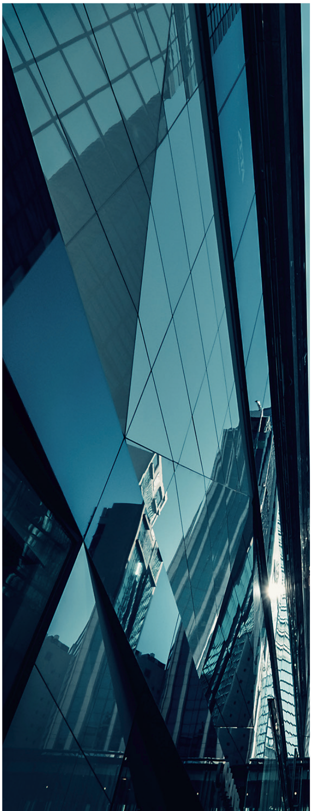

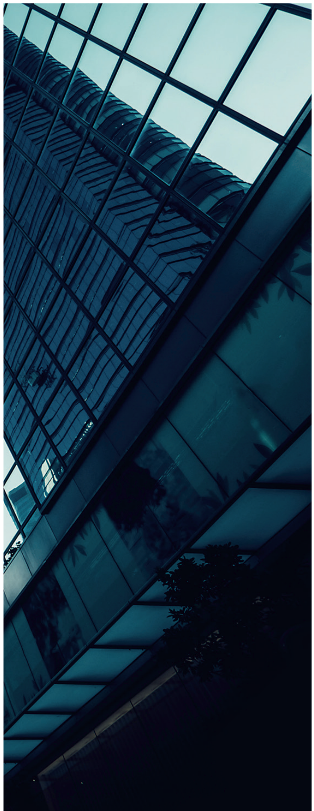

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11

CORPORATE GOVERNANCE
CASE STUDIES

Edited by Prof Mak Yuen Teen

CPA AUSTRALIA

Corporate Governance Case Studies

Volume 11

Mak Yuen Teen, PhD, FCPA (Aust.)

Editor

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GLOBAL CASES

FOREWORD

As organisations continue their recovery from the COVID-19 pandemic, new challenges have emerged. Global supply chain disruptions, rising inflation and energy security risks, are adding immense complexities to maintaining businesses resilience. In these challenging times, good leadership and governance will remain the bedrock of long-term sustainable business performance. Businesses will increasingly need to balance accountability, transparency, and sustainability as key considerations to deliver long-term value to their stakeholders.

The increased pressure on robust corporate governance will need the collective efforts of many stakeholders in the business community. Business leaders will be required to ensure that their own governance processes and structures remain fit for purpose. Aligning processes and structures to support effective corporate governance will be of paramount importance.

Against this backdrop, CPA Australia is proud to publish Volume 11 of the Corporate Governance Case Studies series as we continue our efforts to raise the bar on corporate governance. We hope this new collection of case studies will encourage robust discussions and thought leadership, both in Singapore and globally, to support organisations in their governance journey.

CPA Australia is honoured to have partnered with Professor Mak Yuen Teen FCPA (Aust.) of the National University of Singapore Business School since the inception of this series 11 years ago. We express our gratitude to Professor Mak for his significant efforts and time in writing and editing the cases presented in this volume. We also thank Professor Mak's students at the NUS Business School for their hard work in researching and producing the cases.

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October 2022

PREFACE

This year, I started teaching a course on Corporate Governance and Sustainability in the new MSc programme on Sustainable and Green Financing offered by the National University of Singapore. In this course, I emphasise that good corporate governance provides the foundation for sustainability, and at the same time, corporate governance rules and practices need to incorporate greater consideration of environmental and social factors.

In recent years, I have increasingly selected cases with an ESG theme for my students to write about, and of the 18 cases included this year, five can clearly be classified as ESG cases – Chevron, ExxonMobil, Rio Tinto, Shell and Unilever. I already use many of these cases in my courses.

However, there were already ESG cases even from volume 1 published in 2012, even if that term was not used at that time.

Take the 2010 BP Deepwater Horizon disaster. There was a case on it in the very first volume. The disaster shows very starkly the link between "E", "S" and "G". It was an environmental disaster of unprecedented magnitude. The massive explosion on the oil rig in the Gulf of Mexico on 20 April 2010 sank the rig, causing an oil spill 19 times the size of the 1989 Exxon Valdez spill in Alaska, which at that time was the worst oil spill ever. It affected fishing and the seafood, tourism, oil and gas industries, and caused massive long-lasting damage to bird and marine life. The Exxon Valdez disaster led to the development of the CERES/Valdez Principles on Environmental Reporting Guidelines, and CERES, together with the UN Environment Programme, later launched the Global Reporting Initiative in 1997 which we are all familiar with.

But what caused the explosion? It was a safety issue which also cost 11 employees their lives. Health and safety and product safety are generally classified under "S" in ESG. There was a lack of attention to safety and no clear responsibility for it. Safety documentation required by regulations and information on emergency procedures were not properly maintained. Weeks before the explosion, a confidential survey of workers on the rig showed they were concerned about safety practices, but only about half felt they could report potential safety breaches without reprisal. To me, this is both an "S" issue relating labour management practices and a "G" issue, as effective whistleblowing policies are part of "G".

BP had a history of safety failures prior to the Deepwater Horizon disaster, which can be traced to weaknesses in governance. There was poor tone at the top, with a corporate culture focused on profits. BP at that time had some of the “best” financial and operating numbers among the big oil companies, based on increases in production and refining capacity, high reserves replacement ratio, coupled with reduction in costs.

The profit-focused culture was reflected in its remuneration policy, with top managers receiving bonuses averaging 170% of their salary, with 15% based on safety measures and 70% based on financial and operating performance. There may be questions as to how safety was assessed. Deepwater Horizon was under the oversight of a subsidiary five levels below the parent, which raises questions about governance of subsidiaries in company groups.

In past volumes, there were a number of cases on bribery and corruption, and it was viewed as a governance issue. Bribery and corruption can affect “E” and “S”. For example, a company that wins a contract to build a rig, bridge or building through corrupt means can cause considerable harm because it may not be the best qualified for the job and may have poor quality, safety and environmental standards.

Of the 18 cases in this volume, eight are Singapore cases, including Grab Holdings, which listed in the US through a special purpose acquisition company (SPAC). It is the second case in this series about a SPAC. There is also a first-ever case involving real estate investment trusts – the failed merger of Sabana REIT and ESR-REIT.

The other 10 cases come from a number of countries around the world. Toshiba makes another appearance after featuring in an earlier case – not the first time this has happened and a reminder that problems that are linked to deep-seated corporate culture issues may not be easy to address and may manifest in other ways later on.

The nine other cases which complete the collection include a case on Palantir in the US, a rather secretive company which listed through a direct listing - another fast track way to achieve a listing, like a SPAC. There is also a case on Archegos - the first ever case about a family office - which raises issues about the regulation and governance of family offices. Together with Greensill Capital, which also feature in this volume, it has caused much grief to Credit Suisse, which was featured in the previous volume and gets more mention in these two cases. The Archegos and Greensill cases are like spinoff prequels to the Credit Suisse case in the previous volume.

I would like to thank my trusted, dependable and highly competent editorial assistant, Isabella Ow, who has been helping me since volume 6; the NUS BBA (Accounting) students who wrote the initial cases; and Melvin Yong and his team at CPA Australia for managing the publication process.

As this series draws to a close, I want to especially thank my wife and family for their unstinting support of my work.

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ASPEN: NO HONEY NO MONEY

Case overview

Aspen (Group) Holdings, a Malaysian property development company, listed on the Catalist Board of the Singapore Exchange (SGX) in July 2017 after being rejected for listing on Bursa Malaysia three times. In January 2021, it transferred to the SGX Mainboard. Things seemed to go well initially with increasing revenues and profits before revenues started to decline in FY2019. When the COVID-19 pandemic hit, the company decided to diversify into glove manufacturing with very ambitious plans to quickly scale up the new business. The announcement of a major glove deal with Honeywell International Inc. was later retracted, raising issues about possible disclosure lapses. Other disclosure issues, a major tax dispute, and legal claims related to its glove business followed. Less than two years after venturing into the glove business, it announced that it was scaling down operations in the business. Meanwhile, Aspen's share price had fallen to just S$0.049, compared to its Initial Public Offering price of S$0.23. In August 2022, disciplinary actions were taken by SGX against the company and its directors.

The objective of this case study is to facilitate a discussion of issues such as dominant personalities holding key positions; board composition; director duties; board responsibilities in diversification decisions; disclosure obligations; due diligence for listings; and regulatory effectiveness.

Rise of Aspen

Aspen (Group) Holdings Limited (Aspen) was incorporated in December 2016 as a private company. It was founded by Dato' Murly Manokharan (Murly) and Nazir Ariff bin Mushir Ariff (Nazir) in January 2013 and is headquartered in Penang, Malaysia.[1] Aspen started in the property development business, focusing on developing affordable residential and commercial properties at strategic locations, mainly targeting middle-income class mass market purchasers from both Malaysia and Singapore.[2] It later diversified into the food and beverage segment by buying the franchise rights from Kanada-ya UK Limited to operate its food and beverage outlets in Singapore, Malaysia, and Thailand.[3]

This initial case was prepared by Aafireen Fathima Ajharali, Daryl Tan Dexuan, Jed Reuben Lim and Salahudeen Shirin Irfana. It was substantially re-written, with additional information added, by Professor Mak Yuen Teen, and edited by Isabella Ow. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees.

Aspen claimed to be the only company in Penang that had sales exceeding RM1 billion ringgit (US$239 million) a year, and the only company listed on a stock exchange within three years of incorporation as a real estate company.[4] It partnered Ikano Pte Ltd to embark on a massive RM8 billion property project in Batu Kawan, Penang called Aspen Vision City (AVC).[5] Through this partnership, Aspen acquired a massive 245-acre prime freehold land in the heart of Batu Kawan, its first private-initiated affordable housing project which was completed in 2018. AVC provides a diverse array of facilities and amenities such as shopping, entertainment, hotels and office towers for the rapidly developing southeastern region of Penang. This project was a breakthrough for Aspen and it introduced more development plans such as Vivo Executive Apartment, Vogue Lifestyle Residence, and Viluxe in the vicinity.[6]

Aspen's achievements can be largely attributed to its highly ambitious founder, major shareholder and Group Chief Executive Officer (CEO), Murly. He saw a huge opportunity in the property sector for the middle-class income group and moved swiftly to implement a strategy to capitalise on it. Aspen became widely recognised as one of the fastest growing companies, taking on various high-impact projects such as AVC.[7]

Singapore, here we come!

Despite its apparent success, Aspen tried and failed to list on Bursa Malaysia three times.[8] It was purportedly rejected by Securities Commission Malaysia (SCM) for failing to meet the criterion of having at least three full years of track record as required under paragraph 7.03(b) of the Equity Guidelines issued by the SCM.[9] Even though Murly mentioned that "as we are a Malaysian company our preference would be to list on our local bourse, Bursa Malaysia",[10] Aspen was apparently already in advanced negotiations with the Singapore Exchange (SGX) to list on the Catalist Board, instead of trying for a listing on the ACE Market or Leap Market in Malaysia.

Aspen subsequently listed on the Catalist Board of the SGX on 28 July 2017 through an Initial Public Offering (IPO) at S$0.23 per share.[11] For the half year ended 30 June 2017, it reported revenues of RM108 million, a 230% increase compared to the half year ended 30 June 2016, while profit after tax increased to RM22 million compared to a loss of RM3.4 million. Revenues and profits after tax for FY2017, FY2018, FY2019 and FY2020 were approximately RM453 million and RM95 million;[12] RM570 million and RM49 million;[13] RM288 million and RM24 million;[14] and RM283 million and RM76 million,[15] respectively.

It transferred to the SGX Mainboard on 28 January 2021 in order to have a larger investor base and to provide the company with a wider platform and better opportunities for future fund raising. When it announced its intention to transfer from the Catalist Board to the Mainboard on 26 October 2020,[16] its share price rose from S$0.22 to S$0.275.[17]

Ownership

As at 19 March 2021, the public float for Aspen's shares was 33.41%.[18] Murly had deemed interest of 46.7% held through Aspen Vision Group Sdn Bhd and Intisari Utama Sdn Bhd. Other substantial shareholders were Oh Kim Sun who had direct interest of 3.82% and deemed interest of 6.25%, and SGX-listed property development company, Oxley Holdings Limited (Oxley Holdings), which had a direct interest of 9.36%. Ching Chiat Kwong (Ching) – the Executive Chairman and CEO of Oxley Holdings – and Low See Ching, were deemed to be interested in the shares held by Oxley Holdings by virtue of their substantial shareholdings in the latter.[19]

Board of directors

Aspen has an all-male board comprising eight directors – three executive directors (EDs), three independent directors (IDs), and two non-independent non-executive directors (NINEDs).[20]

The Chairman, Cheah Teik Seng, aged 67, is an ID, and chairs the Audit Committee (AC) and Remuneration Committee (RC), and serves on the Nominating Committee (NC).[21] He is said to have many years of experience in senior management positions in top international investment banks such as Chase Manhattan Bank, BNP Paribas, UBS, Goldman Sachs and Merrill Lynch. He has also held ID positions in public listed companies in Malaysia, Australia and the Philippines,[22] such as Drillsearch Energy Ltd and Maybank Kim Eng Securities. He also serves as Chairman at Maybank Agro Fund Sdn. Bhd., Maybank Cambodia Plc, and Maybank Kim Eng Holdings Ltd.[23]

Another ID is Dato' Alan Teo Kwong Chia, aged 40, who is described as having "served in top and executive roles in various prestigious organisations including AIA Berhad, Great Eastern Life and Genting Group", and as a "specialist in the areas of Human Resources, Operations, Organisational Design and Business Process Management".[24] He chairs the NC and is a member of the AC and RC.

The third ID, 60 year-old Dato' Choong Khuat Seng, Finn, is said to be "esteemed for being a multi-disciplined economist and business rights activist, has extensive experience in multiple sectors, including property construction, building materials, real estate services and property investment". He has served on the Penang Island Municipal Council, as President of a Penang trade association and Vice-President of the Penang Chinese Chamber of Commerce.[25]

The two NINEDs are 55 year-old Ching – Executive Chairman and CEO of substantial shareholder Oxley Holdings – and 46 year-old Dr Lim Su Kiat, who is said to have extensive experience in the areas of direct investments, real estate capital markets and REITs in real estate markets of Asia. Ching has an alternate director, Low See Ching (Low), aged 45, who is a fellow director at Oxley Holdings and also a director of another SGX-listed company, Hafary Holdings Limited.[26]

One of the EDs, 73-year-old Nazir, who is the co-founder of Aspen, is the Executive Deputy Chairman. He has over 40 years of business experience, with more than a decade in the property sector, and has held various key positions and served as a board member in the private sector, in companies focused on businesses such as tin production and retail. Currently, he is also the Chairman of Small Medium Enterprise Development Bank Malaysia Berhad (SME Bank), one of the leading Development Financial Institution (DFI) in Malaysia which is wholly owned by the Ministry of Finance and regulated by Bank Negara Malaysia (BNM).[27] He is an independent director at Texchem Resources Bhd which supplies latex chemicals to produce gloves.[28]

Anilarasu Amaranazan (Anilarasu), aged 40, the group managing director, has an engineering background and project management experience. He joined Aspen as an operations director in 2015 before becoming Chief Operating Officer (COO) in 2016, and then group managing director in 2019.[29] He also serves on the board of Board of Engineers Malaysia and Aspen Vision City Sdn Bhd.[30]

Undoubtedly, the man in charge at Aspen is its founder, President and Group CEO, Murly. He was said to be the youngest executive director to lead a Malaysian public company in history, at just 23 years of age.[31] The company's website only lists him under "Aspen leadership".[32]

Murly has more than 10 years of experience in the property development and construction industry and oversaw many local and international industrial projects in his career. Before Aspen, Murly worked at Ivory Properties Group Bhd, starting as a technical assistant, quickly rising through the ranks, ultimately becoming the COO and executive director "due to his extraordinary business acumen and innovative spirit".[33] He had realised that there was a huge gap in the Malaysian market that no one was targeting: educated, middle-income individuals who are planning to start a family, which resulted in him setting up Aspen, to build and sell affordable properties to such individuals.[34]

From property to gloves

On 12 August 2020, Aspen announced that it was diversifying its business to include production and distribution of latex and nitrile gloves.[35] The glove making segment is unrelated to the property development segment which was the core business of

Aspen.[36] The reason provided for the diversification is that there was rising demand for gloves worldwide in industries like healthcare, food and beverage, hospitality and travel due to the COVID-19 outbreak.[37] Further, the demand for gloves had exceeded the existing glove manufacturers' maximum production capacity which could allow Aspen to set higher prices for its gloves.[38] Hence, Aspen believed that the diversification would increase its revenues and shareholder value significantly.[39]

To enter the glove making business, Aspen purchased 100% of Aspen Glove Sdn. Bhd. (Aspen Glove) from Murly for RM2 in cash through Aspen Vision All Sdn. Bhd. (Aspen Vision) on 11 August 2020.[40] Aspen Glove was to be used as the special purpose vehicle for the glove making business under the joint venture agreement entered into by Aspen Vision, CMY Capital Sdn. Bhd. (CMY Capital) and an individual by the name of Encik Iskandar Basha Bin Abdul Kadir (Iskandar).

CMY Capital is incorporated in Malaysia and described as an active global capital market investor, with its principal activities being investment holding, equity investments, hotel and real estate development. Iskandar is said to be an accomplished veteran in business and the government sector. He was a former deputy general manager of Penang Development Corporation and an advisor in the Economic Planning Unit of Malaysia's Prime Minister Department. In the private sector, he was a finance manager/treasurer in a major global oil firm, and held executive positions in companies in the business of software consulting, banking, and ship building.[41]

Under the joint venture agreement, Aspen Vision would have a 70% equity interest in Aspen Glove, with CMY Capital having a 25% interest and Iskandar a 5% interest. The board of Aspen Glove would comprise six directors – Iskandar, two from CMY Capital, and three from Aspen – Murly, Nazir, and Lim Soo Aun, Aspen's Chief Financial Officer. Murly was to be Aspen Glove's CEO, while Iskandar was to be the managing director.[42]

Aspen added: "The board and key management of [Aspen Glove] will be supported by an experienced senior management team from various areas of the glove manufacturing industry to oversee the day-to-day operations of the business. Currently, the recruitment process is underway to hire key personnel with at least 20 years of relevant experience and further announcements on their appointments will be made when their appointments are finalised and approved by the Nominating Committee of the Group."[43]

On 24 August 2020, Aspen's share price suddenly increased by 70.7% from S$0.145 to S$0.35 and 86.7 million shares were transacted.[44] This prompted SGX to query the price jump and large number of share transactions.[45] Aspen said that the increase in price and large number of share transactions were due to the announcement of its diversification into the glove making business.[46]

On 2 September 2020, Aspen announced the formal appointment of Iskandar as managing director of Aspen Glove.[47] Further appointment of a COO was made on 22 September 2020.[48]

Ambition is my game

Aspen released highly ambitious production plans for its glove manufacturing business.[49] Phase 1 of the proposed new business would be on examination gloves which would cater solely for the export market. It was to be carried in Phase 1(a) and Phase 1(b). Under Phase 1(a), Aspen Glove targeted to bring to market 1.1 billion pieces of gloves per annum. It was expected that Aspen Glove would complete the facilities, commence operations and market the products under Phase 1(a) by the third quarter of 2021. The investment required for Phase 1(a) was RM105 million.

For Phase 1(b), Aspen Glove intended to ramp up the production capacity to 3.5 billion pieces of gloves per annum by the second quarter of 2022. This would require a further investment of RM40 million.

Phase 1(a) was expected to be funded by the three joint venture partners in proportion to their equity interest. For Phase 1(b), new investors may be brought in. The Group might also explore secondary fundraising through share placements and/or debt.

The land to be leased for glove production was in the Kulim Hi-Tech Park (KHTP) in Kedah, which is about 20 minutes away from Penang Port via the Butterworth-Kulim Expressway. Penang Port was to be the main port for the export of the products.

Depending on market demand, Aspen Glove might lease additional adjacent land to increase production capacity to up to 28 billion pieces of gloves per year by adding more production lines over the next three to five years.

Aspen Glove intended to apply for tax incentives, where available. It planned to apply for Pioneer Status in Malaysia, which would allow it to enjoy a five-year partial exemption from the payment of income tax where unabsorbed capital allowances incurred during the pioneer period can be carried forward and deducted from the post pioneer income of the company. Accumulated losses incurred during the pioneer period can also be carried forward and deducted from the post pioneer income of the company for a period of seven consecutive years.

The proposed diversification into the new business, which is substantially different from the existing business, would require shareholders' approval, which the company duly received at an Extraordinary General Meeting conducted on 18 September 2020.[50]

As at financial year ended 31 December 2019, SGX-listed Aspen had total current and non-current liabilities of RM891 million and total current and non-current assets of RM1.346 billion. Cash and cash equivalents were RM68 million. Net profit after tax for that year was RM22 million.[51]

Honey is not well

On 13 January 2021, Aspen announced that Aspen Glove had entered into a sales and distribution agreement with a third party distributor for the offtake of its entire 2021 production of rubber gloves, expected to commence production between 1 May 2021 and 31 December 2021. It did not disclose the name of the distributor but said it was an established specialty and medical glove distributor with a presence of more than 20 years in the industry and which products are available globally.[52]

Under the agreement, Aspen Glove was to manufacture and supply approximately 1 billion pieces of gloves on a best effort basis, which was the estimated capacity for Phase 1(a). The distributor was said to have paid Aspen Glove a cash deposit of US$2 million, being 2% of the total sales value of US$100 million.[53] By the end of the day, Aspen's share price had increased from S$0.24 the day before, to S$0.255.[54]

On 13 April 2021, Aspen announced that Aspen Glove had entered into a contract the day before with Honeywell International Inc. (Honeywell) to provide nitrile gloves worth US$210 million from July 2021 to June 2023.[55,56] The announcement said that Aspen Glove shall receive a total deposit of US$20 million, in equal amounts by April 2021 and May 2021. It said that it was working on plans to expedite the completion of Phase 3 and Phase 4, which would add another 7.2 billion pieces of gloves per annum, bringing the total annual production capacity to approximately 14.4 billion pieces per annum by the fourth quarter of 2022. Aspen released its updated estimated production capacity, which showed the following increases in estimated production capacity: 1.8 billion pieces by 2021 Q2, 1.8 billion pieces by 2021 Q3, 3.6 billion pieces by 2021 Q4, 3.6 billion pieces by 2022 Q3, and 3.6 billion pieces by 2022 Q4.

Together with the earlier US$100 million sales that was announced, Aspen Glove's total sales as at 13 April 2021 was now US$310 million.[57] This announcement was released before trading opened on 13 April 2021. Interestingly, the share price fell from S$0.265 the day before to S$0.245 at the close of trading, despite the announcement of the big deal.[58]

It turns out that there was no sweet Honeywell deal at all.

On 24 April 2021, Aspen retracted the announcement about the Honeywell deal. It said that Honeywell "has not consummated the Agreement on 12 April 2021",[59] even though Aspen had announced on 13 April 2021 that the deal had been entered into on 12 April 2021. It added that in the days leading up to the release of the announcements, Aspen Glove received what it believed to be the final agreement from Honeywell for Aspen Glove's execution, with 12 April 2021 being noted as the effective date. Aspen Glove had also received email instructions from Honeywell to issue an invoice for US$10 million to facilitate the first payment of the deposit in the event the agreement was fully executed. On 12 April 2021, Aspen Glove had completed all necessary internal formalities including obtaining its board's approval, formally executed the agreement and delivered the agreement electronically to Honeywell together with the invoice on the same day. The company said it believed that Honeywell's execution of the agreement was imminent given that 12 April 2021 was noted as the effective date in the unexecuted agreement. Hence, it believed that, in order to comply with the SGX Rulebook, it was necessary to make the announcements on 13 April 2021 to disclose the salient terms of the agreement. However, subsequent to the announcements, Aspen Glove was notified that the agreement had in fact not been signed by Honeywell on 12 April 2021 and remained unsigned.[60]

Not surprisingly, SGX queried Aspen about the matter on 26 April 2021, to which the company responded on 29 April 2021. Aspen explained that the parties had been negotiating since October 2020, and that Aspen Glove had on 10 April 2021 received what it believed to be the final Honeywell agreement. Aspen reiterated what it said in its retraction announcement and added that internal approvals were required at Honeywell before the agreement could be executed.[61]

Aspen also said that it was "made aware of the communication oversight and the non-consummation" of the agreement by Honeywell on 14 April 2021.[62]

When asked why Aspen only announced the retraction 11 days after the announcement of the Honeywell agreement, it said it had announced the retraction within eight working days. The delay was because, in preparing the retraction, it needed to liaise with Honeywell's officers who are based in the U.S., where there is a 12-hour time difference from Malaysia. Therefore, "most of the communication turnaround between the parties took more than 24 hours".[63]

Goodbye, Honey(well)

It was not until 3 June 2021 that SGX further queried Aspen about the entry into the Honeywell agreement and the retraction, which the company responded to on 4 June 2021.[64] SGX asked the company to provide clarity on the Honeywell deal and whether discussions were still ongoing or if discussions had already been terminated.

Aspen responded that the deal was off. It said it did not provide an immediate update because Aspen Glove "had intended to engage in a discussion with Honeywell after a cooling-off period to explore the possibility of entering into an agreement".[65] It did not explain why a cooling-off period was necessary, and said that as there were no further developments with Honeywell, Aspen Glove had been in active discussions with other potential buyers for the offtake of the entire Phase 1(b) production capacity which was originally meant for Honeywell. As yet, there were no takers.[66]

Earlier, on 12 May 2021 and 20 May 2021, the company had announced the resignation of the divisional director of corporate (DDC)[67] and COO of Aspen Glove.[68] The latter was appointed only about eight months earlier. In response to SGX's queries, the company said the resignations were not in any way connected to the developments surrounding the Honeywell deal.[69] The appointment of a new DDC was announced the same day as the cessation announcement,[70] while a new COO for Aspen Glove was appointed on 10 September 2021.[71]

The new COO, Dr Prabakaran Manokharan, who is Murly's brother, was just 32 years old, and his previous appointments were special officer to the managing director of Aspen Glove, house officer at Bali's Government Hospital, and Laboratory Technician at Pantai Hospital Penang.[72]

No secrets, please

On 22 September 2021, Aspen's shares were the fourth most highly traded in the market with 49.1 million shares traded.[73] Its share price had increased by as much as 28.6% that morning, hitting a high of S$0.165 for two months.[74] Two days earlier, on 20 September 2021, the company had announced that Aspen Glove had "on 16 September 2021 successfully obtained two 510(k) Premarket Notification clearances to market Nitrile Examination Gloves and Latex Surgical Gloves from the United States ("US") Food and Drug Administration."[75] It said this would allow Aspen Glove to design, manufacture and directly distribute the gloves in the U.S. market.

SGX queried Aspen about the surge in price and volume.[76] On 22 September 2021 at 12.18pm, Aspen responded that it was not aware of any information that was not previously announced which might explain the trading or any other possible explanation, and confirmed its compliance with the listing rules.[77]

However, the next day, the company announced that Aspen Glove had on 20 September 2021 successfully obtained the same U.S. Food and Drug Administration (FDA) premarket notification clearance to market latex examination powder free gloves in the U.S. market.[78]

SGX queried the company again on 23 September 2021.[79] One of its queries was why the company had said that it was not aware of any explanation that could explain the price movements in the company's shares the day before, given that the U.S. FDA clearance was obtained on 20 September 2021. Aspen replied that its consultant only informed Aspen Glove about the 510(k) clearance on 22 September 2021 at 7.46pm, which was after it had answered SGX's query.[80] Further, Aspen clarified that its latex gloves would only be manufactured at a later stage as its present priority was to sell nitrile gloves to gain advantage from current high market demand and hence, the 510(k) clearance was not expected to affect Aspen's share price.[81]

Sale of medical devices are allowed in the U.S. only if the FDA approves them. The two ways in which manufacturers of medical devices can obtain approval are through premarket approval (PMA) and Section 510(k) clearance.[82] To obtain PMA, products have to undergo clinical trials and laboratory testing to ensure that they are safe and effective for usage.[83] However, obtaining 510(k) clearance is much faster and cheaper as compared to PMA. This is because they do not need to undergo clinical trials and laboratory testing, as long as the manufacturer can show that its product is largely similar to another product that has already obtained the clearance and is currently selling in the market.[84] Products cleared under 510(k) are also subject to less supervision by the government.[85] A research study found that the likelihood of recall for products that have obtained 510(k) clearance is 11.5 times higher than those that have obtained approval through PMA.[86]

Falling out of g(love)

Less than two years after the start of its glove story, it was ending. On 8 June 2022, the company announced that it was significantly scaling down its operations.[87] It cited the following reasons: (a) increasing headwinds for the medical glove market resulting from the drastic reduction in demand due mainly to the easing of the COVID-19 induced demand, high inventory levels, heightened competition, global supply chain challenges, higher shipping and logistics costs, high inflation and continuous decline in average selling prices of gloves; (b) geopolitical tensions and risks of a global economic recession from the ongoing Russia-Ukraine conflict; (c) expected further margin compression due to higher production costs; and (d) with falling average selling prices, glove buyers have refrained from stocking up on gloves and therefore Aspen Glove had been unable to secure new purchase orders.[88]

On 18 June 2022, the company announced that Iskandar had resigned as managing director of Aspen Glove in view of the company's decision to significantly scale down its operations.[89]

The taxman cometh

On 7 October 2021, Aspen said its wholly-owned indirect subsidiary Aspen Vision Land Sdn Bhd (Aspen Vision Land) and three other subsidiaries had entered into composite agreements with the Inland Revenue Board (IRB) of Malaysia for a sum of RM56.4 million as the full and final global settlement of all potential additional tax claims for years of assessment 2014 to 2020.[90] Of the total amount, RM19.63 million was paid to the IRB upon signing of the agreements, and the remaining tax payable of RM36.77 million would be settled via instalment payment over six years.

This was the conclusion to the dispute between Aspen and the IRB, which was first announced on 29 August 2021 following the receipt of a notice of assessment (NOA) for 2014 on 25 August 2021. The NOA included a penalty totaling RM175.44 million in relation to a sale-of-land transaction involving previous landowner Aspen Vision and nominated sub-purchasers in 2014.

Aspen had claimed that the additional assessment arose from the adjustment made by the IRB, treating the whole transaction value as a “gain” for income tax purposes for Aspen Vision Land, without recognising any cost for the said transaction.

On 6 September 2021, the company announced that Aspen Vision Land, upon consultation with and on the advice of its tax solicitors, had initiated legal proceedings in the High Court for leave to commence a judicial review and a stay of the enforcement of the notice pending the final and full determination of Aspen Vision Land’s judicial review application.[91]

According to Aspen, the settlement was not expected to have a material financial impact on the company’s current financial year ending 31 December 2021 (FY2021) as the IRB had agreed on a consolidated basis at a Group level that RM40.73 million from the total tax liability attributable to Aspen Vision Land would be allowed to be treated as claimable as tax credit in the Aspen Vision City development for past, current and future projects together with unsold inventories on hand.[92]

In view of the out-of-court settlement, Aspen Vision Land would withdraw its application with the High Court for leave to commence a judicial review to challenge the notice. It added: “The board would like to emphasise that the settlement with the IRB is not an admission of liability or that the Group carried out tax evasion or concealment of information from the IRB…The settlement is undertaken because the company does not wish to be engaged in protracted litigation with the IRB and wishes to resolve the matter amicably and expeditiously.”[93]

The settlement of RM56.4 million (S$18.3 million) was 78% of Aspen’s net income in 2020 (S$23.6 million) and 14% of its market cap (S$130 million).[94]

Messy affairs

On 7 October 2021, Aspen announced that two of its subsidiaries, Aspen Vision Land and Aspen Vision City, had filed a defence and counterclaim in response to a claim initiated by the Penang Development Corporation (PDC) through the issuance of a writ of summons endorsed with a statement of claim on 1 April 2021 in the High Court of Malaya at Penang Malaysia.[95] There was no earlier announcement about the writ of summons filed by the PDC.

PDC was claiming a sum of RM1,761,156.58 against Aspen Vision Land and Aspen Vision City for progressive claim for infrastructure construction work in connection with the purchase and development of land in Batu Kawan. Aspen Vision Land and Aspen Vision City had made a counterclaim against PDC for damages amounting to a total of RM161,617,507.85 for losses incurred by Aspen Vision Land and Aspen Vision City as a result of misrepresentations and breaches of agreements between the parties.[96] As at 24 August 2022, there was no further update on the claim and counterclaim.

More legal woes were to follow. On 2 March 2022, Aspen announced that its subsidiary, Aspen Vision City, had on 24 February 2022 received a writ of summons endorsed with a statement of claim filed by a group of purchasers of Aspen Vision City's development properties in the High Court of Malaya at Penang Malaysia. The plaintiffs were claiming a sum of RM7,289,223.21 for alleged late delivery of vacant possession of development properties.[97]

The following day, the company announced the receipt of a letter of demand on 1 March 2022 from Tialoc Malaysia Sdn Bhd (Tialoc), claiming for an aggregate sum of RM93,163,334.69 for construction work done in relation to Aspen Glove's manufacturing facilities and other services rendered.[98] Aspen issued a clarification the next day that the claim was allegedly for the full balance contract sum for work done by Tialoc. Aspen said it disputed the claim as there were material unresolved issues in relation to the work done, which resulted in Aspen Glove suffering losses, including from loss of production and drop in efficiency of production capacity. It said it was in negotiation with Tialoc for rectification of defective works, loss of production and/or insurance claims, and that it would only release any outstanding payment to Tialoc once all outstanding issues were resolved. Aspen Glove was also seeking legal advice on a possible counterclaim.[99] Aspen subsequently received a notice of adjudication in relation to the claim, with Tialoc now seeking payment of RM84,348,615.20.[100] The company filed an originating summons against Tialoc seeking to declare that Tialoc's reference of the alleged payment dispute and the reference to adjudication were null and void, and that the dispute be referred to the Dispute Avoidance and Adjudication Board (DAAB) in accordance with the terms and conditions of the contract. Aspen also filed a notice of application seeking an interim injunction to restrain Tialoc from commencing and/or proceeding with the adjudicating proceedings until the full and final determination of its originating summons.[101] The interim injunction was granted on 9 May 2022.[102]

Yet another letter of demand was filed against Aspen Glove on 18 May 2022 from Multi Purpose Metal Tech Sdn Bhd (MPMT), claiming RM29,348,000 allegedly owed for the design, fabrication and installation of glove-dipping lines at Aspen Glove's manufacturing facilities. Again, the company said that the claim was not due and payable as the contractual works had yet to be fully completed and there were unresolved issues arising from defects. Aspen Glove was seeking legal advice and also assessing counterclaims.[103] MPMT followed up with a notice seeking the payment, failing which MPMT shall commence winding-up proceedings against Aspen Glove.[104] On 22 June 2022, Aspen announced that Aspen Glove had filed an originating summons and notice of application against MPMT seeking to declare the notice as null and void and restraining MPMT from proceeding with a winding-up petition. Aspen Glove successfully obtained an ex parte interim injunction.[105]

End of the road?

On 19 November 2021, Aspen announced that it was changing its year end from 31 December to 30 June, which meant that its next set of audited financial statements would cover the 18-month period from 1 January 2021 to 30 June 2022. The reason given was to avoid having the same year end as the majority of SGX-listed companies, which will enable the company to better plan its audit schedule and to hold its Annual General Meeting (AGM) during the off-peak period, thereby resulting in better cost savings and operational efficiencies. At the same time, it announced that it was proposing to change its external auditors from KPMG LLP to Mazars LLP (Mazars), and the change of year end would also allow Mazars more time to perform its audit review. The company said that the change of external auditors was part of good corporate governance initiatives and the Group's efforts to manage its overall business costs and expenses amidst the challenging business climate.[106]

On 12 August 2022, Aspen issued a profit warning that it was expected to report a consolidated net loss for the 18-month period ending 30 June 2022, attributed mainly to the scaling down of its glove manufacturing business.[107] By 24 August 2022, Aspen's share price had fallen to just S$0.049, compared to its IPO price of S$0.23.

The change in year end meant that shareholders would have to wait longer for the AGM, to get answers to the many questions they must have regarding the company's disastrous diversification into the glove manufacturing business, its rapidly deteriorating financial condition and its many legal troubles.

Ching resigned as a director of Aspen on 25 August 2022, citing inability "to allocate sufficient time and resources to perform his duties due to his other existing work commitments".[108] Ching's alternate director, Low, also resigned following his resignation.[109]

Regulator acts...gently

The day after the resignation of Ching and Low, the SGX-ST Listings Disciplinary Committee issued public reprimands against the company and its three EDs, Murly, Nazir and Anilarasu.[110]

The company was reprimanded for releasing an announcement about the Honeywell master supply agreement which was non-factual, false and misleading; failing to promptly disclose the non-consummation of the agreement and that negotiations with Honeywell had been terminated; and failing to have in place adequate and effective systems of internal controls and risk management systems.[111]

Murly was reprimanded for causing the company to breach the listing rules, and was required to sign an undertaking not to be appointed to any SGX-listed issuer (other than Aspen) for six months, and undertake mandatory training on listing rules obligations. Nazir and Anilasaru were reprimanded and required to undertake similar mandatory training.[112]

A private warning was also issued to each of the "other relevant directors".[113] The grounds of decision said that while these non-executive directors may place some reliance on the EDs to handle most of the company's day-to-day affairs, there is a limit to which such reliance is reasonable. These other directors had been put on notice that the company was undergoing material developments that required close monitoring to ensure compliance with the listing rules, but failed to adequately discharge their duties by failing to make reasonable enquiries with management and failing to seek to be kept apprised of the situation. They were required to make their own independent assessments and make reasonable enquiries as and when necessary.

There was no mention of any referral to the authorities to investigate possible breaches of statutory requirements.

Bursa Malaysia may be quietly pleased that this one got away.

Discussion questions

1. What are the key red flags in corporate governance at Aspen?
2. Critically evaluate the composition of the Aspen board. Do you think the board has adequately discharged its duties? Explain.
3. Critically evaluate the decision of Aspen to diversify into the glove manufacturing business. What do you think are the key contributory factors for its failure in this business?
4. What are the responsibilities of a board of directors in diversification decisions? Do you think the Aspen board adequately discharged its responsibilities in relation to this decision? Explain.
5. Discuss the issues relating to the Honeywell deal. What potential rules do you think have been broken, if any? What other potential breaches do you think may have occurred at Aspen?
6. Do you think Aspen should have been allowed to list on SGX after being rejected for listing three times in Malaysia? What are some possible reasons why it was unsuccessful in listing in Malaysia but managed to do so in Singapore?
7. Critically evaluate the effectiveness of the regulators in Singapore in light of the issues at Aspen.

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CITY DEVELOPMENTS: CRACKS IN GOVERNANCE

Case overview

City Developments Limited (CDL) is one of the most successful and well-known family companies in Singapore. In 2021, it learnt an expensive lesson after writing off S$1.78 billion from its equity investment in Chongqing-based Sincere Property Group in 2020, eventually selling its stake in the troubled company for US$1 in September 2021.

Over the span of a year, there were multiple resignations of directors related to disagreement on the Sincere Property Group investment. One of these was long-time director, Kwek Leng Peck, who is also the cousin of CDL's Executive Chairman, Kwek Leng Beng.

The objective of this case study is to facilitate a discussion of issues such as corporate governance of family-controlled companies; succession in family companies; board composition; roles and responsibilities of independent directors; due diligence in investment decisions; and impairments of investments.

We built this City

Founded on 7 September 1963,[1] City Developments Limited (CDL) is a real estate company which principal activities are acquiring, developing and selling properties. In November that same year, it went public, listing its shares on the Singapore Exchange (SGX), then known as the Malayan Stock Exchange.[2] CDL made losses for the first seven years of operations.[3]

In 1969, Hong Leong Group, founded and led by Kwek Hong Png, started investing in CDL.[4] It appointed three directors – Kwek Leng Beng (KLB), Sim Miah Kian, and Chow Chiok Hock[5] – to the CDL board, and injected funds into the troubled company. In 1972, Hong Leong Group acquired a controlling stake in CDL.[6] Through strategic diversification, CDL managed to grow rapidly, expanding its portfolio of properties

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which ranged from residences to shopping malls. It was also known for being one of the first residential developers to introduce the concept of a “showhouse”, which has since become commonplace in the industry.[7]

In 2021, CDL had over 600 subsidiaries and associated companies, spanning across 29 countries globally.[8] Its market capitalisation of over S$5.32 billion as at May 2022[9] made it one of the largest companies in Singapore. Currently, the Hong Leong Group owns approximately 49% of CDL, with the rest owned by the public.[10]

Sustainability pioneer

CDL is widely recognised as a pioneer in sustainability, with sustainability said to be deeply integrated into the company’s business strategy.[11]

It has a dedicated sustainability department led by the Chief Sustainability Officer (CSO) which reports to the Board Sustainability Committee (BSC). The BSC is currently chaired by Group Chief Executive Officer (CEO) Sherman Kwek (SK) and includes three other independent directors – Daniel Desbaillets, Chong Yoon Chou (CYC), and Wong Ai Ai (WAA). Besides providing guidance on sustainability, the BSC is involved in the review of the company’s Environmental, Social and Governance (ESG) framework, as well as the setting and evaluation of ESG targets and long-term sustainability.[12]

As part of its sustainability efforts, CDL has implemented sustainability policies targeting different aspects of its business. In particular, the Green Building Policy aims to incorporate decarbonisation, innovation, inclusivity, health and well-being into the design and operation of its buildings to reduce the negative impact on the environment. The underlying 3S framework – Smart, Sustainable and Super Low Carbon – drives CDL’s commitment to reduce its carbon footprint and environmental impact. This is in line with its net zero whole life carbon buildings commitment and the Singapore Green Plan 2030.[13]

CDL’s efforts in sustainability have been recognised over the years. Under Singapore’s Building and Construction Authority’s (BCA) Green Mark Scheme, CDL has attained 110 BCA Green Mark certifications, making it the most awarded BCA Green Mark Platinum developer in the private sector.[14] In February 2021, CDL signed the World Green Building Council’s Net Zero Carbon Buildings Commitment, aiming to reduce its buildings’ carbon emission to net zero by 2030.[15]

CDL has also won a number of sustainability awards. On the 2021 Global 100 Corporate Knights' index of the world's most sustainable corporations, CDL was ranked the 40th most sustainable company globally.[16] It is the first and only Singapore company to be included on the index for 12 straight years.[17] CDL was also named by World Finance as the 'Most Sustainable Company in the Real Estate Industry' in 2021.[18] On the importance of sustainability to the company, Group CEO SK, said: "Our strong foundation in ESG integration forged over two decades has been vital in future-proofing our business and preparing us for new challenges and unforeseen changes."[19]

A global Singapore company

> "The virus outbreak is a fitting reminder that with globalisation and CDL's scale, we cannot be overly reliant on a specific geography or asset class. We will continue to build a diversified portfolio, enabling us to tap on various sustainable income streams to withstand cyclical headwinds and market shifts."
>
> *– Sherman Kwek, CEO of CDL*[20]

In terms of geographical reach, about half of CDL's 2021 total disaggregated revenue – excluding rental income from investment properties and dividend income from investments – was derived from Singapore. This is followed by China, the U.S., the U.K., and Australasia at 13.2%, 11.2%, 9.4% and 8.7% of total revenue respectively. Around 55% of its disaggregated revenue originates from its property development business, and 38% from hotel operations.[21]

In FY2020, CDL's total revenue was around S$2.1 billion, a sharp fall from FY2019's total revenue of S$3.4 billion and FY2018's total revenue of S$4.2 billion. It reported a loss of S$1.8 billion that year. Its fortunes improved in FY2021, when it recorded total revenue of S$2.6 billion and a profit before tax of S$228 million.[22] The Group's recent poor performance was largely attributed to the COVID-19 pandemic which affected both the hospitality and real estate industries, where the majority of CDL's revenue is derived.[23] CEO SK was of the view that CDL needed to diversify its revenue sources to other sectors in order to stay afloat.[24]

CDL's keyman: Kwek Leng Beng

> "I rely enormously upon our Chairman's experience, his judgment and his mentorship to help guide investment strategy…"
>
> *– Grant Lewis Kelley, Former CEO of CDL*[25]

The keyman of CDL is undoubtedly KLB, the current Executive Chairman. KLB first joined the Hong Leong Group in the 1960s, working with his father in the business. He led Hong Leong Group's takeover of CDL in 1972, when CDL had a market capitalisation of less than S$5 million. Subsequently, CDL expanded its portfolio to include high profile industrial and commercial developments while being supported by Hong Leong Group. In the early 1990s, KLB took advantage of the collapse of hotel prices and boosted CDL's hotel business. He continued to acquire hotels globally, including London's Gloucester Hotel and New York City's Hotel Millennium. In 2000, KLB was named Asian Hotelier of the Decade by Jones Lang LaSalle Hotels and Arthur Andersen. In 2006, hotel operations generated 72% of the Group's total revenue. Over the next three decades, KLB oversaw CDL's transformation into a property conglomerate.[26,27]

KLB was appointed to CDL's board in October 1969, and took on the role of Executive Chairman in January 1995, after his father's death.[28] As at 31 December 2021, he is also the Chairman and managing director of Hong Leong Finance Limited, as well as Executive Chairman of Hong Leong Investment Holdings Pte. Ltd. – the immediate and ultimate holding company of CDL – and Millennium & Copthorne Hotels Limited. He directly holds 397,226 of ordinary shares in CDL as at 31 December 2021.[29]

An outsider joins the family business

> "[I am] not averse personally to getting an outsider to come and run the company…if my relatives or my son cannot perform."
>
> – *Kwek Leng Beng, Executive Chairman of CDL*[30]

In view of the weak domestic property market, KLB was of the view that CDL needed to be "less Singapore-centric".[31] Turning its focus to overseas property and with the hope of accelerating its overseas growth engines, CDL appointed Australian Grant Kelley as CEO of CDL in January 2014.[32] Formerly from Apollo Global Management and U.S. fund Colony Capital, Kelley is a veteran with 25 years of experience in managing private-equity real estate investments and management consulting. He has a master's degree in international relations from the London School of Economics and a master in business administration from Harvard Business School.[33]

KLB said that Kelley would "bring fresh perspectives to a rapidly changing and competitive business landscape".[34] Under Kelley's leadership, CDL launched an initiative to expand into overseas growth markets. He pushed ahead with a diversification plan dubbed the "5-5-5 strategy" and returned CDL to a sustainable growth trajectory. The aim of the strategy was to have S$5 billion in overseas property acquisitions and S$5 billion of funds under management within five years. This was the start of CDL's major global growth drive.[35]

In April 2014, the third-generation of the Kwek family – SK and Kwek Eik Sheng (KES) – were appointed to senior management positions. SK was appointed as Chief Investment Officer while KES took up the role of Chief Strategy Officer.[36] These appointments were made in preparation for succession from the second to the third generation of the Kwek family.[37] SK is the son of KLB, while KES is the son of former CDL Deputy Chairman Kwek Leng Joo.[38]

Building the future

> "I can't force (my children) to do things they don't want…You have to be passionate about the job and understand the nuts and bolts of what you have to fix. If not, it's just report after report."
>
> – *Kwek Leng Beng, Executive Chairman of CDL*[39]

There are a few decisions which are critical to the long-term success of a business, especially so for a family business like CDL. Some analysts such as Rolf Beckers of consulting firm Spencer Stuart argue that CEO succession planning is "the most critical activity that the board of a family-owned business will ever undertake".[40]

CDL has put in place a succession plan to ensure the continuity of leadership. Prior to taking the reins at CDL, SK's roles in the company included the Chief Investment Officer of CDL and the CEO of subsidiary CDL China Ltd.[41] In these roles, he established a presence in both Japan and Australia and led the expansion into the China market for the previous seven years. As a result, CDL managed to obtain prime sites in Shanghai, Suzhou, and Chongqing. Having worked in various overseas markets, he has experience in the areas of investments, mergers and acquisitions, real estate and hospitality.[42]

In September 2016, CDL named SK as its deputy CEO. Although he would relinquish his positions as Chief Investment Officer and CEO of CDL China Ltd as a result, he would still oversee the Group's operations in China through his appointment as Chairman of CDL China Ltd's board.[43]

Less than a year later, on 11 August 2017, SK was named CEO-designate of CDL after Kelley resigned as the CEO.[44] He assumed full responsibilities as Group CEO on 1 January 2018.[45]

The old board

As of 31 December 2019, the board of directors of CDL comprised eight members, including KLB as Executive Chairman; his son SK as executive director; his cousin[46] Kwek Leng Peck (KLP) as non-executive and non-independent director; and Jenny Lim Yin Nee (JLYN) as Lead Independent Director.[47]

Five of the eight board members were independent non-executive directors.[48] This is in line with Provisions 2.2 and 2.3 of the 2018 Singapore Code of Corporate Governance, which recommend that the majority of the board should be made up of independent directors if the Chairman is not independent, and that the majority of the board should be non-executive directors.[49]

Risk management

According to the company, line managers form the first line of defence. They are responsible for setting up monitoring controls in order to ensure risk management policies, risk appetite, risk tolerance and limits are being complied. They are also to report any inadequacy with the risk management system.[50]

The second line of defence consists of the Enterprise Risk Management (ERM) function, as well as internal audit. The ERM function is responsible for establishing and improving the risk management framework. The internal audit function provides periodic independent assessment of the company's risk assessment strategies and controls.[51]

The board, together with the Audit and Risk Committee (ARC) form the third line of defence. Besides overseeing the risk management framework, the board is also responsible for determining the nature of risks face by the company, risk policies, as well as risk appetite, tolerance and limits.[52]

The four broad categories of risks identified by the company include strategic, treasury and financial, operational and compliance, and information technology risks.[53]

Sincere, yet risky moves

Back in May 2019, CDL made the move to invest in Sincere Property Group (SPG), one of China's top 100 real estate developers. The original proposed investment of RMB5.5 billion (approximately S$1.1 billion) represented a 24% effective equity stake in Sincere Property Group.[54] CDL also extended a S$540.6 million loan to SPG and bought another S$311.6 million in bonds issued by SPG with a three-year maturity period.[55] As at 31 December 2019, the loan granted and bonds amounted to approximately S$852 million, representing 14% of CDL's financial assets.[56]

On 15 April 2020, CDL entered into a definitive agreement to acquire a 51.01% joint controlling interest in SPG for an aggregate consideration of RMB4.39 billion (approximately S$0.88 billion). Additionally, CDL would also be given a call option to purchase an additional nine percent effective interest in Sincere Property Group for RMB 0.77 billion (approximately S$0.16 billion), allowing CDL to have sole control and a 60.1% stake in SPG. CEO SK said the deal would "transform the group's scale and firmly establish CDL as a major player in China's property sector", taking CDL's presence in China from three cities to 18.[57]

The investment in SPG was cast into the public spotlight half a year later, when long-time board member KLP resigned from his position as CDL's non-executive and non-independent director on 19 October 2020. In the company announcement, the following reasons were given for his resignation:[58]

(i) disagreements with the board and management in relation to the Group's investment in SPG as well as its continuing provision of financial support to SPG; and

(ii) reservations with the Group's approach in the management of Millennium & Copthorne Hotels Limited

In the week following the announcement, CDL lost approximately eight percent of its market value.[59]

Friction within the family

> "Management boards distracted for reasons other than the core business is usually a recipe for underperformance…"
>
> – *Priyaranjan Kumar, MD at Alvarium Investments*[60]

In 2020, the Hong Leong Group was named as the winner of the EY Family Business Award of Excellence.[61] The award recognises Hong Leong Group for its ability to harmonize business and family matters, enabling the execution of business and living out family values.[62]

However, with the resignation of KLP and the conflict in the handling of CDL's investment in SPG, the unity of one of the most prominent families in Asia has started to crack. According to corporate governance advocate Professor Mak Yuen Teen: "Discord like the case at the Kweks can be harder to avoid as more people from extended families get involved in a business over generations" and "economic problems from the pandemic would have worsened such disagreements". Although conflicts are not unusual among family businesses, such tussles distract business leaders from managing the companies.[63]

Independent directors head for the exit

After the resignation of KLP, independent non-executive directors Koh Thiam Hock,[64] Tan Yee Peng,[65] and JLYN[66] followed suit in quick succession, citing an investment disagreement as the reason for their departures.[67] Separately, another independent non-executive director, Tan Poay Seng, decided not to seek re-election at the company's Annual General Meeting (AGM) on 30 April 2021 after having served on the board for over nine years.[68]

After the series of departures from the CDL board, three directors remained – KLB, SK, and Philip Yeo Liat Kok (PYLK). Five new directors – Ong Lian Jin Colin (OLJC),[69] Desbaillets,[70] CYC,[71] Carol Fong (CF),[72] and Lee Jee Cheng Philip (LJCP)[73] – were appointed between October 2020 and January 2021 to replace the outgoing directors. The new directors had varying backgrounds and expertise. OLJC is a financial services industry veteran; Desbaillets is a hospitality veteran; CYC is a seasoned international fund manager; CF is an investment banker; and LJCP is an accountant.

In the 2020 Singapore Governance and Transparency Index (SGTI), CDL was ranked third out of 577 SGX-listed companies.[74] Companies were assessed in respect of their standards in upholding corporate governance, transparency and accountability. Even though CDL was assessed to have high standards in corporate governance, more than half the 'old' board had left CDL due to disagreements relating to the SPG investments.

The appointment of LJCP in January 2021 was questioned by Professor Mak Yuen Teen. He noted that LJCP, who joined CDL Audit and Risk committee, was a former partner of KPMG and retired in September 2018. Under the 2018 Code of Corporate Governance, the Audit Committee should not comprise of former partners or directors of the company's existing auditor within a period of two years after they cease to be a partner or director of the auditor. In this case, CDL has complied with the letter of the Code as it is about three to four months past LJCP's two-year cooling off period. CDL's current Audit and Risk Committee is chaired by a former partner of KPMG, while KPMG is engaged as CDL's external auditor.[75]

Professor Mak said that this "gives the impression that corporate governance is more about compliance with the letter of the rules, rather than imbuing the spirit for long-term value creation and sustained success".[76]

The new board

On 1 January 2022, following the appointment of the newest board member WAA,[77] CDL's board comprised nine directors, with six being independent. The non-independent directors were Executive Chairman KLB, Group CEO SK, and PYLK.[78]

It was disclosed in CDL's 2021 annual report that pursuant to SGX Listing Rule 210(5)(d)(iii), independent non-executive director PYLK, who has served the CDL board for over nine years, had ceased to be independent with effect from 1 January 2022.[79] It was further disclosed that CDL's Nominating Committee had recommended that PYLK remain on the board "to maintain a balance of experienced and new [independent directors] on the board". As a result, he had been "re-designated from an independent non-executive director to a non-independent non-executive director" with effect from 1 January 2022.[80,81]

Deloitte review

> "Notwithstanding the liquidity challenges, Sincere Property remains a platform for future growth in the Chinese market because of its real estate footprint across China."
>
> – *Kwek Leng Beng, Executive Chairman of CDL*[82]

As of 30 June 2020, CDL's global asset portfolio amounted to S$23.8 billion, of which China accounted for 14%. On 4 November 2020, the CDL board decided to engage Deloitte & Touche Financial Advisory Services Pte. Ltd. (Deloitte) as its external financial advisor to evaluate and review its 51.01% joint venture equity investment in SPG. This was in view of SPG's liquidity position against the backdrop of the COVID-19 pandemic and China's 'three red lines' policy.[83]

Three red lines

China's 'three red lines' policy for the real estate sector is aimed at tightening liquidity requirements for companies to improve the sector's financial health. If developers fail to meet one, two, or all of the 'three red lines', regulators would place limits on the extent to which they can increase their debt. The 'three red lines' are as follows:[84]

1. Liability-to-asset ratio (excluding advance receipts) of less than 70%
2. Net gearing ratio of less than 100%
3. Cash-to-short-term debt ratio of more than 1x

SPG was highly geared and faced serious liquidity problems after the policy was introduced. Analysts commented that there were two ways to deal with the issue. The first was to divest SPG's assets, while the second was for SPG to obtain a cash injection to stay afloat so that it meets the covenants set by the Chinese government. In response to the 'three red lines' policy, CDL said that it would not invest more funds into SPG until it recovers.[85,86]

Special working group

On 4 January 2021, CDL announced the formation of a special working group, following the completion of Deloitte's review. The special working group would lead CDL to work closely with SPG to improve its liquidity and profitability while limiting any additional financial exposure to the Group.[87]

In its review, Deloitte split SPG's projects into those which were profitable and those which required divestments or reviews to improve their liquidity. With regard to the special review group, Professor Mak Yuen Teen said: "This suggests that the special review group will be doing its review within the parameters of a strategy that the company will not deviate from. The departures of the directors from the board likely go beyond issues of how best to make the investment work, but whether this is a strategy that the company should persist with."[88]

Make or break moment

> "Sherman will have to engage with investors and show that he can deliver to convince them that he's the right person to lead the company,"
>
> – *Mak Yuen Teen, corporate governance advocate*[89]

The investment into SPG was spearheaded by CEO SK in 2019. On the investment, he said in a statement, "Our strategic partnership with Sincere Property marks a major milestone in CDL's history and represents a game-changing investment for us."[90]

As CEO, SK had implemented a number of initiatives in CDL. He engineered the privatisation of Millennium & Copthorne Hotels Ltd., established a fund-management division in CDL, and increased CDL's stake in a Singaporean REIT.[91]

However, one of his major moves, the investment into SPG, brought losses to CDL due to the COVID-19 pandemic and ‘three red lines’ policy introduced by the Chinese government, which delayed many of SPG’s projects. In April 2020, CDL had renegotiated the terms of its joint venture, effectively giving it a substantial valuation discount.[92] CDL provided a business update in May 2021 that SPG was still facing liquidity challenges at that point of time and was “working to speed up collections, asset sales and divestments to raise funds”.[93] According to Justin Tang, head of Asian research at United First Partners in Singapore, CDL would have to make a strong push to divest more of Sincere’s properties to improve its liquidity and revamp its operations.[94]

With continued uncertainty in respect of the SPG investment, all eyes were on SK.

An expensive lesson

> “The unprecedented write-downs underscore our prudent approach to ensure that the CDL Group is unimpeded as we chart a post-COVID-19 corporate recovery.”
>
> – *Kwek Leng Beng, Executive Chairman of CDL*[95]

CDL eventually impaired 93% of its total investment in SPG, which amounted to S$1.78 billion.[96] This resulted in CDL reporting a net loss of S$1.8 billion in 2020, the worst financial performance in its history. Other losses came from the impairment losses for CDL’s hotels and investment properties of S$99.5 million and allowance for foreseeable losses for development projects of S$35.0 million. These latter losses were mainly due to the COVID-19 pandemic adversely impacting the hotel industry. After the losses were announced on 26 February 2021, CDL’s shares fell by S$0.15 or two percent to close at S$7.36 that day.[97,98]

SPG’s difficulties continued in 2021, with one of its creditors, Beijing Yi He Mercury Investment, filing a bankruptcy claim against it at a Chongqing court in July.[99] Should the local court accept the bankruptcy application, a formal process would be triggered, resulting in the restructuring or liquidation of SPG, or a settlement between creditors and the company.[100]

> “Bankruptcy can be quite a long drawn process in China and it’s going to draw away management’s time and focus. They realised that this battle is not worth fighting for.”
>
> – *Vijay Natarajan, RHB Singapore analyst*[101]

Two months later, on 10 September 2021, CDL announced the divestment of its interest in Sincere Property Group.[102] CDL sold its 63.75% stake in HCP Chongqing Property Development Co., Ltd, which holds 80.01% of SPG, to an unrelated third party for US$1.[103] The consideration took into account the liquidity issues of SPG, as well as its anticipated bankruptcy.[104] The announcement stated that the CDL board felt that the decision was "in the best interests of the Group as these allow the Group to exit its investment in Sincere, and avoid being engaged in a possibly long drawn bankruptcy reorganisation of Sincere".[105]

On 13 September 2021, the Monday following the announcement, CDL's share price rose by 5.4% to S$7.03.[106] With the exit, CDL would withdraw its nominee directors and personnel from the troubled company and avoid the complication of the bankruptcy process. Nonetheless, CDL would still need to deal with the issue of getting SPG to repay the remaining outstanding loans extended to it by CDL.[107] As of 9 October 2021,[108] CDL had completely fulfilled an obligation for a corporate guarantee given by CDL to a financial institution with regard to a loan extended by the financial institution to HCP Chongqing Property Development (HK) Co. Limited.[109]

With the worst hopefully behind it, will CDL's corporate governance and financial performance recover to match its stellar reputation in sustainability? Shareholders would sincerely hope so.

Discussion questions

1. Why is succession planning important? How do you think succession planning in a family-controlled company like CDL differs from succession planning in a company which is not family-controlled?
2. Evaluate the effectiveness of the CDL board in implementing good corporate governance and discuss whether the influence of the family and the board composition were contributing factors in the disastrous investment in Sincere Property Group.
3. How can the board of directors set the risk appetite for a company? Comment on the risk appetite of CDL. Discuss the factors that might have contributed to CDL's risk appetite and how CDL managed its risks.
4. Critically evaluate the decision of the company to invest in the Sincere Property Group in China. What is the role of the board in such decisions? What due diligence should companies do in making such decisions?

5. Five directors resigned over the span of a year, most of whom cited disagreements with CDL's investment in Sincere Property Group. Do you think the directors should have resigned? Under what circumstances do you think it is justified for directors, particularly independent directors, to resign?
6. Evaluate CDL's sustainability efforts and how this may impact the value of the company.

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ECON HEALTHCARE: HEALTH, NOT WEALTH

Case overview

Econ Healthcare (Asia) Limited (Econ Healthcare), one of the leading nursing home operators in Singapore, came under considerable scrutiny after it was revealed that it had invested $4 million investment in the shares of Hong Kong-listed Crosstec Group Holdings Limited (Crosstec), an interior design company. Within two weeks after it first bought Crosstec shares, Econ Healthcare sold its entire stake, suffering a S$3.4 million loss. The loss was equivalent to two-thirds of its net profit. It was later disclosed that Ong Chu Poh, the Executive Chairman and Chief Executive Officer of Econ Healthcare, was trading in Crosstec shares prior to and during Econ Healthcare's investment. Econ Healthcare's responses to Singapore Exchange (SGX) queries led to further scrutiny of the company's actions.

The objective of this case study is to facilitate a discussion of issues such as the board of directors and its composition; the duties and responsibilities of directors; continuous disclosure; investment in shares of unrelated companies; the SGX Catalist Board; responsibilities of sponsors; and pump-and-dump schemes.

Entry, exit, and re-entry

Econ Healthcare (Asia) Limited (Econ Healthcare) was founded by Ong Chu Poh (OCP), the current Group Executive Chairman and Chief Executive Officer (CEO), and established its first nursing home in Telok Kurau in Singapore in 1987.[1] Today, it is the leading nursing home operator in Singapore, with 11 medicare centres and nursing homes in Singapore, Malaysia, and China. Its two key business segments are medicare centres and nursing homes, and other operations and ancillary services.[2]

Econ Healthcare was initially listed on Singapore Exchange (SGX) in 2002 with an issue price of S$0.28.[3] However, it was delisted in 2012, citing low trading liquidity.[4] On 18 April 2021, Econ Healthcare went public again on the SGX Catalist Board, again at S$0.28 a share, with its Initial Public Offering (IPO) heavily subscribed at

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86.9 times the number of shares offered.[5] According to OCP, re-listing would allow the company to pursue growth opportunities through the use of the estimated net proceeds of S$11.5 million for regional expansion, including acquisitions and investments.[6]

After its listing, 80.54% of Econ Healthcare's shares continue to be held by Econ Healthcare Pte Ltd, which is wholly owned by Econ Investment Holdings Pte Ltd. OCP wholly owns Econ Investment Holding Pte Ltd.[7] Therefore, OCP has a deemed interest of 80.54% in Econ Healthcare.[8]

All on board!

Based on Econ Healthcare's FY2021 annual report, the board of Econ Healthcare consists of five directors, with three being independent.[9] The annual report states that "the Nominating Committee (NC) has reviewed the size and composition of the board and is satisfied that the current size and composition is appropriate and effective, and provides the board with adequate ability to meet the existing scope of needs and the nature of operations of the company, which facilitates effective decision-making."[10] Besides OCP, the other executive director is his daughter, Ong Hui Ming, who is Deputy CEO and a member of the NC.[11]

Econ Healthcare has three board committees – the Audit Committee (AC), NC and Remuneration Committee (RC). All three committees are chaired by an independent director. Only the NC includes an executive director, Ong Hui Ming.[12]

OCP is not a member of any board committee. However, he attended all meetings via invitation in FY2021. The RC was the only committee which meetings were not attended by all board members that year.[13]

Caught in the Cross(tec)fire

Crosstec Group Holdings Limited (Crosstec) is a publicly-listed company in Hong Kong that focuses on interior design solutions, with a majority of its clients being global luxury brands and high-end fashion brands.[14] Since it went public in 2016,[15] Crosstec's share price has remained largely stable at below HK$0.50. However, in November 2021, its share price started to run up sharply.[16] As its share price continued to rise, Econ Healthcare purchased its shares on 30 December 2021 and 6 January 2022, spending S$4 million.[17] However, on 11 January 2022, Crosstec's share price plunged from HK$2.32 to HK$0.38.[18] On 12 January 2022, Econ Healthcare announced that it would sell its entire stake in Crosstec at a loss of S$3.4 million.[19] The loss represented 9.1% of Econ Healthcare's net tangible assets.[20]

Econ Healthcare said that the rationale for the acquisition of Crosstec shares was to improve yield on idle cash, through dividends and share price appreciation.[21] This was questioned by Professor Mak Yuen Teen, a corporate governance advocate, who pointed out that based on Crosstec's annual reports from FY2016 to FY2021, it had never paid a dividend in all those years.[22]

Econ Healthcare said the investment was made from working capital surplus and not funds raised from the IPO in April 2021.[23] An individual called Dr Chan Yan Chong was said to have introduced Econ Healthcare to Crosstec shares.[24]

Online Chinese forums speculated that Crosstec was part of a pump-and-dump scheme.[25]

An ill-advised investment policy?

In response to SGX queries, Econ Healthcare claimed that it had performed due diligence on Crosstec "based on consideration of publicly available information", such as annual reports and financial statements, prior to its investment.[26] However, this was questioned by Professor Mak, who said:

> "Based on Crosstec's latest annual report for the year ended 30 June 2021, it made a loss attributable to shareholders of HK$11.8 million in FY2021 and a loss of HK$28.2 million in FY2020. It has accumulated losses of HK$21.5 million as at 30 June 2021. Net cash used in operating activities was negative HK$9.3 million for FY2021 and negative HK$9.1 million in FY2020."[27]

Professor Mak also pointed out that Crosstec had announced on 21 December 2021 that its Chairman and CEO had disposed of 45.3 million shares worth over HK$1.8 million on 16 December 2021.[28,29]

While Econ Healthcare said that its reason for investing in Crosstec was to improve idle cash through dividends,[30] Crosstec's annual reports stated that it does not have any pre-determined dividend distribution ratio.[31]

Econ Healthcare had invested in United Overseas Bank Limited (UOB) and DBS Group Holdings Ltd (DBS) prior to its acquisition of Crosstec's shares.[32] These banks had consistently paid out dividends in the past.[33] Econ Healthcare acquired UOB and DBS shares on 11 November 2021 and sold all of them on 6 January 2022. The sale of UOB and DBS shares were on the same date as Econ Healthcare's second purchase of Crosstec shares.[34] Based on the disclosed dates of purchase and sale, Econ Healthcare made an estimated gain of S$44,160 and estimated loss of S$3,080 on its investment in DBS[35] and UOB[36] respectively.

No committee, just the duo

> "The horse has not only bolted, it is lying badly injured. It is far too late for the board to only now consider appointing a third member."
>
> – *Professor Mak Yuen Teen*[37]

On 14 January 2022, Econ Healthcare responded to queries from SGX Regco regarding its Crosstec share trading losses.[38] It mentioned that an investment committee (IC) was formed when making the Crosstec share purchases.

It added that the IC consisted of two members: OCP, who is the IC Chairman, and Kang Shwu Huey (Agnes), who is the Group Chief Financial Officer (CFO). However, Econ Healthcare's response to one of the queries states that the IC "shall comprise at least three persons, comprising (1) the Group CEO who will be the Chairman of the IC and also be responsible for the execution of all approved investments, (2) the Group CFO and (3) other member(s) nominated by the Nominating Committee from time to time".[39] Nevertheless, it noted that any investment decision will still require approval by the board of directors before execution.[40]

With regard to the missing committee member, Econ Healthcare stated that "the board will imminently be undertaking a review of the composition of the IC, including appointing a third member to the IC".[41] This indicates that the board had only started or was still sourcing for a third member of the IC after the Crosstec share trading debacle.[42]

This close to disclosed

Prior to the response to the SGX queries on 14 January 2022, there was no disclosure about the IC in Econ Healthcare's annual report or any announcement. Generally, when a board-level committee is formed, it should be disclosed in the company's annual reports and announced. Additionally, the IC consisted of two key management personnel without any independent directors.

Further, prior to Econ Healthcare investing in Crosstec shares, OCP held shares in Crosstec.[43] He purchased 2.7 million Crosstec shares between 24 November 2021 and 7 January 2022, which were sold on 7 January 2022, the day after Econ Healthcare's second purchase. Subsequently, he purchased 1.2 million shares on 7 January 2022, which were sold on 13 January 2022. The amount of shares repurchased on 7 January 2022 was less than half of what he had sold on the same day.[44]

However, in the company's announcement about the acquisition and disposal of Crosstec shares on 7 January[45] and 9 January 2022,[46] it stated that "to the best knowledge of the directors, none of the directors or controlling shareholders of the company has any interest, direct or indirect, for 5% or more in the acquisitions (other than their respective shareholding interests in the company, if any)."

When the company responded to the queries from SGX, it said:

> "Mr Ong Chu Poh has confirmed that he does not have any relationship with Crosstec, its directors or controlling shareholders."[47]

Professor Mak questioned the disclosures made by the company. He said:

> "This statement is different from the required "disclosure of interest'' statement under Rule 1010(11) of the Catalist Rulebook for discloseable transactions, which requires the disclosure of "whether any director or controlling shareholder has any interest, direct or indirect, in the transaction and the nature of such interests" (emphasis mine). Although this statement is not required for a non-discloseable transaction, it raises the question as to why the company chose to modify the statement in Rule 1010(11). It would seem to imply that one or more directors had an interest in the securities, but it was below 5%."[48]

In the company's response to SGX queries, it stated: "In November 2021, the board authorised Mr Ong Chu Poh, the Executive Chairman and Group CEO and Chairman of the IC, to transact the investment in quoted securities at an amount of S$1.2 million."[49]

The initial investment in Crosstec was also not disclosed to shareholders as Econ Healthcare stated that it was a "non-discloseable transaction" under Chapter 10 of the Catalist Rules.[50] It was not until 9 January 2022 that the company disclosed that its latest acquisitions involved Crosstec shares, when its aggregate cost of investment amounted to 5.2% of Econ Healthcare's market capitalisation and it became a discloseable transaction.[51]

According to Professor Mak: "Since Mr Ong has an interest in Crosstec shares, he should not be involved in the decision to invest at all."[52] He added: "There is a need for Mr Ong to more clearly explain his actions."[53]

Econ Healthcare said that Crosstec was recommended to OCP by “an individual purporting to be Dr Chan Yan Chong”.[54] Dr Chan is an academic who is also an advisor to multiple companies, and a stock commentator.[55] However, other than Econ Healthcare’s response to SGX’s query, there has been no evidence of Dr Chan communicating with Ong Chu Poh, or recommending Crosstec shares. In fact, Dr Chan’s website strongly advised against acting on insiders’ information or rumours without sound analysis.[56]

An unhealthy investment

After the first purchase of Crosstec shares on 24 November 2021, Econ Healthcare’s share price fell from S$0.310 to S$0.295. After the selling and repurchasing of shares on 7 January 2022, the share price briefly rose from S$0.300 to S$0.305 on 10 January 2022. The share price subsequently declined to S$0.245 on 14 January 2022 following the sale of the Crosstec shares.[57]

In the case of OCP, using an average of the closing price of Crosstec shares on 24 November 2021 and 7 January 2022, the estimated purchase cost of his Crosstec shares up to 7 January was HK$4,360,500.[58] Deducting the cost price of his Crosstec shares from the amount received from his sale of shares shows an estimated net gain of HK$1,957,500.

However, OCP purchased additional Crosstec shares on 7 January 2022 at an estimated cost of HK$2,808,000 and sold these shares for an estimated HK$231,600, making a loss of HK$2,576,400 on the subsequent trade.[59] Overall, OCP appeared to have made a net loss of HK$618,900 on his own trading of Crosstec shares.

A “Catalist” for unhealthy listings?

Introduced in 2007, the SGX Catalist Board aims to serve as an alternative listing platform for fast-growing companies.[60] It replaced the earlier SESDAQ board.[61] The Catalist Board is a sponsor-supervised rather than exchange-supervised market.

Under the sponsor-based Catalist Board, there are two types of sponsors: Full Sponsors who generally conduct introducing activities including preparing companies for an IPO on the Catalist Board, and Continuing Sponsors who work with companies on their continuing listing obligations.[62] Unlike the Mainboard, full sponsors determine whether an applicant is suitable to be listed on the Catalist Board.[63] They must continue to serve as the listed company’s continuing sponsor for at least three years after listing.

Who is the sponsor?

> "Our sponsors are the linchpin of the Catalist regime, protecting the interests of both investors and issuers."
>
> – *Tan Boon Gin, CEO of SGX RegCo*[64]

DBS Bank was the Full Sponsor for Econ Healthcare's IPO in 2021 and also the issue manager, underwriter and placement agent.[65] DBS Bank also has a close business relationship as the "principal banker" for Econ Healthcare and had S$5.77 million of loans due from Econ Healthcare, out of the total S$11.2 million outstanding bank borrowings.[66] According to Catalist Rule 204(8), sponsors are required to "be independent of, and have no conflicts of interest with, the entities it sponsors".[67]

The Catalist Rules do not preclude the sponsor or its parent, related or associated entity from engaging in other business activities with the sponsored issuers.[68] This is provided that there are "adequate procedures" to avoid any conflict of interest that may arise from sponsor activities and such other business activities.

As a continuing sponsor, DBS Bank also has significant obligations under the Catalist Rules. Catalist Rule 226(2)(b) requires DBS Bank to review documents released to the market by Econ Healthcare.[69] As noted in the recommendations by SGX, sponsors should make reasonable enquiries and be satisfied that the announcement complies with the Catalist Rules and that proper disclosures have been made, before approving its release in the market.[70]

In the case of Econ Healthcare, DBS Bank includes a statement to the company's announcements and annual report stating that it has been "reviewed by the Sponsor for compliance with the Catalist Rules" as required by Catalist Rule 753(2).[71] However, it also includes an additional caveat, not included under Catalist Rules, that it has "not independently verified the contents of this announcement".[72] Some sponsors do not include this additional disclaimer, and instead follow the standard wording in Catalist Rule 753(2).

Sponsors are also required under Catalist Rules 226(1)(b) and (2)(d) to consider and advise on the "suitability" and "efficacy" of the board and management.[73] Further, if there are doubts as to whether the board has acted in the best interests of the sponsored company, the sponsor is required to query the board for an explanation on its decision.[74] However, there is no requirement for either the sponsor or sponsored company to publicly disclose such discussions and work done by the sponsor.

Following the Econ Healthcare debacle, Professor Mak said: "There is also a need to review the announcements to determine whether the continuing sponsor has discharged its responsibilities."[75]

Pump-and-dump scams

Pump-and-dump scams involve the artificial "pumping" of the prices of a company's shares before "dumping" them on other investors.[76] Syndicates inflate a company share price by buying them in high volumes and spreading false good news regarding the company's prospects through social media, messaging or other broadcasting platforms.[77] Through the use of messaging platforms such as WhatsApp, the syndicate is able to build credibility and trust with would-be victims.[78] Outside investors witnessing such strong prospects and bullish news may be none the wiser and purchase these inflated shares. When the share price grows to a high enough level, the syndicate dumps their shares by selling them to other victims.[79]

Illegal wherever and whenever

According to section 199 of the Securities and Futures Act (SFA):[80]

> "No person shall make a statement, or disseminate information, that is false or misleading in a material particular and is likely –
>
> (a) to induce other persons to subscribe for securities, securities-based derivatives contracts or units in a collective investment scheme;
>
> (b) to induce the sale or purchase of securities, securities-based derivatives contracts or units in a collective investment scheme, by other persons; or
>
> (c) to have the effect (whether significant or otherwise) of raising, lowering, maintaining or stabilising the market price of securities, securities-based derivatives contracts or units in a collective investment scheme,
>
> (d) if, when the person makes the statement or disseminates the information -
>
> (e) the person does not care whether the statement or information is true or false; or
>
> (f) the person knows or ought reasonably to have known that the statement or information is false or misleading in a material particular."

Pump-and-dump scams directly contravene subsections (a), (b) and (c), through the structure in which they are done.[81] The syndicates or persons behind such scams also breach subsection (d) and (e).[82] Additionally, section 339 of the SFA states the extraterritorial provision of the act, whereby a person may be guilty of an offence relating to an act occurring partly in Singapore even though the security is listed on an overseas bourse.[83]

Pump-and-dump scene in Hong Kong

Pump-and-dump scams are thought to be particularly rampant in Hong Kong.[84] In early 2021, Hong Kong cracked down on pump-and-dump syndicates, with large scale raids that resulted in the arrest of a dozen suspects and frozen assets worth HK$860 million (S$150 million). These scams proliferated through messaging apps that further drew in unwitting investors. Thomas Atkinson, Hong Kong's Securities and Futures Commission's enforcement chief, noted that the syndicate's clever impersonations of genuine or well-known market commentators lulls even the most professional of investors.[85]

Nursing itself back to health?

After news of Econ Healthcare's investment losses in Crosstec broke, its share price fell and has not recovered.[86] The company stressed that its core business' growth remains its focus. There have been no changes to its board and management.

In early February 2022, it was reported in the news that Econ Healthcare was involved in the erroneous administration of a fourth dose of the COVID-19 vaccine prior to an elderly individual's death.[87] The Ministry of Health started an investigation into the matter.[88] Preliminary findings have shown that the error likely resulted from vaccine procedure irregularities, and poor communication between the nursing home and the vaccine provider.[89] As of August 2022, there has been no update to this situation.

It would appear that Econ Healthcare needs to get both its wealth and health back on track.

Discussion questions

1. Critically evaluate the board composition of Econ Healthcare based on the Singapore Code of Corporate Governance, and other applicable corporate governance rules and good practices.

2. Critically evaluate the composition of Econ Healthcare's Investment Committee and its investment policy.

3. What are directors' duties and responsibilities with regard to investments in unrelated businesses? Should listed companies like Econ Healthcare be involved in the investment in shares of other unrelated companies? Explain.
4. Do you believe Econ Healthcare's directors discharged their fiduciary duties and/or duty to exercise reasonable diligence with respect to the investment in Crosstec shares? Explain.
5. Critically evaluate the announcements by Econ Healthcare and its responses to SGX queries. Do you believe that there have been breaches in listing rules or securities laws? To what extent should the continuing sponsor be held responsible for any disclosure lapses? Explain.
6. Evaluate the pros and cons of the Catalist Board compared to the Mainboard. What are the general challenges that Catalist-listed companies face? What are possible impediments to sponsors discharging their responsibilities?
7. What are pump-and-dump schemes? What are the associated risks for the individuals and companies involved? Discuss the role of regulators in helping prevent such scams.

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GENTING GROUP: HIGH ROLLERS

Case overview

As a result of the COVID-19 pandemic and the strict border controls implemented by countries worldwide, the tourism and hospitality industries are two sectors which have been impacted most negatively during the pandemic. The principal business of Genting Berhad, the main company under the Genting Group, relates to leisure and hospitality. This includes Genting Malaysia, which operates a premier integrated resort in Malaysia. Other entities in the Genting Group include Genting Singapore and Genting Hong Kong. As Genting Group is highly dependent on tourism, its business has suffered greatly during the COVID-19 pandemic.

In March 2021, the remuneration of the Executive Chairman and independent non-executive directors in Genting Singapore came under the spotlight after the remuneration disclosures in its annual report showed a huge increase in the former's remuneration, while the latter received large increases in performance share awards. This was shortly after the company had announced its worst ever financial performance and implemented job cuts.

The objective of this case study is to facilitate a discussion of issues such as corporate governance in a listed family company; board structure; roles and responsibilities of directors; separation of the role of Chairman and Chief Executive Officer; board remuneration; related party transactions; and risk management.

About Genting Group

Founded in 1965 by the late Malaysian entrepreneur Tan Sri Lim Goh Tong (LGT), the Genting Group was born out of LGT's vision of building a mountaintop resort in Malaysia. Today, it is headquartered in Kuala Lumpur, Malaysia and its businesses span across leisure and hospitality, oil palm plantations, power generation, oil and gas, property development, life sciences and biotechnology. The Genting Group has operations worldwide, including in Malaysia, Singapore, Indonesia, the U.S., the

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U.K., India, and China. Its stated vision is to enhance shareholder value and maintain long-term sustainable growth in its core businesses of leisure and hospitality. [1,2]

The Group comprises the holding company Genting Berhad – an investment holding and management company – and other subsidiaries including Genting Malaysia Berhad (Genting Malaysia) and Genting Singapore Limited (Genting Singapore).[3] Genting Berhad was incorporated in 1968 and listed on the main board of Bursa Malaysia in 1971.[4] The Group is currently led by Chief Executive Officer (CEO) Tan Sri Lim Kok Thay (LKT), son of LGT.[5]

Its core leisure and hospitality business include brands such as Genting, Resorts World, Genting Grand, Genting Club, Crockfords, Maxims, Crystal Cruises, Dream Cruises, and Star Cruises. The Group also has partnerships with well-known international brands such as Universal Studios, Premium Outlets, Zouk, Hard Rock Hotel, and Hilton.[6]

Corporate culture

> "By instilling these core values, the Genting Group will emulate our founder's determination and dedication to achieve the company's goals and bring the organisation to greater heights."
>
> *– Tan Sri Lim Kok Thay, CEO of Genting Group*[7]

According to the Group, its corporate culture is built around five core values:[8] hard work, honesty, harmony, loyalty, and compassion. These ideals, which were adopted from LGT's own personal principles and values – are ingrained in the Genting Group's work culture and business processes. It believes that its culture of hard work, diligence, and commitment would allow it to balance long-term thinking with a mind-set of taking immediate action to solve operational challenges. The Genting Group also believes that it has a responsibility to exercise compassion and give back to society.[9]

The Genting Group's mission is to:[10]

- Be responsive to the changing demands of our customers and excel in providing quality products and services.
- Be committed to innovation and the adoption of new technology to achieve competitive advantage.
- Generate a fair return to shareholders.
- Pursue personnel policies that recognize and reward performance and contribution of employees and provide proper training, development and opportunities for career advancement.
- Be a responsible corporate citizen, committed to enhancing corporate governance and transparency.

Genting Singapore

Genting Singapore, which ultimate holding company is Genting Berhad, was incorporated in 1984 in the Isle of Man and subsequently transferred its registration to Singapore on 1 June 2018. The company was listed on the Main Board of the Singapore Exchange (SGX) on 12 December 2005 and is a constituent stock of the Straits Times Index. It is one of the largest companies in Singapore by market capitalisation. The principal activities of Genting Singapore are in the development, management and operations of integrated resort destinations including gaming, attractions, hospitality, meetings, incentives, conferences and exhibitions (MICE), leisure and entertainment facilities.[11]

Board members at the wheel

As of 2021, the board of directors of Genting Singapore comprises six members, as described in Figure 1.

Name	Position	Background
Tan Sri Lim Kok Thay	Executive Chairman	• Chairman of Genting Singapore since 1 November 1993 and Executive Chairman since 1 September 2005 • Chairman and Chief Executive of Genting Berhad • Deputy Chairman and Chief Executive of Genting Malaysia Berhad • Deputy Chairman and Executive Director of Genting Plantations Berhad • Chairman and CEO of Genting Hong Kong Limited (Genting Hong Kong) • Executive Chairman of Genting UK Plc • Chairman of the Board of Trustees of The Community Chest, Malaysia (TCC), as well as a Founding Member and a Permanent Trustee of TCC
Tan Hee Teck	President and Chief Operating Officer	• CEO of Resorts World at Sentosa Pte. Ltd. (RWS) since 1 January 2007 • Previously Chief Operating Officer and Executive Director of DBS Vickers Securities (Singapore) Pte. Ltd. • Council member and Honorary Treasurer of the Singapore National Employers Federation • Board member and Honorary Secretary of the Singapore Hotel Association • Board member of the Central Provident Fund Board of Singapore

Chan Swee Liang Carolina (Carol Fong)	Lead independent director (since 1 May 2018)	• Group CEO of CGSCIMB Securities Group • Chairman of the SGX Securities Advisory Committee • Experienced in financial markets
Tan Wah Yeow	Independent non-executive director (since 1 November 2017)	• Singapore Singapore's Non-Resident Ambassador to the Kingdom of Norway • Board director of the Public Utilities Board and Housing and Development Board in Singapore • Previously Deputy Managing Partner of KPMG • Chairman of the Institute of Singapore Chartered Accountants Sustainability and Climate Change Committee
Jonathan Asherson	Independent non-executive director (since 12 May 2017)	• Advisor to the Singapore Institute of International Affairs • Previously Regional Director for ASEAN and Asia Pacific at Rolls-Royce plc and Non-Executive Chairman of Rolls-Royce in Asia Pacific • Formerly President of the British Chamber of Commerce in Singapore • Formerly board member of the Economic Development Board of Singapore, the Chairman of the Singapore International Chamber of Commerce, as well as a Council Member of the Singapore Business Federation and the Singapore National Employers' Federation • Experienced in strategy and business leadership with multinational corporations

Hauw Sze Shiung Winston	Independent non-executive director (since 31 July 2020)	• Adjunct Professor (Honorary) of the Department of the Built Environment, College of Design and Engineering, National University of Singapore • Strata Titles Board member • Adjudicator with the Singapore Mediation Centre and an expert panel member of the Singapore International Mediation Centre • Formerly Managing Partner of Rider Levett Bucknall LLP Singapore, Managing Director of RLB Consultancy Pte. Ltd. • Experienced in cost management, quantity surveying, project management and advisory services

Figure 1: Genting Singapore's board of directors as at 30 March 2022[12]

Board independence

The board has two executive directors – the Executive Chairman, and the President and Chief Operating Officer (COO) – and four independent non-executive directors. The board evaluates the independence of each director on an annual basis by considering the views of the Nominating Committee, with reference made to the Singapore Code of Corporate Governance 2018 and the SGX-ST Listing Rules.[13] Additionally, it was disclosed that there were no material relationships between the directors, the company and substantial shareholders, apart from the board's Executive Chairman, LKT, who was disclosed to be a substantial shareholder of Genting Singapore with a direct interest of 0.13% and deemed interest of 52.63% in 2021. The President and COO, Tan Hee Teck (THT), was the 16th largest shareholder, owning 0.14% of Genting Singapore's issued shares in 2021.[14]

The 2021 annual report stated that while LKT holds both the roles of Executive Chairman and CEO, his role was separated from the President and COO, THT. The report disclosed that this would “ensure an appropriate balance of power and authority, increased accountability and greater capacity of the board for independent decision making”.[15] It states that the role of the Executive Chairman is to formulate the Group’s business strategies and policies, ensure effective functioning of the board, and facilitate constructive relations within the board and between the board and management, while the role of the President and COO relates to the Group’s overall business development as well as its day-to-day operations and management.[16] Chan Swee Liang Carolina (CSLC), who is lead independent director, would also step in where the Executive Chairman has a conflict of interest, and can be contacted by shareholders directly should issues with management fail to get resolved.[17]

Board diversity

Genting Singapore stated that it values diversity in its corporate culture and in its board composition. It implemented a board diversity policy which enables the board to appoint directors of various genders, ethnicities, academic qualifications and industrial experiences.[18] For instance, the members of the board of directors in 2021 have diverse experiences in hospitality, leisure, accounting and finance, project and cost management, quantity surveying, as well as entrepreneurship and management. They also possess vast experience in both public service and private companies. With regard to gender diversity, 16.7%, or 1 out of the 6 directors is female.[19]

Board committees

Genting Singapore has three board committees – Audit and Risk Committee, Nominating Committee and Remuneration Committee. The duties of each committee are outlined in the terms of reference and comply with Singapore Code of Corporate Governance 2018 where relevant.[20]

The Audit and Risk Committee is chaired by Tan Wah Yeow (TWY), with CSLC and Hauw Sze Shiung Winston as members. All members of the Audit and Risk Committee are said to have accounting or related financial management experience. The key responsibilities of the Audit and Risk Committee are to review the consolidated annual financial statements and oversee the Group’s risk management process and framework, including the adequacy and effectiveness of internal control and risk management systems. The committee also reviews conflicts of interest and interested person transactions falling within the scope of Chapter 9 of the SGX-ST Listing Rules.[21]

The Chairman of the Nominating Committee is Jonathan Asherson (JA). Its other members are CSLC and TWY. The principal functions of the committee include recommending the appointment of new directors to the board, reviewing the board's succession plans, and evaluating and determining the independence of each non-executive director.[22]

The Remuneration Committee comprises CSLC (Chairman), TWY, and JA. The main responsibilities of the Remuneration Committee are to review and recommend to the board an appropriate remuneration framework and remuneration packages for directors and key management personnel.[23]

Too many roles, too little time?

Genting Singapore acknowledged that while some directors hold positions in the management or boards of other organisations, the Nominating Committee believes that the effectiveness of a director is best assessed by their attendance and contributions at board meetings, their time commitment to the company, as well as the quality of contributions to the board. Thus, the Nominating Committee does not impose a restriction on the maximum number of listed company board representations and other principal commitments that directors can hold outside of the company. That being said, the Nominating Committee reviews each director's existing commitments periodically.[24]

Furthermore, the board does not set any restriction on the maximum number of years independent non-executive directors can sit on Genting Singapore's board. Instead, the board believes that "a more critical consideration in ascertaining the effectiveness of each such director's independence is his/her ability to exercise independence of mind and judgment to act honestly and in the best interests of the company".[25]

Directors' remuneration

Genting Singapore's Performance Shares Scheme (PSS) was approved in 2007 for eligible executives and directors. Under this scheme, the company grants shares to participants at no cost if certain criteria are met. In addition, the company issues both short-term and long-term performance share awards to ensure that "there is equal emphasis on short and longer term performance horizons".[26] The PSS is administered by the Remuneration Committee.[27]

Genting Singapore rewards all its directors with performance shares awards under the PSS and claims to achieve a balance between fixed and variable compensation in its remuneration packages while rewarding performance in order to recruit and retain directors with the relevant abilities and expertise.[28] The directors' remuneration was disclosed in bands of S$250,000 in the annual report as shown in Figure 2, which the company said provided a "sufficient overview".[29]

Name of Director	Fee (%)	Salary (%)	Bonus (%)	Defined Contribution Plan (%)	Benefits-in-kind (%)	Total Remuneration(1) (%)	Share Awards granted under the Performance Share Scheme(2) (%)
Non-Independent Executive Directors							
From $6,000,000 to below $6,250,000							
Tan Sri Lim Kok Thay	0.3	70.7	28.8	0.2	0.0	100.0	750,000
From $4,250,000 to below $4,500,000							
Mr Tan Hee Teck	0.6	58.5	40.5	0.4	0.0	100.0	750,000
Independent Non-Executive Directors							
From $250,000 to below $500,000							
Ms Chan Swee Liang Carolina	100.0	0.0	0.0	0.0	0.0	100.0	125,000
Mr Tan Wah Yeow	100.0	0.0	0.0	0.0	0.0	100.0	125,000
Mr Jonathan Asherson	100.0	0.0	0.0	0.0	0.0	100.0	125,000
From $0 to below $250,000							
Mr Hauw Sze Shiung Winston	100.0	0.0	0.0	0.0	0.0	100.0	125,000

Figure 2: Directors' remuneration packages in 2021[30]

The remuneration saga

On 24 March 2021, Genting Singapore's 2020 annual report was released, indicating that Executive Chairman LKT's 2020 remuneration was in the band of S$21.25 million to S$21.5 million – an amount that was more than double that of his remuneration of S$9.5 to S$9.75 million in 2019.[31] This increase came amidst a sharp decline of 90% in Genting Singapore's full-year net profit to S$69.2 million in 2020 – from S$688.6 million in 2019 – which was termed the "worst financial performance" since the inauguration of Resorts World Sentosa (RWS) in Singapore in 2010.[32] Furthermore, RWS had also announced in July 2020 that as part of cost-cutting measures to cope with the impact of the COVID-19 pandemic, it would make the "difficult decision" to lay off employees. The decision was made after it had eliminated non-essential expenditure and reduced salaries of management by up to 30%. In a statement, Genting Singapore stated that "RWS takes a long-term view of [its] manpower needs, including the consideration to maintain a strong Singaporean core."[33] It was reported that about 2,000 employees were laid off.[34]

Professor Mak Yuen Teen, a corporate governance advocate, flagged his concerns regarding the Executive Chairman's "outrageous" remuneration despite Genting Singapore's poor financial performance in 2020 in an online post on LinkedIn, a professional networking platform.[35] He also questioned why the Executive Chairman and independent directors were awarded performance shares, why LKT's stake in Genting Singapore was not sufficient to align his interest with the company, and whether being awarded a large amount of performance shares would impact the independence of independent directors on Genting Singapore's board. He further commented on the lack of transparency regarding the performance measures and targets used for vesting of performance shares, as well as the scope for improvement for Genting Singapore in terms of its disclosures in its annual report.[36]

A day later, on 25 March 2021, the Singapore Exchange (SGX) issued several queries to Genting Singapore in relation to the remuneration disclosures in its FY2020 annual report.[37]

Genting Singapore's response to SGX's queries

The SGX raised four queries, targeting Genting Singapore's remuneration packages for its directors, especially its Executive Chairman, in FY2020. The queries are as follows:[38]

1. Please elaborate on the company's principle of linking rewards to performance in respect of the doubling of Tan Sri Lim Kok Thay's total remuneration for FY2020 on the back of the fall in net profit of 90%.

2. In view of the fall in net profit, please elaborate how the grant of 750,000 performance shares to Tan Sri Lim Kok Thay in FY2020 is designed to align his interests with those of shareholders.

3. Please elaborate on the grant of the total performance shares to the company's independent and non-executive directors in FY2020 and the Remuneration Committee's views of whether the independence of the company's independent and non-executive directors may be compromised.

4. In view of the financial performance of the group, please provide more insight into how the Group had complied with Principle 7 of the Code of Corporate Governance which requires the level and structure of remuneration of the board and key management personnel to be appropriate and proportionate to the sustained performance and value creation of the company, taking into account the strategic objectives of the company.

Executive Chairman's remuneration

In its response to the SGX queries, Genting Singapore justified LKT's remuneration on the basis that "a significant proportion"[39] of the S$21.25 million to S$21.5 million amount stated was attributable to an accounting accrual in respect of a contingent bonus of S$35 million. The bonus was contingent on Genting Singapore winning a bid for an integrated resort in Japan and would be paid to LKT under a "Chairman's Japan Project Incentive Award".[40] It also clarified that in reality, excluding the accrual, LKT received less than S$5 million in remuneration for the FY2020, representing over a 50% decrease from the previous year.[41]

Attributing the decline in remuneration to the impact of the COVID-19 pandemic on its business, Genting Singapore also mentioned its decision to cancel performance shares granted in 2020, resulting in no performance bonus paid out in FY2020. As such, the 750,000 performance shares granted to LKT in 2020 lapsed in 2021 owing to poor business performance in FY2020. In addition, Genting Singapore also highlighted that LKT has continued to suffer a reduction in basic salary of 30% since March 2020.[42]

Remuneration of independent directors

In 2020, the number of performance shares granted to each of three independent directors increased five-fold to 625,000 shares, compared to 125,000 shares in 2019.[43]

In its response to SGX's queries, Genting Singapore disclosed that the 625,000 PSS awards included 500,000 awards that were 'special incentive awards', for which vesting is conditional on the company being successful in the bid for an integrated resort in Japan and other conditions. These awards would lapse if the conditions were not met. Genting Singapore went on to explain that the rationale of the awards was to recognise the "exceptional contribution" of the independent directors in relation to the submission of a bid for the Japan integrated resort project, as well as for their help with requests for information and proposals over the past year.[44] The remaining 125,000 PSS awards was noted by Genting Singapore to be in line with the number of such awards issued in previous years. The company also highlighted that the previous PSS awards also lapsed due to poor business performance in FY2020.[45] It maintained that granting such special incentive awards to the independent directors "does not compromise their independence" and "is commensurate with their contributions towards the proposed bid for the [integrated resort] project".[46]

Japan integrated resort project: Transparent or translucent?

On 20 January 2020, Genting Singapore announced the convening of an Extraordinary General Meeting (EGM) to obtain shareholders' approval for a proposed bid to build an integrated resort in Yokohama City in Japan.[47] The circular to shareholders detailed that the board believed that the Japan integrated resort project presented a unique opportunity for the company to enhance its growth. The board also sought the approval of shareholders for the special remuneration for the independent directors and the Chairman in connection with the proposed bid.[48]

Resolution one relates to the "development, operation, and/or ownership of an integrated resort in Japan". Resolution two was to approve the proposed grant of special incentive awards pursuant to PSS to independent non-executive directors.[49] If resolution two was passed, an additional 500,000 performance shares, on top of the existing 125,000 shares from the PSS which have also been awarded in prior years[50], would be awarded to Genting Singapore's four independent non-executive directors. These 500,000 performance shares would be considered 'special incentive awards', for which vesting is contingent upon Genting Singapore winning the bid for the Japan integrated resort project. 50% would vest upon Genting Singapore being selected by the Japan local government as an integrated resort operator, while the remaining 50% would vest upon certification of the integrated resort area by Japan's Minister for land, infrastructure, transport and tourism. None of the 'special incentive awards' shares will vest in the event the company is unsuccessful in its bid.[51] The rationale behind the proposed 'special incentive awards' was to recognise the directors' contributions in relation to the submission of the proposed bid for the Japan integrated resort project.[52]

Resolution three was to increase the limit on the maximum number of shares that can be awarded under the PSS to Executive Chairman LKT.[53] Similar to the 'special incentive awards', the board intended to grant an incentive award to the Chairman to recognise his contributions to the submission of the proposed bid for the Japan integrated resort project.[54] The proposed award was a S$35 million bonus, with the payment contingent upon a successful bid for the project.[55] The board intended to grant the incentive award to the Chairman using shares. However, in accordance with the PSS, there was a limit on the number of shares – 7.5 million shares – which could be awarded to the Chairman.[56] The resolution was required to propose an increase in the number of shares to be awarded, to the maximum number of 42,043,314 shares, as permitted under the SGX-ST Listing Manual.[57]

What happened at the EGM?

The EGM was held on 4 February 2020, and the proposed resolutions were put to vote and subsequently duly passed by way of poll. 99.94% of total votes cast were in favour of the proposed bid for the Japan integrated resort project, while 84.76% and 84.74% of votes cast were in favour of the proposed grant of special incentive awards to the independent non-executive directors and increase in limit of PSS awards to Chairman LKT respectively.[58]

The public reacts

The issue of Genting Singapore's 2020 remuneration packages generated a lot of controversy among observers. Netizens voiced their anger and disgruntlement by leaving comments on a Facebook post by local newspaper The Straits Times on how top executives of Genting Singapore could receive "such obscene pay hikes" while simultaneously laying off employees.[59] Due to the unwanted attention generated in the public eye, Genting Singapore held a virtual Annual General Meeting (AGM) on 15 April 2021 as a platform for its shareholders to seek clarification "live".[60] With regard to this decision, Professor Mak said: "I'm glad…that Genting Singapore chose to have live textual Q&A, despite the anticipation of a heated AGM, given the questions relating to its remuneration practices."[61]

Robson Lee, a partner at law firm Gibson Dunn, commented that there is "no one-size-fits-all best practices in determining the compensation packages of senior executives and independent directors." He added that "So long as the structure and system of remuneration and rewards have been fully disclosed to the market, academic commentators should leave it to shareholders to endorse the compensation system, or to give it the thumbs down."[62]

However, while it seems like shareholders were given a choice in determining the remuneration of the directors, Professor Mak pointed out how the shareholders at the EGM were asked to approve the limit of the shares issued to LKT as an increase from 7.5 million shares to 42 million shares in order to satisfy the S$35 million contingent bonus if it eventually becomes payable. In the event that the resolution was not passed, the board would still reserve the right to pay the bonus in cash.[63]

Gaming the rules?

Professor Mak also brought up other pertinent points relating to the two resolutions at the February 2020 EGM in his posts on LinkedIn. He noted that in respect of the final voting results at the 4 February 2020 EGM, only Chairman LKT's direct interest shares had to abstain from the voting of resolution three.[64] Professor Mak mentioned that LKT's deemed interest in Genting Singapore of 6.35 billion shares held by Genting Overseas Holdings Limited (GOHL) was not required to abstain from voting on the resolution.[65] With a total of 12 billion shares outstanding, approximately 6.77 billion shares had voted for the resolution while 1.22 billion shares had voted against the resolution. Professor Mak inferred that it appeared that GOHL had voted for the resolution as it was not required to abstain from voting. If so, if GOHL's votes were excluded from the vote tally, the number of shares which had voted for and against resolution three would be 424 million and 1.22 billion respectively,[66] suggesting that resolution three would not have passed.

The fact that "if GOHL's votes were not counted towards the resolution, the resolution would not have passed" was subsequently confirmed during Genting Singapore's 2021 AGM on 15 April 2021.[67] Genting Singapore acknowledged SGX's feedback that the resolution should have been voted on by only independent shareholders and therefore it would not regard resolution three as having been approved. Nonetheless, Genting Singapore indicated that it would continue to accrue for the Chairman's contingent bonus.[68]

According to SGX's Mainboard Listing Rules paragraph 854, "any grant of options to a director or employee of the issuer's parent company and its subsidiaries that, together with options already granted to the person under the scheme, represents 5% or more of the total number of options available to such directors and employees, must be approved by independent shareholders".[69] Given that Chairman LKT was the controlling shareholder of Genting Berhad – the ultimate parent of both GOHL and Genting Singapore – GOHL would not be considered as an independent shareholder.

Genting Hong Kong: The sale of Zouk

There was another entity in the Genting Group which made headlines in 2020. Headquartered in Hong Kong, Genting Hong Kong Limited (Genting Hong Kong) is a holding company under the Genting Group that operates cruise and resort businesses. Its cruise lines include Star Cruises, Dream Cruises, and Crystal Cruises. Genting Hong Kong is listed on the Main Board of the Stock Exchange of Hong Kong.[70] LKT is the Chairman of the Genting Group as well as Chairman and majority shareholder of Genting Hong Kong with 69% ownership as of April 2020.[71] Lim Keong Hui (LKH), LKT's son, held the positions of executive director and Deputy CEO of Genting Hong Kong since 2013 and March 2019 respectively.[72]

On 28 August 2020, LKH stepped down as executive director and Deputy CEO "to devote more time to other business commitments" in view of the fact that he is the Deputy CEO of Genting Berhad, Genting Malaysia, and Genting Plantations Berhad as well. LKH confirmed that he had no disagreement with the board and there was no matter in relation to his resignation which needed to be brought to the attention of Genting Hong Kong's shareholders.[73]

On 1 September 2020, just days after LKH's resignation, Genting Hong Kong sold the Zouk Group – which operates the popular Zouk nightclub – to Tulipa Group (Tulipa). This was said to be part of Genting Hong Kong's efforts to offload non-core assets and generate liquidity as the company's cash flow was heavily impacted by the COVID-19 pandemic. Pending the resumption of cruise operations, the sale would help Genting Hong Kong to conserve cash and serves as an additional source of finance to sustain the business. It was reported that in August 2020, LKT pledged almost his entire stake in Genting Hong Kong as collateral for loans after the company suspended payments to creditors in August 2020 to "preserve services critical to the company's operations".[74,75] Malaysian firm Tulipa is solely owned by LKH.[76]

The total consideration for the sale shares was valued at S$14 million, though the final amount was subject to adjustment based on Zouk's cash level. The cash sale of Zouk Group would result in a gain of about HK$6.7 million (S$1.2 million) for Genting Hong Kong, which would be used as working capital.[77] Although it would be under a new management, Zouk would not change its operations and business directions previously set under the management of Genting Hong Kong.[78]

Re-designation of roles or titles?

In 2020, there were also a number of re-designations of roles within the Genting Group.

Genting Malaysia

On 27 August 2020, LKT was re-designated as Deputy Chairman and CEO of Genting Malaysia. Prior to this re-designation, he held the role of the Chairman and CEO. Tan Sri Dato' Seri Alwi Jantan (SAJ) then became Non-Executive Chairman of Genting Malaysia. Before the re-designation, he was the Deputy Chairman and independent non-executive director since 1 January 2019.[79] This re-designation was for the company to be in line with Malaysia's corporate governance guidelines, which state that the positions of Chairman and CEO should be held by different individuals.[80]

Genting Hong Kong

In respect of Genting Hong Kong, the board decided that LKT should still remain as Chairman and CEO. In the company's 2020 annual report, the board deemed that it was appropriate for LKT to continue holding these two roles due to the following reasons:[81]

1. LKT has been with the Group since the formation of the company in 1993;

2. LKT has considerable experience in the leisure and entertainment industry; and

3. LKT provides leadership for the board in considering and setting the overall strategies and objectives of the company.

After LKH's resignation as Deputy CEO and executive director on 28 August 2020, Au Fook Yew (AFY) was appointed as Deputy CEO and executive director, while Chan Kam Hing Chris (CKHC) was also appointed as an executive director.[82] AFY had served as the Group President since March 2017. He was the founding President and CEO of the company, which pioneered the Asian cruise business close to three decades ago. CKHC had served as the company's Chief Financial Officer since December 2017 and was responsible for internal controls, accounting, corporate finance, treasury management, and other Group financial and corporate functions.[83]

Moving forward

On 22 August 2021, Genting Singapore's dream of clinching an integrated resort bid in Yokohama seemed to be dashed due to the victory of anti-integrated resort campaigner – former Yokohama City university professor Takeharu Yamanaka – in the Yokohama mayoral election. The newly elected mayor had promised to "end Yokohama's [integrated resort] bid, having described casinos as a 'poison apple'".[84]

Subsequently, an official cancellation of the integrated resort bid process by Yokohama City in September left Genting Singapore "surprised and disappointed by the unexpected turn of events leading to the city's decision to cancel the Yokohama [integrated resort] bid".[85] However, Public Investment Bank Bhd analyst Eltricia Foong suggested that Genting would not be impacted by the cancellation of the integrated resort project.[86] She added that "Genting Singapore should deliver better performance as Singapore has been able to control the spread of COVID-19 relatively well compared to its regional peers".[87] Tellimer analyst Nirgunan Tiruchelvam agreed, saying that Genting Singapore's Q2 2022 results "showed that the recovery was in full swing".[88]

Abandoned assets

In January 2022, following failed last-minute talks between the German authorities and Genting Hong Kong, MV Werften and Lloyd Werft – Genting Hong Kong's indirect wholly owned shipbuilding subsidiaries – filed for insolvency in Germany.[89] MV Werften operated three shipyards in the German federal state of Mecklenburg-Vorpommern,[90] while Lloyd Werft in Bremerhaven was one of the oldest German shipyards in operation, with its heritage dating back to 1857.[91]

In respect of MV Werften, the impasse arose over the financial contributions and guarantees the German federal government requested from Genting. The state of Mecklenburg-Vorpommern had previously provided bridge loans in 2020 to complete an expedition cruise ship for Genting's Crystal Cruises. In June 2021, it was announced that the German federal and state governments had developed a new package to restructure the shipyard operations in order to complete construction on the first of two Global Dream cruise ships.[92] The package was restructured several times,[93] though eventually a US$678 million bailout by the German government that required Genting to put up 10% of the capital – down from the original 20% requirement under the federal government Economic Stabilization Fund[94] as it sought a compromise in the face of massive job losses[95] – fell through.[96] It was reported that Genting Hong Kong "had not been able or willing to co-fund the state money with its funds at a 10% rate".[97]

IG Metall, Germany's largest union criticised the "exhaustion of trust" between the two negotiators, and called the collapse of MV Werften a "dark day for shipbuilding".[98] The closure of the shipyards resulted in many job losses in Germany and caused huge anger. It was reported that Germany's federal government blamed Genting Hong Kong for MV Werften's insolvency and the resultant 1,900 jobs lost, criticising the company's rejection of its offer of aid.[99] Economy and Climate Minister Robert Habeck said that the government had "pulled out all the stops" to avoid MV Werften filing for bankruptcy.[100] An administrator was subsequently appointed by the courts, with the main aim to pay the outstanding worker salaries and complete the construction of Global Dream.[101]

Slightly over a week later, following the insolvency of its German shipbuilding subsidiaries, Genting Hong Kong – which owns Star Cruises, Dream Cruises and Crystal Cruises – filed to wind up the company at the Supreme Court of Bermuda. Genting Hong Kong reportedly "exhausted all reasonable efforts" to negotiate with its creditors and stakeholders but failed to secure funding to help it stay afloat. In an exchange filing, Genting Hong Kong also disclosed that a German court had rejected its application that would have given MV Werften access to a US$88 million lifeline.[102] The collapse of Genting Hong Kong was reported to be the cruise industry's highest-profile casualty since the start of the COVID-19 pandemic.[103]

After its parent company – Genting Hong Kong – folded, cruise operator Dream Cruises applied to be wound up with the Bermuda courts on 27 January 2022. It appointed joint provisional liquidators to develop and propose any restructuring plans in respect of Dream Cruises' debts and liabilities as restructuring would offer "higher recoveries to all creditors and stakeholders" compared to liquidation.[104] As a result, it stopped operations of its cruise ship, World Dream, in Singapore, and left thousands of customers demanding refunds.[105]

A fresh start

On 9 March 2022, LKT reportedly registered a new company, Resorts World Cruises (RWC), in Singapore. RWC's parent company is Two Trees Family – an investment holding company incorporated in Singapore on 19 March 2021 – with LKT, LKH, and Gerard Lim Ewe Keng as directors. RWC swiftly stepped in to offer credits to customers affected by World Dream's cruise cancellations in Singapore. The new company also deployed Genting Dream – a cruise ship previously operated by Dream Cruises – for cruise trips, and planned to increase its fleet in the future.[106]

Observers have questioned the motive of setting up RWC,[107,108] which has been branded as "a new Asian luxury and dynamic lifestyle cruise brand".[109] They commented that it allowed LKT to restart its cruise business at a lower cost, and questioned whether he would still be motivated to "revive Genting Hong Kong and take on its remaining debts".[110] Furthermore, RWC has reportedly been in negotiations to acquire World Dream and Explore Dream, two other cruise ships previously operated by Dream Cruises.[111] The Edge Malaysia went so far as to call the restructuring "more of asset disposal at cheap prices than anything else".[112]

As the world adapts to the aftermath of the COVID-19 pandemic, there is some good news for the Genting Group on the horizon. It welcomed a strong response for its cruise offerings from both the local and international markets and plans to go full steam ahead with more trips to international destinations.[113]

Discussion questions

1. Discuss the roles that social media and traditional media play in promoting good corporate governance or in exposing corporate governance issues that may otherwise remain hidden in companies.
2. Discuss areas where Genting Singapore can improve with regard to its corporate governance practices.
3. Critically evaluate the appropriateness of the "contingent bonus" payable to the Executive Chairman of Genting Singapore and the special share awards payable to the independent directors that were tied to the successful bid for the Yokohama integrated resort project. Could the latter compromise the independence of the independent directors? Explain.
4. Should the remuneration of independent directors be linked to outcomes such as winning projects, improving profits or increasing share price? Explain. Non-executive directors may be required under certain circumstances, such as when a company is undertaking mergers and acquisitions, to spend additional time to perform their duties. How should these directors be remunerated under such circumstances?

5. Unlike related party transactions exceeding certain thresholds requiring shareholder approval, executive remuneration is not subject to shareholder approval in markets such as Singapore, Malaysia and Hong Kong, even if the recipients of the remuneration are major shareholders or their family members. Should the remuneration of executive directors in general or under specific circumstances be subject to shareholders' approval? What are the rules in markets such as Australia, the U.K. and the U.S.? Should countries like Singapore, Malaysia and Hong Kong adopt similar rules?

6. Discuss the events that transpired at Genting Singapore's Extraordinary General Meeting in February 2020. What corporate governance issues were raised?

7. What is a related party transaction? Do you think the sale of Zouk Group by Genting Hong Kong to Tulipa Group is a related party transaction? In your market, what are the rules that apply to such transactions?

8. Evaluate the actions of Genting Hong Kong and the major shareholders of the Genting group of companies with respect to the collapse of the German shipyards, the winding up of Genting Hong Kong and the formation of the new company, Resorts World Cruises, to restart the cruise business, from legal and ethical perspectives. To what extent does the limited liability and separate legal entity of a company facilitate such actions and what are the pros and cons from a stakeholders' perspective?

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G.H.Y. CULTURE & MEDIA: MAKING MOVIES

Case overview

In December 2020, G.H.Y. Culture & Media (GHY) became the first company with a variable interest entity (VIE) structure to list on the Singapore Exchange. With the "King of Legendary Drama" Guo Jingyu helming the company and having purportedly sound financials, GHY screamed "buy". The shares publicly available for subscription were oversubscribed by around 16 times. Shortly after its Initial Public Offering, GHY reported that its net profits for FY2020 had increased by more than threefold compared to FY2019.

However, within one year, GHY's net profits were reported to have declined by over 91% in FY2021. Although GHY attributed this sharp decline to the impacts arising from the COVID-19 pandemic, closer scrutiny of the company reveals several red flags that raise the question as to whether investors and regulators should have seen this coming.

The objective of this case study is to facilitate a discussion of issues such as board composition; board independence; keyman risks; corporate governance and accounting risks associated with the VIE structure and PRC companies; role of issue managers and underwriters; and share buybacks.

Opening act

G.H.Y. Culture & Media Holding Co Limited., together with its subsidiaries and affiliated entities (GHY), is an entertainment company active in the Asia-Pacific region. GHY is currently headquartered in both Singapore and China with over 170 employees from regions such as Singapore, Malaysia, China, and Australia. The Group deals in a myriad of businesses related to the entertainment sector, ranging from TV programs and film productions to concert productions and talent management services.[1]

This case was prepared by Liau G Kent, Sheryl Lee Wen Xin, Sheryl Lee Wen Xin, Wang Chun Min, Xan Awe De Hui and Yiu Bin Hong. It was substantially re-written with additional information added by Professor Mak Yuen Teen, and edited by Isabella Ow under the supervision of Professor Mak. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees.

On 18 December 2020, GHY became the first company listed on the Singapore Exchange (SGX) with a variable interest entity (VIE) structure.[2] DBS Bank and UOB Kay Hian (UOBKH) were appointed as joint issue managers and global coordinators, as well as joint underwriters and bookrunners for the Initial Public Offering (IPO).[3]

GHY was so popular that the shares available for subscription by the public was oversubscribed by approximately 16 times.[4] It began its first day of trading with much fanfare, trading at S$0.70 or 6.1% higher than its IPO price.[5]

Helmed by the "King of Legendary Drama" Guo Jingyu (Guo), GHY's prospectus claims that its key strengths include its ability to "produce high-quality and well-received dramas and films" which was anchored by its "talented scriptwriting team and end-to-end production capabilities".[6] GHY also has big plans for the future, with SGX's head of global sales and origination stating that GHY intends to leverage technology to diversify into new media such as interactive drama.[7]

However, since its IPO, GHY's net profit has declined by 72% from S$12,434,000 in 2019[8] to S$3,468,000 by 2021.[9] Similarly, its share price has since steadily dropped, reaching a low of S$0.395 by the end of February 2022 although it has since increased back to S$0.47 in August 2022. GHY's high profile deal to acquire a majority stake in Clover Films Group also fell through.[10]

What happened?

I come from Perfect World

In May 2017, Guo, still an employee of Perfect World Pictures (Singapore) Pte. Ltd (Perfect World), decided that he wanted to explore the media and entertainment industry in Singapore. Hence, concurrent to his employment in Perfect World, Guo was appointed as the sole director of GHY Culture & Media (Singapore) Pte. Ltd. (GHY Singapore), incorporated by John Ho Ah Huat (Ho) and his spouse, Lian Lee Lee (Lian).[11]

In September 2017, Perfect World acquired 60% of the shares of GHY Singapore through its subsidiary, Perfect Credit Pictures (Singapore) Pte Ltd. Guo left Perfect World in December 2018, at which point GHY had been incorporated for seven months. Guo apparently "agreed with Perfect World amicably" that he would make decisions for GHY Singapore as an individual, without any employment ties, to focus on GHY. As of March 2022, Guo did not have any shareholding interest in Perfect World.[12]

After the incorporation of GHY on 29 May 2018, GHY acquired GHY Singapore from various shareholders. Despite holding no shares in GHY Singapore, Guo had a 64% shareholding in GHY upon its inception. Alongside him were Yang Jun Rong (Yang), Ho, Lian, and Perfect World respectively holding 8%, 13%, 3% and 12% of shares in GHY. Following this, Perfect World's shareholding was reduced to 2.2% in December 2019 after GHY repurchased a portion of its shares.[13]

After letting go of Perfect World, GHY underwent a rebranding to demonstrate the change in control and explicitly separate the two entities. Despite efforts to identify GHY as a separate entity from Perfect World, the companies remain closely tied to each other through production collaborations, not to mention that several members of GHY's board of directors had been employees of Perfect World.[14]

For instance, Guo was an employee of Perfect World from March 2011 to March 2018. His spouse, current executive director (ED) Yue Lina (Yue), current senior director of TV program and film production Xue Xin (Xue), and current ED Wang Qing (Wang) had all left Perfect World in March 2019 to join GHY. Additionally, newly appointed non-executive director (NED) Zeng Yingxue (Zeng), remains an ED and Chief Financial Officer (CFO) of Perfect World Holding Co. Ltd, as well as the senior vice president of Perfect World Co. Ltd.[15] Interestingly, GHY defends this choice extensively in its prospectus and even lists "We are dependent on our key management team for our continued success and growth" as one of its key risks.[16]

Ho initially acquired 10.45% of GHY shares in December 2020,[17] which gradually increased to a total of 10.55% of shares on 1 March 2021.[18] Ho and his wife, Lian, had together incorporated the original GHY Singapore, which was later acquired by GHY. Meanwhile, Lian holds 2.79% of GHY shares.[19]

Guo's Perfect World

Guo is both GHY's Executive Chairman and Group Chief Executive Officer (CEO). He is also the controlling shareholder of GHY, owning 59.6% of the shares.

Yue, Guo's wife, was appointed to the GHY board on 23 November 2020. She is responsible for the promotion and distribution of the Group's drama and film projects and is an established actress with decades of experience in the drama and film industry. She also acts as a joint guarantor for some of the company's loans and is also an ED on the board.[20] She also starred in a few dramas and movies produced by GHY.[21]

Guo's brother, Yang Zhigang, is also an actor managed by the Group's talent management services business and acts in the Group's drama and film projects. Yang Zhigang plays the lead role in many of Guo's productions but has been criticised by netizens for not having acting skills.[22]

Main or supporting actor?

Ho – who was also instrumental in the founding of the company – is GHY's group adviser and its substantial shareholder. As group adviser, his role is to provide advisory services in identifying potential business opportunities and general advice concerning the business operations of the Group by introducing business contacts and potential business opportunities. Under the service agreement signed with the company, which is automatically renewed annually unless terminated in accordance with the terms, Ho is paid a monthly fee of not more than S$30,000.[23] According to the prospectus, Ho is not involved in the day-to-day operations and does not participate in the execution or implementation of business strategies.

In October 2011, disciplinary action was taken by SGX against Ho for his involvement in questionable transactions at Catalist-listed Scorpio East Holdings Ltd (Scorpio East) while he was CEO and ED.[24] Ho was placed on the directors' and executive officers' watch-list by SGX RegCo, following a reprimand against company Scorpio East and several directors – including Ho – for breaching listing rules and other corporate governance failures.[25] The reprimand said that he had "not demonstrated the qualities expected of directors and management of SGX-listed companies" and failed to act in the interests of shareholders as a whole. Several contracts that Scorpio East had entered into were terminated without the approval or knowledge of the board, and were not announced. There were also "round-tripping" of cash, proposed material remittances without proper due diligence, doubts about the veracity of contracts, and a lack of proper internal controls. Ho had taken steps to terminate the contracts without board approval and after he had stepped down as CEO and ED to become a consultant. He had directed the finance staff to issue receipts for the terminated contracts arising from the "round-tripping" transactions despite his knowledge that no such refunds had been made.[26]

Board or movie director?

At the time of listing, GHY had a nine-member board.

Guo, 47 years old, is the Executive Chairman and Group CEO, but his prior experience as a director was of a different type. According to the prospectus: "Guo is responsible for supervising the overall business operations and management of our Group, as well as business strategies and providing executive leadership and supervision to the senior management team. He is also responsible for directing and producing the drama, film and online video series projects produced by our Group… Guo has more than 25 years of experience as a producer, director and scriptwriter with Perfect World…"[27] However, Guo did not have any experience as a director or a CEO of a public-listed company prior to his appointment at GHY.

The statements made by the board and Nominating Committee (NC) justifying Guo's suitability as the Executive Chairman and Group CEO were questioned by Professor Mak Yuen Teen, a corporate governance advocate.[28] He also questioned the claims that Guo "only retains supervisory oversight in the drama and film projects" of the Group and is "not involved in the operational aspects thereof" as the prospectus lists the "strong in-house script production team" co-led by Guo as one of the company's competitive strengths, and said that Guo spearheads the group's TV program and film production business.[29] Professor Mak said that leading the script production team and the Group's TV program and film production business sounded like extensive involvement in operations.[30]

Guo's spouse, 46 year-old Yue, is an ED and was described as "an established executive producer and actress with over 20 years of experience in the drama and film industry. Prior to joining our Group, she was an artistic director with Perfect World…". Wang, another ED, was "responsible for overseeing the accounts functions of the PRC entities of our Group." She was 42 years old.[31]

Like Guo, Yue and Wang did not have prior experience as directors of listed companies, nor did Yang, a non-independent non-executive director (NINED).[32]

Supporting cast

The other five directors were independent directors (IDs). Yeo Guat Kwang (Yeo), 59, is the lead ID and Chairman of the NC. He was a former Singapore Member of Parliament (MP) for 18 years, and has extensive prior experience as a director of listed companies in Singapore. Professor Mak pointed out that according to the prospectus, prior to its listing, GHY had entered into a service agreement with Yeo on 1 September 2017 for the provision of advisory services to the Group for the period from 1 September 2017 to 31 December 2019. He received a monthly fee of S$10,000 in respect of such advisory services and was paid S$40,000 in FY2017, S$120,000 in FY2018 and S$120,000 in FY2019. The prospectus said that the advisory services "related primarily to his business and working experience, as our Group had sought to tap into his business network and contacts in Singapore to facilitate and to act as a springboard, where relevant, for the business operations of our Group in Singapore". [33]

Professor Mak also questioned GHY's statement in the Corporate Governance Report of its FY2020 annual report, which stated: "As at the date of this report, there is no relationship or circumstance set forth in Provision 2.1 of the Code which puts the independence of the independent directors in question." He asked: "Since Mr Yeo provided advisory services for FY2019 and was paid S$120,000, why was this not disclosed?"[34]

The other two Singaporean IDs – 63 year-old Ang Chun Giap (Ang), who was Chairman of the Audit and Risk Management Committee (ARMC), and 64 year-old Sng Peng Chye (Sng), Chairman of the Remuneration Committee (RC), have prior experience as directors of listed companies in Singapore. Ang has accounting, auditing, finance and management experience, while Sng has extensive banking experience.[35]

The remaining two IDs, 57 year-old Chen Mingyu (Chen) and 55 year-old Jiang Mingua (Jiang), are based in PRC, and have some past or current experience as listed company directors in PRC. Chen is managing partner of a business consulting firm specialising in finance, tax and business advisory services. He was a former partner of Deloitte, EY and KPMG in PRC, providing advice on cross-border M&A transactions, enterprise valuation, and in other areas. Jiang is a professor in Guanghua School of Management at Peking University, where he teaches marketing and brand management.[36]

The ninth director, 57 year-old Yang, is the only NINED on the board. He is said to be "an established music album producer with more than 20 years of experience in the music industry" and is manager of Jay Chou, a well-known Taiwanese musician and singer-songwriter.[37]

Of the nine directors, there are two female directors, Yue and Wang, who are both EDs.

New cast members

Unfortunately, one of the IDs, Sng, passed away in August 2021.[38] On 28 January 2022, GHY appointed two new IDs and a NINED.

One new ID is 50 year-old Singaporean, Shamsul Kamar Bin Mohamed Razali, who is currently an ID of another SGX-listed company, Advancer Global Limited. Prior to this, he did not serve on any listed boards. Like Yeo, he was a former MP, serving from 2006 to 2015.[39]

Another new ID is Li Qi (Li), who is 61. Li is resident in China and is an Associate Professor at Guanghua School of Management at Peking University. He has a Bachelor of Economics degree from Peking University and a doctorate degree in Social and Economic Sciences from Vienna University of Economics and Business.[40]

Zeng, 52, who was appointed as NINED, is said to have 17 years of experience in the media and entertainment industry. Also resident in China, she is a China certified public accountant and has a Master of Business Administration from the National University of Singapore. She holds various management positions in several Perfect World companies and their subsidiaries, including being an ED and CFO of Perfect World Holding Co., Ltd. and its subsidiaries. In the appointment announcement, GHY said that she has a duty to disclose the interests of Perfect World Group in any matter in which the latter has any material interest and will abstain from deliberating and participating in any proceedings in such cases. The company said that "her experience in business development and familiarity with the nature of the businesses of the Group would likely contribute positively to the growth and business strategies of the Group". It also said her appointment "will also enhance the gender diversity on the board which optimises performance and long-term value."[41]

Following the changes to the board, it has 11 board members with three being female.

Rare appearances

During FY2021, the board of directors met twice, the ARMC and NC met three times, while the RC met once.[42]

The company only disclosed the remuneration in bands for the three EDs (S$250,000 to S$500,000) and five IDs and single NINED (below S$250,000). It said that the total remuneration paid to the directors for FY2021 was approximately S$307,000, although this clearly excludes the remuneration of the three EDs.[43] At the AGM held in April 2022, GHY sought shareholders' approval for payment of director fees of S$410,000 for the year ending 31 December 2022.[44]

"Independent" spouse

In May 2021, Lian was appointed as Group Deputy CEO of GHY. Lian had previously served as the NED of Scorpio East, although she was not subjected to SGX Regco's disciplinary action.[45]

Since Ho was on SGX's watch-list for directors and key officers, he was not permitted to be appointed as a director or member of the management of any SGX-listed companies without prior approval from the SGX.

In GHY's prospectus, Ho provided an undertaking, which disclosed the facts regarding Ho's directorship in Scorpio and the reprimand. In the prospectus, GHY's NC stated that "none of Mr John Ho and/or his nominees will be appointed as a director or executive officer of any of the entities in our Group [...]. If any associate of Mr John Ho proposes to be a director or executive officer of our company or our Group, our Nominating Committee will assess that such relevant associate possesses the relevant experience, expertise, qualification, character and integrity to perform the proposed role as a director or executive officer and will ensure that an announcement is made on the SGXNET, [...]."[46]

SGX noted that since Lian is Ho's wife, disclosure was required regarding the assessment of whether the undertaking was complied with. The appointment was questioned by Professor Mak due to the relationship between Ho and Lian and the undertaking provided in the prospectus.[47]

In response, GHY stated that the undertaking was put in place to prevent Ho from being appointed or from appointing a nominee on the board or management of GHY.[48] It explained that Lian was not a "nominee" of Ho, but an "associate", and that "a distinction should be drawn between the definition[s]". It added that "none of Mr Ho's associates, which in this case refers to his immediate family [...], are named in the SGX-ST's watch-list".[49]

On this basis, the company argued that immediate family are "separate and independent persons", and "should not be deemed to be his nominees or representatives solely by virtue of the fact that they are his immediate family members".[50] GHY also pointed out Lian's "vast working experience" and "leadership roles" which "would require Ms Lian to exercise independent decision-making".[51]

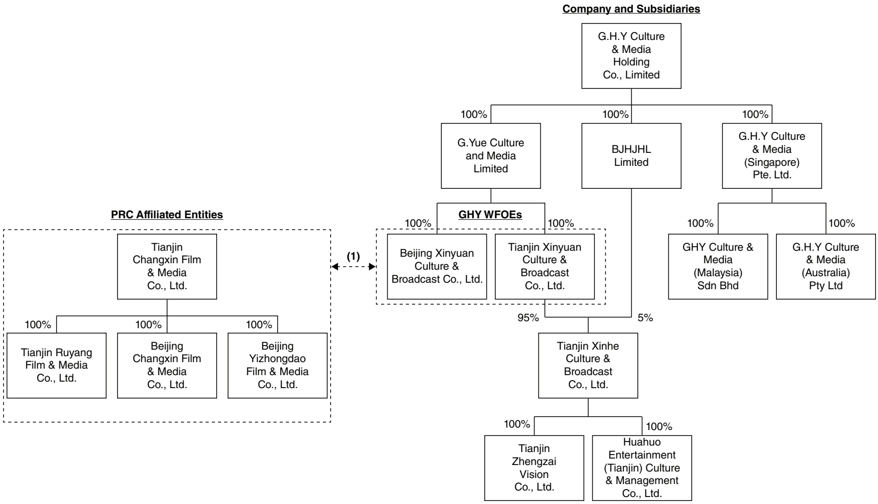
Professor Mak questioned the NC's assessment of whether Lian acts independently and is a nominee of her spouse. The company had said in response to SGX's queries: "As stated in the announcement dated 14 May 2021, the NC had conducted an interview with Ms Lian and assessed that she acts independently and does not act under the direction, control or influence of any party, nor is she a nominee of any party, including Mr Ho."[52]

Professor Mak said: "However, the company did not explain how the NC could have reached that conclusion on the basis of an interview or by whatever other means. Perhaps the NC could shed more light on this, which I had also asked in my previous post, including what steps have the NC and board taken to ensure that this is the case and continues to be so?"[53]

Great Wall of China

China has a 'Negative List' of several industries that foreign investors are forbidden from investing in, based on China's national interest or public interest.[54] The list includes industries ranging from mining and tobacco to news companies. "Investment in film production companies, distribution companies, cinema companies, and film importation businesses" is also prohibited for foreign investors.[55]

To overcome such restrictions, companies such as GHY use the VIE structure to allow foreign investors to invest. Figure 1 shows the VIE structure used by GHY.



Note:

(1) Our Company, through our GHY WFOEs, has entered into Contractual Arrangements with the Individual Shareholders and each of our PRC Affiliated Entities, under which our Group is conferred operational control and economic rights over our PRC Affiliated Entities which allow our Group to exercise control over the business operations of each of our PRC Affiliated Entities and enjoy substantially all the economic rights arising from the business of our PRC Affiliated Entities. See the section entitled “Corporate Structure and Ownership – Contractual Arrangements in respect of our PRC Affiliated Entities” of this Prospectus for further information.

Figure 1: GHY’s VIE structure[56]

Under a VIE structure, foreign investors and PRC individuals will first incorporate a special purpose vehicle (SPV) in jurisdictions such as the Cayman Islands to take advantage of its taxation and confidentiality policies and regulations.[57] The SPV will then create another SPV, often in Hong Kong, to not only create an additional layer of liability protection[58] but also leverage Hong Kong’s favourable corporate structure and taxation policies.[59] The Hong Kong SPV will then create a wholly foreign-owned enterprise (WFOE) in China. Due to the restrictions on foreign investment, the WFOE will be unable to obtain the license needed to operate in the restricted industries. To circumvent this, the WFOE will then rely on several contractual arrangements such as pledge agreements or call option agreements to essentially maintain control over a domestic China company that has the necessary operating licenses.[60]

The SPV incorporated in the Cayman Islands will then be listed on foreign stock exchanges such as the New York Stock Exchange or in GHY’s case, SGX. Despite the arduous process, VIEs are very common and are used by major Chinese companies such as Alibaba and JD.com. It was found that in 2017, of the US$700 billion worth of Chinese companies’ shares held by U.S. investors, US$477 billion related to shell companies based in the Cayman Islands.[61]

GHY follows a similar structure whereby a Cayman Islands-incorporated holding company is listed on SGX.[62] To circumvent the restrictions highlighted above, GHY similarly created a Chinese entity named Tianjin Changxin Film & Media Co., Ltd. (TCFMC).[63] However, given that film is a restricted industry, GHY is unable to hold any shares in TCFMC. Instead, TCFMC is controlled by GHY through a series of contractual agreements between TCFMC and the WFOEs incorporated by GHY.

The potentially significant risks associated with investing in companies that utilise the VIE structure, such as GHY, are sometimes overlooked. Recently, China's rapidly changing regulatory environment has come under the spotlight due to its crackdown on the Chinese tech sector that wiped out large portions of the sector's market value.[64]

As VIEs are essentially a legal loophole used to circumvent China's laws to allow foreign investors to invest in China, VIEs are often described as a structure that falls into a legally grey area.[65] As such, given that the very existence of VIE relies on contractual agreements, the fact that Chinese law states that any contract intended to avoid a law is unenforceable could potentially render an investor's entire investment to become worthless.[66] GHY's prospectus specifically states that if China's government were to deem the VIE structure as non-compliant, GHY could potentially be subject to severe penalties or be forced to relinquish its interests in its operations in China.[67]

GHY's prospectus outlines several other potential risks of the VIE structure. For instance, if GHY's affiliated entities in China were to declare themselves bankrupt or enter liquidation or dissolution proceedings, GHY might lose the right to use or benefit from the licenses and assets of the affiliated entities.[68] This is a major risk given that the vast majority of GHY's profits come from the Chinese market.[69]

Likewise, the Chinese government may potentially deem the contractual arrangements underpinning the VIE structure as agreements that were not entered into on an arm's length basis, or agreements that result in prohibited tax reductions. The Chinese government may then choose to impose significant penalties on GHY through transfer pricing adjustments or late payment fees.[70] Although the China Securities Regulatory Commission has recently issued draft rules that would clarify its position on VIEs,[71] it remains to be seen whether these draft rules will eventually be passed.

Likewise, the multi-layered corporate structure made up of many legal entities incorporated in different countries produces compliance and complexity risks for the Group. Legal and compliance requirements are different for different countries. For example, the ultimate parent company is incorporated in the Cayman Islands but is publicly-listed in Singapore. It is therefore not subject to Singapore's Companies Act but is instead subject to the Companies Act in Cayman Islands. One example of differences between the two sets of company legislation is that details of shareholders need not be filed with the Cayman Islands Registrar of Companies under the Cayman legislation[72] while under the Singapore Companies Act, all types of companies require these details to be filed with the Accounting and Corporate Regulatory Authority of Singapore (ACRA).[73]

Guarding the wall

According to China's Company Law, every business established in China must appoint a legal representative.[74] The role is a vital one because the legal representative holds the company's chop which serves as an affirmative signature that grants its holder the authority to execute the powers and duties of the company. However, given that the legal representative has the discretion to use the chop, companies face significant risks should the legal representative choose to abuse his/her position.[75]

For instance, Arm Limited (Arm), one of the world's largest semiconductor companies, has been embroiled in a protracted legal dispute with Allen Wu, its current legal representative and CEO of Arm's China subsidiary. Despite Arm's repeated attempts to remove him, Allen Wu has been able to retain control of the subsidiary through the ownership of the company chop. Moreover, despite protests from the parent company, Allen Wu is currently even seeking an independent IPO for the subsidiary.[76]

In the case of GHY, Xue currently serves not only as the senior director of TV program and film production but also as the legal representative of GHY's PRC affiliated associates.[77] Given that the role that Xue holds is a significant one, steps are typically taken to ensure that the interests of the legal representative are aligned with GHY and its shareholders.[78] However, given that the smallest of GHY's 20 largest shareholders holds only a 0.03% stake in the company and Xue's name is not part of that list,[79] it appears unlikely that Xue holds a meaningful amount of shares in GHY. Any disputes with Xue could lead to a disaster for GHY. This exact risk is identified in GHY's prospectus, which states that "there can be no assurance that they [the legal representatives] will always act in [its] best interests or perform their obligations under these contracts". GHY stated that in the event of a dispute, GHY will rely on "the operation of PRC Law and/or arbitral or judicial agencies" to enforce its contractual arrangements.[80] However, given how the Arm dispute is playing out, it begs the question as to whether GHY's current contingency plans are sufficient.

Multiverse accounts?

Figure 2 shows GHY's statements of profit or loss for FY2018, FY2019, and for the first six months of 2019 and 2020 that were disclosed in its prospectus issued in 2020,[81] and the half year and full year results after its listing.[82,83,84,85]

	6M2019	6M2020	6M2021	6M2022	FY2018	FY2019	FY2020	FY2021
	S$'000	S$'000	S$'000	S$'000	S$'000	S$'000	S$'000	S$'000
Revenue	41,622	37,152	43,785	20,625	3,442	66,000	127,095	83,319
Cost of sales	(29,707)	(17,594)	(31,452)	(15,605)	(334)	(47,184)	(71,426)	(61,564)
Gross profit	11,915	19,558	12,333	5,020	3,108	18,816	55,669	21,755
Other income	6,151	4,178	2,397	5,801	12	6,575	9,668	5,961
Share of result of associate	(41)	(11)	-	8	-	35	(11)	(8)
Share of results of joint venture	-	-	(67)	(154)	-	-	-	(285)
Administrative expenses	(2,151)	(5,000)	(5,082)	(5,997)	(1,969)	(5,177)	(10,942)	(11,514)
Selling and distribution expenses	(350)	(2,859)	(2,339)	(2,824)	(375)	(1,887)	(6,701)	(5,957)
Other expenses	(1,195)	(518)	(303)	(3,167)	(1,288)	(2,035)	(623)	(2,263)
Finance costs	(350)	(606)	(475)	(638)	(56)	(931)	(985)	(1,048)
(Loss)/profit before tax	13,979	14,742	6,464	(1,951)	(568)	15,396	46,075	6,641
Income tax expense	(2,350)	(1,732)	(3,038)	166	(174)	(2,962)	(8,009)	(3,173)
(Loss)/profit for the period	11,629	13,010	3,426	(1,785)	(742)	12,434	38,066	3,468

Figure 2: GHY's statement of profit and loss for FY2019, FY2020 and FY2021, and the six months ended FY2019, FY2020 and FY2021

Figure 2 shows that GHY's gross profit increased substantially to S$19.558 million in the six months ended 30 June 2020 – the latest set of results before its IPO – from S$11.915 million for the six months ended 30 June 2019, even though revenue fell from S$41.622 million to S$37.152 million. This increase was largely driven by a large decrease in the cost of sales from S$29.707 million [86] to S$17.594 million.[87] As a result, the gross profit margin increased from 28.63% to 52.64%.

The gross profit for the six months ended 30 June 2020 was higher than the gross profit for the entire FY2019, even though revenue for those six months was only S$37.152 million compared to S$66 million for FY2019. Net profit increased from S$11.629 million to S$13.01 million for the two comparative six-month periods. Meanwhile, the statement of cash flows shows net cash generated from operating activities increased from a negative S$12.656 million[88] to a positive S$9.452 million.[89]

Professor Mak, who had observed the unusual trends and wrote about it, added: "To be fair, the prospectus does highlight as a risk factor the fact that the financial statements for different periods are not comparable and cited its short operating history and a range of general factors that may cause financial results to vary from period to period. Notwithstanding, it is unclear why results for the most recent six-month period were considerably better than the past. Investors should bear this in mind and not assume that the latest six-month results are representative of future performance."[90]

It turned out that the warning about future performance was borne out by subsequent results even though things initially continued to look good after its listing. The first set of full year results for the year ended 31 December 2020 released after its listing showed revenue had nearly doubled from the year before, increasing from S$66 million to S$127.095 million, while gross profit nearly tripled from S$18.816 million to S$55.669 million. Net profit more than tripled from S$12.434 million to S$38.066 million. This is despite China going into lockdown starting from Wuhan and other cities in Hubei from January 2020 due to the COVID-19 pandemic.

Then the bad news started. Net profit for the first six months of 2021 fell to S$3.426 million from S$13.01 million for the comparative six-month period. Full year net profit fell from S$38.066 million to S$3.468 million. It got worse as the company reported a net loss of S$1.785 million for the first six months of 2022. The company largely blamed the COVID-19 pandemic for the drastic change in its fortunes.

Following the release of GHY's semi-annual results for 2021, SGX issued several queries. It asked GHY to disclose the breakdown of its large current "other receivables" that amounted to S$16.996 million.[91] GHY disclosed that it comprised S$6.209 million worth of advances to third party contractors and S$7.552 million of prepayments.[92] SGX also queried why GHY was unable to generate net cash inflow from its operating activities despite having a net profit.[93] GHY said that this was due to increases in film and drama productions in progress by S$1.2 million, increases in trade and other receivables by S$2.1 million and increases in contract assets of S$19.5 million.[94] Between FY2020 and FY2021, GHY's trade receivables increased from S$27.474 million to S$48.059 million, while net profit decreased by more than 91%.[95]

Who audits the auditors?

A key concern regarding Chinese companies listed overseas is the inability of overseas audit regulators to inspect the work of Chinese audit firms.[96] This raises concerns about the reliability of audited financial statements of such companies. A study found that the weak institutional environment in China resulted in lower-quality audits.[97] This is exacerbated by Chinese secrecy laws that prevent foreign regulators from inspecting the audits of Chinese companies listed overseas.

In GHY's prospectus, it was disclosed that Deloitte & Touche LLP (Singapore) (Deloitte) was the independent tax adviser, independent auditor and reporting accountants for GHY. Although Deloitte Singapore is the Group auditor and is subject to oversight by the ACRA in Singapore, and GHY's Singapore subsidiary is also audited by it, certain of GHY's PRC subsidiaries and affiliated entities are audited by Deloitte's Beijing branch, which also audited certain other PRC subsidiaries and affiliated entities for

Group consolidation purposes.[98] Deloitte Beijing branch is not subject to oversight of ACRA.

Given that the majority of GHY's revenue is derived from China and its China entities – 69.48% in FY2020 –[99] the audits of these PRC entities are critical.

In February 2021, a Deloitte employee in the Beijing branch blew the whistle by circulating a 55-page PowerPoint presentation, alleging massive auditing violations being committed within that branch. That same month, China's Ministry of Finance ordered Deloitte to conduct an internal investigation.[100] Although the whistleblower did not name any GHY-affiliated entity among those she had named for auditing violations, it does raise concerns about the Beijing branch if the allegations are true. There has been no further update on the investigation of the whistleblower allegations as of 19 August 2022.

Share buyback factory

On 22 December 2020, shortly after GHY's IPO, Ho acquired an additional 600,000 shares in GHY, increasing his total shareholding from 10.45% to 10.50%.[101] This was followed by a series of additional share acquisitions by Ho and Guo, increasing their total shareholding to 10.54%[102] and 59.7%[103] respectively by the end of 2020.

Ho bought an additional 148,900 shares on 1 March 2021, bringing his total shareholding to 10.55%,[104] while Guo continued to sporadically acquire more shares in the company, ending with a total shareholding of 60.03% by 14 September 2021.[105]

GHY commenced a series of share buybacks from 2 December 2021. By 30 March 2022, it had bought back 2,491,000 shares over 28 days at a total cost of S$1,207,270 at an average of S$0.48465 per share (amounting to 0.122% of total outstanding shares).[106] Most of the share buybacks significantly exceeded 30% of daily on-market trading volume, which the SGX Regulator's Column deemed to be excessive.[107]

The share buybacks continued unabated, with another 44 daily share buybacks made from 1 April to 17 August 2022. Meanwhile, the company's share price has fallen from S$0.55 to S$0.47 between the day the share buybacks started and 17 August 2022.

Will this movie have a happy ending or will it end in tears for investors?

Discussion questions

1. Provide an overview of the key risks that investors who invest in GHY Culture & Media should be aware of. Explain why they are key risks.
2. What are the pros and cons of Guo Jingyu being Chairman, CEO and majority shareholder of GHY? What are possible safeguards to mitigate the risks?
3. Critically evaluate the composition of GHY's board and specific board practices highlighted in the case study and suggest possible improvements. Do you think Yeo Guat Kwang should be considered independent given his prior advisory role with the company? Explain, making reference to the Singapore Code of Corporate Governance.
4. What are the benefits and risks of having politicians (including former politicians) and academics as directors of boards of listed companies? Why do you think GHY appointed several such individuals as directors?
5. Critically evaluate how the board and Nominating Committee handled the appointment of Lian Lee Lee, John Ho's spouse, as Deputy CEO. Do you believe that the spirit of the rules has been complied with? Explain.
6. What are some of the major risks related to the variable interest entity structure in Chinese companies? Discuss these risks in the context of GHY. With regard to the risks pertaining to the legal representative, what steps could GHY take to better mitigate these risks?
7. What are the risks associated with financial reporting and auditing identified in the case? How should directors address such risks?
8. What are the reasons for companies conducting share buybacks? Why do you think GHY was making so many buybacks? What are directors' responsibilities in overseeing share buybacks? Do you think GHY's directors fulfilled these responsibilities?

Endnotes

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GRAB: JUST A SPAC-ULATION?

Case overview

On 13 April 2021, Grab Holdings Limited (Grab) announced a merger with a special purpose acquisition company (SPAC), Altimeter Growth Corporation (AGC), marking the start of its public listing journey. As the first Southeast Asian tech company to go public via a SPAC on such a large scale, Grab's NASDAQ listing process garnered the attention of many.

Despite some delay due to the finalisation of its financial audit in accordance with Public Company Accounting Oversight Board standards as required by the U.S. Securities and Exchange Commission, Grab successfully listed on NASDAQ on 2 December 2021, following the merger with AGC. At a valuation of about US$40 billion, Grab's listing was not only the largest SPAC listing in the U.S. but also the biggest debut for a Southeast Asian company. It was thus deemed to be a potential milestone for Southeast Asia's digital economy.

The objective of this case study is to facilitate a discussion of issues such as valuation of tech companies; SPAC listings; board composition; dual-class share structures and concentration of power; foreign private issuers; and independence of directors and key management.

Grab-bing the attention of regulators

Grab Holdings Limited (Grab) was founded in Malaysia as MyTeksi by Anthony Tan (Tan) and Tan Hooi Ling (THL) in 2012. The original idea behind the initial ride-hailing mobile application was to provide a safe and reliable alternative to Malaysia's shady taxi drivers. Since its launch, Grab has advanced rapidly from being a humble ride-hailing mobile application based in Malaysia to a Southeast Asian tech giant offering an integrated "superapp"[1] platform that provides a wide array of locally-suited transportation booking options, food delivery and financial services.[2] In 2014, Grab decided to move its headquarters to Singapore.[3]

This case was prepared by Akmal Bin Fazili, Lee Jun Hong, Daryl, Sonia Seow Shi Yi, Taam Yin Kwan, Eunice and Wesley Loo Yong Hwee, 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 organisations named in the case, or any of their directors or employees.

Grab's initial success from its ride-sharing services was largely due to its sharing economy model, which boasted low fixed costs (from being asset light) and high scalability (from being a cloud-based mobile app technology).[4] The rapid rise in smart phone usage by consumers and the availability of affordable mobile data also contributed in Grab's speedy growth.[5] Leveraging its regionally leading ride-hailing business, Grab later extended its business offerings to include delivery of food orders and groceries, and digital payments.[6]

Can it profit?

However, the barriers to entry were extremely low[7] and new entrants could be undifferentiated competitors to well-established ride-sharing firms in the market. With ride-hailing markets having winner-takes-all dynamics,[8] such competition is, as described by IMD Business School's Howard Yu,[9] "ruinous" and often results in only one or a handful of firms remaining in the market. Competition often takes the form of a price war, as evident from the predatory pricing models adopted by Grab and its rival Uber Technologies, Inc. (Uber) to compete in the Southeast Asian market in 2016.[10] The margins in the ride-hailing market are thus razor thin, and Grab has been bleeding money since its inception in 2012.[11]

According to credit rating agencies Moody's Investors Service and Standard & Poor's (S&P) Global Ratings in 2021,[12] Grab has been expected to continue to be loss-making over the next two years. In an attempt to achieve positive EBITDA (earnings before interest, tax, depreciation and amortisation), Grab slashed over S$600 million worth of incentives for drivers and merchants in 2020.[13] With such measures undertaken to cut costs and increase profit margins, it was evident that Grab could not afford to bear any further increases in costs should it wish to continue as a going concern or "achieve profitability".[14]

Job protection for delivery workers

Unfortunately, dark clouds continued to loom over Grab. During the National Day Rally in 2021, the Prime Minister of Singapore announced the government's plans to provide better job protection for delivery workers.[15] The newly formed advisory committee focused on the possibility of mandating employers' Central Provident Fund (CPF) contributions, imposing workplace injury compensation, and setting up union representation for delivery workers.[16]

Earlier in 2021, Uber granted its British drivers "worker status" and gave them employment benefits.[17] According to Uber, such a move resulted in "significant additional expenses"[18] for the company. Likewise, Grab also echoed similar sentiments in its Form F-4 – it expressed its concerns that should the company be required to reclassify its drivers as employees, it might suffer "adverse business, financial, tax, legal and other consequences".[19]

A setback to expansion plans

Regulations are not only driving Grab's costs up but could possibly stifle its plans of expanding its financial services within Southeast Asia as well. Most recently, Grab doubled its holdings in Indonesia mobile wallet operator OVO in an attempt to gain an edge in Indonesia's e-commerce market.[20] While Grab makes progress towards the advancement of its financial services arm, regulations for data governance around the region are quickly catching up. Singapore's enhancement of its Personal Data Protection Act, Thailand's adoption of a regulatory framework similar to EU's General Data Protection Regulation and Indonesia's upcoming Personal Data Protection Bill[21] all point towards regulations in the Southeast Asian region catching up with technological changes tied directly to Grab's expansion plans.

Up for grabs: Grab's SPAC IPO

> "This is a milestone in our journey to open up access for everyone to benefit from the digital economy."
>
> – *Anthony Tan, Group CEO and Co-founder of Grab*[22]

A special purpose acquisition company (SPAC) is a shell company that takes firms public without having to go through the traditional Initial Public Offering (IPO) procedure. Instead, the shell business in question would go public and subsequently acquire and combine with the target company.[23] Due to the uncertainties of the COVID-19 pandemic, going public through a SPAC had become increasingly attractive as private enterprises were unsure of their capacity to obtain large quantities of funding in the foreseeable future.[24] In the first quarter of 2021, SPACs raised more than US$99 billion, which was already more than the US$83.3 billion raised in 2020[25]. Traditional IPOs are less appealing since companies have less control over the amount of money they can raise and often take several years to execute, prompting them to seek out speedier alternatives.[26] A SPAC merger may take as little as three to four months, though the company would also need to make appropriate filings with the U.S. Securities and Exchange Commission (SEC), such as financial reports and tax papers during that time.[27] The corporation could also bargain with the SPAC over the merger price, ensuring that no money is left on the table[28]. This differs from a traditional IPO, in which the IPO price is established by investment banks, which may not be completely accurate in their valuation.[29]

On 13 April 2021, Grab announced that it was going public in the U.S. stock market through a merger with a SPAC, Altimeter Growth Corporation (AGC).[30] The planned merger would make Grab the first Southeast Asian tech unicorn to go public via a SPAC and was expected to raise over US$4 billion in cash proceeds.[31] It was set to have a market value of US$39.6 billion,[32] a jump from its valuation of approximately US$16 billion in early 2020.[33]

Altimeter Capital Management, which led AGC's IPO in September 2020, would invest US$750 million in Grab, with its sponsor shares locked up for three years.[34] Grab's CEO Tan stated that this demonstrated Altimeter's "long-term commitment to Grab".[35] Altimeter also committed as much as US$500 million to a contingent investment which is equivalent to the total amount of redemptions made by AGC's shareholders.[36]

Howdy partner: Altimeter Growth Corporation

AGC is a special purpose investment vehicle – also known as a blank-check company – sponsored by Altimeter Growth Holdings, an affiliate of Altimeter Capital Management (Altimeter)[37] that manages both public equity funds and private growth equity funds.[38] Altimeter had about US$16.3 billion of assets under management as of 31 December 2020. It has previously invested in leading technology companies such as Expedia, Zillow, Facebook, Uber, and Airbnb.[39]

The merger of AGC with Grab was led by Brad Gerstner – founder, Chairman and CEO of Altimeter. Prior to establishing Altimeter, Gerstner had co-founded several internet search businesses, including one which was sold to Google in 2012.[40] Along with Gerstner, Altimeter's board of directors also included four other directors, namely Hab Siam, Richard Barton, Dev Ittycheria, and Aishetu Fatima Dozie.[41]

A secondary listing?

It was reported on 16 April 2021 – days after its announcement of its SPAC listing – that Grab was also already contemplating a secondary offering on the Singapore Exchange (SGX),[42] which would allow it to attract investors in close proximity to its regional operations. Observers have opined that the motive behind this secondary listing was to "buy him goodwill from the Singapore Government" since Grab did not require the additional funds from the secondary listing.[43] This was especially since the company would require "ongoing accommodation from regulators" to overcome any pushbacks from traditional banks in the implementation of its financial services offerings.[44]

Two heads are better than one: Merger with AGC

> "You have a sponsor champing at the bit to get their 500% return,"
>
> – *Michael Klausner, business and law professor at Stanford University*[45]

Grab's decision to go public was motivated by "strong financial performance" in 2020, with a Gross Merchandise Value (GMV) of US$12.5 billion.[46] It was reported that a SPAC listing was not Grab's first choice – it previously tapped its partners JPMorgan and Morgan Stanley for a traditional IPO but explored going public via a SPAC only after receiving interest from numerous SPACs. Among the various offers received, Grab held the view that Altimeter's proposal was the strongest, and that its move to lock up its sponsor shares for three years and donate 10% of the sponsor shares to Grab's endowment fund was a big draw.[47] The donated shares would go to the GrabForGood Fund "to support programs with long-term social and environmental impact".[48]

Grab president Ming Maa (Maa) stated that Grab's decision to merge with Altimeter was driven by "a desire to find committed, long-term investment partners who shared Grab's values and strategic vision – and had nothing to do with concerns about speed or market volatility".[49] He also believed that Altimeter has an edge as it is a repeat entrepreneur, and would be able to use its experience to help Grab as a long-term partner and co-owner of the business.[50]

Observers have commented that one compelling reason for Grab's preference for going public via a SPAC is that such an option would save time and money. IMD Business School's Howard Yu said that Grab was operating on a time crunch, and that the company should get listed "before Grab's core business shows any signs of plateauing".[51] Another reason for a SPAC listing was that Grab has not been profitable and "will have to shave off hundreds of millions of dollars each year, in order to reach profitability".[52] Grab had already eliminated more than S$600 million in incentives for drivers and merchants in 2020 and was expected to reduce incentives even further in order to meet its 2023 profitability target. If such financial information had been released in an IPO prospectus, it would have garnered public scrutiny and criticism, and might adversely affect Grab's listing price.[53]

Additionally, by going public via a SPAC, Grab would be able to avoid many of the compliance issues that come with a traditional IPO. Notably, the filing of a detailed prospectus, or S-1, would not be necessary.[54] For example, CEO Tan might face challenges in securing his 60.4% voting rights despite only holding 2.2% of ordinary shares in Grab if the company opted for an IPO listing.[55] Observers have noted that although having a disproportionate share of ownership and voting power under a dual-class share structure is not unusual, Tan's voting power to ownership ratio, at 27.45 is "very, very high", which might give rise to a risk of entrenchment where senior management make decisions that benefit themselves and put other investors at risk.[56]

Foreign private issuer

Grab's Form F-4 stated that the company is qualified as a "foreign private issuer (FPI) under the Securities Act and Exchange Act".[57] To determine whether a foreign company qualifies as a foreign private issuer in the U.S., there are two tests to conduct: the first relates to the relative degree of its U.S. share ownership, and the second relates to the level of its U.S. business contacts.[58]

The FPI status eases regulatory burdens for Grab due to various exemptions on requirements, including the exemption from filing certain reports and greater flexibility in accounting rules. Another significant benefit of being a FPI is that Grab would be permitted to follow its home country's rules and regulations with regard to corporate governance.[59] As Grab was incorporated under the laws of Cayman Islands,[60] Grab would be allowed to follow the rules and regulations of Cayman Islands, widely known to be a "secrecy jurisdiction"[61] and "tax haven".[62] Cayman Islands was ranked first in the Financial Secrecy Index for 2020. The index ranks countries based on how big of a role they play in enabling financial secrecy worldwide.[63]

Unlike the NASDAQ rules, the corporate governance standards of Cayman Islands do not require a majority of the board to be independent, and do not require a Compensation or Nominating Committee comprising independent directors.[64]

Introducing Grab's board

Given that Grab is a foreign private issuer under the Exchange Act, it is not bound by the NASDAQ listing rule requiring the majority of the board to comprise independent directors.[65] Despite the concessions afforded to it, Grab still implemented a board of directors, Compensation Committee, and Nominating Committee comprising a majority of independent directors.[66] Grab's board composition is shown in Figure 1.

Name	Position	Board committee participation
Anthony Tan Ping Yeow	Founder, Chairman and CEO	Nominating Committee (Chairperson), Compensation Committee
Tan Hooi Ling	Founder, COO, and director	-
Dara Khosrowshahi	Independent director	-
Richard N. Barton	Independent director	Audit Committee
Ng Shin Ein	Independent director	Audit Committee (Chairperson), Compensation Committee
Oliver Jay	Independent director	Compensation Committee (Chairperson), Audit Committee, Nominating Committee

Figure 1: Grab's post-merger board composition[67]

Controversy involving independent director

Ng Shin Ein (Ng), one of Grab's independent directors[68] was a former independent director of Sabana Real Estate Investment Management Pte. Ltd (Sabana REIM), the manager of Singapore Exchange-listed Sabana REIT. She found herself in the spotlight after a co-founder of Sabana REIT alleged that she was "incompetent", "unscrupulous in her dealings" and "only secured her position on the board of several organisations because of her familial ties". The latter was subsequently fined S$8,000 for harassment.[69] His comments came from anger over the proposed merger of ESR-REIT and Sabana REIT, as he felt that the merger would bring down the value of Sabana REIT.[70]

In 2019, while serving on the board of Sabana REIM, Ng was abruptly re-designated from a non-independent director to an independent director despite her deemed business relationship with Sabana REIM. This drew criticisms from corporate governance advocate, Professor Mak Yuen Teen. In the first of several articles, he questioned Ng's independence and the manager's highly technical approach to defining independence.[71]

Ng – who was a supporter of a proposed merger between ESR-REIT and Sabana REIT – subsequently resigned from Sabana REIM's board on 7 December 2020 following the failure of the merger and after a 16-month term on the REIT's board.[72,73]

Ng, who joined Grab's board in 2020,[74] coincidentally sits on the board of Avarga Ltd,[75] a company controlled by Tong Kooi Ong, Tan's father-in-law.[76]

Uber: Friend or foe?

Dara Khosrowshahi (Khosrowshahi) – who is CEO, board member[77] and one of the top three individual owners of Uber[78] – also sits on Grab's board as an independent director.[79] Uber was previously one of Grab's biggest competitors in Southeast Asia before Grab's acquisition of Uber's Southeast Asia business in exchange for a reported 27.5% stake in Grab.[80] In addition, Grab disclosed that it has a non-competition agreement (NCA) with Uber which will expire on the later of 25 March 2023 or one year after Uber disposes of all shareholdings in Grab.[81] In the absence of the NCA, Khosrowshahi's role in both the Grab and Uber boards might flout antitrust laws in some jurisdictions due to interlocking directorates.[82] Interlocking directorates are not illegal as long as the involved companies do not compete with each other.[83]

Fellow alumni

Like founders Tan and THL, Oliver Jay – another Grab independent director, who has been on the board since 2015 – also graduated with his MBA from Harvard Business School in 2011.[84]

Tan - the man who rules Grab

> "The onus is on Grab and Tan to justify the dichotomy between ownership and voting shares and prove it is in the interest of the shareholders."
>
> *– Nirgunan Tiruchelvam, head of consumer sector equity research at Tellimer Group*[85]

Grab disclosed in its Form F-4 that after the merger with AGC, it planned to employ the dual-class share (DCS) structure, with Class A ordinary shares having one vote per share and Class B ordinary shares commanding 45 votes per share. The key executives of Grab –Tan, THL and Maa – will hold all the outstanding Class B ordinary shares.[86] The shares held by THL and Maa "will be deemed beneficially owned by [Anthony] Tan pursuant to a shareholders' deed to be entered into concurrently with the business combination agreement, irrevocably appointing [Anthony] Tan as attorney-in-fact and proxy to vote all of their Class B ordinary shares" during shareholders meetings.[87] This effectively gives Tan 60.4% of the voting power with a "disproportionate"[88] less than 5% ownership in the firm, and cements Tan's control over Grab. The arrangement did not come as a surprise – it was reported that in a previous discussion with rival firm Gojek on a possible merger between the two companies, CEO Tan allegedly demanded indefinite control as a "CEO for life".[89]

It was also stipulated in Grab's Form F-4 that upon any transfer of Class B ordinary shares to any person which is not a Permitted Transferee, the Class B Ordinary Shares shall be immediately converted to Class A Ordinary Shares.[90]

Observers opined that the ownership structure suggested that Grab wanted to achieve a balance between speeding up decision-making in navigating Grab's eight markets while also securing some governance by keeping their ownership below two-thirds of total voting power.[91] Proponents of the DCS structure argued that giving Tan majority voting control is desirable as it allows founders and entrepreneurs to execute their vision without having to worry about stock market performance. On the flip side, the DCS structure could also introduce agency costs such as management entrenchment for public shareholders, hence resulting in inadequate investor protection.[92]

Additionally, Grab's Form F-4 stated that CEO Tan, by virtue of his majority voting power, "will effectively have the ability to elect the entire [Grab] board of directors".[93] He "will effectively have the right to nominate, appoint and remove all of the Class B directors" as well.[94]

Playing by the rules

The years 2020 and 2021 saw a boom in SPACs as a way to bring private companies public. They represented over 59% of total new listings in the U.S. in 2021, an increase from around 53% in 2020. 2021 saw a total of 613 SPAC listings, which cumulatively raised US$145 billion, representing a 91% increase from the amount raised in 2020.[95]

However, in Q2 2021, the number of IPOs involving SPACs plunged 87% compared with Q1 2021 as regulators and investors increased scrutiny of such listings. In May 2021, SEC Chairman Gary Gensler flagged risks to investors and said that the SEC planned to investigate how the shell companies raise cash from the public and merge with target companies. Gensler said that the SEC's corporate finance, examinations and enforcement divisions would "be closely looking at each stage to ensure that investors are being protected" as "each new issuer that enters the public markets presents a potential risk for fraud or other violations".[96]

Some concerns raised by the SEC included the duration of a sponsor's investment in the post-merger entity, as well as the percentage of SPAC investors seeking redemptions during a merger transaction.[97] Previous guidance from the SEC also stated that the economic interests of parties involved in a SPAC – including sponsors, officers, directors, and affiliates – often differ from the economic interests of public shareholders, which may result in conflicts of interests. The regulatory authority was particularly concerned with proper disclosures regarding SPAC sponsors' control of approving a business combination transaction, and how the SPAC "evaluated and decided to propose the identified transaction" and select "the target company".[98]

In March 2022, the U.S. SEC proposed new rules and amendments to enhance disclosure and investor protection in IPOs by SPACs and in business combination transactions involving SPACs. Among other things, the proposed new rules and amendments would require additional disclosures about SPAC sponsors, conflicts of interest, and sources of dilution, as well as further disclosures regarding business combination transactions between SPACs and private operating companies. The new rules would also address issues relating to projections made by SPACs and their target companies. Should the proposed rules be adopted, they would "more closely align the required financial statements of private operating companies in transactions involving shell companies with those required in registration statements for an initial public offering".[99]

Better late than never

> "We wanted to set the bar in transparent financial reporting. It may have taken a little longer than we expected."
>
> – *Anthony Tan, Group CEO and Co-founder, Grab*[100]

In June 2021, Grab announced the postponement of its merger with AGC to the fourth quarter of 2021[101] as it was in the midst of finalising its financial audit in accordance with Public Company Accounting Oversight Board standards as required by the SEC.[102] In a statement, the ride-hailing and food delivery giant stated that "We are working with the SEC to obtain pre-clearance of certain accounting policies and related financial disclosures in accordance with the SEC's procedures. As a result, our financial information for these periods remain subject to further review and revision."[103]

Matthew Kanterman, an analyst with Bloomberg Intelligence said that a delay is not surprising as "the audit process can take several quarters, especially if there needs to be back and forth with the SEC over certain accounting decisions and policies".[104] It was reported that after a growing trend of SPAC listings, U.S. financial regulators such as the SEC have stepped up scrutiny on deals involving SPACs.[105] According to Refinitiv data, as of June 2021, companies raised about US$130 billion in the U.S., of which US$88.2 billion were SPAC deals.[106]

Grab disclosed that financial information was to be restated in order to correct the accounting treatment relating to its OVO financial services business in Indonesia, after discussions with external auditors and a reassessment of the legal arrangements and commercial intent of the OVO points program. In a nutshell, there was a material overstatement of revenue and cost of revenue in relation to OVO. To correct the misstatements, Grab then had to record a reversal of revenues amounting to US$204 million and US$135 million, and a corresponding reversal of cost of revenue for 2019 and 2020 respectively.[107]

Grab's Form F-4 further raised that there were weak points in the company's internal control over its financial reporting. It highlighted issues raised in the review process over the assumptions and inputs used in several key accounting estimates, as well as having insufficient people with the appropriate International Financial Reporting Standards (IFRS) accounting skills, SEC reporting knowledge and expertise, and training in internal controls over financial reporting.[108]

Grab disclosed its commitment to ratifying its material weaknesses as soon as possible through the assessment and improvement of its channels of communication in ensuring subsidiaries comply with Grab's accounting policies, the inclusion of proper management reviews, the performance of a skill gap analysis, and the provision of regular training to relevant accounting and financial reporting personnel.[109]

The 'why' behind Grab's think-tank

In October 2021, Grab launched Tech for Good Institute (TFGI), a non-profit think-tank aimed at advancing "research and dialogue on Southeast Asia's fast-growing digital economy".[110] In view of the increasing digital adoption in Southeast Asia in recent years, TFGI's aspirations included being the leadership platform for the public and private sector to jointly study, discuss and develop capabilities to enhance policy understanding and design "to help harness the positive impact of technology in society and address key issues".[111]

Despite Grab's admirable claims about the intention behind TFGI, some critics opined that TFGI was "a classic corporate move" to shape the public's perception of Grab in its favour, against the backdrop of increasing public scrutiny on the gig economy in recent years. They argued that TFGI was designed to influence policy and help Grab position itself as the ultimate digital platform that would empower the economic future of Southeast Asia to gain investors' confidence.[112]

Done and dusted

> "We truly believe this is Southeast Asia's time to shine, and we hope that our entrance into the global public market will help bring greater attention to the tremendous opportunity here in the region,"
>
> – *Anthony Tan, Group CEO and co-founder of Grab*[113]

On 2 December 2021, subsequent to approval by AGC shareholders in a special meeting on 30 November 2021, Grab successfully listed on the NASDAQ after the completion of the business combination with AGC. The listing raised gross proceeds of US$4.5 billion and was reported to be the largest U.S. public market debut by a Southeast Asian company. Investors included funds and accounts managed or advised by BlackRock, Counterpoint Global (Morgan Stanley Investment Management), and Temasek.[114]

Following its NASDAQ debut, shares in Grab slid more than 20% from an opening price of US$13.06 to close at US$8.75 on the same day.[115] Despite this, CEO Tan said: "The price makes no difference to me. I'm going to celebrate tonight and get back to work tomorrow."[116]

Just the beginning?

In December 2021, Grab revamped its GrabGifts interface to add new cross-border gifting features, which allowed Grab users to send presents to others over 100 Southeast Asian cities in Indonesia, Malaysia, Myanmar, the Philippines, Thailand and Singapore.[117]

In January 2022, Grab acquired Jaya Grocer, Malaysia's premium grocery chain. Grab CEO Tan said that the move would help Grab make on-demand groceries more accessible in Malaysia and accelerate the growth of its grocery delivery business. It was also announced that GrabPay and GrabRewards would be rolled out across all Jaya Grocer physical retail stores, expanding usage of Grab's cashless wallet in Malaysia.[118]

On 3 March 2022, Grab announced that it had recorded a net loss of US$1.1 billion in Q4 2021, nearly double of the US$576 million loss a year earlier.[119] This contributed to Grab's full-year loss of US$3.4 billion in 2021, compared to a US$2.6 billion loss in 2020,[120] despite a 44% increase in revenue to US$675 million in 2021, up from US$469 in 2020.[121] Following the earnings announcement, Grab's shares closed down 37% on the same day.[122]

Although Grab's NASDAQ listing initially drew much attention from investors, its shares have slumped since. As at 3 March 2022, Grab's market capitalisation was approximately US$20 billion – half the value it had expected prior to its listing.[123] As of 19 August 2022, its share price was US$3.44, valuing the company at US$13.21 billion. It had earlier fallen well below US$3 at one point.[124]

In light of the tightening of monetary policies by central banks in 2022, which has resulted in a global tech stock sell-off, improving profitability is vital for Grab. CEO Tan announced that Grab aimed to develop a digital banking business in Singapore and pursue opportunities in the on-demand delivery segment. Looking ahead, he said: "We will continue to focus on the recovery of mobility."[125]

Epilogue

On 3 March 2022, Grab's shares crashed by approximately 37% to US$3.09 after it announced a fourth-quarter net loss of US$1.1 billion, wiping off over US$7 billion from its market value. This was a drastic fall from its opening price of US$13.06 on its first day of trading. The loss came amid a worse-than-expected drop in revenue due to more funds being channeled into larger incentives being paid out to attract drivers and consumers with the easing of COVID-19 restrictions.[126]

Later that month, it was reported that at least eight law firms had announced their intention to investigate Grab for various issues such as false and misleading statements, possible fraud and other violations of U.S. federal securities laws. One such law firm is Schall Law Firm, a shareholder rights litigation company, which disclosed that it would be focusing on whether Grab issued false and/or misleading statements or failed to disclose information pertinent to investors.[127] Another law firm, securities litigation practice Pomerantz Law Firm, had filed a class action lawsuit in April 2022 in the U.S. District Court for the Southern District of New York against Grab and certain executives. The complaint alleged that Grab's management and board "made materially false and/or misleading statements, as well as failed to disclose material adverse facts about the Company's business, operations, and prospects".[128]

Calls for investors to mount securities class action lawsuits are "fairly common" in the U.S. even if most of these cases do not make it to court. In 'stock-drop' lawsuits, lawyers typically argue that a plunge in stock price serves as evidence that a company "failed to be forthcoming about looming bad news".[129] Now that Grab is a full-fledged NASDAQ-listed company, will it be able to survive the hailstones?

Discussion questions

1. What are the inherent risks of Grab's business model and the challenges it faces? How would you recommend Grab address these risks and challenges? Would you invest in Grab today? Explain.
2. Explore the pros and cons of a SPAC listing. Critically evaluate the rationale behind Grab's choice of using a SPAC to go public instead of a traditional IPO. Do you think the reasons provided by Grab for its decision to go for a SPAC listing are justified? Explain.
3. Discuss the advantages and disadvantages of employing a dual-class share structure. If a company employs a dual-class share structure, do you think there is an appropriate amount of voting power and ownership that founders should have? What safeguards, if any, do you think should be put in place? Are dual class shares more appropriate for certain markets? Explain.
4. Dara Khosrowshahi is concurrently a board member of both Uber and Grab, which are rival firms in the same industry. Discuss the impacts of such an arrangement and suggest how companies can still practise strong corporate governance with such interlocking directorates.
5. Critically evaluate the appointment of Ng Shin Ein to Grab's board of directors. Even though she sits on the board of Avarga Ltd – a company owned by Anthony Tan's father-in-law – she is still deemed to be independent. Should she be considered independent? What is the guidance surrounding the concept of 'independence' in your country? Would you recommend any changes to existing guidance?
6. In March 2022, the U.S. Securities and Exchange Commission proposed new rules and amendments to enhance disclosure and investor protection in transactions involving SPACs. Discuss the potential impact of these proposed new rules and amendments and whether they are sufficient to curb the risks associated with SPAC listings and business combination transactions.

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HOW I MET YOUR MERGER: ESR-SABANA REIT

Case overview

On 16 July 2020, the managers of ESR-REIT and Sabana Industrial REIT (Sabana REIT) issued a joint announcement of a proposed merger between the two REITs by way of a trust scheme of arrangement. The proposed merger set off a heated chain reaction of events, including close scrutiny and stinging criticisms of Sabana REIT's management and corporate governance, and questions being raised about the regulatory framework for REITs in Singapore. In a rare case of public activism, two overseas funds led a campaign to thwart the merger, which ultimately led to it falling through.

The objective of this case study is to facilitate a discussion of issues such as corporate governance of REITs; mergers and acquisitions (M&As); investor activism; importance in engagement of minority shareholders; independence of directors; conflicts of interest; and the role of regulators.

The rise of REITs

Real estate investment trusts (REITs) operate by pooling money from investors to invest in a diversified portfolio of professionally managed real estate assets such as shopping malls, offices, or hotels. Revenues generated from assets, less any fees, are usually distributed at regular intervals to REIT holders.[1]

REITs have been growing in prominence in recent years, and Singapore has become one of Asia's largest REIT markets.[2] Singapore REITs (S-REITs) are diverse in terms of the geography and asset classes. Three REIT-focused exchange-traded funds were launched in Singapore in recent years and the Singapore Exchange (SGX) launched two international REIT futures in August 2020. Analysts predict that more of such products will become available in the future.[3]

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Sabana REIT

Listed on the Singapore Exchange since 26 November 2010, Sabana Industrial REIT (Sabana REIT), like nearly all REITs in Singapore, is an externally managed REIT. Sabana REIT's manager is Sabana Real Estate Investment Management Pte. Ltd (Sabana REIM). Prior to a revision of the investment mandate in October 2021, Sabana REIT was formerly known as Sabana Shari'ah Compliant Industrial REIT, which invested in real estate in line with Shari'ah investment principles.[4]

Sabana REIT is one of Singapore's smallest REITs.[5] It has a diversified portfolio of 18 properties in Singapore – with a gross floor area of 4.1 million square feet and valued at about S$866 million as at 31 December 2021– in the high-tech industrial, chemical warehouse and logistics, warehouse and logistics, and general industrial sectors. The REIT is a constituent of the SGX S-REIT Index, MSCI Singapore Micro Cap Index, and FTSE ST Singapore Shariah Index.[6]

It has not performed well over many years, with falling net property income and distribution per unit (DPU), and its unit price has fallen significantly since its Initial Public Offering (IPO) in 2010.[7] Since 2017, Sabana REIT's share price has been trading consistently lower than S$0.50,[8] less than half of its IPO price of S$1.05.[9] As at 22 August 2022, it was trading at S$0.44.[10]

Consequently, Sabana REIT Manager had several brushes with the REIT's unitholders, who have continually expressed its unhappiness with the REIT's performance. In addition to the drop in DPU, the unitholders also cited excessive fees to the REIT's property manager, overpaying for previous acquisitions, and the dwindling valuation of assets in its portfolio, as other grievances. In February 2017, an Extraordinary General Meeting (EGM) was requisitioned by a group of its unitholders to vote on the removal of Sabana REIT Manager as the manager of the REIT and to appoint, in its place, an in-house team better aligned with unitholders. It also included a resolution to divest all properties in the REIT's portfolio if the required approval from the authorities to act as manager cannot be obtained after the removal of the incumbent manager.[11,12]

Although the resolutions were ultimately not passed, the revolt led Sabana REIT Manager and its sponsor, Vibrant Group Limited (Vibrant), to undertake a strategic review. A joint statement sought to assure dissatisfied unitholders that the review would provide the opportunity to explore options for the sustainable growth of the REIT. The announcement resulted in a 10.4% spike in the unit price of the REIT that day.[13] Morgan Stanley Asia (Singapore) Pte. Ltd (Morgan Stanley) was subsequently appointed as the financial adviser for the strategic review.[14]

It was at this juncture that the first point of contact between Sabana REIT and ESR-REIT occurred. In the course of its strategic review, Sabana REIT reached out to the latter and discussed a possible merger. However, the deal ultimately fell through in November 2017, with the management of Sabana REIT issuing a statement that "discussions between the Manager and the ESR-REIT Manager have ceased".[15]

Building an empire: ESR

Co-founded by its senior management team and private equity firm Warburg Pincus,[16] ESR Cayman Limited (ESR Cayman) is a real estate and investment services firm listed on Hong Kong's stock exchange, with its main portfolio comprising building and the management of logistics real estate, such as warehouses and distribution centres. It develops and manages logistics facilities across China, Japan, South Korea, Singapore, Australia and India, with 336 properties across these six markets at the end of 2020.[17] As of 31 December 2020, ESR Cayman has a 67.3% stake in ESR Funds Management (S) Limited (ESR Funds), the REIT manager of ESR-REIT.[18]

ESR-REIT has been listed on SGX since 25 July 2006. As of 31 December 2020, the REIT held a diversified portfolio of 57 properties in Singapore, across sectors such as business parks, high-specs industrial, logistics/warehouse and general industrial, with a total gross floor area of about 15.1 million square feet and an aggregate property value of S$3.1 billion.[19]

> "I think our vision has been that, over time, we want to have sizeable vehicles not just in Singapore, but elsewhere across the region because we want to be long-term holders of warehouses, where we go from developing the warehouses to continuing to own and manage those assets over the long term."
>
> *– Jeffrey Perlman, director of ESR and non-executive director at ESR Funds*[20]

In 2018, the ESR Group signalled its intention to increase its market share in S-REITs. By growing in size and acquiring "subscale" REITs, it hoped to enjoy better cost of capital, trading prices, and capitalise on economies of scale. As a group, ESR has been aggressive in raising funds from institutional investors and making substantial acquisitions. ESR's accelerated acquisition activity, which has contributed to its rapid growth, was in part due to numerous platforms failing to reach a certain scale and needing to look for opportunities to become part of a bigger platform.[21]

One notable acquisition was Viva Industrial Trust (Viva) in 2018. At the time of the merger with Viva, the target company held total assets amounting to S$1.3 billion, owned nine properties in Singapore with a gross floor area of 3.9 million square feet, with 68% of its portfolio consisted of business parks. The reasons cited for the merger included greater exposure to business parks and high-spec warehouses which commanded the highest rent among industrial properties, and a greater ability to extract value from the trust assets through Viva's experience in asset enhancement initiatives (AEIs).[22]

The terms of the merger included ESR Funds offering S$0.96 per stapled security of Viva. This consisted of 10% payment in cash, and the remaining in new ESR-REIT units to be issued at S$0.54 per unit.[23] The consideration represented a 26% premium over net asset value (NAV) per unit of stapled security, and a 8% premium over the last closing price on 17 May 2018.[24] Despite the premium paid, ESR-REIT unitholders were supportive of the merger, with 94.2% of the non-abstaining votes cast in favour of the merger.[25]

Strategic acquisitions by ESR Group

In May 2019, the ESR Group acquired a 51% stake in Sabana Investment Partners Pte Ltd (SIP) for a consideration of S$20.5 million from Vibrant. SIP is an investment holding company that wholly owns both Sabana REIM and Sabana Property Management Pte Ltd, the property manager of the listed trust. This gave ESR an indirect holding of 93.8% in Sabana REIM.[26]

ESR also made a move to acquire more units of Sabana REIT. It made two separate deals with Vibrant – one to acquire 6.51% of total units in Sabana REIT for S$32.9 million, and the second to acquire another 1.48% stake in Sabana REIT for approximately S$7.5 million.[27] Through its wholly-owned subsidiary e-Shang Infinity Cayman Limited, ESR Cayman also entered into agreements to purchase another 9.9% of Sabana REIT's total issued units. It further purchased 1.75% and 0.17% of Sabana REIT's units from two individuals, Eric Khua Kian Keong and Khua Hock Su, respectively.[28]

Following the transactions, ESR indirectly held about a 93.8% equity interest in SIP and 21.4% of the total issued units in Sabana REIT.[29] This made ESR the largest unitholder of Sabana REIT.[30] Jeffrey Shen and Stuart Gibson, co-founders and co-CEOs of ESR, said: "The transaction would allow us to enhance our income diversification and provide further opportunities for growth in the future. With this acquisition, we have further established our presence in Singapore and ESR is poised to leverage our Singapore platform as a gateway for expansion into ASEAN, thus expanding our Asia Pacific footprint linking North Asia, India and Singapore to Australia."[31]

An invitation to merge

> "As a recently listed company in Hong Kong, ESR has a fiduciary duty to enhance the value of its shareholders, which translates to ensuring that the value of its stakes in both ESR and Sabana REITs are maximized."
>
> – *Quarz Capital Management Ltd.*[32]

In November 2019, in an open letter to Sabana REIT and ESR Cayman Ltd., Quarz Capital Management Ltd. (Quarz) – an activist fund and minority stakeholder holding a 4 to 5% interest in Sabana REIT – called for a merger between Sabana REIT and ESR-REIT. It questioned whether ESR Cayman would be able to manage both separate REITs independently, without favoring one over the other[33] and believed that the two REITs "should merge to solve the issue of overlapping investment mandates between the two trusts, which may have corporate governance implications".[34] Quarz also argued that given that both REITs primarily invested in Singapore, and the island nation's severely restricted industrial estate market size, both REITs would potentially end up bidding for the same assets and evaluating potential transactions regarding each other's portfolio.[35]

According to Quarz's open letter,[36] the proposed "win-win" merger would operate by way of a trust scheme of arrangement. Quarz even went ahead to propose a cash-and-unit transaction for the merger – 0.92 unit of ESR REIT and S$0.07 of cash in exchange for 1 unit of Sabana REIT, which would provide Sabana REIT unitholders with a premium of about 21%. As for ESR-REIT unitholders, they could expect an increased dividend per unit of S$0.037, a 7% increase in dividend yield. If pursued, the merger would result in the creation of the fourth-largest Singapore-listed industrial REIT, with total assets of over S$3.9 billion.[37]

Great Sabana sale

> "The current ESR Cayman-owned Sabana REIT Manager has failed to execute on sensible steps to close the NAV discount and now recommends a value destructive merger with a REIT controlled by its owner. Clearly, a new, independent manager is required to restore value for Sabana unitholders!"
>
> – *Jan Moermann, Chief Investment Officer of Quarz Capital*[38]

On 16 July 2020, a joint announcement was made by ESR-REIT and Sabana REIT to propose a merger of the two REITs. Under the terms of the proposed merger, Sabana REIT unitholders would receive 94 units of new ESR-REIT for every 100 units of Sabana REIT held.[39] This suggested that effectively, the proposed consideration was S$0.362, which was significantly below the NAV per Sabana unit as at 30 June 2020 of S$0.512.[40] Both Sabana REIT's and ESR-REIT's managers said that the discount "is reflective of how the market has valued Sabana REIT over the years, and that the implied offer price actually represents a premium to Sabana REIT's last traded price prior to the announcement of the deal".[41]

The terms, which were allegedly disadvantageous to Sabana REIT's unitholders, were heavily criticised by Quarz and Black Crane Capital (Black Crane), minority unitholders which collectively owned more than 10% of the units of Sabana REIT.[42] The two investment firms issued an open letter to the management and board of Sabana REIT announcing their intentions to vote against the proposed merger. They expressed concerns on the deal's significant discount of 26% and 34% to Sabana REIT's NAV at 30 June 2020 and 31 December 2019 respectively, and claimed that the proposed merger was potentially DPU dilutive for Sabana unitholders based on FY2019 distributions after adjustments for its lower gearing.[43]

Quarz and Black Crane claimed that "in the 18-year history of the Singapore REIT market with multiple takeovers/mergers, there has never been a single takeover/merger of a REIT target at such a substantial discount to book value".[44] Describing the terms as "absurd" and taking umbrage at the unfair terms of the proposed merger, Quarz and Black Crane led minority unitholders in a revolt to oppose the merger.[45]

Additionally, Quarz and Black Crane started a website, "Save Sabana REIT", with the original intent to "carefully monitor how sincerely the board and management of Sabana REIT address unitholders' proposals, listen to unitholders' views and endeavour to increase the value of the Sabana REIT units in the best interest of all unitholders".[46] The investment funds also uploaded presentations against the merger, and held webinars to win over retail investors.[47] A Facebook private group page was also created to facilitate discussion on Sabana REIT.[48]

Sabana REIM claimed that the merger with ESR-Reit was "negotiated at length" and that the offer was the best it could get after a "lengthy negotiation".[49] ESR-REIT also told disgruntled Sabana REIT's unitholders that its offer was final and that it would not revise the offer price.[50]

Independence of the managers

Apart from the issue of the "lowball" offer, more than fifty minority unitholders, including Quarz and Black Crane, also raised concerns about the potential independence issues due to ESR Cayman holding controlling stakes in both the managers of Sabana and ESR REITs, and alleged that Sabana REIT's manager was not acting in the best interests of its unitholders.[51] Quarz and Black Crane even called the merger a "bold attempt by ESR to potentially solve a conflict of interest issue at the expense of Sabana unitholders".[52]

They sent the Monetary Authority of Singapore (MAS) and SGX Regco a letter requesting for guidance. In response, MAS and SGX replied: "REIT managers and their directors are required to act in the best interests of unitholders, and prioritise their interests over those of the REIT manager and its shareholders. In this regard, MAS and SGX RegCo require REIT managers to have in place measures to address any conflicts of interest that may arise and to manage the REIT with unitholders' interests in mind."[53]

Some observers, however, believed that the independence and conflict of interest issues raised were secondary considerations. Ben Paul, senior correspondent at The Business Times, was of the view that looking beyond all the noise and voiced frustrations, the conflict over the potential merger was "actually little more than a disagreement about the price for Sabana REIT".[54]

Potential conflict of interest

In 2019, Sabana REIM had added three former ESR-REIT employees to its senior management team. They were Amy Low, director of finance; Lim Wei Huang, senior vice president, finance; and Pamela Siow, head of investments and asset management. All three had previously worked at ESR-REIT for more than five years, with Low and Lim joining Sabana REIM directly after leaving ESR-REIT.[55]

These individuals were given significant appointments, and their roles required them to be heavily involved in the operations of Sabana REIM. In particular, as senior vice president of finance, Lim was responsible for all finance functions including accounting, capital management, and financial reporting. Lim was also said to work closely with the Chief Executive Officer (CEO) and management team to formulate business strategies for Sabana REIT in line with the REIT manager's investment strategy.[56] On 1 November 2021, Lim was appointed as the Chief Financial Officer of REIM.[57] Meanwhile, Siow's role as head of investments and asset management required her to oversee the company's investments, divestments, and asset management of the company's portfolio of assets.[58]

In response to the hires, Quarz and Black Crane sent a requisition notice, dated 10 November 2020, to Sabana REIM's board of directors. They requested that Sabana REIM's board explain the rationale for appointing these three individuals and disclose all meeting minutes relating to their appointment, and further inquired whether the board was aware of their employment history.[59] However, Sabana REIM was adamant that the appointments were based purely on merit, and that it had "assessed the competency and relevant experience of all prospective candidates", and acted in accordance with the Sabana Manager's hiring process before recruiting them for their respective roles. Furthermore, it was highlighted that the said employees were not involved in Sabana REIT's proposed merger with ESR-REIT and thus were not in any position to influence the decision-making processes.[60]

Return of the director

Sabana REIT's non-independent non-executive director Ng Shin Ein first made the news when she announced her resignation from Sabana REIT's board of directors on 27 February 2017[61] – three days after the REIT appointed Morgan Stanley as financial adviser for its strategic review.[62] At the time, Ng believed that the REIT manager's shareholding structure made it difficult for Sabana REIT to access a good pipeline of properties. In her resignation, she cited low confidence in the framework and processes in place to address these internal dynamics, which would involve the shareholders of the REIT manager divesting their stakes to other strategic shareholders with higher quality assets.[63]

Ng had also been involved with Blackwood Investment Pte Ltd (Blackwood), first as a shareholder through her acquisition of a 10% stake in 2011.[64] She then came to own a further 30% in Blackwood by virtue of her exercising her right of first refusal on the planned divestment of shares by Bobby Tay – a Blackwood shareholder – to Vibrant in 2018.[65] Following Tay's exit as a Blackwood shareholder, he ceased to be a director of Blackwood and Ng was appointed to the board of Blackwood. Blackwood held a 45% indirect interest in Sabana REIM.[66]

Ng later sold her shares to InfinitySub Pte Ltd (InfinitySub) between 2018 and 2019, with the last transaction occurring on 30 August 2019.[67] This gave rise to a deemed business relationship with InfinitySub under Regulation 13G(2)(b) of the Securities and Futures (Licensing and Conduct of Business) Regulations (SFLCBR).[68] InfinitySub, a wholly owned subsidiary of E-Shang Infinity Cayman Limited, is indirectly owned by ESR Cayman.[69] On 27 August 2019, she was appointed to the board of Sabana REIM as a non-independent non-executive director,[70] before resigning from the board of Blackwood in October 2019.[71]

Independent overnight?

> "The re-designation of Ms Ng from non-independent to independent… effectively meant that she went to bed on 31 October as non-independent and woke up the next day as independent."
>
> – *Professor Mak Yuen Teen*[72]

On 21 September 2020, Sabana REIM issued an addendum to its FY 2019 report, to amend disclosure regarding the redesignation of Ng as an independent director on 1 November 2019.[73] It justified that it had reviewed and assessed the transactions made between Ng and InfinitySub, but nevertheless concurred that she was independent as she had not received any further payment from InfinitySub, "no longer had any other relationship with the Manager, the REIT or their related corporations for purposes of the SFLCBR", had confirmed herself as independent and met the requirements set out in the 2018 Code of Corporate Governance. As such, it was believed that she "was able to act in the best interests of all Unitholders of the REIT as a whole".[74]

This was scrutinised in an article by corporate governance advocate Professor Mak Yuen Teen, where he argued that Ng would not be deemed independent if she was a substantial shareholder, director or executive officer of a for-profit corporation and has in the current or immediately preceding financial year made any payment to, or received any payment from, a "relevant person", which includes a related corporation of the manager.[75]

Quarz and Black Crane also voiced their reservations in the requisition notice dated 10 November 2020, demanding the release of the meeting minutes in connection with the redesignation of Ng as independent, as well as details of any declarations made to the board concerning her substantial business relationships with ESR Cayman, including the valuation of the sale of her shares to InfinitySub in comparison to other shareholders. It also suggested that she may have played an extended role in allowing ESR Cayman to acquire the remaining 60% of Blackwood's shares.[76]

Sabana REIM issued a response to Professor Mak's article, stating that its redesignation was in accordance with S13D(8) of the SFLCBR, reiterating its belief that Ng would be able to exercise independent judgment and act in the best interest of Sabana unitholders as a whole despite her deemed business relationship. It also provided clarifications on steps undertaken to establish her independence, including the confirmation that the consideration she had received from her sale of shares were in line with the consideration given to Vibrant for its divestment of shares in 2019 and that there were no additional terms agreed in the divestment of shares that required Ng to act in a particular manner in relation to Sabana REIT or the Sabana Group.[77]

In two further articles, Professor Mak said that he was not convinced with Sabana REIM's response, raised more questions and said that "regulators should want answers too".[78,79]

Proxy voting system

During the process of the merger, Sabana REIT had sought to amend its trust deed to allow the appointment of only one proxy for the scheme meeting by custodians. This was in line with REIT mergers that have occurred in Singapore to-date, whereby unitholders (including nominee companies and custodians), were only allowed to appoint one proxy, and unitholders could only vote their units in one direction.[80]

Quarz and Black Crane raised concerns over the system of proxy voting for the proposed merger in a letter dated 30 November 2020 to the MAS, stating that such an amendment would prejudice their interests unfairly, and that there was potential for "voting irregularities" to arise from the "one-proxy rule". The investment funds urged custodians to "properly submit" both approving and dissenting votes and asked them to publicly disclose their practices and share the underlying vote of unitholders.[81]

Professor Mak commented that the single proxy rule was "unsatisfactory" and not in line with the usual practice for companies of giving custodians and nominee companies multiple proxies. He added: "We don't know if the different custodians are adopting different rules. It would seem the whole voting process becomes a bit of a lottery at the very least. Further, this latest twist has come to attention rather late given the voting deadline."[82]

The EGM was scheduled to take place virtually on 4 December 2020, and voting would be carried out via proxy forms submitted by 1 December.[83]

Fallout of the failed merger

> "When we agreed to the merger process, it was due to a bigger ship sailing past and we wanted to hop onto it so we could continue the journey whatever the weather,"
>
> *– Donald Han, CEO of Sabana Real Estate Investment Management Pte. Ltd*[84]

The build-up of events surrounding the controversial proposed merger between ESR-REIT and Sabana REIT culminated in the shareholder vote during the EGM held on 4 December 2020. Unitholders rejected a proposal to amend the Sabana Trust Deed, thus terminating the merger. Only 66.67% of the unitholders voted in favour of the amendment, with the remaining 33.33% opposing it.[85] Meanwhile, ESR-REIT unitholders voted overwhelmingly in favour of the merger.[86]

In response to the results, Sabana REIM commented that voting against the proposed merger with its much larger rival would "harm its growth prospects amid a lack of alternative bidders".[87] However, Sabana REIM's CEO, Donald Han, said that it respected the decision of its unitholders, and reiterated its commitment to creating value for its unitholders.[88]

Quarz and Black Crane further said in a statement: "This is the first time in the 18-year history of Singapore Exchange's REIT market that a proposed merger has been voted down." The result was indeed a "rare win for shareholder activism" in a market dominated by retail investors.[89] However, not everyone thought that the outcome was worthy of a celebration. Justin Tang, research head at United First Partners, said: "The activists have pinned themselves into a corner. Is Sabana worth more? Yes, but is there anyone else who can unlock its value in this weak market? No."[90]

Who's going to pay?

Following the failed merger, shareholders were still dissatisfied over underlying issues that remained unsolved. One of these issues was the substantial cost of S$2.7 million incurred for failed merger. Quarz and Black Crane demanded that the Sabana REIT Manager pay for all fees incurred, rather than have unitholders bear the cost, on the basis that it was fully responsible for the value destructive proposed merger.[91]

I resign…again

On 7 December 2020, merely three days after the EGM, Ng resigned from her position as independent non-executive director of Sabana REIT.[92] She cited a disagreement with unitholders on the direction of the REIT as the primary factor, and reiterated her belief that "scaling up is the right way forward for Sabana REIT, given the limitations of its portfolio and the uncertainties of the external environment". Her tenure as a director this time lasted approximately 1.5 years.[93]

Unitholders refuse to endorse directors

On 1 January 2021, Willy Shee Ping Yah[94] and Yeo Wee Kiong[95] were appointed to Sabana REIM's board of directors. After their appointments, Sabana REIM's board consisted of four independent non-executive directors. However, Quarz and Black Crane expressed unwillingness to endorse the two proposed new independent non-executive directors via an open letter,[96] conveying their lack of confidence in the directors' capabilities to close the substantial valuation gap, as well as commitment to adequately defend minority investors' interests.[97] Subsequently, following the unitholders' refusal to endorse their appointments, Shee and Yeo resigned within three months of their appointment to the board.[98]

We don't want you either…

> "Notwithstanding Sabana's justifications, the key issue here is that although Chan fits the definition of an ID on paper and in terms of form, a good case can be made against his independence if substance is the defining criteria."
>
> *– David Gerald, Founder, President and CEO of the Securities Investors Association (Singapore)*[99]

On 2 June 2021, Charlie Chan Wai Kheong was appointed to Sabana REIM's board as an independent non-executive director.[100] This was despite him being a substantial unitholder of AIMS APAC REIT, which was considered a key competitor of Sabana REIT due to a similar investment mandate comprising primarily industrial assets in Singapore. Chan had also previously sold his stake in ESR REIT to ESR Cayman in 2017 for what was said to be a "substantial premium".[101]

Chan's appointment was met with strong disapproval from Quarz and Black Crane, which believed that Chan would not be able to act independently in the interest of Sabana REIT and that Chan's appointment to the board of Sabana REIM "further complicates the substantial potential conflict of interest issues that already exist with ESR Cayman being the controlling shareholder of both ESR REIT's manager and Sabana REIT's manager".[102] Instead, the two investment firms proposed the appointment of their own Chief Investment Officers (CIOs) as non-independent, non-executive directors to Sabana REIM's board. They then requisitioned another EGM for the REIT's unitholders to vote on the appointments of Chan and their CIOs.[103]

Sabana REIM conveyed its "total surprise" to the investment funds' objections "since Mr Chan Wai Kheong was one of the nominees for independent director that Quarz Capital had proposed to the manager".[104] It justified Chan's substantial holding in AIMS APAC REIT by stating that "the regulations and listing rules do not regard a director to be non-independent by virtue only of his investment in another REIT even if that other REIT is a competitor".[105] Chan was neither on the board of the manager of AIMS APAC REIT nor involved in the management of the REIT. It also added that it considered Chan's history with ESR Cayman to be irrelevant due to the substantial amount of time between the sale transaction and his appointment to the board.[106]

Sabana REIM also rejected the requisition of the EGM on the basis that "the reasons put forth by Quarz and Black Crane lacked grounds".[107] Instead, it elected for the endorsement of Chan as independent director to be carried out at the following Annual General Meeting (AGM), which was to be held about nine months later. It also called the proposal of adding the two funds' CIOs to the Sabana REIT Manager's board "contradictory", saying that "this will in fact dilute the overall independence of the board of directors of the Manager."[108]

At the AGM held on 26 April 2022, unitholders of Sabana REIT voted not to endorse the appointment of independent non-executive director Chan. As a result, Chan stepped down from REIM's board effective immediately. The remaining two board members were independent non-executive directors Tan Cheong Hin and Wong Heng Tew.[109]

ESR's acquisition of ARA

On 4 August 2021, ESR Cayman announced plans to acquire ARA Asset Management Limited (ARA).[110] ARA is a real estate fund management company that focuses on the management of public-listed REITs. ESR Cayman's rationale for the merger was to expand its fund management platform across geographies, investment strategies and risk/reward profiles through its "new economy" real estate platform[111] comprising logistics and data centers.[112] The deal was valued at US$5.2 billion, with ARA set to receive a consideration of US$519 million in cash, and US$4.7 billion in new ESR Cayman shares and vendor loan notes.[113]

As part of the consideration, the new ESR Cayman shares issued were valued at HK$27.00 (US$3.46), which is a discount on the HK$27.70 (US$3.55) closing price prior to the announcement of the merger. Terence Wong, founder of fund management firm Azure Capital, had earlier predicted ESR Cayman's investors would take issue with this transaction as the proposed offer was "not chump change".[114]

On the EGM held on 3 November 2021, ESR Cayman's shareholders voted overwhelmingly in favour of the acquisition, with 91.81% of votes cast in favour of the merger. Under this new combined entity, the total assets managed was expected to amount to S$131 billion, making ESR Cayman the largest real asset manager in Asia Pacific, and third largest listed real estate investment manager globally. A proposal for a merger between ESR-REIT and ARA Logos Logistics Trust was also raised, with the proposed merged entity, ESR-Logos REIT, expected to rank eighth largest based on market capitalisation on SGX.[115]

In March 2022, the managers of the two REITs received approval from their respective unitholders to proceed with the merger.[116] The combined entity, ESR-Logos REIT, holds a diversified portfolio of logistics/warehouse, high-specifications industrial properties, business parks and general industrial properties across Singapore and Australia. Based on reported total assets as of 31 December 2021, the REIT's total assets were valued at approximately S$5.5 billion. ESR-Logos REIT was listed on the SGX on 5 May 2022.[117,118]

What next for Sabana REIT?

ESR-REIT's merger attempts with Sabana REIT and ARA Logos Logistics Trust clearly produced two very different outcomes. Nonetheless, the failed merger between ESR-REIT and Sabana REIT still represents an important episode not just for the REIT industry, but for the market as a whole. Robson Lee, a partner in Gibson Dunn's Singapore office and a member of the firm's M&A and capital markets practice groups, views the failed merger as a "cautionary tale" on the importance of considering the composition of unitholders and engaging with minority unitholders.[119]

On 17 August 2022, it was disclosed that Switzerland-based Volare Group AG became a substantial unitholder of Sabana REIT.[120] What will happen next to the small Singapore REIT? Will history repeat itself?

Discussion questions

1. Identify the potential conflicts of interest arising from ESR Group's proposed acquisition of Sabana REIT and their implications. Consider this from the perspective of both ESR-REIT and Sabana REIT's stakeholders.

2. To what extent do you think unitholders can influence a REIT's corporate governance? What are the pros and cons of increased shareholder activism? Is shareholder activism common in your country? Elaborate why you think that is the case.

3. To what extent should the management and board of directors of Sabana REIT's Manager be held responsible for the failed merger between Sabana REIT and ESR-REIT? Do you think the offer from ESR-REIT was indeed a "lowball" offer and if so, why did the Sabana REIT's Manager accept it?
4. Do you think Sabana REIT Manager's justification for the re-designation of Ng Shin Ein from non-independent to independent was appropriate? Explain.
5. What do you think are the major risks that Sabana REIT should have considered before engaging in merger talks with ESR-REIT? What are some recommendations to mitigate such risks?
6. What do you think contributed to ESR-REIT's success in its merger with ARA Logos Logistics Trust to form ESR-Logos REIT, while it failed with the proposed merger with Sabana REIT? Do you think ESR-REIT made the right move by pursuing the merger?
7. It appears that many REITs believe that "bigger is better", given the merger trends in Singapore. Do you agree with this sentiment? What are the pros and cons of pursuing mergers to achieve scale?
8. In Singapore, nearly all REITs and business trusts are externally managed, while this is not necessarily the case in other markets. What are the pros and cons of internally versus externally managed trusts?

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SINGAPORE PRESS HOLDINGS: MAKER OF ITS OWN NEWS

Case overview

On 6 May 2021, news broke that Singapore Press Holdings Ltd (SPH) would be transferring its media business to a not-for-profit entity, a newly formed public company limited by guarantee (CLG), due to its declining advertising revenues and poor financial performance. SPH planned to contribute assets and shares to the CLG to facilitate its operations.

SPH said that running the media business under a listed company framework was not sustainable as the revenues from the media business were expected to fall further in the future, and it could not meet the expectations of shareholders in terms of profitability and regular dividend payouts. The decision and subsequent execution of the business transfer were questioned by shareholders and members of the public.

Subsequently, SPH received offers for its non-media businesses. After a tug of war between Keppel Corporation Limited and consortium Cuscaden Peak (CP), the latter eventually won the approval of shareholders with its more favourable offer. CP acquired SPH after the deconsolidation of its media business, and SPH was to be delisted from the Singapore Exchange (SGX).

The objective of this case study is to facilitate a discussion of issues such as corporate restructuring; mergers and acquisitions; diversification as a business strategy; the viability of a media company as a listed company; the company limited by guarantee structure; board composition; multi-vote share structure; stakeholder management; and the shareholder versus stakeholder model.

This case was prepared by Law Wing Sum, Shin Thant, Liu Xinxin, Zhang Jiawen and Guo Jingxue, 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 organisations named in the case, or any of their directors or employees.

The origin story

Singapore Press Holdings Ltd (SPH) was incorporated on 4 August 1984 after the merger of Times Publishing Berhad, The Straits Times Press (1975) Limited, and Singapore News and Publications Limited.[1] In December 1984, it was listed on the SGX Mainboard.[2] SPH has two types of shares, ordinary shares and management shares. Both types of shares have one vote per share, except on resolutions relating to "appointment or dismissal of a director or any member of the staff of the company", where management shares have 200 votes per share.[3] The Newspaper and Printing Presses Act (NPPA), which regulates print media in Singapore, provides that shareholding in SPH cannot exceed five percent per shareholder.[4] The number of management shares held by each shareholder as disclosed in SPH's 2021 annual report is shown in Figure 1.

HOLDERS OF MANAGEMENT SHARES

	NAME OF SHAREHOLDER	NO. OF SHARES	%
1	THE GREAT EASTERN LIFE ASSURANCE COMPANY LIMITED	3,698,297	22.60
2	OVERSEA-CHINESE BANKING CORPORATION LTD	2,748,829	16.80
3	NTUC INCOME INSURANCE COOPERATIVE LIMITED	2,674,219	16.35
4	SINGAPORE TELECOMMUNICATIONS LIMITED	2,176,119	13.30
5	DBS BANK LTD	1,554,362	9.50
6	UNITED OVERSEAS BANK LTD	1,316,578	8.05
7	NATIONAL UNIVERSITY OF SINGAPORE	876,797	5.36
8	FULLERTON (PRIVATE) LIMITED	658,260	4.02
9	NANYANG TECHNOLOGICAL UNIVERSITY	658,260	4.02
10	NG YAT CHUNG	8	0.00
11	DIRECTORS* (FOUR EACH)	40	0.00
	Total:	**16,361,769**	**100.00**

* *Excluding the Chief Executive Officer.*

Figure 1: Number of management shares held by each shareholder in 2021[5]

In its early days, SPH was a full-fledged media company with advertisement revenues and printing and distribution of publications as its main business model.[6] Strict licensing rules for media companies in Singapore under the NPPA[7] meant that SPH enjoyed a "near monopoly" in the country's newspaper industry.[8,9]

SPH then ventured into the property market in 1996 by acquiring two buildings – The Promenade and the Paragon by Sogo.[10] It subsequently listed SPH REIT – its subsidiary established principally to invest in a portfolio of income-producing real estate which is used primarily for retail purposes in Asia-Pacific, as well as real estate-related assets – on SGX in July 2013, and participated actively in condominium development projects.[11] It also invested in Purpose-Built Student Accommodation (PBSA) as an owner, manager and developer of a PBSA portfolio in the U.K. and Germany.[12]

SPH continued to branch out from its media business in 2017 when it ventured into the aged healthcare sector by acquiring Orange Valley Healthcare Pte Ltd (Orange Valley) and its subsidiary, Invest Healthcare Pte Ltd. Orange Valley was operating five nursing homes in Singapore at the time of purchase.[13] SPH then expanded this business segment further in 2020 through its purchase of five aged care assets in Japan.[14] SPH's 2020 annual report stated that the S$66 million acquisition was "in line with [its] strategy of investing in aged care and healthcare assets, and expanding its business footprint in markets with fast-ageing populations".[15]

The authors

SPH's board of directors prior to the restructuring exercise comprised 11 directors, including three female directors. Apart from SPH Chief Executive Officer (CEO), Ng Yat Chung, the board was entirely composed of non-executive and independent directors. There were five board committees: Executive Committee; Nominating Committee; Remuneration Committee; Board Risk Committee; and Audit Committee.[16]

The board was led by Non-Executive Chairman Dr. Lee Boon Yang. Dr. Lee was appointed to the SPH board on 1 October 2011. He previously held the position of Non-Executive Chairman of Keppel Corporation Limited (Keppel) for close to 12 years, until 23 April 2021. He is an experienced public servant, having previously held positions of Minister for Information, Communications and the Arts, as well as Minister in the Prime Minister's Office, Minister for Defence, Minister for Labour and Minister for Manpower.[17]

Chairman Lee's predecessor was Dr. Tony Tan Keng Yam, who had served as Chairman of SPH from December 2005. Dr. Tan stepped down on 1 July 2011 and subsequently became the President of Singapore. He was previously the Deputy Prime Minister and Co-ordinating Minister for Security & Defence and has helmed the Finance, Trade & Industry, Education and Defence ministries in Singapore. He also has experience in the private sector as the Chairman and CEO of Oversea-Chinese Banking Corporation.[18]

Ng joined the SPH board on 1 August 2016 and was appointed SPH's CEO a year later on 1 September 2017. Ng's previous roles prior to joining SPH included executive director and Group CEO of Neptune Orient Lines Ltd and senior managing director at Temasek Holdings (Private) Limited. Before his corporate roles, Ng was the Chief of Defence Force in the Singapore Armed Forces.[19] He was the Chairman of the Singapore Institute of Technology board of trustees until his retirement on 15 March 2022.[20]

Alan Chan Heng Loon was the previous CEO. Prior to joining SPH, Chan was an administrative officer in the civil service. He worked in the government for 25 years in various roles, including Permanent Secretary of the Ministry of Transport, Deputy Secretary of the Ministry of Foreign Affairs, Principal Private Secretary to then Senior Minister Lee Kuan Yew and Director of Manpower, Ministry of Defence.[21]

The reviewers

Apart from Chairman Lee and CEO Ng, the other directors on the SPH board comprised Janet Ang Guat Har, Andrew Lim Ming-Hui, Bahren Shaari, Lim Ming Yan, Quek See Tiat, Tan Chin Hwee, Tan Yen Yen, Tracey Woon, and Yeoh Oon Jin.[22]

A summary of the educational backgrounds and corporate experience of each board member is shown in Figure 2. The majority of the board has experience in the legal, IT, finance, investment and accounting industries.[23]

Board member	**Educational background and corporate experience**
Janet Ang Guat Har	• Bachelor of Business Administration (Honours) from the National University of Singapore (NUS) • Ang has had a 37-year career in the information technology sector, including as Managing Director of IBM Singapore from 2001 to 2003 and from 2011-2015. • Ang served as Chairman of the NUS Institute of Systems Science, and Singapore Polytechnic.
Andrew Lim Ming-Hui	• Bachelor of Law (Honours) and Masters of Law degrees from NUS • Lim is a partner of Allen & Gledhill LLP and a Fellow of the Singapore Institute of Directors. • Lim serves as a Trustee on the Board of Trustees of NUS and as a member of the board of Sentosa Development Corporation.

Bahren Shaari	• Graduated with an accountancy degree from NUS • Shaari has over three decades of banking experience, and is currently the CEO of Bank of Singapore. • Shaari was conferred the Singapore Institute of Banking and Finance Distinguished Fellow award in 2016 in recognition of his contribution to the financial industry and leadership capabilities.
Lim Ming Yan	• First Class Honours degree in Mechanical Engineering and Economics from the University of Birmingham • Lim worked for CapitaLand Limited for 22 years, and was its President and Group CEO from 2013 to 2018. • Lim holds the position of Chairman of the Singapore Business Federation and member of Singapore's Future Economy Council, and the National Jobs Council.
Quek See Tiat	• Honours (Second Class Upper) in Economics from the London School of Economics & Political Science • Quek has extensive audit and business advisory experience, having been a Partner and subsequently Deputy Chairman of PricewaterhouseCoopers LLP for 25 years. • Quek serves on the boards of Singapore Technologies Engineering Ltd, Pavillion Energy Pte Ltd, Pavillion Energy S.A.U., the Monetary Authority of Singapore, Temasek Foundation Connects CLG Limited, Temasek Foundation Limited, Centre for Liveable Cities Limited and TF IPC Limited.
Tan Chin Hwee	• Bachelor of Accountancy (Second Class Upper Honours) from Nanyang Technological University, and a Master in Business Administration from Yale University • Tan is a director of Trafigura Holdings Pte Ltd and Trafigura Pte Ltd, as well as Nayara Energy Ltd, India. He is the Asia-Pacific CEO of Trafigura. • Tan was previously the founding partner and Director of Apollo Management Singapore Pte Ltd., Managing Director of Amaranth Advisors, as well as President and Director of CFA Singapore.

Tan Yen Yen	• Graduated with a degree in Computer Science from NUS and an Executive MBA degree from Helsinki School of Economics Executive Education • Tan is a director of Oversea-Chinese Banking Corporation Limited, Jardine Cycle & Carriage Limited, and In.Corp Global Pte Ltd. • Tan is a veteran in the technology and telecommunication sectors, having held senior positions in Vodafone Global Enterprise Singapore Pte Ltd, SAS South Asia Pacific, Oracle Corporation Asia Pacific and Hewlett-Packard Singapore.
Tracey Woon	• Bachelor of Law (Honours) from NUS • Woon has more than 37 years of investment banking experience, and is a director of United Overseas Bank Limited. • Prior to joining UOB, Woon was the Vice Chairman, Asia Pacific, Global Wealth Management at UBS AG. She was previously Vice Chairman of Citibank ASEAN Corporate and Investment Banking.
Yeoh Oon Jin	• B Com (Accounting) (First Class Honours) from the University of Birmingham • Yeoh was the Executive Chairman of PwC Singapore before his retirement following a 38-year career with PwC. • Yeoh is a Fellow of the Institute of Singapore Chartered Accountants and the Institute of Chartered Accountants in England and Wales

Figure 2: SPH board of directors in 2021[24]

Professor Mak Yuen Teen, a corporate governance advocate and shareholder of SPH, observed that none of the SPH board members appear to have any prior working experience in the news media or advertising industries at the time of their appointment. This is in direct contrast with other large news media companies worldwide,[25,26] which have board members or senior management with significant experience in the news media industry and closely-related industries. This prompted him to question whether the SPH board and senior management were equipped to oversee and manage SPH's media business.[27]

Fall from favour

SPH's revenue has been on a steady decline since 2012, as seen in Figure 3 below. Most notably, SPH swung from a net profit of S$213.2 million in 2019 to a net loss of S$83.7 million in 2020.[28] SPH's media division has seen a decline in revenue in recent years, from S$963.4 million in 2014 to S$445.1 million in 2020. As a result of its worsening performance, SPH's dividend has correspondingly been falling – the annual dividend in 2014 was S$0.21, but fell to S$0.025 in 2020.[29]

Figure 3: SPH's revenue and net profit from 2010 to 2020[30]

SPH's share price has also experienced a downward trend from a peak of S$4.60 per share in 2013 to a historical low of S$0.99 in 2020.[31] In June 2020, SPH was removed from the Straits Times Index (STI), the benchmark index for the Singapore stock market which comprises the top 30 stocks listed on SGX's Mainboard, ranked by market capitalisation. It was replaced by Mapletree Industrial Trust. At that time, SPH's market capitalisation was a mere S$2.18 billion, less than half of the market capitalisation of Mapletree Industrial Trust of S$5.83 billion.[32]

The sky is falling

Of its three main business segments, SPH was most concerned about its poorly performing media business. Print advertising revenue has been steadily declining for years as advertisers shift towards digital advertising. This was made worse by the COVID-19 pandemic and resulting sluggish economy.[33] SPH expected these trends to persist and worsen, with a decline in print advertising revenue as media consumption moved online.[34]

Warning signs of the failing media business could be seen as early as 2013 when SPH's media segment's revenue dropped by about 4% from the previous year, and the trend continued in subsequent years.[35] In 2016, SPH attempted to stem losses by laying off up to 10% of its workforce and merging two of its newspapers – The New Paper and My Paper. It aimed to increase circulation of the revamped newspaper to up to 300,000 copies to attract advertisers.[36] However, the initiatives were not sufficient – media revenues continued to worsen and SPH accelerated layoffs for hundreds of staff between 2017 and 2020.[37,38]

In an attempt to improve its media business, SPH invested heavily in digital transformation efforts. It boosted its spending in technology, product development and data analytics talent by 48% to over S$20 million a year and invested S$35 million in digital content and audience development talent. It also invested in new consumer-facing digital platforms and products.[39] SPH's efforts included partnerships and ventures with other companies. This included its S$6.8 million investment into Brand New Media Singapore (BNMS) to move into the video content marketing space in 2016. BNMS is a wholly-owned subsidiary of Brand New Media Pty Ltd, a leading Australian video content marketing company.[40] In 2018, SPH entered into a joint venture with Mediacorp Pte. Ltd. (Mediacorp), a Singaporean mass media conglomerate, to launch Singapore Media Exchange (SMX), a new digital advertising marketplace.[41]

Despite these digital transformation efforts, SPH's media segment posted its first ever loss before taxation of S$11.4 million for the financial year ending 2020, against the backdrop of the COVID-19 pandemic.[42]

Too little, too late?

In respect of SPH's most widely read local newspaper, The Straits Times, digital copies accounted for 9% of circulated copies in 2012,[43] increasing to 31% in 2017.[44] It took eight years for digital circulation to finally exceed print – in 2020, digital copies made up 65% of circulated copies.[45]

Hari Shankar, the former Chief Executive of SMX, argued that SPH responded poorly when big technology firms disrupted the advertising market. While setting up SMX in 2018, Shankar realised that there was "a lot of ground to cover before SPH could have a meaningful conversation with the digital media buyers of the day". He said that this was in contrast to Australian publishers which were able to retain a significant share of the advertising market as they decisively took on digital transformation early on and continued to improve on their digital strategies over the years.[46]

Ranganathan Somanathan, a media veteran and former CEO of Omnicom Media Group, was of the view that SPH's leadership was more focused on increasing shareholder value, choosing to diversify instead of transforming its core media business. Eventually, SPH's goal detracted from the company becoming the leading multimedia company in Asia, seeking instead to increase returns from its property arm in order to cushion its fading media revenue. Shankar echoed the same sentiments based on his experience, saying "...when the market was screaming for more innovation on the ad product, targeting, performance and packaging front, there was hardly any activity to address that need except some loosely-coupled partnerships, which meant that precious time to set up in-house adtech and ad product plan was thereby lost".[47]

Ventures into property

In 1996, as part of its strategy to diversify its core businesses, SPH made its first move into the property business by acquiring two buildings – The Promenade for S$270 million, and the Paragon by Sogo for S$682 million, which were later developed into today's Paragon mall.[48]

Slightly over a decade later, SPH launched the Sky@eleven condominium in 2007,[49] which was well received by the public.[50] SPH further strengthened its property business in 2009 when it led a joint venture with NTUC FairPrice Co-Operative Limited and NTUC Income Insurance Co-Operative Limited to win the tender for Clementi Mall at a S$541.9 million price tag.[51] The bid was about 42% higher than the second highest bid of S$382 million. This raised eyebrows, with some analysts commenting on how SPH might have been unnecessarily aggressive in its bid for the mall.[52]

On 24 July 2013, SPH REIT was listed on the SGX.[53] Its property portfolio at the time of listing consisted of Paragon and Clementi Mall. SPH REIT made a strong debut and raised S$504 million, with its share price rising above its Initial Public Offering price by nine percent on the same day.[54] Since then, SPH REIT has acquired several shopping malls, including The Rail Mall in 2018, as well as stakes in Australian malls Figtree Grove Shopping Centre in 2018 and Westfield Marion Shopping Centre in 2019.[55]

SPH then diversified into PBSA in 2018 by first acquiring a U.K. student accommodation portfolio for S$321 million.[56] Earlier that year, its U.K. subsidiary, Straits Capitol Limited, which principal business was property management, was incorporated.[57] In November 2019, SPH acquired Galileo Residenz – a property comprising 284 beds – in Bremen, Germany, for a consideration of S$23.4 million.[58] This was followed by the acquisition of Student Castle Investments Holdco Limited and its seven PBSA assets in the U.K. for S$739.9 million.[59,60]

Going digital

In 2006, SPH Magazines Pte Ltd – a wholly-owned subsidiary of SPH – acquired Hardware Zone Pte Ltd (HWZ) and its subsidiaries for S$7.1 million in cash.[61] According to SPH, HWZ was "the leading IT media company in Asia, providing marketing channels and services to the information communications, technology and interactive entertainment industry", and the acquisition would allow SPH to expand its magazine portfolio to include IT publications.[62] This served to complement SPH's existing print magazine business, and represented a step towards becoming a major magazine publisher with multi-platforms for readers and advertisers.[63]

SPH's attempt to modernise its offering by investing in new media technologies continued in 2013 through its S$12.5 million investment in Magzter Inc. (Magzter), a global digital magazine store and newsstand.[64] At the time of the investment announcement, Magzter had offices in New York, London, Chennai, and Singapore and had more than 16 million digital consumers, over 2850 magazine titles and 900 publishers.[65] That same year, SPH also acquired SGCM Pte. Ltd.[66] and subscribed for 865,703 new preference shares in Chope Group Pte Ltd (Chope).[67] SGCM Pte. Ltd., which owns and operates SgCarMart.com, a popular online classified site for cars in Singapore, was acquired for S$60 million –12 times its 2012 revenue.[68] Chope, then a Singapore start-up, received investment of S$1.81 million from SPH even though it was not yet profitable at the point of time. SPH justified the investment citing its "viable business model that has gained much traction since its inception" and potential synergy between Chope and the food content in SPH newspapers.[69]

SPH's also dabbled in analytics and e-commerce platforms as part of its ongoing investments. In 2015, SPH bought a 20% stake in DC Frontiers Pte Ltd – which operates an analytics platform for relational information about companies and the people who run or own them – for S$2 million.[70] SPH also led a Series A funding round for Qoo10, an e-commerce site, raising US$82.1 million (S$113 million) together with other investors such as eBay and Saban Capital Group. SPH emphasised that it would become a strategic partner of Qoo100 as its lead investor, advising on classifieds strategies, advertising, content, and other opportunities. According to Alan Chan, then-CEO of SPH, the investment would enhance SPH's digital assets portfolio and could create opportunities for marketing collaborations.[71]

SPH's interest in e-commerce did not stop at there. In 2020, SPH launched its own e-commerce platform, Shop For Good, which aimed to "help businesses and consumers stimulate the economy" in the difficult COVID-19 business environment.[72] In 2021, SPH announced that it had accumulated a 0.1% indirect stake in Coupang after its initial US$3.9 million (S$5 million) investment in the South Korean e-commerce company in 2014.[73]

Aged care

In 2017, the acquisition of Orange Valley – one of Singapore's largest private nursing home operators in Singapore[74] – marked SPH's move into the aged healthcare sector and its strategy of building a third business leg in healthcare.[75] The acquisition is unrelated to SPH's core businesses of media and property, sparking opinions as to whether SPH was "diworsifying" – the act of a company acquiring completely unrelated businesses and causing its overall results to worsen.[76] The S$164 million all-cash deal was approximately 2.3 times Orange Valley's net asset value of S$71 million as at 31 March 2017.[77] Just two years later, SPH recognised an impairment charge of S$22.1 million mainly for its aged care business. The reason for the impairment was that "the increase in build-own-lease (BOL) nursing home bed capacity coming on stream has impacted the original business projections of Orange Valley".[78]

In 2020, SPH expanded its aged care business overseas by acquiring five aged care assets in Japan for S$65.8 million. According to Anthony Tan, Deputy CEO of SPH, "the aged care industry is set for continued growth in countries with fast-ageing populations like Singapore and Japan".[79] There were also plans to acquire six senior housing properties in Canada for S$244.5 million as part of SPH's strategy to "acquire cash-yielding assets in defensive sectors",[80] but the agreement was cancelled just one month after SPH's announcement due to global market instability brought about by the COVID-19 pandemic.[81]

Dropping the bombshell

> "Many shareholders and investors are, therefore, at a loss as to why the SPH media business would not be profitable given the near monopoly that SPH has for its print publications."
>
> – *David Gerald, founder, president and CEO of Securities Investors Association (Singapore)*[82]

On 6 May 2021, SPH announced that as part of a strategic review of its business, it would transfer its loss-making media business to a not-for-profit organisation. The entire media arm of SPH – including relevant subsidiaries, employees, News Centre and Print Centre along with their leaseholds, all related intellectual property and information technology assets – would be transferred to a newly incorporated wholly-owned subsidiary, SPH Media Holdings Pte Ltd (SPH Media). SPH Media would then be transferred to a not-for-profit entity, which is a public company limited by guarantee (CLG), for a nominal sum. Former Cabinet minister Khaw Boon Wan would take on the role of Chairman of the board of the newly formed CLG.[83] The proposed restructuring exercise was subject to SPH shareholders' approval at an extraordinary general meeting (EGM).[84,85] With the deconsolidation of the media arm, SPH would be left with its property and aged care business segments.

SPH Chairman Lee said the restructuring would “enable the media business to focus on quality journalism and invest in talent and new technology to strengthen its digital capabilities”.[86] Following the restructuring, SPH would not be subjected to shareholder and other relevant restrictions under the NPPA.[87] This would allow SPH “greater financial flexibility to tailor its capital and shareholding structure to pursue strategic growth opportunities across its other businesses and maximise returns for shareholders”.[88]

As part of the spin-off, SPH agreed to contribute S$356.8 million for the operation and maintenance of the restructured media business.[89] The quantum of the contribution was based on the following:[90]

- Net asset value (NAV) of the target shares of S$98.8 million, as at 28 February 2021;
- Market value of the key leases of S$142.5 million, as at 4 June 2021;
- NAV of the relevant SPH REIT units of S$21.4 million, as at 28 February 2021;
- NAV of the relevant SPH shares of S$14.1 million, as at 28 February 2021; and
- Minimum cash balance of S$80 million

The bombshell announcement shook shareholders and the general public. On 7 May 2021, SPH’s shares fell by 15%, closing down S$0.27 at S$1.52.[91]

Taking umbrage

During the press conference organised by SPH on 6 May 2021, a Mediacorp reporter asked if the company would “now pivot to emphasise editorial integrity, for example, ahead of advertiser interests”. Ng got upset at the pointed question, and responded: “The fact that you dare to question the SPH title for, in your words, ‘conceding to the advertisers’, I take umbrage in that comment.”[92]

Videos of the heated exchange were shared widely on social media and messaging platforms, and there was a spike in Google searches for the word "umbrage".[93] Law and Home Affairs Minister K Shanmugam was of the view that "Mr Ng's reaction and the way he answered the question...was very unfortunate". He defended the reporter's question, calling it a fair one.[94] Two days later, Ng apologised for his comments in the heat of the moment, saying "I had stood up for SPH Media's long cherished editorial integrity and will continue to do so. Being a direct and blunt-speaking person, I apologise for any offence I might have caused and regret any distraction from the merits of the proposed restructuring."[95]

Appointment of Credit Suisse as financial adviser

> "While SPH's media business continues to face a challenging operating environment and outlook, the board of directors believes that SPH remains undervalued and the objective of the strategic review is to unlock and maximise long-term shareholder value,"
>
> – *SPH on 30 March 2021*[96]

Two months earlier, in March 2021, SPH's board had appointed Credit Suisse (Singapore) Limited (CS) as the financial adviser for the company's strategic review of its various businesses in view of the challenges faced by the media business. The strategic review was undertaken with a view to unlock and maximise shareholder value. SPH stated that CS was selected in view of its "expertise and past experience in navigating complex and nuanced corporate actions; relevant investment banking credentials especially in the Singapore listed company space; and helping clients unlock value via M&A and/or other corporate actions".[97,98]

CS was appointed at a time when the investment banking group faced significant backlash regarding its involvement in the failure of Greensill Capital, as well as its roles in cases of corporate misconduct such as Luckin Coffee, Wirecard and Wework.[99] More recently, an investigation into the CS Group uncovered that years of mistakes and misjudgements had led to the CS Group suffering a US$5.5 billion loss following the collapse of Archegos Capital Management.[100]

Professor Mak questioned the suitability of CS as a financial advisor for SPH's strategic review in view of the potential issues in the corporate governance and management of CS. In addition, Professor Mak also urged for more clarity in the role of CS as part of SPH's strategic review. This was because CS might potentially be motivated to push for the restructuring option so as to earn extra advisory fees during SPH's restructuring process.[101] In its defence, SPH stated that it also engaged a number of other competent and experienced advisors such as Allen & Gledhill LLP as legal advisor and Evercore Asia (Singapore) Pte. Ltd. (Evercore) as financial adviser to the board.[102]

What is the best option?

SPH said that it had considered various strategic options in relation to its media business before arriving at the decision to deconsolidate its media arm.[103] In an analysts' briefing held by SPH on 6 May 2021, it identified several obstacles in operating SPH's media business under the existing framework, including shifting consumer habits leading to poor demand for traditional print media, and intensified competition for digital revenue. Hence, SPH was of the opinion that it was not feasible to run the media business in the long run due to widening losses, greater investments required for digitalisation, and maintaining journalism quality with reduced expenses.[104] As a result, it "came to the conclusion that the business should no longer be in a commercial, listed company where shareholders expect a fair return".

SPH CEO Ng expounded on this in a dialogue between Securities Investors Association (Singapore) (SIAS) and SPH, saying "The best way is to structure it as a non-profit entity where any surpluses that might be made in future will not be distributed to shareholders but kept within the business."[105]

Company limited by guarantee

SPH asserted that a CLG was the most suitable option as it takes care of the interests of the relevant stakeholders such as their staff, shareholders, business partners and the Singapore community.[106] A CLG is an entity that has members who act as guarantors of the company's liabilities, instead of share capital or shareholders, although their "guarantee" is limited to the nominal contribution they make as members. By transferring SPH's entire media business to a newly formed CLG, profits would be reinvested in the company instead of being distributed to shareholders. The structure would also allow SPH Media to seek funding from public and private sources.[107]

The Ministry of Communications and Information (MCI), which regulates SPH under the NPPA, indicated its support for the SPH restructuring framework.[108] As mentioned by MCI, "the government is prepared to provide funding support to the CLG to help SPH Media accelerate its digital transformation and build capabilities for the future" to achieve the goal of helping local news media adapt and thrive in the digital age while upholding high professional standards.[109] That being said, Professor Mak highlighted that even with the Singapore government's support, the newly formed CLG board must review the business model and strategies to ensure sustainability of the business.[110]

Concerns on editorial independence

> "Who it gets its funding from...would dictate the direction SPH is taking. That's the clarity people are asking for right now."
>
> – *Anonymous SPH staff member*[111]

The issue of funding also raised concerns about editorial independence of the not-for-profit funding model. It was reported that SPH employees were questioning whether the new entity would be able to maintain editorial independence from its funders, especially given that the Singapore government was expected to be the largest source of public funding.

Dr. Liew Kai Khuin, an independent media and culture researcher, opined that the restructuring may represent a move towards nationalising media because he could not foresee how the CLG would be able to get sufficient donations or funding from non-government institutions.[112] During a parliamentary debate on 10 May 2021, Communications and Information Minister S. Iswaran said that the Singapore government was prepared to assist financially if required but it was "premature" to specify exact funding figures at that juncture. Funding aside, he asserted that a culture of editorial independence exists in the country's news media.[113]

Communication with shareholders

On 26 August 2021, SIAS organised a virtual dialogue session with SPH for shareholders to discuss issues relating to the restructuring proposal.[114] There was a limit on the number of shareholders who can attend this one-hour session.[115] Among other concerns discussed was how SPH arrived at the final decision of giving its media business away and how this would impact its shareholders.[116]

During the virtual EGM held on 10 September 2021, SPH obtained approval from its shareholders to transfer its media business to the CLG. Approximately 97.5% of over 300 shareholders voted in favour of the proposed restructuring and the majority also agreed to the conversion of management shares to ordinary shares and the adoption of a new constitution following the restructuring.[117]

Out of the 1.6 billion outstanding SPH shares, only 370 million shares, or 23% of the outstanding shares, were voted.[118,119] Professor Mak contrasted this turnout with the typical 58% of shares that would have been voted at shareholder meetings before the COVID-19 pandemic, suggesting that the virtual EGM format did not help matters.[120] He also added that there were several technical difficulties faced before getting into the EGM. Some shareholders also complained about the lack of physical documents issued by SPH and the onus put on shareholders to download, print, and either mail or email the proxy form.[121] The conduct of SPH's EGM was also contrary to a commentary by SIAS, which mentioned that shareholder meetings should be either physical or hybrid – as opposed to fully online – and "live" voting should be mandatory.[122]

A surprise offer

On 2 August 2021, a privatisation offer was made by Keppel for SPH's non-media businesses, valuing the group at S$3.4 billion. Under the proposed scheme of arrangement, SPH shareholders are entitled to a consideration of S$2.099 per share, comprising S$0.668 in cash, 0.596 Keppel REIT unit, and 0.782 SPH REIT unit. The S$2.099 a share offer represents almost a 40% premium to the last traded share price of SPH of S$1.50 prior to the strategic review announcement in May. The scheme would need approval from both SPH and Keppel shareholders. If Keppel were successful in its bid to take SPH private, SPH would be delisted and become a wholly-owned subsidiary of Keppel. Keppel would hold approximately 20% stakes in both Keppel REIT and SPH REIT.[123,124] The offer came with a break fee of S$34 million, approximately one percent of the total consideration.[125]

Despite the consideration being only paid partially in cash, analysts believed that Keppel's offer was reasonable and were optimistic of the potential synergies Keppel would achieve through the acquisition.[126,127] Two days after the surprise offer, on 4 August 2021, SPH appointed Evercore as its independent financial adviser for Keppel's proposed deal.[128]

SPH commented through a press statement that after reviewing various strategic options for SPH, the final decision by the board was to privatise the entire company as it would "maximise value and minimise disruption for shareholders". It said that taking the company private would derive "a better valuation outcome for all shareholders where a control premium is paid for the entire company".[129] Chua Hwee Song, SPH's Chief Financial Officer, added that Keppel's proposal was selected after the evaluation of numerous proposals by over 20 potential bidders.[130] CEO Ng also mentioned that no all-cash offers were received.[131]

In response to a question on Chairman Lee's involvement in the selection of Keppel's proposal given his position as former Keppel Chairman from 2009 to 2021, CEO Ng said that Dr. Lee had recused himself from discussions on Keppel's privatisation offer. Dr. Lee had stepped down from Keppel's board in April 2021 after SPH announced the strategic review but prior to the release of the CLG proposal.[132]

Surprise! A competing offer presents itself

Cuscaden Peak (CP) is a consortium comprising Hotel Properties Limited (HPL), businessman Ong Beng Seng, and two Temasek-linked companies – CLA Real Estate Holdings and Mapletree Investments.[133] On 29 October 2021, CP announced the submission of a proposal to SPH to acquire SPH at a total consideration of S$3.4 billion, which translated to S$2.10 per share in cash.[134] The acquisition would occur by way of a scheme of arrangement. Upon completion of its proposed cash offer, CP would then be obliged to undertake a chain offer for all SPH REIT units, in accordance with Singapore Code on Take-overs and Mergers.[135]

On 1 November 2021, CP disclosed in a SGX filing that the minimum chain offer price offered per SPH REIT unit would be S$0.964, fully in cash.[136] The next day, SIAS said that SPH shareholders had voiced concerns that the existing offers by Keppel and CP still undervalue the company and questioned whether SPH should continue operations as a listed company in view of the deconsolidation of the media business.[137]

Following SIAS' statement, both Keppel and CP upped the ante, revising their existing offers in a bidding war. On 10 November 2021, Keppel revised its offer with a "compelling" final offer of S$2.351 per share, which included additional cash of S$0.20 per share. Keppel added that the revised offer was "firm and irrevocable".[138] The Keppel scheme meeting was to be held no later than 8 December even if another party provided a better proposal.[139] Keppel CEO Loh Chin Hua said that the revised offer price reflected improved global economic conditions and clearer business synergies.[140]

Five days later, CP announced its improved offer, giving SPH shareholders the option of either an all-cash offer of S$2.36, or S$2.40 per share consisting of S$1.602 in cash and 0.782 of SPH REIT unit via a distribution-in-specie by SPH. CP's scheme meeting could only proceed if SPH shareholders voted against Keppel's offer at Keppel's scheme meeting on 8 December 2021. Additionally, CP was prepared to pay the S$34 million break fee should SPH shareholders vote against the Keppel offer.[141] After considering both offers, analysts generally were of the opinion that the CP offer was superior due to its higher price and cash consideration.[142] SPH independent directors also concurred, and preliminarily recommended that shareholders vote against the Keppel offer – subject to the independent financial adviser's opinion.[143]

A head-to-head battle

Knowing that it had an edge over Keppel, CP said that both scheme meetings should be held at the same time.[144] However, SPH had earlier agreed as part of Keppel's revised offer that it could not hold an alternative scheme meeting within eight weeks from the date of Keppel's own scheme meeting. This clause could be waived only if

SPH's shareholders voted against the Keppel scheme. As such, SPH shareholders could only vote on the CP scheme if they rejected Keppel's offer.[145] On 24 November 2021, SPH announced the delay of the Keppel scheme meeting till after 8 December 2021.[146]

Meanwhile, during Keppel's EGM held on 9 December 2021, 98.2% of Keppel shareholders voted in favour of the SPH acquisition, signalling their strong support for the deal.[147]

On 22 December 2021, the Securities Industry Council (SIC) – the regulator for takeovers and mergers – ruled that the clause in Keppel's offer that restricted SPH from holding another scheme meeting for a rival offer within eight weeks from the Keppel scheme meeting should be disregarded. This ruling permitted SPH to hold a shareholders' meeting to vote on both acquisition offers on the same day.[148]

SPH's fate is sealed

> "I am confident that SPH Media Trust will fulfil its mission of serving as a trusted source of domestic and international news and I wish them every success as they embark on this exciting, meaningful and rewarding new chapter,"
>
> *– Dr. Lee Boon Yang, SPH Chairman*[149]

While SPH's non-media assets were being pulled in two opposing directions by Keppel and CP, the restructuring of its media arm progressed according to plan.

In May 2021, veteran journalist Patrick Daniel was named interim CEO for the newly formed CLG, SPH Media Trust (SMT). His former roles included the deputy CEO of SPH and editor-in-chief of SPH's English/Malay/Tamil Media Group. Daniel came out of retirement to work together with SMT Chairman Khaw to ensure a smooth transition of the media business to the CLG.[150]

On 1 December 2021, SPH reported that it had completed its media business restructuring exercise. SPH's entire media-related business was transferred to SMT, for a nominal consideration of S$1.[151]

SMT announced the appointment of six new directors to the board of SPH Media Group in February 2022, including Shaari, who was on SPH's board of directors. The five other newly elected directors are Lee Yi Shyan, OUE Limited executive adviser; Philip Lee, vice-chairman of global banking for South-east Asia at HSBC Singapore; Lim Mei, co-head of corporate mergers and acquisitions at Allen & Gledhill LLP; Max Loh, managing partner for EY in Singapore and Brunei; and Elaine Yew, senior partner at Egon Zehnder.[152]

In the same month, SMT also appointed Teo Lay Lim as CEO of SPH Media Group. Teo graduated with a Bachelor of Business Administration from the National University of Singapore and has held various leadership positions at Accenture – a multinational professional services company – for over three decades. Her latest position with the company before her departure on 31 August 2021 was Accenture's Singapore Chairman. Teo is also an independent director and executive committee member of UOB, and serves on the boards of SPH Media Trust, Workforce Singapore, the Singapore Accountancy Commission and the Institute for Human Resources Professionals.[153]

A two-decade plan

On 14 March 2022, Daniel announced his vision that SMT could be a "financially independent, thriving media group with products in four languages that are trusted by audiences who pay for premium content, both in Singapore and abroad" by 2045 – 23 years into the future. He expressed confidence that SMT's goal of being financially independent would be achievable if given resources, and emphasised that SMT would need to focus on talent acquisition, retention and employee engagement, and investments in technology as part of its plan. Additionally, his hope is for SMT to distinguish its offerings from competitors in the industry through high content quality, and the trust it would have gained from consumers over the years through accuracy and balanced coverage.[154]

The end of SPH as we know it?

In a dramatic turn of events for Keppel, SPH announced in February 2022 that following a consultation with the SIC regarding termination rights, it had terminated the implementation agreement with Keppel on the basis that not all the scheme conditions set out in the implementation agreement had been satisfied. SIC reportedly had no objections to SPH exercising the termination right.[155] Subsequently, SPH obtained court approval to reject Keppel's final offer of S$2.351 per share and withdraw the application to convene the Keppel scheme meeting. In response, Keppel disputed the rejection and sought arbitration "to enforce its rights and seek various reliefs against SPH", claiming that SPH was obliged to put its offer to a vote.[156] Keppel also argued that SPH should not have consulted with SIC on the termination, "given the prevailing circumstances where the Keppel scheme should have been put to shareholders of SPH for their consideration".[157]

On 22 March 2022, SPH held an EGM where SPH shareholders voted to sell the company's assets to CP. SPH obtained the support of 89.19% of shareholders – representing 96.55% of the number of shares voted - approving the CP scheme. The resolution required the approval of more than 50% of the number of shareholders and a minimum of 75% in the value of votes cast. Voting was carried out electronically, and the results were revealed by SPH board member Tracey Woon during the virtual EGM meeting.[158,159]

The takeover scheme was sanctioned by the court on 1 April 2022, and the last day of trading for SPH shares was 7 April 2022.[160]

On 26 April 2022, 42.1% of SPH shareholders elected to receive both cash and units, while 57.9% elected the all-cash consideration. Approximately 26.1% of SPH REIT units would therefore be transferred to CP, resulting in the consortium owning more than 30% of the REIT and triggering a chain offer for SPH REIT.[161]

The transfer of SPH REIT units to CP on 12 May 2022 marked the last act by SPH. Its long-drawn restructuring exercise was undoubtedly one of the largest and most radical shake-ups in the local business scene, affecting multiple industries and involving various players.

Discussion questions

1. What do you think were the major factors that contributed to the poor performance of the media business in SPH? Rank these factors in terms of their relative importance. Do you think SPH could have better handled the disruption of the media industry and if so, how? Did the experience and composition of SPH's board of directors and management contribute to the poor performance of SPH's media business? Explain.
2. Critically evaluate the dual class share structure in SPH. How does this structure impact the composition of the board of directors and the selection of senior management personnel? How does this structure impact the institutional and retail shareholders of SPH? How does the dual class share structure and restriction of shareholding to 5% affect its corporate governance? Do you believe it was a contributing factor to the poor financial and share price performance of SPH? Explain.
3. Evaluate SPH's past ventures and acquisitions and whether they were in the best interest of the company. To what extent has SPH benefitted from its diversification into property and aged care? Evaluate whether this business strategy of growth by acquisitions of businesses is sustainable for the company.
4. What are the roles and responsibilities of the board in restructuring, merger and acquisitions, and privatisation decisions? What are the options available to the SPH board in light of the poor performance of its media business and how should the board have evaluated these options?
5. Evaluate SPH's decision to engage Credit Suisse as a financial adviser. Were there any potential conflicts of interest?

6. Discuss whether SPH has adequately communicated the details of the proposed restructuring exercise to its shareholders and stakeholders. In view of COVID-19 restrictions in place due to the pandemic, how should virtual shareholder meetings be best organised? How could SPH have improved its communication with shareholders?

7. Comment on the actions undertaken by the players involved in the privatisation of SPH's non-media businesses. Who do you think stands to gain the most from the bidding war between Keppel and Cuscaden Peak?

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ARCHEGOS, ARCHE-WENT

Case overview

On 26 March 2021, Archegos Capital Management (Archegos), a family office owned by billionaire investor Bill Hwang, collapsed after defaulting on margin calls issued by investment banks including Credit Suisse, Morgan Stanley and Nomura. Prior to its collapse, Archegos had used equity swaps to leverage its exposure to equities, profiting from the bull market in technology stocks since 2013. However, in March 2021, several companies which Archegos had invested in experienced sharp declines in share prices. This triggered margin calls from Archegos' prime brokers. As Archegos was unable to raise sufficient capital to meet margin requirements, it was forced to liquidate its positions in companies such as Viacom CBS, Discovery Inc., and Tencent Music. Due to the nature of equity swaps, the prime brokers which held the underlying shares on behalf of Archegos were forced to liquidate their positions, resulting in large financial losses. It was reported that Hwang lost a total of US$20 billion during the collapse, while the losses suffered by the investment banks amounted to US$10 billion.

The objective of this case study is to facilitate a discussion of issues such as the regulation and oversight of family offices; fit and proper criteria for those in fiduciary and management roles; role of regulatory authorities; Know-Your-Client and risk management practices in banks; and the nature of swaps.

Rags to riches

Professional life – Aggressive Tiger Cub

> "He was the best salesman we had. He introduced us to Korea. No one was focusing on Korea back then and we hired him soon after."
>
> *– Julian Robertson, hedge fund legend*[1]

This case was prepared by Chen Xiao Min, Chloe Menendez, Christian Spenninger, Christopher Mak Jun-Min and Tammy Tan Xin Ning, 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 organisations named in the case, or any of their directors or employees.

Sung Kook Hwang, who went by the name of Bill, was a South Korean immigrant who moved to the U.S. as a teenager. He came from humble beginnings – his father was a pastor and his mother was widowed when he was a teenager.[2] Hwang claimed that when he had first arrived in the U.S., he was unable to speak or write in English. It was only while working part-time at a fast food chain that he picked up the language. With grit and determination, he went on to earn an economics degree from the UCLA and an MBA from Carnegie Mellon University.[3]

After graduation in the early 1990s, Hwang worked as an equity salesman in Hyundai Securities Co., Ltd., which was part of Hyundai Group, a Korean conglomerate.[4] During this period, he attracted the attention of hedge fund superstar and billionaire investor Julian Robertson. Robertson is the founder of Tiger Management, a world-renowned hedge fund.[5] Between 1980 and 2000, Tiger Management delivered average annual returns of over 25%, consistently outperforming the U.S. market. Hwang was offered the opportunity to join Tiger Management and became one of Robertson's 'Tiger Cub' protégés.[6]

Many 'Tiger Cubs' later went on to become founders of their own funds and achieve great success in the hedge fund industry.[7] A year after Tiger Management closed its doors in 2000, Hwang founded his own hedge fund, Tiger Asia Management LLC (Tiger Asia). This was done with the support of Robertson, who invested US$23 million in the fund.[8] Based in New York, Tiger Asia subsequently became one of the largest Asia-focused hedge funds, managing assets valued at more than US$5 billion at its peak.[9]

Personal life – Religious and modest

Despite his Wall Street career and unlike other finance high rollers, Hwang is known to live rather modestly. He reportedly lived in a suburban New Jersey home and drove an unassuming Hyundai SUV.[10] Hwang also "wears his Christian faith on his sleeve"[11] and is devoted to his church. Speaking in a video for the Fuller Foundation, Hwang said: "It's not all about money. God certainly has a long-term view. It's really helping a lot of people learn how to invest well and use capitalism to help human society advance."[12]

Motivated by his strong religious beliefs, Hwang was driven to give generously. This was reflected in the activities of the Grace and Mercy Foundation (GMF), a non-profit grant-making organisation he founded in 2006 which was almost entirely funded by him. Hwang has reportedly given US$591 million to GMF, of which over US$500 million was contributed from 2015 to 2018. Most of the money Hwang put into the foundation came in the form of blue-chip growth stocks such as shares in Netflix, Amazon, and Facebook. Public records of the GMF disclose that it has distributed US$79 million to theological seminaries, Christian humanitarian charities and other religious-affiliated institutions and non-profits from 2007 to 2018, with payments growing in size in recent years.[13,14]

Trouble with the law

> "Hwang today learned the painful lesson that illegal offshore trading is not off limits from U.S. law enforcement…"
>
> *– Robert Khuzami, U.S. SEC enforcement director*[15]

Running his own hedge fund was not all smooth sailing for Hwang. The fund's returns were volatile, and Hwang suffered a string of high-profile losses in the late 2000s, having been impacted by the bankruptcy of Lehman Brothers and the breakdown of the proposed merger between Porsche and Volkswagen AG.[16]

In 2012, the U.S. Securities and Exchange Commission (SEC) launched an investigation into Tiger Asia for insider trading in several stocks listed on the Hong Kong Stock Exchange. In a federal court hearing, Hwang pleaded guilty to using information disclosed in confidence by investment banks as part of private placements on at least three occasions to make profitable securities trades. Investment bankers had approached Tiger Asia's head trader, Raymond Y. H. Park to gauge the company's interest in joining a block sale of stock. Although Park agreed to keep the information confidential and not trade on it, Tiger Asia used this confidential information to short shares of Bank of China Ltd and China Construction Bank Corp, making close to US$16 million in illicit profit.[17,18]

As a result, Tiger Asia, Hwang, and Park were forced to pay US$44 million to settle the U.S. SEC's charges. Sanjay Wadhwa, Associate Director of the U.S. SEC's New York Regional Office and Deputy Chief of the Enforcement Division's Market Abuse Unit, said: "Hwang betrayed his duty of confidentiality by trading ahead of the private placements, and betrayed his fiduciary obligations when he defrauded his investors by collecting fees earned from his attempted manipulation scheme."[19] Tiger Asia also forfeited US$16.3 million of gains made from the illegal trades to resolve the criminal case made against it in New Jersey, and the fund was placed on probation for a year.[20] In 2014, it was announced that Tiger Asia and Hwang were banned from trading securities in Hong Kong for four years.[21]

With a tarnished reputation after pleading guilty to insider trading, Hwang decided to return all his outside money,[22] and in 2013, he converted the Tiger Asia fund into a family office to manage his personal wealth, signifying the birth of Archegos Capital Management (Archegos).[23] Hwang started off with around US$200 million of his personal assets, which eventually grew to a staggering US$30 billion at its peak.[24]

Despite the significant amount of assets held by Archegos, it did not show up in regulatory filings which disclose major shareholders of public stocks. This was primarily because family offices are generally outside regulatory scrutiny in the U.S., and most of their information is not made publicly available.[25] Unless they exceed certain thresholds for disclosure based on the size of their stakes in public companies, or they make the decision to reveal their investments, family offices keep their information private.[26]

A spectacular implosion

The week of 22 March 2021 saw Archegos suddenly losing US$20 billion.[27] Over the course of a few days, two stocks that Archegos had significant exposure to – ViacomCBS Inc. (VIAC) and Discovery Inc. (Discovery) – lost over 30% of their value.[28] VIAC's sharp drop in share price came after the company announced a US$1.93 billion sale in common shares and US$1.13 billion in Series A mandatory convertible preferred shares.[29] Meanwhile, Discovery's shares closed down more than 13% after investment bank UBS Group downgraded the stock to 'sell' over its concern about "the ultimate scalability of the service in relation to the decline of the linear business".[30]

The sudden plunge in share prices prompted margin calls from Archegos' banks, requiring the fund to add more collateral to cover its increased exposure on the swaps undertaken on the stocks. Due to the extent of the drop in share prices, Archegos did not have sufficient liquidity to meet the calls,[31] which meant it had little choice but to sell the shares or put itself at risk of a default.[32]

On Thursday, 25 March, meetings were held between Hwang and the banks, during which some banks reportedly appealed to Hwang to sell shares to prevent a default. Hwang, however, requested that the banks delay the sale of shares that underpinned his swap trades and wait for share prices to recover, so as to avoid incurring massive losses. A number of banks – such as Credit Suisse Group AG (Credit Suisse) and Nomura Holdings – were agreeable to this, while others were sceptical that the share prices would bounce back.[33]

The share prices of VIAC and Discovery continued to nosedive. By Friday, 26 March, VIAC and Discovery had fallen by about 50% and 45% respectively for the week.[34] That day, Goldman Sachs Group Inc. (Goldman Sachs) sold over US$10.5 billion of shares in VIAC, Baidu Inc., and others. Morgan Stanley also disposed shares worth US$8 billion, while Deutsche Bank offloaded US$4 billion of shares.[35]

The following week, on 29 March, Archegos released a written statement through a company spokeswoman. The statement said, "This is a challenging time for the family office of Archegos Capital Management, our partners and employees. All plans are being discussed as Mr. Hwang and the team determine the best path forward."[36]

Two days later, on 31 March, the U.S. SEC and the U.K.'s Financial Conduct Authority were reported to have started an examination of the actions of several banks involved with Archegos over their block trades after Archegos failed to meet margin calls.[37] The next day, the U.S. SEC commenced a preliminary investigation into Hwang and the Archegos trades.[38]

A recipe for disaster

Despite managing US$36 billion in invested capital, Archegos was subject to little direct regulatory scrutiny due to its operations as a family office and its usage of certain types of lightly regulated swaps to avoid other reporting rules.[39] These contributed to Hwang's ability to lay low without disclosing his positions to other market participants while amassing.[40]

The nature of swaps

In swap contracts, the value or cash flow of an asset held by one party is swapped with that of the asset held by another party where there is no exchange of principal between both parties. This gives investors exposure to the gains or losses in an underlying asset without them owning it directly. They are traded over the counter and are customisable and adaptable to an investor's needs. Archegos took substantial, concentrated positions in companies and held positions via total return swaps, which are "contracts brokered by Wall Street banks that allow a user to take on the profits and losses of a portfolio of stocks or other assets in exchange for a fee".[41] The off-balance sheet transactions merely required agreement to meet margin calls, instead of full payment of the purchase price.[42] Such financial derivatives allowed Hwang to take extremely outsized positions on limited funds, akin to borrowing from banks. This was evident in Archegos' holdings with Credit Suisse, where only 10% of the total sum borrowed was held as collateral.[43] Capital investment was also extremely low for Archegos as it was able to synthetically increase its exposure to equities using derivative contracts.[44]

The use of swap contracts also allowed Hwang to fly under the radar, even as Archegos allegedly had exposure to over 10% of various companies' shares. Investors that own more than 10% of a public company's shares are considered to be insiders and are subject to greater regulation around disclosures and profits.[45] Through utilising these swap contracts, no transfer of shares occurred – Archegos did not legally own the shares and ownership of the shares remained with the bank. This concealed both Hwang's identity and the size of his positions. Even the banks that financed his investments did not have full visibility of his portfolio.[46]

Under the radar

At its peak, Archegos amassed US$30 billion worth of assets, which would have placed Hwang in the top ranks of the wealthiest investors in the world.[47] However, given Archegos' classification as a family office and the nature of the financial derivatives it took on, it was exempt from certain filings and regulations imposed by the SEC and other regulatory bodies. Notably, Archegos was exempt from filing a form PF, which hedge funds and private-equity firms are required to file in order for regulators to assess the risks posed to the financial system.[48]

Due to the lack of disclosure and the use of swap agreements, the banks Archegos dealt with had limited visibility on the Archegos' leverage. Further, although U.S. rules prevent individual investors from purchasing securities with more than 50% of the money borrowed on margin, this does not apply to hedge funds and family offices. Hwang took advantage of the situation to continuously pile on leverage.[49] Consequently, little was known about Hwang and Archegos until the time of its collapse.

Credit Suisse investigates

Four months after the collapse of Archegos, Credit Suisse – one of its main prime brokers – published a report by law firm Paul, Weiss, Rifkind, Wharton & Garrison LLP (Paul, Weiss) which the bank had commissioned, describing the bank's shortcomings in dealing with the crisis and over-exposure to risk.[50]

Credit Suisse's sneaky link

> "If you come from a Tiger pedigree, it helps convince anyone to do business with you,"
>
> *– A prime broker at an unnamed bank which lost money from the Archegos collapse*[51]

Hwang's relationship with Credit Suisse dated back to his Tiger Asia days. He had been a client of Credit Suisse while managing Tiger Asia and continued using their services after converting his fund into a family office. Despite Hwang's previous charges of insider trading and market manipulation, Credit Suisse did not place any additional scrutiny on Archegos due to Archegos' "strong market performance and self-proclaimed "best in class" infrastructure and compliance". The charges against Hwang were dismissed as one-time events. Although Credit Suisse Compliance initially raised concerns about having Hwang as a client, its concerns were put aside without any in-depth evaluation of the potential reputational risks to the bank, with no conditions or limitations were imposed on Credit Suisse's business dealings with Archegos.[52]

Credit Suisse's relationship with Archegos was centred on its Prime Brokerage and Prime Financing business units. Prime Brokerage handled Archegos' cash trading while Prime Financing handled Archegos' synthetic trading, which included the use of derivatives and other types of synthetic leverage exposure. Both Prime Brokerage and Prime Financing were intended to be low-risk businesses in which "counterparty risk should be assessed and then offset through effective margining, and market risk should be evaluated and offset through hedging".[53]

Credit Suisse's risk management policies

Credit Suisse's risk management policies involve several lines of defence.[54]

The first line of defence is its Prime Services function, which deals with hedge fund and family office clients. To manage the bank's risk, Prime Services has a dedicated in-business risk unit called Prime Services Risk (PSR) that is responsible for setting margin rates and communicating any necessary margin increases directly to the client. PSR's also runs software designed to flag client exposures that are of concern and reviews any potential loss scenarios, while monitoring client portfolios to ensure that they do not exceed risk limits prescribed by the risk management function, which is the second line of defence.[55]

Credit Risk Management (CRM), the next line of defence, is independent from PSR and responsible for assessing credit risk across all Credit Suisse businesses. Among other functions, CRM was responsible for setting risk-related counterparty trading limits, such as limits on the potential exposure and stress scenario exposure, which are risk management tools relied upon by both the Prime Services business and CRM to manage Archegos' counterparty credit risk.[56]

Additionally, Credit Suisse has to perform an annual counterparty risk review of Archegos and assign Archegos an internal credit rating. CRM's annual credit reviews characterised Archegos as having a "solid capital base," "experienced management team," "strong performance," and "appropriate use of leverage". At the same time, it identified Archegos' weaknesses as "key man reliance," "volatile performance," "mediocre operational management practices/fraud risk," and "poor risk management practices and procedures." It also observed that "Archegos [did] not operate with a formalised set of risk management policies and procedures, operates off informal concentration guidelines, and does not use stop loss limits". Despite these deficiencies, CRM's internal credit rating for Archegos improved between 2012 and 2016, from B- to BB-, partially because of its increasing net asset value.[57]

No margin for error

In 2019, Archegos requested Credit Suisse to materially lower its swap margins in order to take on greater leverage. Archegos argued that another prime broker had offered lower margin rates and allowed it to be covered by a single margin call. Credit Suisse agreed to the request and lowered the swap margin rate to 7.5% despite a stress scenario analysis showing severe levels of margin debt. Credit Suisse ignored this key risk, drawing comfort from the fact that the bank had the contractual right to terminate the swaps on a daily basis and change initial margin amounts at its discretion. However, this contractual right was an illusion as the bank had no intention of invoking it for fear of alienating Archegos.[58]

Heightened alert

CRM's annual credit review of Archegos in November 2019 reiterated a BB- rating despite a 40% net asset value decline due to poor performance. Archegos' portfolio also became much more concentrated, with its top ten long Prime Brokerage positions constituting 75% of its gross market value (GMV).[59]

In February 2020, the late head of PSR was replaced by a managing director who was acquainted with Archegos from a previous sales and marketing role for several years. The new head became PSR's main point of contact with Archegos going forward.[60]

Throughout 2020, Archegos' risk profile increased significantly and it began regularly breaching its stress scenario limits. Rather than making additional margin calls, Credit Suisse attempted to re-balance Archegos' portfolio by requiring it to add market shorts to its portfolio. Although Archegos did add some index shorts, its riskier long bias in its swap portfolio persisted. Archegos' portfolio fluctuated between 63% and 95% in long positions almost every week until its eventual default in March 2021.[61]

By 1 September 2020, Archegos' overall holdings at Credit Suisse had ballooned to US$9.5 billion – of which over 75% consisted of long positions. Archegos' swaps were margined at merely 5.9% on average compared to its initial margin of 15% to 25%.[62]

Risk management falls on deaf ears

In August 2020, Archegos' scenario exposure stood at US$800 million, exacerbated by new long positions put on that month. By the end of the month, CRM insisted that Archegos not expand its "already outsized" long positions, given the potential exposure and scenario limit breaches. However, for internal credit assessments, Prime Services urged Archegos to be evaluated based on a more relaxed risk scenario given that its portfolio comprised liquid large-cap stocks and Credit Suisse had a daily termination right to its swap contracts.[63]

Around this time, an analyst at CRM raised concerns about PSR's management of counterparty risk, specifically involving Archegos. He observed that the PSR team was not "adequately staffed to be reliable" as experienced PSR employees who had previously left Credit Suisse had not been replaced. He further criticised the team for being "run by a salesperson" who "did not have a backbone" to push back on Archegos' demands. After his complaint, he was told by PSR that "progress was being made". Despite PSR's assurances that it would insist on higher margins, it allowed Archegos to renew long swap positions at the same rate of 7.5%.[64]

Credit Suisse assembles its avengers – The CPOC

Credit Suisse had created a new committee, the Investment Bank (IB) Counterparty Oversight Committee (CPOC), co-chaired by the IB's Chief Risk Officer (CRO) and Chief Operating Officer (COO), and whose membership included several IB senior executives, such as the global head of equities. The purpose of CPOC was to analyse and evaluate counterparty relationships with significant exposure relative to their revenue generation and to direct remedial measures where appropriate.[65]

At the request of CRM, Archegos was one of a handful of counterparties covered at the inaugural September 2020 CPOC meeting. The meeting materials observed that Archegos "makes substantial use of leverage relative to peer [long/short] equity funds and exhibits a highly volatile performance pattern"; that Archegos "has generated some of the largest scenario exposures in global [hedge fund] portfolio"; and that Archegos had "[c]hunky single-name stock exposures (a number of positions > US$750 mm and > 10% GMV) albeit in liquid name". The Head of PSR, who represented Archegos during the meeting, noted that PSR and CRM had already agreed on actions to address Archegos' limit breaches and observed that Archegos had never missed a margin call, even during the tumultuous markets earlier in the year.[66]

As a result, CRM was requested to "notify of any changes with the counterparty and revisit the counterparty at a future meeting." CPOC did not discuss Archegos again for nearly six months, until 8 March 2021, at which point Archegos' risk exposure had skyrocketed.[67]

Things got complicated

Following the September CPOC meeting, Credit Suisse made very little progress in reducing Archegos' counterparty risk. In January 2021, in connection with its 2020 annual credit review, CRM downgraded Archegos' credit rating from BB- to B+, which put Archegos in the bottom-third of Credit Suisse's hedge fund counterparties by rating.[68]

In February 2021, Credit Suisse finally asked Archegos for US$750 million in additional initial margin. While Archegos refused to post the amount requested, it did agree to provide US$500 million in additional margin. The next day, CRM held a due diligence call with Archegos, during which Archegos told CRM that it had unencumbered cash as well as margin excess at its prime brokers totalling US$6.6 billion. While this provided CRM some comfort, the CRM analyst for Archegos was becoming increasingly concerned that Archegos held the same positions with other prime brokers and that if other banks also increased margins, it might force a liquidation. CRM recommended that Archegos be addressed at the next CPOC meeting.[69]

Credit Suisse loses its credit

On 8 March 2021, Credit Suisse's leaders once again convened at the CPOC meeting to discuss about potential risks to the business. Archegos was once again highlighted as an outlier with GMV exposures of US$20 billion. The next-largest client had GMV exposures of US$5 billion. Archegos also had a net-long bias of over US$7 billion, while the next-largest long-biased client was at US$1.5 billion. Furthermore, Archegos held large, concentrated positions, which might result in Credit Suisse having difficulty liquidating these outsized positions quickly. Despite these red flags, the CPOC concluded that Archegos should be moved to dynamic margining with add-ons for concentration and liquidity as well a request for an additional US$250 million from the counterparty.[70]

In response, Archegos refused to accept the new dynamic margining proposal but continued doing business with the bank. On 12 March, Credit Suisse renewed US$13 billion in net long positions with Archegos for two additional years, mostly at the existing 7.5% margin. The bank also permitted Archegos to execute US$1.48 billion of additional net long positions at a higher average margin rate of 21.2%.[71]

Archegos broke the bank

Apart from Credit Suisse, many of the world's largest investment banks also found themselves entangled with Archegos during its collapse. The extent of losses each bank suffered varied – while some managed to cut their losses early, others learnt very painful lessons. Deutsche Bank and Goldman Sachs were two banks which were quick to act to limit their losses,[72] with Goldman Sachs reporting that the effects of the incident on the company were immaterial.[73] However, other banks such as Credit Suisse and Nomura Holdings that had initially hesitated in selling exposed shares were left reeling. Credit Suisse reportedly recorded losses amounting to US$5.5 billion[74] while Nomura Holdings and UBS Group took hits of US$2.9 billion and US$774 million respectively.[75]

Spring cleaning at Credit Suisse

> "Within the organisation as a whole, we have failed too often to anticipate material risks in good time in order to counter them proactively and to prevent them."
>
> – *Axel Lehmann, Chairman of Credit Suisse*[76]

In early April 2021, Credit Suisse announced that Investment Bank CEO Brian Chin and Chief Risk and Compliance Officer Lara Warner were to step down from their positions.[77] This was followed by a string of other departures, including Paul Galietto, head of equities trading; Parshu Shah, head of prime service risk; Ryan Atkinson, head of credit risk; Ilana Ash, head of counterparty credit risk management; and Manish Mehta, head of counterparty hedge fund risk.[78]

However, this was not enough to appease shareholders, who indicated that they would vote for the dismissal of key board members at Credit Suisse's annual general meeting.[79] Chairman of the Risk Committee Andreas Gottschling did not seek re-election after prominent investors and proxy advisor Glass Lewis[80] indicated their intention to oust him.[81] Chairman Urs Rohner – who helmed the Credit Suisse board for 12 years[82] – also stepped down and apologised for the losses suffered, calling it "inexcusable".[83]

It was reported in November 2021 that about 90 senior employees parted ways with Credit Suisse in the aftermath of the Archegos collapse. The bank also cut its senior executives' bonuses by a whopping 64%. During the bank's third-quarter earnings call on 4 November 2021, it announced that it planned to scale back its investment bank and exit most of its prime services business in January 2022.[84,85]

The following year, during Credit Suisse's AGM on 29 April 2022, 59.95% shareholders rejected the board of directors' proposal to discharge the directors and executives for FY2020, which would have absolved them from the trading losses suffered during Archegos' collapse.[86] Incumbent Credit Suisse Chairman Axel Lehmann – Rohner's successor – admitted during the AGM that "the challenges of the past were not solely attributable to isolated poor decisions or to individual decision makers". It was further reported that Credit Suisse employees attributed the bank's failings to its risk department which was often overruled by "commercially minded executives who were chasing higher returns from riskier deals". The bank's structure also apparently made it difficult to obtain a big picture of the total global risk.[87]

Dusting down Nomura Holdings

As at the end of April 2021, Nomura Holdings had exited about 97% of its remaining positions relating to Archegos.[88] However, it was a little too late. The extreme losses resulted in the Japanese bank's decision to shut down its cash prime-brokerage operations in the U.S. and Europe, which was a setback to CEO Kentaro Okuda's plans to expand its business in the U.S., which has the largest pool of banking fees worldwide.[89]

Nomura Holdings also saw the exit of several senior executives and the replacement of a top risk official. In late April 2021, Dougal Brech, global head of the prime-brokerage division that caters to hedge funds, together with U.S. prime head Joshua Kurek and co-head of global equities Michael Caperonis, were suspended from their positions. Additionally, global head of credit risk, Douglas Lyons, was replaced by Patrick McGarry. Nomura Holdings also named Christopher Willcox – a former J.P. Morgan executive – as the new CEO of its New York-based subsidiary Nomura Securities, in a move to strengthen the company's risk management.[90,91]

Paying the bills

> "None of this trading was based on a principled view of the true value of a particular issuer and instead was intended to artificially inflate share prices."
>
> – *U.S. SEC*[92]

Ever since Archegos defaulted on its margin calls in March 2021, the U.S. SEC had been investigating both Archegos and Hwang, with a focus on Archegos' trading activity and whether it concealed the size of its investments in public companies to avoid regulatory scrutiny. The SEC also investigated potential market manipulation that Hwang was involved in even before Archegos' collapse, tracing all of the family office's business that had not been previously disclosed.[93]

On 27 April 2022, the U.S. authorities charged Hwang with racketeering, fraud and market manipulation over the Archegos meltdown. It also accused Hwang of ignoring his research analysts and directing Archegos to trade before markets opened or during the last half hour of trading days to maximise market impact. However, observers commented that it would be an uphill battle for the U.S. authorities, given that the burden of proof is on the U.S. authorities and the "huge evidentiary challenge" of distilling the pile of evidence and trading data into a comprehensible format for jurors. The involvement of U.S.-listed corporate giants also added to the complexity of the case. In response to the accusations, Hwang's lawyer said he was "entirely innocent of any wrongdoing" and that the allegations were "overblown".[94,95]

Reforms ahead?

> "The lies fed the [stock price] inflation and the inflation fed more lies. Round and round it went. But last year the music stopped, the bubble burst, the prices dropped, and when they did billions of dollars nearly evaporated overnight."
>
> – *Damian Williams, U.S. attorney for the Southern District of New York*[96]

The Archegos meltdown has attracted much criticism from regulators and watchdogs.[97] The incident exposed the potential threats building up in the economy, and served as a warning to regulators not to be complacent when dealing with such threats.[98] Gary Gensler, chair of the SEC, called for greater transparency in swaps markets. In December 2021, the SEC proposed new rules that would require investors to make additional public disclosures on swap positions once they exceed US$300 million or account for five percent of a company's shares.[99] In February 2022, it further proposed that hedge funds and other activist investors would have half the amount of time to report substantial shareholdings, and to tighten the rules around multiple investors working together.[100] The proposals sparked anger among activist investors and their backers, which felt that the rules would "hamstring the industry by allowing other investors to front-run their strategies and give companies more time to plot defences against shareholders agitating for change".[101]

Archegos, or "the one who leads the way"[102], was founded with the intention of managing Hwang's personal wealth as well as becoming a vehicle for philanthropy. Despite its connotation, Archegos ended up being a textbook example of an investment vehicle that was out of control. Perhaps the sliver of light which has come out of the meltdown was that it has paved the way for regulatory improvements in the family office space and reminded investors about the importance of risk management policies in financial institutions.

Discussion questions

1. Bill Hwang reportedly lived modestly despite being enormously wealthy and apparently gave away a lot of his money. What do you think motivates a person like Bill Hwang to do the things he did? What were the red flags relating to him and why were these ignored by those dealing with him?
2. Discuss the corporate governance issues which existed in Archegos, Bill Hwang's family office. What other factors played a role in the downfall of Archegos?
3. Critically evaluate Bill Hwang's investment strategy and the use of derivatives such as equity swaps for leverage. To what extent was it successful and what were the pitfalls?

4. What risks do banks face when dealing with wealthy and influential clients such as Bill Hwang? What are some precautions and considerations that banks should take into account to balance the risks and rewards from working with such clients?
5. Discuss Credit Suisse's different lines of defence and the role that it played in risk management. Which of these lines failed in the context of Archegos?
6. Discuss Credit Suisse's actions undertaken (or lack thereof) to mitigate the risks presented by Archegos. How could the bank have done better in terms of its risk management? What would you recommend to Credit Suisse to avoid crises relating to counterparty risk in the future?
7. What are some of the existing regulatory exemptions given by the U.S. SEC to family offices? How are family offices regulated in your country? Critically evaluate any differences. Do you believe that the regulation of family offices should be tightened? Explain.

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CHEVRON: DON'T BE A FOSSIL FOOL

Case overview

As a Big Oil company and one of the largest emitters of greenhouse gases in the world, Chevron Corporation (Chevron) has been embroiled in numerous environmental pollution scandals. In 2016, Chevron voiced its support for the Paris Agreement, an international treaty on climate change, and pledged to join the fight against the "Carbon Crisis". This was followed by a flurry of plans targeted at reducing its environmental impact. Some critics contended that Chevron was engaging in greenwashing, while others were sceptical of the oil giant's emissions reduction plans. However, a small group of environmental activists applauded it for its efforts towards achieving net zero targets.

The objective of this case study is to facilitate a discussion of issues such as environmental impact and the climate crisis; environmental, social, and governance (ESG) factors; greenwashing; directors' duties; board composition; and shareholder activism.

Into the fire

> "We're going to fight this until hell freezes over, and then we'll fight it on the ice,"
>
> – *A Chevron attorney on the Ecuador litigation*[1]

In 2001, Chevron Corporation (Chevron) acquired Texaco Inc. (Texaco), an American oil company, and inherited its liabilities for alleged substandard oil extraction in Ecuador's rainforest between 1964 and 1992. This included the "Amazon Chernobyl", a huge environmental disaster in Ecuador which arose from Texaco's alleged disregard for the health of the region's population.[2] In 2011, a decade after its acquisition of Texaco, Chevron was fined US$18 billion – the largest judgment ever awarded in an environmental lawsuit – by a court in Ecuador for contamination from oil extraction in the Amazon.

This case was prepared by Lee Lin Hui, Lee Shao Min, Lee Rukai Nicole, Lee Wen Ting Cheryl and Low Yuan Jia Dannica, 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 organisations named in the case, or any of their directors or employees.

However, Chevron filed an appeal against the court's decision, saying that it was "illegitimate and unenforceable".[3] The company also accused the plaintiffs – Ecuadorian villagers and their lawyers – of having ghost-written an expert environmental opinion. In response, the plaintiffs rebuffed that the expert opinion was fraudulent and retorted the fine was too low in view of the scale of pollution. The fine was later reduced to US$9.5 billion by Ecuador's national court of justice in 2013. Chevron continued to pursue a multi-year campaign with an aggressive legal strategy against the plaintiffs and even the country of Ecuador. Five years later, in 2018, an international tribunal found that Ecuador violated a treaty with the U.S.[4] and ordered Ecuador not to enforce the US$9.5 billion judgment on Chevron.[5,6]

Fuel was added to the fire when Chevron was subsequently scrutinised by the U.S. Securities and Exchange Commission (SEC) after Trillium Asset Management – a Boston-based sustainable and responsible investment fund – filed a request to review the company's shareholder disclosures on the magnitude of its financial and operational risks.[7] Trillium also sponsored a proposal at the Annual General Meeting (AGM) asking Chevron to nominate an independent board member with environmental expertise from an energy perspective. Chevron urged shareholders to reject the proposal, claiming that its board's "qualification standards adequately recognise the importance of environmental expertise".[8] It added that "board members and candidates should possess a broad range of skills, qualifications and attributes rather than a single expertise".[9] Eventually, only about 25% of shareholders supported the proposal.[10]

There was a small win for environmentally concerned shareholders in 2013 when a group of shareholders successfully obtained approval from the SEC to put a key corporate governance proposal onto the agenda of Chevron's 2013 AGM. The proposal called for common-sense governance reforms to improve the company's accountability, responsiveness, and transparency.[11] More specifically, it proposed that Chevron amend its bylaws to give shareholders which have a 10% stake in the company "the power to call special shareholder meetings to allow them to consider important matters that crop up between AGMs". The proposal stemmed from the Ecuador litigation and the company's alleged "campaign of shareholder intimidation".[12]

The Paris Agreement

> "We support well-designed climate policies and believe a price on carbon is the most efficient mechanism to harness market forces to reduce emissions."
>
> – *Chevron Corporation*[13]

On 12 December 2015, the U.S., along with 195 other countries, adopted a new climate accord, the Paris Agreement, which covers climate change mitigation, adaptation, and finance.[14] The agreement, which came into effect after 2020, aims to keep global average temperature rise to below two degrees Celsius compared to pre-industrial levels, and pursue efforts to limit the temperature rise to 1.5°C. According a 2017 report by the CDP – a not-for-profit charity that runs the global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts – over half of worldwide industrial greenhouse gas emissions can be traced to 25 corporate and state producers, including Chevron.[15]

As one of the world's major emitters, Chevron has long been scrutinised by the public for its efforts to mitigate climate change. The company has been outspoken about its support for the Paris Agreement, and highlights its climate policy framework as part of its environmental, social and governance (ESG) efforts on the company website.[16] Its stated goal is ultimately to reduce the carbon intensity of its operations and assets by optimising carbon-reduction opportunities and integrating greenhouse gas mitigation technologies.[17]

In June 2017, then U.S. President Donald Trump announced that the U.S. would cease all participation in the Paris Agreement. The reactions of U.S. corporations were mixed but a large number of organisations – including Chevron – expressed their opposition to Trump's decision.[18] However, Chevron's stance on environmental issues soon took a U-turn and it sought to block climate-related shareholder proposals in 2017 and 2018, recommending that shareholders vote against all climate-related resolutions in those years.[19] In its public statements and reports on climate change, Chevron also downplayed the role of human activity and the need to reduce emissions of heat trapping greenhouse gases. Additionally, between 2010 and 2018, Chevron reportedly dedicated only 0.2% of its capital expenditure to sources of low-carbon energy. This was despite the fact that Chevron described itself as a provider of "affordable, reliable, ever-cleaner energy to improve people's lives and enable human progress".[20] This has led to Chevron's critics calling the company out for hypocrisy: "Chevron's rhetoric and the public image that they put forward [are] very different from how they're actually operating."[21]

An attempt to put out the fire

> "The great tragedy of the climate crisis is that seven and a half billion people must pay the price – in the form of a degraded planet – so that a couple of dozen polluting interests can continue to make record profits."
>
> – *Michael Mann, leading climate scientist*[22]

While Chevron had openly expressed support for the Paris Agreement, the company's annual emissions have steadily increased to 672 million metric tonnes of carbon dioxide in 2021,[23] solidifying the company's status as one of the world's largest polluters. It was reported in 2019 that Chevron, together with other fossil fuel companies Exxon, BP and Shell, were behind more than 10% of the world's carbon emissions since 1965. Since then, more environmentalists and activists have pushed for further climate action, especially from players in the oil and gas industry.[24]

To quell public anger over its significant contributions to the world's greenhouse gases, Chevron announced in October 2019 that it planned to reduce the intensity of greenhouse gas emissions from its oil production and of its upstream gas by five to ten percent and two to five percent respectively over a seven-year period ending in 2023. In the company announcement, Michael Wirth, Chevron's Chairman and Chief Executive Officer (CEO), reiterated the company's commitment to reducing its operations' environmental impact: "Global demand for energy continues to grow, and we are committed to delivering more energy with less environmental impact."[25,26]

In the same month, it was reported by The New York Times that Chevron seemed to have stricter internal rules in relation to flaring and venting of natural gases and other greenhouse gases directly into the atmosphere, which discourage drilling in areas that offer few prospects of economically recovering the natural gas produced. The processes of flaring and venting emit carbon dioxide and methane into the atmosphere respectively, and are "a tremendous waste of a natural resource". The World Bank estimated that in 2018, flaring released over 350 million tons of carbon dioxide globally.[27] Chevron and other large oil groups have committed to end "routine flaring" by 2030, many as part of a global partnership initiative lead by the World Bank.[28]

Chevron has also announced how it targeted to reduce methane emissions by expanding its methane-detection capabilities and partnering with industry and academic experts to ensure the accuracy and credibility of global methane reporting. Further efforts for methane management include various partnerships such as being a founding partner of The Environmental Partnership – an industry initiative targeted at accelerating the adoption of practices which reduce methane emissions, and participating in Project ASTRA to demonstrate a new approach to measure methane emissions.[29]

In its 2021 climate change resilience report, Chevron went one step further to communicate its commitment to advancing a lower carbon future to its stakeholders and its support of the global net zero target of the Paris Agreement. As part of its commitment, it would support carbon pricing as the primary policy tool to achieve greenhouse gas emissions reduction goals, research and innovation to improve the management of greenhouse gas emissions, as well as targeted policies to enable cost-effective lower carbon opportunities. It was also disclosed in the report that Chevron has identified about 100 greenhouse gas-abatement projects and planned to spend over US$300 million in 2022 and eventually US$2 billion on similar projects through 2028. It expected the projects to cumulatively achieve about 4 million tonnes of emissions reductions yearly.[30]

Too good to be true?

On 9 March 2021, Chevron revealed that it had met its environmental targets three years ahead of schedule. However, the news raised eyebrows on whether meaningful efforts were truly made to combat global climate change and some analysts were unimpressed with its climate and emissions goals, seeing them as being too modest.[31,32]

After the early completion of its 2023 upstream carbon intensity reduction goals, Chevron announced its strategy centred on "higher returns, lower carbon" and upgraded its environmental commitments and goals, which included a 35% decrease in carbon intensity for oil and gas production and a 50% reduction in methane emissions compared with 2016 levels.[33] These new goals aligned with the second "global stocktake" period under the Paris Agreement. Additionally, Chevron aimed to reduce the carbon intensity from its traditional oil and natural gas development and chemicals processing; increase the use of renewable biofuels; and raise its investment in advanced technologies, such as hydrogen power and carbon capture, utilisation, and storage.[34]

Critics will criticise

Despite Chevron's efforts, some critics have voiced that the company has not been doing enough to combat climate change,[35] while others accused the oil company of "greenwashing",[36] where an organisation spends more time and money on marketing itself as environmentally friendly than on actual efforts to minimise its environmental impact.[37]

Accusations of greenwashing

> "We would hope that a successful case against Chevron would set a precedent that would discourage other companies ... from engaging in these kinds of greenwashing tactics,"
>
> – *Zorka Milin, senior legal advisor at Global Witness*[38]

A week after Chevron's announced its new environmental strategy, environmental groups filed a complaint with the Federal Trade Commission (FTC), accusing the company of greenwashing and misleading consumers about its efforts to reduce greenhouse gas emissions. Global Witness, Greenpeace USA and Earthworks alleged that the oil giant's pledge of "ever-cleaner energy" conceals the fact that its production plans may end up increasing absolute emissions. They added that advertisements touting Chevron's environmental record and investments in green technology disguise its role as one of the most significant corporate polluters worldwide. They also contended that Chevron's 2021 climate change resilience report mirrored many of the same greenwashing tactics used to mislead consumers for years. Chevron called the allegations "frivolous" and stated that it was "honest" about its energy transition.[39]

The American Petroleum Institute (API), the largest U.S. trade association for the oil and natural gas industry, stepped in to support Chevron, claiming that the allegations about the green advertising campaigns used by companies in the oil and gas industry were false and that the industry was making progress in balancing new climate realities with customer needs.[40] However, earlier in 2018, Kathy Mulvey – accountability campaign director and advocate for the Climate & Energy team at the Union of Concerned Scientists – said that the API has been promoting disinformation about global warming for decades, and this "fraudulent behaviour" has also been adopted by Chevron.[41]

Truly doing good?

A media article by ClientEarth, an environmental law charity, also challenged the goals set by Chevron. It took issue with the fact that the oil company sets targets on an intensity basis instead of an absolute basis. This suggests that Chevron is able to continue to increase fossil fuel production and thus increase its absolute emissions. ClientEarth highlighted that although Chevron disclosed that its carbon capture and storage projects are expected to reduce greenhouse gas emissions by approximately five million tonnes yearly, its 2019 annual emissions stood at 697 million tonnes of carbon dioxide equivalent – more than 130 times larger than its carbon capture plans.[42] Fieldwork conducted by Earthworks also found that Chevron still regularly pollutes methane despite its environmental claims.[43]

Furthermore, as the timing of Chevron's targets has been synchronised with stocktake milestones outlined in the Paris Agreement, it was argued that targets are set against a 2016 baseline, which were levels prior to the advent of new sustainability trends such as renewable energy and net-zero initiatives. ClientEarth said that Chevron's alignment of timelines with the Paris Agreement was not meaningful given that the emissions targets have been falling short of what is required to attain the Paris goals.[44]

Analysis by Climate Action 100+ – an investor-led initiative aimed at making the largest corporate greenhouse gas emitters worldwide take necessary action on climate change – found that Chevron has neither disclosed the methodology used to determine the Paris alignment of its future capital expenditures nor has a Paris Agreement-aligned climate lobbying position.[45]

Succumbing to the heat

> "The votes signal investors' impatience with Big Oil's refusal to curb emissions by 2030,"
>
> – *Mark van Baal, founder of Follow This*[46]

In the midst of the anti-greenwashing storm, Chevron has also been under increasing shareholder pressure to look into scope 3 emissions generated from customers burning its fuel.[47] This coincided with the period when activist hedge fund Engine No. 1 won three board seats at Chevron's competitor Exxon Mobil in mid-2021 after claiming that the latter's focus on fossil fuels was putting its future at risk.[48] Despite the fact that scope 3 emissions amounted to more than 580 million tonnes of carbon dioxide equivalent in 2020, Chevron had not proposed any additional steps to cut its scope 3 emissions.[49]

Earlier in March 2021, Chevron requested the SEC to exclude a proposal from Dutch activist shareholder group Follow This for its 2021 AGM, calling for the company "to substantially reduce the greenhouse gas emissions of their energy product". The oil giant claimed that the proposal sought to "micromanage" the company and stated that the resolution would impose "prescriptive methods" on its greenhouse gas emissions-management program. However, on 30 March 2021, the SEC denied Chevron's request to exclude the resolution, thereby allowing shareholders to vote on the carbon emissions reduction proposal during the 2021 AGM.[50,51] This signalled a victory for climate activists in the global fight against climate change.

At the AGM on 26 May 2021, 61% of Chevron's shareholders voted in support of the Follow This resolution calling on Chevron to cut scope 3 greenhouse gas emissions.[52] Mark van Baal, founder of Follow This, commented: "Chevron cannot ignore this unequivocal request from its shareholders. Big Oil can make or break the Paris Accord. Investors in oil companies are saying now: we want you to act by decreasing emissions now, not in the distant future."[53]

Chevron's third largest shareholder, BlackRock Inc. (BlackRock) – which earlier supported Engine No. 1's campaign against Exxon – said that it supported the shareholder proposal because it is consistent with what it expected of large corporations such as Chevron. The proposal was also in line with BlackRock's belief that "it is particularly important to assume responsibility, where reasonable, for the complete emissions profile of the company as the world transitions to a low carbon economy".[54] This followed BlackRock's decision to progressively exit investments that "present a high sustainability-related risk" in January 2020 – a significant move by the world's largest asset manager which was welcomed by environmental activists to "reshape the relationship between money and the climate crisis".[55]

Hidden motives?

BlackRock and The Vanguard Group Inc. (Vanguard) – two of Chevron's largest shareholders – are investment firms which have signed the Net Zero Asset Managers initiative,[56] an international group of asset managers which are committed to supporting the goal of net zero greenhouse gas emissions by 2050.[57]

BlackRock has been vocal about its shareholder campaigns against Chevron to cut down carbon emissions and other ESG issues. In 2020, it also voted for a proposal calling for Chevron to report on how the company's lobbying aligned with the Paris Agreement goals.[58] Although the investment firm appeared to be aligned with environmental activists in their goals to save the environment, BlackRock CEO Larry Fink explained in his 2019 and 2020 letters to CEOs that BlackRock's shareholder activism was primarily a way to market its investment products to millennials, a targeted group perceived to view the primary objective of business as altruistic rather than profit generation.[59] That being said, Fink also argued that sustainable-focused investing strategies were sensible not solely from a social perspective, but also an economic one.[60]

Vanguard has also consistently claimed to be a firm supporter of ESG issues and has promoted its credentials in tackling sustainability issues. However, in 2019, Financial Times uncovered from Vanguard's voting records how little it had truly done to support environmental and social shareholder proposals.[61] CNBC's findings also corroborated this; it reported that BlackRock and Vanguard voted against all of the 2019 U.S. shareholder proposals backed by Climate Action 100+, which represented US$34 trillion in assets. This even occurred in the investment firms' ESG-branded portfolios, which were found to have voted in favour of shareholder resolutions less frequently than its peers.[62]

U.S. issue-advocacy organisation Majority Action also mentioned that collectively as key shareholders, Blackrock and Vanguard hold outsized voting power at numerous S&P 500 companies, including Chevron, and hence they should bear the responsibility of holding corporate boards accountable on sustainability issues. Despite this, Majority Action found that both investment firms used their shareholder voting power to shield corporate boards from accountability and undermine investor efforts to promote responsible corporate climate action. This was in contrast with other large asset managers which have made conscious decisions to set and enforce policies to hold corporate boards accountable should climate-related issues not be adequately addressed.[63]

Sounds like a plan

As a result of the growing pressure from investors, governments, and environmentalists alike, Chevron announced plans to invest more capital to grow lower carbon energy businesses during its Energy Transition Spotlight event on 14 September 2021.[64] This was complemented by Chevron's updated climate change resilience report in October 2021, which further detailed its ambition to progress towards a lower carbon future.[65]

The oil giant adopted a 2050 net zero aspiration for equity upstream scope 1 and 2 emissions. It also introduced a portfolio carbon intensity (PCI) target that represents its carbon intensity across the full value chain – comprising scope 1, 2 and 3 emissions. This would be accompanied by plans to release a PCI methodology document and an online tool that would allow third parties to calculate PCI for energy companies – a step towards transparent carbon accounting.[66] Furthermore, the oil giant pledged to increase its investments to US$10 billion – US$3 billion on carbon capture and storage and offsets, US$3 billion on renewable fuels, US$2 billion on hydrogen, and US$2 billion on greenhouse gas reduction activities – to reduce its carbon emissions footprint through 2028.[67]

However, Chevron's CEO Wirth said that the company was "not yet ready to commit to a 2050 net-zero emissions target". He justified the statement by saying that the company was reluctant to be "in a position where we lay out ambitions that we don't believe are realistic and deliverable".[68] Andrew Logan, senior director of oil and gas at non-profit organisation Ceres, opined that Chevron's announcement "looks like a step forward, but a relatively modest step when what is needed is a giant leap".[69] David Victor, a professor of innovation and public policy at the School of Global Policy and Strategy at the University of California San Diego, also expressed some scepticism at the US$10 billion budget, commenting that it was "not really nailed down", but also acknowledged the industry's challenges in navigating the changing landscape around emissions reductions.[70]

The move towards divestment

To further demonstrate its commitment to expanding renewables and offsets, Chevron launched a number of renewable natural gas (RNG) ventures. On 14 September 2021, it reported that it was ahead of its plan of increasing RNG production tenfold by 2025. Through partnerships with companies like Brightmark LLC and California Bioenergy for production, and Clean Energy Fuels Corp. (Clean Energy) and Mercuria Energy Trading for marketing, Chevron has been able to strengthen the value of its RNG supply chain.[71]

For instance, Chevron pumped US$28 million into its "Adopt-A-Port" initiative with Clean Energy, which would provide local truck operators with affordable access to cleaner, carbon negative RNG and in turn reduce greenhouse gas emissions.[72] Such initiatives were expected to contribute to Chevron's aim to become a U.S. market leader in RNG.[73]

Despite RNG's smaller climate impact as compared to fossil fuels, some environmental activists say that it is not an antidote for climate change. They argue that the huge demand for RNG and methane leakage from their use might nonetheless have an adverse impact on human and environmental health.[74] Sightline Institute, an independent research organisation, has also criticised the misuse of RNG, stating that although it may seem green, it has numerous flaws – availability, cost, and a large carbon footprint. It also alleged that the industry was greenwashing its image by marketing RNG as a "renewable" solution, creating an illusion that the use of RNG would be significant greenhouse gas reductions.[75]

Self defence

In the face of public outcry, Chevron has repeatedly attempted to defend itself, claiming that it has been continuously improving its framework to better address evolving ESG issues.

Operational Excellence Management System

In 2004, Chevron launched its Operational Excellence Management System (OEMS), a comprehensive system that helped build its operational excellence culture and improve its health, environment and safety performance. Chevron updated its OEMS in 2018 to emphasise linkages between risk, assurance and safeguards, and a streamlined approach to manage risk. These updates have helped Chevron to improve its focus on preventing high-consequence incidents and impacts.[76]

Since 2004, Chevron has engaged an independent accredited assurance organisation, Lloyd's Register Quality Assurance, Inc. (LRQA), to verify that its OEMS meets international environmental and safety management system standards and specifications. The certificate of approval issued by LRQA demonstrated the alignment of Chevron's OEMS with ISO 14001:2015 and 45001:2018 standards, and the integrity of the Chevron Technical Center in setting the strategic direction of the OEMS and providing oversight and verification of its effectiveness.[77]

Risk management

Chevron disclosed its risk management processes in place to manage climate-change-related risks. Chevron's strategies, business planning as well as risk management take into consideration greenhouse gas emissions issues, climate change risks and carbon pricing risks. It also evaluates the global energy demand, the role of fossil fuels in supplying the required amount of energy, the updates of energy and climate policies, and the advancement of new energy technologies when analysing its business risks.[78]

Executive-level committees

At the executive level, Chevron has also put in place the Global Issues Committee (GIC), a subcommittee which oversees the company's policies and positions on sustainability issues and practices. These include energy transition, lobbying and trade association activity, ESG reporting, revenue transparency, human capital management, and human rights issues. The other executive-level subcommittee, the Enterprise Leadership Team (ELT), has the primary responsibility of managing the composition, resource allocation and strategic direction of Chevron's portfolio to achieve its objectives. The areas covered by the ELT include operational excellence, performance improvement, energy transition, enterprise risk management processes, and market and price forecasts.[79]

A dedicated ESG team

In 2018, Chevron formed a dedicated ESG team to engage with stakeholders – investors, framework developers, the Sustainability Accounting Standards Board (SASB), and ESG rating agencies – on ESG issues. Together with senior executives, subject matter experts and Chevron's lead director, the ESG team regularly conducts in-depth discussions with investors and stakeholders to gain valuable feedback, which is then shared with the board and relevant board committees.[80]

The need for greater governance

Leading the oil giant is Chevron's board of directors which oversees and provides guidance with regard to its business and affairs. This includes the company's business plan, the following year's capital expenditure budget, as well as key financial and supplemental objectives. The Chevron board has four committees – Audit Committee, Board Nominating and Governance Committee, Management Compensation Committee (MCC), and Public Policy and Sustainability Committee (PPSC). Board committee members are appointed annually by the board based on recommendations from the Board Nominating and Governance Committee. The Chairman of the board is also selected by independent directors annually, giving them the flexibility to select the most optimal leadership structure based on the current needs and situations.[81]

Amongst the four board committees, the PPSC has the key oversight role of Chevron's environmental matters, including those related to sustainability and climate change. The committee assists the board in overseeing policy issues and potential risks in areas such as environmental matters, legislative and regulatory initiatives, as well as political contributions and lobbying. In particular, the charter of the PPSC clarifies the manner in which the committee assists the board with climate change and other sustainability issues. The committee's other roles include assisting the board in fulfilling its oversight of risks that may arise in connection with the social, political, environmental, human rights, and public policy aspects of Chevron's business and the communities in which it operates; providing oversight and guidance on and receiving reports regarding environmental matters in connection with Chevron's projects and operations; and discussing risk management in the context of legislative and regulatory initiatives, safety and environmental stewardship, community relations, government and non-governmental organisation relations, and Chevron's global reputation.[82,83] The Chairman of the GIC – the vice president of strategy and sustainability – serves as the secretary to the PPSC, connecting the GIC's work to the oversight of the PPSC.[84]

In 2021, the PPSC comprised four independent directors, namely Wanda M. Austin, Enrique Hernandez Jr, Alice P. Gast, and Jon M. Huntsman Jr.[85] Based on Chevron's 2021 sustainability report, Gast and Huntsman have "environmental" expertise.[86] Gast has been president of Imperial College London since 2014, where she oversees environmental institutes and centers as well as leads the university crisis management group.[87] Huntsman oversaw environmental policy as Governor of Utah during his term from 2005 to 2009, including the signing of the Western Climate Initiative, where Utah banded together with other U.S. state governments to pursue reductions in greenhouse gas emissions. He also has substantial experience overseeing environmental practices as Vice Chairman of Huntsman Corporation and Chairman and CEO of Huntsman Holdings Corporation.[88]

ESG incentives and compensation plans

In 2021, Chevron had substantive engagements regarding ESG issues with stockholders holding more than 39% of Chevron's outstanding common stock. These discussions included the topic of executive compensation. The company's Say-on-Pay vote outcome garnered 94% support in 2021, indicating strong support for its executive compensation practices and pay for performance alignment.[89]

The MCC is chaired by Hernandez, and consists of three other Committee members – Huntsman, Ronald D. Sugar, and D. James Umpleby III. The company said that the MCC maintains a disciplined and consistent approach in aligning incentive program design with its sustainability strategy. It assists the board in fulfilling its oversight of risks that may arise in connection with Chevron's compensation programs and practices; reviews the design and goals of Chevron's compensation programs and practices in the context of possible risks to Chevron's financial and reputational well-being, and alignment with stockholders' interests, including those related to sustainability and climate change risks and opportunities; and reviews Chevron's strategies and supporting processes for executive retention and diversity.[90]

Links to the environment

The MCC also oversees the Chevron Incentive Plan (CIP), an annual cash incentive plan that links awards to performance results of the prior year. CIP awards are designed to reward plan participants for business and individual performances. In 2021, the MCC modified the 2021 CIP scorecard to include "energy transition" as one of the four performance categories. Performance would be measured against Chevron's progress towards reducing greenhouse gas intensity, increasing renewable energy and carbon offsets, and investing in low-carbon technologies. This addition was a response to investors' input and are believed to reinforce Chevron's objective of "higher returns, lower carbon".[91,92]

According to Chevron's 2021 proxy statement, the CIP award for the CEO and other named executive officers is calculated based on a corporate performance rating multiplied by individual bonus component. A raw score range is assigned based on the actual performance of each CIP category, namely financial results; capital management; operating performance; and health, environmental and safety performance. The minimum score is zero and the maximum is two. The weightage allocated to financial results and capital management in the CIP scorecard is 40% and 30% respectively.[93]

In 2021, the health, environmental and safety performance category – which has a 15% weightage – scored the highest amongst the other categories, with a score of between 1.50-1.60. The high score was attributed to its prudent greenhouse gas management while staying on track to achieving oil, gas, flaring and methane intensity reductions.

Links to share price

In contrast, the determination of the number of awarded performance shares, restricted stock units (RSU) and stock options and most of the at-risk compensation are tied to Chevron's common stock price.[94] A company's share price is often used as an indicator of investors' perceptions of its ability to earn and grow its profits in the future.[95]

While the inclusion of ESG metrics into a company's remuneration structure may appear to be a well thought out strategy at face value, some experts argue that it might be a way for the company to check the right boxes and to divert shareholders' attention away from whether executive pay has in fact delivered shareholder value. Companies may include ESG metrics in their remuneration structures to try to appease their shareholders in light of growing pressures by investors to do so, or to disguise potentially unjustified compensation paid out to senior management despite underperformance of the companies.[96]

What's next for Chevron?

> "We are working hard to win back investors. This is a sector that has underperformed for 10 years, for five years, for three years,"
>
> – *Pierre Breber, Chevron's Chief Financial Officer*[97]

Chevron's credibility has taken a hit in light of the controversy surrounding its efforts to reduce greenhouse gas emissions. Is prioritising ESG the key to turning Chevron's around? Opposing views have emerged on whether adopting ESG policies would pave the future. Some experts highlighted that ESG investors pushing for sustainability actions in oil and gas giants do not actually invest in corporations which have adopted the mainstream climate change narrative. In this regard, corporations investing in ESG efforts might not guarantee better share price performance.[98]

Other experts have asserted that divesting from fossil fuels makes long-term financial sense as well because intangible assets such as brand value and customer loyalty are increasingly key components of corporate value reflected in a company's share price.[99] Some have reported that during the market uncertainty brought by the COVID-19 pandemic, many companies with strong ESG track records displayed lower volatility than their non-ESG counterparts. This suggested that having a focus on ESG indicates a lower downside risk, represented strong leadership leading the company in the right direction, and therefore higher returns.[100]

Luckily for Chevron, its business outlook in the near future seemed to be undeniably positive. The oil giant's share price recovered to pre-COVID levels in the tail end of 2021,[101] and it reported 2021 annual net profits of US$15.6 billion, following a loss of US$5.5 billion the year prior.[102] The record profits were largely spurred by higher oil and natural gas prices.[103] Share prices of Chevron and its competitors in the oil and gas industry had outpaced the broader market in 2021 and 2022 – a sharp turnaround after close to ten years of poor returns when the industry was left behind by many investors.[104] Furthermore, in April 2022, against the backdrop of Russia's invasion of Ukraine, crude oil and natural gas prices continued to surge to multi-year highs, prompting Chevron to pledge to ramp up shareholder returns.[105]

As the big players in the oil and gas industry have all returned to profitability, some analysts and ESG investors expected that they would take advantage of their bumper profits to increase investments into new gas exploration and low-carbon technologies. Instead, Big Oil seemed to have placed any form of green investment on hold. With rising oil prices, oil corporations like Chevron have been shoring up their businesses by repaying outstanding debts, increasing dividends, and planning share buy-backs.[106] Has all the progress on environmental awareness and push towards global net zero been undone? Will Big Oil ever achieve the right balance of ESG and profits?

Discussion questions

1. Sustainability measures and targets implemented by Chevron have been consistently criticised by environmental activists as a form of greenwashing. Was Chevron's response to the growing backlash sufficient? If not, what additional measures could Chevron have taken to better handle the criticisms?
2. Evaluate Chevron's executive-level and board committees from an environmental sustainability standpoint.
3. What are the possible pitfalls and benefits of Chevron's compensation policies? Comment on the appropriateness of these policies in tackling ESG issues while delivering shareholder value.
4. Given that Chevron has been blamed for the excessive emissions of greenhouse gases, to what extent should the company's board and management be responsible? Are there other stakeholders who should also bear part of this responsibility? Explain.
5. Discuss the possible motivation and consequences behind the persistent shareholder activism against Chevron. Do you think that activists such as Follow This truly care about ESG issues, or do they have hidden underlying motivations and agendas?
6. How do you think the increasing emphasis on ESG has impacted the way investment firms such as BlackRock and Vanguard Group invest in companies? Discuss the challenges that such investment firms face when choosing to invest – or not invest – in companies which are not green?

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EXXONMOBIL: ENGINE TROUBLE

Case overview

Between December 2020 and May 2021, Exxon Mobil Corporation (ExxonMobil), one of the world's largest and most established oil and gas companies, was caught up in a tussle with a relatively small activist hedge fund, Engine No. 1. This culminated in a proxy fight at ExxonMobil's 2021 Annual Meeting of Shareholders, where three of the four directors nominated by Engine No. 1 were elected to the oil giant's board of directors. This was a result of ExxonMobil's shareholders being frustrated by subpar shareholder returns, aggressive spending amidst poor financial performance, and deficiencies in addressing climate change concerns.

ExxonMobil was also involved in several scandals involving greenwashing. Environmental advocates have been pushing for Big Oil companies such as ExxonMobil to make the switch to greener energy alternatives and to drastically cut down on carbon emissions.

The objective of this case study is to facilitate a discussion of issues such as greenwashing; environmental, social and governance (ESG) matters in the oil and gas industry; the board's role in overseeing ESG issues; alignment of compensation policies to ESG factors; risk management; proxy fights; and shareholder activism.

The oil giant's legacy

> "It is clear, however, that the industry and the world it operates in are changing and that ExxonMobil must change as well."
>
> *– Engine No.1, U.S. impact-focused investment firm*[1]

This case was prepared by Alvin Phua Wei Da, Ashley Seah Wen Xi, Chelsea Chua Xin Tong, Chen Wanyi and Teo Jun Quan, 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 organisations named in the case, or any of their directors or employees.

Exxon Mobil Corporation (ExxonMobil) is a Texas-based U.S. multinational oil and gas company incorporated in 1882.[2] Its name is an amalgamation of its two main brands – Exxon, and Mobil – which merged in 1999. The US$75.3 billion merger was the biggest of its time and turned the newly amalgamated company into one of the world's biggest corporations.[3] Today, ExxonMobil is the world's largest refiner with a total global refining capacity of 4.6 million barrels of oil per day, and one of the largest manufacturers of commodity and specialty chemicals globally.[4] The company has a wide scope of operations under three principal business: upstream (exploration and production), downstream (refinery, synthesis and manufacturing), and chemicals.[5] ExxonMobil has been listed on the New York Stock Exchange (NYSE) since 1920.[6]

Prior to the COVID-19 pandemic, which placed downward pressure on the demand for energy, ExxonMobil had produced close to 2.4 million barrels of oil per day in 2019,[7] equating approximately to 2.4% of the total global daily demand.[8] ExxonMobil has won numerous awards over the years such as the 'Large Cap Company of the Year' and 'Explorer of the Year' by the Oil & Gas Council in 2018, in recognition of excellence and innovation in the global energy industry.[9]

What goes up, must come down

For many years, companies in the oil and gas industry such as ExxonMobil were thriving due to the huge demand for energy in various sectors, such as in the manufacturing of plastics and other petroleum-based products, fuel for transport, and for electricity generation.[10] However, with the call for action against climate change and global warming in recent years,[11] fossil fuel usage in the future is up in the air.

Major players in the industry have found themselves in the spotlight, with companies such as ExxonMobil and its competitors scrutinised for their compliance with climate change policies, with some critics accusing them of greenwashing.[12]

Carbon-emitting fossil fuels are considered one of the largest contributors to global warming. International climate change agreements such as the Kyoto Protocol,[13] Paris Agreement,[14] and the recent 2021 United Nations Climate Change Conference (COP26)[15] are placing increasing pressure on corporations to lower carbon emissions and prioritise environmental, social and governance (ESG) policies – particularly in the oil and gas industry. ExxonMobil has supported the Paris Agreement since 2015 by taking actions to reduce its greenhouse gas emissions through initiatives such as energy efficiency, carbon capture and sequestration, and research into next-generation biofuels.[16]

Board members

In 2020, ExxonMobil's board comprised 10 directors, with all except the current Chief Executive Officer (CEO) and Chairman, Darren W. Woods, being independent. Under ExxonMobil's corporate governance guidelines, a substantial majority of the board should be deemed independent. This is aligned with the standards specified under the NYSE corporate governance rules which require a majority of independent directors.[17]

CEO Woods chaired the Finance Committee and Executive Committee. The Board Affairs Committee was headed by Kenneth C. Frazier, who is also the lead independent director. The Compensation Committee was chaired by Samuel J. Palmisano, while the Audit Committee was chaired by Ursula M. Burns. The other directors on the board in 2020 were Joseph L. Hooley, William C. Weldon, and Douglas R. Oberhelman.[18]

Oversight of climate change risks

ExxonMobil does not have a standalone risk committee. Instead, the company takes an "integrated risk management approach" which "facilitates recognition and oversight of important risk interdependencies more effectively than risk-specific committees".[19] All five board committees in ExxonMobil – Finance, Audit, Board Affairs, Compensation and Public Issues & Contributions Committee (PICC) – have climate-related risks integrated within their activities.[20] These climate change risk management activities are overseen by the ExxonMobil's board of directors, which "reviews ExxonMobil's environmental approach and performance". This is carried out at least annually, where all members of the board engage on the latest developments in climate science and policy.[21]

The Finance Committee and Audit Committee oversee risks in areas relating to finance and accounting. They also periodically review the company's overall risk management approach and structure, which includes climate change risks among various business risks. The Board Affairs Committee oversees matters relating to corporate governance and is involved in the identification of experts in energy transition. The Compensation Committee reviews executive compensation packages that incentivise executives to maximise long-term shareholder return while considering climate change risks.

The PICC oversees operational risks, including those relating to environmental performance and actions taken to address climate-related risks.[22] The committee, along with the board, makes visits to operating locations to provide feedback on operating practices and engagement, evaluate the effectiveness of ExxonMobil's risk management processes, and give input on how the company's Operations Integrity Management System (OIMS) helps protect the environment and society at large. The PICC also reviews and proposes objectives, policies, and programs, including appropriate targets and criteria and level of corporate contributions.[23] In 2020, the committee comprised of Chairman Angela F. Braly, Susan K. Avery, and Steven A. Kandarian. During that time, Avery was the only PICC member with expertise relating to the environment, having achieved prominence in the field of carbon and renewable energy.[24] In 2021, Avery became Chairman of the PICC, while the other members of the committee were Braly, Kandarian, Alexander A. Karsner, and Jeffrey W. Ubben.[25]

ExxonMobil also established an External Sustainability Advisory Panel in 2009, led by Woods. The panel's role is to independently review and assess ExxonMobil's efforts towards sustainability in terms of its reporting and transparency.[26]

Pay for performance?

> "Exxon's executive pay program has remained largely unchanged for the better part of a decade. What has not remained constant over this period, however, are prevailing market practices and investors' expectations around executive compensation and related disclosure,"
>
> – *Institutional Shareholder Services*[27]

In 2020, ExxonMobil suffered a blow as a result of the COVID-19 pandemic, which saw falling demand for its products, amidst an already plummeting stock price.[28] As a result, the company intended to downsize its global workforce as part of its restructuring in an effort to cut costs. In July that year, Business Insider reported that ExxonMobil had adjusted the performance review process to slash headcount and allegedly "disguised layoffs as performance-based job cuts".[29] According to the report, ExxonMobil changed its policy in April 2020 to require managers to classify 8 to 10% – up from 3% previously – of U.S. salaried employees into the lowest performance category. This was regardless of whether the managers considered the 8 to 10% of workers to be poor performers. Employees ranked in the bottom category are forced to resign, retire, or enrol in a performance-improvement plan.[30]

While employees were being axed in a bid to cut costs, CEO Woods' salary in 2020 amounted to US$15.6 million.[31] This was despite ExxonMobil reporting a US$22.4 billion loss in 2020, its worst performance in four decades.[32] As the bonus program was suspended in 2020 due to the depressed business environment, his salary package comprised a base salary of US$1,615,000, stock awards of US$8,434,725, and other components.[33] Woods' total compensation had increased by 35% between 2017 and 2019, while cumulative total shareholder return was negative 12% during the same period.[34]

According to ExxonMobil's Compensation Committee charter, one of the committee's primary purposes is to discharge the board's responsibilities relating to the evaluation and compensation of the CEO and other senior executives.[35] In delivering on this purpose, the committee's activities are in part, to "review and approve the corporate goals and objectives relevant to the compensation of the CEO", to "evaluate the CEO's performance as measured against the goals and objectives", and to "set the salary and other cash and equity compensation for the CEO based on the evaluation". It sets out an aim to promote long-term accountability and ensure alignment with the results of senior executives' decisions and long-term shareholder value. In doing so, executives are required to manage current and future risks, including that of climate change.[36]

Bonus program

The annual bonus program in ExxonMobil is intended to link executive pay to ExxonMobil's annual earnings performance and tie payouts to near- and mid-term performance. It represents 10% to 20% of total direct compensation. Bonuses are issued via a 50% cash payment in the year of grant and 50% Earnings Bonus Units (EBU), with the payment of the EBU dependent on future earnings performance and at risk of forfeiture.[37]

Long-term award program

Performance shares represent more than 70% of senior executives' total direct compensation. These shares vest 50% five years after the grant date and 50% in a decade. This structure aims to align compensation with ExxonMobil's business and commodity cycles in the energy industry, where investment lead times are often 10 years or longer. Based on its 2021 proxy statement, ExxonMobil's long-term award program has one of the "longest restriction periods in any industry", ensuring that a significant portion of pay reflects the outcome of senior executives' business decisions and "the experience of long-term shareholders". As senior executives would have to remain in the company to reap the benefits of the performance share awards, ExxonMobil believes that this program would allow it to "retain key talent".[38]

Further, having a high proportion of senior executives' compensation packages in the form of performance shares would "link pay to returns of long-term shareholders", and "encourage long-term view through the commodity price cycle". ExxonMobil's 2021 proxy statement also disclosed that share grants are not adjusted to offset changes in share prices, which results in senior executives "seeing a one-for-one change in compensation in share price, aligned with the experience of shareholders".[39]

Woods was awarded 132,000 shares in 2017[40] when he was first appointed as CEO, and this number grew by approximately 1.5 times to 205,000 shares in 2020.[41] Meanwhile, Principal Financial Officer, Andrew P. Swiger, who was awarded 99,200 shares in 2017, did not receive an increased number of shares during the same period. In 2020, when ExxonMobil incurred losses of US$22.4 billion – as compared to a profit of US$14.3 billion in 2019 – the number of shares awarded to top executives amounted to 554,400 in restricted stock awards, valued at about US$22.8 million in total. This represented an increase from the 545,700 stock awards – valued at US$37.5 million – issued in 2019.[42]

Performance measures

Prior to 2018, executive performance was measured in seven performance areas: safety and operations integrity, ROCE, free cash flows (FCF), shareholder distributions, total shareholder returns (TSR), strategic business results and project execution.[43] In 2018, FCF and shareholder distributions were removed from the assessment criteria, and replaced with cash flow from operations and asset sales (CFOAS).[44] On the change to CFOAS, the company explained that it "focuses on cash generation and is neutral to uses of cash". It also justified that shareholder distribution yield "could inappropriately benefit from stock price decreases and vice versa".[45]

Linking compensation to climate change

ExxonMobil highlighted in its 2021 Energy Carbon Summary that the performance metrics used in determining performance share awards is integrated with risk management, and take climate change risks into consideration. The two performance metrics linked to managing risks related to climate change are "progress toward strategic objectives" – which includes reducing environmental impacts – and "safety and operations integrity".[46]

Prior to 2021, safety and operations integrity, together with ROCE, were disclosed in ExxonMobil's proxy statements as the highest priority metrics considered by the Compensation Committee.[47] However, the committee has also chosen not to assign a specific weight to any of these metrics. Activist investors commented that the lack of assigned weights "allow[s] for ad hoc changes including alteration of key compensation metrics".[48] They also highlighted that ExxonMobil's peers such as

Chevron Corporation, BP plc, and Shell plc have in place management scorecards which have well-defined weights for metrics and targets.[49]

Critics also alleged that the compensation packages of senior executives of Big Oil companies such as ExxonMobil "incentivises them to undermine climate action". This is primarily because their compensation is linked to "continued extraction of fossil fuels, exploration of new fields and the promotion of strong market demand through advertising, lobbying and government subsidies".[50] On this matter, Richard Heede of the Climate Accountability Institute in the U.S. said, "That carbon mindset needs to be revised by realigning compensation towards success in lowering absolute emissions."[51]

Change engine

> "We were founded as an impact investment firm…We have multiple strategies within the firm that we will offer, but the urgency of Exxon, given the scale of its impacts, forced us to introduce the firm through the active engagement strategy."
>
> *– Christopher James, founder of Engine No. 1*[52]

On 7 December 2020, ExxonMobil received a letter directed at its board, to the attention of CEO Woods. The letter outlined numerous issues relating to ExxonMobil's board, board members' remuneration, aggressive expenditure plans, among others.[53]

The author of the letter was a small San Francisco-based activist hedge fund called Engine No. 1. The firm held only a 0.02% stake in ExxonMobil[54] – amounting to merely US$54 million in a company with a US$248 billion market capitalisation.[55] Engine No. 1 identifies itself as an investment company that is "purpose-built to create long-term value and to drive positive impact through active ownership",[56] and states that it is a staunch believer that any company's performance is greatly enhanced by its investments in its employees, customers, communities and the environment.[57] It was founded by an established hedge fund investor, Christopher James, who also founded Partner Fund Management, an investment firm with assets under management of US$6 billion at its peak.[58]

Exxon's No. 1 problem

Engine No. 1 laid out several key performance metrics comparing ExxonMobil and the industry, other key competitors, and its own historical performance. Its analysis indicated that ExxonMobil had negative shareholder return over the past decade compared to the S&P500, declining return on capital employed (ROCE), and increasing debt levels as compared to other oil majors. Engine No. 1 also alleged that ExxonMobil was putting itself at "existential risk" by spending big on oil and natural gas megaprojects, and not fully comprehending the business threat posed by the global push for energy transition.[59,60]

Engine No. 1 attributed what it deemed as gross underperformance to six fundamental issues:[61,62]

(1) A failure to position ExxonMobil for long-term value creation

ExxonMobil's poor risk management is reflected through its "static view of the future" – developing long-term business strategies around the assumption that the oil and gas industry will see the same success it has in previous decades. Its "near total reliance" on carbon capture to preserve and avoid the need to change its current business model was also deemed by Engine No. 1 to be unsustainable in the long-term. This has manifested in a declining terminal value and increased cost of capital, representing a "valuation issue for all long-term investors".[63]

(2) Failure to address long-term business risk from emissions

ExxonMobil allegedly distorted its long-term emissions trajectory and reported only Scope 1 and 2 (but not Scope 3) emissions to obscure its long-term risks. Scope 1 emissions refer to direct emissions, Scope 2 relate to indirect emissions, and Scope 3 includes all other indirect emissions not included in Scopes 1 and 2 that occur in the value chain, including both upstream and downstream emissions.[64] Further, ExxonMobil's refusal to join the Oil and Gas Methane Partnership (OGMP) 2.0, which requires verified emission reduction reporting instead of theoretical engineering calculations, further called into question the legitimacy of its carbon reduction efforts.[65] Instead of channelling resources to address business risks, ExxonMobil was accused of focusing on face-level advertising of its Global Thermostat,[66] carbon vapourware capture, and algae biofuel investments, which "lack real substance" and "viability".[67]

(3) Lack of capital allocation discipline

ExxonMobil had an approximately 80% decline in capital productivity, measured through the lower number of barrels of oil equivalent (boe) per US$1,000 capital employed. In 2001, this figure was at 39 boe. It subsequently dropped to 20 boe in 2009, and fell further to eight boe by 2020.[68] Low productivity was allegedly exacerbated by "highly aggressive spending" and costs that were about triple of other oil corporations.[69] Despite declining returns, ExxonMobil "chose to accelerate (capital expenditure) instead of pulling back", a move that both deviates from its peers, and is "not in favour with investors".[70]

(4) Little reason to trust newfound spending discipline

In late 2020, ExxonMobil had finally cut its capital expenditure. However, Engine No. 1 believed that this move "instils little confidence" due to the company's history of "shifting stances" in other business decisions.[71] On 7 April 2020, ExxonMobil had stated that it would reduce capital spending in the Permian Basin. However, in November that year, it mentioned instead that it would "prioritise near-term capital spending on advantaged assets … in the Permian Basin".[72]

(5) Lack of successful and transformative energy experience on the board

Prior to 2021, ExxonMobil had consistently "filled its board with former CEOs without any energy experience". Engine No. 1 also believed that certain directors on the board had poor track records of underperformance from their previous companies, but yet had been on ExxonMobil's board for many years.[73]

(6) Misaligned incentives

Between 2017 and 2019, while ExxonMobil's total return was -12%, CEO stock awards rose sharply by 35%.[74] Furthermore, the oil giant's compensation plans reward executives for aggressive spending even if shareholder value is destroyed. Its performance metrics are also linked to industry averages without reference to overall market or cost of capital.

The No. 1 mission

Apart from highlighting its issues with the management and business practices of ExxonMobil, Engine No. 1 proposed a plan to realign management incentives, impose greater long-term capital allocation discipline and implement a strategic plan for sustainable value creation.[75] To actualise its mission to "reenergise ExxonMobil", Engine No. 1 intended to place directors of its choice on ExxonMobil's board. On 27 January 2021, it formally put forward four candidates to join the oil giant's board – Gregory J. Goff, Kaisa H. Hietala, Alexander A. Karsner, and Anders Runevad.[76] According to Engine No. 1, it had "reviewed the qualifications of these individuals" alongside California State Teachers' Retirement System (CalSTRS), and believed that their diverse and successful track records in the energy industry are a necessary input in ExxonMobil's board[77] to "create a complementary mix of general and industry-specific expertise" to motivate further value creation for their stakeholders.[78]

Goff is widely recognised in the oil and gas industry and boasts over 30 years of experience in U.S. energy production. He was the former CEO of oil refiner Andeavor, which was later acquired by Marathon Petroleum. During his stint as CEO, he achieved a whopping 1,224% return for shareholders.[79]

Hietala was the former head of renewable fuels at Finish refiner Neste Oil Oyj and played a big role in the company's rise to becoming the world's largest and most profitable producer of renewable fuel – an area which ExxonMobil had sought to explore.[80] Hietala is also a trained geophysicist and environmental scientist.[81]

Karsner possesses decades of experience in energy infrastructure, legislation and new energy technology, as well as the expertise in areas such as carbon capture and smart grids.[82] He was also previously the U.S. Assistant Secretary of Energy, and is currently a senior strategist at X, the innovation lab of Alphabet Inc., where he helms investments in large-scale and advanced energy technologies.[83]

Runevad served as Group CEO and President of Vestas Wind Systems (Vestas) – a wind turbine manufacturing, installation and servicing company – between 2013 and 2019.[84] Engine No. 1 highlighted his "in-depth understanding of how renewable energy companies with growing markets and declining cost curves are transforming the industry".[85] The investment firm also claimed that Runevad turned the company around during his tenure, resulting in a 480% return enjoyed by Vestas' shareholders. In addition, under Runevad's leadership, the company joined the Paris Pledge for Action as a non-party stakeholder, which supports the adoption of the Paris Agreement.[86]

Yet another letter

On 8 December 2020, a day after Engine No. 1 issued its letter to ExxonMobil's board, D.E. Shaw & Co. (D.E. Shaw) – a global investment and technology development firm – sent a private letter to ExxonMobil, urging the oil giant to cut its expenditure and operating expenses to improve performance and maintain its dividend, as well as to "improve its environmental reputation". It tried to persuade the board that changes should be made due to the company's underperformance compared to its peers such as Chevron Corporation. At that time, D.E. Shaw held a 0.06% stake in ExxonMobil.[87,88]

Appeasing its shareholders

On 2 February 2021, Tan Sri Wan Zulkiflee Wan Ariffin was appointed by ExxonMobil to its board.[89] Zulkiflee was the former President and Group CEO of Petroliam Nasional Berhad (Petronas), the national oil and gas company of Malaysia, between 2015 and 2020. He was credited for Petronas' transformation in the areas of operational efficiency, commercial excellence, portfolio optimization, digital transformation efforts and organisational culture.[90,91] Woods said that "his global industry expertise coupled with his insights related to the energy transition will complement [ExxonMobil's] highly experienced board".[92]

ExxonMobil also introduced two more non-executive directors – Michael J. Angelakis and Jeffrey W. Ubben – to its board on 1 March 2021. Angelakis was then Chairman and CEO of Atairos, an independent strategic investment company focused on supporting growth-oriented businesses. He also previously served as Vice Chairman and Chief Financial Officer in Comcast Corporation, a telecommunications company. Ubben was the co-founder of Inclusive Capital Partners, an investment firm focusing on improving shareholder value and promoting sound ESG practices. At the time of his appointment, Ubben was a non-executive director for Appharvest Inc., Enviva Partners LP, and Nikola Corporation.[93]

My nominees, not yours!

> "A board that has underperformed this dramatically and defied shareholder sentiment for this long has not earned the right to choose its own new members or pack itself in the face of calls for change. ExxonMobil shareholders deserve a board that works proactively to create long-term value, not defensively in the face of deteriorating returns and the threat of losing their seats."
>
> – *Engine No. 1*[94]

While D.E. Shaw welcomed the fresh additions to ExxonMobil's board and ended its activist stance in March 2021,[95,96] Engine No. 1 regarded the move as merely one "to ward off the addition of [Engine No. 1's] more highly qualified nominees, with whom the board refused to even meet", and that the newly appointed directors "do not fill the need for successful energy experience or fill other unmet needs".[97] In the activist hedge fund's opinion, Zulkiflee did not have a pivotal role in any significant energy transition, and his experiences running a state-owned enterprise would be starkly different from a company which needs to consider the benefits of public shareholders. Further, ExxonMobil had production sharing contracts with Petronas to produce a fifth of Malaysia's oil production, and half of its gas production.[98] Engine No. 1 also pointed out that since the ExxonMobil board already had numerous executives with capital allocation, risk management and ESG investing experience, the addition of Angelakis and Ubben would not "fill other unmet needs" of ExxonMobil.[99]

Big Oil, small engine?

On 16 March 2021, ExxonMobil released a shareholder letter in response to Engine No. 1's allegations. It stated that the investment firm had made "false statements" about ExxonMobil's plans and strategies, and that its initiatives "would jeopardise [ExxonMobil's] ability to generate the earnings and cash flow that [it] needs to pay [its] dividend, invest in future growth and work on technologies that will be important to help tackle climate change".[100] The oil giant defended its investment portfolio as "the best [it] had in over 20 years", and boasted that its board was "a world-class, highly qualified, diverse and engaged board" that is "one of the deepest, most talented and most diverse in business".[101] It also cited support from analysts and investors such as the Bank of America and Evercore ISI as testimony to its adherence to decarbonisation and shareholder value creation.[102]

ESG ratings: Out of gas

In addition to concerns raised by activist investors, ESG rating agencies have also raised issues with ExxonMobil through the issuance of poor to average ratings, benchmarked against competitors in the oil and gas industry. ExxonMobil's ESG ratings by MSCI Inc. (MSCI), S&P Global Inc. (S&P Global), and Sustainalytics are summarised in Figure 1.

ESG rating agency	**MSCI**[103]	**S&P Global**[104]	**Sustainalytics**[105]
Overall rating	**BBB**	**36/100**	**36.5 (High risk)**
Industry bench-mark	Average among 24 companies in the integrated oil and gas industry	All ESG dimensions ranked above industry mean, but lagged behind industry best	Ranked 61 out of 256 in oil and gas producers industry group
Poor Ratings	Biodiversity and land use, and community relations	Risk and crisis management, climate strategy and human rights	High exposure to different material ESG issues

Average Ratings	Corporate governance, corporate behaviour, carbon emissions, health and safety, and toxic emissions and waste	Corporate governance, occupational health and safety, biodiversity, and energy mix	-
Good Ratings	-	Social impacts on communities, and operational eco-efficiency	Strong management of ESG material risk

Figure 1: ExxonMobil ESG ratings by MSCI, S&P Global, and Sustainalytics

Fuelling the engine

> "This is an unprecedented action by investors, putting all companies on notice that climate inaction can cost a board member their job."
>
> – *Andrew Logan, senior director, oil and gas at Ceres*[106]

Engine No. 1 made it clear that its campaign was equally targeted at ExxonMobil's financial underperformance in recent years as it was about climate change.[107] The activist hedge fund's vision for a cleaner and more disciplined ExxonMobil garnered the support of investors which held larger stakes in the oil giant. Like Engine No. 1, ExxonMobil's second largest shareholder, BlackRock Inc. (BlackRock), believed that "more needs to be done in Exxon's long-term strategy and short-term actions in relation to the energy transition".[108] Engine No. 1's proposal to refresh ExxonMobil's board was backed by BlackRock.[109] Meanwhile, The Vanguard Group Inc. (Vanguard), ExxonMobil's largest shareholder, supported two dissident director nominees to join ExxonMobil's board and indicated that its observations about ExxonMobil's board dynamics and company performance were aligned with Engine No. 1's concerns. Vanguard further observed that the company's "risk oversight process has not led to long-term value creation, with the company significantly underperforming peers and the market over all relevant short- and longer-term periods" and believed that its underperformance could be attributed to its "insular culture".[110] State Street Corporation, ExxonMobil's third largest shareholder,[111] echoed its concerns on the oil giant's underperformance and opined that ExxonMobil's "existing strategy leaves the company more exposed to climate-related transition risk over the long-term".[112]

Furthermore, CalSTRS, one of the biggest U.S. pension funds, was vocal in its support of Engine No. 1's proposals. In alignment with CalSTRS' stewardship priority of low-carbon transition, Aeisha Mastagni – portfolio manager in CalSTRS sustainable investment and stewardship strategies unit – said "We are not trying to argue with them about when this low carbon transition will happen, but it will happen. The biggest risk for Exxon is assuming the status quo – that is a very risky bet for us."[113] Other sizeable U.S. pension funds like California Public Employees' Retirement Scheme (CalPERS) and New York State Common Retirement Fund also supported the Engine No. 1's proposals.[114] The three pension funds supported the nomination of all four of Engine No. 1's candidates to ExxonMobil's board.[115]

Apart from institutional investors, two of the most prominent proxy advisory firms – Institutional Shareholder Services (ISS) and Glass Lewis & Co (Glass Lewis) – also gave their support to the activist hedge fund. On 14 May 2021, ISS urged ExxonMobil shareholders to vote for Goff, Hietala and Karsner to join ExxonMobil's board of directors,[116] stating that the three candidates "address the need for independent industry expertise" and "elevate the board's ability to assess the energy transition".[117] Meanwhile, Glass Lewis indicated support for the nomination of Goff and Karsner to the board, commenting that ExxonMobil's existing board had "failed to demonstrate the foresight needed to position the company for long-term value creation".[118]

Small stake, big win

> "Watching that meeting yesterday was such a perfect example of how they don't realise the world has changed. It was all on display."
>
> *– Christopher James, founder of Engine No. 1*[119]

On 26 May 2021, shareholders cast their votes during ExxonMobil's Annual Meeting of Shareholders. After the preliminary vote count, it was announced that the majority of shareholders selected at least two of the four directors nominated by Engine No. 1 – Goff and Hietala – to ExxonMobil's board.[120] Supporters said that the victory in the 'David and Goliath'[121] proxy battle was a huge breakthrough in activists' efforts to put the climate crisis "at the centre of American capitalism and the global oil business".[122] Exxon's share price increased by 0.7% to US$58.64 on the same day.[123]

On 2 June 2021, after the final vote tally, it was announced that a third Engine No. 1 nominee, Karsner, was elected to ExxonMobil's board as well.[124] Palmisano, Kandarian and Zulkiflee were removed from the board.[125] Some analysts opined that although the new board members would make up a minority of the board, they could still change the tone of board meetings and persuade the other board members to reconsider key positions. Anne Simpson, the managing investment director for board governance and sustainability at CalPERS, said "We need climate competent directors willing and able to drive the energy transition. The votes at Exxon mark a new era in financial markets, with investors behaving like owners."[126]

Greenwashing – The great deception

> "... yet rather than changing its long-term strategy, Exxon is trying to change the subject."
>
> – *Engine No.1 on ExxonMobil's climate strategy*[127]

Engine No. 1's victory shook ExxonMobil and underscored the deep reforms being demanded from Big Oil companies against the backdrop of the global shift to cleaner energy alternatives.[128] The new board would have to tackle ESG issues as one of its first priorities. Would this be a challenge given ExxonMobil's history of greenwashing activities?

Big bets on 'green' projects

In July 2009, ExxonMobil announced that it would invest US$600 million over five to six years – a fraction of its annual capital budget of well over US$20 billion[129] – on trying to develop biofuel from algae which the company claims will have about 50% lower life cycle greenhouse gas emissions than petroleum-derived fuel. It would take several years for the project to achieve commercial viability. Then Chairman and CEO Rex Tillerson said in a 2013 interview that the company's scientists had not been able to develop an optimal strain of algae and that it was "probably further" than 25 years away from achieving success.[130] In fact, several Big Oil companies including BP and Shell have abandoned their algae biofuel projects due to scientific and economic limitations.[131] Although ExxonMobil most recently in 2018 set a target of producing 10,000 barrels of algae biofuel per day by 2025, it constitutes only 0.2% of its refinery capacity.[132]

Similarly, ExxonMobil's efforts in other areas such as carbon capture have not yielded significant results. Engine No.1 pointed out that the company's carbon capture volumes had changed minimally from 2014 to 2019, yet ExxonMobil claims to be the "global leader" in carbon capture.[133] The International Energy Agency also warned that carbon capture and storage technologies cannot replace much needed emissions reductions or be an excuse for delayed action to control global warming.[134]

Is it all an illusion?

ExxonMobil continued to publicise its sustainability efforts in a bid to appear 'green'. Between 2009 and 2015, the company spent more than US$500 million in advertisements across numerous media channels that portray its algae-based fuels as the future of green fuels.[135] During the 2016 Rio Olympics, it spent US$19.3 million to run advertisements on its "green" projects 233 times in the U.S. market, reaching about 335 million television screens.[136] However, none of ExxonMobil's advertisements disclosed the fact that its existing investments in biofuels were only a small fraction of its fossil fuel operations and that its carbon capture projects only account for around two percent of its annual emissions.[137]

Robert Brulle, a professor of environmental science at Drexel University, explained in a 2019 research article that Big Oil companies splurge in advertising campaigns for two primary reasons: to boost their reputations amidst negative media coverage, and to influence policymakers on climate legislation.[138] ExxonMobil's advertising campaigns helped to create an impression that environmentalism is one of its priorities and reduced pressure on its climate strategy.[139] It remains to be seen how ExxonMobil can materially address the business risks associated with the global aim of reducing carbon emissions.

All talk, no action?

Not long after ExxonMobil's US$600 million investment into algae biofuels was announced, the U.K. Advertising Standards Authority in 2011 banned one of its algae biofuel television advertisements as it "overstated the technology's total environmental impact" and might mislead viewers to think that it would reduce carbon levels.[140] The ban turned out to be only one of numerous controversies involving ExxonMobil in the following years.

U.S. lawsuits

From 2018 to 2021, at least five states and cities in the U.S. filed lawsuits against ExxonMobil for fraud and violation of consumer protection laws. These include the State of New York,[141] the Commonwealth of Massachusetts,[142] the State of Minnesota,[143] the State of Connecticut,[144] and New York City.[145] The cases cover a range of issues including the misrepresentation of climate costs, false advertising, public deception, and lack of disclosure of climate risks.

One of the more notable legal suits – Commonwealth of Massachusetts v Exxon Mobil Corporation – dates back to April 2016 when Massachusetts Attorney General Maura Healey issued a civil investigative demand to ExxonMobil concerning the potential violations of Massachusetts' business practices for consumers protection.[146] Two months later, ExxonMobil approached not only the state court in Massachusetts but also the federal courts in Texas and New York to petition against the investigation on grounds that Healey was "impermissibly biased" against it and had a political agenda.[147] Unfortunately for ExxonMobil, the appeals were eventually dismissed by the U.S. Supreme Court.[148]

After the three-year attempt to derail investigations by ExxonMobil, Healey successfully filed a lawsuit against ExxonMobil on 24 October 2019.[149] Healey accused ExxonMobil of deceiving Massachusetts consumers through misleading advertisements which sowed doubt in climate science and downplayed the nexus between fossil fuels and climate change, and through greenwashing campaigns that portrayed itself as an environmentally responsible company.[150] In particular, Healey pointed out that ExxonMobil's series of paid full-page advertisements in The New York Times misled consumers by falsely representing itself as a leader in developing clean energy when in actual fact it increased production of fossil fuels and spent little on clean energy research and development.[151] ExxonMobil attempted to dismiss the lawsuit but was eventually rejected by Massachusetts' highest court in May 2022. The Big Oil company has since denied all allegations about spreading disinformation about the contribution of fossil fuels to global warming.[152]

From courtroom to classroom

> "These patterns mimic the tobacco industry's documented strategy of shifting responsibility away from corporations – which knowingly sold a deadly product while denying its harms – and onto consumers."
>
> – *Harvard University researchers*[153]

ExxonMobil's public relations tactics have also attracted attention from academic institutions. In May 2021, two researchers from Harvard University published a new analysis of ExxonMobil's climate change communications in the environmental science journal One Earth.[154] They used algorithms, machine-learning and inductive frame analysis on 180 ExxonMobil climate change communications, including peer-reviewed publications, internal company documents, and advertorials in The New York Times, and found that ExxonMobil advertisements deflected responsibility of global warming towards consumers to downplay its role in climate change.[155]

The study revealed that ExxonMobil's public facing messaging on climate change consistently emphasised "consumer", "energy demand" and individual "needs" and not fossil fuel supply as the reasons for climate change.[156] In addition, another strategy it employed was to use the terms "climate risk", "potential risks" and "long-term risk", instead of acknowledging climate change. Through semantics, ExxonMobil suggested uncertainty over how climate change would play out.[157] In response, ExxonMobil spokesperson Casey Norton accused the research paper of being part of a litigation strategy against the company.[158]

What is to come?

As Engine No. 1 had warned, ExxonMobil faces the risk of value destruction and asset stranding by entrenching its business in fossil fuels given that governments worldwide are moving to cut emissions.[159] Fortunately, ExxonMobil seems to have now realised the impact of climate risks to its bottom line. In January 2022, it announced that it would aim to eliminate net emissions from its own operations by 2050, making it the last of the Big Oil companies to publicly disclose a net-zero goal. ExxonMobil stated its intention to spend US$15 billion over the next five years – representing about 14% of its estimated capital spending – on low-carbon efforts and emissions reduction plans. This includes the development of lower-carbon fuels and carbon capture use and storage projects while reducing company-wide methane intensity by 80%.[160]

However, CEO Woods has not departed from fossil fuels altogether. In an interview in May 2022, he highlighted that the recent global oil supply crunch arising from the Russia's invasion of Ukraine and corresponding sharp rise in prices reminded people of the need for "affordable, reliable energy". Observers have thus noted the risk that Big Oil companies such as ExxonMobil would "slide back" to their old ways and reverse the efforts made towards reducing their impact on climate change. Nonetheless, CalSTRS' Mastagni remains hopeful, saying "2021 was a watershed year…shareholders now feel very empowered to hold these companies accountable."[161]

The battle between under-the-radar Engine No.1 and oil giant ExxonMobil was likened to the 'David and Goliath of Wall Street'[162] by many analysts – and rightfully so. Engine No. 1 only held a miniature 0.02% stake in ExxonMobil but managed to successfully place three out of four of its candidates on ExxonMobil's board of directors. After ExxonMobil's boardroom 'defeat', will Engine No. 1 be able to achieve continuous and lasting success in driving tangible change in the oil giant's business strategy and attitude towards climate change in the years to come? Stakeholders will no doubt continue to keep their eyes on developments relating to if and how an oil giant like ExxonMobil can shift gears and channel momentum towards sustainability.

Discussion questions

1. According to Engine No. 1, ExxonMobil had underperformed on numerous grounds, from both financial performance and environmental impact standpoints. What factors do you think may have contributed to this?
2. Based on the ExxonMobil case study, what is the role of investors in shaping the business strategy of a company?

3. What are the responsibilities of the board of directors of a company? Evaluate if ExxonMobil's board had effectively discharged its duties. Do fiduciary duties of directors require them to address climate and other ESG risks? Should directors be responsible for a company's compliance with ESG standards?
4. Evaluate the composition of ExxonMobil's board of directors before and after three of Engine No. 1's nominees were placed on the board.
5. Critics have been sceptical about the ability of a few new board members to reform the company, given that most of the board, including the CEO have not been replaced. To what extent do you agree with this statement?
6. How do compensation policies influence executive behaviour? To what extent did it contribute to ExxonMobil's situation? Are there any changes you would recommend to ExxonMobil's existing executive compensation policies?
7. Many environmental activists push for companies to commit to sustainability and lower environmental impacts. In view that the principal business of Big Oil companies such as ExxonMobil is founded on the bedrock of fossil fuels, to what extent do you think such companies should move towards cleaner energy alternatives? What are the main roadblocks that the Big Oil companies may encounter, and what can they do to overcome them?

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OUT OF GREENSILL CAPITAL

Case overview

Founded in 2011 by Lex Greensill, Greensill Capital (Greensill) promoted itself as a revolutionary finance firm which wanted to "make finance fairer" and "democratise capital", offering strategies for businesses to receive payment faster.

As a "saviour" of small businesses, Greensill grew exponentially, rising to be one of the biggest players in the industry and being dubbed as a "once in a generation" company that had the potential to be valued at US$30 billion. However, after Tokio Marine discontinued its insurance policies with Greensill and Credit Suisse Group AG froze US$10 billion of Greensill funds, it took only two days for Greensill to collapse. Greensill filed for insolvency in March 2021, and investigations began looking into what went wrong.

The objective of this case study is to facilitate a discussion of issues such as supply chain financing; risk management; fraud; disclosures; corporate lobbying; relationships between former government officials and businesses; and role of investment banks.

Alexander the Great Greensill

> "I had an ambition that's shared with my brothers, we're all partners together, to make a difference and I guess we have in that way been able to grow something that makes a difference to hundreds of thousands of people."
>
> – *Lex Greensill*[1]

Born in 1976, Alexander "Lex" Greensill (Lex Greensill) grew up mainly on his parents' melon and sugar cane farm in Bundaberg, a small town north of Brisbane. The family farm often found itself in debt due to prolonged delays in payments for their produce. As a result, the family often lived hand-to-mouth, resulting in Lex Greensill having to take on a correspondence course as his family could not afford to send him to university.[2]

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In 2001, Lex Greensill, then 24 years old, moved to the U.K. from Australia. Four years later, he joined investment bank Morgan Stanley, which was expanding in supply chain finance at that time. In 2011, he established the supply chain finance company, Greensill Capital (Greensill), with its headquarters in London, to help small businesses get paid faster.[3] This was accomplished by having Greensill act as a middleman, providing businesses with alternative sources of funding. This model provided suppliers with the opportunity for faster payment, while concurrently preserving Greensill's own capital position.[4]

From its inception until the end of 2019, Greensill facilitated payments to over eight million suppliers in 165 countries.[5] At its peak, Greensill was valued at US$4 billion after a US$1.5 billion capital injection from SoftBank Group Corp.'s (Softbank) Vision Fund.[6] As a result of the company's achievements, Bloomberg once heralded Lex as "the king of supply chain finance",[7] while Masayoshi Son frequently lauded Greensill as an "innovator" and "artificial intelligence entrepreneur".[8]

Greensill's formula for "success"

Comprising of three main entities – Greensill Capital Pty Ltd (Australia), Greensill Capital U.K. (U.K.), and Greensill Bank (Germany)[9] – Greensill specialised in supply chain finance, also known as reverse-factoring. In its simplest form, supply chain financing involves companies making arrangements with banks to quickly pay supplier bills so that they can maintain their cash for a longer period of time. The transaction is in substance a loan that the company subsequently repays. The amount paid to the supplier is discounted in return for quicker payment, and the financial intermediary profits from that margin.[10]

A summary of the supply chain financing mechanism is shown in Figure 1.

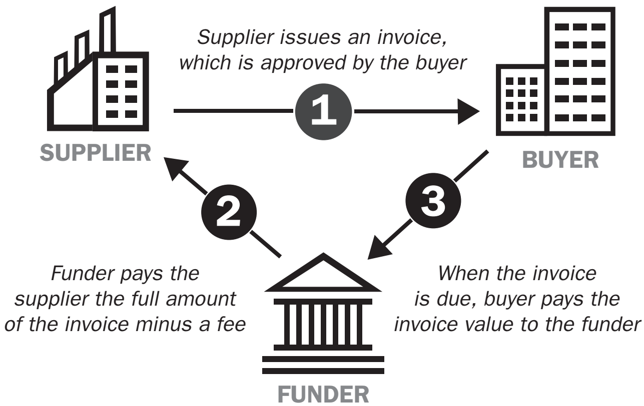

Figure 1: Basic mechanism of supply chain financing[11]

Supporters of supply chain financing state that the mutually beneficial arrangement enables prompt payment for suppliers, while big businesses can smooth out their flow of outgoings.[12] Additionally, suppliers benefit from their buyer's high credit rating to obtain financing at lower rates.[13]

As supply chain financing does not have the same disclosure standards as more traditional forms of debt, businesses which engage in such arrangements reportedly often just say that they "have an arrangement with suppliers for early payments" in their accounts.[14,15] Furthermore, under accounting rules, companies using such facilities do not have to classify them as debt but are able to book them as "accounts payable" on their balance sheets. Analysts have raised concerns that as a result of this, "spiralling de facto corporate borrowing" can be hidden.[16]

Greensill's special supply chain financing

Unlike traditional supply chain financing, Greensill packaged the short-term cash advances into bond-like securities which promised to give investors a higher return than typical bank deposits.[17] The securities were then sold through Credit Suisse Group AG (Credit Suisse) and a Swiss management firm called GAM Holdings AG (GAM). The money received from investors were then used to pay the suppliers. The end result was that suppliers get paid early for invoices.[18]

Greensill ultimately built its business prowess by transforming a "mundane" finance practice into a "win-win" profitable business by pushing risks involved to insurance companies and other financial companies.[19]

Ground-breaking technology

Greensill also presented itself as a "fintech revolution"[20] and "the UK's most valuable financial technology company".[21] Greensill claimed that its technology could assess the risk of loans using artificial intelligence, and sold the debt to outside investors – who saw it as an opportunity to earn greater returns with almost no risk – rather than providing loans to businesses with its own cash.[22] However, it was subsequently revealed that despite its claims, Greensill had a heavy reliance on third-party software platforms such as Taulia.[23]

Lex Greensill also made lofty claims that with complex algorithms going through real-time information on sales and suppliers, Greensill could predict future cash flows with accuracy and spot changes in a borrower's creditworthiness in a timely manner. In reality, much of Greensill's lending was based on "rudimentary forecasting", with employees allegedly using simple spreadsheets instead of groundbreaking technology it had claimed.[24]

Shady business

Swiss fund manager, GAM, was a major buyer of Greensill's notes, and served as a type of "off-balance-sheet financing tool for Greensill's clients".[25] As a major investor in supply chain finance deals arranged by Greensill, GAM provided large sums of money to metals magnate Sanjeev Gupta's Gupta Family Group Alliance (GFG Alliance).

In 2015, Tim Haywood – a star portfolio manager at GAM – had begun investing into Greensill's supply-chain finance notes. The initial investment ballooned, and in 2016, Haywood's funds had lent US$128 million to Greensill.[26] The following year, a whistleblower raised concerns regarding the Greensill investments – many of which were very illiquid, triggering an internal investigation. GAM engaged law firm Bryan Cave Leighton Paisner to review the allegations, as well as Grant Thornton to conduct forensic audit work. The internal investigation's findings uncovered serious flaws in GAM's due diligence – in particular, risk management and record keeping procedures[27] – with respect to the Greensill deals.[28] Haywood was found to have gone against risk management procedures to safeguard against "rogue deals".[29]

GAM suspended Haywood in July 2018 and eventually dismissed him for "gross misconduct" in February 2019.[30] The initial suspension of the star trader caused alarmed investors to exit his funds,[31] and eventually the funds Haywood managed were closed.[32] Between September 2016 and May 2018, Haywood had invested over £2 billion into Greensill-sourced assets, which included securities backed by aircraft lease payments from Norwegian Air and a Russian cargo carrier, as well as a loan to a property developer for a stake in a New York skyscraper. A significant amount of money was also used to "effectively finance Greensill itself".[33]

More red flags

After the GAM fiasco, Credit Suisse stepped in to become Greensill's main source of funding through a US$10 billion range of supply-chain finance funds which bought Greensill's invoice-backed debt products. However, during the stock market crash arising from the COVID-19 pandemic, Credit Suisse's unnerved clients withdrew billions of dollars from its funds in March 2020.[34] With its supply chain funds on the verge of closure, Credit Suisse entered into a deal with Softbank, which was willing to invest US$1.5 billion into the Swiss bank's funds containing Greensill securities to keep it afloat.[35] In exchange, Softbank's Vision Fund received more equity in Greensill, cumulating to a 40% stake. Greensill subsequently used the Credit Suisse funds to finance a number of poorly performing start-ups in the Vision Fund. As a result, Greensill and SoftBank were "in effect channelling a circular flow of financing through the funds".[36]

Earlier in 2019, SoftBank's Vision Fund invested US$8 million in Greensill and valued the supply chain finance company at approximately US$3.5 billion.[37] However, a SoftBank due diligence report issued ahead of its investment in Greensill raised a red flag – almost 75% of Greensill's 2018 revenues had been derived from just five clients. Nevertheless, the conclusion of the report was that Greensill faced "minimal legal or regulatory risk", partly based on the "expectation that GAM clients ultimately will profit" when the Greensill investments were repaid.[38] It was later reported that the Vision Fund had backed Greensill with a total of US$1.5 billion in 2019.[39]

Man of steel

In 2019, over 90% of Greensill's revenue came from five clients, including coal-mining company Bluestone Resources Inc. (Bluestone), British wireless giant Vodafone Group PLC, and U.K. steel magnate Sanjeev Gupta.[40] GFG Alliance – Greensill's most important client[41] – is a network of businesses owned by or linked to Gupta, who was once celebrated as "the saviour of steel". Gupta led GFG Alliance on a mission "to rescue dying industrial communities".[42] Gupta's family business expanded rapidly, and after a series of acquisitions, turned into a sprawling business empire, spanning metals to banking. Its operations eventually covered four continents, employed over 30,000 people, and produced revenue of over US$20 billion.[43]

Gupta took many loans from Greensill – including US$900 million "backed by cash flows from projected government subsidies tied to experimental biofuel generators"[44] – and the relationship between Gupta and Greensill was "unusually close".[45]

The relationship between Gupta and Greensill began in 2015.[46] The following year, Greensill posted losses of US$54 million for the year and was looking for ways to rejuvenate its business.[47] At the time, Gupta was looking for financing after his trading house, Liberty Commodities, and parent company Liberty House Group, had been shunned by the conventional banking sector for irregularities and problems around trade documentation.[48,49] Major banks such as Goldman Sachs Group and ICBC Standard Bank refused to offer credit to Gupta's trading company, questioning the veracity of documents provided by Gupta. Despite Gupta's unstable credit history, Greensill extended US$5 billion worth of credit from 2015.[50] In 2017, 69% of Greensill's net revenue was derived from arrangements with GFG.[51]

In 2019, GFG used money borrowed from Greensill to finance the US$877 million purchase of a number of aging steel plants in countries such as Romania, North Macedonia, and the Czech Republic from ArcelorMittal SA. Although the loans had been secured against inventories of Gupta's Australian businesses, he shuffled the funds to another company involved in the European acquisition. After successfully acquiring the steel plants, Gupta used the assets to obtain a further US$2.6 billion credit line from Greensill.[52,53]

Growing concerns

Greensill's continued exposure to GFG Alliance grew as the steel and commodities conglomerate developed a growing reliance on Greensill to continue providing funding.[54]

In December 2020, the Federal Financial Supervisory Authority (BaFin), Germany's financial watchdog, proposed a concentration reduction plan for Greensill to minimise its exposure to Gupta-linked companies after it lent more than €1 billion (US$1.1 billion) to them collectively. In response, Lex Greensill said that the plan "was going to be impossible for Greensill to comply with".[55] In February 2021, BaFin once again raised its objections on Greensill Bank's concentration risk relating to GFG Alliance. It was reported that by late 2019, Greensill Bank's exposure related to GFG Alliance had ballooned to about €1.5 billion (US$1.65 billion).[56]

Tokio Marine pulls the plug

> "Given the current situation, we will not be able to bind any new policies, take on any additional risk nor extend or renew any Greensill [sic] policy past what had previously been agreed. Please take this statement as a blanket answer for any requests from Greensill to look at additional limit coverage, maximum limit capacity or timeframe of a policy period."
>
> – *Tokio Marine*[57]

In July 2020, Japanese insurer Tokio Marine Holdings (Tokio Marine) informed Greensill that it would not renew US$4.6 billion in insurance policies. The decision came after Tokio Marine discovered that an employee at one of its subsidiaries, Bond & Credit Company (BCC), had provided insurance coverage that exceeded its risk limits.[58] Tokio Marine had purchased the insurance underwriter from Insurance Australia Group (Insurance Australia) in April 2019, but only took notice of its dealings with Greensill about a year later. BCC had extended insurance to over US$7.7 billion in trade credit to Greensill.[59]

It was reported that Tokio Marine's insurance coverage effectively made the Greensill funds "almost risk-free – almost as safe as cash in the bank but with a slightly better return".[60] However, with Tokio Marine pulling out, Greensill's business model could not function as "without them, the machine was stuck".[61]

In desperation, Greensill tried to obtain an extension of the coverage by taking legal action against its insurers – BCC Trade Credit, Tokio Marine and Insurance Australia. It said that in the event the insurance policies are not extended, Greensill's "economic viability would immediately and seriously be impaired as its primary sources of funding, and revenue, would immediately cease".[62] Its plea was ultimately unsuccessful when a judge in the Supreme Court of New South Wales in Australia ruled against it in March 2021.[63] The effects were almost immediate, setting off a wave of events that would eventually propel Greensill to its demise. Hours following the court's ruling and alarmed by the lack of insurance, Credit Suisse froze US$10 billion worth of Greensill funds,[64] setting off concerns that Greensill "could go bankrupt within days".[65] Greensill later attempted to secure insurance from other firms, but did not succeed.[66]

On 3 March 2021, BaFin froze the operations of Greensill Bank and filed a criminal complaint with prosecutors, alleging potential accounting manipulation.[67] The watchdog's forensic audit on Greensill Bank discovered that the company was "unable to provide evidence of the existence of receivables in its balance sheet that it had purchased from the GFG Alliance Group".[68] Later that month, it filed a bankruptcy petition for Greensill Bank and determined that compensation was payable to its depositors as it was no longer able to repay all of its customers' deposits. Insolvency proceedings were also initiated against Greensill Bank with the Amtsgericht Bremen, the District Court of Bremen.[69]

Grant Thornton was then appointed as Greensill's liquidator. On 22 April 2021, creditors of Greensill Capital Pty Ltd – the parent company of the Greensill Group – voted to liquidate the company. In response, Grant Thornton said: "The liquidators will continue to identify and realise available assets, monitor developments in relation to the administrations of Greensill UK and the Greensill Bank AG, and continue their investigations in relation to Greensill Capital Pty [Ltd]." The vote came as prosecutors in Bremen raided the offices and homes of Greensill bankers suspected of possible wrongdoing.[70]

Fake it until you make it

> "A condition of our facilities… is that they must do business with the customer. They must have a history to support that, and the data to support that."
>
> *– Lex Greensill, giving evidence to the U.K. parliament's Treasury Committee*[71]

Grant Thorton was unable to verify a number of invoices used to raise funding from Greensill, which were allegedly "issued by companies that said they had never traded with Gupta's Liberty Commodities".[72] It was reported that some invoices underpinning loans to Liberty Commodities were based on "prospective receivables" which business "confidently anticipated" – speculative transactions which had not occurred and might never occur.[73]

However, Lex Greensill stepped in and denied Gupta's description of the future receivables program.[74] Greensill's claims are purportedly supported by Grant Thorton's findings – that Gupta's invoices appeared to have no relation with hypothetical future trading activity. In particular, the invoices included exact dollar amounts for individual transactions, as opposed to rounded estimates, besides details of specific warehouses that goods would be shipped to. These characteristics are usually indicative of real trades more than any form of forecast activity. Most critically, the invoices were dated in the past, suggesting invoices for accounts receivables instead of future receivables and thus revenue must have been captured. Further documentation provided by Credit Suisse revealed that Liberty Commodities did not have a future receivables financing line.[75]

This was a different case from Bluestone, where a significant portion of Greensill's debt was backed by predictions of future sales rather than actual invoices.

Seeking justice

Bluestone is a coal-mining company based in West Virginia owned by West Virginia governor Jim Justice. While Bluestone was not Greensill's largest client, its acquired debt between 2018 and 2021 had amounted to US$850 million.[76] The coal-mining company was unable to repay its debts when pressured by Greensill for accelerated payments of its loans. Furthermore, the governor's family had signed personal guarantees for the money loaned, with US$780 million borrowed under "prospective receivables" based on existing customers as well as entities "that were not and might not ever become customers of Bluestone". Not only did this arrangement threaten the viability of the company, but also the Justice family's fortunes.[77]

Greensill and Bluestone operated on a "cashless roll", whereby Bluestone would only pay fees and interest with no money changing hands. Greensill would advance Bluestone US$15 million at a time for "prospective receivables", and every few months, Greensill would "roll" these loans and provide Justice with new monies to pay off old advances.[78] To Bluestone, this signified a form of de facto long-term financing. On Greensill's end however, such funds were given the same treatment as other short-term funds – they were packaged into notes and sold through Credit Suisse funds.[79]

In February 2021, Greensill demanded that Bluestone accelerate the return of its borrowed money and give Credit Suisse US$300 million by the end of the third quarter of 2021. Justice claimed that this was the first time the Swiss bank was brought up in discussions with Greensill.[80] Instead of doing as they were told, in March 2021, Bluestone sued Greensill for alleged fraud "under the guise of establishing a long-term financing arrangement".[81] According to Bluestone's lawsuit, it had borrowed US$70 million from Greensill based on actual invoices, while the remaining US$780 million credit was based on future sales that had not materialised yet.[82]

Bluestone was also chased by Credit Suisse, which was pressured by clients to recover its lost monies. Justice and Credit Suisse reportedly discussed ways to sort out the Bluestone debt from July 2021.[83] Over a year later, in June 2022, Bluestone signed an agreement with Credit Suisse to start repaying the Swiss bank's clients the amount owed. The Justice family also agreed to share the proceeds of any sale of the business with Credit Suisse clients. The settlement was arrived at after year-long talks between Credit Suisse negotiators and the Justice family.[84]

Credit squeeze

> "Clearly they didn't do their due diligence...If Credit Suisse was doing its job properly there is no way that they could not have identified these problems."
>
> – *Scott Levy, Chief Executive of Bedford Row Capital*[85]

Despite freezing US$10 billion in client funds linked to Greensill in March 2021, Credit Suisse did not get out of the Greensill fiasco unscathed. Prior to Greensill's downfall, Credit Suisse bought the supply chain finance firm's packaged securities, and touted and sold its supply-chain finance funds as "among the safest investments it offered", as the loans were backed by invoices "usually paid in a matter of weeks". However, as the funds grew larger, they diverged from what was marketed and "much of the money was lent through Greensill against expected future invoices".[86]

After the collapse of Greensill, it was reported that US$7.3 billion worth of funds had been collected, while the remaining amount of US$2.3 billion was allegedly difficult to recoup. The bank identified the amount as linked to three debtors, namely GFG Alliance, Bluestone, and SoftBank-backed construction startup Katerra Inc. (Katerra).[87] Despite anger from clients, the Swiss bank decided it would not make up the shortfall, partially because it feared such a decision would set a precedent.[88]

Credit Suisse commissioned a report into its failings in relation to the Greensill saga, conducted by Swiss law firm Walder Wyss and accounting firm Deloitte.[89] However, in February 2022, it was reported that the Swiss bank decided to keep the report under wraps. The Greensill report was shared with the Swiss Financial Market Supervisory Authority, but the bank's board decided not to publish the full report as it was "wary of releasing too much information that could harm it in potential lawsuits or insurance claims" while it sought to recover Greensill-linked funds.[90]

Two months later, in April 2022, Credit Suisse said an internal review determined that the reputational damage and economic losses from the Greensill saga could have been averted if certain managers and employees had conducted themselves "more appropriately". After Greensill's downfall, Credit Suisse dismissed 10 people and clawed back remuneration amounting to US$43 million.[91]

In July 2022, Credit Suisse informed clients that its effort to recover the lost monies was expected to cost US$291 million, and might take as long as five years of legal battles and contested insurance claims. Investors were not pleased with the news, with one investor saying: "It's devastating that the investors are paying for all these expenses that are based on a mess up by Credit Suisse."[92]

In August 2022, Credit Suisse stepped up its legal claim against SoftBank in an attempt to recoup US$440 million on behalf of its clients that it had lent to Katerra – a U.S. construction group backed by SoftBank's Vision Fund which subsequently filed for bankruptcy – through Greensill.[93] This was following the Swiss bank's initial legal action launched against SoftBank in December 2021.[94] Credit Suisse alleged that SoftBank masterminded a financial restructuring of Katerra that benefited the Japanese group at the expense of the Credit Suisse's clients. However, SoftBank denied the claim.[95]

Political lobbying

> "My view is that what I did was I made a choice to work for a business which I hoped would be the U.K. fintech success story – and many people believed that it would – and I wanted to help that company grow and expand."
>
> – *David Cameron, former U.K. Prime Minister*[96]

David Cameron, the former Prime Minister of the U.K., was once a pioneer advocate of transparency in political and corporate lobbying. Cameron's 2010 campaign saw him vow to eradicate "secret corporate lobbying" which he claimed was "undermining public confidence in the political system".[97] Furthermore, under his leadership as U.K. Prime Minister, the Transparency of Lobbying, Non-Party Campaigning and Trade Union Administration Act 2014 was introduced.[98] However, he was embroiled in questionable lobbying tactics with Greensill and was heavily criticised for his "lack of judgment" as a result.[99]

The history of Lex Greensill and David Cameron dated back to 2011 when Lex Greensill was brought in as a government advisor by then cabinet secretary, Jeremy Heywood. The following year, in 2012, Greensill helped the Cameron government implement a new supply chain finance initiative. In 2014, the Cabinet Office recruited Lex Greensill as a new "crown representative" to help tackle the issue of "wasteful contracts" and ensure that suppliers "provide the best value for money".[100] Following Cameron's resignation in June 2016 after losing the European Union referendum, the former U.K. Prime Minister joined Greensill as an advisor in 2018.[101]

In 2020, while acting on behalf of Greensill, Cameron allegedly sent text messages to Chancellor Rishi Sunak and other top government officials to persuade them to include Greensill in the Covid Corporate Financing Facility, a state-backed pandemic lending program.[102] Between 5 March and 26 June 2020, Cameron and his staff reportedly sent 45 emails, texts and WhatsApp messages regarding Greensill to government officials.[103] He was later reported to have lobbied the Bank of England as well. This was despite the fact that Greensill was ineligible for the joint Treasury-BOE support program as financial firms were excluded for the program.[104] Greensill and Cameron were ultimately unsuccessful in their lobbying attempts.[105]

In June 2020, Greensill had been approved as a lender under the government-owned Coronavirus Large Business Interruption Loan Scheme (CLBILS) – set up in response to the economic challenges faced by companies due to the COVID-19 pandemic – allowing it to issue CLBILS loans of up to £50 million (US$67 million). The company attempted to persuade the Treasury to increase the limit on the loans it could provide under the scheme to £200 million (US$267 million).[106] The Treasury denied its request, stating that the increase would represent "significant exposure". Nonetheless, through the program, Greensill was still able to lend "hundreds of millions of pounds through multiple loans" to Gupta-linked companies.[107]

The National Audit Office later launched an investigation into whether Greensill's access to the scheme had created any risk to public funds and how the company's accreditation to CLBILS was approved.[108,109] It was concluded that in its accreditation of Greensill, the British Business Bank had undertaken a "streamlined" accreditation process "in response to the policy need to deliver money to businesses at pace during the pandemic".[110]

Cameron has since justified his lobbying efforts, citing that he had a "big economic investment in the future of Greensill".[111] However, Treasury Committee Chairperson Mel Stride rebutted Cameron's claims, stating the ex-prime minister was motivated to engage in lobbying as he perceived that his "opportunity to make large amount of money was at risk".[112]

Money talks

The spotlight was also cast on Cameron's remuneration during his stint at Greensill, as he stood to make about US$10 million in total from Greensill. He received a salary of US$1 million a year as a part-time advisor, was paid a bonus of US$700,000 million in 2019, and was due to be paid US$4.5 million after tax for a portion of Greensill shares.[113] Angela Rayner, deputy leader of the opposition Labour Party, said that it was "utterly ludicrous" that he had earned a large sum.[114]

Cameron's political lobbying scandal raised concerns over corporations' ability to recruit and utilise former government officials to seek exclusive access to government schemes. Calls have been made to reform the U.K.'s lobbying policies, for the implementation of stricter regulations on ex-officials entering the private sector, and for the transparency of lobbyists to be strengthened.[115,116]

Lobbying down under

Julie Bishop, Australia's former Minister for Foreign Affairs from 2014 to 2018 and deputy leader of the Liberal Party also made headlines regarding her role as special advisor to Greensill. She reportedly received an annual salary of US$800,000 as Greensill's board advisor.[117] It was reported that Bishop "was not registered as a lobbyist when she was clearly lobbying the government".[118] Bishop was said to have personally approached then Australian Treasurer Josh Frydenberg's office on behalf of Greensill seeking information about the government's small and medium enterprise scheme.[119]

Aftermath

The Greensill saga brought to light the risks in supply chain finance. Observers have opined that Greensill's demise might prove to be the sector's blessing in disguise if it learns from the lessons and implements safeguards, to pave the way to more sustainable and transparent growth.[120]

Although the initial reaction towards Greensill's demise was that "a fatal loss of confidence" in supply chain finance could arise, starting a "domino effect" of investors withdrawing their funding,[121] market activities in the latter half of 2021 suggested that the market impact of Greensill had been curbed by evidence that the company was an outlier which operated "a significantly riskier form of lending than traditional supply chain finance."[122] Mark Ling, head of trade and supplier finance at Banco Santander SA, commented that the wider market acted "very, very quickly" to replace supply chain funds after Greensill's collapse. It was reported that existing lenders ramped up their supply chain finance capabilities and new players were keen on entering the market. For example, in October 2021, Mastercard Inc. and Standard Chartered PLC introduced new supply chain finance offerings to meet the increase in demand.[123]

A market aberration?

Many observers were of the view that Greensill's collapse was a market aberration[124,125] – it diverged from traditional supply chain finance into "more exotic long-term financing structures", operated with a lack of transparency and controls, and managed its products in a way that "allowed questionable practises to pass unnoticed".[126]

In theory, short-term loans such as those involved in traditional supply-chain finance should be considered low-risk. Furthermore, in traditional supply chain financing, lenders would typically rely on their own balance sheet to finance payments.[127] However, Greensill deviated from the roots of supply chain financing and added more complexity by slicing and dicing its bills and invoices and packaging them into bond-like investments for sale to investors looking for an opportunity to obtain better returns, thereby relying on external investors.[128]

In July 2021, a U.K. parliamentary inquiry into the Greensill scandal concluded that its collapse did not demonstrate "a need to bring supply chain finance within the regulatory perimeter for financial services".[129] That being said, it acknowledged that the scandal "highlighted risks around the growth of the non-bank sector and the expansion of non-banks into areas of financial intermediation traditionally dominated by banks".[130] Treasury Committee Chairperson Mel Stride said that the inquiry concluded that there are "a number of lessons for the operation of our financial system", including urgent reforms around bank acquisitions and other regulatory arrangements.[131] The report also recommended that there should be a reform of the Change in Control process which "regulates who can acquire ownership of an existing bank, to ensure that the Prudential Regulation Authority (PRA) has powers to ensure that existing banks do not fall into the hands of owners who would not be granted a banking licence in their own right".[132]

In response to the Treasury Committee's report on 'Lessons from Greensill Capital', the U.K. Government, Financial Conduct Authority (FCA), and Bank of England (BoE) have noted the recommendations. U.K. chancellor Rishi Sunak said that the Treasury was working with both the FCA and the PRA and the government was "committed to ensure [it] learn[s] any wider lesson from this episode".[133]

A long recovery ahead

Following Greensill's insolvency, Softbank wrote down US$1.5 billion of its investments in the company at the end of 2020.[134] This marked yet another high-profile loss for Softbank and its Vision Fund following the WeWork fiasco in 2019.[135]

In May 2021, the U.K. Serious Fraud Office (SFO) launched an investigation into suspected fraud, fraudulent trading and money laundering in relation to the financing and conduct of the business of GFG Alliance, which included its financing arrangements with Greensill. A year later, in April 2022, it was reported that the SFO had stepped up its probe into GFG Alliance, with SFO officers arriving unannounced at premises to seek access to documents.[136] This followed a raid of the Paris offices of GFG Alliance by the French police in the same month. Earlier in 2021, the Paris Prosecutor's Office launched a similar investigation into Gupta's French operations.[137] Investigations are ongoing. In June 2022, Liberty Steel reached a standstill agreement with Greensill Bank AG on debt facilities relating to its European steel operations, giving it "much-needed breathing space" to refinance its debts. Gupta has been trying to secure fresh financing for GFG Alliance since Greensill's collapse but has yet to secure a long-term alternative at the time.[138]

It seems like the "most spectacular collapse of a global finance firm" in over a decade[139] had left behind many casualties.

Discussion questions

1. Explain what is supply chain financing and why it has grown in popularity. What are the benefits and risks of supply chain financing from a business and accounting standpoint?
2. Are current disclosure standards sufficient in the supply chain financing industry? Do accounting standards sufficiently address how supply chain financing components should be recorded in companies' books? If not, what are the risks involved in the current standards and how can they be further reinforced?
3. What factors contributed to Greensill Capital's collapse? Should the investment banks and insurance firms bear the most responsibility? Explain.
4. GFG Alliance played a key role in both Greensill Capital's rise and collapse. Do you think Greensill Capital would manage to survive if it did not have such a high exposure to GFG Alliance? Discuss.
5. Both David Cameron and Julie Bishop were former politicians who lobbied for Greensill Capital with the U.K. and Australian governments respectively. Discuss the potential issues of former politicians turned corporate lobbyists and propose measures to encourage greater transparency.
6. What is the role of financial regulatory authorities such as Germany's Federal Financial Supervisory Authority (BaFin)? Do you think BaFin fulfilled its role as a financial regulatory authority in the Greensill saga?
7. Why do you think SoftBank and its founder Masayoshi Son invested so heavily into Greensill Capital? Do you think it learnt its lesson from the fall of WeWork? Where did SoftBank go wrong this time?

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MCDONALD’S: FROM GOLDEN ARCHES TO GOLDEN PARACHUTES

Case overview

In November 2019, Steve Easterbrook, Chief Executive Officer of McDonald’s Corporation (McDonald’s) ended his 26-year employment with the world’s most famous fast food chain after his inappropriate relationship with a company employee was revealed. Allegations of relationships with other employees – which were reportedly deliberately hidden from McDonald’s board of directors – later came to light. As a result, Easterbrook found himself embroiled in a lawsuit as McDonald’s sought to claw back the enormous severance package previously handed out to him. The scandal occurred against the backdrop of the #MeToo movement, with several high-profile individuals exposed for their involvement in similar scandals. As the movement gained momentum in the U.S., McDonald’s found itself battling a slew of sexual harassment allegations by various female employees.

The objective of this case study is to facilitate a discussion of issues such as corporate culture; board composition and responsibilities; handling of sexual harassment and misconduct allegations; whistleblowing policy; remuneration policies; and golden parachutes.

Investors (initially) lovin’ it...

> “It’s tough to say goodbye to the McFamily, but there is a time and season for everything,”
>
> – *Don Thompson, CEO of McDonald’s*[1]

This case was prepared by Chee Xuan Rong, Daniel Ong Hong Yu, Hong Shiqing, Natalie, Natasha Ho Mun Yee, Wan Qian Hui Vanessa and Wong Wei Lin Ilena, 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 organisations named in the case, or any of their directors or employees.

On 28 January 2015, investors rejoiced at the announcement that Briton Steve Easterbrook – who was then Chief Brand Officer – was taking over as Chief Executive Officer (CEO) of McDonald's Corporation (McDonald's) from Don Thompson from 1 March 2015. The company had experienced some of its worst financial years in decades during Thompson's tenure.[2] Following the announcement, shares in the world's most famous fast food chain rose by 3.2% in extended trading.[3]

Thompson, who had been with McDonald's for almost 25 years, had faced immense pressure since July 2012. He first saw a decline in McDonald's same-store sales in September 2012,[4] which continued in the following two years as the company faced challenges in retaining customers with changing preferences, intensified competition from rival fast food chains, and significant operational issues.[5] One week before Thompson's retirement, McDonald's posted shocking fourth-quarter results, with a 21% plunge in earnings and a decline in store traffic of 4.1% in the U.S. and 3.6% globally.[6] McDonald's stock had remained largely stagnant since Thompson took over as CEO. In contrast, the Dow Jones Industrial Average rose 36% during the same period.[7]

The poor performance pointed to a bearish outlook for McDonald's. The fast food chain had failed to improve its image among millennials, with its 2014 Super Bowl marketing strategy falling on deaf ears.[8] McDonald's had also failed to cater to consumer demand for "fast-casual" dining, which had become extremely popular.[9] Thompson was hesitant to adopt the fast-casual model, putting McDonald's at a comparative disadvantage against rival restaurants such as Chipotle and Panera Bread, which offer custom meals and premium ingredients at higher prices.[10]

In 2014, McDonald's was also hard hit by the tainted meat scandal in China, resulting in its restaurants in China removing popular items off the menu, after its long-time meat supplier, Shanghai Husi Food, was found to have repackaged expired meat and processed meat in unsanitary ways. The scandal adversely affected McDonald's sales and consumer confidence.[11] McDonald's needed to redefine its brand to drive sales growth and improve its tarnished reputation.

Prior to taking the helm of McDonald's, Easterbrook was leading the company's efforts to elevate its global marketing, advance menu innovation, and create an infrastructure for its digital initiatives. He was crucial in turning around McDonald's operations in the U.K. by turning the focus on its core business of selling hamburgers when business was stagnant in the early 2000s. Together with his prior experience in leading U.K. restaurant chains PizzaExpress Ltd and Wagamama Ltd, investors were positive about the change in leadership.[12] Easterbrook promised to act as an "internal activist" and transform the struggling fast food chain into a "modern and progressive" one.[13]

New beginning

> "Having such long service board members can represent a real problem, as they've been around each other so long that they may be reluctant to challenge each other."
>
> – *Eleanor Bloxham, Chief Executive of the Value Alliance and Corporate Governance Alliance*[14]

When the announcement that Easterbrook would take on the role of McDonald's CEO broke, shareholder CtW Investment Group called for the company to revamp its board as well, as it believed that the change in CEO was insufficient to improve the company's business outlook.[15] Other critics also said that the fast food chain was "run by a coterie of long-serving insiders whose relationships raise very big red flags".[16]

According to McDonald's 2015 proxy statement, apart from CEO Easterbrook, all other directors on the 13-member board were independent directors.[17] Eight directors on the board had served for at least a decade, with five having served for more than 15 years.[18] British newspaper The Guardian said that McDonald's had a "dinosaur" board, which could present a challenge for the company to become more progressive.[19] It added that many board members were long-serving insiders, with eight directors having a direct connection with another board member prior to joining the board. It highlighted that Non-Executive Chairman Andrew McKenna had not retired at age 85, despite the company's mandatory retirement age of 73. The company's three longest-serving directors - McKenna, Roger W. Stone and Enrique Hernandez - were also alleged to have been involved in more than US$150 million of related person transactions, with McDonald's making payments to companies linked to them.[20]

That year, there were several changes to the board.[21] Cary D. McMillan[22] and Roger W. Stone,[23] who were both part of the Audit and Finance Committee, stepped down. Three new directors, Margaret H. Georgiadis, Lloyd H. Dean, and John J. Mulligan, were elected.[24] The new directors had expertise in various areas, including retail, technology, consulting, and healthcare. Together with the other directors, most of the McDonald's board had experience in global brand management, finance, and consumer goods/food.[25]

The good times are back

Under Easterbrook's leadership, McDonald's experienced 17 consecutive quarters of growth.[26] McDonald's share price jumped from US$97 in August 2015 to US$211 in August 2019, driven mainly by continuous re-franchising and an increase in margins.[27] This was a stark contrast to McDonald's sales slump under Thompson's leadership.[28]

Easterbrook launched many new initiatives. He formulated a turnaround plan which involved listening to customers' feedback and catering to the changes in consumers' taste. This led to changes such as a revitalisation of McDonald's menu, launch of delivery services, and capital investments to boost sales. Within a year after his appointment, Easterbrook started all-day breakfast across the U.S., introduced the wildly popular buttermilk crispy-chicken sandwich, and made the switch to using fresh – instead of frozen – beef patties in its quarter pound burgers. The switch yielded positive results, with the sales of the quarter pounder burgers rising 30% in the year following its introduction.[29,30]

In 2017, Easterbrook rolled out the Velocity Growth Plan which was built around three pillars to grow McDonald's customer base. These three pillars aimed to retain existing customers, regain customers who visited less often and convert casual customers to committed ones. Easterbrook also focused on initiatives involving the use of technology, delivery and the deployment of "Experience of the Future" restaurants in the U.S. to accelerate the fast food chain's growth.[31] That year, Easterbrook received US$21.8 million in total compensation – an increase of US$6.4 million or 42% over his previous year's compensation.[32] He received total compensation of US$15.9 million in 2018[33] and US$18 million in 2019 respectively.[34] Although Easterbrook was reaping the benefits of the growth he brought to McDonald's, little did he know that he would not be able to see the Velocity Growth Plan to the end.

One relationship is all it takes

> "I engaged in a recent consensual relationship with an employee, which violated McDonald's policy. This was a mistake. Given the values of the company, I agree with the board that it is time for me to move on. Beyond this, I hope you can respect my desire to maintain my privacy."
>
> – *Steve Easterbrook*[35]

Four years after Easterbrook took the helm of the world's most famous fast food chain, the company faced yet another crisis regarding its CEO, this time unrelated to the company's performance.

In October 2019, a McDonald's employee notified the company of her relationship with Easterbrook, out of fear that her misconduct would surface and she would be punished.[36] The relationship, which spanned a few weeks, was consensual. It involved the exchange of text messages and video calls, but never a physical relationship.[37] Nonetheless, their relationship violated McDonald's non-fraternisation policy as stated in McDonald's Standards of Business Conduct. The Standards outline the "ethical and legal responsibilities" that serve as guidance to the company's employees. Under the "Dating" sub-section in the Standards of Business Conduct, it is specifically spelled out that "employees who have a direct or indirect reporting relationship to each other are prohibited from dating or having a sexual relationship".[38]

Upon becoming aware of Easterbrook's violation of the company's policy, McDonald's took action, including engaging external counsel – Wachtell, Lipton, Rosen, & Katz[39] – to inspect Easterbrook's company-issued mobile phone and his iCloud account. However, this did not include his electronic communications stored on the company's computer servers.[40] Easterbrook admitted to a single case of inappropriate relationship and told the company there were no other such instances.[41]

The McDonald's board decided to dismiss Easterbrook in November 2019. While the company's share price dipped by 2% on the day that Easterbrook's termination was announced,[42] it rebounded quickly and by mid-December, the share price had fully recovered.[43]

The McDonald's board said that Easterbrook "demonstrated poor judgment involving a recent consensual relationship with an employee".[44] Carl Tobias, a law professor at the University of Richmond, said that McDonald's dismissal of CEO Easterbrook reflected a zero-tolerance policy regarding senior managers having relationships with subordinates.[45] Experts also believed that McDonald's was under pressure to enforce the company's policy, especially in view of the #MeToo movement that started in 2017. Laurie Weingart, a professor of organisational behavior and theory at Carnegie Mellon University's Tepper School of Business, said: "Allowing Easterbrook to stay at the company would send the message that the company's policies don't matter – and that not everyone in the workforce will be treated equitably."[46] Erika James, Dean of Emory University's Goizueta Business School, also believed that "companies and executives and boards are being far more sensitive to personal relationships, whether consensual or non-consensual, than has been true in the past." [47]

Easterbrook left McDonald's with a severance package that included awarded stock and options valued at US$41 million. As McDonald's share price soared from US$193 in 2019 to US$264 in 2021, the value of those stock and options grew to US$89 million.[48]

The McDonald's board made the decision to award Easterbrook the severance package to avoid a potentially lengthy dispute with him if it had fired him for cause instead. Under the latter scenario, Easterbrook would have to give up his previously awarded compensation, including stock options that he could not yet cash in. McDonald's severance plan contained a clause which states: "If, in the future, McDonald's determined that an employee was dishonest and actually deserved to be fired for cause, the company had the right to recoup the severance payouts."[49]

McDonald's Chief People Officer (CPO), David Fairhurst, was ousted along with Easterbrook in November 2019. Both men had previously worked together in the U.K., and Fairhurst was promoted by Easterbrook.[50] At the time of Fairhurst's dismissal, McDonald's did not disclose the reason and insisted that both dismissals were unconnected.[51] However, family members of Fairhurst said that he was caught in a difficult position as he allegedly knew about Easterbrook's relationship but did not do anything about it.[52]

Tip of the iceberg

In July 2020, McDonald's received an anonymous tip alleging that Easterbrook had engaged in other relationships. In response, the fast food chain carried out an internal investigation into whether Easterbrook covered up acts of impropriety involving other McDonald's employees, as well as potential misconduct in the human resources department led by Fairhurst.[53]

New evidence uncovered included a number of nude or sexually explicit pictures of several female McDonald's employees. The pictures were taken in late 2018 or early 2019, while Easterbrook was still CEO. Easterbrook had sent the pictures as attachments from his work email to his personal email, and deleted the pictures and corresponding emails before his email account was searched by the external counsel in October 2019. However, the pictures were retained on the company's servers and provided evidence of Easterbrook's involvement in three other relationships with employees that he had hidden from the board. Furthermore, the investigations found that Easterbrook had awarded shares worth hundreds of thousands of dollars to one of the employees involved, under a "special retention grant", a few days after their initial sexual encounter. These share awards could be offered by senior executives to outstanding employees and did not require approval from the board.[54,55]

The investigations also revealed "allegations of potential misconduct within the human resources department".[56] It was alleged that human resources leaders disregarded protests regarding employee misconduct, fuelling an environment in which employees were fearful of retaliation for reporting misconduct. There were also claims that Fairhurst himself had improper physical contact with his subordinates and made women at the company feel uncomfortable during several business events.[57,58] Fairhurst also allegedly contributed to a party culture among executives and managers. Fairhurst and Easterbrook were said to have attended these parties, which involved late night mingling and flirting with female employees.[59,60] Employees and managers who were not part of the said social circle alleged that the human resources leaders showed favouritism and intentionally overlooked their promotion opportunities.[61]

America's best first job?

On 12 November 2019, a class action suit was filed against McDonald's for failing to address the "systemic problem of sexual harassment" in its U.S. restaurants.[62] The plaintiff, Jenna Ries, a former McDonald's employee in Lansing, Michigan, sought compensation of US$5 million for employees in that particular franchise. Ries alleged that she was physically and verbally assaulted by her male co-worker and manager from 2017 to 2019. Further, she said she had witnessed her co-workers – some of whom were underage – being subjected to similar treatment, but her reports to the general manager were dismissed.[63,64] McDonald's issued a statement saying that the company is "demonstrating its continued commitment to this issue" by implementing training for a safe and respectful workplace in its corporate-owned restaurants.[65]

Not the first time

Prior to Ries' class action suit, McDonald's had come under fire for similar allegations. In May 2018, former workers in nine U.S. cities filed complaints alleging that they were victims of "sexual advances, lewd comments by supervisors and instances of inappropriate on-the-job behaviour".[66] An underage employee, Breauna Morrow, said, "McDonald's advertises all over television saying it's 'America's best first job', but my experience has been a nightmare."[67]

In response, McDonald's began working with Rape, Abuse & Incest National Network (RAINN), the U.S.' largest anti-sexual violence organisation, to improve its discrimination and harassment prevention policies.[68] McDonald's also introduced a new hotline that allowed workers to anonymously highlight concerns and report harassment[69] and rolled out a new training program to address harassment, violence, and workplace discrimination in an effort to make its stores safer for employees.[70] Easterbrook mentioned that through these improvements, "listening to employees across the system, McDonald's is sending a clear message that we are committed to creating and sustaining a culture of trust where employees feel safe, valued and respected."[71]

Under its Standards of Business Conduct, McDonald's has its own reporting line for any alleged misconduct, and the reporting of actual or potential violations of the standard is encouraged. In the "Reporting Concerns" sub-section, various courses of action are available to an employee who wishes to raise an ethics or compliance concern. Employees can approach their direct supervisor or other managers, directly contact the global compliance office or call the business integrity line – which is serviced by an external firm – if they wish to remain anonymous. Concerns from anonymous persons and those that cannot be addressed by supervisors are routed to the global compliance office. Thereafter, issues are either resolved or follow up actions will be decided upon. The company also stated a very clear stance on protecting employees against retaliation. Any sort of retaliation against an employee who reports non-compliance is strictly prohibited and disciplinary actions will be taken if not complied with.[72]

Ineffective measures?

In April 2020, McDonald's was hit with yet another US$500 million class action lawsuit, months after the new measures were implemented. The lawsuit was filed on behalf of 5,000 women who claimed that they were subjected to physical assaults, groping and sexually charged comments while working at corporate-owned, non-franchised McDonald's restaurants in Florida since 2016. The lawsuit also demanded that McDonald's implement "worker-centered anti-harassment policies and training, including teaching in-store and upper-level managers how to investigate complaints and discipline harassers".[73,74]

Outside of the U.S., an international group of labour unions filed a complaint at the Organisation for Economic Cooperation and Development's offices in the Netherlands against McDonald's for "systemic sexual harassment" at its restaurants worldwide in May 2020. Sue Longley, the general secretary of the International Union of Foodworkers, commented that, "McDonald's workers have sounded the alarm about sexual harassment and gender-based violence for years, but a company with a culture rotten from the top has failed to take meaningful action to address the problem."[75] As such, she argued that the Dutch government should use the complaint to "empower workers to address the rampant harassment" faced in McDonald's.[76]

No discretion or excessive discretion?

> "The board awarded Easterbrook a total severance package of potentially US$44 million, US$28 million of which pertains to his outstanding options – each additional year of vesting continuation could mean several millions more in compensation to Easterbrook. This, in our view, is not just discretion, but excessive discretion."
>
> – *CtW Investment Group's letter to shareholders*[77]

In August 2020, slightly less than a year after Easterbrook was ousted by the board and a month after the discovery of the former CEO's undisclosed multiple relationships with employees, the company filed a lawsuit in Delaware state court accusing Easterbrook of lying about multiple relationships with employees and sought to claw back his substantial severance package.[78] McDonald's further alleged that Easterbrook had lied to obtain a more favourable severance agreement.[79]

The former CEO shot back, asserting that the lawsuit was "meritless" and "misleading".[80] He sought to dismiss the case, claiming that there was language in the separation agreement barring the company from reversing it and that the emails which McDonald's uncovered in mid-2020 were already available to the company prior to the signing of the separation agreement. McDonald's slammed Easterbrook as "morally bankrupt" for arguing that "he should not be held responsible for even repeated bad acts".[81,82]

The separation agreement

When Easterbrook departed from McDonald's, he entered into a separation agreement setting out his benefits under the company's severance plan as well as his equity award agreements.[83] The separation agreement provided that Easterbrook's termination would be "without cause" for the purpose of determining the quantum of his severance compensation and benefits. Easterbrook was therefore entitled to receive the severance compensation and benefits provided for under his existing compensation arrangements. The board said that it would not have agreed to the provisions of the separation agreement if it had clear evidence at that time to terminate Easterbrook for cause.[84]

Easterbrook's benefits included a severance payment, a pro-rata short-term incentive plan payout, as well as continued vesting of a portion of his outstanding stock options. The committee allowed Easterbrook's unvested options to vest three years past his termination date. This meant that Easterbrook's options would vest even though he was no longer with the company, allowing him to reap the benefits of any stock price appreciation without directly contributing to its success after his departure. In addition, it also included a pro-rata portion of his performance-based restricted stock units, which was subject to the achievement of the performance goals.[85] In all, Easterbrook's severance package was worth US$57.3 million.[86]

In return, Easterbrook agreed to a release of claims and restrictive covenants, including non-solicitation of employees and non-interference with business partners for two years post-termination and perpetual confidentiality and non-disparagement covenants. There was also a two-year post-termination noncompetition covenant.[87]

Easterbrook's separation agreement incorporated McDonald's Corporation Severance Plan. Under the terms of the plan, if McDonald's determined at any time that a qualifying employee committed any act or omission that would constitute cause while he or she was employed by McDonald's, the company may cease payment of any benefit otherwise payable and require the qualifying employee to repay compensation previously paid. McDonald's would also have the right to seek enforcement of its rights in any court of competent jurisdiction.[88]

The separation agreement also included provisions regarding Easterbrook's 2018 and 2019 equity awards, which stated that the benefits granted were subject to repayment or forfeiture if "the Company determines, in its sole and absolute discretion, that the [Grantee] engaged in Detrimental Conduct" which is defined to include "willful fraud that causes harm to the Company."[89]

Cause for concern

> "When McDonald's investigated, Steve Easterbrook lied. He violated the company's policies, disrespected its values, and abused the trust of his co-workers, the board, our franchisees, and our shareholders. His argument that he should not be held responsible for even repeated bad acts is morally bankrupt and fails under the law."
>
> – *McDonald's Corporation*[90]

On 4 November 2019, in a letter[91] to McDonald's Chairman Enrique Hernandez, New York City Comptroller Scott Stringer and other institutional investors called on the company to adopt a stronger clawback policy in view of Easterbrook's generous severance package. He also condemned the board's decision to give Easterbrook substantial post-employment benefits as "tone deaf at the top", especially in view of the company's inadequate response to extensive sexual harassment in McDonald's restaurants. He further urged the board to demonstrate strong tone at the top and take responsibility for overseeing the sexual harassment prevention efforts going forward.[92]

Clawback provisions are not uncommon – bankers and traders often have clawback provisions in their contracts, generally tied to actions that lead to substantial or unexpected losses. However, in McDonald's case, the company was intent on suing a former employee by claiming that the terms of separation were drafted based on fraudulent statements made by the employee and was hoping to recover the compensation which had already been paid.[93]

Stringer's letter also mentioned that the board should immediately adopt amendments to its clawback policy to make it clear that executives whose actions violate the Standards of Business Conduct or damage the reputation of the company would not be allowed to retain equity grants and other relevant compensation. This would signal to company shareholders, employees, and the public that the board was fully aware of the gravity of such situations and recognises the importance of setting the correct tone at the top.[94]

Time for a change?

> "The board seems to have overlooked important warning signs, red flags."
>
> – *Dieter Waizenneger, executive director of CtW Investment Group*[95]

On 17 December 2020, a group of McDonald's investors called for the resignation of two board members – Chairman Hernandez and Compensation Committee Chair Richard Lenny – whom they deemed "most responsible" for wrongfully terminating Easterbrook "without cause" after a "bungled" independent investigation into Easterbrook's misconduct and for approving his excessive severance package, which it was only now attempting to recover in "costly" litigation. The letter addressed to McDonald's board was signed by CtW Investment Group, Stringer, and Connecticut Treasurer Shawn Wooden.[96]

Dieter Waizenegger, executive director of CtW Investment Group, opined that the McDonald's board was "slow to react", as evidenced by its unwillingness to take decisive actions during the investigations into Easterbrook's misconduct.[97] He also commented that the board's lengthy tenure and lack of experience on regulatory and legal compliance might have contributed to the company's missteps. Hernandez and Lenny had been on McDonald's board for 24 years and 15 years respectively.[98] According to him, apart from Chairman Hernandez, no other board member had any background in regulatory or legal compliance. He also decried that the board did not disclose the scope of its investigation into Easterbrook's conduct before he was terminated in 2019. In addition, the board and the independent law firm which conducted the investigation did not identify the directors or the committee responsible for directing and overseeing the review and it was unclear which members of the board were qualified to provide the active oversight and direction that was needed.[99]

The letter also highlighted the Association of the Corporate Counsel's recommendation that when conducting an internal investigation in response to allegations of executive misconduct, investigators should "suspend the scheduled deletion of email files on the company's e-mail server, so that email deleted beforehand by the subjects can be preserved."[100] Although Easterbrook's other misdeeds were uncovered from deleted email files on McDonald's company server, the investigators failed to search for them during the initial investigation. The letter said this turned out to be a "costly and preventable omission" on the investigators' part and the board should have been responsible for actively overseeing and directing the entire investigation.[101]

In another letter dated 26 April 2021, CtW Investment Group and Stringer addressed McDonald's shareholders, reiterating their position that Hernandez and Lenny "should be held accountable and removed from the board" and urging them to vote against their re-election at McDonald's Annual Shareholders' Meeting on 20 May 2021.[102] McDonald's, however, stood by the two directors, and recommended that shareholders approve their re-election. At the meeting, Chairman Hernandez emphasised that the McDonald's board took swift action when it caught wind of Easterbrook's misconduct. Eventually, McDonald's shareholders voted to retain all the directors.[103]

Finally giving in

The legal battle between the fast food giant and Easterbrook finally came to an end in December 2021. Easterbrook returned US$105 million in cash and stock to McDonald's – one of the largest clawbacks in U.S. history – and McDonald's agreed to drop its lawsuit against him. Chairman Hernandez said that the settlement achieved McDonald's goal of holding Easterbrook "accountable for his lies and misconduct, including the way in which he exploited his position as CEO". Easterbrook issued an apology to his former co-workers, the board, and McDonald's franchisees and suppliers for his failure "to uphold McDonald's values and fulfill certain of my responsibilities as a leader of the company".[104]

Waizenegger said that as a shareholder, he was pleased at the eventual outcome but was still of the opinion that the McDonald's board failed to do its job.[105] Despite the successful clawback of Easterbrook's severance package, the current CEO and the board have work to do to restore investor confidence.

Is the worst over?

Under Easterbrook's successor, Chris Kempczinski, McDonald's has performed well even against the backdrop of the COVID-19 pandemic. McDonald's 2021 revenues topped US$23 billion[106] – the highest in five years. The fast food giant's performance was attributable to a number of successful business initiatives, including increased drive-through business, uptake of its mobile application and loyalty programs by eager consumers, and meal collaborations with various celebrities such as K-pop boy band BTS.[107]

Kempczinski and the board would now need to turn their attention to the transformation of McDonald's workplace, which is still allegedly rife with sexual harassment.[108]

Discussion questions

1. What is the role of the board of directors in setting the corporate culture of a company? How can the board monitor the corporate culture?
2. To what extent were the sexual harassment cases over the years a reflection of McDonald's corporate culture? How far should McDonald's be held legally responsible for the actions of its franchisees with regard to the sexual harassment of employees?
3. Should McDonald's have relied solely on whistleblowers to uncover the extent of inappropriate relationships in the company? What could the company have done to prevent and detect such inappropriate relationships?
4. Critically evaluate the McDonald's board handling of Easterbrook's misconduct, from the initial investigations to the legal actions it took to recover Easterbrook's severance package.
5. Evaluate Easterbrook's severance package and discuss whether McDonald's Corporation Severance Plan could have influenced the board's decision to terminate Easterbrook without cause.
6. Critically evaluate McDonald's board of directors, including its independence and diversity, as well as the effectiveness of the board. To what extent did the board composition have a part to play in McDonald's corporate culture and the handling of Easterbrook's misconduct?
7. Should the board have fired Easterbrook given the stellar company performance under his tenure? Explain.

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PALANTIR TECHNOLOGIES: WE'LL BE WATCHING YOU

Case overview

"Love us or don't invest in us!" This was one of the founder's messages to potential investors on Palantir Technologies' (Palantir) "Investor Day". Unlike usual investors' presentations, Palantir's "Investor Day" began with its co-founder jogging up the terrains in bright-coloured attire, setting the tone for Palantir's unconventional business model. When Palantir first made its public debut in 2020, it was a company shrouded in mystery. Its involvement in the finding of Osama bin Laden's hideout and the uncovering of the Bernie Madoff Ponzi scheme gave investors great confidence about the company's future prospects, despite the secretive nature of the company, leading to a valuation of over US$22 billion. The general public's lack of knowledge pertaining to Palantir is unsurprising, given that Palantir's business model as an enterprise software company offering data analytics services was mainly geared towards other businesses. However, it had gone downhill since then, losing more than half of its valuation in the first half of 2022. This was attributable to investor uncertainty regarding Palantir and the many controversies that it has been broiled in.

The objective of this case study is to facilitate a discussion of issues such as questionable business model and clients; unusual corporate governance features; direct listings versus Initial Public Offerings; and multi-vote shares.

Business model or secret model?

Founded in 2003, Palantir Technologies (Palantir) is an American data-mining company which specialises in big data analytics, offering analysis services ranging from cell phone records, financial documents, airline reservation systems to social media files. Palantir caters to its clients' specific needs with a high level of customisation,[1] providing them with a unique set of data according to their requirements and business proposition.

This case was prepared by Cara Tan Hui Shan, Darelyn Lim Qi Xuan, Goh Yang Yu Terence, Kok Kian You Alvis, Tan Yan Sheng and Yong YueRong Luanne, rewritten with additional content added by Timothy Lee Kay Hwee, 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 organisations named in the case, or any of their directors or employees.

Palantir was co-founded by Peter Thiel, Alex Karp, Joseph Londale, Nathan Gettings and Stephen Cohen. Out of the five co-founders, Peter Thiel, Alex Karp and Stephen Cohen remain in firm control of the company due to their ownership of shares with multiple voting rights. Although owning as little as 0.5% of the company's shares, they collectively control approximately 68% of the voting power within Palantir.[2] Despite the secretive nature of its business model with little information about its actual business model and operations being disclosed to the public, many investors were still willing to invest into the company, leading to a valuation of US$22 billion when it first went public.[3]

Palantir has a diverse client basis, consisting of federal agencies, state and local governments, and financial and healthcare institutions,[4] with its revenue being skewed towards government agencies. As Palantir's controversial business model has resulted in ethical, privacy and political concerns, the deals struck between Palantir and these large organisations gave rise to public backlash.

Palantir is able to charge its clients high fees as its services provide substantial value to its customers, making available vast amounts of data that can be easily accessed and understood for decision-making purposes.[5] Palantir is able to cater to the specific needs of its customers with a high level of customisation, providing them with a unique set of data according to their requirements.

Corporate governance

Palantir's current board of directors consists of seven members, including its three co-founders, Peter Thiel, Alexander Karp and Stephen Cohen, who are involved in executive management.

Peter Thiel has a wealth of experience in setting up and managing tech companies. Prior to establishing Palantir in 2003, he was the co-founder and Chief Executive Officer (CEO) of PayPal Holdings, Inc., which was sold to eBay Inc. in 2002. He became a venture capitalist and was the first outside investor of Facebook.[6] Since then, he has founded Clarium Capital, a global macro hedge fund based in San Francisco, and multiple venture capital funds, including Valar Ventures and Founders Fund. He also set up the Thiel Foundation to fund non-profit research into artificial intelligence, life extension, and seasteading. As Thiel is a conservative libertarian, he has given speeches at the Republican National Convention.[7] He was also a vocal supporter of Donald Trump in the Donald Trump 2016 presidential campaign, donating US$1.25 million for campaign funding,[8] thereby putting Thiel high up the list of Trump's election campaign contributors.[9] However, he distanced himself from Trump's 2020 re-election campaign, partly due to the Trump Administration's slow and ineffective response to the threat posed by the COVID-19 pandemic.[10]

Alex Karp assumed the role of Palantir's CEO in 2004 and is known as an "unusual and eccentric leader". Prior to joining Palantir, he pursued a Ph.D. in philosophy and "is recognisable by his wild hair and brightly coloured athletic attire".[11] His eccentric nature was exemplified by the unconventional execution of Palantir's "Investor Day" presentation, with Karp jogging up the terrace in bright-coloured attire[12] and his message to potential investors to "love us or don't invest in us".

Stephen Cohen graduated from Stanford University with a Bachelor of Science in Computer Science, where he focused on machine learning, artificial intelligence and natural language processing. He currently serves as the president and secretary of Palantir and has been credited with creating the initial prototype of Palantir in eight weeks.[13]

Independent directors

Palantir has four independent directors on its board – Alexander Moore, Alexandra Schiff, Lauren Stat, and Eric H. Woersching. Woersching replaced Spencer Rascoff as independent director at Palantir's 2022 Annual General Meeting. In its Schedule 14A Proxy Statement, Palantir stated that its "board of directors has determined that each of Messrs. Moore, Rascoff and Woersching and Mses. Schiff and Stat do not have any material relationship with us (either directly or as a partner, stockholder, or officer of an organisation that has a relationship with us) and that each of these directors and our director nominee is "independent" as that term is defined under the listing standards of the NYSE."[14]

Based on Section 803(A)(2) of the NYSE American Company Guide, an "independent director" means a person other than an executive officer or employee of the company. The independence of Alexander Moore may be called into question as he was the first employee hired by Palantir to be the director of operations. He is also a partner at a venture capitalist firm 8VC, which was founded and controlled by Palantir's co-founder Joseph Lonsdale.[15]

Dark knight?

Palantir has received both criticism and praise for the powerful nature of its data analytics software. As Palantir's profiling tools operate under extreme secrecy with little oversight, this had led to a business model that many believe to be controversial and both a boon and a bane. While its data analytics functions have provided great benefits to organisations in their operations and decision-making capabilities, it has also brought about ethical, privacy, and political concerns.

Ethical concerns

Palantir's technology has been critical to defence and law enforcement work. In-Q-Tel, the venture investment arm of the Central Intelligence Bureau, was an early investor in the firm. Palantir has been commended for the role it played in counter-terrorism military operations, which has led to the location and apprehension of criminals. Its technology had helped to locate Osama bin Laden's hideout and zero in on terrorists in Afghanistan and Iraq.[16]

However, the same technology has also been adopted by the Immigration and Customs Enforcement (ICE) agency, and this has raised concerns regarding the violation of human rights. Palantir's technology has aided in the locating of illegal immigrants and asylum-seekers, enabling ICE to carry out massive raids[17] and deport a record number of people from the U.S. in recent years.[18] This has led to many families being divided, bringing about widespread unhappiness to the dismay of many civil rights groups, and significant psychological stress and trauma on the families who were separated from their loved ones.[19]

Palantir has also been reported to work with foreign governments that are alleged to engage in bribery and corruption.[20] This has raised concerns regarding Palantir's business ethics, as it is willing to conduct businesses with partners that engage in such allegedly unethical behaviour.

Privacy concerns

Palantir works with local police forces to pioneer predictive policing technology. This involves the use of statistical analysis to predict and reduce potential criminal activity. For approximately eight years, the Los Angeles Police Department (LAPD) has used Palantir's software for Operation LASER and assign scores to Los Angeles residents based on their interactions and contacts with the LAPD. When residents exceed a certain score threshold, officers would be assigned to knock on their doors and inform them that they are being monitored and allegedly would look for opportunities to stop or arrest them.[21] Additionally, Palantir's Gotham software has provided the local police departments with massive amounts of personal data, enabling law enforcement officers to gain a deeper understanding of a suspect's life and daily activities without the need for a warrant.[22]

It has been argued that this technology would help to lower the number of crimes being carried out in the respective states, as these potential suspects would be monitored more closely by police agencies. However, this has also brought about privacy concerns as individuals are unaware of the extent to which their personal data is being collected and provided to the police.

Palantir also played a role in helping the U.S. tackle the COVID-19 pandemic. It was engaged by the U.S. Department of Health and Human Services (HHS) to collect and analyse vast amounts of data to form a model to understand the spread of the COVID-19 virus and to anticipate hospital needs. There is a service recovery planning clause within the contract between HHS and Palantir, which provides HHS the ability to use Palantir's data for future business-as-usual monitoring. This suggests that the software and health data would be stored and used in the long term by HHS.[23] However, there have been concerns regarding the use of the data collected by Palantir for HHS by other federal agencies in "unexpected, unregulated, and potentially harmful ways". In response, a HHS spokesperson assured the public that Palantir would only utilise the data collected for the purposes as directed by HHS for its public health response efforts. However, such privacy concerns are not completely unwarranted due to Palantir's track record in assisting ICE. Additionally, the HHS' Office of Refugee Resettlement was found to have given ICE access to its records in 2018, which were subsequently used to arrest hundreds of people who sponsored unaccompanied minors to cross the U.S. border.[24]

In the U.K., Palantir secured a contract with the National Health Service (NHS) to provide it with data management platform services to power the NHS' COVID-19 data store.[25] This deal triggered concerns from privacy advocates, who urged the NHS to be "extremely cautious and transparent in its dealings with Palantir". In response, Foxglove, an independent non-profit organisation, has filed a lawsuit over the NHS deal over claims that it had failed to consider the impact of the deal on patients and the public. The basis of the lawsuit was that the U.K. Government has a legal duty to consult the public before entering into contracts that may potentially affect the country's wellbeing and to ensure that personal information, such as health records and human rights, are being protected. After Foxglove sent legal letters to demand transparency regarding the agreement with Palantir in February 2020, the U.K. government eventually rescinded its contracts with Palantir in June 2020.[26]

Political concerns

In 2020, Palantir was awarded the two contracts with HHS, worth US$24.9 million, without any requirement to bid for them. While it was acknowledged that Palantir's services were helpful to the government and public at large, the procurement process raised suspicions. There is typically a competition requirement for such contracts, which requires companies to bid for the projects. However, the HHS asserted that adhering to such requirements would result in "unacceptable time delays in fulfilling the agency's urgent needs in addressing a global pandemic and national public health emergency".[27] Consequently, the contracts were offered to Palantir, without being put up for bid. Although there was no evidence that Palantir had inappropriately received such government contracts, concerns were raised as to whether Palantir had benefited from the heavy lobbying efforts and the close personal relationship between Thiel and former U.S. President Trump.[28,29]

Furthermore, Palantir's CEO Alex Karp has clearly indicated the company's geopolitical preferences, proclaiming that the company has chosen sides to aid "the West" and noting that its services will be crucial in making the U.S. the strongest country in the world. Palantir also explicitly stated in its Initial Public Offering (IPO) filing that the company would not be working with China and the Chinese Communist Party because it is inconsistent with its culture and mission and would limit its growth prospects.[30]

Wobbly financials

Despite being in the industry for close to 19 years, Palantir has never turned a profit, incurring losses each year since its inception.[31] Although Palantir has seen increasing revenue growth rates, averaging a revenue growth rate of 36% since its public listing in 2019 to 2022,[32] it still reported a negative net income each year. It incurred US$1.172 billion in losses in 2020 and US$0.52 billion in losses in 2021.[33] Palantir has also disclosed a risk regarding its inability to become profitable in the future, as it expects its operating expenses to increase over time.[34]

Initially, Palantir's secretive business model, unfavourable year-on-year bottom line and unconventional board structure did not seem to faze investors, who had huge expectations regarding Palantir's future potential. Palantir's share price shot up from US$10 during its IPO in September 2020 to a peak of US$35.18 in January 2021. However, the company has gone downhill since then, losing half of its valuation in the first half of 2022.[35] Palantir's share price dipped below US$10 in May 2022, and sits at US$7.86 as of 29 August 2022.[36]

Palantir has issued public statements stating that it seeks to reduce its reliance on government contracts by seeking out more corporate clients.[37] However, the majority of Palantir's revenue still comes from its government contracts. In 2020, Palantir generated US$610 million in government-derived revenue (56%), compared to US$482 million in commercial revenue (44%). In 2019, government revenue was US$345 million (45%) and commercial revenue was US$397 million (55%). Comparing across the years, government revenue increased by 77%, versus just 22% growth in its commercial business. The company's government revenues are higher today in both absolute dollar amounts and relative terms when compared to prior years.[38]

Remuneration

Despite Palantir's inability to turn a profit in its 19 years of operations, it has provided substantial stock-based compensation to both its board members and employees, as shown in Figure 1.

Financial year	Net income/loss[39] (US$)	Stock-based compensation[40] (US$)
2019	0.58 billion	0.242 billion
2020	1.166 billion	1.271 billion
2021	0.52 billion	0.778 billion
2022	1.267 billion	1.834 billion

Figure 1: Stock-based compensation in Palantir

While Palantir has reported negative GAAP earnings, it has been reporting positive adjusted earnings. Palantir's adjusted earnings involved the addition of stock-based compensation back to its net income. However, stock-based compensation is a real, material cost that dilutes equity and impacts existing shareholders' ownership stakes.

Related party transactions: is anyone keeping tabs?

Palantir has entered into several commercial arrangements, in which the company pays for services from other affiliated businesses owned or run by executives and board members. This is further compounded by the fact that Palantir does not provide much information about the related party transactions that it enters into. Figure 2 shows selected related party transactions of Palantir.[41]

Company	Transactions	Related Party
Piazza	During financial years 2017, 2018, 2019, and the six months ended June 30, 2019, Palantir made payments of US$412,000, US$202,000, US$167,000, and US$135,000 respectively, for a license for its online recruiting platform and other services provided by Piazza.	Pooja Sankar is the CEO of Piazza and is the spouse of Shyam Sankar, Palantir's Chief Operating Officer.
Collective Health	During financial years 2017, 2018, and the six months ended June 30, 2019, Palantir made service payments to Collective of US$439,627, US$470,770, and US$267,202 respectively. Entities affiliated with Founders Fund held a greater than 10% equity interest in Collective Health until June 2019.	Peter Thiel, a member of Palantir's board of directors, is a managing member of the General Partner of several Founders Fund entities.

Disruptive Securities	During the six months ended June 30, 2020, Palantir paid Disruptive Securities commissions of US$6.8 million in connection with sales of Palantir's capital stock to parties introduced to the Company by Disruptive Securities.	Disruptive Securities is affiliated with entities that beneficially own more than 5% of Class A shares.
Lonsdale Enterprise	During financial years 2018, 2019, and the six months ended June 30, 2020, Palantir paid Lonsdale Enterprises consulting fees of US$144,000, US$240,000, and US$120,000 respectively.	Lonsdale Enterprises is affiliated with Joseph Lonsdale. Joseph Lonsdale is also affiliated with entities that own greater than 5% of Class A shares.
SOMPO and Palantir Japan	In November 2019, Palantir and SOMPO launched a US$100 million joint venture, Palantir Japan, to distribute Palantir platforms to the Japanese market. Palantir and SOMPO both hold 50% of the voting interest in Palantir Japan. Concurrently with the formation of Palantir Japan, Palantir entered into a ten-year license and services agreement with Palantir Japan for a limited non-transferable right to resell Palantir's platforms and use certain trademarks in exchange for US$25.0 million and future quarterly royalty payments to be paid based on Palantir Japan's net revenue. In addition, Palantir received a prepayment of US$50.0 million to be used toward future services provided by it to support the business operations and future deployments of its platforms by Palantir Japan.	SOMPO is the beneficial owner of more than 5% of Class A shares in Palantir.

Figure 2: Selected related party transactions of Palantir

Palantir's S-1 filings indicate that it had lent co-founder Stephen Cohen US$25.9 million[42] on 10 November 2016 at an interest rate of 1.5%, collateralised against 10.5 million of his company shares. The loan had not been repaid as of 6 August 2020.

Eventually, an agreement was struck, under which US$0.8m in repayment on the loan was forgiven and Cohen settled his debt in exchange for 3.5 million of his Class B shares.[43] Palantir did not disclose the reasons for providing the loan and why the loan remained unpaid for such a long period.[44]

Palantir also sold its shares to entities affiliated with board members Alexander Moore and Spencer Rascoff at US$4.65 between April 2020 and June 2020.[45]

Legal problems

Back in 2017, Palantir was the subject of a lawsuit by the U.S. Department of Labour. The lawsuit was in relation to allegations surrounding Palantir's use of discriminatory recruitment procedures since 2010. In making its case against Palantir, the U.S. Department of Labour relied on its data regarding the company's hiring pools and decisions, and alleged that Asian applicants "were routinely eliminated in the resume screen and telephone interview phases despite being as qualified as white applicants". The labour department alleged that from a pool of more than 1,160 qualified software engineer applicants, 85% of whom were Asian, Asians only made up 11 of the 25 employees hired. Additionally, Palantir hired four times more non-Asians than Asians for its interns' applications. Palantir paid US$1.7 million to settle the government lawsuit.[46]

Let there be light!

There has been a slew of lawsuits between Palantir and Marc Abramowitz from KT4 Partners LLC. Abramowitz was an early investor in Palantir, initially investing US$100,000 in 2003 and having a close relationship with Alex Karp. However, relationships soured when Palantir lodged a lawsuit against Abramowitz, alleging that he had made use of his position in the company to obtain information on its confidential products and subsequently filed patents under his name in the German patent tribunal. When Abramowitz attempted to sell off his stock in the company for an estimated US$60 million, the transaction was blocked by Palantir.[47]

In response, Abramowitz sued Palantir over possible fraud and mismanagement. Abramowitz asserted that Palantir barred him and others from selling their shares, whilst permitting CEO Alex Karp and Chairman Peter Thiel to do so. Part of Abramowitz's lawsuit revolved around the lack of information provided to Palantir's shareholders, especially its lack of formal board resolutions or minutes.[48] The U.S. Supreme Court held that companies which failed to produce traditional board-level documents for shareholders to investigate into the company's proper purpose may be required to produce emails through court orders.[49]

Let's go public

There are three ways in which a company can publicly list on the New York Stock Exchange (NYSE) and NASDAQ: IPOs, special purpose acquisition company (SPAC), and direct listings.[50]

Initial public offering

Listing through an IPO is still the most common way for companies to access the public markets.[51] During the IPO process, the company will typically engage underwriters to assist in the process, such as crafting the equity story, marketing the offering, planning roadshows with prospective investors, and conducting due diligence. These underwriters collect feedback from investors during roadshows, and utilise this knowledge to further refine the final offer price, terms, and size of the IPO. Once the final IPO price is agreed upon by the company, the underwriting agreement is executed, whereby the underwriters make a firm commitment to purchase shares from the company at the IPO price, guaranteeing the proceeds to the company.[52]

In return for the risk underwriters assume, as well as the certainty of a minimum amount of proceeds from the IPO, the underwriting fee often assumes the largest proportion of costs incurred by a company in going public, ranging from 3.5% to 7.0% of gross proceeds, depending on the deal size.[53]

Investors in IPOs benefit from the strict due diligence conducted by the underwriters, as failure to detect disclosure lapses in the IPO prospectus would expose them to liability under Section 11 of the U.S. Securities Act.[54] Further, scrutiny of the company increases during the roadshow process, whereby prospective investors conduct their own due diligence, further lending credence to the offering.[55]

From a company's perspective, the key shortcomings of listing through a traditional IPO is the speed of execution and disclosure requirements. IPOs may take around four to six months to complete,[56] and the timeline varies significantly between different companies due to factors such as market sentiment and complexity of the transaction.[57] There are also many disclosure requirements that the company needs to fulfil, such as having three years of audited financial information, which may be costly and time-consuming to procure.[58]

Further, there is a phenomenon known as the famous IPO 'pops', whereby the company's shares are deliberately under-priced, which results in a significant share price surge relative to the IPO price on the first day of trading. This has been viewed as a tactic to entice public market investors to invest into a company with no prior history of public trading. IPO 'pops' have drawn criticism due to the implied under-pricing of the offer by underwriters.[59] The under-pricing acts as an indirect cost to the company going public, as it essentially results in "money left on the table" by the company.[60]

Special purpose acquisition company

A SPAC is a special purpose vehicle that has no operating business, with the sole purpose of scouting for an entity to combine with in a de-SPAC transaction. The SPAC is managed by a sponsor, which typically includes experienced professionals who have expertise relating to investments in the capital market, such as investment bankers.

The SPAC starts off as a shell entity that raises funds through an IPO. Upon listing, the SPAC creates a cash pool that is placed in a trust fund[61] that it would be required to use within a period of 24 months to merge with an unlisted target company. When the SPAC is incorporated, there is no target company in mind. There are two types of SPACs – a Clean Slate SPAC, which allows for the target company to be from any company from any industry, and Targeted SPACs, which requires the target company to be in a specific industry or jurisdiction. When the sponsor identifies a target company, shareholder approval must be obtained before a de-SPAC transaction can take place, in which the SPAC acquires the target company. If shareholder approval is not obtained, the sponsor can continue to search for another target company, as long as it is within the stipulated timeframe. As an additional layer of protection for shareholders, the SPAC charter document typically offers all public shareholders the right to redeem their shares in the SPAC, based on a pro-rata portion of proceeds held in the trust fund, if they do not approve the target company chosen by the SPAC. This provides an exit for shareholders who deem that the de-SPAC transaction is not in their favour. In the event that the sponsor fails to find a target company within the timeframe, the SPAC will be liquidated, and the IPO proceeds will be returned to the public investors.[62]

After both shareholder and regulatory approvals are obtained and the de-SPAC transaction is completed, the merger will result in the target company becoming a public entity, and the SPAC's ticker changes to reflect the acquired company.[63] The sponsor will obtain a promote, which typically amounts to 20% of the post-IPO equity at nominal consideration, in return for its efforts in finding an appropriate target company.[64] From the investors' perspectives, their investments into the cash pool will represent only 80% of the post-IPO share capital. However, the promote given to the sponsor may vary and competition between different SPACs would likely drive the promote given to sponsors, thereby making investments in SPACs more attractive to public investors.[65]

The key advantage of SPAC listings over traditional IPOs is the speed at which target companies can tap the public markets, accelerating the time to market by two to four months. It also allows retail investors to leverage on the expertise of the SPAC's management and sponsors, thereby giving them access to "private equity type" returns that they would not typically have access to.[66]

However, the tight timeline for SPACs also creates significant time pressure for sponsors to successfully identify a target company. Given that sponsors only earn their promote upon the completion of de-SPAC transactions, the risk of a less-than-optimal deal for SPAC investors is increased.[67]

There is also the presence of regulatory arbitrage, as SPACs act as a backdoor listing that allows the target company to bypass disclosures and liabilities for its listing. Unlike IPOs, SPACs may be riskier for investors due to them circumventing the rigorous due diligence process conducted by IPO underwriters.[68,69]

At the time of listing, the SPAC's disclosure is minimal, as the SPAC is a cash-shell entity with no business to be disclosed. Upon the completion of the de-SPAC transaction, the target company can rely on the SPAC to avoid listing requirements that it is typically subject to under U.S. Securities Regulations. Target companies do not need to start the IPO process from scratch and can negotiate directly with the SPAC, which has cash-on-hand and a public listing. A SPAC listing would also not be affected by any potential market volatility that may exist if the target company were to start with an IPO.[70]

The promote that the SPAC sponsors are compensated with have been found to result in higher overall costs for listing companies when compared to IPOs.[71]

Direct listing

Palantir did not list through an IPO or SPAC. Instead, it went public on the NYSE in September 2020 through a direct listing,[72] allowing it to list its privately held shares on a stock exchange without the need for intermediaries, such as underwriters. This reduced the amount of time required for Palantir to list on a public stock exchange and resulted in less costs incurred by the company.[73]

The direct listing method of going public has gained popularity in recent years.[74] Initially, companies that listed through direct listings were not allowed to raise fresh capital and were limited to the sale of shares that were held by existing shareholders. However, in December 2020, the U.S. Securities and Exchange Commission (SEC) approved Primary Direct Floor Listings, which allow firms to issue new shares as well.[75] While there are benefits of a direct listing, there are also several drawbacks that investors should be aware of.

Potential reduction in rigour of due diligence and disclosure processes

The removal of the need for intermediaries results in lower fees for the company going public. However, the lack of underwriters may increase the risk of insufficient due diligence performed prior to listing.[76] Underwriters provide an additional check on the company as an independent party, as failure to do so may subject the underwriter to strict penalties under U.S. securities laws. Underwriters also face reputational risks, as the securities that they underwrite are often sold to their clients. As underwriters have a share in potential liabilities that may result if inaccurate disclosures were made in the S-1 registration document, they are incentivised to be more stringent in the due diligence process.[77]

Although Palantir, together with other companies which have directly listed shares, had engaged financial advisers prior to listing to assist in the construction of their equity stories and the preparation of registration statements,[78] these financial advisers often structure their participation such that their liability is limited in the event of any wrongful disclosures.[79] Overall, the removal of a key gatekeeper in the direct listing process could result in greater risks for investors looking to partake in such offerings.[80]

Diminished ability of investors to obtain recourse

Primary direct listings introduce a problem of "traceability" of shares, where investors who purchase directly listed shares may not be able to seek recourse even if they relied on any misstatements in the registration statement. This is due to the availability of two types of shares simultaneously sold during a direct listing – shares sold under the registration statement, and shares not sold under the registration statement. Section 11 of the U.S. Securities Act only allows investors to make claims for shares sold under the registration statement, which are subject to stricter rules. To succeed in their claims, investors must be able to "trace" their shares to the misleading claims made in the registration statement.[81] However, the lack of distinction between the two types of shares that are sold during the direct listing may result in investors being unable to establish traceability upon purchase. Hence, they may not be protected in the event of any unveiled issues with the registration statement. Traceability issues that are already inherent in traditional IPOs are exacerbated by direct listings.[82]

Difficult for shareholders to amend ownership structures

Companies that list through IPOs are typically subjected to governance checks by the underwriters, banks, and institutional investors during the roadshows.[83] If a company's corporate governance framework deviates greatly from guidelines, these institutional investors would typically voice their concerns, resulting in pressure from underwriters to alter the governance model in order to placate them. As Palantir was publicly listed through a direct listing, it was able to sidestep this governance check and implement its corporate governance structure without significant pushback from its financial advisers. This may be a contributing factor to the lack of sunset provisions pertaining to Palantir's three-class voting structure, thereby allowing its co-founders to retain indefinite control over Palantir and its major business decisions.[84]

The more class, the better?

Palantir adopts a three-class voting structure which allows its co-founders to retain controlling interest indefinitely.[85] In its Form S-1 filing with the SEC, it disclosed that it has three classes of shares – Class A, Class B, and Class F. The three classes of shares have equal rights, with the exception of voting, transfer, and conversion rights. Class A shares are entitled to 1 vote per share while Class B shares are entitled to 10 votes per share. Class F shares will have a variable number of votes per share and are owned by the three co-founders – Peter Thiel, Alex Karp, and Stephen Cohen. In accordance with the Founder Voting Trust Agreement and Founder Voting Agreement, the co-founders holding Class F shares will each approximately have a percentage of the voting power that is equal to 49.999999% of the voting power of all outstanding shares.[86]

Additionally, the co-founders' voting power in Palantir may exceed 49.999999%, as there are no clauses in Palantir's certificate of incorporation that prevent the co-founders and their affiliates from obtaining more than 49.999999% voting power. As of 30 August 2022, the founders and their affiliates owned approximately 11.37% of the voting power of the outstanding capital stock, excluding the voting power of the Class F shares.[87]

Palantir acknowledges its "novel" capital structure and admits that the issuance of a special class of shares, Class F, will enable the co-founders to "effectively control the outcome of matters requiring stockholder approval, even if they own significantly less than a majority of the shares of our outstanding shares".[88]

The Founder Voting Trust Agreement and the Founder Voting Agreement are set to remain in place until the passing of Palantir's last founder. If these agreements are terminated, the Class F shares will be converted automatically into Class B shares. This still allows the co-founders to retain a certain amount of voting rights in Palantir, due to the 10:1 voting ratio between the Class B and Class A shares.

Further, a portion of the Class B and Class A shares that are beneficially owned by Peter Thiel and his affiliates have been identified as Designated Founders' Excluded Shares, which are not subject to the Founder Voting Agreement. While it is not compulsory for the voting power of these shares to be exercised, it would effectively reduce the proportion of non-controlling interests within the company.

As of 31 December 2021, Palantir's Class A shares comprises 95.02% of total shares outstanding, while Class B and Class F shares comprise 4.93% and 0.05% of total shares outstanding. Only Class A shares are listed on the NYSE and are available to public investors. However, Palantir's "novel" multi-class capital structure limits the ability of Class A shareholders to exercise their voting power at any time.[89]

Multi-class share structures are adopted by many companies in the U.S. due to their ability to allow founders to retain control over their companies, despite only owning a small portion of equity. This allows for the founders to realise their long-term plans, without fears of investor pressures to prioritise short-term returns. Facebook, Google, and Berkshire Hathaway are some of the most successful companies which adopt a dual-class share structure.[90]

There have been calls for Palantir to add sunset provisions to its multi-class share structure. Amy Borrus, an executive director at the Council of Institutional Investors, wrote a letter to Palantir on behalf of the shareholder representative group to demand a seven-year limit to its "distorted voting" structure.[91] Such limits have been agreed upon by several tech companies including Slack and Zoom, where the founders will have control for 10 and 15 years respectively.[92] However, as it stands, Palantir's co-founders can retain their control over Palantir for life.

Lockup expiration

When Palantir went public, a lockup clause prohibited early investors from selling their shares.[93] The lockup clause expired on 18 February 2021 and roughly 80% of Palantir's shares were free to trade in the open market. The release of an SEC filing on 18 February 2021 revealed the sale of approximately 20 million shares by Peter Thiel after converting Class B shares into Class A shares. Stephen Cohen and two other top executives also took advantage of the lockup clause expiration to sell approximately 2.7 million shares.[94] Palantir's stock price fell as much as 13% on 23 February 2021 after the SEC filings were released.

What checks and balances?

The concentration of voting power with the co-founders and their affiliates effectively eliminates the ability of other shareholders to influence the outcome of important transactions. In addition to the imbalance in voting power, Palantir has clearly established its stance regarding the issue of additional shares, as disclosed in its latest Form 10-K:[95]

> "Any future issuances of additional shares of Class A common stock and Class B common stock will not be subject to approval by our stockholders except as required by the listing standards of the NYSE."

Pursuant to the listing standards of NYSE Rule 312.03(c), a company must obtain shareholder approval prior to the issuance of shares, or related convertible or exercisable securities, in two scenarios. In the first scenario, shareholder approval must be obtained if the amount of shares issued equal to or is in excess of 20% of the voting power in the company. In the second scenario, the amount of shares issued is equal to or is in excess of 20% of the shares outstanding in the company before the share issuance. However, there are two exceptions where shareholder approval is not required – any public offering for cash and any issuance involving a 'bona fide private financing'.[96] Consequently, Palantir will be able to issue additional shares at any time without shareholders' approval by issuing shares amounting to less than 20% of voting power or 20% of the total number of shares outstanding.

Palantir's ability to issue additional Class A and Class B shares may result in the dilution of the voting power of its existing shareholders, despite the fact that the NYSE listing standards pertaining to issuance shares was enacted with the purpose of protection against dilution of existing shareholders voting rights.[97] The voting rights of Palantir's existing shareholders would always be compromised, since Palantir has the ability to bypass shareholders' approval to issue additional shares. Even if shareholder approval is required, the presence of Class F shares provides its co-founders with sufficient voting rights to pass any shareholder resolution.

Controlled company

Pursuant to the NYSE corporate governance rules, a 'controlled company' is a company in which more than 50% of the voting power is held by an individual, group, or another company. Many controlled companies originate from family businesses that grew past the bounds of private ownership and thus tapped on opportunities brought by external capital and diversified ownership.[98] The concept of a 'controlled company' recognises the reality that the company structure would inherently not be independent because of how family members, who assume the various non-independent and independent roles, are related to each other. Studies have shown that controlled companies generally underperform compared to non-controlled ones. The average CEO remuneration in controlled companies with multi-class stock structures is also significantly higher. Furthermore, in controlled companies, directors hold their positions for longer periods, changes in the board composition are slower, and boards have less diversity.[99]

Palantir asserts that it does not currently fall within the scope of a "controlled company" according to NYSE corporate governance rules.[100]

> "Although we currently are not considered to be a "controlled company" under the NYSE corporate governance rules, we may in the future become a controlled company due to the concentration of voting power among our Founders and their affiliates."

With reference to Palantir's Founder Voting Trust Agreement and the Founder Voting Agreement laid out in Palantir's bylaws, Palantir is not considered a "controlled company" as the founders only hold 49.999999% voting power, which is below the 50% threshold. However, this seems to ignore the fact that Palantir's co-founders have effective control over the company and its operations, which suggests that Palantir is a "controlled company" in substance.

Exemption for certain independence requirements as a Controlled Company

A controlled company enjoys exemption from certain corporate governance requirements in the NYSE rules, and it is not required to abide by the following requirements:

- The majority of board of directors is to comprise of independent directors;
- A listed company is to have a nominating and governance, and compensation committee, with each of the committees to comprise entirely of independent directors and have a written charter that scopes the committee's purpose and responsibilities; and
- An annual performance evaluation for each of the nominating and governance committee and compensation committee is to be performed.

However, according to NASDAQ Listing Rule 5615(c)(2),[101] while a controlled company does not require a majority of independent directors, independent directors must have regularly scheduled meetings (otherwise known as executive sessions), where only these directors are present.

If a controlled company opts to rely on the exemption, it is required to provide the following disclosures, as set out in SEC Rule Instruction 1 to Item 407(a) of Regulation S-K,[102] that:

- It is relying on the exemption;
- Its basis for exemption; and
- Corporate governance standards that it does not comply with.

Fiduciary duties not owed by controlling shareholders

In a controlled company, the controlling shareholder(s) owe a fiduciary duty to the company, as they wield substantial voting powers that allows them to influence the fundamental corporate decisions of the company. This effectively renders the voting rights of minority shareholders ineffective, as minority shareholders are unable to overrule the decisions made by the controlling shareholders.[103] In contrast, in a non-controlled company, only directors owe fiduciary duties to the company, as they are responsible for making business decisions, and the shareholders generally do not owe fiduciary duties to the company. As Palantir is not classified as a controlled company, its co-founders do not owe fiduciary duties to the company.

Falling out of love?

Investors were initially attracted to the charm of Palantir when it went public, as seen from the bullish stock performance since its direct listing on 29 September 2020, with its share price trading at a high of US$39 in January 2021.[104]

In March 2021, CEO Alex Karp proudly proclaimed to investors – "…buy some other stock. You don't have to buy Palantir. No one is forcing you," and lambasted investors who took a short-term view of the performance of Palantir's stock. This drew criticism and resulted in a nearly 4% dip in its share price.[105] Palantir's shares are currently trading below its IPO price at US$7.85 as of 29 August 2022.[106]

Palantir's future remains uncertain as it continues to face unique risks. It is still heavily dependent on government contracts and has faced challenges scaling up on its corporate user base. The onset of the COVID-19 pandemic in 2020 was a big driver of growth for Palantir, which benefitted from its ability to track COVID-19 data from hospitals and trace the spread of the disease. However, as the pandemic recedes and government contracts wind down, Palantir's business model faces new questions.

Discussion questions

1. What are the key corporate governance and ethical issues relating to Palantir?
2. Do you believe Palantir is suitable to be a public company given its business model? Explain.
3. Evaluate the composition of the Palantir board. Would any factors adversely affect the ability of certain directors to discharge their fiduciary duties and for the board to effectively perform its oversight role? Explain.

4. Critically evaluate Palantir's related party transactions and explain what risks they pose. To what extent are these related party transactions potentially harmful to minority shareholders? What are possible safeguards to mitigate abuses through related party transactions?
5. What are the pros and cons of having a multi-class share structure? Evaluate this from the perspectives of investors and founders of Palantir.
6. Highlight the differences in corporate governance standards between a non-controlled and controlled company in the U.S. and evaluate why a company may choose to be defined as a controlled company over a non-controlled company and vice versa, with reference to the case. Do you think a controlled company concept should be available to companies in your country?
7. Discuss the advantages and disadvantages of the various listing methods in the U.S. markets. What are the potential reasons for Palantir's chosen listing method?

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RIO TINTO: BLOWING UP HISTORY

Case overview

The destruction of the culturally significant Juukan Gorge caves in Western Australia by mining giant Rio Tinto sparked national and international outrage, which eventually led to a shareholder upheaval, a parliamentary inquiry and the dismissal of three top executives. Although it was legal to do so under Australian law, the destruction resulted in the loss of a 46,000-year-old site sacred to the local Puutu Kunti Kurrama and Pinikura people (PKKP). This incident negatively affected the long-established relations between the PKKP and Rio Tinto, and tarnished the company's reputation in the mining industry. First approved by the Government of Western Australia in 2013, the demolition was carried out on 24 May 2020 as the site was rich in high-grade iron ore valued at US$135 million. This was despite objections from the PKKP, who accused Rio Tinto of providing misleading information. Although Rio Tinto subsequently issued an apology and corrective actions are in progress, many believed that the event had left a 'gaping hole' in the culture and heritage of the area.

The objective of this case study is to facilitate a discussion of issues such as environmental, social and governance issues; company culture and values; risk management; crisis management; board structure; and remuneration policies.

Cast into shape

Founded in 1873, Rio Tinto's name comes from the Rio Tinto River in Spain, a historical copper mining site. By 1877, the company had become the top copper producer in the world and it subsequently underwent a series of mergers and acquisitions in the following years. Notably, in 1962, the company merged with The Consolidated Zinc Company in Australia to form The Rio Tinto-Zinc Corporation and subsidiary Conzinc Riotinto of Australia Limited, which were later merged in the same year to form the Rio Tinto Group.[1]

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The Group grew over the decades and as of 2021, Rio Tinto Group is the second-largest mining and metals corporation in the world,[2] with operations in 35 countries, producing and refining iron ore, aluminium, copper, diamonds, and other materials.[3] It is organised into four operational businesses, divided by product type – Aluminium, Copper, Minerals and Iron Ore.[4] The company has two head offices, Rio Tinto plc and Rio Tinto Limited, located in London and Melbourne respectively. Both business entities are headed by the same board of directors. Rio Tinto is listed on three stock exchanges – the New York Stock Exchange, the London Stock Exchange and the Australian Stock Exchange.[5]

The mining crown jewel

Notoriously difficult to operate in, the mining industry not only incurs high capital expenditure but also high environmental and social costs. In the face of these challenges, Rio Tinto has managed to stay financially competitive in the industry, experiencing a steady increase in revenue in the past five years from US$33.8 billion in 2016 to US$63.5 billion in 2021.[6] Rio Tinto's core competencies include substantial technical and operational knowledge, which allows the company to select economically viable projects that are profitable in the long term despite the high operating costs.[7] The company also utilises its capital and expertise to innovate in the mining process. For example, it introduced an automated hub in Perth to remotely control facilities in the Pilbara region in Western Australia, located over 1,500 kilometres away, thereby reducing costs using what some call the "largest implementation of automation in mining on the planet".[8] Rio Tinto also had positive growth in both basic earnings per share and dividends per share, providing great value to shareholders through its competitive advantages.[9]

Rio Tinto also strives to maintain high standards in environmental, social, and governance (ESG) issues and sustainability to offset the negative impact of mining industry activities. The company has set greenhouse gas emissions targets, aiming to reduce emissions by 15% by 2025, 50% by 2030 and eventually attaining net zero emissions by 2050. It recognises its major carbon footprint and planned to invest about US$7.5 billion between 2022 and 2030 to achieve its decarbonisation strategy.[10]

By 2020, 75% of the electricity used in directly managed projects was generated using renewable sources.[11] In 2018, Rio Tinto became the first major mining company to entirely remove the use of coal in the production of its electricity.[12] Rio Tinto was also ranked the top mining company in the Corporate Human Rights Benchmark in 2019.[13] The mining giant had an initial score of 63% in 2017, which increased to 76% in 2018 and maintained in 2019, placing Rio Tinto among the top-scoring companies.[14] In terms of safety, Rio Tinto has robust safety protocols and has committed to the elimination of work-related injuries, achieving zero work-related fatalities since 2019.[15,16]

Faults in the rock

Despite the company's efforts to maintain sustainable operations, operating in the mining industry poses numerous risks, and competitive pressures have affected Rio Tinto in the past. In the process of mining, toxic substances are released into the air, water and soil, causing pollution.[17] Moreover, waste such as surface waste rocks and other unwanted materials are produced. These waste products are often quite toxic.[18]

Rio Tinto's long history of mining activities is accompanied by an equally long history of environmental damage concerns. On 27 December 2005, the Grasberg Mine in Indonesia, which holds the world's largest gold deposit and second-largest copper deposit,[19] was found to have generated 700,000 tonnes of tailings from their mining activities every day.[20] Rio Tinto had owned 40% of the mine and was reported to be responsible for dumping 230,000 tonnes of tailings every day into the Ajkwa riverine system, a natural river that flows into the Arafura Sea.[21,22] On 9 September 2008, the Government Pension Fund of Norway decided to sell its entire stake in Rio Tinto valued at US$850 million due to the company's contribution to severe environmental damage.[23] A Rio Tinto spokesperson disputed these claims, stating that the company has been the industry leader in safety and environmental records. Nonetheless, the Fund's position did not change.[24] Its decision was also based on the consideration that the company's actions were unlikely to change in the foreseeable future.[25] The dumping of tailings allegedly continued for years after that, and Rio Tinto only divested its interest in the Grasberg mine in December 2018.[26]

The company also faced multiple lawsuits regarding its social impact and governance failures. In 2020, the Human Rights Law Centre filed a complaint to hold Rio Tinto accountable for leaving behind large amounts of waste in the island of Bougainville in the Solomon Islands after divesting one of its mines in 2016.[27] The contaminated water sources and toxic waste on land had allegedly resulted in negative health effects on the local community, including skin and respiratory diseases, as well as pregnancy complications.[28] Further, in 2017, the U.S. Securities and Exchange Commission charged Rio Tinto's former Chief Executive Officer (CEO) Tom Albanese and former Chief Financial Officer (CFO) Guy Elliott with fraud and breach of disclosure obligations and corporate duties. The company was accused of hiding the failure in its large investment in Rio Tinto Coal Mozambique (RTCM) after both the CEO and CFO resigned after selling assets in RTCM for just US$50 million, far below its acquisition cost of US$3.7 billion.[29]

The worst was yet to be

> "In many of these respects, the site is the only one in the Pilbara to contain such aspects of material culture and provide a likely strong connection through DNA analysis to the contemporary traditional owners of such old Pleistocene antiquity."
>
> – *Dr Michael Slack, archaeologist*[30]

Rio Tinto has operated in Australia for over a century. Its iron ore operating product group has operated for more than 50 years in the Pilbara region of Western Australia, which comprises 18 iron ore mines, four independent port terminals, and close to 2,000 kilometres of rail network.[31] The Juukan Gorge is located in the Pilbara region and is primarily known for rock shelters that provided archaeological evidence of continuous human occupation for over 46,000 years – the only inland site in Australia to do so.[32] Artefacts such as a 28,000-year-old animal bone tool and a 4,000-year-old belt made of human hair were recovered from the caves, and DNA testing linked the hair to the direct ancestors of the PKKP people who live in the region today.[33] Besides its historic and anthropologic significance, the caves in Juukan Gorge are also culturally significant for the PKKP, its traditional owners.[34]

On 24 May 2020, Rio Tinto caused public outrage after it destroyed the historically significant and sacred Juukan Gorge cave site. The caves, which were sacred sites for the PKKP, were demolished to expand one of the mining giant's iron ore mines. Although the blasts were legal, the destruction caused deep distress to the traditional owners and increased investor pressure on the mining industry to address heritage management practices.[35] The mining giant's reputation was also severely tarnished as a result.[36]

The sacred Juukan Gorge site provided a 4,000-year-old genetic link to the present-day traditional owners, the PKKP, highlighting the native ties to the land that date back centuries.[37] It was also considered one of the most significant archaeological research sites of Australia, making the site not only significant for the PKKP but also for the history of the entire region.[38] The destruction of the historically rich site upset the PKKP as they felt that after the irreversible destruction, they were unable to pass down the rich heritage of the site to their future generations.[39]

Relationship with the PKKP

The PKKP, represented by the PKKP Aboriginal Corporation, are the Aboriginal natives in the Pilbara region of Western Australia.[40]

Prior to the incident, Rio Tinto had a good reputation with regards to managing indigenous affairs in the region.[41] In Australia, Rio Tinto was one of the largest employers of indigenous people,[42] with 11.9% of the Pilbara mines workforce comprising local indigenous people in 2019.[43] The company also supported a campaign to increase indigenous recognition in the Australian constitution in 2019,[44] supported indigenous-owned local businesses by involving them in its operations and was involved in other programmes to support the indigenous community,[45] such as the partnering with the Western Australian indigenous football programs.[46]

Despite the engagement of the local indigenous community, Rio Tinto's board did not include any indigenous leader or a person with indigenous ties. Its first Aboriginal director, the cousin of Australia's minister for Indigenous Affairs and former treasurer for Western Australia, Ben Wyatt, was only appointed to the mining giant's board on 1 September 2021, long after the Juukan Gorge incident.[47]

Reaching an agreement

> "The lack of free prior and informed consent, the forcing of people into contracting out their rights, the management of culture that ties traditional owners and takes advantage of weak laws … this is a form of incremental genocide,"
>
> – *Patrick Dodson, Western Australia senator*[48]

The PKKP were not new to agreements with mining companies, having previously dealt with other iron ore mining companies.[49] In Rio Tinto's case, discussions were initiated with Juukan's traditional owners in 2003,[50] and the PKKP signed financial agreements with the mining giant in 2011 and 2013 not to oppose any applications to destroy or damage heritage under section 18 of the Aboriginal Heritage Act, "provided Rio Tinto used its reasonable endeavours to minimise impacts of those operations on Aboriginal heritage sites and consulted with the PKKP about the means of doing so".[51] The PKKP were initially aware of the planned demolition at Juukan Gorge, but later, an archaeological survey in 2014 discovered tools, fireplaces and other artefacts that were dated to be much older than previously thought.[52] With the discovery, the PKKP felt that the site was much more significant than they previously realised during the signing of the land use agreement.[53] PKKP subsequently informed Rio Tinto that they wanted to preserve the site and issued an urgent request to halt the blasts five days before the detonation.[54]

After the blasting of the Aboriginal site, Rio Tinto initially argued that these concerns "did not arise through the engagements that have taken place over many years" and that it had "all necessary approvals" to blast the site.[55] The mining giant also claimed that the traditional owners had given consent for the expansion work at the Brockman 4 iron ore mine.[56]

However, evidence soon came in the form of "Ngurra Minarli" – which means "In Our Country"[57] – a 2015 documentary film that was funded by Rio Tinto itself. The documentary showed members of the PKKP did not approve the blasting of the Juukan Gorge caves.[58]

Broken ties

> "We're not opposed to mining. However, we want to ensure that we're around the table when it comes to making decisions about impact on our country."
>
> – *Burchell Hayes, PKKP Aboriginal Corporation spokesman*[59]

The PKKP learned about the scheduled blast on 14 May 2020, a day after Rio Tinto started setting explosives above the rock shelters. Despite the PKKP's objections, the company continued to set explosives in the following days.[60]

Ties with the local community were negatively impacted after the destruction of the sacred site, with the PKKP accusing Rio Tinto of proceeding with the demolition against their wishes.[61] Matters were made worse when CEO Jean-Sébastien Jacques informed a federal parliamentary inquiry launched after the Juukan Gorge caves destruction that there were three other options to expand the Brockman 4 mine without demolishing the Juukan shelters. A more profitable fourth option was chosen as the cave site would give Rio Tinto access to eight million tonnes of high-grade iron ore, valued at an estimated US$135 million.[62] Jacques also confirmed that the PKKP were not made aware of the other options, which cast doubts on whether the PKKP had given "free, prior and informed consent" to the demolition of the caves.[63]

No change in plan

In the company's submission to the inquiry, Rio Tinto disclosed that it was made aware in 2014 and 2018 that the Juukan 2 rock shelter was of "the highest archaeological significance in Australia" through archaeological reports. Archaeologist Dr Michael Slack stated in his 2018 report that "the Juukan 2 rock shelter has the amazing potential to radically change our understanding of the earliest human behaviour in Australia".[64]

Rio Tinto obtained ministerial consent to destroy the sites from the Western Australian government under the state's Aboriginal Heritage Act in 2013 after consulting with the PKKP and the Yamatji Marlpa Aboriginal Corporation, but did not reconsider that agreement after receiving new information about the sites from the 2014 digs.[65]

The board inquiry

Following the Juukan Gorge destruction, Rio Tinto launched a board-led review of its heritage management processes within its iron ore division, which was conducted by its independent non-executive director, Michael L'Estrange AO. The review was intended to focus on events at Juukan Gorge and appraise the mining giant's internal heritage standards, procedures, reporting and governance. Through engagement with indigenous leaders, traditional owners, and subject matter experts, the review also aimed to examine Rio Tinto's relationship and communications with the PKKP.[66]

Rio Tinto published the findings from its review on 24 August 2020. It admitted that the company "failed to meet some of its own internal standards and procedures in relation to the responsible management and protection of cultural heritage". It also expressed that "The review found no single root cause or error that directly resulted in the destruction of the rockshelters. It was the result of a series of decisions, actions and omissions over an extended period of time, underpinned by flaws in systems, data sharing, engagement within the company and with the PKKP, and poor decision-making."[67] As a result of the report's findings, the Rio Tinto board voted to withhold the bonuses of three senior executives, with other managers also potentially losing their bonuses. Additionally, the board's non-executive directors decided to donate 10% of their 2020 director fees to the Clontarf Foundation, an organisation which supports Aboriginal education and employment.[68,69]

The mining giant's board review drew criticism from industry and shareholder groups, as well as aboriginal leaders. The Australian Centre for Corporate Responsibility commented that the review was "highly disappointing" and "little more than a public relations exercise that still attempts to blame the PKKP; previous Rio Tinto administrations; and anyone else, rather than the company's current senior management". The Australian Council of Superannuation Investors added that the review "does not deliver any meaningful accountability".[70,71] Aboriginal leader Noel Pearson denounced the review as "a whitewash", "evasive and opaque on many fronts", and "riddled with problems and completely inadequate as a public explanation".[72]

The interim report

With numerous unanswered questions and no one admitting responsibility for the Juukan Gorge destruction, the Joint Standing Committee on Northern Australia launched an inquiry into the incident in June 2020 as well. Half a year later, the committee issued an interim report in December 2020 detailing its findings and broad recommendations.[73]

The law down under

> "They were let down by Rio Tinto, the Western Australian Government, the Australian Government, their own lawyers, native title law."
>
> – *A report by the parliament of Australia*[74]

The interim report stated that Western Australia law played "a critical role" in the Juukan Gorge destruction.[75] There were questions on how the destruction of such an invaluable sacred indigenous aboriginal site could even be allowed to proceed, and whether there were sufficient laws in place to protect indigenous heritage.[76]

In Australia, the national Native Title Act was established in 1993 with the aim of conserving native titles in the country.[77] Under the Act, traditional landowners are conferred the right to negotiate and enter into agreements with companies called Indigenous Land Use Agreements.[78] In return for giving mining companies rights to mine in the sites, financial benefits such as employment and royalties are given to these traditional owners. Within these agreements, traditional landowners could, in theory, also enforce "no-go" zones around the most important sites. However, out of the 163 cases where mining companies had appealed to the national Native Title Tribunal since 1994, the Tribunal has overruled traditional owners in favour of the mining companies in 160 of these cases. In a federal inquiry into the Juukan Gorge destruction, the interim report said that such agreements were effectively on a "take it or leave it" basis due to the power of the mining companies. In essence, traditional landowners could either consent to an agreement with the mining company or reject the agreement and be excluded from the benefits while the company proceeds with mining the sites.[79]

In addition, under the Aboriginal Heritage Act of 1972, mining companies could apply for the minister's approval to demolish sites where obstructions are faced. Such approvals have been granted to nearly every major corporation in Pilbara – out of a total of over 1,000 applications made since 2010, only five have been rejected. Even as the inquiry into the Juukan Gorge destruction concluded that federal laws were crucial in protecting these interests, the two laws intended to protect indigenous heritage – the Environment Protection and Biodiversity Conservation Act enacted in

1999 and the Aboriginal and Torres Strait Island Heritage Protection Act enacted in 1984 – have failed to protect these interests.[80]

Traditional owners were also critically under-resourced. In the case of the Juukan Gorge destruction, the PKKP was severely handicapped in its negotiations with Rio Tinto. Notably, the PKKP appointed another local Aboriginal corporation to represent them in negotiations but as a result of communication issues, the PKKP signed agreements without having full comprehension of its implications. These included ceding their rights, waiving their ability to appeal against decisions related to the Juukan Gorge, and a gag order.[81]

The interim report said the Aboriginal Heritage Act of 1972 was "outdated, unfit for purpose and in urgent need of replacement". It went on to say that the Act "has failed to protect Aboriginal Heritage, making the destruction of Indigenous heritage not only legal but almost inevitable". As such, it concluded that Australia should take further steps to protect Aboriginal cultural heritage by overhauling "grossly inadequate" laws and giving traditional owners the "right to withhold consent" over developments in Australia.[82]

Rio Tinto's role in the tragedy

The interim report stated that the mining giant's role in the Juukan Gorge destruction was "inexcusable" as it went ahead with the destruction of the sacred indigenous heritage site knowing its archaeological significance and against the wishes of the PKKP.[83] The report found severe deficiencies at Rio Tinto such as failures of consultation, transparency and heritage management.[84] Senator Patrick Dodson, a member of the Joint Standing Committee on Northern Australia which carried out the inquiry, said "These failures were symptomatic of the 'don't care' culture that infected Rio Tinto from the top down." He also added, "It had gone through a rapid decline in the way it did business."[85]

Board composition

Just prior to the events of cave destruction in 2020, the Rio Tinto board consisted of 11 members, with Simon Thompson being the Chairman of the board. Alongside him on the board were executive directors CEO Jacques and CFO Jakob Stausholm, together with eight other non-executive directors. The industry experience of the members ranged from mining and commodities, finance, science and technology to public policy.[86]

Rio Tinto has five board committees, namely Audit Committee, Nominations Committee, Remuneration Committee, Sustainability Committee, and Chairman's Committee.[87]

Audit Committee

In 2020, the Audit Committee of Rio Tinto focused on changes in the estimated provision for closure, restoration and environmental obligations, and ensuring that sufficient disclosure was provided. The Audit Committee was also informed of management's efforts in addressing climate change and the corresponding financial reporting implications, such as its progress in relation to the Paris Agreement as well as accounting judgements.[88] After the Juukan Gorge destruction, the Audit Committee was handed the additional responsibility of reviewing and benchmarking the progress of heritage management together with the Sustainability Committee.[89]

With no separate risk management committee in the company, Rio Tinto's Audit Committee is also responsible for the company's risk management and reviewing the effectiveness of the risk management framework. According to Matteo Tonello, director of corporate governance for research group The Conference Board, Inc., while a dedicated risk management committee is not compulsory, it is still ideal for companies that face complex operational risks to implement one as the members of the Audit Committee might only have the skills and knowledge to understand financial risks.[90]

Risk management

Overseen by the Audit Committee, Rio Tinto implemented a comprehensive risk management process, identifying key risks and highlighting the way in which these risks will be managed. The risk management framework identified and delegated responsibilities related to risk management in the company. Prior to the Juukan Gorge incident, key risks identified included geopolitical trade tensions and trade wars that slowed and destabilised demand, and technological advancement creating competitive pressures and increasing cybersecurity threats.[91] Rio Tinto also dedicated a large portion of its risk management towards its social impact, stating that many investors were looking at ESG-related criteria when investing in a company. The identified impacts on society largely focused on climate change, with the aim of reducing net carbon emissions to zero by 2050. Rio Tinto also identified the risk of exposure of the Group to different economic, political, societal and regulatory environments.[92]

In a meeting of shareholders, Rio Tinto senior independent director Sam Laidlaw said that there was a "critical risk assessment failure" in not recognising and remediating weaknesses in the heritage risk management process.[93] In its 2020 annual report, Rio Tinto acknowledged that it did not achieve clear expectations and consistency of application of its risk framework across different product groups and businesses, countries of operation and functional areas of expertise. It formed a new Communities and Social Performance (CSP) function to monitor external societal trends; develop and review standards, systems and risk and assurance processes; build capability;

provide strategic regional and technical advice to businesses; as well as provide the second line of defence for CSP. The company's internal audit team, which reports directly to the Sustainability Committee, would be the third line of defence.

The Audit Committee has been tasked to monitor the effectiveness of these changes to the company's overall risk management and internal control framework. Rio Tinto believes that these changes to cultural heritage risk management would deliver more rigorous assurance of the way it manages its communities and cultural heritage risks across its operations globally.[94,95]

Jacques of all trades

As the youngest-ever CEO of Rio Tinto at 44 years old, Jacques had risen to the top after working for only five years in Rio Tinto's copper and coal division, where he had successfully entered into an agreement with the Mongolian government to enable Rio Tinto to have its immense Oyu Tolgoi copper and gold project expanded, and strip out copper assets which were underperforming. During his tenure as CEO, Rio Tinto's share price was at its peak in almost seven years, surpassing the expectations of analysts.[96] Under Jacques' leadership, the mining giant also returned substantial amounts of cash to shareholders and became the first big mining company to abandon thermal coal, a polluting fossil fuel.[97]

Following his appointment as CEO in 2016, a major restructuring was implemented within Rio Tinto. Jacques had transferred the responsibility of the company's global community and indigenous relations to the external relations division in its London headquarters. Bruce Harvey, who led the former division, stated that the move had essentially relegated the line of authority into the "PR division". He added that Jacques had also authorised a change in the line of direct accountability, from asset senior leaders to an individual in a centralised role with "no skin in the game". A former advisor at Rio Tinto, Glynn Cochrane, concurred with these views, saying that it was only in recent years that the company had begun to ignore Aboriginal anthropologists and archaeologists in favour of individuals with specialisations in "branding, marketing and media". Dedicated practitioners driven to serve both the community and the company had existed under the previous Aboriginal relations policies in Rio Tinto. However, in 2016, these individuals had all been removed from the company.[98]

Jacques also reduced the size of Rio Tinto's headquarters in Melbourne, preferring to run Rio Tinto's operations from the headquarters in London instead.[99] Rio Tinto implied that this was because London was where the company's Chairman, CEO, CFO, and two product groups were based.[100] This was in spite of the fact that Rio Tinto did not operate extensively there and only hired about 200 employees – out of 55,000 employees globally – in London.[101] The move to run operations from the London office had resulted in executives being out of touch with the mining activities Rio Tinto was conducting in Pilbara.[102]

Shake-up in the rubble

In September 2020, Jacques resigned as CEO, but would remain in his role until the appointment of his successor. Two other executives – Chris Salisbury, the head of iron ore, and corporate affairs leader Simone Niven, who had responsibility for indigenous affairs – followed suit.[103] L'Estrange, the board director who led the board inquiry into the Juukan Gorge destruction that critics said largely absolved senior management of blame, retired before the mining giant's 2021 annual meeting.[104]

December 2020 saw the appointment of a new CEO, Stausholm, who was the CFO under Jacques' leadership. In its 2020 annual report, Rio Tinto disclosed that one major reason for Stausholm's appointment is that the board believed that he could provide clear leadership of the company's efforts to re-establish its reputation as an industry leader in environmental and social performance. This is in addition to his stellar strategy development and performance management during his stint as CFO, as well as deep industrial and resources experience.[105] Investors were dismayed by the move as they had expected an external person to be appointed.[106] Some critics commented that the selection represented poor corporate governance and a lack of succession planning.[107] Analysts at Morgan Stanley said Stausholm's appointment would minimise disruption as a result of a transition in senior management, but "could indicate little change in the overall strategy".[108]

In March 2021, Chairman Thompson announced that he would not seek re-election at the company's 2022 annual meeting. It was reported that Thompson hoped to "draw a line under the questions about board accountability" for the Juukan Gorge destruction and the company can instead focus on repairing Rio Tinto's broken relationship with indigenous groups.[109]

In September 2021, Rio Tinto appointed Ben Wyatt, a new non-executive director of indigenous origin, to replace L'Estrange on its board. Thompson said that Wyatt's experience in public policy, finance, international trade and indigenous affairs "at a time when [Rio Tinto is] seeking to strengthen relationships with key stakeholders in Australia and around the world" would greatly add value to Rio Tinto's board.[110]

Worth their weight in gold

> "The penalties applied to the responsible executives were, in the best view of the board, the most that could durably be applied and legally defended in light of the extent of the executives' ultimately accountability for Juukan Gorge,"
>
> – *Sam Laidlaw, Chairman of Remuneration Committee*[111]

While Jacques stepped down as Rio Tinto's CEO, he received total remuneration amounting to US$18.6 million. This amount included the value of share awards not yet vested. Salisbury received total remuneration of US$5.3 million and Niven received £5.1 million (US$6.8 million), including termination benefits and unvested share awards, respectively.[112] The total remuneration amounts took into consideration the fact that the board had previously penalised Jacques by forfeiting £2.7 million (US$3.6 million) in awards, while Salisbury and Niven lost A$1.1 million (US$0.8 million) and £525,000 (US$700,000) in short-term incentives respectively.[113]

Rio Tinto's shareholders were against the board's decision to award the generous payouts to the former CEO and senior executives. More than 60% of shareholders voted against the miner's remuneration policy at its 2021 Annual General Meetings.[114,115] However, as these votes were advisory under U.K. and Australian law, Rio Tinto was under no legal obligation to further reduce its senior executives' total remuneration.[116] Jacques' golden parachute also received strong criticism from the Australasian Centre for Corporate Responsibility, which argued that Jacques should not be well rewarded given that the Juukan Gorge scandal occurred under his watch.[117]

In response to the "failed" resolutions and shareholders' disagreements with the huge payouts, Rio Tinto said it would engage with shareholders and "reflect" on any "new input" in relation to its remuneration policy.[118] The Chairman of Rio Tinto's Remuneration Committee, Sam Laidlaw, further justified that "The board fully recognised the gravity of the destruction at Juukan Gorge but was mindful that they did not deliberately cause the events to happen, they did not do anything unlawful, nor did they engage in fraudulent or dishonest behaviour or wilfully neglect their duties."[119]

Due to the Juukan Gorge Cave incident, Rio Tinto had implemented some changes in its remuneration policy for executive directors. Most notably, short-term incentive plan (STIP) awards now include an ESG component with a 15% weighting. The 1.2 multiplier for the STIP has been removed, and bonuses linked to individual performance were reduced from 30% to 15%. The maximum LTIP award was reduced to 400%. Malus and clawback provisions for both STIP and LTIP awards have also been extended to include material impacts on Rio Tinto's social license to operate.[120]

Rio Tinto's non-executive directors and receive their entire remuneration in cash and other non-monetary benefits. All non-executive director fees are subject to review by the board.[121]

'Tis but a scratch

Despite the Juukan Gorge scandal, as of June 2022, the mining giant has an S&P Global ESG Score of 73, scoring well above the industry averages in all aspects of ESG.[122] This is an increase from 66 in 2019 and 68 in 2020, despite the destruction of the Juukan Gorge caves. A breakdown of the company's S&P Global ESG Score is shown in Figure 1.

	Rio Tinto	**Industry average**
Environmental	76	24
Social	69	23
Governance and economic	73	32

Figure 1: Rio Tinto's S&P Global ESG Score for 2021[123]

Meanwhile, as of May 2022, Sustainalytics gave Rio Tinto an ESG rating of 32.1, comprising an environmental risk score of 14.5, social risk score of 11.0 and governance risk score of 6.6.[124] This places the company in the 'high risk' category, even though it ranks 34 out of 166 in its industry group of diversified metals.[125]

Professor Martina Linnenluecke, head of Macquarie Business School's Centre for Corporate Sustainability and Environmental Finance at Macquarie University, believes that the recognition of indigenous peoples' rights and culture in ESG (environmental, social and governance) scoring systems should be strengthened. According to her: "Indigenous concerns around sacred sites will not be reflected in a company's ESG score since only a few indicators measure indigenous issues and the scores are diluted in the aggregation process".[126] She further pointed out that the different ESG agencies that issue companies ESG scores have varying rating treatments for indigenous issues. For example, Sustainalytics' indicators include society and community-related controversies or incidents, and a "Policy on Indigenous people and land rights", while Refinitiv only has an indicator for business ethic controversies but no specific indicator for indigenous issues.[127]

Paving the way forward

More than a year after the Juukan Gorge caves' destruction, the Western Australian government re-drafted heritage protection laws which had allowed damage to significant Aboriginal sites. Under the Aboriginal Cultural Heritage Bill 2021,[128] which was released to the public in November 2021, greater emphasis is placed on agreement between developers and indigenous groups, and traditional owners do not have veto rights over the destruction of their sacred sites. Instead, Western Australia's Aboriginal affairs minister makes the final decision, while traditional owners have limited rights to judicial appeal. The proposed new heritage laws have been criticised by traditional owners and legal experts, with Senator Patrick Dodson condemning the Western Australian government for "failing its one opportunity to protect Aboriginal heritage and stop the tyranny of cultural genocide".[129]

Earlier in September 2021, when the draft heritage laws were under review, a group of Aboriginal people filed a formal complaint to the United Nations (UN) over the draft heritage protection laws of Western Australia in a bid to pressurise the state government to make greater changes. The group asked the UN Committee on the Elimination of Racial Discrimination to review the cultural heritage bill, which was "incompatible with Australia's international obligations" in its view.[130] As at May 2022, the laws have yet to take effect.[131]

In October 2021, the Joint Standing Committee on Northern Australia issued its final report on the inquiry into the destruction of the Juukan Gorge indigenous heritage sites, titled: "A Way Forward". In preparing the report, the committee collaborated with indigenous groups on a framework and issued several recommendations for change.[132] This included a review of the Native Title Act by the Australian government that would address the inequalities the indigenous people face in negotiations, as well as an increase in transparency and accountability of prescribed body corporates and Native Title Representative Bodies under the Native Title Act. This is to ensure sufficient disclosure and that consultation has been conducted with indigenous groups prior to changing or destroying any cultural heritage sites. Even with these recommendations, however, it remains uncertain if and when such changes will materialise.[133]

Corrective actions by Rio Tinto

The Rio Tinto board announced a series of actions to repair the situation. These include the establishment of a 'social performance' function to focus on the rights of the people affected by projects.[134] Social performance staff would report to the executive committee and would be 'embedded' into the local management of mines.[135] Rio Tinto also gave its commitment to involve local indigenous people in decision making and improving heritage management standards going forward so that indigenous interests are represented at a higher level.[136]

Epilogue

> "This agreement provides clear acknowledgment that Rio Tinto accepts that the destruction of the rock shelters should not have happened and makes clear that it is absolutely committed to listening, learning, changing and co-managing country,"
>
> – *Burchall Hayes, Chair of the PKKP Aboriginal Corporation*[137]

In May 2022, Rio Tinto signed a preliminary agreement with the traditional owners of Juukan Gorge to co-manage the land mined for iron ore as a first step in rebuilding its damaged relationship with the local indigenous community. The agreement outlined principles of co-management of Aboriginal heritage sites on PKKP lands that fall within Rio Tinto's mining leases, which include greater involvement of the PKKP in mining activities on their land.[138]

The Juukan Gorge catastrophe has put a spotlight on the power imbalance between Australia's mining giants and indigenous communities. It has also raised questions on whether there is a greater need to have legal protections in place for traditional owners to safeguard culturally significant heritage sites.[139] One thing is for sure – both mining companies and the Australian government will think twice before such irreversible destruction happens again.

Meanwhile, the mining giant has other issues to deal with. In July 2022, it was announced that Rio Tinto had settled a decade-long tax dispute with the Australian Taxation Office (ATO). The ATO had secured nearly A$1 billion (US$703 million) – comprising A$378 million (US$266 million) relating to amended assessments issued by the ATO (including interest and penalties) and an additional A$613 million (US$437 million) for unpaid tax between 2010 and 2021 – from the mining giant. The ATO's Tax Avoidance Taskforce investigated Rio Tinto for using Singapore as a marketing hub of products such as iron ore to reduce Australian tax payables through transfer pricing. With a corporate tax rate of 17%, Singapore has a lower corporate tax rate than Australia, which has a corporate tax rate of 30%.[140] Rio Tinto has also agreed with Singapore on its transfer pricing tax issues for the same period, to prevent double taxation.[141,142]

Discussion questions

1. Do you think that Rio Tinto's response to the Juukan Gorge incident was adequate? What else could have been done?
2. Evaluate the decisions made by CEO Jean-Sébastien Jacques during his tenure at Rio Tinto. To what extent do you think he was responsible for the Juukan Gorge destruction?
3. Critically evaluate the board structure of Rio Tinto, including its board committees. Do you think it was a contributing factor to the Juukan Gorge incident? Explain.
4. Evaluate Rio Tinto's overall risk management strategy. What factors do you think contributed to the failure of the risk management in the company?
5. Do you think the remuneration packages offered to Jean-Sébastien Jacques, Chris Salisbury, and Simone Niven were fair? Elaborate.
6. Who should ultimately be held responsible for the Juukan Gorge destruction? Do you think sufficient corrective actions were undertaken by all parties which contributed to the Juukan Gorge destruction? Explain.

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SHELLED BY STAKEHOLDERS

Case overview

Shell and its Big Oil rivals have been identified as among the highest corporate emitters of greenhouse gases. Amidst the rise in interest in environmental concerns and impact of global warming, Shell's shareholders have for years questioned the oil giant's corporate strategy, which has been heavily concentrated in burning fossil fuels for energy production. Under pressure from governments, environmentalists and shareholders, Shell has recently focused on moving towards cleaner energy alternatives and reducing its carbon dioxide emissions. In 2017, Shell announced its intention to halve its carbon footprint by 2050 and increase spending to up to USD2 billion yearly on clean energy to meet the goals of the Paris Climate Change Agreement. It also published its 2018 Energy Transition Report and 'Powering Progress' strategy to accomplish net zero emissions by 2050. Despite this, in May 2021, a ground-breaking court ruling in the Netherlands ordered Shell to reduce emissions by 45% by 2030 compared with 2019 levels and align its climate goals to the 2015 Paris Agreement.

The objective of this case study is to facilitate a discussion of issues such as greenwashing; ESG matters in the oil and gas industry; the board's role in overseeing ESG issues; alignment of compensation policies to ESG factors; risk management; proxy fights; and shareholder activism.

From shells to oil

A multinational energy and petrochemical group, Shell plc (Shell), previously known as Royal Dutch Shell plc, is an oil and gas giant with approximately 82,000 employees and operates in more than 70 countries.[1]

Shell's roots can be traced back to 1833, in London, when Marcus Samuel, who was in the business of antiques, decided to trade seashells. When Samuel passed away, his business was further expanded by his two sons into the oil exporting business. In 1987, the Shell Transport and Trading Company was established as an import-export organisation, with kerosene trading as its main source of income.[2]

This case was prepared by Annette Low Hui Xian, Onn Wei Sin, Shevarnie G, Tan Woei Jun Kelvin, Valli Letchumanan, Wu Jie Qi and Yong Hsuen Ping Magdalene 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 organisations named in the case, or any of their directors or employees.

Today, Shell's purpose is to "power progress together by providing more and cleaner energy solutions".[3] Its business model encompasses four major business segments: upstream (exploration and extraction of crude oil, natural gas and natural gas liquids), downstream (trading of end products including gasoline, aviation fuel and biofuel), integrated gas and renewables and energy solutions; and projects and technology (research and innovation, technical services and technology capability).[4] Shell is listed on the London Stock Exchange, Euronext Amsterdam, and New York Stock Exchange.[5]

Who is at the top?

Based on its 2021 annual report, Shell's board of directors consists of 12 directors – the Non-Executive Chairman, one senior independent director (ID) who is also the Deputy Chairman, eight independent non-executive directors (INEDs), and two Executive Directors (EDs).[6] The Non-Executive Chairman is Sir Andrew Mackenzie, who was appointed in May 2021 and is also the Chair of the Nomination and Succession Committee.[7] He replaced Charles O. Holliday, who was the previous Chairman for six years before stepping down from the board.[8] Sir Nigel Sheinwald also retired from the board in 2021 after serving for nine years. He was an INED and the former Chair of the Safety, Environment and Sustainability Committee (SESCo) prior to his departure from the board.[9]

Chairman Mackenzie has a wealth of expertise in environmental issues such as climate change and energy transition. He is an earth scientist with more than 30 years' experience in the oil and gas, petrochemicals and minerals industry. Recognised as "one of the world's most influential earth scientists", he is said to have made important contributions to geochemistry, including disruptive methods for oil exploration and recovery. Jane Holl Lute, another INED, has experience in risk management and sustainability, and was formerly Executive Vice President and Chief Operating Officer of the United Nations Foundation and has served on various committees including those which focus on environmental and sustainability, nomination and governance issues. A third INED, Abraham Schot, is said to possess expertise in social responsibility and risk management.[10]

The two EDs on the board are Shell's Chief Executive Officer (CEO) and Chief Financial Officer (CFO). CEO Ben van Beurden, who has been at the helm since January 2014, has over 38 years of working experience in Shell and as a result has a deep understanding of the oil and gas industry. He is said to have "proven management expertise across the technical and commercial roles".[11] Having spent 17 years at Shell, CFO Jessica Uhl is described as having "a track record of delivering key business objectives, from cost leadership in complex operations to mergers and acquisitions". Prior to working for Shell, Uhl held financial leadership roles in Enron and Citibank.[12]

Safety, Environment and Sustainability Committee

The board committee responsible for sustainability governance in Shell was originally named the Corporate and Social Responsibility (CSR) Committee and was re-named to SESCo in 2019.[13]

The overall role of SESCo is to review the policies and performance of Shell against the Shell General Business Principles, its Code of Conduct and its mandatory Health, Safety, Security, Environment and Social Performance standards. It reviews and advises on sustainability policies and practices to ensure that such topics are discussed, understood, owned and promoted at the board level. Main topics discussed by SESCo include the safe and responsible operation of Shell's facilities, environmental protection and greenhouse gas emissions, major incidents that impact safety and environmental performance, progress towards Shell's Net Carbon Footprint targets and ambition, and climate change and energy transition.[14,15]

SESCo also conducts on-the-ground engagement exercises, visits various Shell operations yearly to actively gather feedback from internal and external stakeholders, and shares its insights with the board and management accountable for various projects. It also advises the Remuneration Committee on metrics involving sustainable development and energy transition that are linked to the Executive Committee scorecard and incentive programme.[16,17]

Powering progress

In February 2021, Shell announced its 'Powering Progress' strategy, aimed to "accelerate the transition of [its] business to net-zero emissions, in step with society".[18] The strategy combined the company's ambitions under four goals: generating shareholder value, achieving net-zero emissions, powering lives and respecting nature, and involved the setting of "ambitious, but realistic" short- and medium-term targets to reduce carbon dioxide emissions.[19] It was designed to integrate sustainability with Shell's overall business strategy and reaffirm its commitment to contribute to sustainable development. Shell states on its company website that it strives to "provide more and cleaner energy solutions in a responsible manner – in a way that balances short- and long-term interests, and that integrates economic, environmental and social considerations".[20]

That same year, Shell also released its 2021 Energy Transition Progress Report, which outlined its progress since its energy transition strategy secured about 89% of the shareholders' vote at the 2021 Annual General Meeting (AGM). Shell informed stakeholders that it would put the energy transition strategy update to an advisory shareholder vote at its yearly AGM until 2050.[21,22]

The report disclosed that by the end of 2021, Shell reported Scope 1 and 2 emissions reduction of 18% compared to 2016 levels. It also detailed the critical investment decisions undertaken by Shell in the production of low-carbon fuels, solar and wind power, and hydrogen, as well as changes to its upstream and refinery portfolios.[23]

Despite its efforts, in April 2021, Shell's auditor, Ernst & Young, allegedly refused to sign off its sustainability plans as it found it neither feasible nor accurate to state that Shell had abided by the Paris Agreement.[24]

Remuneration

To further strengthen its transition to a net-zero emissions energy business by 2050, Shell included an energy transition performance metric in its long-term incentive plan (LTIP) for senior executives in 2019. It was the first major energy company to do so. In 2021, Shell increased the weighting of the energy transition performance metric in the LTIP from 10% to 20%.[25]

Shell also included progress in the energy transition key performance indicators in the calculation of the annual bonus for almost all of its employees in 2021. It further linked the remuneration of over 16,500 employees to its target of reducing carbon intensity of its energy products by 6% to 8% by 2023, compared with 2016.[26] The other components in the 2021 annual bonus scorecard were a 15% weighting on safety performance, 35% weighting on financial delivery, and 35% on operational excellence.[27]

Shell's Remuneration Committee reviewed the annual bonus scorecard and believed that it remained aligned with Shell's strategic and operational priorities. While the performance measures and respective weightings for the 2022 annual bonus scorecard remain unchanged, Shell extended how it would measure progress in the energy transition to cover three key themes from 2022: reducing emissions from operations, sales of low-carbon and zero-carbon products, and partnering with others to decarbonise road transport.[28]

Climate change and risk management

Shell disclosed in its 2021 annual report that during the year, it reshaped and restructured the company to make its energy transition strategy the heart of everything it does. It identified climate change and the associated energy transition as a material risk, based on the rapidly evolving societal concerns and developments related to climate change and managing greenhouse gas emissions.[29]

Shell has in place a detailed governance framework to manage its climate-related risks and opportunities. A summary of how Shell's board of directors and senior management collaborate and work together to assess and manage the oil giant's climate-related risks and opportunities is disclosed in Figure 1.

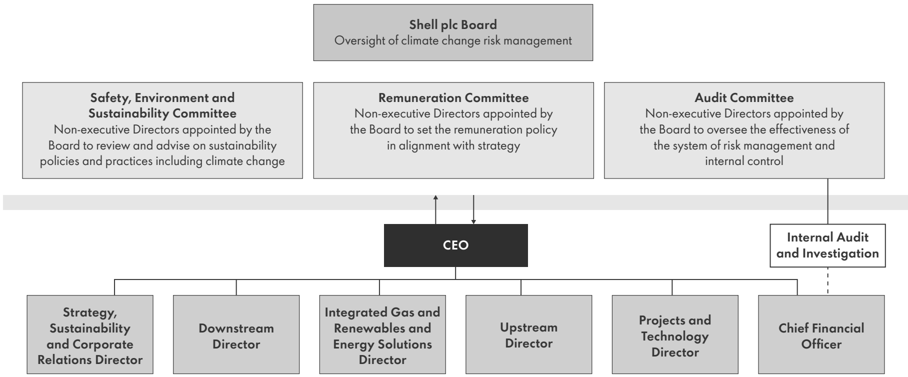

Figure 1: Shell's climate change management organogram[30]

Board level[31]

At the board level, board members first discuss and approve Shell's energy transition strategy and oversight of its implementation and delivery. In 2021, climate-related matters were frequently debated during the board's review of the energy transition strategy, assessment of risk management policies, and endorsement of business plans and budgets, which included capital expenditures, acquisitions and divestments.[32]

Three of the four board committees – SESCo, the Audit Committee and the Remuneration Committee – provide primary oversight of the delivery of Shell's energy transition strategy. SESCo provides oversight of the company's technical delivery in driving carbon emissions reductions, and the potential impacts and adaptation measures related to climate change risks. This also encompasses reviews of Shell's Carbon Management Framework and monitoring of emissions reductions progress. The Audit Committee provides oversight of the effectiveness of Shell's internal controls and risk management framework to ensure that its financial statements accurately reflect the risks and opportunities associated with its energy transition strategy and climate change. The Remuneration Committee determines the company's remuneration policy and targets designed to motivate strategic decisions to reduce carbon emissions while maintaining shareholder value.

Management

In addition to CEO van Beurden, members of the senior management team assist him on climate-related matters in implementing and monitoring Shell's energy transition strategy.[33]

In February 2022, a new role titled strategy, sustainability and corporate relations director was created. Ed Daniels, who has been with Shell since 1988, was appointed for the role and became the newest member of Shell's Executive Committee. He previously served as the executive vice president strategy, portfolio and sustainability, leading the company's 'Powering Progress' strategy to accomplish net zero emissions by 2050. He has over thirty years of diverse, related industry and leadership experience under his belt.[34] Daniels assists in the development of Shell's energy transition strategy, including climate scenarios development, and augmenting the Company's Carbon Management Framework (CMF). The CMF sets carbon budgets in its operating plan, and aids in the assessment of trade-offs between emitting carbon and generating value.[35]

Wael Sawan is the oil giant's integrated gas, renewables and energy solutions director. He oversees Shell's expansion into low-carbon and renewable energy alternatives, as well as the power markets, which are part of the company's strategy to achieve net zero emissions by 2050.[36] Sawan searches for and develops low-carbon solutions and opportunities, as well as manages and mitigates carbon emissions.[37]

Harry Brekelmans is Shell's projects and technology director and plays a key role in the partnership of Shell with Baker Hughes Co., an energy technology firm, to aid in the achievement of net-zero carbon emissions targets. Brekelmans is responsible for setting emissions, climate, and reporting standards that are rolled out to all businesses. He also develops new technologies geared towards energy efficiency and decarbonisation.[38]

Huibert Vigeveno and Zoe Yujnovich, the downstream director and upstream director respectively, are tasked with identifying climate-related, low-carbon, and emission reduction opportunities while managing and mitigating the climate risks of Shell's downstream and upstream oil and gas businesses. CFO Uhl is in charge of monitoring the effective application of the Shell Control Framework, to manage Shell's material risks as well as provide assurance over its financial information, carbon emissions and climate-related disclosures.[39]

Management Committees

Shell set up the Capital Investment Committee (CIC) and Carbon Reporting Committee (CRC), to deliver its environmental ambitions. The CIC, which comprises senior executives such as the CEO, CFO and business directors, facilitates the portfolio management discussions to ensure that the climate risks and opportunities are embedded in investment decision-making. The CRC is responsible for ensuring that greenhouse gas emissions measures comply with all regulatory and legal requirements, the review and approval of external disclosures, as well as the embedding of training plans, measurement and reporting of greenhouse emissions metrics. The CRC includes senior management business representatives, projects and technology climate-related disciplines, and other functions.

First hit

Convinced that the fossil fuel industry would need to change in light of global warming, Mark van Baal, an activist investor, realised in 2015 that he needed to be a shareholder of Shell to convince enough shareholders to submit a resolution at the shareholders' meeting to push it in a greener direction. Hence, the idea of "Follow This", a movement to unite large shareholders, was born. Eventually, van Baal's efforts paid off and Follow This tabled its first shareholder's resolution at Shell's 2016 AGM.[40]

The resolution called for Shell to "become a renewable energy company by investing the profits from fossil fuels in renewable energy", and the shareholders "[expected] a new strategy within one year".[41] Shell's board appealed to its shareholders to vote against the resolution, stating that it was not in the best interests of the company.[42] Ultimately, with 2.78% voting in support of the shareholder resolution, it was not passed.[43]

Follow This did not give up and followed through with similar shareholder resolutions from 2017 to 2021. These resolutions consistently reiterated Follow This' original demands – to set and publish emissions targets in accordance with the Paris Agreement to limit global warming to well below 2°C above pre-industrial levels. However, Shell's board recommended shareholders to vote against the new resolutions every year.[44,45,46,47,48]

From "unwise" in 2016, "unreasonable" in 2017, to "unnecessary and potentially counter-productive" in 2019 and 2020, Shell's board consistently rejected Follow This' resolutions.[49] In 2017, the board stated that the solution was "comprehensive government policies" to "accelerate the necessary investment in low-carbon technologies and drive the shift in demand from high to lower carbon forms of energy".[50] In 2020, Shell claimed that "While this is technically and economically possible, it will require unprecedented collaboration and coordination. Shell aims to play its part to help deliver this outcome, in line with society and in collaboration with its customers who need and rely on energy."[51]

In 2017, 2018, 2020 and 2021, the resolutions gained 6.34%, 5.54%, 14.39% and 30.47% votes in support respectively.[52,53,54,55] In 2019, Follow This withdrew its resolution, with the aim of giving Shell more time to advance its climate ambition to be aligned with the Paris Agreement.[56,57] Follow This acknowledged Shell's progress, including Shell's plans to cut its net carbon footprint by "around half by 2050".[58]

2021 AGM advisory vote

Prior to the 2021 AGM, Shell released its 2021 Energy Transition Strategy, detailing Shell's strategy to become a net-zero emissions energy business by 2050, "in step with society's progress towards the goal of the Paris Agreement on climate change". The strategy was subjected to a non-binding shareholder advisory vote in the 2021 AGM.[59]

Institutional investors and proxy advisors had varied reactions. Proxy advisor Pensions and Investment Research Consultants (PIRC) said Shell's strategy "does not seem to have a clear plan for the competitive aspects of the energy transition". It further criticised the strategy for lacking individual accountability for the board, and for not listing the Chairman as responsible for the strategy.[60] Another institutional investor, the U.K.'s Local Authority Pension Fund Forum (LAPFF), also found fault with Shell's plan, questioning its reliance on carbon capture and storage, which it asserts "does not result in 'net zero'". It also highlighted that the strategy did not sufficiently address the challenges that Shell was facing, and called for investors to vote against the strategy.[61] Both PIRC and LAPFF criticised Shell for decarbonising "in step with society" instead of taking the lead to drastically reduce its emissions. London's Legal & General Investment Management (LGIM),[62] U.K. boutiques RWC Partners and Sarasin & Partners,[63] along with some other investors who shared similar sentiments on the inadequacy of Shell's plans, also joined the shareholder rebellion, voting against Shell's proposal to endorse the firm's energy transition strategy.

On the other hand, several investors voted for Shell's strategy. One such investor is Church of England Pensions Board (CEPB), which recognised Shell's first phase of transition. However, it stated that it would divest its shareholding if Shell was not on track to meet the Paris Agreement targets by 2023.[64] U.S. proxy advisor Glass Lewis also backed Shell's plan, stating that the oil giant's plan was "robust", and its disclosure was "comprehensive and thorough", but would re-consider future proposals if the company does not adequately address shareholders' concerns.[65]

Eventually, approximately 89% of shareholders voted in favour of the 2021 Energy Transition Strategy.[66]

Friends of the Earth, not of Big Oil

> "If successful it would set a precedent. It would be the first time a court could force an oil major to change course."
>
> *– Roger Cox, environmental litigator for Friends of the Earth*[67]

In 2019, a class action lawsuit was filed against Shell by Milieudefensie – the Dutch wing of Friends of the Earth International, an international network of environmental organisations in 73 countries – as well as six other Dutch non-governmental organisations and 17,379 individual co-claimants. They claimed that Shell has an obligation, ensuing from the unwritten standard of care in the Dutch civil code, to prevent dangerous levels of climate change through its existing corporate policies.[68] They further claimed that Shell's existing climate ambitions "do not guarantee any emissions reductions, but would in fact contribute to a huge overshoot of 1.5 degrees of global warming", and accused Shell of violating its duty of care and threatening human rights by knowingly undermining the world's plans to limit global warming to 1.5 degrees Celsius.[69] The Shell case was eventually brought on the basis of "unlawful endangerment" under the Dutch civil code.[70]

The lawsuit by Milieudefensie highlighted that Shell had early knowledge of its role in causing climate change.[71] In a 2018 report released by the Center for International Environmental Law (CIEL), the organisation allegedly uncovered documents which proved that Shell had known about climate change since the 1950s. This included a 1988 internal report which stated that the oil giant accounted for 4% of carbon emissions worldwide in 1984.[72] The report, titled "The Greenhouse Effect", stated that carbon dioxide levels in the atmosphere were increasing and that fossil fuel combustion was the main contributor at the time. The report warned that there was "reasonable scientific agreement that increased levels of greenhouse gases would cause a global warming" as well as the dangers of climate change such as rising sea levels.[73]

However, despite Shell's alleged awareness of the negative impact of fossil fuel emissions on climate change, it joined the Global Climate Coalition (GCC) – a group which fought against climate change regulations and the adoption of the Kyoto Protocol – from 1989 to 1998.[74] Shell also continued to aggressively open new oil and gas horizons. Around 2006, Shell invested in tar sand in Canada to extract tar sand oil,[75] which emits up to three times more global warming pollution than conventional crude oil.[76] From late 2017, the Group focused on extracting oil and gas from shale, an intensive energy process which results in higher carbon dioxide emissions compared to the extraction of petroleum and natural gas.[77]

Furthermore, in an open letter to shareholders in May 2014, Shell allegedly indicated that the Paris Agreement targets were unlikely to be achieved, and thus there was no need to change its business model.[78] Shell further wrote that "there is a high degree of confidence that global warming will exceed 2°C by the end of the 21st century".[79] The letter was in response to claims that climate laws would leave it with "stranded" reserves of coal, oil and gas.[80]

Shell took a U-turn in December 2017 when it presented its "Net Carbon Footprint Ambition", which sought to reduce the carbon dioxide intensity of the energy products sold by the Group by 2050, through the reduction of Scope 1, 2 and 3 emissions.[81] In 2018, Shell released its 2018 Energy Transition Report, explaining its business strategy in the context of climate-related risks and opportunities. The company disclosed that it planned to reduce its Net Carbon Footprint by around 20% by 2035 as an interim measure, and would review its progress every five years.[82]

Despite Shell's new goals to reduce carbon dioxide emissions, some observers were sceptical about whether its plans would materialise.[83] Shell's 2018 Energy Transition Report disclaims that "while we seek to enhance our operations' average energy intensity through both the development of new projects and divestments, we have no immediate plans to move to a net-zero emissions portfolio over our investment horizon of 10 to 20 years".[84] Furthermore, in October 2018, Shell's CEO Ben Van Beurden further emphasised that Shell's core business will be for the foreseeable future, "very much in oil and gas".[85]

In this regard, Milieudefensie argued that in spite of Shell's recent steps towards clean energy transition and its claims to subscribe to climate goals of the Paris Agreement, Shell was in fact headed towards higher carbon emissions by 2030. In particular, this argument was based on Shell's substantial investments in new oil and gas fields and a 30% increase in production as a result of its growth strategy for oil and gas activities.[86] Roger Cox, the environmental litigator acting on behalf of Milieudefensie and the group of environmental activists, said Shell's business model and corporate strategy "is on a collision course with global climate targets" and presented "a great danger for humanity". The activists' ultimate goal was for Shell to slash its total carbon dioxide emissions by 45% by 2030, compared with 2019 levels, which would force the Group to overhaul its operations and corporate strategy.[87]

The second jab: A ground-breaking ruling

> "This is a monumental victory for our planet, for our children and a big leap towards a liveable future for everyone,"
>
> – *Donald Pols, director of Milieudefensie*[88]

On 26 May 2021, Shell lost the landmark legal case with a Dutch court, which ordered the oil giant to reduce its net carbon emissions by 45% by 2030 compared to its 2019 levels. The reduction obligation relates to Shell's entire energy portfolio and the aggregate volume of all carbon dioxide emissions into the atmosphere, which includes all scope 1, 2 and 3 emissions.[89] Scope 1 refers to direct emissions, Scope 2 refers to indirect emissions from third-party energy sources necessary for its operations, and Scope 3 refers to all other indirect emissions, which includes consumers. While it is mandatory for Shell to reduce emissions by net 45% for its Scope 1 emissions by the end of 2030, the obligation to reduce Scope 2 and Scope 3 emissions is not mandatory but rather a "significant best-efforts obligation".[90]

For the first time in corporate history, a company has been legally bound to align its policies with the Paris Climate Agreement.[91] Judge Larisa Alwin of the district court in The Hague said that Shell's existing climate strategy was not sufficiently concrete and that it has a human rights obligation to take further action to reduce its environmental impact. The judge's decision would require "a change of policy" from the oil giant.[92]

The ruling represented a "monumental victory"[93] by Milieudefensie. Paul Benson, a lawyer at ClientEarth, an environmental law charity, remarked that it was "a defining moment in climate litigation".[94] Observers opined that the ruling could set a global precedent for other cases against large corporate polluters, and that such companies could expect to face similar environmental lawsuits in the future.[95] Lawyers, environmentalists and energy analysts also predicted that Shell and its Big Oil competitors might pre-emptively adopt policies such as increasing investments in clean energy to avoid further legal action. They added that Big Oil companies would need to be prepared for climate litigation failure as a financial risk going forward. Some analysts went so far as to say that future legal cases would target investors and banks associated with fossil fuel companies.[96]

Climate litigation against fossil fuel companies has gained momentum over the past few years. Until recently, cases tended to be focused on liability suits, with corporations asked to pay damages for past behaviour. But the legal case against Shell is among a growing number of so-called human rights-based cases, which aim to radically change a company's strategy and potentially disrupt its business model.[97] These cases are designed to advance climate policies, raise public awareness and drive behavioural shifts of specific industries.[98]

Shell's defence

> "Companies have an independent responsibility, aside from what states do. Even if states do nothing or only a little, companies have the responsibility to respect human rights."
>
> – *Judge Larisa Alwin*[99]

In recent years, Big Oil companies have come under mounting pressure from environmentalists and investors to be more accountable for their contribution to greenhouse gas emissions and thus climate change. They have already been forced by various stakeholders such as investors, regulators, and the public to increase disclosures about their environmental footprints.[100]

The rising scrutiny over their operations comes against the backdrop of the COVID-19 pandemic which has dampened their finances and threatened their ability to carry out their ambitious green plans. Prior to the COVID-19 pandemic, Shell planned to spend up to 10% of its US$30 billion annual capital expenditure on its clean energy business until 2025. Due to the pandemic, its planned expenditure dropped to US$20 billion in 2020.[101]

Others should be held responsible too!

Shell has repeatedly reinforced its belief that action to fight climate change is necessary. The oil giant had invested in clean energy alternatives such as biofuels and hydrogen, smart energy storage solutions, and planned to increase investment in low carbon technologies. However, it argued that given the global nature of climate change, a courtroom fight would "do little to overhaul the energy system". It also contended that even in the event it supports international efforts, the Paris Agreement obligates governments – not individual corporations – to take action. Shell also said that consumers should be held equally responsible for their energy usage choices and producers should not be penalised disproportionately.[102] Shell said: "We agree with Milieudefensie that action is needed now on climate change… What will accelerate the energy transition is effective policy, investment in technology and changing customer behaviour, none of which will be achieved with this court action."[103]

Shell further argued that the reduction obligation will have no effect, because of increasing emissions from its competitors.[104] However, while the Dutch court acknowledged that although society as a whole have the responsibility to work towards achieving the goals set out in the Paris Agreement, and that Shell "cannot solve this global problem on its own", this did not "absolve" it of its responsibility to reduce the amount of emissions under its "control and influence".[105]

The world needs energy producers

Shell and other oil companies have also pointed to the global dependence on fossil fuels. While environmental activists are pushing for a shift towards renewable forms of energy, the world's consumption patterns remain at the same high level. Shell argued that attacking energy giants without a simultaneous push to change consumption habits would do little to tackle climate change. As such, Van Beurden stuck to the business strategy of producing fossil fuels, which generate the bulk of Shell's revenue.[106]

Shell also argued that the reduction obligation proposed by the Dutch court would lead to unfair competition and disrupt the level playing field in the oil and gas industry.[107] Although the court agreed that the reduction obligation would require a change in Shell's policy – which might "curb the potential growth of the Shell group"[108] – the court stood firm that the interest arising from the reduction obligation outweighs Shell's commercial interests.[109]

Shell said at the time of the ruling that it would appeal.[110] Its London-traded shares fell by 0.7% on the day of the ruling, compared with 0.8% gain in the broader European energy sector.[111]

Indignation

In the month following the Dutch ruling, Shell responded that it would accelerate its plan to cut greenhouse gas emissions after the court order, saying it would "rise to the challenge".[112]

A month later, on 20 July 2021, Shell confirmed its decision to appeal the Dutch court ruling through a media release.[113] CEO Van Beurden said that he was "disappointed" that Shell was being "singled out" by a ruling he felt did little to reduce global carbon dioxide emissions. He also contended that while Shell was working towards cutting a greater amount of carbon dioxide emissions at a faster rate, the ruling in May did not take into consideration the full extent of Shell's "Powering Progress" strategy published earlier in the same year as the initial hearings in the trial had been held earlier.[114]

In response, Donald Pols, director of Milieudefensie, wrote on Twitter that Shell would be better off investing "its money and energy in preventing dangerous climate change" instead of appealing the court order. He stated: "The longer Shell waits, the more serious the consequences for all of us."[115]

In January 2022, Van Beurden described the court order as a "body blow", saying "[The ruling] goes against everything I believe in when it comes to climate change, namely that this is a societal problem, not a problem for a single company to solve."[116] In March 2022, Shell officially filed its appeal. Reinforcing his belief that Shell could achieve net zero only if society as a whole takes action to achieve net zero, Van Beurden said "We question how Shell can have a legal obligation to reduce carbon emissions we do not control from customers who are not under a similar legal obligation to reduce their emissions."[117] There has been no outcome from the appeal as at July 2022.

Making a Third Point

> "Shell has too many competing stakeholders pushing it in too many different directions, resulting in an incoherent, conflicting set of strategies attempting to appease multiple interests but satisfying none,"
>
> *– Daniel S. Loeb, Chief Executive of Third Point LLC*[118]

Third Point LLC (Third Point), a high-profile investment adviser based in New York, had a stake in Shell valued at about US$750 million in late 2021.[119] On 27 October 2021, Third Point's Chief Executive, Daniel S. Loeb, published a letter to investors, calling for Shell to be broken up into two stand-alone companies – one comprising Shell's oil and gas extraction business and the other focusing on its renewables and liquified natural gas activities. Third Point believed instead of trying to "do it all" and trying to please all shareholders, such a strategy would likely "lead to an acceleration of [carbon dioxide] reduction" and "significantly increased returns for shareholders".[120] John Browne, the former CEO of Big Oil rival BP, concurred and said that the company needs to be "bolder in separating low-and zero-carbon activity from their fossil fuels business". He added that large oil and gas companies are trying to "achieve the impossible" by investing in high growth renewables businesses that should be well valued in the market while keeping the polluting fossil fuels which contribute to their bottom lines. [121]

In response to the investor letter, CEO van Beurden stated that Shell's energy transition is primarily funded by its legacy oil and gas business, hence a break-up of the firm implies Shell would not have the funds to go green quickly.[122] Shell has also argued that integration is intrinsically valuable in the energy transition, citing examples such as the ability to work with customers and to connect energy generation with carbon capture or hydrogen infrastructure.[123]

Loeb also raised a pertinent point on diversity in shareholders' beliefs on where Shell should be headed in terms of its corporate strategy. In his letter, he said "Some shareholders want Shell to invest aggressively in renewable energy. Other shareholders want it to prioritise return of capital and enjoy the exposure to legacy oil and gas."[124] Kirsten Spalding, head of the Ceres Investor Network, opined that "The most important thing is investing in renewables and making the transition and becoming a diversified energy company and not a fossil fuels company."[125] On the other hand, others believe that giving up on plans to transform into a renewable energy company and focusing on the divestment of its assets is the only option, and that investors' engagement attempts with fossil fuel companies would not bear fruit.[126,127]

In 2022, Third Point increased its stake in Shell, saying the company was undervalued. In Loeb's letter, he shared his view that "with proper management we believe the company can simultaneously deliver shareholder returns, reliable energy and decarbonization of the global economy,"[128]

Directors in deep oil

> "Shell is seriously exposed to the risks of climate change, yet its climate plan is fundamentally flawed. In failing to properly prepare the company for the net-zero transition, Shell's board is increasing the company's vulnerability to climate risk, putting the long-term value of the company in jeopardy."
>
> *– Paul Benson, a lawyer at environmental law charity ClientEarth*[129]

On 15 March 2022, ClientEarth announced it was intending to take legal action against Shell's board of directors for failing to adequately prepare the company for net zero carbon emissions and hence, breaching their fiduciary duties as directors.[130]

ClientEarth asserts that the company's directors failed to implement a climate strategy which truly aligns with the Paris Agreement and which amounts to a breach of the board's legal duties under the U.K. Companies Act. This marks the first legal case seeking to hold directors liable for the lack of preparation in a company's energy transition movement.[131] ClientEarth also argued that the "mismanagement" affected the Shell's "long-term commercial viability".[132] If successful, Shell's board could be legally forced to change its corporate strategy and take concrete steps to align its plans to tackle climate change with the Paris Agreement. As of July 2022, the outcome of ClientEarth's lawsuit against Shell's directors remains to be seen.[133]

No one is safe

> "All of these world firsts have significant precedent-setting value, with legal implications that spread far beyond the oil and gas sector."
>
> *– Paul Benson, a lawyer at environmental law charity ClientEarth*[134]

Today, climate activists are better funded and have more legal expertise than ever before. Against the backdrop of improved climate research and ambitious scientific endeavours, they are challenging companies to be accountable for their environmental impact – especially in the form of greenhouse gas emissions – in an unprecedented way.[135] The oil and gas industry has borne the brunt of it in recent years, with Big Oil rivals facing disgruntled stakeholders and the industry suffering a degradation of its reputation as a whole. But observers are also looking at other big emitters. It is only a matter of time that the focus will shift away from the oil and gas industry. Which industry will be the next target?

Discussion questions

1. Do you agree with the Dutch court ruling that individual corporate emitters should be held accountable for their contributions to global warming? To what extent do you think Shell's defence against the court ruling was valid? Explain.
2. Did Shell's Safety, Environment and Sustainability Committee fulfil its intended objectives? In general, do you think that climate change should be a part of the fiduciary duties of directors?
3. What are the potential challenges faced by companies in traditional fossil fuel businesses in switching to renewable energy sources? How should the board and management manage potential risks from the energy transition?
4. There is currently a push for companies to link remuneration to ESG metrics. Do you think this should be applied to all companies? Discuss the potential challenges that companies may face in doing so.
5. What is the role of institutional investors and proxy advisors in the global push for climate change action? Should shareholders have a say in a company's climate plans? What other stakeholders should be involved to ensure that a company's climate change plans are appropriate and carried out?
6. Suggest measures companies can take to ensure they report a more accurate picture of their sustainability practices. Discuss the extent to which regulators should prescribe mandatory reporting of ESG issues and independent assurance of sustainability reports, as well as the resulting implications.

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TOSHIBA: SUMO WRESTLING WITH MINORITY SHAREHOLDERS

Case overview

In 2015, Toshiba was faced with a major accounting fraud, with profits reportedly overstated by ¥151.8 billion (US$1.2 billion) over seven years. Two years later, it was faced with another scandal relating to its nuclear business, after it disclosed an estimated US$6.3 billion in losses due to its U.S. nuclear unit, Westinghouse Electric Company, which it had acquired about a decade earlier. Its shareholders' equity became negative and it was at risk of being delisted from the Tokyo Stock Exchange. In response, the board approved a share sale plan in November 2017 – which involved the issuance of 2.28 billion new shares, equivalent to 54% of its outstanding shares at the time – to raise capital from overseas investors. Many of the 60 overseas investment funds that accepted the shares sold under the share plan were activist investors. This was the start of ongoing disagreements between activist shareholders and management over a number of issues, including share buybacks, capital allocation, proposed split of the company, privatisation, and allegations of voting misconduct at the Annual General Meeting.

The objective of this case study is to facilitate a discussion of issues such as societal and corporate culture and their impact on corporate governance; board composition and effectiveness, roles of the board versus shareholders in major corporate actions; issues that boards should consider when evaluating strategic options such as spin-offs and privatisation; risk management; and shareholder activism.

Birth of a samurai

> "Do the right thing. We act with integrity, honesty and openness, doing what's right – not what's easy."
>
> – *Toshiba's values*[1]

This case was prepared by Chok Jia Tien, Chur Calvin, Gan Wei En Gabriel, Loh Wye Yee, Raphael Emmanuel Ng Zhu Xiang, Sabelle Chong Xue Ting and Teoh Jer Suen, 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 organisations named in the case, or any of their directors or employees.

Toshiba was formed in 1939 when Tokyo Electric Company Ltd merged with Shibaura Seisaku-sho (Shibaura Engineering Works Co., Ltd.) to form Tokyo Shibaura Denki (Tokyo Shibaura Electric Co., Ltd.).[2] A Japanese multinational conglomerate headquartered in Japan, its shares were first listed on the Osaka and Tokyo stock exchanges in 1949. The name of the company was officially changed to Toshiba Corporation in 1978.[3] Being one of the largest and oldest producers of electronic products, Toshiba was also among global leaders in the semiconductor industry. It was also a pride of Japan when it came to corporate governance.[4]

> "Full of yes men that do things because they think the boss wants them to do it, rather than what they think is a good idea or the right thing to do."
>
> – *Professor Ulrike Schaede, University of California, San Diego*[5]

Toshiba is known for its top-down culture, also known as "Makoto", which originated from the Japanese Samurai culture. The "Makoto" principle emphasises achieving social harmony through compliance and obedience to authority. Under this hierarchical culture, the word of senior management must be followed without question.[6]

Big cracks emerge

> "Get it done like your life depends on it."
>
> – *Atsutoshi Nishida, Toshiba's former president*[7]

Issues started emerging during Atsutoshi Nishida's tenure as Chief Executive Officer (CEO) in 2008. His aggressive stance on profit maximisation earned him the reputation as the "tough as nails" target setter.[8] His successor, Norio Sasaki, was known to set unrealistic performance targets known as "challenges" for each division and further increased the pressure to increase profits. The challenge system remained in place after the baton was passed to Sasaki's successor, Hisao Tanaka.[9,10] Both Nishida and Sasaki remained influential within the company as an adviser and Vice Chairman respectively.[11]

The unrealistic targets led to immense pressure to produce results, resulting in employees artificially inflating profits to meet targets. The independent investigation committee noted that "[Toshiba's] employees felt cornered into resorting to inappropriate measures" to meet their income targets.[12] Profits were overstated by ¥151.8 billion (US$1.2 billion) over seven years, an amount too large to be resolved while under Tanaka's leadership. It was only uncovered after the Japan's Securities and Exchange Surveillance Commission was tipped off by an anonymous whistle-blower.[13] The agency's probe following the revelation sent shockwaves throughout the Japanese society, as it became the biggest accounting scandal in Japanese history.[14]

Ironically, Toshiba had been lauded for its corporate culture, being ranked ninth out of 120 publicly traded Japanese companies in 2013, just two years before the accounting scandal was uncovered.[15]

The two former CEOs, Nishida and Sasaki and the incumbent CEO, Tanaka, announced their resignations on 21 July 2015 to take responsibility for the accounting scandal.[16] Tanaka bowed regretfully before the flashing camera lenses during the press conference announcing his resignation.[17] He said he was "deeply sorry for all the inconvenience and concern that we have caused our investors."[18] However, it was all too late as the damage had already been done.

However, history was to repeat itself in February 2020. During an audit by the Tokyo Regional Taxation Bureau, Toshiba's subsidiary, Toshiba IT-Services Corp, was found to be involved in round-tripping transactions amounting to ¥43.5 billion (US$391.6 million) related to the sales of information technology equipment between 2015 and 2019. These fictitious transactions were only recorded on paper and did not involve any commercial goods or end users.[19,20]

Nu-clearing the path to a yokozuna (grand champion)

The 2015 accounting fraud was soon followed by another major scandal in 2017 involving Toshiba's nuclear business. Its entry into the nuclear business started when then president Atsutoshi Nishida saw it as a platform for high growth. This led him to jump on the opportunity to acquire Westinghouse Electric Company (Westinghouse) when British Nuclear Fuels Limited (BNFL) put it up for sale in June 2005.[21] The bidding war with Hitachi Ltd and Mitsubishi Corp caused the deal value to increase to almost three times the initial offer of US$1.8 billion[22] to a final value of US$5 billion, which was agreed between BNFL and Toshiba in January 2006.[23]

Two years after the acquisition, Westinghouse received orders in April 2008 for four U.S. nuclear plants valued at a total of US$13.7 billion.[24] Toshiba's decision to venture into the nuclear business seemed to be paying off.

However, on 11 March 2011, Fukushima saw one of the most destructive earthquakes in history, triggering a radioactive leak at the Fukushima Daiichi nuclear power station. This catastrophic event not only led to deaths in the thousands,[25] but also marked the start of the demise of Toshiba's nuclear business.[26]

The Fukushima nuclear disaster had a significant global impact on the nuclear industry, with a significant increase in the decommissioning of nuclear plants and the shutting down of nuclear plants which were in operation.[27] There was also a significant increase in regulations revolving around the safety of the nuclear industry, which contributed to rising costs.[28] The fall in public confidence in the nuclear industry also saw Toshiba's dream of the nuclear business as a strong growth segment begin to falter.[29]

A series of grave miscalculations

> "Fundamentally, it was an experimental project, but they were under pressure to show it could be a commercially viable project, so they grossly underestimated the time and the cost and the difficulty."
>
> – *Edwin Lyman, a senior scientist at the Union of Concerned Scientists*[30]

Problems also arose at Westinghouse when it came up with the AP1000 design which got its final approval from the U.S. Nuclear Regulatory Commission in December 2005.[31] The AP1000 was an overly ambitious new approach attempting to solve what had been notoriously known in the nuclear industry to be problems of cost overruns and delays in the construction of nuclear plants.[32]

Westinghouse's approach, which involved building pre-fabricated sections of the nuclear plants before sending them to construction sites for assembly, was supposed to "revolutionise the industry" by making it cheaper and safer to build nuclear plants. However, Westinghouse failed to conduct proper testing and planning to consider the possible pitfalls that could happen during the rolling out of its AP1000 design, leading to safety issues, extensive delays, and huge cost overruns. The cost overruns amounted to an estimated US$13 billion and left in doubt the future of two U.S. nuclear plants.[33] Westinghouse later admitted that it had "not properly considered" the issues that could arise from their materials which might impede safety.[34]

The massive cost overruns due to the Westinghouse's design flaws left significant doubt as to whether Westinghouse could continue its operations in the nuclear industry. Eventually on 29 March 2017, a decade after its acquisition by Toshiba, Westinghouse filed for Chapter 11 bankruptcy protection, signalling the end of Toshiba's nuclear venture.[35]

Observers have opined that there were already earlier red flags such as the increasing regulation in the nuclear industry which led to rising costs of operations. It was also felt that Toshiba could have cut its losses earlier by exiting the industry, but failed to do so. The company had clung to its overconfident outlook even while the nuclear industry was deteriorating.[36] In the end, Toshiba suffered an estimated US$6.3 billion in losses due to its U.S. nuclear unit.[37]

Sue-mo lawsuit against Toshiba

> "They were allowed to charge the customers for all the money that they spent, plus a return even though they failed to deliver the project."
>
> – *Gregory Jaczko, former Nuclear Regulatory Commissioner*[38]

In July 2017, following Westinghouse's bankruptcy application, Toshiba bailed out of a deal involving the construction of two nuclear reactors in South Carolina for US$2.2 billion. The agreement capped Toshiba's liability for guaranteeing that its Westinghouse subsidiary would complete the contract. The halt in the project in South Carolina left the nuclear reactor constructions unfinished.[39]

In December 2017, a class action lawsuit was filed against Toshiba[40] to claim damages for the cost of building the nuclear reactors. A portion of the building costs was previously paid for through the premiums that South Carolina Electric & Gas – whose parent, Scana Corp, managed the nuclear plant – charged customers on their electric bills. After the project was abandoned, the plaintiffs demanded that Toshiba pay the customers who helped foot the bill for the cancelled project.[41]

Sumo misses the target

Toshiba was reeling from the devastating consequences of Westinghouse's bankruptcy in 2017, with Toshiba recording a ¥712.5 billion (US$6.3 billion) write-down. As of 15 February 2017, Toshiba's shareholder equity stood at a negative ¥150.0 billion (negative US$1.3 billion).[42,43]

On 14 March 2017, Toshiba released a public statement that it would miss its second deadline to report its third-quarter earnings. This was due to the need for more time to complete an auditor review of the results for the period ended 31 December 2016. The statement painted a grim picture of the conglomerate's outlook, causing a fall in its share price by as much as 5.1%.[44]

There was also a difference in opinion with its auditors, PriceWaterhouseCoopers Aarata LLC (PwC), regarding the amount of losses to be recognised from Toshiba's subsidiary Westinghouse. PwC eventually gave a "qualified opinion" on Toshiba's financial results for the year ended March 2017 as well as for the period of April-June 2017, but issued a separate "adverse opinion" on Toshiba's corporate governance as it was late in booking the Westinghouse losses.[45]

Under Tokyo Stock Exchange rules, any company with a negative shareholder equity for two consecutive years or an adverse or disclaimer opinion issued relating to its financial statements would be delisted from the exchange. Toshiba faced a delisting threat if it failed to report its earnings by 21 April 2017.[46]

In June 2017, Toshiba narrowly escaped delisting and was only demoted to the second section of the Tokyo Stock Exchange from 1 August 2017 due to negative shareholders' equity.[47,48] Nonetheless, Toshiba still had to avoid a second consecutive financial year of negative shareholder equity in order to be out of the woods.

Enter the gaijin (foreigners)

> "We will do whatever it takes, including increasing capital."
>
> – *Satoshi Tsunakawa, Toshiba's former Chief Executive*[49]

To rescue the firm from insolvency and delisting, Toshiba's management proposed to sell some of its most profitable assets, including a 60% stake in its crown-jewel semiconductor memory business.[50] This was announced in a late-night announcement through the exchange on 20 September 2017. Toshiba aimed to close the transaction by end-March 2018, after receiving competition law approvals in key jurisdictions and clearance of other required processes.[51] However, there were numerous hurdles to overcome, including obtaining regulatory approval to ensure the agreement is not in breach of antitrust rules or does not threaten national security.[52]

Toshiba's board then approved a new share sale plan on 20 November 2017 as a short-term solution in an attempt to retain its listing on the Tokyo Stock Exchange. The plan was to raise capital from overseas investors by issuing 2.28 billion new shares – equivalent to 54% of its outstanding shares[53] – at a discount of ¥262.8 apiece. The ¥600 billion (US$5.4 billion) equity offering would allow Toshiba to reverse its negative shareholder equity.[54,55]

Many of the 60 overseas investment funds that accepted the shares sold under the share plan were activist investors.[56] After the deal was sealed in December 2017, Singapore-based fund Effissimo Capital Management Pte Ltd (Effissimo), established by former colleagues of one of Japan's most famous activist investors Yoshiaki Murakami,[57] became the largest shareholder in Toshiba with an 11.34% stake. Other significant shareholders were Farallon Capital Management LLC (Farallon) and King Street Capital Management LP (King Street). Non-Japanese investors now accounted for nearly 70% of the total shares in Toshiba.[58,59]

Despite no longer urgently needing funds after the issuance of new shares, Toshiba's management proceeded with its delayed sale of its semiconductor business, which was at odds with its shareholders. Toshiba's prized memory chip business had accounted for around three-quarter of its overall company's profit in 2016.[60] Eventually, on 1 June 2018, the semiconductor sale was closed with a consortium led by a U.S. private equity firm, Bain Capital, in a deal amounting to US$18 billion.[61]

Changing wrestlers

After the series of scandals, Toshiba had gone through significant management restructuring, including the appointment of Nobuaki Kurumatani in April 2018 as CEO, who vowed to "[help] Toshiba back on its feet".[62] Kurumatani was a veteran banker and a former deputy president of Sumitomo Mitsui Financial Group, one of Toshiba's main creditors. Even though Kurumatani had no working experience in the manufacturing industry, it was said that his extensive financial experience and prior involvement in turning around another troubled big corporate, Tokyo Electric Power Co., would be helpful in leading the company out of financial distress.[63]

However, according to Japanese standards, Kurumatani was considered an 'outsider' to the firm, as it has always been a common practice for executives within conglomerates to spend over decades developing internal connections while rising to the top ranks. In Japanese terms, this is a traditional policy known as "shanai shoshin", or "promotion from within".[64] Therefore, unsurprisingly, there were many senior executives at Toshiba who reportedly opposed the idea of an outsider at the helm, much like when the company last sourced for an 'outside' leader, Toshio Doko, in 1965.[65] Without full support from his subordinates, it was a challenge for the new CEO to reform the corporate culture of the 143-year-old conglomerate.

Although there was new management, there were questions as to whether they had improved the company's corporate governance framework and if their "efforts" had been nothing more than a facade.

The wrestle continues...and continues

October 2018 saw the first major sign of dissatisfaction from Toshiba's overseas investors. King Street, a U.S. hedge fund owning a 6.35% stake – which was the second largest shareholder at that time – launched the first public activist campaign through a public letter and accompanying presentation sent to Toshiba's management and board of directors. In its letter, King Street expressed its concerns about a lack of follow-up action taken by management in the implementation of share buyback and re-evaluation of its capital allocation strategies. It called on the company to accelerate and significantly increase share buybacks from ¥700 billion

(US$6.3 billion) to ¥1.1 trillion (US$9.9 billion) with its excess capital, followed by strategies to improve the profit margin.[66,67]

In response, Toshiba's management promised to accelerate the buyback of ¥700 billion (US$6.3 billion) of shares with the proceeds from the semiconductor business. By November 2018, Toshiba said that the company had bought back ¥120.8 billion (US$1.1 billion) of its own shares, and planned to continue its buyback plan for another year.[68]

In March 2019, King Street once again wrote to CEO Kurumatani and called for a board overhaul. It proposed to nominate a slate of independent directors to replace majority of the board. Among the candidates proposed to lead Toshiba's turnaround plan was Brian Higgins, co-founder of the hedge fund.[69]

Under immense pressure from activist shareholders, Toshiba's management eventually bowed to King Street's request to replace members of its board. During the Annual General Meeting (AGM) held in June 2019, Toshiba announced 12 board nominees for an expanded and more independent board, with the number of independent directors increased from seven to 10, and five foreign directors being nominated. This appeared to be a major breakthrough as the previous boards were filled by Japanese directors for almost 80 years.[70]

The newly appointed foreign directors possessed skills and experience ranging from international corporate portfolio management, business transformation to expertise in markets and capital allocation. The diversity of the new board was seen to be integral to the oversight and implementation of Toshiba's five-year road map for corporate transformation, driving sustainable growth and enhanced shareholder value.[71]

However, some of the 'outside' directors who were appointed may raise questions about Toshiba's search and nomination process. For example, Paul J. Brough, who was appointed as an 'outside' director in June 2019, was Executive Chairman at Singapore-listed Hong Kong-headquartered commodities trading firm Noble Group (Noble). Noble's share price nosedived in 2015 following allegations of accounting fraud by Iceberg Research.[72] Brough had joined Noble in 2015 as an independent director after the initial slew of allegations from Iceberg Research, before taking on the role of Executive Chairman.[73] Noble eventually collapsed and Brough resigned in October 2019.[74]

Another ‘outside’ director, Yoshiaki Fujimori, also had a mixed track record. When Fujimori was the CEO and adviser to LIXIL Corporation, he failed to improve the company’s share price and many problems arose during his tenure, such as losses and accounting fraud from its mergers and acquisitions, and misuse of management rights.[75] According to 3D Investment Partners Pte Ltd (3D), his relationship with Kurumatani is also questionable as they both came from the same company, CVC Capital Partners, and was appointed as ‘outside’ director one year after Kurumatani became Toshiba’s CEO.[76]

A fair fight that never was?

Prior to Toshiba’s AGM on 31 July 2020, 3D, which held a 4.2% stake,[77] had publicly announced that it would vote against the re-election of president and CEO Kurumatani and director Yoshiaki Fujimori.[78] Moreover, 3D and Effissimo Capital Management, Toshiba’s largest shareholder – which are both based in Singapore – wanted to appoint two and three independent director candidates respectively to the company’s board.[79] However, they narrowly failed to do so.

3D later discovered that one of its voting forms that was mailed out on 27 July 2020 was not counted in the tally, as it was told that the form had reached Sumitomo Mitsui Trust Bank (SMTB), Toshiba’s shareholder registry administrator, only after the 30 July 2020 deadline.[80] According to the post office’s website, it should have taken only one day to deliver the form. 3D felt that it was very odd when another voting form that was posted out one day later from the same post office arrived at SMTB on 29 July 2020 in time for the meeting.[81] This prompted 3D to send a letter to Toshiba’s ‘outside’ directors on 9 August 2020, requesting them to launch a probe into the overall integrity of Toshiba’s electoral voting process for the AGM, which allegedly did not recognise 1.1% out of the 4.2% stake that it held.[82]

On 18 September 2020, Toshiba confirmed that 1,139 postal voting forms for its shareholder meeting were omitted from the results despite being delivered on time.[83] The reason provided by SMTB for nullifying and leaving out the voting forms was that they arrived a day before the appointed “delivery date”,[84] but were “post-dated as part of a long-standing arrangement with the postal service”.[85] Japan Post expedites mail delivery during the shareholder meeting season and deliveries occur a day ahead of the usual time, but the mail is still recorded as arriving on the originally scheduled date. The oversight by two Japanese providers of shareholder services – SMTB and Mizuho Trust & Banking Co. – and miscounting of investors’ votes had also affected close to a thousand other listed companies, casting doubt on the credibility of AGMs in Japan as a whole.[86] Although the results for Toshiba’s AGM would not change even if the uncounted votes were included in the tabulation,[87] the incident deepened concerns about corporate governance in Japan.

Shareholder interference?

Toshiba came under the spotlight again on 23 September 2020 when Effissimo requested an investigation by a third-party committee comprising independent members to determine whether the July AGM had been conducted fairly.[88] When the third-party committee was not established, Effissimo requested that Toshiba convene an "emergency" extraordinary general meeting (EGM) to investigate the July AGM.[89]

In particular, an advisor from the Japanese government, Hiromichi Mizuno, had held an online meeting with N. P. Narvekar, the CEO of the Harvard University endowment fund, just days before the AGM. During the meeting, Mizuno allegedly told N.P. Narvekar that if the Harvard University endowment fund does not follow the recommendations of the election of the directors set out by Toshiba's management, the Harvard University endowment fund could be "subject to regulatory probe".[90] Mizuno also made reference to the ties that Toshiba had with the Japanese government, and said that if the Harvard fund voted against the management's direction, it would have an impact on Harvard's reputation.[91] This led the Harvard fund to abstain from voting in the AGM, which was a substantial boost for Kurumatani given that Harvard was one of the largest shareholders of Toshiba at that time, with a stake of about 4.5%.[92] The fund later learnt that there was no basis for Mizuno's statement about a regulatory probe.[93] It was unclear how Mizuno was related to Toshiba (given that Mizuno was a board member of Tesla and a former Chief Investment Officer of the Government Pension Investment Fund).[94]

At the AGM, Kurumatani managed to keep his job with a mere 58% approval. This was a far cry compared to previous years when he obtained overwhelming support from shareholders.[95] However, stories of investors being pressured on their voting choices unfolded. As one of the large shareholders of Toshiba put it: "The more vulnerable Nobuaki Kurumatani's position seemed, the more unorthodox the methods of securing his survival seemed to become. It was dark arts at their best. We made sure that we had lawyers in every meeting".[96]

In response to these doubts, Toshiba conducted its own investigation and concluded that there was no evidence that it was involved in pressuring shareholders, specifically, the Harvard endowment fund.[97] However, the probe was criticised as "perfunctory and insufficient".[98] Shareholders were not convinced since the investigation was done by the Audit Committee of Toshiba without the involvement of independent parties.[99] Effissimo further said that it interviewed various major shareholders and "confirmed that there were in fact shareholders that have given up exercising their voting rights due to such pressure".[100]

We want a rematch!

In December 2020, Effissimo nominated three candidates as members of the committee to be set up to conduct an independent investigation. The three candidates were Takao Nakamura, Yoji Maeda and Takashi Kizaki, all of whom were independent from Toshiba's management and Effissimo as well as having expertise as attorneys at law. This was done because its prior requests for Toshiba to set up an independent third-party investigatory committee were not carried out.[101,102]

Effissimo also made it clear to Toshiba that it intended to call an EGM itself with the courts' approval if there were no action or plans within eight weeks. It proceeded to do so in January 2021, after Toshiba received a notice from the Tokyo District Court on this matter and, after a week, only stated that it had plans to do so by the end of April but had not made any official decision yet.[103]

In its proposal to shareholders on 17 March 2021, Effissimo stated its reasons for calling for a probe. Effissimo questioned why Toshiba and its Audit Committee chose to believe the explanation given by SMTB, rather than Japan Post which is an independent third-party. It claimed that Toshiba was trying to misinform investors into believing that it was normal for Japan Post to have slow delivery times by saying that postal service takes "approximately" four days to deliver mail, which would have violated the service levels set out in the Postal Laws. The shareholder also said that the review conducted by the Audit Committee was not an investigation at all but was merely a "passive consumption of information fed to it by SMTB and Japan Post".[104] Hence, Toshiba did not adequately address the conflicting accounts given by SMTB and Japan Post and did not address the issue of interference at all.

At the EGM which was held on 18 March 2021, 57.9% of the votes was in favour of a probe.[105] The vote marks only the fourth time that a shareholder motion has won approval in Japan and the first "at a major company that is a household name".[106] The success of the motion was expected to increase pressure on Toshiba's board, which had failed to regain investors' confidence since its accounting scandals.[107]

Farallon joins the wrestle

On 24 December 2020, Farallon also requested for Toshiba to convene an EGM for shareholders to vote on and approve amendments to the Toshiba Next Plan (TNP), a one trillion-yen growth investing plan.[108] Farallon's request came in one week after Effissimo's request, placing Toshiba under immense pressure from two large investors.

At the July 2020 AGM, the proposal to amend Toshiba's Articles of Incorporation for a general meeting to be held with shareholders with regards to Toshiba's capital policy garnered 97.74% votes. The overwhelming support for the proposal indicates that Toshiba's shareholders were of the view that any significant changes made to the TNP relating Toshiba's capital policy should be put to shareholders, instead of allowing management to make changes at their own discretion.[109]

However, on 11 November 2020, Toshiba made a sudden announcement about a growth strategy that was significantly different from what was provided in the TNP. The funds of one trillion yen would be used for conducting large-scale mergers and acquisitions (M&As), as opposed to the initial strategy that "focused on a disciplined capital policy and targeted growth through organic expansion and small-scale, programmatic M&A".[110] This raised concerns as the change was made without providing shareholders with information about the reason or how it would benefit Toshiba. Farallon accused Toshiba of "backpedalling" on this strategy and said that it "has led to further trust issues and concerns".[111] Farallon also brought up Toshiba's poor M&A track record over the past 20 years, raising doubt about the change in growth strategy. It demanded that Toshiba's board clearly put its intentions across to the shareholders, provide an explanation on the new growth strategy, as well as to seek inputs from shareholders.[112]

On three separate occasions, Farallon issued statements to Toshiba's shareholders to garner their support to vote in favour of its EGM proposal to have Toshiba follow the initial TNP strategy, or provide explanations to shareholders and seek their approval for the changes. The fund wanted the board to present a five-year capital policy plan or make certain returns to shareholders. In the two weeks leading up to the EGM on 18 March 2021, Farallon was desperately garnering shareholders' support for the proposal.[113,114,115]

On 16 March 2021, Toshiba claimed that the proposal by Farallon to return cash to shareholders if shareholders do not approve spending plans "will completely destroy all seeds for medium-to-long-term growth."[116] At the EGM, in an attempt to please shareholders, Toshiba changed its tune on its proactive M&A investments and stated that "capital in excess of the appropriate level will be used for shareholder returns". Toshiba's board also reiterated its statement made three months prior that the company "would use excess funds to buy back shares if there are no strategic investment opportunities" that meet its criteria.[117]

Farallon's motion was rejected by shareholders, with 57.79% of votes cast against it.[118,119] Although Farallon's proposal was rejected, the investment firm stated in a statement that the votes during the EGM had brought across the message that there is an increase in expectations from the shareholders in transparency and accountability from the board.[120]

A helping hand from an old friend?

On 7 April 2021, CVC Capital Partners (CVC) announced an offer of ¥5,000 per share, or well over US$20 billion in total, to take Toshiba private and delist from the Tokyo Stock Exchange, with an intention of improving its value and relisting it a few years later. The offer price was a 31% premium to the previous day's closing price, Following the announcement, Toshiba's shares surged by its daily limit of 18%.[121] The deal could potentially save Toshiba from the ongoing conflicts with its activist investors.

However, the timing of CVC's proposal raised questions, considering Toshiba's struggle to keep its shares listed, after facing an accounting scandal and being close to bankruptcy.[122] Further, Toshiba's current CEO Kurumatani used to chair CVC's Japanese operations. Toshiba's current involvement in several sensitive industries[123] may also lead to complications regarding government approvals for such a sale to a foreign entity. The buyout by CVC would also require financing assistance from other co-investors and financial institutions, which would involve a substantial amount of time and complexity.[124]

Following the controversy over the unsolicited acquisition offer from CVC, Kurumatani resigned on 14 April 2021, a week after the offer. The departure cast doubt on CVC's proposed buyout deal, with other buyers said to be weighing bids. KKR & Co (KKR) was said to be considering an offer that would exceed CVC's, whilst Brookfield Asset Management was also said to be in the early stages of exploring an offer.[125]

We have a plan...

In November 2021, the Toshiba board took the market by surprise when it proposed to split the 140-year-old company into three, following what it said was four months of deliberations by a special committee.[126] However, this did not go down well with the activist investors.

The company backtracked and later proposed to split the company into two listed companies instead of the original proposed of three. Investors remained unconvinced and at the EGM held on 24 March 2022, shareholders voted against the proposal. This triggered a heavy sell-off of its shares, which fell by as much as five percent. However, a proposal from 3D that would have obliged the company to reopen talks with private equity firms and other investors for a possible take-private deal was also rejected by shareholders. This indicated the sharp division among shareholders, putting the company in a difficult position.[127]

The board said it will continue exploring strategic options. In June 2022, it was reported that bidders were weighing up offers valuing Toshiba at up to US$22 billion, leading its shares to jump by as much as 6.5%.[128] However, by mid-August 2022, there was still no firm deal in sight.

What will come next for the company is anyone's guess.

Discussion questions

1. There have been a number of corporate governance and accounting scandals involving major Japanese companies in recent years, despite significant corporate governance reforms in Japan. To what extent do you think cultural factors may have played a part in these scandals? How so? How might Japanese societal culture affect corporate culture?
2. Toshiba's board comprised of 12 directors, with the CEO and COO being executive directors, and 10 'outside' directors. One of its 'outside' directors is a woman who chairs the Compensation Committee, and there are four foreign directors. Compared to most other Japanese companies, Toshiba's board composition may be considered best in class. What are the attributes of an effective board and what may inhibit the effectiveness of the Toshiba board?
3. At Toshiba, two former CEOs, Nishida and Sasaki, were appointed as an adviser and Vice Chairman respectively, after they retired as CEOs. What are the pros and cons of doing so? On balance, do you believe this is a good corporate governance practice? Explain.
4. What are the key risk management failures at Toshiba? What are the board's and management's roles with regards to risk management?
5. Discuss the pros and cons of shareholder activism in driving good corporate governance practices in a company. Evaluate the effectiveness of shareholder activism in Toshiba by Effissimo Capital Management, 3D Investment Partners and Farallon Capital Management in pushing for changes and improving corporate governance.
6. Contrast shareholder activism in Japan and your home country and the contributing factors to any difference.
7. In Toshiba's case, to what extent do you feel shareholders should intervene in management's decisions pertaining to the overall direction of Toshiba's strategy and the Toshiba Next Plan? Was Farallon's demand for cash to be returned to shareholders reasonable? Should shareholders be given more power in making decisions on corporate actions such as share buybacks, spin-offs and privatisation? Explain.

8. There have been many cases of shareholders pushing international companies to undertake spin-offs or to take them private. In Toshiba's case, the board proposed a spin-off which was rejected by shareholders. What is the role of the board in strategic decisions such as spin-offs and privatisation? What are the key factors that a board should consider when evaluating spin-offs and privatisation?
9. Contrast a stakeholder-focused and shareholder-focused model of corporate governance. How would you describe the Japanese model of corporate governance? Do you think it is changing and in what way?

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THE (UNI)LEVER FOR DRIVING SUSTAINABILITY

Case overview

Unilever PLC (Unilever) has established itself as the No. 1 corporate sustainability leader for the tenth year in a row, according to the latest GlobeScan-SustainAbility survey. It is also one of the largest consumer goods businesses in the world, with more than 400 market-leading brands. Emphasising social and sustainability issues, Unilever's strategy, 'The Compass', aims to double the size of the business, while reducing its environmental footprint and increasing its positive social impact. It seeks to create value through the amalgamation of sustainability practices into its business model.

The objective of this case study is to facilitate a discussion of issues such as ethics and tone at the top; integrating Environmental, Social and Governance (ESG) issues into strategies, policies and practices; board composition; and linking ESG factors to remuneration.

Pulling the lever

Unilever's beginnings can be traced back to 1929, when Margarine Unie and Lever Brothers initially sought to negotiate an agreement to keep out of each other's principal interests of margarine and soap production but ultimately decided to merge into one.[1] At that time, Margarine Unie was one of the largest margarine producers in Britain while the Lever Brothers controlled 60% of the U.K.'s soap manufacturing output.[2] Both companies enjoyed major influence in global markets, especially in Africa, where they sourced most of their raw materials and inked export trade deals.

The large size of both companies made it the largest international merger prior to World War II.[3] According to The Economist, it was "one of the biggest industrial amalgamations in European history".[4]

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Subsequently, Unilever continued to exert its influence around the world while diversifying its business through various acquisitions. It also continued to invest heavily in innovation, research and development. By the 1980s, it was ranked as the world's 26th largest business. It remained fervent in its efforts in maintaining tropical plantations and cutting down the use of plastics in the consumer goods sector. To keep the company lean and efficient, it also actively engaged in restructuring and consolidation through divestments.[5]

Unilever is widely considered as one of the pioneers of sustainable business operations, with its company culture seen to be rooted in sustainability. As far back as 1996, it started the initiative of ensuring the sustainable sourcing of fish. The company set up the Marine Stewardship Council (MSC) with the World Wildlife Fund (WWF) to prevent overfishing and sea pollution.[6]

The year 1999, however, saw a sharp drop in Unilever's share price. This was both a result of investor interest shifting to the technology and internet sectors, and Unilever's lack of competitiveness in the laundry market in Latin America.[7] To combat this, Unilever made significant improvements to its Environmental, Social and Governance (ESG) efforts in the 2000s, by embedding sustainable thinking into its daily operations. In doing so, Unilever stood out from a crowded group of fast-moving consumer goods (FMCG) companies which were less focused on sustainability.[8]

In 2004, Unilever took its focus on ESG factors further, underpinned by a new mission statement which states:

> "Unilever's mission is to add Vitality to life. We meet every day needs for nutrition, hygiene and personal care with brands that help people feel good, look good and get more out of life…This is our road to sustainable, profitable growth, creating long-term value for our shareholders, our people, and our business partners."[9]

That same year, it joined the Roundtable on Sustainable Palm Oil (RSPO) to advocate the use of sustainable energy sources. It also launched the Campaign for Real Beauty[10] to support feminism and rolled out a new logo to represent the diversity of the company. Since then, consumers have become increasingly educated about sustainability issues and the impact of businesses on the environment. Unilever's ESG efforts have gained significant traction from consumers. To keep its momentum going, the company has continued such efforts through the mitigation of negative environmental consequences and advocacy of sustainable business operations.[11]

Today, Unilever is one of the top ESG companies worldwide and has been named an industry leader by S&P Dow Jones Sustainability Index (DJSI) 2020.[12] It continues to strive to meet its ESG goals while staying committed to the constant improvement of its business practices.

The gold standard for sustainability

Without doubt, Unilever has put a strong focus on ESG, gaining recognition from peers and consumers alike. The firm has bagged many ESG-related awards and is often ranked amongst the top three corporate sustainability leaders. In 2012 and 2016, Unilever won the Sustainable Business Award of the British Business Awards, which recognised the company's continual efforts in building a sustainable business and for promoting a sustainable business model in the Chinese market.[13] The award was based on Unilever's superior commitment in promoting economic prosperity, improving environmental quality and social equity, and educating different stakeholders on the importance of sustainability. In 2020, Unilever was named as the industry leader in personal products in the S&P Dow Jones Sustainability Index 2020, achieving a score of 90 out of 100 across 27 ESG criteria.[14] It was also recognised as the No. 1 corporate sustainability leader for the tenth year in a row by the latest GlobeScan-SustainAbility survey.[15]

Sustainability as a business strategy

Unilever has long recognised the tectonic shift in societal expectations for a sustainable future, with companies being called upon to actively participate in social roles and to be transparent about their social impacts.[16] To effectively address this change, Unilever publishes the Social Review that sets out Unilever's approach to Corporate Social Responsibility (CSR). The Social Review sets the scene by explaining what CSR means to Unilever, maps and reviews the impact of its economic and social policies and practices, and how it is moving forward.[17] This is done together with Unilever's online Environmental Performance Report which shows its continual progress in reducing the company's global environmental impact.[18]

Unilever Sustainable Living Plan

In the 2000s, Unilever was struggling to overcome rising commodity prices and the impact of the global financial crisis of 2008.[19] When Paul Polman joined the company as Chief Executive Officer (CEO) in 2009, he recognised the need for change and repositioned Unilever to become a purpose-driven company. Early in his tenure, he made several bold and unconventional moves, such as stopping the issuance of quarterly guidance[20] and acquiring companies known for their eco-friendly approaches.[21]

One of Polman's most important initiatives was to launch the Unilever Sustainable Living Plan (USLP),[22] which sets out the company's sustainability commitments and targets for the next decade. This plan served as the company's blueprint for sustainable growth in an uncertain world by helping to drive profitable growth for their brands, save costs, and fuel innovation.[23]

The USLP has three main global goals – to improve health and wellbeing, reduce environmental impact, and enhance livelihood, with more than 70 time-bound measurable targets. By the time the plan reached the end of its ten years in 2020, Unilever had achieved most of its targets and made significant progress in tackling societal and environmental issues. Some of these achievements include reaching 1.3 billion people through its health and hygiene programmes, enabling 2.34 million women to access initiatives to develop their skills, and reducing greenhouse gas emissions from its own manufacturing by 65%.[24]

Even though many of these targets initially drew criticism for being too ambitious and detrimental to short-term profits, the USLP has proven to be a key driver of success for Unilever. Unilever's "Sustainable Living Brands", which includes brands like Dove, Hellmann's and Domestos, have consistently outperformed the average growth rate of the rest of the portfolio. This strategy has allowed Unilever to avoid over €1 billion in costs, by improving water and energy efficiency in factories, using less material and producing less waste. Furthermore, the USLP has helped Unilever to attract and retain the best talent who want to contribute to sustainable development, and has been instrumental in forging strong partnerships with NGOs, government organisations and other businesses.[25]

Unilever Responsible Sourcing Policy

While striving to uphold the highest standards of sustainability within its own organisation, Unilever also expects the same standards from all its suppliers. In 2014, it launched the Responsible Sourcing Policy (RSP),[26] with the goal of conducting business in a manner that improves the lives of workers and the environment across its supply chain. This policy is based on the following twelve Fundamental Principles:[27]

1. Business is conducted lawfully and with integrity.
2. Work is conducted on the basis of freely agreed and documented terms of employment.
3. All workers are treated equally with respect and dignity.
4. Work is conducted on a voluntary basis.
5. All workers are of an appropriate age.
6. All workers are paid fair wages.
7. Working hours for all workers are reasonable.
8. All workers are free to exercise their right to form and/or join trade unions or refrain from doing so and to bargain collectively.

9. All workers' health and safety are protected at work.

10. All workers have access to fair procedures and remedies.

11. Land rights of communities, including indigenous peoples, will be protected and promoted.

12. Business is conducted in a manner which embraces sustainability and reduces environmental impact.

In line with these Fundamental Principles, Unilever introduced a continuous improvement ladder that sets out benchmarks for three performance levels: Mandatory Requirements, Good Practice and Best Practice. The first level, Mandatory Requirements, ensures that all the suppliers who work with Unilever are grounded in the foundational elements of the Fundamental Principles. For example, its suppliers are required to treat all of their workers equally and ensure that their health and safety are protected at work. Unilever then encourages its suppliers to move up the ladder to Good Practice, and towards Best Practice. By consistently sharing the best practices and updated guidelines on continuous improvement with its suppliers, Unilever helps them to reach those levels.

To verify its suppliers' compliance with the RSP's mandatory requirements, Unilever requires self-declaration from suppliers and the completion of online assessments. For suppliers situated in designated high-risk countries, independent verification, including third-party audits, are carried out.

The RSP was further updated in 2017 to reinforce Unilever's commitment to work together with its suppliers towards a sustainable future for all parties.[28] The RSP is instrumental in ensuring that Unilever delivers its business objectives while making a positive social impact on the millions of lives that the firm's supply chain affects. These ambitions are also at the core of Unilever's USLP and continue to underpin The Compass strategy going forward.

Unilever also believes that transparency and accountability are imperative to the advancement of human rights. As such, it made a commitment in 2014[29] to disclose its efforts and challenges in implementing the United Nations Guiding Principles on Business and Human Rights. This includes publishing audit findings from its extended supply chain, including any non-conformances with the mandatory requirements of the RSP. For such non-conformances, Unilever works with suppliers to address the identified issues and find appropriate solutions. Unilever also allows suppliers, their employees, workers or contractors to report actual or suspected breaches of the RSP anonymously by phone or online. In extreme cases where a supplier is unwilling to alter its practices and take corrective actions, Unilever will cease to source from the supplier.

Norway and Unilever Fund – Global Climate Action Resilience

The catastrophic effects of the 2017 Atlantic Hurricane was a warning to the world of the urgent need to invest in societies to build resilience to climate impacts.[30] It brought together public and private partners to assist communities and countries to "anticipate and absorb" climate risks.[31]

At the Global Climate Action Resilience Day during the 2017 United Nations Climate Conference, Unilever, together with Norway, committed a US$400 million fund to stimulate "resilient social development".[32] The initiative seeks to invest in business models that combine investments in high productivity agriculture, smallholder inclusion and forest protection.[33] The fund also serves as an exemplar to inspire the public and private sectors to get involved in building more climate-resistant societies.

Battling the COVID-19 pandemic

The COVID-19 pandemic took a toll on societies all around the world. Countless organisations, including Unilever, were forced to adapt swiftly to restrictions that negatively impacted economies. Unilever took a step further to help its stakeholders and communities.

In March 2020, Unilever announced a wide range of supportive efforts to tackle the impact of the virus on its different stakeholders – consumers and communities, customers and suppliers, and its workforce.[34] For consumers and communities, Unilever contributed €100 million through the donation of necessities such as sanitisers, soaps, bleaches and supplements to national health organisations and non-governmental organisations (NGOs).[35] This was carried out through initiatives such as the COVID Action Platform of the World Economic Forum and UNICEF to support hospitals, frontline health workers and local communities who are most in need.[36] It also implemented handwashing education programmes to educate communities on pertinent hygiene issues. To help customers and suppliers across its extended value chain, Unilever offered a cash flow relief of €500 million to vulnerable small-medium sized suppliers.[37] It also extended credit and early payments to selected retail customers who relied heavily on Unilever. Unilever also protected its disrupted workforce which was not protected by the government or their direct employers, with the continuation of their salary pay-outs for up to three months.[38]

In addition, Unilever collaborated with PA Consulting Group to create the COVID-19 Awareness and Situational Intelligence (CASI), "a live dashboard that monitors and accurately predicts COVID-19 trends, providing real-time and predictive intelligence from a global and regional level down to individual Unilever sites worldwide".[39] This aids Unilever in quickly adapting its workforce strategy to protect its stakeholders, while continuing to supply its products to 2.5 billion consumers globally.[40]

Save our planet

The Climate Transition Action Plan was introduced by Unilever to achieve one of the three overarching goals of the USLP – reduce environmental impact.[41] The plan sets out to improve the Earth's health through new measures and commitments that are more effective in combating climate change. Its goal is to preserve and regenerate nature and resources for future generations. This action further supports one of the main aims of the 2021 Glasgow COP26[42] to "Secure global net zero by mid-century and keep 1.5 degrees within reach."[43] For short and medium term goals, it aims "to reduce in absolute terms, Unilever's operational emission (Scope 1 & 2)"[44] by 70% by 2025 and 100% by 2030 against a 2015 baseline. As for its long term goal, it aims to pursue a sustainable supply chain and is committed to achieve net zero emissions from all its products by 2039 or earlier.[45]

In implementing the plan, Unilever focuses on the importance of scope 3 emissions which covers purchased goods and services, employee commuting, waste disposal, use of sold products, upstream and downstream transportation and distribution, investments, business travel and leased assets and franchises.[46] Unilever has identified the shift in consumer preference, where the consumer wants a better understanding of carbon footprints of the products they use.[47] However, one of the challenges faced by Unilever is the complexity of its supply chain. With multiple parties involved, it is difficult to track scope 3 emissions both upstream and downstream along its supply chain. Another challenge faced by Unilever is the difficulty in interpreting and analysing complicated datasets such as the carbon footprint datasets.

Unilever continues to make an effort in publishing its carbon footprint and providing transparency to the public, albeit facing challenges in this regard. By the end of 2021, Unilever aims to pilot carbon labels on about 20 of its products in Europe and North America.[48] In two to five years, it aims to label all its product lines with their carbon footprints and has suggested that supermarkets have a "carbon-neutral and carbon-friendly" aisle to assist consumers in making environmentally conscious decisions by choosing sustainable options.[49] Unilever believes that labelling carbon footprint information at the product level not only allows its users to obtain the data with greater accessibility and ease, but also aids Unilever itself in tracking the progress of its net zero emissions target, which is set to be accomplished by 2039.

Unilever is also a pioneer amongst companies of its size in putting such a climate plan to a shareholder vote to promote transparency and foster investor engagement. At its Annual General Meeting (AGM) held in May 2021, a whopping 99.59% voted for the plan, indicating strong investor support.[50]

> "We think COVID-19 is a problem, but it's child's play compared with the impact of climate change."
>
> *– Alan Jope, CEO of Unilever*[51]

Inclusive society

Unilever has been operating a sustainable business and stakeholder model, which aims to create, deliver and capture value for all its stakeholders without depleting the natural, economic, and social capital they rely on. It aims to be a positive force in tackling some of the most persistent issues of social inequality that were exacerbated during the pandemic, including racial and social justice issues. Unilever has committed to the following three goals to rectify social issues: (i) standard of living, (ii) creating opportunity through inclusivity, and (iii) preparing its people and extended value chain.[52]

Firstly, Unilever seeks to raise the standard of living of lower-waged workers globally. Anyone who directly supplies goods and services to Unilever is ensured a living income by 2030. Unilever's own employees have already secured such an income. It coordinates and cooperates with peers, academia, governments and NGOs such as UNICEF and Oxfam to promote change and worldwide adoption of living wage practices through sustainable purchasing practices.[53]

Secondly, Unilever seeks to drive diversity and inclusivity beyond its own people and operations by 2025 through its commitment to spend €2 billion annually with diverse suppliers. This includes SMEs owned and managed by women or racial and ethnic minorities, people with special needs and LGBTQI+. Additionally, Unilever has initiated a new Supplier Development Programme to provide accessibility to expertise, financing and networking opportunities.[54]

Lastly, Unilever aims to prepare young people for the future of work through the upskilling of its employees. It also intends to extend the value chain for the future by pioneering new employment models for employees that promote security and flexibility. Further, it has partnered with LevelUp, a youth employability platform, to develop apprenticeship schemes globally to increase related training, volunteering and job opportunities by 2030 and equip 10 million young adults with the necessary skills to enter the workforce.[55]

Into the future!

As part of its recent efforts to continuously pursue sustainability, Unilever has put forward 'The Unilever Compass: Our next game-changer for business' to be a leader in sustainability, backed by its decade of experience from the USLP.[56]

Sustainability as a takeover defence

On 10 February 2017, U.S.-based Kraft Heinz Company (KHC) made an unsolicited US$143 billion takeover bid for Unilever, at US$50 per share. However, this offer was quickly turned down by Unilever in just two days, which led 3G Capital-backed KHC to withdraw the bid.[57]

KHC was previously acquired by Brazilian-based private equity firm 3G Capital in 2013. 3G Capital is well-known for its strategy of cutting costs in its acquired companies to achieve rapid increases in profits and cash flows, which in turn achieves immediate returns for its shareholders. At that time, Polman, the CEO of Unilever, who has been at the forefront of corporate social responsibility at Unilever, decided to forego quarterly profit targets. He believed that higher profits would create a tunnel vision phenomenon, resulting in a shift in focus to increase the share price, with diminishing emphasis placed on long term sustainability goals that Unilever values most.[58]

Unilever was quick to issue a firm rebuke, saying that the company saw “no merit, either financial or strategic” in KHC’s offer.[59] Subsequently, Unilever and KHC made a joint announcement about the withdrawal of the proposed combination.

> “Unilever and Kraft Heinz hereby announce that Kraft Heinz has amicably agreed to withdraw its proposal for a combination of the two companies. Unilever and Kraft Heinz hold each other in high regard. Kraft Heinz has the utmost respect for the culture, strategy and leadership of Unilever.”[60]

The following Monday, Unilever’s share price dropped by 7.3% in early trade in London.[61]

According to an employee involved in the takeover defence by Unilever, CEO Polman had privately described the successful fight against the hostile takeover as a “near-death experience”, which might potentially prompt Polman to restructure the company and shift its headquarters from London to Rotterdam for sanctuary against such hostile bids.[62] Many shareholders at that time had expressed their discontentment about the fact that exorbitant resources are being channelled into promoting sustainable efforts at the expense of shareholder interests.[63]

According to Professor Julian Birkinshaw of the London Business School:

> “I think the bid was actually a contest between two different models of capitalism. And it is good news – for the sake of capitalism as a whole – that there was no outright winner, and that Kraft Heinz and Unilever continue to do things their own way.”[64]

Board of directors

As of FY2020, Unilever's board of directors comprised 12 members, of which 10, including the Chairman, are independent non-executive directors (INEDs). The executive directors are the Group's CEO, Alan Jope and Group's CFO, Graeme Pitkethly. All board members have served on the board for less than nine years.[65]

Five out of the 12 directors are female. The directors are between 51 and 71 years old and are from a diverse range of ethnic backgrounds, including Chinese, Danish, Dutch, Zimbabwean, Canadian, and British.[66]

The directors also have different educational backgrounds, ranging from Business, English Literature, Engineering, Science to Law, with three having doctorate degrees. They also hold key positions in other companies from different industries such as banking, mining, education, aviation, beauty and personal care, technology, water technology, media, entertainment etc.[67]

The company's board diversity policy reflects its support for the recommendations of the Hampton-Alexander Review on gender diversity and the Parker Review on ethnic diversity.[68]

Unilever's board diversity policy states:

> "The composition and quality of the board should be in keeping with the size and geographical spread of Unilever, its portfolio, culture and status as a listed company. A diverse board with a range of views enhances decision-making, which is beneficial to the company's long-term success in the interests of Unilever's stakeholders. Thus, the board of Unilever believes that Unilever directors must be selected on the basis of wide-ranging experience, backgrounds, skills, knowledge and insight with a continuing emphasis on diversity of its members."[69]

There are four board committees: Audit Committee, Compensation Committee, Corporate Responsibility Committee, and Nominating and Corporate Governance Committee. All these committees only have INEDs as members.[70]

Sustainability governance

Unilever's board has vast experience and knowledge in sustainability issues. A majority of Unilever's directors are personally involved in various ESG-related initiatives. For example, Youngmee Moon[71] is a member in the Task Force on the Prevention of Sexual Assault[72] while Andrea Jung is a prominent women's issues supporter.[73] Strive Masiyiwa is the co-founder and Chairman of Africa Against Ebola Solidarity Trust and the Co-Chairman of Grow Africa, an organisation that aims to enable countries to realise the potential of the agriculture sector for economic growth and job creation, particularly among farmers, women and youth.[74]

Jope, the group CEO, was crowned as the number one advocate executive for women at work in 2020[75] and was responsible for consolidating Unilever's sustainability and business strategies into one.[76] This initiative is known as The Compass and was designed to link Unilever's leadership in sustainability to the acceleration of business performance. Pitkethly, the CFO of Unilever, is also the Vice-Chair of the Task Force on Climate-Related Financial Disclosures.[77]

The Corporate Responsibility Committee, established in 2006, oversees Unilever's corporate responsibility and ensures that the company lives up its reputation as a responsible corporate citizen.[78] The committee reviews health and safety policies to ensure that Unilever's code of business is upheld. In addition, it provides guidance on minimising any negative environmental impact from the company's business operations. It also tracks the progress and potential risks associated with the decade-old USLP. As the plan came to its conclusion in 2020, it turned its attention to monitoring the company's progress as guided by its new Compass strategy.[79]

Unilever has also established several other sustainability-related committees at the management level, such as Divisional Sustainability Team and Sustainable Packaging Committee. It also seeks the experts' input from across the business, such as through the Carbon Neutral Board, Safety & Environmental Assurance Centre (SEAC), Sustainable Packaging Committee and Sustainable Sourcing Steering Group, for guidance and advice.[80]

Remuneration policy

Unilever's remuneration policy states that the total remuneration package for Executive Directors (ED) should be competitive with other global companies, and that a significant proportion should be performance-related. In 2021, Unilever introduced the Performance Share Plan (PSP), which replaced the Management Co-Investment Plan (MCIP) as the sole long-term incentive plan.[81] The new plan is operated entirely separately from the annual bonus plan, and comprises performance measures which align with Unilever's short-term performance targets and long-term business strategy objectives. Under this plan, the EDs are granted rights to receive free shares which normally vest after three years, to the extent that performance conditions are achieved.

Remuneration linked to achievement of sustainability and climate change targets is a key part of Unilever's framework. For employees at the management level, reward packages include fixed pay, a bonus as a percentage of fixed pay and the PSP, which is linked to financial and sustainability performance. The Sustainability Progress Index (SPI) accounts for 25% of the total PSP award.[82] It includes, inter alia, consideration of progress against its manufacturing Scope 1 and 2 greenhouse gas target and a deforestation goal covering palm oil.

The SPI serves as an assessment of the business' sustainability performance and is designed to capture both quantitative and qualitative elements. To capture the breadth and depth of the Compass in relation to the SPI, Unilever's Corporate Responsibility Committee and Compensation Committee selects a number of key performance indicators (KPIs) to assess its progress towards The Compass' targets and sustainability commitments. They will then agree on a SPI achievement level against the KPI, after taking into account the performance across the entire SPI category.

Paul Polman's departure

Polman spent ten years in Unilever as the group CEO from 2009 to 2018. During his tenure, returns to shareholders amounted to 290%,[83] helping Unilever's share price to increase at twice the pace of the FTSE 100 index.[84] After fending off KHC's hostile takeover bid and initiating the restructuring and simplification of the company, Polman stepped down as CEO on 31 December 2018.[85] He had lost a bruising battle with shareholders over moving the company's headquarters out of London.

Polman was succeeded by Jope, who was previously the president of the Beauty & Personal Care Division, the largest division of Unilever. Jope also worked in leadership roles in North America for 14 years and Asia for 13 years, and helped Unilever double its presence in the Chinese market when he led the business in China.[86]

The announcement of Polman's departure was made on 29 November 2018, with the company saying that "CEO Paul Polman has decided to retire from the company."[87] Polman tweeted on the same day that he decided to "step down from my role as CEO," adding that "It's been a great honour to lead this team for the past ten years and together build a sustainable business that has made a difference to millions of lives."[88]

After Unilever announced its restructuring plan, the company had faced stern opposition from key shareholders, including Aviva Investors, Columbia Threadneedle, Royal London, Legal & General Investment Management, Lindsell Train, M&G Investments and Brewin Dolphin.[89] A top-ten U.K. shareholder told reporters: "It does raise questions about the suitability of some individuals, namely the CEO and

Chairman." He added: "I suspect there won't be too many tears shed on either side if [Mr Polman] accelerated his departure. We think he has been a great CEO. We buy into his sustainability vision…but I don't think this level of friction [between shareholders and management] can be sustained."[90]

Polman's focus on sustainability and social impact was not always appreciated by investors. According to Bernstein analyst Andrew Wood, some investors were dissatisfied with Polman's "preachy" way of leading the company, and Polman engendered strongly differing opinions from investors. However, many investors still considered Polman as an exceptionally good CEO of Unilever due to his strong record in the past decade.[91]

Sustainability at the expense of profitability?

Unilever has mainly evolved under a Darwinian system; retaining what was useful and rejecting what no longer worked.[92] Business practices were adapted to respond swiftly to a dynamic marketplace. The word "sustainable" first became relevant to Unilever in 1996 when it made an ambitious commitment to source all fish from sustainable stock and started working with the WWF to establish a certification programme for sustainable fisheries through the newly created Marine Stewardship Council.[93]

Many have asked, however, whether a focus on ESG translates to superior business performance. Does putting so much emphasis on ESG come at a higher cost?

The integration of ESG into Unilever's business model has brought various benefits to the company's business operations. USLP is one example of how the company sets out to achieve its sustainable goals, making it a role model in the area of corporate ESG initiatives. Back in 2014, Unilever began to measure the performance of its "sustainable living brands",[94] which include Dove, Lipton and Hellman's. Statistically, these brands, whose values are most in line with USLP, have consistently performed better than those that are not part of the plan. The adoption of USLP and sustainable initiatives have not slowed down the growth of these brands.

The Global Director of Sustainability of Packaging at Unilever, Brett Domoy, mentioned in an interview in March 2020 that 46% of Unilever's top sustainable brands are growing rapidly with sustainability as their core. In 2017, 70% of Unilever's growth came from sustainable brands. This attests to the benefits derived from emphasising sustainable business practices. In terms of Unilever's financial performance from 2011 to 2020, operating profits grew steadily, peaking at €12,639 million in 2018.[95]

The USLP motivates the company to put innovation at the forefront of its business to aid in achieving maximum cost efficiency. The Eco-efficiency Programme promotes the adoption of sustainable strategies to help Unilever reduce its production costs. Since 2008, the Group has saved more than €1 billion in costs through improving the efficacy of its water and energy usage and by reducing the usage of raw materials and the production of waste.[96]

The USLP also emphasises fairness in the workplace and opportunities for women to create an inclusive work environment. According to Unilever, almost 90% of its employees have expressed that they feel proud to work for Unilever while 79% feel that their job contributes to the USLP.[97] The emphasis on ESG has resulted in high employee satisfaction, which in turn allows Unilever to attract and retain the best talent.

There is, however, some external criticism regarding Unilever's emphasis on ESG. In an article published in New Internationalist in 2017, journalist Daphné Dupont-Nivet discredited Unilever's sustainability efforts, claiming that the company scores well because it sets the standard of sustainability for itself.[98] In addition, Unilever's close cooperation with NGOs, the authorities and the media has given it an almost unassailable status. Other companies wanting to opt for sustainability are confronted with dilemmas that Unilever refuses to acknowledge.

In some respects, there is a cost in doing the right thing. Inevitably, Unilever incurs additional costs through its efforts to invest in sustainable practices. Though its net profit margins have seen a steady annual increase of around 10.8% in the last ten years, its most recent net profit margin of 11.0% was much lower than the personal and household products industry average of 17.33%.[99]

When Polman, the "sustainability evangelist", was still the CEO of Unilever in 2017, his focus in combating climate change and social issues was said to have distracted him from addressing core business challenges. In a Fortune magazine interview, Polman expressed more interest in supporting the United Nations Sustainable Development Goals than Unilever's 2016 financial results. The company's 2016 fourth-quarter sales reported in January 2017 grew only 2.2%, which was lower than analysts' expectations of 2.8%. Sales for the entire 2016 year were also 3.7% below Wall Street's estimation of 3.9%.[100]

Secretly UNsustainable?

Not all is dandy in the world of Unilever. Its advertising has been alleged to perpetuate racist beauty standards. It has also been linked to Indonesian forest fires and child labour.

Racist South African TRESemme advertisements have surfaced, depicting black hair as “frizzy and dull” and “dry and damaged”, while a white woman’s hair was referred to as “normal”. Unilever also faced a social media outcry over an advertisement for Dove body wash in 2017, which showed a black woman removing her top to reveal a white woman.[101] Unilever took disciplinary action against those involved in racist campaigns.[102] It also removed the word “Fair” after its acquisition of “Fair and Lovely” skin lightening products in India to promote more inclusive beauty standards.[103]

Unilever has also been alleged to be linked to Indonesian forest fires and child labour. According to new research from Greenpeace, Unilever has been buying palm oil from suppliers deemed partly responsible for forest fires in Indonesia.[104] This is despite the fact that Unilever was a founding member of the RSPO, a not-for-profit initiative set up in co-operation with the WWF in 2004, that aims to increase the amount of certified and sustainable palm oil available and which has set sustainability criteria against which suppliers can be certified. The United Nations has warned that nearly 10 million children are at risk due to air pollution from the fires. “Companies have created a facade of sustainability. But they source from the very worst offenders across the board,” said Annisa Rahmawati, senior forest campaigner at Greenpeace Indonesia.[105] These allegations have not been addressed by Unilever.

In August 2022, the Advertising Standards Authority (ASA) in the U.K. banned a television advertisement by Unilever over “misleading” environmental claims for its laundry detergent brand Persil. The advertisement claimed that Persil was “kinder to our planet” and stated that Persil bottles were made with 50% recycled plastic and its liquid detergent was cleaned at low temperatures. The ASA said that the advertisement failed to demonstrate environmental benefits and ruled that the advertisement “must not appear again in its current form”. In response, Unilever said: “We are committed to making on-going improvements to all our products to make them more sustainable and will continue to look at how we can share this with our shoppers.”[106]

Discussion questions

1. Discuss and explain ways that Unilever incorporates sustainability into its business strategies.
2. How does Unilever's Responsible Sourcing Policy (RSP) impact its suppliers?
3. To what extent do you think Unilever's ESG efforts have benefited the company? What are some of the possible challenges Unilever may face in comparison to a company that is less focused on ESG? How should companies balance the trade-off between ESG and profitability?
4. Evaluate the relationship that Unilever has with its stakeholders and cite examples that demonstrate the business model that it is following. Do these relationships help Unilever in achieving its ESG goals?
5. How does Unilever's board composition and sustainability governance support the company's focus on ESG?
6. Evaluate Unilever's remuneration policy. Is its remuneration policy consistent with the company's focus on ESG? What factors should a company consider in deciding whether and how to link ESG factors to remuneration?
7. To what extent has your own company integrated ESG factors into its business strategies, policies, practices and remuneration?

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