do you think the directors have adequately discharged them?

3. Evaluate the changes in the board composition of Nyrstar prior to the restructuring and whether these changes created issues from a corporate governance standpoint.

4. Evaluate the independence of the directors on Nyrstar's board. To what extent do you think the board of directors of Nyrstar is responsible for the downfall of Nyrstar?

5. Based on the case, what are some challenges faced by minority shareholders of Belgian listed companies such as Nyrstar? Should there be better protection for minority shareholders and if so, what measures would you recommend be introduced?

6. Consider Trafigura's ESG scandals described in the case. Discuss to what extent have the fiduciary duties of directors, in particular the duty of care, been fulfilled? Critically evaluate Trafigura's involvement in these scandals from an ethical standpoint. Do you think a company's actions can be considered ethical as long as its actions are legal? Explain.

7. Evaluate Trafigura's responses when reports about its ESG scandals were published, as well as the company's subsequent efforts to rebrand itself as a socially responsible corporation. Do you think these rebranding attempts are superficial methods used by Trafigura to recover from the scandals, or has it genuinely changed for the better?

8. Comment on the adequacy of the current regulations for large unlisted companies such as Trafigura from an ESG perspective. Should Trafigura be subjected to the same standards as a company like Glencore? Explain.

9. As a privately-held company, Trafigura is subjected to less regulation and oversight, and does not face scrutiny from institutional investors such as pension funds and asset managers. Does this give Trafigura a competitive advantage as compared to its publicly-listed peers? Which stakeholders do you think would be most able to influence the company's conduct? Do you think Trafigura will eventually align its practices with those of its publicly-listed peers or will it continue to play largely by its own rules? Explain.

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UNAOIL: DIRTY HANDS IN THE BRIBE FACTORY

Case overview

In 2016, a leak of confidential documents exposed the massive corruption within the oil industry facilitated by Unaoil S.A.M. (Unaoil) and other agents. Unaoil, run by the Ahsani family, acted as the middleman between large energy companies and corrupt governments in the Middle East, Eastern Europe and Africa. It collected multi-million dollar payments from its clients and funneled the monies to the pockets of corrupt government officials in exchange for insider information or sizeable contract wins. Notable clients of Unaoil allegedly included well-known companies such as Rolls-Royce, Halliburton, Leighton Holdings and Samsung. The Ahsani family relied on its extensive network of connections to conduct its illicit business, while putting up a squeaky clean front by setting up charities and sitting on the boards of non-governmental organisations. Through the use of false statements and concealed information, Unaoil's industrial scale bribery operation lasted about 17 years before it finally came to an end. After its bribe scandal was exposed, regulatory authorities worldwide went after Unaoil and the Ahsani family, including the U.K. Serious Fraud Office and U.S. Department of Justice.

The objective of this case study is to facilitate a discussion of issues such as ethics; corruption; money laundering; cross-border transactions; roles and responsibilities of regulatory authorities; role of the media in exposing large-scale crime; and the importance of country and industry regulations.

Unaoil – born in haven

Unaoil S.A.M. (Unaoil) was established as a family-run market consultancy company providing industrial solutions to the energy sector in the Middle East, Central Asia, and Africa.[1] In reality, it acted as a middleman between multinational energy companies and corrupt governments in the Middle East, Eastern Europe and Africa. Based in Monaco, the company was incorporated in the British Virgin Islands (BVI) in the 1990s by its founder, an Iranian-born U.K. resident, Ata Ahsani. Both Monaco and the BVI are well-known tax havens.[2] Ata Ahsani took on the role as Chairman of Unaoil, while the founder's two sons, Cyrus and Saman Ahsani, ran the company as its Chief Executive Officer and Chief Operating Officer (COO) respectively.[3,4]

This case was prepared by Ang Hui Ru, Sarah Frances Ong Sze Ann, Sito Wynice, Soh Rui Min and Sylvester Lek Jun Han. It was re-written and edited by Isabella Ow 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 organizations named in the case, or any of their directors or employees.

Leaks and exposé

The role of Unaoil in facilitating corruption by multinational companies (MNCs) and government officials was revealed on 30 March 2016, when The Age – an Australian newspaper publication – published a multi-part exposé on Unaoil's industrial scale bribery operation, calling Unaoil "the company that bribed the world".[5]

An anonymous source provided Fairfax Media – which owns The Age – with hundreds of thousands of documents detailing Unaoil's clandestine bribery operations – including emails, records and receipts – via a hard drive.[6] These documents detailed how Unaoil distributed bribe payments on behalf of MNCs which were looking to expand into the energy and oil industry, such as Rolls-Royce Motor Cars Limited (Rolls-Royce), and exposed the true extent of corruption within the oil industry.[7] The Age later shared the leaked information with its media partner, The Huffington Post.[8] After a six-month investigation across two continents, the two media companies revealed Unaoil's scandal to the world.[9]

It was reported that the anonymous source also wanted the documents shared with Australian law enforcement. Acting upon his instruction, a journalist at The Age gave officials a heads-up on the date when The Age intended to publish its report.[10]

On 29 March 2016, the day before the exposé was published by The Age, the U.K.'s Serious Fraud Office (SFO) – with the help of the Monaco authorities – raided Unaoil's offices and the homes of a number of Unaoil executives in Monaco. The SFO had been made aware of the upcoming reports, and informed Monaco officials that the raids should be conducted prior to the publication of the exposé as it was concerned that "the suspects would destroy evidence".[11]

We are innocent!

When the bribery allegations were first made, Unaoil and its executives vehemently denied them and called them "malicious and damaging".[12] Despite operating in some of the world's most corrupt countries, the Ahsanis maintained that Unaoil only gave its MNC clients "local knowledge and services", nothing more.[13] Earlier in 2014, Chairman Ata Ahsani even swore on oath in the U.K. High Court that the allegation of Unaoil being "some sort of a bribe-paying fixer for multinationals" was "sheer nonsense".[14]

The Ahsanis claimed that Unaoil had an advisory division, and that its activities relied on "cultivated relationships and hard-won knowledge, not graft". They also said that the advisory division oversaw many joint ventures and employed over 1,000 workers in countries such as Iraq and Kazakhstan to work on engineering and construction projects. However, despite their vehement denial of wrongdoing, the Ahsanis never said the documents revealed in the exposé are not authentic.[15]

Unaoil contended that it had been “the victim of an extortion attempt by embittered former employees who stole a cache of sensitive documents and correspondence”.[16] Lawyers for the Ahsanis later said that the hard drive of leaked documents was used in an attempt to extort US$5 million in cryptocurrency from the Ahsanis in December 2015 – months before the raid by the Monaco authorities. It was alleged that the blackmailer, “Komrade”, threatened that if the payment was not received, the leaked documents would be “sent to newspapers and Wikileaks”.[17] The Ahsanis were advised by Guidepost Solutions, a cybersecurity firm, to only pay a fraction of amount to keep negotiations with the blackmailer open. After failing to obtain the full ransom amount from the Ahsanis following a four-month negotiation, “Komrade” issued his final words to the Ahsanis: “Is time now for you feel some pain.”[18]

It has not been verified whether “Komrade” and the anonymous source which leaked the documents to Fairfax Media were the same people. Nonetheless, it was eventually revealed that the Ahsanis were feigning innocence. Unaoil had indeed engaged in widespread bribery in multiple countries across the Middle East, Eastern Europe and Africa to secure billions of dollars’ worth of government contracts for its MNC clients.[19]

Opaque operations

Nine main countries were involved in this scandal – namely Algeria, Angola, Azerbaijan, the Democratic Republic of Congo, Iran, Iraq, Kazakhstan, Libya and Syria. These are countries which were considered highly corrupt and ranked lowly on Transparency International’s Corruption Perceptions Index. In 2016, these nine countries were ranked 108th, 164th, 123rd, 156th, 131st, 166th, 131st, 170th, and 173rd out of the 176 countries in Transparency International’s rankings.[20] These countries “are plagued by untrustworthy and badly functioning public institutions like the police and judiciary” and anti-corruption laws in these countries are “often skirted or ignored”.[21]

Funny money

Unaoil carried out its illegal operations undetected over 17 years from 1999 to 2016.[22] The company employed several unscrupulous methods to gain business and retain clients while flying under the radar, by making false statements, concealing information, and destroying documents to evade detection.

Unaoil engaged heavily in facilitating bribes to executives of state-owned oil companies and government officials on behalf of multinational firms in order to secure oil and gas contracts for its clients.[23] Its executives conspired to engage in bid-rigging by paying out or authorising the provision of kickbacks from Unaoil to “sub-agents” or “subcontractors”. In return, the middlemen within these state-owned oil companies provided them with insider information on energy and oil contracts to be released. In some cases, these sub-agents would even disclose the amount the state would be willing to pay in these contracts. Unaoil and its client would then use this insider information to inflate its prices to gain maximum profit.[24] Through this modus operandi, Unaoil was able to attract business from clients looking to engage in deals in the energy and oil sector.

Unaoil was able to mask these bribery schemes through the laundering of bribe payments in tranches using various offshore U.S. bank accounts and intermediary companies. It avoided detection through its use of unique secret code names to refer to certain sub-agents and personnel involved. Without context and understanding of in-house terminology, the information would not make any sense. In using these code names, Unaoil not only protected itself but also the key personnel involved.[25] As a family-run company, Unaoil heavily engaged in related party transactions and capitalised on high-society connections the Ahsani family had. This helped Unaoil ensure that there was no leak of its unlawful operations beyond those who were involved.

For example, Unaoil paid monthly retainer fees of US$6,000 – in addition to two initial US$5,000 payments and a one-off amount of US$400,000 – to Oday Al Quoraishi, an official of South Oil Company (SOC) in Iraq.[26] SOC was a state-owned company in charge of Southern Iraq's oil resources. Through Al Quoraishi, Unaoil gathered insider information regarding tender agreements released by the Iraqi government as part of its Iraq Crude Oil Export Expansion Project. The bribes were wired from Unaoil to Al Quoraishi indirectly through an intermediary company – Al Kassim Technical Services FZC (Al Kassim) – based at Sharjah Airport, International Free Zone, UAE, in tranches ranging from US$28,000 to US$36,000.[27] To add an additional layer of secrecy, Al Quoraishi was referred to as "Ivan" in email correspondence.[28] Other parties involved were similarly given code names – the Iraqi Minister of Oil, Kareem Luaibi was labelled "M"; and the Iraqi vice-premier Al Shahristani was given the name "the teacher".[29]

The transactions carried out through the Al Kassim bank account – Unaoil's vehicle used to transfer bribes – was handled by a man known as "Mamoodi" (Muhammed Noor), who owned a stake in Al Kassim Technical Services. Mamoodi is the brother of Basil Al Jarah, Unaoil's former Iraqi partner. Another shareholder of Al Kassim was Pinnacle Finance Investment. The majority shareholder of Pinnacle Finance Investment was none other than Ata Ahsani – the founder and Chairman of Unaoil.[30]

Putting on a mask

On the surface, Unaoil seemed to be a company which complied with regulations. From 2006, Unaoil's due diligence reviews were certified by TRACE International (TRACE),[31] the world's leading anti-bribery accreditation agency which provides companies with anti-bribery compliance support.[32] However, it was later discovered that Unaoil had bribed its clients' executives to provide good references to TRACE on behalf of Unaoil. TRACE certified Unaoil as a member yearly from 2006, helping it pass due diligence tests conducted by its clients.[33]

Shadows in the dark

Over the years, Unaoil attracted many clients from all over the world. Some of the key companies which were allegedly involved in the Unaoil scandal are shown in Figure 1. Rolls-Royce was one of the major corporations which actively engaged in corrupt practices with Unaoil.

Region	Companies which worked with Unaoil
Australia	• Leighton Offshore • Worley Parsons • Wood Group PSN
North America	• Halliburton/Kellogg Brand and Root • Honeywell • FMC technologies • Cameron/Natco • Weatherford • The Shaw Group • Core Labs • Canuck Completions • Precision Drilling/Grey Wolf • MI SWACO
U.K./ Europe	• Petrofac • Rolls-Royce • Elliot • Weir Pumps • Clyde Pumps • Total • Man Turbo • ENI • Saipem • Consolidated Contractors Group • SBM Offshore • Tecnicas Reunidas • Technip • ABB • Aker Kvaerner • GATE • Sulzer • Rosetti Marino
Asia	• Samsung • Hyundai • ISU • Ranhill • Petronas • Sinopec • Keppel • Yokogawa

Figure 1: Companies which allegedly worked with Unaoil[34]

Fast driving with Rolls-Royce

Rolls-Royce's involvement with Unaoil started in 2000 when it established its energy division.[35] Rolls-Royce planned to ramp up growth by introducing a broader range of diesels and gas turbines.[36] In 2001, its oil and gas business grew, along with an increasing number of Long Term Service Agreements with customers internationally.[37] The energy division experienced steady growth in the following decade. In 2008, its revenue jumped by 35% to £755 million. Despite the financial crisis of 2007-2008, African and Asian oil markets remained particularly active for Rolls-Royce. However, there was no mention of sales to Iran, Kazakhstan and Angola in its 2008 annual report.[38]

Between 2000 and 2013, Rolls-Royce conspired to pay over US$35 million in bribes to foreign officials to obtain confidential information on government contracts. According to the U.S. Department of Justice (DoJ), Unaoil "regularly bribed foreign officials and others in order to secure work for Rolls-Royce" and its U.S. subsidiary on at least seven projects in Iraq, Azerbaijan, Kazakhstan and Angola from 2000 to 2012. In many of these countries, Rolls-Royce engaged an intermediary to bribe government officials through "commission payment".[39] It was reported to have hired agents in at least 12 countries – Brazil, India, China, Indonesia, South Africa, Angola, Iraq, Iran, Kazakhstan, Azerbaijan, Nigeria and Saudi Arabia.[40]

Middle East

After the Iraq war, Rolls-Royce engaged Unaoil to secure a contract with the state-owned SOC to sell three industrial turbines.[41] Over the years, multi-million dollar "commission payments" were made by Rolls-Royce to officials in SOC.[42]

One of Unaoil's subsidiaries was hired to represent Rolls-Royce in neighbouring Iran in 2008. A year later, the contract was cancelled over fears of reputational damage. Rolls-Royce also hired other agents prior to this to sell industrial components to Iran.[43]

Central Asia

From 2008, Unaoil represented Rolls-Royce in Kazakhstan to secure a contract for the China-Kazakhstan pipeline.[44] Rolls-Royce's subsidiary Rolls-Royce Energy Systems Inc. had conspired to bribe officials for contracts to supply gas turbines to Asia Gas Pipeline LLP[45] – a joint venture between Kazakh and Chinese state-owned entities – to build a gas pipeline between both countries.[46]

In Azerbaijan, Rolls-Royce employed Unaoil to secure contracts as early as 2001. In 2006, plans were made for Unaoil's Baku operations to be incorporated into Rolls-Royce's international division – as opposed to shutting down – as work tapered off.[47]

Africa

In Angola, Rolls-Royce bribed officials at Sonangal Group – a powerful state-owned oil company that oversees petroleum and natural gas production in the country – in return for confidential information and government contracts. From 2008 to 2013, Rolls-Royce used Unaoil and another firm of agents as intermediaries to obtain contracts worth over US$110 million.[48,49]

Stepping on the gas with Petronas

"They have lived up to their obligation to get PF [Petrofac] qualified technically. According to them, PF would have been initially technically disqualified,"

– Affandi Yusuf, Malaysian middleman engaged by Unaoil[50]

Petroliam Nasional Berhad (Petronas) is a state-owned oil and gas company in Malaysia and one of the "new seven sisters" – the seven most influential national oil and gas companies from countries outside the OECD.[51] It was one of the Asian companies allegedly involved in the Unaoil bribery scandal.

In the exposé published by The Huffington Post and The Age, it was reported that Unaoil had bribed Petronas executives on behalf of British oil field services company Petrofac Limited (Petrofac) to influence the outcome of a sizeable contract in oilfields in Iraq that Petronas was managing in 2010. Leaked emails showed that Unaoil agreed to pay millions of dollars to a Malaysian middleman named Affandi Yusuf, who claimed he could "influence a top Petronas executive and other Malaysian officials". Affandi allegedly bribed his executive contacts in Petronas and in exchange for inside information from a Petronas tender committee. The confidential information subsequently helped Petrofac qualify for a sizeable contract awarded by Petronas.[52,53]

In response to media reports of alleged improprieties in procedures for awarding contracts in its operations in Iraq, Petronas said it took the allegations very seriously and that it has "a zero-tolerance policy against all forms of bribery and corruption and expressly prohibits improper solicitation, bribery and other corrupt activity by employees, directors and third parties performing work or services for or on behalf of companies in the Petronas group".[54]

Cruising with Keppel

"In my opinion we have a lot at stake here, apart from the $30m [in fees from Keppel] – we could set-up a long term association with these guys [Keppel]…The problems of working with a US or European outfit do not apply here,"

– An unnamed Unaoil executive[55]

Keppel Corporation (Keppel) is a Singaporean conglomerate which has several affiliated businesses that specialise in offshore and marine, urban development, infrastructure and asset management businesses.[56] One of the companies in the Keppel Group is Keppel FELS Limited (Keppel FELS), a company which constructs, fabricates, and repairs offshore production facilities and drilling rigs. It provides services for the global offshore and marine industries and operates worldwide.[57]

A leaked 2007 memo outlined Unaoil's plans to assist Keppel FELS secure offshore oil rig and barge contracts on the Kashagan oil field in Kazakhstan. It was reported that Unaoil regarded Keppel FELS as an agreeable client due to its lax anti-corruption controls. In 2006, Keppel FELS went head-to-head with French oil services company Technip S.A. for a contract to build an offshore oil rig in Kazakhstan. Keppel FELS engaged Unaoil, which allegedly used a corrupt contact codenamed "small D" – an Italian oil executive working with the Kazakhstan government – to acquire inside information on bidding strategy. Apart from Unaoil, it was alleged that Keppel FELS also had its own connections to corrupt Kazakh government officials.[58]

Keppel dismissed allegations in the foreign media reports that the Group was involved in the global oil bribery scandal at Unaoil. A company spokesman said in a statement: "Keppel FELS strongly refutes allegations made in the media regarding its involvement in the payment of bribes relating to Unaoil. Keppel has a code of conduct which prohibits, among others, bribery and corruption."[59]

However, in December 2017, Keppel subsidiary, Keppel Offshore & Marine, agreed to pay US$422 million in fines as part of global resolution with authorities in Singapore, Brazil and the U.S. in relation to its participation in an international corruption scandal involving Brazil's state-run oil company Petrobras. Prior to the settlement, the Keppel Group had similarly issued statements denying the allegations and emphasising its zero tolerance towards corruption.[60] This cast doubt on the Keppel Group's credibility and led observers to question whether Keppel entities could also have been involved in other bribery cases such as the one involving Unaoil.[61]

Oil masters

It is an open secret that MNCs competing for contracts in an industry with widespread corruption and in countries with endemic bribery have been quietly hiring middlemen for decades, seeking assistance "to navigate countries where they don't know the folkways or politics".[62] Many of these middlemen – whose roles are generally "invisible" – abide by the law in their activities, offering expert advice and connections based on their years of experience in the oil industry. However, there are some who cross the line. The Ahsani family belongs to the latter group, having used its stature and credibility to conceal large-scale criminal activity.[63]

The Ahsani family is a prominent Monaco-based millionaire family of Iranian origin. The family has resided for many years in Monaco, which is well known for its luxury shopping and well-maintained streets. They were members of the global elite who rubbed shoulders with royalty, politicians and the well-heeled. Cyrus Ahsani was treasurer of the Monaco Ambassadors Club – an elite group of executives, diplomats and celebrities led by Prince Albert of Monaco.[64] Cyrus and Saman Ahsani were also known to plan extravagant parties.[65]

The Ahsani family also established charities to support children and the arts. One of the charities, Unakids, was known to hold lavish fundraising events. Together with former politicians and billionaires, Ahsani family members were members of the boards of non-governmental organisations as well.[66,67]

However, the good life enjoyed by the Ahsani family fell apart after Unaoil's illicit operations were exposed in the media. In an interview with The New York Times in September 2017, Saman Ahsani said: "Our reputation has been shredded. Within 24 hours, we became pariahs. A toxic brand, overnight."[68] However, this was once again an attempt to cast his family in a less damning light and "portray themselves as victims".[69] There was substantial evidence to support the allegations that Unaoil and the Ahsanis conducted an illegal global bribery scheme that "it ultimately left the Ahsanis with no choice but to confess".[70] Cyrus and Saman Ahsani eventually dropped all pretences and confessed to their misdeeds in October 2019.[71]

Capturing the criminals

"This was a classic case of corruption, where powerful men took advantage of the desperation and vulnerability of others to line their own pockets,"

– Lisa Osofsky, Director of the UK's Serious Fraud Office[72]

Since 2016, there have been ongoing investigations into Unaoil and other parties involved in the global bribery operation. The main regulatory bodies involved in this joint investigation include the U.S. DoJ, the U.K. SFO and the Australian Federal Police. Governments around the world have cooperated with the ongoing investigation due to the involvement of companies and government officials worldwide.[73]

In 2016, after the leak of Unaoil's confidential information to Fairfax Media journalists, the SFO initiated an investigation into the alleged bribery and money laundering claims.[74] The SFO investigation initially focused on the Ahsanis but failed extradition attempts thwarted its attempts to prosecute them in the U.K.[75] In April 2018, Saman Ahsani was arrested by the Italian police and held on a European arrest warrant issued by the SFO. However, the U.S. DoJ anticipated the SFO's plan to extradite him from Italy and went ahead to do so before SFO could make its move. This was despite the SFO believing that they had agreed to "leave the field clear".[76] It was reported that the tussle over which country would prosecute Unaoil and its executives led to "testy exchanges between senior U.S. and U.K. prosecutors".[77]

In October 2019, Cyrus and Saman Ahsani pleaded guilty to arranging bribes to officials across Africa and the Middle East on behalf of companies between 1999 and 2016.[78] Together with Steven Hunter – a former Unaoil business development director who had earlier pleaded guilty to one count of conspiring to violate the U.S. Foreign Corrupt Practices Act (FCPA) after being accused of bribing Libyan officials over a six-year period[79] – the Ahsani brothers were charged with conspiracy to violate the FCPA rules. Further, the U.S. DoJ said the brothers "laundered the proceeds of their bribery scheme in order to promote and conceal the schemes and to cause the destruction of evidence in order to obstruct investigations in the United States and elsewhere."[80] They are awaiting sentencing in the U.S. as of June 2021. Meanwhile, Ata Ahsani has not been prosecuted.[81]

In July 2020, the SFO found British Stephen Whiteley – Unaoil's territory manager for Iraq – guilty of conspiring with others to bribe public officials at Iraq's SOC, and he was sentenced to three years in jail.[82] His colleague, British-Lebanese Ziad Akle, who was also Unaoil's territory manager for Iraq, was sentenced to five years in prison. Akle was found guilty of two counts of conspiracy to give corrupt payments.[83,84]

In October 2020, Basil Al Jarah – Unaoil's former Iraq country manager and partner in a Unaoil subsidiary, Unaoil E&C Iraq (BVI) Ltd – pleaded guilty to paying Iraqi government officials US$17 million in bribes to secure contracts amounting to US$1.7 billion[85] to construct oil pipelines, an oil platform and offshore mooring buoys in the Persian Gulf. The SFO sentenced him to three years and four months in jail.[86] He was also ordered to pay US$560,000 by a London judge over the Iraq bribery incidents.[87]

What about the clients?

In January 2017, Rolls-Royce paid a US$1.1 billion settlement in relation to corruption probes in the U.K. and U.S., admitting to engaging Unaoil to pay bribes in several countries. The settlement was part of a deferred prosecution agreement, an arrangement under which a company admits corruption but does not face court. It was reported that information uncovered by Fairfax Media's 2016 exposé was used to "make serious corruption findings" against Rolls-Royce.[88]

In November 2020, after a nine-year investigation by the Australian Federal Police, Russell Waugh of Leighton Holdings Limited (Leighton Holdings) – an Australian company which was also heavily involved in the Unaoil bribery scandal – was arrested in Brisbane, Australia on bribery charges. It was reported that his colleagues – COO David Savage and executive Peter Cox – would also face criminal charges if they return to Australia from France and Asia respectively. The three men allegedly participated in an illicit bribery scheme with Unaoil, resulting in Leighton Holdings being awarded a huge Iraqi government oil pipeline project. Documents uncovered that an Iraqi deputy prime minister, two oil ministers and several high-ranking oil officials in Iraq received millions of dollars in bribes.[89]

In 2021, an Aberdeen oil and gas company, PSN Limited, paid £6.46 million (US$8.9 million) to the U.K. Civil Recovery Unit after it confessed to benefitting from payments made to Unaoil to clinch contracts in Kazakhstan in 2008 and 2010. The payments to Unaoil continued until 2015, and were in connection with three contract tenders to provide services for "the operation and maintenance of onshore and offshore oil and gas, chemical and petrochemical facilities in Kazakhstan".[90]

However, authorities in many other countries have so far not publicised any investigations into their companies which were allegedly involved in the bribery scandal.

Bribery never pays

The Unaoil bribery scandal has exposed the extent of corruption within the oil industry. However, this is just the tip of the iceberg. With bribes being the "usual way of business" in many countries, are companies justified in engaging in corrupt practices to grow their business? Is it only wishful thinking that widespread corruption in the oil industry will cease to exist?

Regarding the Unaoil bribery scandal, experts have commented that in the short run, prosecutors hope that companies involved in the scandal would sign settlements and that guilty executives would be jailed. Andrew Spalding, a professor at the University of Richmond School of Law commented that in the long run, "their hope is that this case changes the cost-benefit analysis of any company that thinks it needs to engage in bribery to compete."[91] Seeing how Unaoil collapsed after 17 years, exposing corruption by major global corporations and causing huge financial and reputational damage – along with the increasing willingness of whistleblowers to provide information – companies may need to re-think their position that bribery is just another risk that comes with doing business, with the benefit outweighing the cost.

Discussion questions

1. How do differences in regulations in different countries affect a company's corporate governance? In the case of bribery, should companies "do as the Romans do in Rome" when they operate in certain industries and markets, or should they adhere to the strictest standards at the risk of losing business? Explain.

2. For those companies which were exposed for using Unaoil to pay bribes, do you think the senior management and board of directors would likely not be aware? In such companies, what factors could have contributed to the willingness of these companies to pay bribes, and what are the major factors? Explain.

3. What can board of directors and senior management do to minimise the risk of bribery in their companies, from a corporate governance and risk management perspective?

4. Should the directors and senior management of the companies that were involved in the Unaoil bribery scandal be held personally liable? Under what circumstances do you think they should be and under what circumstances they should not be?

5. The media played a major role in exposing the entire bribery scandal. With reference to the case, discuss the role of the media in promoting good corporate governance, and factors that may limit its effectiveness.

6. Comment on the effectiveness of the regulatory bodies involved in the joint investigation into Unaoil and other companies. Do you think the regulatory bodies only chose to ignore obvious signs of bribery until they were going to be exposed by the media? Do you think regulatory authorities in other countries such as Malaysia and Singapore, which have companies named in the scandal, should also investigate these companies? What factors may influence their decision as to whether to investigate? Explain.

7. It has been said that in certain industries and countries, it is impossible to do business without paying bribes. Therefore, there is no choice for companies operating in those industries and countries. Do you agree? Explain.

8. "Certain countries are more tolerant of their companies paying bribes overseas compared to other countries. This puts companies in the latter countries at a competitive disadvantage." Do you agree? What should authorities do about this?

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VALE S.A.: MARIANA, NEVER AGAIN

Case overview

It was just past midday on 25 January 2019 when Brazil experienced one of its deadliest man-made geological disasters at a tailings dam at the Córrego do Feijão iron ore mine, 9km east of Brumadinho, Minas Gerais. A wall holding back mining waste at the Brumadinho dam collapsed, sending a giant wave of mud speeding towards the mine's administrative area where most employees had gathered for lunch. The Brumadinho disaster claimed 270 lives, most of whom were employees of Vale S.A. (Vale), sparking national outrage as it occurred just three years after the Mariana dam collapse, which was then considered to be the worst environmental disaster in Brazil.

Following the collapse of the Brumadinho dam, 12 million cubic meters of toxic waste was released into the Paraopeba River, which supplies a third of the Metropolitan Region of Belo Horizonte. The metals in the waste material seeped into the soil of the river, impacting the entire ecosystem. Consequently, Vale was hit with multiple financial penalties and criminal charges. The objective of this case study is to facilitate a discussion of issues such as board composition; board responsibilities; corporate culture; remuneration policies; risk management; crisis management; Brazil's system of governance; and Environmental, Social and Governance (ESG) issues.

Mining for a better tomorrow

Formerly known as Companhia Vale do Rio Doce (CVRD), Vale was originally a state-owned company founded in June 1942[1] by the Brazilian federal government in a bid to capitalise on the country's natural resources.[2] In 1997, CVRD was privatised when the Brazilian government sold off 41.73% of the company for US$3.13 billion.[3] Since its privatisation, the company has undergone rapid expansion and won awards for its management and sustainable initiatives.[4] In 2007, the CVRD name was retired and the company was rebranded as Vale.[5]

This case was prepared by Anthony Putra Haryono, Ho Jun Feng, Lee Shao Jie, Lim Chun Hon, Ling Shen Fen Stacius and Ngoi Kai Han, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been substantially re-written by 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 organizations named in the case, or any of their directors or employees.

Vale S.A. (Vale) has since grown to become one of Brazil's most prized success stories – a home-grown company that is able to compete globally. It is one of the world's largest mining companies, with four main lines of business: mining, logistics, energy, and steelmaking.[6] The company is headquartered in Rio de Janerio, Brazil,[7] and is currently listed on three stock exchanges: Brasil, Bolsa, Balcão (B3 S.A.); New York Stock Exchange; and Latibex: Bolsa de Madrid. Vale's operations span across 25 countries with more than 71,000 employees globally.[8] In 2018 – just before the Brumadinho disaster – Vale boasted revenues of US$36.6 billion.[9]

Dam-nation: The first cracks

"The motivation of the homicides was the excessive greed of the companies – Samarco, here charged, as well as its shareholders – in the name of profit."

– Eduardo Santos de Oliveira, federal prosecutor[10]

On 5 November 2015, a tailings dam at the iron ore mine at the Samarco Mariana Mining Complex near Mariana, Minas Gerais, collapsed and sent 40 million litres of toxic mining waste material into nearby villages, killing 19 people. The waste material also flowed into the Doce River, polluting the water supply for thousands of people.[11] The mud and waste from the burst dam also destroyed numerous houses, leaving about 750 people homeless.[12]

The tailings dam was built by Samarco Mineração S.A. (Samarco), a joint venture between Vale and BHP Billiton Ltd (BHP). Reports had shown that management at Samarco was aware that the integrity of the Mariana tailings dam was compromised but had neglected to take any corrective actions to fix it.[13] Prosecutors said that Samarco's board, which comprised Vale and BHP officials, was informed of structural problems in the dam but responded by pressuring Samarco to extract even more iron ore. The board was allegedly also informed of the consequence of a dam failure.[14] Eventually, after a year-long criminal investigation, 21 individuals across all three companies were charged for homicide by Brazilian federal prosecutors in 2016. The three companies were also charged with 12 different environmental crimes. In response, Vale offered its "deep respect and total solidarity" with the victims of the deadly dam burst but said it "vehemently repudiates" the charges.[15]

In addition to the federal prosecution, Vale faced a class action lawsuit from U.S. shareholders, which only came to a close in June 2020 when Vale reached a US$25 million settlement agreement.[16]

In March 2016, Samarco, BHP, and Vale agreed to pay R$20 billion to the Brazil federal government for socioeconomic and environmental recovery work over 15 years. This would be carried out through a newly established foundation to "develop and execute environmental and socio-economic programs to restore the environment, local communities and social conditions of the affected areas".[17,18] Vale also pledged its commitment to keep employees safe and reduce environmental damage in its 2016 U.S. Securities and Exchange Commission filing.[19]

The day Brazil stood still – The Brumadinho dam collapse

"It was a huge tragedy that took us completely by surprise. I am completely torn apart by what has happened."

– Fabio Schvartsman, former CEO of Vale[20]

Slightly more than three years after the devastating collapse of the Mariana tailings dam, another disaster struck Minas Gerais – this time in the municipality of Brumadinho. On 25 January 2019, the structure of a tailings dam owned by Vale was compromised, unleashing a tidal wave of toxic mining waste.[21] Within hours, the wave of toxic mud had submerged not only the Vale mine headquarters, but also residential areas and farmland, making a beeline towards the Paraopeba River – one of the main sources of water for the Greater Belo Horizonte region.[22]

Immediately following the catastrophe, Vale worked tirelessly with rescue teams and provided lighting towers, backhoes, ambulances, helicopters, portable water as well as private hospital care and support to affected communities.[23] Rescue efforts failed as the death toll increased rapidly over the days followed the initial collapse, finally reaching 259 deaths and at least 11 people missing, whose bodies had not been found.[24] The dam collapse left Brazil in a state of anger and shock, and had an extensive impact on the country's wider community, environment, and economy.[25]

Crisis management 101

As part of measures undertaken, Vale leased 20 houses and three farms as long-term accommodation for affected individuals and made donations of R$100,000 to each family affected by fatalities or missing family members.[26] In addition, Vale committed to paying R$12,000 – the equivalent of 12 months of minimum wages in Brazil – for every adult, R$6,000 for every teenager and R$3,000 for every child in Brumadinho as compensation, calling such payments an act of "respect to the families affect by the tragedy" and an "unprecedented deal in the history of Brazil."[27]

Vale reportedly incurred US$4.5 billion (approximately R$24 billion) in expenses related to the Brumadinho disaster, which included provisions for a compensation programme and the decommissioning of tailings dams.[28] In February 2021, Vale and the government of Minas Gerais signed a R$37.7 billion agreement for the reparation of the socio-economic and environmental damage caused by the Brumadinho dam collapse – the largest reparation agreement in Brazil's history.[29]

Vale declared its priority was to repair all the damage caused by the Brumadinho dam collapse to people and impacted municipalities – considering environmental, social and economic aspects – with social engagement and transparency. It aimed to achieve this target by 2025. In terms of environmental reparation, Vale focused its efforts on two fronts: socio-environmental and municipal compensation. This entailed the monitoring and study of water quality, sediments, waste, air quality, noise and vibration, among others, with a goal of cooperating closely with Vale's engineering department with respect to emergency and containment works.[30]

At that time, Vale had 19 dams built using the upstream method, which was also used for both the Mariana and Brumadinho dams. By its own accord, Vale decided to cease all operations at the dams and initiate the decommissioning process.[31]

Just a few days after the Brumadinho dam collapse, Vale announced that the law firm Skadden, Arps, Slate, Meagher and Flom LLP had been engaged to select and cooperate with experts to conduct an internal investigation on the incident. Selected experts were to be entirely independent from Vale to provide an unbiased opinion. Subsequently, all findings would be voluntarily shared with federal and state authorities to ensure that appropriate actions are taken against liable parties.[32]

In response to the Brumadinho disaster, Vale also restructured its board committees to include three extraordinary committees, including the Extraordinary Independent Consulting Committee for Dam Safety, which focuses on dam safety. The other two extraordinary committees are the Extraordinary Independent Consulting Committee for Investigation (CIAE-A) and the Extraordinary Committee for Support and Recovery. All three extraordinary committees comprised wholly of external independent members “with unblemished reputation and with experience in the subjects of their respective occupations”.[33]

Vale pays the price

Vale’s share price nosedived on 28 January 2019, three days after the Brumadinho dam collapse, wiping out R$71.34 billion in market value.[34]

The authorities also took swift action against Vale. Assets amounting to R$11.8 billion were frozen by the Minas Gerais court to ensure that the damages from the disaster could be recovered from the company. An additional R$250 million of administrative sanctions were imposed by the Brazilian Institute of the Environment and Renewable Natural Resources and the state of Minas Gerais.[35]

In the wake of the disaster, Vale was removed from the Corporate Human Rights Benchmark, which measures how companies perform – using publicly available information – across 100 indicators based on the UN Guiding Principles on Human Rights.[36] Sustainalytics, one of the big houses which ranks companies based on environmental, social and governance (ESG) metrics, also downgraded its ESG rating for Vale to reflect the two tailings dams disasters, the severe impact of the mud spills on local communities and the environment, as well as the financially material risk for the mining company.[37]

Furthermore, the Brumadinho disaster resulted in the resignation of Fabio Schvartsman, Vale’s then-Chief Executive, in March 2019 amid pressure from prosecutors.[38] He took the helm of the mining giant in May 2017, after the Mariana dam disaster. Although Schvartsman once said, “We must all adopt a motto: ‘Mariana never again’”, he was forced to eat his words after the second deadly dam disaster involving Vale in three years.[39]

On 29 April 2019, Eduardo Bartolomeo was appointed as Vale's new CEO. He expressed his commitment to lead Vale through the crisis and "work tirelessly to ensure the safety of people and the company's operations".[40]

Where was the board?

Pursuant to articles 145 to 160 of the Brazilian Law of Corporations, directors of a company owe three fundamental fiduciary duties to the company.[41]

The first is a duty of care, which obligates the director to run the business with the necessary care and diligence that any average and honest individual would use in the administration of his own business. In this regard, directors must always act in the best interests of the company. The second is a duty of loyalty, which states that directors should not use any confidential information relating to the company or business opportunities for his own benefit or for the benefit of third parties. Lastly, a duty of disclosure requires directors to maintain transparency of the company's business activities. This implies that directors must disclose to the markets any material information – such as important business decisions – as well as declare their own interests in the company.[42,43]

In addition, a director must not take part in any corporate transaction in which he has a conflict of interest. He must disclose the conflict of interest and ensure that the nature and extent of his interest is recorded in the minutes of the administrative council or the board of directors' meeting.[44]

Board composition

Vale's bylaws provide for a board of directors which comprises 12 directors and 12 alternate directors – each of whom serves on behalf of a director. It is also provided that the Chief Executive Officer cannot serve as Chairman of the board. Prior to the Brumadinho dam collapse in January 2019, the board consisted of four permanent standing committees: Personnel Committee; Finance Committee; Governance, Compliance and Risk Committee; and Sustainability Committee. Committee members include both directors and external members. In lieu of establishing an independent Audit Committee, Vale opted to give its Fiscal Council the requisite powers to qualify for the exemption set forth in Brazil's Exchange Act Rule 10A-3(c)(3).[45]

In March 2020, Vale decided to set up the Audit Committee. The Audit Committee's role includes supervising the internal audit activities, internal controls and the preparation of financial statements, among other duties.[46] Vale also created a Chief Compliance Officer (CCO) role, who reports directly to the board and continually interacts with the Audit Committee. The CCO is responsible for overseeing the company's whistleblower channel, and the internal audit and integrity department.[47]

At the time of the Brumadinho dam collapse, Vale’s board of directors consisted of mainly bankers and financiers representing large shareholders. Only two of the board members had a background in the mining industry.[48] The board also only had two independent directors.[49] Subsequently, the board underwent a number of changes and currently includes more directors with mining or industry-related experience, expertise in sustainability, and background in governance. Additionally, as at December 2019, in addition to the independent board Chairman, there were three independent directors on Vale’s board.[50,51]

In Brazil, there is no minimum number of non-executive or independent directors required by law. However, for the Novo Mercado segment of B3, there should be at least two independent directors or independent directors comprising a minimum of 20% of the members of the board – whichever is higher.[52]

In July 2020, the board established a Nomination Committee. The Nomination Committee will be comprised of three members, and is subject to the following rules: (i) the majority of the members must be independent and must not be part of the board of directors and other corporate bodies; (ii) one of the members must necessarily be the Chairman of Vale’s board of directors; (iii) all must have proven experience and technical capacity to the matters under the responsibility of the Committee; and (iv) the coordinator will be chosen by Vale’s board of directors among the independent and external members.[53]

The Nomination Committee’s main role is to propose improvements to the structure, size, and skills of the board, and recommend the skills, profiles and potential nominees for the board. It also engages with investors to seek their views on what they would like to see on Vale’s board.[54,55]

Whistleblowing policy

Vale has a whistleblowing channel available to both internal and external stakeholders. The whistleblowing channel is “a proactive, transparent, independent and impartial communication tool for reporting violations or suspected non-compliance with any of the topics described in our Code of Conduct”. It also reports directly to the board of directors and is thus, according to Vale, “impartial” in its activities especially when handling complaints.[56]

According to Vale, since the creation of the whistleblowing channel in 2013, the number of complaints had increased by more than two-fold. In 2020, it was disclosed that there was an increase of 232% in the number of complaints received.[57]

However, the effectiveness of the whistleblowing channel was called into question following the collapse of the Brumadinho dam. According to a Vale spokesperson, although the whistleblowing channel allowed for the filing of anonymous complaints, the company did not receive any complaints or warnings from employees about dam safety. Helio Gonçalves, a retired worker at the mine, said that the workers “talked about the problems at the dam a lot among ourselves, but people were afraid of raising the issues with the bosses”.[58]

Besides the fear of losing their jobs, some employees said that the attitude of senior executives contributed to the lack of complaints and warnings from employees. When employees did report about safety issues relating to the dam, they were met with an apathetic attitude. Wilson José Ferreira, a machine operator, said he tried to warn his bosses about the growing number of leaks, but they paid little attention to him and did not believe what he was reporting.[59]

Risk management policies

Vale is principally in the business of mining and related logistics operations.[60] It recognises that any potential risks could impact communities, the environment, business continuity, reputation and the achievement of its overall business objectives. As such, it has in place an integrated framework for managing risk, and its risk management policies are applied across the organisation, including its subsidiaries.[61]

Vale integrates the three lines of defence to ensure that risks are regularly reviewed, and excluded or included in its integrated risk map (IRM). Vale's five main areas of risk comprises operational; geotechnical; strategic, financial and cybernetics; compliance; and sustainability and reputational risks.[62]

Employees on the ground play a crucial part in Vale's risk management. As the first line of defence, risk owners would have an intimate knowledge of the business unit which would allow them to suggest adjustments in the IRM. Their input on applicability of risks and recommendations would allow Vale to place more emphasis on risks that they may have overlooked. They are also responsible for integrating Crisis Management Protocols (CMP) and Business Continuity Plans (BCP). Drills were also scheduled to be performed to evaluate the CMP and BCP regularly.[63]

The second line of defence corresponds to risk management, internal controls, policy management, legal compliance and other specialist areas. The Enterprise Risk Management structure is in charge of developing and implementing policies, methodologies, processes and infrastructure for integrated risk management. It also provides training and instruments for risk management. Additionally, it is also responsible for identifying and monitoring new and emerging risks, ensuring compliance with laws and regulations, and promoting continuous improvement in risk management.[64,65]

The Internal Audit and the Ethics and Conduct Office – which is entirely independent from the business units – is the third line of defence, and serves to provide additional checks and balances for the company. They actively conduct inspections by the execution of controls tests and investigation of allegations, providing exempt assurance, including on the effectiveness of risk management, internal controls, and compliance.[66]

"Structural instability"

"What I think was lacking was a belief in the worst-case scenario, that the worst-case scenario was viable."

– Joaquim Pimenta de Ávila, Brazil's foremost tailings-dam engineer[67]

Following investigations into the Mariana dam disaster, it was found that Samarco had ample warning of the impending collapse but failed to take appropriate action. In September 2014, 14 months before the disaster, Joaquim Pimenta de Ávila – one of Brazil's top tailing dam engineers – conducted an inspection of a crack in the Mariana dam. As he believed it was the start of a break, he recommended that Samarco increases monitoring and proposed the construction of a buttress to reinforce the dam. However, Samarco disputed Pimenta de Ávila's account and argued that he did not project the possibility of a complete and sudden collapse. Samarco also said that it followed his recommendations and that the strengthening of the dam was in progress when it collapsed.[68]

Dam-ning reports on the Brumadinho dam catastrophe

In February 2020, Vale published the results of an independent report into the Brumadinho dam collapse. The report was prepared by the CIAE-A, an independent committee formed by Vale to investigate the causes and responsibilities relating to the collapse. The CIAE-A highlighted several red flags contributing to the disaster, and provided recommendations to tackle these issues in the report.[69]

Corporate culture

"It's not [a] lack [of] time or money to meet the requirements. It's five years since the first disaster. The problem is the company's culture."

– Edison Vitorelli, federal prosecutor[70]

According to the report, Vale had a "strong hierarchical culture that is resistant to the exposure of problems to higher levels of the organisation". Additionally, Vale's corporate culture was found to be "siloed", with business and corporate areas being closed off from each other. Issues were typically addressed within each business area without any exposure to the corporate areas.[71]

There was also no incentive for speaking out against decisions made at a higher level. The independent report found that Peter Poppinga – former ferrous and coal executive director – made the decision to terminate the disposal of tailings at the Brumadinho dam in July 2016. José Flavio Gouveia – then director of south iron ore operations – responded to Poppinga's email, saying that he was unaware of the reasons for this decision, but would act according to Poppinga's orders. Gouveia also stated that his team was not aware of what would have been reported regarding the Brumadinho dam. The report went on to state that Poppinga neither documented the reasons for his decision in writing, nor made the reasons known to higher authorities or Vale's governance bodies.[72]

Safety second?

In the aftermath of the Brumadinho disaster, Vale's compensation and incentive structure was called into question. Investigations revealed that there was greater emphasis placed on financial goals, and safety was not a significant factor for employee compensation.[73]

A Wall Street Journal article reported that there was intense competition for promotions and performance-related bonuses amongst Vale employees, which encouraged them to reduce costs and stifle safety concerns. The article further stated that individuals responsible for the Brumadinho site cut corners from time to time, refusing extra safety measures on several occasions due to budget constraints. This "compensation and retaliation" model also resulted in severe neglect of workplace safety due to the fear of getting fired if safety concerns were brought up. Contractors, employees and auditors who issued alerts over the Brumadinho dam's safety were reportedly either ignored or sacked.[74,75]

For employees who were part of Operations Geotechnical – whose responsibilities included operating, maintaining and monitoring the structure – there were no safety goals set for geotechnical structures with respect to variable compensation in FY2018. In FY2016 and FY2017, safety goals mainly comprised the acquisition of stability condition declarations (DCEs). Furthermore, according to the independent report, Vale's objective was to obtain the DCEs through any means, as evidenced by its use of "higher strength parameters and/or lower minimum factor of safety criteria than recommended based on technically questionable justifications".[76]

After the tragic Brumadinho dam collapse, the National Mining Agency (ANM) – Brazil's mining regulator – publicly stated that Vale had withheld information relating to structural concerns in the dam from government inspectors. The ANM classified the Brumadinho dam as "low risk" just weeks before its failure.[77] In view of limited resources, the mining regulator said that it had to rely on companies to report critical information so that it could prioritise dam inspections and mandate precautionary measures to be undertaken by mining companies to prevent potential catastrophes. Unfortunately, Vale was not completely honest.[78]

Damaged assurance reports

The collapse of Brumadinho dam occurred only three years after the Mariana dam burst. After the Mariana dam incident, Brazil's government mandated that mining companies hire external auditors to provide assurance on the stability of their dams.[79]

TÜV SÜD, an external quality assurance company, was hired by Vale to provide assurance on the structural integrity of the Brumadinho dam. In June 2018, TÜV SÜD had certified the dam as stable. Three months later, in September 2018, Vale engaged the services of another external auditor, but later dismissed it after it refused to certify the Brumadinho dam as safe.[80] Vale then engaged TÜV SÜD again, which signed off on the dam's safety.[81] It was reported that TÜV SÜD gave the dam the green light to operate for fear of losing the world's largest iron ore producer as a client.[82] This was despite emails and reports expressing concern about the dam's safety. Makoto Namba, a senior engineering inspector at TÜV SÜD, found that the dam was at risk of liquefaction[83] during his inspections and went so far as to state in an email that "everything suggests [the dam] won't pass a key safety test".[84]

Collusion vs collision?

"But, as always, Vale is going to push us to the wall."

– Makoto Namba, a senior engineering inspector at TÜV SÜD[85]

Namba was arrested after the collapse of the Brumadinho dam. When questioned, the inspector confessed that he was under duress to certify the safety of Vale's dam. During the June 2018 inspection, prior to sign-off, Felipe Rocha – a risk manager at Vale – pressured Namba by informing him that another auditor agreed to sign off on the Brumadinho dam's safety despite not passing the liquefaction study, implying that Vale would change its auditor if TÜV SÜD failed to certify the dam's safety. Namba's colleague, Andre Yassuda, eventually signed off the June 2018 safety declaration. Subsequently, the September 2018 audit report noted that a number of previously reported problems remained unresolved and indicated that the earlier liquefaction study presented a high risk of collapse if water was not sufficiently drained from the dam. The report concluded that "safety levels were within acceptable parameters" and Namba certified the dam as stable.[86]

In Brazil, external independent auditors provide assurance for dams' safety through regular inspections and analysis of written records. However, experts say that there is little oversight of ties between mining companies and external auditors. Brazil's mine-safety rules are relatively lax and cosy relationships may form between both parties that may result in inspectors masking serious flaws present in the dams. Further, there may be a conflict of interest in the certification process as mining companies select and pay the external auditors for their services, and provide the information which inspectors base their analyses on.[87,88]

TÜV SÜD had over 30 contracts for dam safety audits with Vale in Brazil.[89] While TÜV SÜD was performing the audit on the Brumadinho dam, it also had other contracts with Vale. For example, TÜV SÜD employees took on the role of consultants on Vale mine closures in Brazil as well.[90] After the September 2018 audit was completed, TÜV SÜD won another contract to assist Vale in dismantling the aged dam.[91]

Eyes wide shut

Two weeks prior to the Brumadinho disaster, Vale's senior management received an anonymous email warning pertaining to the state of the dam. However, instead of taking the necessary action to rectify the faults in the dam, then-CEO Schvartsman dismissed the authenticity of the information and pursued the author's identity, calling him a "cancer".[92] In a report issued by Brazil's federal police, it was alleged that studies conducted by Vale's own personnel in the year preceding the Brumadinho dam collapse showed the dam was fragile and would eventually collapse.[93]

Cristina Malheiros – whom employees nicknamed the “dam boss” – was the Vale engineer in charge of the Brumadinho dam. She was revealed to have been aware that the structure’s safety factor did not meet international standards as early as 2018. The absence of any action taken was attributed to a lack of oversight of the risk management team of the dam and also the fact that Malheiros lacked the technical expertise to question the conclusions of the dam’s external auditors.[94]

Investigations by the CIAE-A also uncovered the reason for the Brumadinho dam burst and found that Vale had not learnt from its mistakes which led to the Mariana dam collapse. It was concluded that the Brumadinho dam burst was due to structural instability caused by liquefaction and inadequate drainage of the reservoir. Vale knew about this issue as early as 2003 but took minimal steps to mitigate it. In 2016, studies found that the dam was already in a “fragile” condition and by 2017 it was considered to be “barely marginal”. However, Vale’s geotechnical division conducted its own studies and found the condition of the dam to be acceptable.[95]

In the early stages of the disaster’s aftermath, prosecution efforts were mainly directed at the employees who had worked directly on the dam. Eight employees, including the Vale executive director of geotechnical operations were arrested in early 2019, on grounds that they “had full knowledge of the situation of instability in the dam and each one of them, as part of their job, also had the power and ability to adopt measures for either stabilizing the structure or evacuating areas at risk,” but chose not to do so.[96]

However, as the year-long investigation continued, the authorities began to take aim at Vale’s top executives as well. In early 2020, Brazilian prosecutors charged Vale’s former CEO Schvartsman and 10 others from the mining giant with homicide. William Garcio Pinto Coelho, the lead prosecutor in the case, accused Schvartsman, along with Vale’s other top management, of prioritising Vale’s share performance over the safety of its dams.[97]

Forever a work-in-progress

Despite a long history of mining in Brazil, regulation pertaining to tailings dam safety was relatively new. After the Mariana dam collapse in November 2015, significant changes to regulations regarding tailings dam safety were made. Changes included the modification of the National Mining Dams Registry; revision of the classification criteria for tailings dams; enhancements to emergency action planning requirements; and the establishment of periodic dam safety review requirements. The push for reforms resulted in extensive updates of Brazil’s dam safety monitoring standards. Observers claimed that this made Brazil’s safety standards state-of-the-art, exceeding standards of practices in other parts of the world.[98]

After the Brumadinho dam collapse, in February 2019, Regional Development Minister Gustavo Canuto announced that more than 3,300 dams across Brazil classified as “high risk” or “high potential harm” would be reviewed. This decision was triggered by the uncovering of the ANM classification of the Brumadinho dam as “low risk”. Analysts said that the certification was of concern as it undermined audits of dams in Brazil.[99]

Who’s in control?

Vale has a unique shareholding structure for a public company, given the deep-rooted government influence post-privatisation. Prior to 2017, a holding company called Valepar S.A. (Valepar) owned 53.9% of Vale’s shares, and the Brazilian government directly owned 6.5% of the mining company’s shares. A few majority shareholders – including Brazil’s national bank, BNDES Participações S.A. (BNDES), and a number of Brazilian pension funds – control Valepar, jointly holding 99.976% of all common shares and 100% of preferred shares.[100]

Aside from its direct and indirect shareholdings in Vale through BNDES and the pension funds, the Brazilian government also held 12 special class preference shares called golden shares,[101] which entitle the holder of such shares to the same voting rights as holders of preferred Class A shares. The golden shares also confer additional rights, such as the right to veto on certain matters, including a change in name or head office location, change in corporate purpose, as well as liquidation, disposal or winding up activities.[102]

On December 2017, Vale announced its migration to the Novo Mercado, a special listing segment of B3 S.A. which provides for the highest standards in terms of corporate governance. The listing in the Novo Mercado entailed the adoption of certain corporate governance rules – beyond those required by Brazilian legislation – that increased shareholders’ rights and enhanced the disclosure of policies and the existence of transparency, monitoring and control structures.[103,104]

A shareholder agreement was signed in 2017 to “provide the company with stability and to adjust its corporate governance structure during the transition period to become a dispersed capital company”. The agreement saw the amendment of Vale’s bylaws to adhere to Novo Mercado listing rules as well as the merger of Valepar into Vale.[105]

On account of the new shareholders' agreement, Vale now has a diversified shareholding. According to Vale's company website, "minority shareholders became more represented in the company's main decisions, and receive full voting rights and equal treatment with the controlling shareholders" as a result.[106] Vale's shareholding structure as at 30 April 2021 is shown in Figure 1 below.

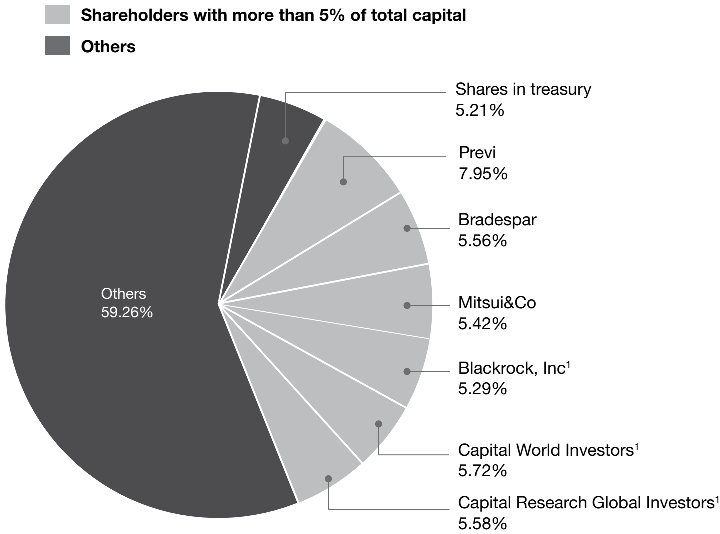

Figure 1: Vale's shareholding structure as at 30 April 2021[107]

Puppet masters and inner circles

"Suppri decides behind closed doors what the priority projects are and also decides how it can simplify environmental licensing."

– Professor Klemens Laschefski, Minas Gerais Federal University[108]

Three years before the Brumadinho disaster, Minas Gerais created a new body to streamline mining approvals called the Superintendence of Prioritised Projects (Suppri). Through Suppri, licenses were obtained in months. Complex applications which had previously required layers of assessments would now only need go through a single assessment. There was an increase in the number of licenses issued each year due to the decrease in the average time spent per license from 51 days to under 10 days.[109]

Vale's Brumadinho dam was assessed by Suppri. In November 2018, the head of Suppri, Rodrigo Ribas, had addressed the Mining Activities Chamber and urged it to downgrade the dam's risk level. The chamber agreed to move the Brumadinho dam to a lower risk band.[110]

Professor Klemens Laschefski from the Institute of Geosciences at Minas Gerais Federal University, believed Suppri was set up to afford mining companies' greater influence over government decisions. He alleged that Suppri prioritised the assessment of companies which had made political contributions.[111]

A repeat of history?

In 2010, shortly after the Brazil government proposed to review the National Mineral Law, the mining industry upped its political spending.[112] Political contributions also grew during the 2014 election for congressional candidates. Mining companies contributed close to R$15 million to political campaigns in Minas Gerais in 2014 – the most of any state, according to an article published by the Brazilian newspaper Estadão.[113] In 2014, Vale reportedly spent R$82.2 million on Brazil's political campaigns.[114] This form of political spending ended in 2015, when the Brazilian supreme court made corporate donations to electoral campaigns illegal amid a corruption scandal in the country.[115]

Actions undertaken by the authorities

In April 2020, the ANM halted operations at 47 mining dams that failed to certify their safety; Vale owned at least 25 of these dams. In response, Vale reiterated its commitment to institute improvements to its dam oversight system and provided details on planned actions to improve safety at its dams.[116]

A month after the Brumadinho dam incident, in February 2019, Brazilian Senate committees passed a bill to ban upstream tailings dams and implement heavier penalties. The legislation is similar to a proposed regulation bill which was not passed after the Mariana dam disaster.[117]

According to federal prosecutor Vitorelli, who was part of a task force of federal and state prosecutors who pressed charges against Vale after the Brumadinho disaster, Vale had yet to comply with the commitments signed with authorities to prevent a potential third disaster as at September 2020. He said that there were elevated safety risks in 29 tailings dams operated by Vale at that time.[118]

ESG – Doing good or sounding good?

In spite of the various environmental disasters, Vale claims to be heavily involved in ESG efforts. One of Vale's strategic pillars is to "incorporate sustainability into its business by building economic, social and environmental legacies and mitigating the impacts of its operations".[119]

Based on its 2019 sustainability report, Vale aims to actively undertake actions to reduce greenhouse gas emissions in the steel, metallurgical and shipping chains and eventually become carbon neutral in its operations by 2050. Additionally, in 2019, Vale invested approximately US$102 million (approximately R$551 million) in operational improvements and new atmospheric emissions control and management technologies, and successfully reduced around 54% of its particulate matter emissions from fixed sources. It also sustainably distributed 52% of non-mineral waste through reprocessing, recycling and reuse.[120]

Through the Vale Foundation, Vale also invested R$50.9 million in voluntary social projects to contribute back to society in 2019. Vale Foundation's mission is to contribute to the integrated economic, environmental and social development of the territories where the company operates, strengthening human capital in communities and respecting local cultural identities. In 2019, the Vale Foundation reached approximately 770,000 individuals through 690 social projects in six Brazilian states. The company also sponsored 96 cultural and technical-institutional projects as a way of giving back to local communities.[121]

After the Brumadinho dam collapse, as part of its efforts to regain its reputation, Vale implemented a number of ESG-related initiatives. A year after the incident, Vale announced the inclusion of ESG goals to the long-term variable compensation of its top management. From FY2020, fulfilment of health, safety and sustainability targets would contribute to 20% of the long-term variable compensation, while the remaining would be based on the company's total shareholder return compared to its peers. Prior to the change, top management's long-term compensation was wholly based on shareholder return, although short-term bonuses did include sustainability goals.[122] In February 2021, Vale created a new executive post of sustainability executive officer as well as an executive-level division focused exclusively to address sustainability issues.[123,124]

Vale's sustainability key performance index

Vale has put in place a sustainability key performance index (KPI) goals program to continuously improve on its performance on material socio-environmental issues. The evaluation metrics used to determine performance level is based on ESG indicators for the business area.[125]

Based on the 2019 results, Vale's performance with regards to its sustainability KPIs were generally within expectations despite the Brumadinho dam collapse. In most areas, KPI goals were successfully achieved, with the exception of greenhouse gas emissions and water resources for certain business areas.[126]

Vale's 2019 sustainability report states that the sustainability KPIs have an impact – 10% in 2019 – on the variable compensation of all Vale employees at all hierarchical levels, including the CEO.[127]

Is Vale doing enough for ESG?

Despite Vale’s efforts, some observers remain sceptical. One such individual, a Harvard Business School alumnus, questioned whether Vale was doing enough to mitigate the environmental impact of its actions. For example, Vale’s S11D complex is located in the heart of the Amazon Rainforest, which hosts the largest plant species biodiversity on earth. Even though the innovations adopted by Vale at the S11D complex claimed to have the capability to mitigate the negative environmental impacts associated with most mining operations, the true sustainability of such projects remained uncertain.[128] Susana Penarrubia, DWS Group GmbH & Co. KGaA’s head of ESG integration said that the Brumadinho dam collapse “confirms once again our very cautious ESG view on the mining sector”. She also stated that the German asset manager had excluded Vale from its ESG investments and would review positions it held on behalf of institutional clients.[129]

Is investing in mining companies against ESG principles of institutional funds?

In light of the numerous mining disasters, investors have begun to put pressure on institutional funds to focus on ESG issues within the sector. Taking reference from BlackRock, Inc.’s (BlackRock) ESG integration policy, the firm has stated that its integration of ESG is “incorporating material ESG information into investment decisions with the objective of improving long term financial outcomes” of their clients’ portfolios.[130]

However, BlackRock still made investments in the mining industry despite the negative environmental and social impacts of mining disasters. Over a year after the Brumadinho dam collapse, Vale remained as one of the top holdings of BlackRock World Mining. In addition to its position in Vale, BlackRock also had a stake in BHP Group, which was involved in the Mariana dam collapse. That being said, BlackRock stated that, pending investigations, it might review its investment in Vale.[131]

In a bid to defend its actions, BlackRock fund manager Evy Hambro said that sustainability was improving rapidly in the mining industry despite numerous issues. He opined that while there had been significant coverage of negative incidents, the positive activities of mining companies were not publicly highlighted enough. He cited the example of Rio Tinto Group – another mining giant – which he claimed had done “incredible things” over many years, as highlighted in its sustainability reports but not covered elsewhere. As such, Hambro’s view is that while it was not possible to fully “offset” the impact of disasters, the benefits brought about by the mining industry should be given due attention to form a “balanced view”.[132]

On the other hand, Vale had also earned the ire of other investors as a result of two dam failures in the span of three years. Sasja Beslik, head of sustainable finance at Swedish bank Nordea, was not satisfied with assurances from Vale and had banned any additional purchase of Vale shares by the bank. Dutch asset management firm Robeco, which had been taking part in "enhanced engagement" with Vale since the Mariana dam collapse, had also placed the mining giant on a banned list. Generally, investors claimed that there was insufficient data available to comprehensively assess whether mining companies such as Vale have in place proper risk assessment and prevention measures. In this regard, Ian Woodley – an investment analyst at Old Mutual – said that investors needed to a have a degree of trust in the mining companies; if they deemed the risk as too high, they should exit investments in the mining industry.[133]

Restoration works for a tarnished reputation

"It is difficult to have confidence in the company's ability to maintain safety."

– Jeanett Bergan, head of responsible investment at Kommunal Landspensjonskasse[134]

The Brumadinho disaster proved to be one of Brazil's most devastating human and environmental disasters.[135] As a result, Vale's reputation had deteriorated severely in the eyes of institutional investors and the general public.

ESG funds, institutional investors and the society at large seemed to have lost confidence in the company's ability to maintain safety. Even with compensation and Vale's commitment to restore the city of Brumadinho, residents' opinions on Vale remained unchanged up to a year from the disaster. The disaster took away homes, assets, and loved ones – to some, that was all that they had.[136]

As Sandra Guerra – Vale's independent director – conceded during an interview, regaining confidence takes a long time. However, she said that "people in Vale are determined to pursue the objective of transforming the company into the safest mining company in the world and to making the necessary changes". According to her, the statement repeated many times by Vale's CEO – "We will never forget Brumadinho" – genuinely expresses what is in the heart of Vale's management and board.[137] Indeed, the lessons of the Brumadinho disaster must never be forgotten.

Discussion questions

1. Evaluate the role that the board of directors and management played in the Mariana and Brumadinho disasters. Who is directly responsible for the disaster? If you were a member of the board, what would you have done differently?
2. Evaluate the board structure (including board committees) of Vale before and after the Brumadinho disaster. Are there other changes you would recommend? Explain.

3. Evaluate the extent to which Vale's corporate culture contributed to the Brumadinho disaster and its effect on the effectiveness of Vale's existing whistleblowing policy. Assume you are a member of the board of directors of a company. How would you assess the effectiveness of the company's whistleblowing policy?

4. Evaluate the remuneration policies of Vale before and after the Brumadinho disaster. Are there other changes in the remuneration policies you would recommend? Explain.

5. Identify the key lapses in Vale's risk management and suggest improvements to Vale's existing risk management framework.

6. Are the regulatory bodies also responsible for the dam collapse? Discuss the role of the regulatory bodies and their influence on companies' corporate governance.

7. Do you think Vale's ESG efforts have been sufficient and meaningful, especially in relation to its operations? Explain.

8. How should institutional investors engage with companies on ESG issues? Should investors that are focused on ESG invest in mining companies? Explain.

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