

# CORPORATE GOVERNANCE CASE STUDIES

**VOLUME THREE**

Edited by **Mak Yuen Teen**

**60** YEARS IN  
SINGAPORE

BE HEARD.  
BE RECOGNISED.





# **Corporate Governance Case Studies**

## **Volume three**

**Mak Yuen Teen FCPA (Aust.)**

Editor

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## **Corporate Governance Case Studies Volume Three**

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# Foreword

Globalisation is increasingly putting the spotlight on the evolving governance issues faced by companies, resulting in even greater pressure on directors and management of such organisations. Companies need to uplift governance and transparency standards as a strategic priority to excel in the marketplace. High standards of corporate governance are also critical in helping Singapore build its reputation as a global financial centre.

Over the last few years, Singapore companies have made positive strides in reinforcing the values of good corporate governance, risk management and transparency, which are at the core of financial infrastructure and foundation. While there is room for improvement, it is clear that well-governed entities create sustainable value for organisations and are trusted by investors big and small.

Corporate governance is not a destination. It is a journey where all stakeholders – regulators, directors, management, investors, industry groups and professional bodies – have a part to play. The on-going challenge is for boards and management to continue to embrace the highest standards of governance to meet the increasing expectations of various stakeholders – not just in letter but also in spirit.

As a professional accountancy body with 150,000 members worldwide, CPA Australia believes that good governance is the foundation on which companies build their reputation. It is therefore critical for directors and management to provide effective stewardship for their companies to excel.

This is why CPA Australia is proud to partner well-known governance expert, Associate Professor Mak Yuen Teen FCPA (Aust.), in publishing Volume 3 of this collection of teaching case studies. We are grateful to Associate Professor Mak for supervising and editing the case studies produced by students of the NUS Business School. Our aim is to encourage rich debate and discussion to raise standards of governance and transparency in Singapore and international markets. We hope that this bumper collection of case studies will further serve this purpose and enhance your professional development.

Associate Professor Themis Suwardy FCPA (Aust.)  
Divisional President – Singapore  
CPA Australia

October 2014

# Preface

I started collaborating with CPA Australia on this corporate governance case studies publication in 2012 to address the dearth of good corporate governance cases, especially Asian ones. The response to the first two volumes of this publication has been quite remarkable and beyond our expectations.

We regularly receive requests for permission to use the cases, from universities, professional bodies and other organisations providing training and education in corporate governance, in countries such as Australia, United States, Hong Kong, Malaysia, Philippines, Sri Lanka and Oman. For example, the Australian Institute of Company Directors has used one of our cases for its professional development programmes for directors and is considering using other cases. Chinese University of Hong Kong uses some of the cases for their executive MBA programme. Fordham University Graduate School of Business Administration in New York is using about ten cases for their International EMBA programme.

This third volume is a bumper issue, containing 24 cases from Singapore, Asia Pacific and around the world. This is apt in light of this year being CPA Australia's 60th Anniversary in Singapore.

The cases were written by senior BBA (Accountancy) students in my Corporate Governance and Ethics class. They have shared with me that they have benefited immensely from writing the cases. It gave them an opportunity to develop a deep understanding of corporate governance issues in real companies and situations, and to identify and analyse these issues. The quality of the cases continues to improve. The fact that the best cases are selected for publication, thereby allowing their work to be exposed to a wider audience, provides students with that extra motivation to produce good work.

Although the students in my course produce excellent work, there is still a fairly long process before the cases are published. Each year, I select another group of students to help me with editing the cases. In addition to the usual tasks such as checking accuracy and referencing and correcting for spelling and grammar, they are also expected to update the cases for recent developments if necessary. For this volume, I also hired a very capable editorial assistant, Amanda Aw Yong Zhi Xin, who helped me ensure consistency in format and style across the cases, and further editing. She has been a wonderful help to me. After the student assistants

and Amanda have done multiple rounds of editing, I read through and edit every single case personally, which then results in further amendments, before the cases go to CPA Australia.

I would like to share a bit more about how I use the cases. The cases included in this collection are meant to be self-contained. In other words, the case content and discussion questions should be sufficient to generate rich discussions of issues relating to corporate governance and ethics without having to gather additional information about the companies and situations. They can be assigned to small groups of participants in executive and director education programmes for discussion and debate. For degree-type programmes where the cases are used for analysis and presentation by students and which may constitute part of their course assessment, students can be encouraged to go beyond the content in the cases, and additional discussion questions can be assigned. For example, it may be useful to assign additional questions getting students to discuss how the cases would apply to their own countries and the applicable rules and regulations.

CPA Australia has been a wonderful partner in this initiative. They have been generous in sponsoring the hiring of the student assistants and publication, and very timely and professional in taking the cases forward to the final publication stage.

I would like to thank CPA Australia, all the students who wrote the cases, the student assistants who edited them, and of course, Amanda Aw.

I would like to dedicate this volume to my wonderful family – my always supportive wife, Linda, and my two wonderful children, Lucinda and Dillon – and my parents who taught me the most important value of all, of “doing the right thing”.

I look forward to continuing this fruitful collaboration with CPA Australia for many years to come.

Associate Professor Mak Yuen Teen, PhD, FCPA (Aust.)  
Department of Accounting  
NUS Business School  
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October 2014

# Airocean in Choppy Waters

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## Case Overview

In 2011, three directors of Airocean Group Limited were convicted of market misconduct under the following charges: misleading non-disclosure, misleading statement, and insider trading<sup>1</sup>. The objective of this case is to allow a discussion of issues such as duties of directors, director responsibilities in relation to disclosure of material non-public information, regulation of market misconduct, and enforcement of director duties.

## About Airocean

Airocean was a freight forwarding service provider, with airfreight offices in Singapore, Malaysia, Indonesia, Australia, Hong Kong and the United States. Prior to 2007, it boasted an extensive network of 78 exclusive overseas agents and 46 non-exclusive overseas agents spread over 50 countries<sup>2</sup>.

On 11 December 2006, Airocean was delisted from the Singapore Stock Exchange (SGX) and became a subsidiary of A-Sonic Aerospace Limited<sup>3,4</sup>.

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This is the abridged version of a case prepared by Chua Woon Peng, Ervan Calviano Hudyono, Yang Yibo and Ysabel Tan Shiwen under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Chloe Chua under the supervision of Professor Mak Yuen Teen.

## **Board of Directors**

The board had six directors, with three executive directors and three independent directors. The executive directors were Thomas Tay (Chief Executive Officer), Johnson Chong (Chief Operating Officer) and Paul Dunn. The three independent directors were Ong Chow Hong, Ong Seow Yong and Peter Madhavan. Ong Chow Hong also served as Chairman of the board.

## **The Trouble Begins<sup>5</sup>**

On 6 September 2005, the Corrupt Practices Investigation Bureau (CPIB) interrogated Airocean CEO Thomas Tay regarding two of Airocean's subsidiaries – Airlines GSA and WICE Logistics. Upon learning of the investigations, COO Johnson Chong and independent director Peter Madhavan called an urgent board meeting on 7 September 2005 to decide on the company's next course of action. Although several key personnel –i.e., Chong, Madhavan, S.Y. Ong, and Doris Koh (Director of Finance at Airocean) – attended the meeting, there was no conclusion or plan of action. Thus, they agreed to engage Senior Counsel Chelva Rajah from law firm TRC to advise them on the proper course of action. Rajah did not personally follow up on the engagement but sent his partner, Imran Hamid Khwaja, to deal with the situation instead.

On 7 September 2005, Tay was arrested for bribery under Section 6(b) of the Prevention of Corruption Act, but was released on bail that very night. Thereafter, he met up with Madhavan and Chong who had both gone to look him up at his house after his release.

The next day, on 8 September 2005, a formal board meeting was held with S.Y. Ong, Tay, Chong and Madhavan in attendance. The independent Chairman C. H. Ong and the legal counsel TRC did not attend both board meetings held on 7 and 8 September. The board decided that no action needed to be taken. Mr Khwaja from TRC later conducted interviews with the parties involved in the CPIB investigation on 8, 9 and 16 September 2005.

In late September, Chong sold a total 2,015,000 Airocean shares. He also bought over 3,000,000 shares from Tay in November<sup>6</sup>.

On 25 November 2005, the Straits Times published an article titled “Airocean’s chief executive Thomas Tay under CPIB probe”. SGX called up Airocean’s company secretary Ang Lay Hua to request for an announcement to explain the Straits Times article. As an announcement could not be made before trading started, Airocean applied for a trading halt as requested by SGX. C.H. Ong informed Ang that he would be agreeable to any announcement that Madhavan approved.

Madhavan then drafted an announcement – a move he explained as giving Khwaja a head start. He sent the announcement to Khwaja who amended the announcement and sent it back to Madhavan. Madhavan later revised the edited draft and circulated it to Chong, S.Y. Ong and Tay for final changes before it was sent out via SGXNET. The announcement is reproduced below.

**Clarification of Straits Times article on 25 November 2005  
(via SGXNET on 25 November 2005)<sup>7</sup>**

“We refer to the article entitled “AIROCEAN’S CHIEF EXECUTIVE THOMAS TAY UNDER CPIB PROBE” which appeared in the 25 November 2005 issue of the Straits Times.

The Company learnt of the CPIB investigations with regard to practices of some other companies in the Aircargo Industry sometime in early September 2005 when the Company’s CEO Mr. Thomas Tay was called for an interview by the CPIB.

The Company was advised by Mr. Thomas Tay that he provided Statements to the CPIB and offered his full co-operation.

The Company also immediately appointed Solicitors to ascertain the nature of the investigations and advise the Company of its Corporate obligations and compliance.

The Company was, inter alia, advised by Counsel that the scope of the CPIB investigations was uncertain but on the information presently available, there did not appear to be any impropriety on the part of the Company or its CEO Mr. Thomas Tay.

Further, since then the CPIB has not made any allegations of impropriety against the Company or its CEO Mr. Thomas Tay.”

On 28 November 2005, Khwaja advised the board to meet up as soon as possible and gave written legal advice stating that Airocean was not obliged by law to provide any announcements with regards to the CPIB investigation.

SGX was not satisfied by the announcement made by Airocean and asked for further clarification during a meeting with Tay and Madhavan on 1 December 2005. Airocean then released another announcement drafted by S.Y. Ong that evening without consulting TRC.

On 2 December 2005, the Commercial Affairs Department (CAD) raided the premises of Airocean and commenced investigation of the company and its directors. Later that night, Airocean released a final announcement on the incident on SGXNET (See below).

### **Airocean announcement on SGXNET dated 2nd December 2005<sup>8</sup>**

“The Board of Directors of Airocean Group Limited (“Company”) wishes to announce that the Commercial Affairs Department (“CAD”) has instituted investigations into alleged disclosure contraventions under the Securities and Futures Act (Cap 289) relating to announcements made by the Company on 25 November 2005 and 1 December 2005 on the article “Airocean chief executive Thomas Tay under CPIB probe” published in the Straits Times on 25 November 2005. The Board of Directors today attended an interview at the office of CAD.

The Board of Directors will closely monitor the situation and will keep shareholders informed accordingly.

In respect of yesterday’s announcement (announcement NO. 112 of 1 December 2005), the Board of Directors, at the request of SGX, wishes to clarify that Mr. Thomas Tay and three (3) officers of the Company’s subsidiaries were interviewed by the Corrupt Practices Investigation Bureau (“CPIB”) in September 2005. The interview concerned two (2) transactions involving the Company’s subsidiaries with other companies in the air cargo industry.”

### ***Decisions by the Court<sup>9</sup>***

Five of the six Airocean Directors were tried and sentenced. On 13 August 2009, Tay was found guilty of attempted bribery and was fined<sup>10</sup>.

C.H. Ong was charged under Section 157(1) of the Singapore Companies Act due to his failure to use reasonable diligence in the discharge of his duties of his office as a director. The court found that he had approved the release of the announcement on 25 November 2005 to the SGX-ST without sight or knowledge of the contents of the announcement. The court held that he was guilty of the offence, and imposed a fine of S\$4,000 and a disqualification order that would prevent him from taking part in the management of a company for one year.

On 29 March 2011, Chong, Madhavan and S.Y. Ong were tried in the same hearing. Madhavan faced two charges, namely the failure to notify SGX on Tay's investigation, and the release of false public announcements to stabilise market prices. He was sentenced to four months' imprisonment and a total fine of S\$120,000.

Chong faced similar charges, and in addition, three other charges related to insider trading. He was fined a total of S\$280,000 and sentenced to six months' imprisonment in relation to his five charges.

S.Y. Ong was also charged for releasing a false public announcement to stabilise market prices. For this charge, a S\$170,000 fine was imposed.

In addition to the punishment mentioned above, Madhavan, Chong and S.Y. Ong were also disqualified from holding office as a director for five years.

For the same charge, Madhavan's sentence was heavier than that meted out to Chong and S.Y. Ong. This was because the other Airocean directors had held Madhavan in greater regard when it came to matters relating to legal proceedings, since he was a lawyer<sup>11</sup>. Furthermore, the court also held that Madhavan was the most active in making the misleading statement since he had been the one consulting the external counsel, and had drafted and prepared the announcement<sup>12</sup>. Therefore, the court found Madhavan to be the most culpable and imposed a harsher sentence.

### ***Appeal Made***

Subsequent to the judgement by the District Judge (DJ), Madhavan, Chong and S.Y. Ong made an appeal against their convictions. The case was heard before the High Court by Chief Justice Chan Sek Keong (CJ).

First, CJ analysed the charges on the non-disclosure. He found that there was insufficient evidence to show that the information regarding Tay's investigation by CPIB would, beyond reasonable doubt, "materially affect the price or value of Airocean shares"<sup>13</sup>. One reason was that Tay had not been charged with any offence at that point in time. More importantly, Airocean's turnover had increased by over S\$700 million in 2005<sup>14</sup>. Furthermore, the share price movements were considered to be reasonable over a period of time. Hence, CJ ruled that the information was not materially price sensitive and need not be disclosed<sup>15</sup>.

Second, in their defence against allegations that they were reckless in issuing the announcements, the directors said that they had simply relied on the legal advice given to them. The DJ believed that the decision of Airocean to rely on the legal advice from its legal counsel without asking for the underlying reasons was reckless. However, the CJ argued otherwise, saying, "clients have no duty to question their lawyer's advice and it would not be reasonable to expect or require them to do so, unless the advice is manifestly absurd, irrational or wrong". The CJ further explained the fact that Airocean sought for immediate legal advice showed that they were acting appropriately.

Concerning the misleading disclosure charge, CJ believed that the announcement made on 25 November 2005 was indeed misleading. However, it was not materially misleading to the extent that: (i) it was likely to significantly affect the price of Airocean shares, and (ii) to be deserving of the sentence in the prior conviction. Hence, the appeal against the misleading disclosure charge was accepted<sup>16</sup>.

C.H. Ong also made a separate appeal regarding the disqualification order barring him from taking part in management of any company for a period of one year. However, V. K. Rajah JA, who heard the appeal case, believed that the disqualification order imposed by the DJ was not adequate. He believed that apart from being "punitive" in nature, the disqualification order must also be "protective". Given that C.H. Ong had failed to recognise the severity of the circumstances and to react appropriately, Rajah JA felt that C.H. Ong should not hold directorship positions where "perceptive judgements are fundamental"<sup>17</sup>.

In summary, the convictions and disqualification orders in connection to the non-disclosure and misleading disclosure charges of Madhavan, S.Y. Ong and Chong were set aside. Regarding Chong's other charges, the CJ upheld the decision of the DJ on the insider trading, but reduced the sentence to only a fine of S\$200,000

while the previous disqualification order was still upheld. C.H. Ong's appeal was dismissed separately and his disqualification order was increased to 24 months<sup>18</sup>.

### **Further Acquittal<sup>19</sup>**

A year after the appeal that saw the acquittal of directors Madhavan, S.Y. Ong and Chong, charges against Airocean chief Thomas Tay were dropped at the prosecution's initiative. Deputy Public Prosecutor (DPP) Peter Koy explained that the facts leading to Tay's conviction had been found lacking in light of rulings in the appeal case. Thus it would be a "serious injustice" for Tay to remain convicted while the other three were acquitted. On 4 October 2013, Tay's conviction was set aside and his S\$240,000 fine for non-disclosure and false statement offences were refunded.

## **Discussion Questions:**

1. Based on the successful appeal, information that could materially affect the share prices of the company should be disclosed to the SGX. What are the challenges in implementing such a rule?
2. Refer to the initial decisions made by the court. Do you think that the sentence for Independent Chairman C.H. Ong is excessive, fair or inadequate? In your opinion, what are the possible implications of such a ruling?
3. What do you think are the implications of the appeal that overruled the initial convictions, for corporate governance? In your view, do you think the appeal decision was fair?
4. In light of the judgment by the High Court, many say that it is harder to prosecute independent directors for breach of their duties ("Harder to prosecute IDs in wake of Airocean ruling," The Business Times Singapore, 6 August 2012). Do you agree? Do you think that the law should be reformed to make it easier to take enforcement actions against companies and directors for failure to disclose market sensitive information?
5. With respect to Airocean's non-disclosure on the CPIB investigation on the company's CEO Thomas Tay, Madhavan argued that Airocean had to act cautiously as any misjudged disclosure could be detrimental to Airocean and its investors. Do you agree with him? Discuss to what extent you think a company should disclose sensitive information which may adversely affect the share price.

## Endnotes

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- <sup>16</sup> *Ibid.*
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# A Brewing Takeover Battle for F&N

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## Case Overview

Thai Tycoon, Charoen Sirivadhanabhakdi, initially bought an 8.6% stake in Asia Pacific Breweries (APB) and a 22% stake in F&N from the open market. This prompted Heineken, the largest shareholder of APB, to start a bidding war for APB by making an offer for F&N's entire 39.7% stake in APB. Charoen eventually gave in to Heineken in exchange for Heineken's promise to not bid for F&N's shares. F&N's sale of its prized asset, APB, to Heineken eventually sparked off a huge battle between Charoen and Overseas Union Enterprise's (OUE) for F&N's soft drink and property assets. Ultimately, Charoen won the takeover battle with the withdrawal of his former bidding rival OUE, after he raised his offer from his earlier bid of S\$8.88 per share. The objective of this case is to allow discussion of issues such as takeovers and the role of regulators, board composition and the role of the board in takeovers.

## F&N: 130 Years Of Rich History

Fraser and Neave ("F&N") was established by John Fraser and David Neave in 1883<sup>1</sup>, and has since established itself as a household name to many, and as a leader in the food & beverages arena in Singapore and Malaysia. Beyond soft drinks, it also ventured into the brewing business with the Netherlands' Heineken, jointly setting up Asia Pacific Brewery (APB) and the Tiger brand beer in 1931<sup>2</sup>. It also diversified into property and publishing businesses.

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This is the abridged version of a case prepared by Cui Chunhao, Lei Xianhong, Neo Sze Ying, and Yeo Hui Ying under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Amanda Aw Yong under the supervision of Professor Mak Yuen Teen.

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F&N is currently listed on the Singapore stock exchange<sup>3</sup>; as of 2012, F&N boasted a market capitalisation and total assets of over S\$13 billion and S\$14 billion respectively. According to the company, it has all along operated on the basis that good corporate governance is crucial to the continuous maximisation of long-term shareholder value<sup>4</sup>, and the company has been showing consistently strong financials. F&N's revenues in 2012 stood at S\$5.57 billion, with a profit of S\$952 million<sup>5</sup>.

### Composition Of The Board

Sitting on the F&N Board were two directors who were linked to companies that were substantial shareholders of F&N. Koh Beng Seng who was a non-executive independent director at F&N was also a director at Great Eastern Holdings, which was a former substantial shareholder of F&N that sold its shareholdings to Charoen on 18 July 2012<sup>6</sup>. Mr Hirotake Kobayashi was a nominee director of F&N, and simultaneously held the position of Managing Director of Kirin Holdings, which was another substantial shareholder of F&N<sup>7</sup>. Among the independent directors, Ho Tian Yee had been independent director for 14 years and 10 months (as at December 2012), while Nicky Tan Ng Kuang had been independent director for 8 years and 11 months (as at September 2012)<sup>8</sup>.

### Crouching Tiger, Hidden Charoen

Charoen Sirivadhanabhakdi, a Thai billionaire<sup>9</sup>, was eyeing the potential synergies stemming from the brewing, beverage and property businesses<sup>10</sup>. In June 2012, he met OCBC's Chairman Cheong Choong Kong, CEO Samuel Tsien, and Fang Ai Lian, Chairman of the bank's insurance unit Great Eastern Holdings, to convince them to sell F&N's shares<sup>11</sup>. Negotiations took almost a month and finally, on 18 July, OCBC, Great Eastern Holdings ("GEH") and Lee Rubber (all controlled by the Lee family) agreed to sell their combined 22% stake in F&N for S\$8.88 per share to Thai Beverage ("ThaiBev")<sup>12</sup>. ThaiBev is a company controlled by TCC Assets Limited ("TCC"), which is in turn owned by Charoen<sup>13</sup>. Part of this package deal is the agreement that the three companies will also sell their combined 8.6%<sup>14</sup> stake in APB at S\$45 per share to Kindest Place Groups Limited ("KPGL"), a company belonging to Chotipat, who is Charoen's son-in-law<sup>15</sup>. The announcement, however, startled Heineken and forced its hand in starting a takeover bid for APB—F&N's most prized asset.

## **Tiger, Tiger, Burning Bright**

APB was established as a joint venture between Heineken and F&N, and with Tiger Beer as its flagship product<sup>16</sup>. First produced in 1932, Tiger Beer has won over 40 international awards and accolades, and a strong brand recognition has led to its continued popularity in both Asia Pacific and globally<sup>17</sup>.

Afraid that Charoen (who was then the new major shareholder) may end up forcing F&N to pursue a different strategy for APB, Heineken offered a buyout of the total direct and indirect 40% stake that F&N owned in APB at S\$50 per share on 20 July<sup>18</sup>. If F&N's shareholders were to agree to this deal, Heineken's stake in APB would increase to 81.6%, allowing it to gain full control of APB<sup>19</sup>.

Charoen launched a counter-offer on 7 August (via KPGL) to purchase F&N's direct 7.4% stake in APB at S\$55 per share - a 10% premium over Heineken's offer price<sup>20</sup>. If successful, this effectively increases Charoen's stake in the beer maker to 15.9%. The F&N board, which had earlier accepted Heineken's offer (subject to shareholders' approval), announced that it will now evaluate Charoen's higher offer.

Heineken retaliated on 18 August, making a final offer of S\$53 per share for F&N's stake in APB<sup>21</sup>. However, this offer was still lower than KPGL's offer of S\$55 per share. Heineken then claimed that this was because "[t]he unsolicited offer is not comparable to the Heineken Offer", since Heineken was offering S\$5.59 billion for a 39.7% stake in APB whereas KPGL was offering only S\$1 billion for a 7.3% share of APB<sup>22</sup>.

In an apparent reversal of his original intentions, Charoen announced on 19 September that he would support Heineken's offer for APB's stake in exchange for Heineken's promise to not bid for F&N<sup>23</sup>. Hence, the APB battle ended on 28 September when F&N shareholders passed a resolution to divest the company's interest in APB to Heineken.

## **Giving Up The Trees For The Forest**

While APB was a significant profit-driver for F&N<sup>24</sup>, all was not lost for Charoen. Even without APB, F&N still had other business segments such as the non-alcoholic beverage business and the real estate business<sup>25</sup>. In fact, Charoen appeared to have cleverly made use of the APB battle as a smokescreen for his ultimate takeover bid for F&N.

In the midst of the battle for APB, Charoen had quietly increased his shareholdings in F&N to over 30%. This triggered a mandatory cash offer of S\$8.88 per share<sup>26</sup> by TCC for all the issued and paid up ordinary F&N's shares on 13 September<sup>27</sup>. After Charoen struck the deal with Heineken to not make a bid for F&N, it no longer appeared as though there will be any more likely contestants, and he looked set to be the only bidder for F&N.

## A New Challenger Appears

Just as things appeared to be going smoothly for Charoen, a new competitor presented itself in the form of Overseas Union Enterprise Limited (OUE), which is a company controlled by the Riady family<sup>28</sup>. OUE was interested in F&N's leading integrated property businesses, which are complementary with its existing property portfolio<sup>29</sup>.

To help its pursuit of F&N, OUE approached Japan's Kirin Holdings Co ("Kirin") - F&N's second largest shareholder with a 14.76% stake. Kirin is in the F&B industry and would be interested in F&N's F&B business segments, while OUE's core business is in property and would be mainly interested in F&N's property business<sup>30</sup>. Dividing the deal would enable OUE to maximise the use of its finances as well as minimise its upfront cost.

On 15 November, OUE made a counterbid to purchase the entire 85.2% of F&N's shares at S\$9.08 per share (totalling S\$13.1 billion); Kirin would buy over F&N's food and beverage business for S\$2.7 billion if OUE's bid was successful. This counter-offer signalled the start of a second bidding war - the battle for F&N.

## A Make Or Break Behind The Scenes

During the bidding war, it was revealed that F&N's nine-member board actually incentivised OUE with a break fee of up to S\$50 million. This break fee was to cover OUE's takeover expenses and will be paid to OUE in the event that they lose the bid<sup>31</sup>. In short, the break fee ensured that OUE has nothing to lose in either situation<sup>32</sup>.

Apparently, this was not the first time that the F&N board had offered a break fee to Charoen's competitor. Heineken also had a break fee clause in its revised offer for APB, which set aside over S\$56 million to be paid to Heineken in the event that shareholders do not approve of the APB takeover, or if the F&N board does not recommend the offer, or fails to fulfil its other obligations<sup>33</sup>.

Therefore, it appeared as though the board had shown favouritism to Charoen's competitors. The F&N board defended itself by saying that the break fee was to "create a competitive bid situation, thereby maximising value for shareholders"<sup>34</sup>.

## Breaking The Deadlock

F&N's independent directors considered both Charoen and OUE's bids as "not compelling, but fair"<sup>35</sup>. Meanwhile, both parties refused to budge and instead extended the deadline of their offers several times. The impasse saw the SGX introduce, for the first time, an auction process to resolve the stalemate. SGX set a deadline of 20 January 2013 for both companies to make a final offer, and an auction process will be held if the stalemate remained<sup>36</sup>.

On 18 January, two days before SGX's mandated deadline, Charoen revised his mandatory cash offer to S\$9.55 per share<sup>37</sup>, thereby exceeding OUE's bid. Unexpectedly, the 20 January SGX deadline passed without OUE raising its bid. Thereafter, OUE withdrew its bid, citing the recent cooling measures in Singapore's property market as the rationale<sup>38</sup>.

Even so, Charoen continued to acquire shareholdings of F&N<sup>39</sup> from various shareholders and the open market before TCC's offer expired. His efforts finally paid off on 31 January, when he achieved 50.92% ownership of F&N and became the majority shareholder of F&N. This made his takeover offer unconditional<sup>40</sup>, and further ensured that even if anyone else bids for F&N, he would be the deciding factor in the bid.

Subsequently, four members of the F&N board of directors who owned F&N shares, Lee Hsien Yang, Timothy Chia Chee Ming, Tan Chong Meng, and Nicky Tan Ng Kuang, expressed their intention to accept the revised TCC's offer to buy their shares<sup>41</sup>. Kirin also agreed to sell its 14.76% stake to TCC for approximately S\$2 billion<sup>42</sup>. All of these boosted Charoen's control of the drinks and property group to 82.59%<sup>43</sup>.

## Nothing To See Here, Let's Go Home

In a surprise move before the dust had fully settled, F&N's directors said its entire board would resign en masse after the closure of Charoen's offer<sup>44</sup>. Chairman Lee said at the AGM on 29 January that this changing of guards would allow Charoen "a free hand to appoint a board to chart a course forward for the company"<sup>45</sup>.

The directors' resignation came into effect on 27 February 2013, with Thapana and Chotiphat being appointed to the board on the very same day<sup>46</sup>.

And so, Singapore will now witness a local historic brand switch over to foreign ownership.

## Discussion Questions

1. Would you consider the takeover of F&N hostile? Can you identify any takeover defence mechanisms implemented here? How would the situation change if the takeover took place in the U.S.?
2. Do you think the board composition was appropriate? Do you think the board acted reasonably during the whole takeover proceedings?
3. What regulatory bodies are involved in overseeing takeovers in Singapore and what are their roles?
4. Explain whether you think F&N's offer of break fees to both of Chaoren's competitors in both takeovers is appropriate.
5. "F&N (shares) have been held by families for generations. We are losing it to a foreign company so it's a bit sad," Mr Michael Tay, 55, told The Straits Times on the sidelines of the meeting. If you were a minority shareholder of F&N, how would you feel on knowing that the entire board resigned en masse upon the takeover of F&N? Do you think your interests were adequately protected?

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# Hong Fok Corporation: The Badger and The Bear

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## Case Overview

The long-standing frustration of minority shareholders of Hong Fok finally burst out during the AGM held on 26 April 2012. The battle between minority shareholders and the Cheong family, which is the controlling shareholder of Hong Fok and also dominated the company's board and management, triggered significant media coverage and queries from the Singapore Exchange (SGX). The objective of the case is to allow a discussion of issues such as corporate governance and minority shareholder rights in family-controlled companies; the entrenchment of the founding family in ownership, management and the board; role of regulators in protecting minority shareholders, with respect to excessive remuneration and interested person transactions; and the enforcement of good corporate governance practices in general.

## The Story Of The Cheong Family

The Cheong family established their footing in the real estate industry as early as the 1950s, during which it owned properties in Singapore and several other South East Asian countries, including Indonesia and Malaysia<sup>1</sup>. On 15 December 1967, the Cheong family founded another business, International Hotel Private Limited, to become the developer and owner of the Singapore Hyatt Hotel. As the business of the company shifted towards property development and investment, it was renamed

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This is the abridged version of a case prepared by Cao Hui, Luo Jing, Wang Lu Yang and Wang Ruo Xi under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Ng Jun Yan under the supervision of Professor Mak Yuen Teen.

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as Hong Fok Corporation Limited (Hong Fok) on 15 August 1980. On 8 July 1981, Hong Fok filed for an initial public offering and was officially listed on the Singapore Exchange Securities Trading (SGX) and Stock Exchange of Hong Kong (SEHK). Although it was de-listed from the SEHK on 15 July 1992, it remains listed on SGX till this day. The company currently holds a number of premium commercial and residential properties in Singapore, among which the residential property Concourse Skyline is the only on-going development project.

## About Hong Fok

Today, the Cheong family still maintains control over the company by holding more than 50% of Hong Fok's shares directly or indirectly. The family members are also actively involved in running the company. Cheong Kim Pong has been the CEO of Hong Fok since 13 January 1968. Up till 31 January 2014, he also held the positions of Chairman of the Board and Managing Director<sup>2</sup>. Cheong Puay Kheng, Ms Cheong Loo Kheng and Cheong Aik Yen, who are all siblings of Cheong Kim Pong, held positions as the Hong Fok Vice President of Administration and Personnel, Vice President of Property Maintenance and Personal Assistant to Directors respectively.

As of 31 December 2011, the board comprised of four executive directors and three non-executive directors. Besides Cheong Kim Pong, the other three executive directors were also from Cheong family, namely Cheong Pin Chuan, Cheong Hoi Kheng and Cheong Sim Eng, who are brothers and sister of the chairman. The three non-executive directors, Jackson Lee, Tan Tock Han, Lai Meng Seng, were designated as independent directors. Among them, Tan Tock Han is the brother-in-law of the four executive directors, and Jackson Lee had served the board since his first appointment in 1976.

Until 2011, the board only had an audit committee. The board disclosed that the absence of a nominating committee was firstly, due to low board turnover and secondly, due to the fact that the nomination as well as appointment of new directors would be decided by the board as a whole<sup>3</sup>. Similarly, the board did not have a remuneration committee but instead informally assessed individual director and senior management personnel's performance<sup>4</sup>.

## The Controversial AGM

On 26 April 2012, Hong Fok held its Annual General Meeting (AGM) for Financial Year ended 31 December 2011 (i.e. FY2011). During the meeting, minority shareholders questioned the absence of dividend payments since 2007 despite increasing revenue, the high remuneration paid to four executive directors in excess of S\$10 million in the past few years, and profit recognition for its flagship project, the Concourse Skyline<sup>5</sup>.

The debate between minority shareholders and board further intensified when the chairman Cheong Kim Pong requested for a change of voting methods mid-way. Minority shareholder Mr Mano Sabnani later complained to Business Times, "... shareholders rejected the directors' report and the audited results by show of hands... so chairman proposed that all the resolutions be put through the poll"<sup>6</sup>.

Such change angered minority shareholders and some left before voting for other resolutions<sup>7</sup>. However, the AGM continued with the remaining shareholders and all resolutions were passed by poll almost unanimously.

## SGX Queries

On 27 April 2012, SGX requested Hong Fok to explain its switch of voting methods and its remuneration policies. It also asked Hong Fok to post its AGM minutes on SGXNET for all shareholders.

Within the same day, Hong Fok clarified that the voting was validly conducted based on the Company's articles of association, as the chairman proposed the switching before the result of the show of hands was declared and pointed out that voting by poll was encouraged by SGX itself<sup>8</sup>. Hong Fok further explained that voting by poll was consistent with the fundamental premise that shareholders should be accorded rights proportionate to their shareholding and economic interest at stake.

Reiterating that the absence of a remuneration committee was already disclosed in annual report, Hong Fok reasoned that publicly available information such as reports by the Singapore National Employers Federation was used to benchmark director and management's compensation.

However, Hong Fok resisted SGX's request to post the meeting minutes by citing provisions in the Companies Act<sup>9</sup>. This was the latest case of a listed company seeming to resist SGX's request. According to SGX's lawyer, companies and directors were contractually obliged to comply with SGX directives, even though SGX was not a statutory body<sup>10</sup>.

On 30 April 2012, SGX requested Hong Fok to confirm whether there was any material information disseminated at the meeting that required a public dissemination via SGXNET. Hong Fok confirmed that there were none.

## **The Fight Against Oppression**

Not long after the AGM, one of Hong Fok's minority shareholders developed a website named "HONGFOKminorities" hosted on wordpress.com in May 2012. The website was titled "fight against shareholder oppression" and primarily contained minority shareholders' posts that documented evidence of the company's actions for possible future legal actions<sup>11</sup>.

## **The Missing Dividends**

Hong Fok declared its last dividend of 6 cents per share back in FY2007<sup>12</sup>. No cash dividends were declared between FY2008 and FY2011, although revenue of the company increased from S\$58 million to S\$129.2 million. For FY2011, Hong Fok declared a 5-for-1 bonus issue instead.

During the AGM, minority shareholder Mano questioned the lack of cash dividends. The board explained that Hong Fok intended to conserve cash to finance on-going projects such as the Concourse Skyline Project and other upcoming projects. They clarified that the profit in FY2011 was mainly derived from the revaluation gain of investment properties. Mano was not fully convinced and reiterated that Hong Fok should reconsider paying cash dividends. Another shareholder expressed that he had made a similar request for dividends back in 2009 and was told the same answer - that dividends would be deferred to future years.

## Directors And Executives' Remuneration

Mano also questioned the excessive remuneration paid to executive directors, especially considering the lack of dividends and a remuneration committee. Another minority shareholder cited that directors were paid highly even when Hong Fok was making losses. However, their opposition to directors' remuneration by show of hands was over-riden when the chairman the requested to switch to voting by poll<sup>13</sup>.

On 28 April 2012, Teh Hooi Ling from the Business Times also expressed her concern over Hong Fok's director remuneration. She concluded that Hong Fok paid its directors substantially more than another publicly listed local real estate company Hotel Property Limited (HPL), although Hong Fok had much lower market capitalisation, group assets and profits compared to HPL<sup>14</sup>.

Disgruntled by the board's action, minority shareholders posted on the "HONGFOKminorities" website in June 2012 that cumulative remuneration paid to the four executive directors amounted to S\$43 million from 2007 to 2011, almost 3.23 times the cumulative company's profit after tax, after excluding revaluation gains or losses<sup>15</sup>.

## The Flagship Project Concourse Skyline

Strategically located near major city attractions such as Gardens by the Bay<sup>16</sup>, Concourse Skyline will offer 360 luxury residential units upon completion at end of 2013<sup>17</sup>.

In September 2008, Hong Fok launched the first phase of Skyline Concourse, with 90 residential units released for sale. Executive Director Cheong Sim Eng believed that the property is "priced-to-sell" and was confident of demand<sup>18</sup>. Indeed, more than 70% of the units released were sold within a week, with the average price ranging from S\$1,500 to S\$1,800 per square foot as targeted<sup>19</sup>.

Between 2008 and 2010, the Cheong family members bought a total of 23 residential units from Concourse Skyline at a 3% discount. All units bought were located on 296 and 298 Beach Road with unobstructed sea views. Hong Fok disclosed these interested person transactions (IPTs) in the Director's Report<sup>20</sup>. These IPTs amounted to S\$12,034,557 in 2008, S\$12,034,557 in 2009 and S\$6,442,740 in 2010<sup>21</sup>.

During the controversial AGM for FY2011, minority shareholders enquired about the profit earned for the 230 units sold (i.e. 64 % of total units), but the board did not address their queries promptly. Deeply frustrated, minority shareholders again turned to the website HONGFOKminorities to air their grievances in June 2012, questioning the inconsistency between the profit booked and the percentage of completion<sup>22</sup>.

Minority shareholders' anger further escalated after announcement of Q2 2012 results on 14 August 2012. The reported earnings of S\$3.72 million were far below estimates of S\$127.6 million based on 64% units sold for Concourse Skyline<sup>23</sup>, and they wrote to SGX for assistance.

On 17 September 2012, SGX replied by reassuring minority shareholders that it had highlighted its concern to Hong Fok. SGX further provided the contact of Hong Fok Company Secretary for minority shareholders to directly raise their concern with the company<sup>24</sup>.

## The Aftermath

On 31 July 2012, Hong Fok announced that Ms Cheong Loo Kheng, Vice President for Property Maintenance, resigned to pursue other interests<sup>25</sup>. The company also declared a dividend of 0.6 cents per share for FY2012. On 30 March 2013, Hong Fok announced that it would appoint Mr Chow Yew Hon as an independent director and Mr Jackson Lee as the Lead Independent Director of the company. It further disclosed that a nominating committee and a remuneration committee would be established, both with Mr Chow Yew Hon serving as chairman, and with Mr Jackson Lee and Mr Tan Tock Han as members. The company also renamed its audit committee to an audit and risk management committee<sup>26</sup>.

## Discussion Questions

1. What are the benefit(s) and drawback(s) of voting by a show of hands compared to voting by poll? In your opinion, was the change of voting methods during Hong Fok's AGM legitimate and fair to minority shareholders?
2. Evaluate the board composition and structure of Hong Fok for FY2011. In your opinion, how might the announced changes (e.g. the appointment of independent directors, set-up of nomination committee and remuneration committee, etc.) on 30<sup>th</sup> March 2013 affect the corporate governance of Hong Fok?
3. In the case of Hong Fok, were the levels of directors' remuneration appropriate? Currently, what are the available safeguards against excessive directors' and management's remuneration?
4. In your opinion, was the interference by SGX sufficient or effective? What is the role of SGX in protecting minority shareholders?
5. Compare the SGX listing rules with that of the Stock Exchange of Hong Kong with regard to Interested Person Transactions (IPTs). Which stock exchange provides more effective safeguards for minority shareholders against IPTs?
6. In many Asian countries, family-controlled companies are very common. What are the key challenges in fostering good corporate governance in such companies?

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# Olam in Muddy Waters

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## Case Overview

In 2011, CLSA, a leading brokerage and investment group in Asia, started questioning Olam's accounting practices, specifically with regards to the latter's Nigerian export incentives, differences between its earnings announcements and annual reports, and negative Economic Value Added. This was followed by a much more critical attack by Muddy Waters in 2012. Olam responded by filing a lawsuit against Muddy Waters, and a heated debate ensued in the following months. Eventually, the lawsuit was dropped and Temasek Holdings showed its support for Olam by raising its stake to 24%, while Muddy Waters gained from short-selling Olam's stocks during this period. The objective of this case is to allow a discussion of issues such as accounting for intangibles and fair value accounting, whistle blowing, conflict of interests, ethics, and shareholder communication.

## Olam International Limited (“Olam”)

Olam is a leading global integrated supply chain manager and processor of agricultural products and food ingredients, supplying products across 16 platforms in 65 countries<sup>1</sup>. It was established in 1989 by the Kewalram Chanrai (“KC”) Group, to set up a non-oil based export operation out of Nigeria. Its headquarters was later relocated to London and subsequently to Singapore, where it was incorporated in July 1995 and became publicly listed on the SGX mainboard in February 2005<sup>2</sup>.

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This is the abridged version of a case prepared by Adrianus Steffan, Brandon Teo, Chiang Teck Chuan, Felicia Peh, and Ng Tong Hin under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Amanda Aw Yong under the supervision of Professor Mak Yuen Teen.

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Olam's current CEO, Sunny Verghese, has been with the KC Group for two decades. He was tasked to start Olam back in 1989 and has won several awards since; the most notable being "Best CEO of the Year 2011" at the Singapore Corporate Awards. The Olam Board also won the Best Managed Board Award that same year.

## **Muddy Waters Research LLC ("MW")**

Carson Block, the Founder and Research Director of MW, started the business with the aim of exposing publicly traded companies that are sub-par but trading at inflated values<sup>3</sup>. MW has been well known for spotting accounting fraud practices in Chinese companies listed in North America.

In 2012, MW had focused its attention on Olam, putting Olam's accounting practices under the microscope. Olam quickly found itself on the defensive, and like two boxers in a ring, both companies continued taking jabs at each other in a war of words that over a period of five months.

## **CLSA Raises Discrepancy Issues**

Doubts were first cast on Olam financials on 21 February 2011, when CLSA questioned Olam's profitability and accounting. This drove Olam's share price to S\$2.56, down from S\$2.89, over a period of two days<sup>4</sup>. Olam hit back with its own Clarification Report on 23 February 2011 and by the end of the week, its share price recovered to S\$2.67. Three contentious issues were raised by CLSA:

### **1. Nigerian Export Incentives ("NEI")**

CLSA's report claimed that NEI accounted for 30%-40% of Olam's profits, and questioned the sustainability of Olam's earnings should the incentives be withdrawn. Olam strongly disagreed with CLSA, explaining that almost all of the NEI were passed on to suppliers and thus did not directly flow to Olam's profits<sup>5</sup>. Besides, the company was well diversified across 65 countries, with Nigeria's share of total profits being in single digits.

### **2. Reporting Differences Between Results Announcements And Annual Reports**

CLSA noticed that there had been reporting differences in several accounts, for example, Cash Balances and Capital Expenditure (CapEx), between Olam's

announced results and annual report over a few financial years. Olam explained that the ‘reporting differences’ were presentation differences arising mostly from reclassifications in the consolidation process when preparing Olam’s annual report<sup>6</sup>. Olam further stressed that the reporting differences had no impact on its P&L, nor did they result in any material changes in the financial statements.

### **3. Negative Economic Value Added (“EVA”)/ Economic Profit (“EP”)**

Olam also refuted CLSA’s claim that it was generating a negative EP. In Olam’s Clarification Report, the EP generated by the company for FY2008-2010 was disclosed to be positive<sup>7</sup>.

With the Clarification Report, Olam seemed to have effectively addressed the concerns raised by CLSA. However, DBS believed that going forward, there was a need for Olam to (1) strengthen its consolidation process and (2) provide more detailed disclosure<sup>8</sup>.

## **Muddy Waters Draws First Blood**

More than a year later on 19 November 2012, Block spoke about Olam at the Ira Sohn Investment Conference in London, questioning Olam’s finances and accounting practices. Block went on to accuse Olam of dishonesty and predicted that it will fail<sup>9</sup>.

Expecting MW to release its report detailing the allegations, Olam requested for a trading halt the next day to allow the company a few hours to react<sup>10</sup>. By late afternoon, however, there was no sign of the anticipated report. The trading halt was thus lifted<sup>11</sup> and Olam’s share price plunged 7.47% from S\$1.74 to close at S\$1.61.

## **Olam Files Lawsuit**

Olam took further action by filing a petition with the High Court of Singapore against MW and Block on 21 November 2012<sup>12</sup>. Olam intended to sue MW for defamation on the basis that the claims by MW were “baseless and unsubstantiated”<sup>13</sup>.

A few days later on 26 November 2012, MW finally published its report on Olam. This seemingly calculated move drew flak from the industry, with Lex from Financial Times questioning Block's real motives<sup>14</sup>, as this delay deviated from his norm where attacks through MW were launched almost immediately alongside lengthy public reports.

## **Muddy Waters' Conflict of Interest**

As a short-selling investment research firm, MW makes profits when the stock price of the target company that it has shorted falls. In this case, MW had shorted Olam's shares and would benefit from the fall in Olam's share price, resulting in the CFA Institute questioning the possible conflict of interest<sup>15</sup>.

The release of MW's report pushed Olam's share price down further by 6.02% to close at S\$1.56 on 27 November 2012, the next trading day. On 28 November 2012, Olam retorted with a 45-page report and its share price rebounded by 4%<sup>16</sup>. Separately, Verghese reiterated his belief in a CNBC interview that MW was acting "in concert with a group of hedge funds" to attack the company<sup>17</sup>.

The main issues raised by MW and Olam's refutations are summarised below.

### **1. Aggressive Accounting And Questionable Accounting Practices**

#### *Muddy Waters' Claim*

Olam frequently books Non-Cash Accounting Gains ("NCAGs"), especially in negative goodwill and biological gains. Block claimed that these practices can result in spending on low quality assets, so long as there are potential accounting gains. NCAGs account for 37.9% of Olam's Profit After Tax of S\$1.2 billion<sup>18</sup> from FY2010 to FY2012. MW highlighted that 62.5% of Olam's reported negative goodwill arose not through acquiring assets below book values, but rather when assets are revalued to be higher than their purchase price. MW thus suggested that Olam aggressively revalued assets upward to recognise more negative goodwill<sup>19</sup>.

#### *Olam's Response*

Olam argued that its biological assets accounting was in line with Singapore Financial Reporting Standard (SFRS) 41 and that fair value better reflects the assets' current values<sup>20</sup>. The company had also engaged an independent professional valuer to carry out valuation, and disclosed in its financial statements the fair value determination and the underlying assumptions.

Similarly, Purchase Price Allocation exercise was carried out by an independent third party valuer and verified by Ernst & Young during acquisitions for accounting purposes and goodwill recognition. Olam stressed that it did not rely on negative goodwill to enhance profits, and that MW failed to mention those Olam acquisitions that resulted in positive goodwill. Olam further argued that negative goodwill gains are one-off in nature, and are thus excluded from core operational profits.

## **2. Aggressive Capital Expenditure And Acquisitions**

### *Muddy Waters' Claim*

MW criticised Olam for not making higher-quality acquisitions, but instead purchased troubled businesses. It also claimed that Olam was incurring a very large CapEx, spending S\$1.587 billion over four years on property, plant and equipment<sup>21</sup>.

### *Olam's Response*

Olam explained that the company was in an investment ramp-up phase, and its recent years' CapEx resulted from the execution of its current strategic plan (FY2010-2016) under which the company would invest in upstream and midstream segments in the value chain<sup>22</sup>. To support the CapEx, Olam had also pre-emptively raised capital through diversified debt and equity.

## **3. Solvency Concern As A Result Of Over-Leverage**

### *Muddy Waters' Claim*

MW claimed that out of the S\$1.1 billion cash reported in Olam's 2012 Annual Report, S\$445.7 million came from bank overdrafts and S\$602.2 million came from withdrawing substantial amounts of cash from margin accounts with Olam's brokers. Hence, MW asserted that Olam only had approximately S\$60 million of truly free cash, or three weeks of operating cash at the end of FY2012<sup>23</sup>.

Based on MW's forecast, Olam would need to refinance a total of S\$4.6 billion in the next 12 months to stay solvent. MW also highlighted Olam's highly-levered balance sheet, low operating margins, and high CapEx as reasons for Olam's high risk of insolvency.

### *Olam's Response*

With regards to its cash balance, Olam explained that its margin account movements were mainly correlated with the net position on its hedges, and withdrawals from these accounts can happen only if the positions are in the money. Also, bank overdrafts are routine short-term loans drawn mainly to avoid foreign currency exposures.

As for the risk of insolvency, Olam retorted that the liquidity of agriculture commodities gives it financial flexibility and reduces its risk of inventory write-downs. Olam also had a short-term working capital of S\$6.36 billion as at 30 September 2012, of which S\$5.01 billion comprised of Readily Marketable Inventories and secured receivables, which are convertible into cash<sup>24</sup>. Thus, Olam believes that it need not raise further debt to meet its cash flow needs.

#### **4. Nigerian Export Incentives: Sustainability and impact**

##### *Muddy Waters' Claim*

MW claimed that Olam's trading business is heavily dependent on export subsidies ("EEGs") in countries like Nigeria and Gabon, and gave the opinion that these subsidies were unsustainable, citing past instances where the Nigerian government stopped issuing grants. In particular, MW highlighted the impact of government grants on Olam's bottom line, which accounted for 35% of Olam's Profits After Tax in 2012<sup>25</sup>.

##### *Olam's Response*

Olam's management downplayed the impact that the EEGs had on the company's bottom line. The EEGs were either 1) passed on to its suppliers; or 2) used to offset the higher cost of operations in Nigeria arising from infrastructural deficiency<sup>26</sup>.

#### **5. Olam Is A "Black Box"; Appears To Be A Failing Business Model**

##### *Muddy Waters' Claim*

MW held the view that Olam has a complex business model, which is poorly understood and highly leveraged. Analysts do not understand Olam's financials, and their annual earnings estimates for Olam differ substantially from one another's. Even their forecasts for Olam's CapEx fall way below explicit management guidance. Thus, MW thinks that management can easily hide misconduct, as no one understood its business model<sup>27</sup>. MW also pointed out that Olam's profits were especially sensitive to assumptions used in valuation models, which were based on Olam's own sensitivity analysis.

##### *Olam's Response*

While Olam admitted that it uses a complicated business model, it nonetheless maintained that the company was adopting a differentiated strategy that was well thought through and was also yielding the intended results<sup>28</sup>. Olam further pointed out that its proven track record and growth in recent years only goes to demonstrate Olam's continuing strength in the business.

## 6. The Next Enron?

### *Muddy Waters' Claim*

MW likened Olam to Enron; it noticed that both companies (1) are asset-rich and are involved in “asset-heavy” production; (2) are trying to scale their trading business too far and too fast; and (3) use a complicated accounting model. MW concluded that Olam uses “black box” accounting, which is complex and vulnerable to fraud. It felt that Olam’s myriad of CapEx problems are particularly similar to Enron’s<sup>29</sup>. Michael Dee, Temasek’s former senior managing director, on the other hand, objected to MW’s claim. However, he conceded that Olam seemed to be going a little bit too fast and added that Olam should reduce its debt level<sup>30</sup>.

## Olam Raises More Funds

On 3 December 2012, Olam announced its plan to raise up to US\$1.25 billion through a rights issue; US\$750 million 6.75% US\$ denominated bonds will be issued together with 387,365,079 warrants<sup>31</sup>. The announcement came just a few days after Verghese said on 29 November 2012 that Olam was not looking to tap debt markets for at least five to six months.

MW viewed the announcement as an indication that Olam was failing. Block argued that Olam could be facing financing problems, with banks being reluctant to lend it more money. Earlier on, he had said that Olam’s shareholders should be worried of margin calls as he felt that the management could have possibly pledged significant numbers of shares. When asked, Verghese refused to comment on share pledges, saying “I don’t think that is anybody’s business”<sup>32</sup>.

Block further questioned Olam management’s credibility in its “180-degree reversal” on tapping the markets. He also felt that Olam’s refusal to take up MW’s offer (made on 30 November 2012) to pay for Olam’s debts to be rated by S&P was unfair to its investors, as there would be substantial benefits to them from the increased transparency. Michael Dee echoed the same view, saying that Olam should get its debts rated, especially for bond issues<sup>33</sup>.

Also, on 30 November 2012, Verghese purchased one million Olam shares in the open market at S\$1.54, after independent directors Robert M. Tomlin and Lim Choo San each purchased 200,000 shares the day before. This drew questions as to whether the share purchase just ahead of the rights issue announcement was a breach of market rules and regulations. At Olam’s extraordinary general meeting, Verghese and Lim explained that

the matter of the rights issue came before the board only after their purchases when the board met on 1 December 2012. The rights issue was proposed by the board in an aim to re-inject confidence into Olam's stocks. Verghese further added that he owned 111.646 million shares in the company and would not risk his reputation to profit from the one million shares<sup>34</sup>.

On 24 January 2013, Olam announced strong endorsement for its rights issue, with a 10% oversubscription. At the time of announcement, Olam's shares traded at S\$1.62.

## **Olam Drops Lawsuit**

On 5 April 2013, Olam withdrew its lawsuit against MW, after receiving feedback from shareholders who suggested that Olam should "focus on delivering value rather than fighting critics". Another reason was that Olam had been unable to serve notice against Block and MW, as they did not have "assets of consequence" against which claims can be made<sup>35</sup>.

## **Temasek Holdings ("Temasek") Backs Olam**

In less than three months, Temasek had raised its stake in Olam from 16% to 21%, becoming Olam's largest shareholder. By April 2013, its stake was further raised to 24% through a series of transactions. Temasek had also given full backing to Olam in December 2012 by committing to fully sub-underwrite the rights issue<sup>36</sup>. Block characterised this as a "sovereign bailout" to prevent "systemic failure", while Temasek explained its strong support for Olam, stating that they "remained comfortable with Olam's credit position and longer term prospects."

## **Olam's Strategic Recalibration**

Verghese had initially defended Olam's investments as being in line with Olam's articulated strategy, saying that the company was still in an investment ramp-up phase. Following MW's allegations, Olam further acquired Dehydro Foods Ltd on 30 November 2012 at US\$30.80 million and Seda Solubles S.L.'s coffee business unit on 21 December 2012 at US\$52 million, both on cash terms.

However, Olam later responded that they would slow down CapEx, recalibrate investments, and build a growth strategy if needed. On 21 December 2012, Olam abandoned its US\$240 million bid for a Brazilian sugar mill<sup>37</sup>. The company had also separately sold and leased-back 4,700 acres of almond orchards in California, raising US\$55 million in cash.

On 25 April 2013, Olam concluded its annual strategy review and unveiled its Strategic Plan for the three-year period FY2014-2016, highlighting four key priorities. These include accelerating free cash flow generation (positive FCF by FY2014), reducing gearing, reducing complexity and promoting better understanding of Olam's business. In particular, the company said it would be reducing its planned CapEx by S\$1 billion and at the same time look into enhancing stakeholder communication through corporate disclosure and transparency<sup>38</sup>.

## Conclusion

In the five months since Block questioned Olam's accounts, many events had transpired, and more are still unfolding in relation to the attack by Carson Block. For Block, he had arguably managed to score a victory for himself and MW.

For Olam, while MW's allegations pushed the management into reviewing and revising its strategy, the company can nonetheless take comfort in the knowledge that Singapore's state-owned Temasek is fully supportive of the company, with its increased stake of 24%.

Olam's shareholders are perhaps the biggest winners to emerge from this. The commodity trader has now realised the need to communicate better with and account to stakeholders, and shareholders can expect Olam to be more transparent and responsive going forward.

## Epilogue

A year later in September 2013, MW published an article on its website, reiterating its stance on Olam, saying, "In a world where capital is allocated to Maximise economic efficiency, Olam's shares have no value"<sup>39</sup>.

However, almost two years after the saga, Bloomberg published an article in March 2014, quoting Block's praise for Olam. In an e-mail to Bloomberg, Block said that "Olam gets credit for taking steps to mitigate some of the issues [he] identified", and "that the stock has inexplicably outperformed in the past month"<sup>40</sup>. Indeed, since the initial attack in November 2012, Olam's share price has increased tremendously since, closing at S\$2.23 on 15 March 2014<sup>41</sup>.

The praise from MW also comes after a takeover offer from Breedens Investment Pte, which is a unit of Temasek Holdings. This offer values Olam at S\$5.3 billion, which is a far cry from MW's prediction of Olam collapsing<sup>42</sup>. Although the takeover offer and process is still ongoing, Olam's management can definitely heave a sigh of relief with the closure of the MW saga, and proving Carson Block wrong.

## Discussion Questions

1. What is the role of short sellers in the market? Explore the possible conflict of interest that exists, if any, for short-selling investment research firms like Muddy Waters LLC.
2. The CEO and two independent directors of Olam bought Olam shares shortly before the announcement of the rights issues. This led to market talk about possible rule breaches. What rules might be breached and what is your view on this? What are the pros and cons of independent directors owning shares in a company?
3. Temasek had increased its stake in Olam from 16% to 24%. What could be the motivations behind this action? Was Olam quickly becoming an entity that was too big to fail?
4. Arguably Olam has not been entirely transparent with its investors in terms of its corporate strategies and accounting practices. Is this indicative of bad corporate governance? To what extent are the accusations of questionable accounting practices by MW justified?
5. Olam's Profit After Tax is heavily influenced by the management's discretion. Suggest ways in which earnings management can be mitigated.

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# Sakae: Who Moved My Sushi?

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## Case Overview

On 7 January 2011, Sakae entered into various Interested Party Transactions to acquire two companies that one of its directors holds directorships in. The transaction was passed. However, this transaction resulted in problems that were discovered in 2013. A director who had interest in multiple shareholdings was accused of misappropriating funds of up to S\$34 million. After being asked to resign and sued by the company, he was eventually removed by shareholders at the Extraordinary General Meeting. The objective of this case is to allow for a discussion on issues such as the potential problems and conflicts of interest that cross-directorships and investments in associates may bring about.

## About Sakae

Sakae Holdings Ltd (“Sakae”), previously known as Apex-Pal International Pte Ltd, is a Singapore incorporated company<sup>1</sup>. Formed in 1996, it was listed on the Singapore Stock Exchange (now Singapore Exchange) in 2003<sup>2</sup>.

Sakae is in the food and beverage industry and its main business is as an operator of restaurants, kiosks and cafes. It is most well-known for its Sakae Sushi outlets in Asia that provide a kaiten (conveyor belt) sushi experience<sup>3</sup>. Sakae derives its revenue from its main business as well as selling items to and collecting royalties from its franchisees, and also providing management and consultancy services<sup>4</sup>.

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This is the abridged version of a case prepared by Andrew Ho Chung Hang, Julfri Kosasih, Liang Chenghui and Cindy Tan Pei Yun under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Trina Ling Tzi Chi under the supervision of Professor Mak Yuen Teen.

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The corporate governance issues revolving around Sakae concerns not their main business but their alternative income through investments.

## **Interested Person Transactions (“IPT”)**

On 7 January 2011, Sakae held an extraordinary general meeting (“EGM”) to obtain shareholders’ approval for three resolutions, all of which were passed successfully. One of them was the subscription of 24.69% of the issued and paid-up share capital of Griffin Real Estate Investment Holdings Pte Ltd (“GREIH”), in relation to a subscription and joint venture agreement entered into by Sakae, Gryphon Real Estate Investment Corporation Pte Ltd (“GREIC”), and GREIH earlier on 3 September 2010. This investment was said to be beneficial as the rental income generated from a property owned by GREIH could serve as a form of hedge against the rising rental costs and property prices that would affect Sakae in its rental of retail spaces for the operations of its outlets<sup>5</sup>.

Next was the subscription of 20% of the issued and paid-up share capital of Gryphon Capital Management Pte Ltd (“GCM”). This was to allow Sakae to have a greater influence in GCM’s provision of management and consultancy services on the rental operations of GREIH<sup>6</sup>, provided for in the third resolution.

Under the requirements of Chapter 9 of the Singapore Exchange (“SGX”) Mainboard Rules, the transactions under the first and second resolutions were considered IPTs<sup>7</sup> as Andy Ong Siew Kwee (“Ong”), a non-executive and independent director of Sakae then, had shareholdings in GREIH and GCM. He was also the Chief Executive Officer (“CEO”) of ERC Holdings (“ERC”), the ultimate holding company of GREIH and GCM.

The third resolution, which involves the subscription of 20% of the issued and paid-up share capital of GCM, would be considered an IPT after the first and second resolutions were passed because at that time, Sakae would have an interest in both GREIH and GCM, as seen in Figure 1 below.

As Ong could be seen to have a significant interest in the transactions, he gave an undertaking that he and his associates will abstain from voting on and advocating for the transactions during the general meetings in respect of the first two one-off resolutions and the annual third resolution, as required by the Mainboard Rules.

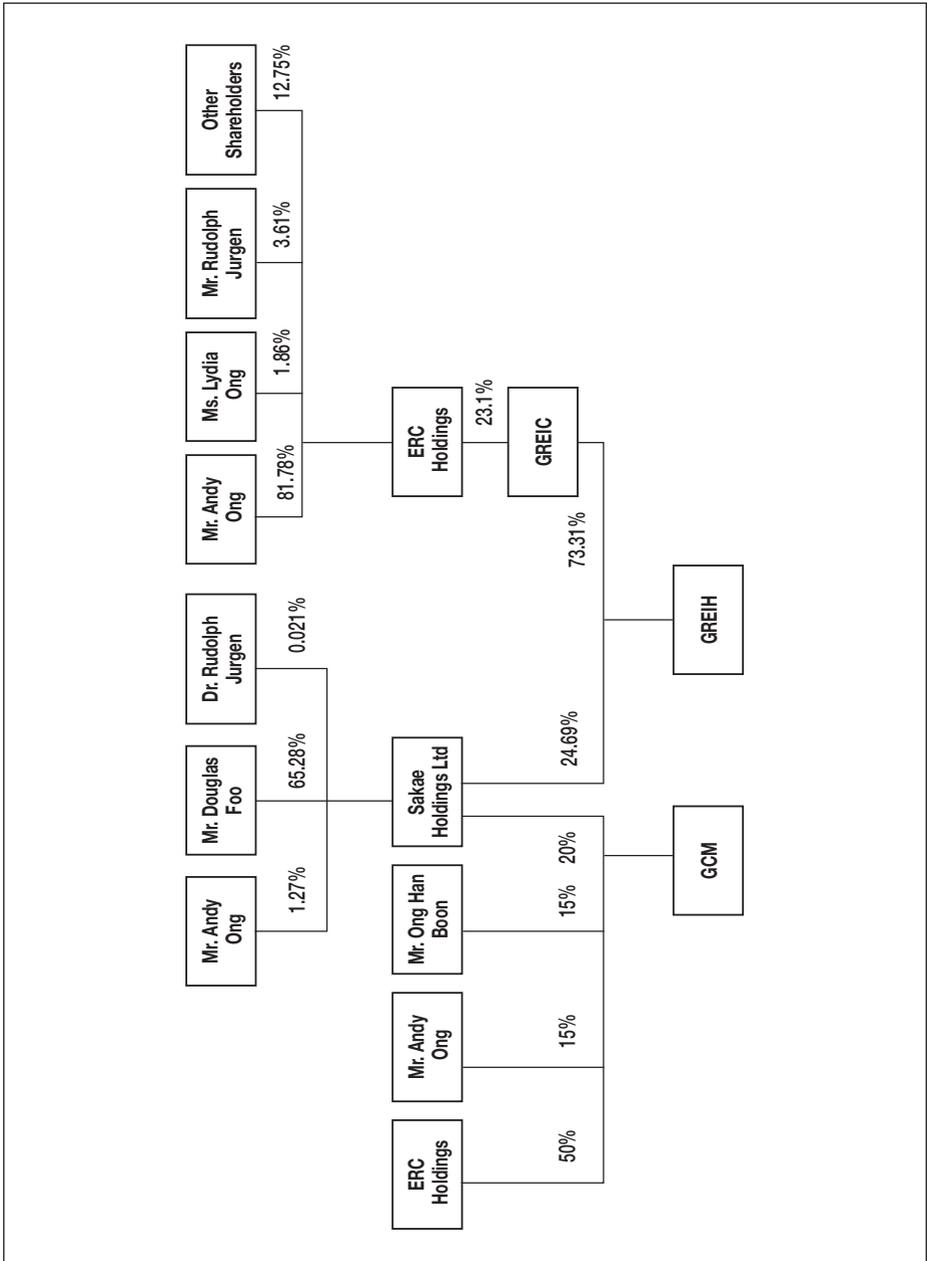


Figure 1: Ownership Structure of GREIH and GCM after Sakae's acquisition<sup>8</sup>

## Board Changes

As a result of these three transactions, a new director Nandakumar Ponniya took over Ong's responsibilities in the Audit Committee but Ong remained on Sakae's board, as a non-executive and non-independent director<sup>9,10,11</sup>.

Douglas Foo Peow Yong ("Foo"), the Chairman and CEO of Sakae, sits on the board of GREIH to represent Sakae's interest<sup>12</sup>. Besides Foo, the GREIH board also includes Ong and Ho Yew Kong ("Ho"), both of whom are executive directors<sup>13</sup>.

## The Discovery

In 2012, Foo hired PricewaterhouseCoopers ("PwC") to investigate GREIH's accounts. The PwC report contained allegations of financial irregularities at GREIH. Foo immediately notified Sakae's Audit Committee and the external auditors. Sakae then filed a confidential report to the SGX and the Ministry of Finance ("MOF") on 21 January 2013<sup>14</sup>. According to the filing, Ong was alleged to have misappropriated at least S\$34 million through suspicious transactions which included payments of substantial sums of monies and "apparent contracts which purport to oblige (GREIH) to make substantial payments to companies majority-owned or controlled by Ong"<sup>15</sup>.

According to Foo, he had become suspicious when Ong rushed him to sign documents including board resolutions required for the granting of additional loans from United Overseas Bank. Ong had earlier claimed that the additional loan was required for the extension of expiring funds used to purchase a commercial property under GREIH's care, Bugis Cube, but the loans were now purportedly for the financing of retrofitting works. Foo later realised that the loan was apparently not for GREIH but for ERC Unicampus Pte Ltd ("Unicampus"), which Ong had an interest in. Hence, it was in fact a significant intercompany loan that had not been approved by Sakae. Foo said, "When Andy realised that I had read and understood the import of the 4 May 2012 resolution, Andy asked me to 'pretend I did not see it' "<sup>16</sup>.

In addition, just four days after S\$8 million was paid to Ong on 28 May 2012, S\$8.8 million was in turn paid to GREIH by ERC from the exercise of a share option supposedly granted to ERC by GREIH. The PwC report quoted that "it is possible that the receipt of the S\$8.8 million from ERC was partly funded by the S\$8 million paid to Ong"<sup>17</sup>.

Another financial irregularity flagged was the early termination of the lease agreement between GREIH and ERC Institute, in which S\$1.5 million and S\$14.3 million were purportedly paid as compensation respectively to Unicampus and ERC International on 13 September 2012. However, the agreement was not approved by GREIH's board and "the underlying basis for the computation of the S\$16 million is also questionable and inconsistent", said the PwC report<sup>18</sup>.

In addition to these alleged financial irregularities, there was a concern regarding the engagement of ERC Consulting's service to market Bugis Cube. In PwC's report, it was said that there was no satisfactory explanation for this decision, given that Knight Frank is the sole marketing agent for the strata units. ERC Consulting purportedly had S\$160,500 in consultancy fees owing to it when there was no approval from the board of directors for such a consulting agreement<sup>19</sup>.

Ong was also alleged to have given "inconsistent explanations" to Sakae about GREIH's financial position and engaged in "deliberate attempts to prevent meaningful inquiries" into its financial affairs. For example, when Sakae probed for details about the marketing of Bugis Cube as part of its accounting process, Ong allegedly replied: "I am not revealing any more info!!!!!" via e-mail to Sakae Chief Financial Officer Voon Sze Yin<sup>20</sup>.

## **Actions Taken**

Sakae's share price took a dip from S\$0.34 to S\$0.29 per share when these issues came to light<sup>21</sup>. The alleged lack of disclosure on the transactions and possible conflicts of interest would constitute a breach of director's duties by Ong. As a director, he had both statutory and fiduciary duties that required him not to act against the interest of the Company and not to place himself in a position where he would have a conflict of interest.

In response to these issues, Sakae announced on 1 February 2013 that the board had accepted its Nominating Committee's recommendation to have Ong resign within the next seven days. During this period of investigation, he was also not to participate in board discussions in connection with GREIH and himself<sup>22</sup>. In addition, Sakae and Foo filed an application to the Court on 7 February 2013 to bring about a statutory derivative action on behalf of GREIH against Ong and Ho for breaches of duties owed to GREIH. Sakae also sued Ong for breach of duties in acting against Sakae's interest<sup>23</sup>.

## Ong's Denial And Turnaround On Foo

Ong refuted the allegations about the financial irregularities in a press statement released by Financial PR Pte Ltd ("Financial PR") whom Ong had appointed to help publish his statements. He explained that he had in fact pointed out to Foo that the S\$10 million loan was a loan to Unicampus, which Foo held a large stake in. In addition, the S\$8 million was the payment for the renovation works on GREIH's property, North Bridge Commercial Complex. He claimed that he had even personally assumed financial responsibility for the renovations to ensure that costs were kept within the budget. As for the S\$16 million compensation to ERC Institute for the early termination of lease agreement, it was to benefit GREIH with a higher lease price by splitting the gross leasable area into smaller retail strata titles.

Unhappy with the accusations, he went on to allege that Foo had approved Sakae's 24.69% investment in GREIH even before obtaining shareholders' approval; he also "failed to disclose to Sakae's board that Sakae was actually offered a higher stake of 30.86% in GREIH" and instead took the opportunity to invest the difference in GREIH via his family investment vehicle, KPM Holdings.

As a sign of protest, Ong sold his stake of 1.804 million shares on 15 February 2013<sup>24</sup>.

## Sakae's Response

On 23 February 2013, the spat continued, with Sakae responding to Ong's press statement, saying that it was "calculated to disparage Sakae and Foo in their office, profession, calling, trade and/or business". They deemed the statement defamatory in suggesting that the Sakae board of directors were incompetent and that Foo had abused his powers and breached his statutory duties to act bona fide for the interest of the company<sup>25</sup>.

It was through the statement that Financial PR got embroiled in the conflict. Sakae took legal action against them for not taking care in publishing the baseless statement, when they refused to apologise and withdraw the allegations<sup>26</sup>.

## Extraordinary General Meeting

An EGM was convened on 18 March 2013 to remove Ong from his directorship as he had failed to tender his resignation. Ong turned up and presented his side of story to the shareholders. In his speech, he voiced the unfairness of being sued and kicked out of the board when he was the one who had introduced the investment in GREIH, “which will reap very handsome rewards”.

The directors sought to only discuss their views and the financial effects of the irregular transactions in the upcoming annual general meeting, so as to avoid selective disclosure of information to the shareholders present when shares continue to trade during the EGM. Even so, the 30 odd shareholders who turned up unanimously voted for the removal of Ong as the director<sup>27</sup>.

## The Recovery

Sakae had earlier sensed that its position was in jeopardy, therefore prompting it to apply to the Court for the appointment of receivers for some assets in GREIH on 7 February 2013. These assets include funds from bank accounts and proceeds from the sale of Bugis Cube. The first to fifth storeys of Bugis Cube were earlier sold for S\$142.8 million between June and October 2012. It could possibly fetch another S\$27 million from the sale of the remaining sixth storey but it is, according to Sakae, “at risk of being sold at undervalue to Ong and his companies under the ERC Group”<sup>28</sup>.

The company had also made a S\$10.1 million full provision for an impairment loss in the associated companies related to Ong, though it was still uncertain if such a provision was needed as the appropriate provision amount cannot be determined. Deloitte & Touche thus issued a qualified opinion on Sakae’s accounts on 27 March 2013<sup>29</sup>.

The appointment of receivers had, according to GREIC, breached the joint venture agreement as the unanimous approval of all shareholders and directors was not obtained. Furthermore, the statutory derivative action that Sakae had taken on behalf of GREIH, was not approved by a majority of the board. As such, GREIC issued a default notice, requiring Sakae to sell all its shares in GREIH to them at 90% of the fair value of the price stated in the default notice within 30 days. Sakae responded that the notice had no legal effect, thereby prompting GREIC to call for arbitration against Sakae under the Agreement on 16 April 2013<sup>30</sup>.

The saga continues and the various allegations and accusations relating to Foo and Ong will have to be proven. However, the implication of the alleged conflicts of interest is clear; the economic benefits in the investment are diminished and the reputation of the company and key personnel are at stake.

## Epilogue

On 23 July 2014, Sakae Holdings and Foo reached an out of court settlement with Financial PR. In a statement, it was stated that “pursuant to the terms of the settlement agreement, the company and Douglas Foo shall discontinue the defamation suit with no order as to costs within seven days from the date of the settlement agreement”<sup>31</sup>.

## Discussion Questions

1. Evaluate the independence of the board of directors in Sakae, particularly Ong before and after the acquisition of the stake in GREIH.
2. What are the current rules governing investment in associated companies that a director is connected to? Are the current rules sufficient?
3. What are the potential problems when Sakae invest in its associated companies, GREIH? Use the ownership structure of GREIH to explain. Suggest ways to mitigate the problem.
4. Based on the facts of this case, is there a possible breach of duties by Ong and Foo?

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# Bumi PLC: A Clash of Dynasties

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## Case Overview

Bumi PLC is a listed coal mining company founded by the Indonesian Bakrie family and UK financier Nathaniel Rothschild. In 2012, an internal conflict between the Bakries and Rothschild made the news. It was reported that the latter had written a letter to the Bakries demanding a “radical cleanup” in the corporate governance of Bumi Resources. Later that year, US\$200 million worth of funds were discovered to be missing<sup>1</sup>. The objective of this case is to allow a discussion of corporate governance issues such as those in joint ventures and reverse takeovers, cross-border listings and companies with controlling shareholders; cultural differences; and regulatory issues.

## A Time For Reflection

*“I am the first to admit we made a terrible mistake”*

– Nat Rothschild, March 2013

Nat Rothschild spoke candidly from his ski chalet in the Swiss Alps as he reflected on the ill-fated relationship he had with his former partner, the Bakries. Just two weeks earlier, he had been resoundingly beaten in a shareholder vote to wrest board control of Bumi PLC back from them. The company he co-founded was in tatters, ravaged by depressed commodity prices, murky financial wrongdoing and boardroom feuds that had become all too public.

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This is the abridged version of a case prepared by Daniel Peck, Royce Ng, Mabel Lee and Wee Shuo Ting under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Chloe Chua under the supervision of Professor Mak Yuen Teen.

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Yet, it was clear that the powerful financier had not admitted defeat. His crusade would go on, just like it had for the last fifteen months. Before heading out to the ski slopes, Rothschild sounded more optimistic already. He mulled, “I’ve had a lot of luck in my life ... This time, I got unlucky”<sup>2</sup>. Introspection, perhaps, had resumed its usual spot in the backseat.

## The Honourable Nathaniel Rothschild

The limelight had seldom eluded Nathaniel Rothschild. The scion of one of Europe’s most successful and secretive banking families, Rothschild led a life of wealth that was often shrouded in controversy.

Critics had questioned whether he could live up to his illustrious family name, but Rothschild worked hard to prove them wrong, eventually carving out a name for himself in fund management. After stints at Lazard and Gleacher, he became an equity partner at hedge fund firm Atticus LLC, taking over as co-chairman in 2005. Under his leadership, Atticus grew to manage up to US\$20 billion at its 2007 peak, but later disbanded in 2009 after the global financial crisis<sup>3</sup>.

Unhappy with the lack of recognition accorded to him, Rothschild embarked on his boldest venture yet. In July 2010, he floated a £707m cash shell company Vallar plc on the London Stock Exchange<sup>4</sup>, promising shareholders that he would invest the IPO funds in emerging market natural resource assets<sup>5</sup>.

Western-style corporate governance standards<sup>6</sup> coupled with lucrative mining resources that were in high demand in the world’s largest engines of growth appealed to investors. By installing a strong board of directors and reputable managers, and adhering strictly to corporate governance codes<sup>7</sup>, the risk that usually afflicted emerging market assets was greatly reduced. Investors responded favourably, oversubscribing the IPO at £10 per share. Rothschild himself made a £100 million investment<sup>8</sup>.

## The Birth Of Bumi PLC

*“If you know them, or you get to actually talk to people who have done business with them, in my experience, the view of the Bakries is universally good.”*

– Nat Rothschild, December 2010

The Vallar board was chaired by Sir Julian-Horn-Smith and Rothschild was a director. Their search for targets did not take long. In October 2010, investment banker Ian Hannam recommended Indonesian coal miner PT Bumi Resources ('PT Bumi') to Rothschild as "the best deal he ever saw"<sup>9</sup>. PT Bumi was Indonesia's largest coal producer and was under the control of the wealthy and powerful Bakrie family<sup>10</sup>.

Rothschild acted swiftly upon Hannam's advice. Within three weeks, he met up with Nirwan Bakrie to discuss a potential deal. Three weeks after, on 16 November 2010, Vallar announced a massive US\$3 billion cash-and-share deal to acquire 25% in PT Bumi from the Bakries and 75% of PT Berau Coal Energy ('Berau') from businessman Rosan Roeslani<sup>11</sup>. These percentages would swell up to 29.2% and 84.7% respectively through additional acquisitions and a mandatory cash offer for Berau<sup>12</sup>. The completion of the deal in June 2011 led the company to become one of the world's largest exporters of thermal coal and the company was rebranded as Bumi plc ('Bumi').

## Power Resides With The Few

The injection of PT Bumi and Berau assets into Vallar was a reverse takeover. This, along with the issue of nearly 16.1 million bonus shares to Rothschild, resulted in new shareholding structures and substantial shareholders (Table 1).

	Voting Shares	Suspended Shares	Total	Stake	Voting Power
<b>Bumi plc</b>	<b>180,514,285<sup>13</sup></b>	<b>60,442,782<sup>14</sup></b>	<b>240,957,067</b>	<b>100%</b>	<b>100%</b>
PT Bukit Mutiara	24,055,942 <sup>15</sup>	–	24,055,942	10% <sup>16</sup>	13.3% <sup>17</sup>
Bakrie Group	54,154,285 <sup>18</sup>	60,442,782 <sup>19</sup>	114,597,067	47.6% <sup>20</sup>	29.99% <sup>21</sup>
Nat Rothschild	21,032,418 <sup>22</sup>	–	21,032,418	8.7%	11.7% <sup>23</sup>

Table 1: Bumi Shareholding Structure at 30 September 2011

Notably, the Bakries now held 47.6% of the share capital of the company through their companies PT Bakrie & Brothers Tbk. and Long Haul Holdings. Under the UK Takeover Code, the acquisition of 30% or more of the voting rights of a company required a mandatory cash offer for all the company shares. To obtain a waiver, the

Bakries agreed to limit their voting power to 29.9%<sup>24</sup>. Roeslani received 10% of the share capital, which in light of the Bakrie waiver was worth 13.3% of the voting rights in the company. In total, 43.3% of Bumi's voting rights were controlled by Indonesian businessmen.

As for Rothschild, the reverse takeover left him with a 2.4% stake with 3.66% of voting rights. However, on 30 September, he exchanged the nearly 16.1 million bonus shares that he had received upon completion of the acquisition for 16,064,608 new Bumi Voting ordinary shares. This boosted his voting power to 11.7%.

The shift in power inevitably cast the spotlight on these new key players. The Bakries were a business dynasty steeped in political influence. They were risk-takers<sup>25</sup> who had built their sprawling empire on debt and leverage. The family business was controlled by three brothers and the eldest, Aburizal Bakrie, was a front-runner for the 2014 Indonesian Presidential Election<sup>26</sup>. Roeslani controlled a diverse portfolio of businesses under the umbrella of Recapital Group. Though their relationship was unclear, Roeslani and the Bakries had had significant business dealings with each other. At the time of the reverse takeover, Roeslani controlled PT Recapital Asset Management and PT Bukit Mutiara owed PT Bumi US\$231m and US\$251m in outstanding loans<sup>27</sup>.

## Board Games

The reverse takeover also significantly changed Bumi's board composition. Indra Bakrie and Rothschild took over as Co-Chairmen of the board. New executive directors were also appointed. PT Bumi President Director Ari Hudaya became Chief Executive Officer (CEO) while PT Bumi Chief Financial Officer (CFO) Andrew Beckham assumed the CFO role. Meanwhile, Roeslani became a non-independent<sup>28</sup>, non-executive director.

The make-up of the board was heavily influenced by the Bakries. On 16 June 2011, the Bakrie Group signed a relationship agreement with Bumi. As long as they controlled 15% of voting rights, they would be entitled to nominate the Chairman, CEO and the CFO of the Bumi board<sup>29</sup>. Roeslani's PT Bukit Mutiara had an identical agreement, except it could only appoint one non-executive director. These relationship agreements would become a bone of contention in the ensuing debacle.

## Samin Tan: The Bakries' White Knight

It was public knowledge that the heavily leveraged Bakries had pledged all their Bumi shares for a US\$1.345 billion credit facility from Credit Suisse AG. In October 2011, Bumi warned that the repayment deadline was nearing but the Bakries still did not have a solution<sup>30</sup>.

Mining tycoon Samin Tan then entered the fray<sup>31</sup>. On 1 November 2011, he agreed to purchase half of the Bakries' 47.6% Bumi stake for US\$1 billion through his company PT Borneo Lumbung Energi and Metal ('PT Borneo')<sup>32</sup>. He paid an average of £10.91 per share - a stunning 47% premium to Bumi's previous day close. The stake would not be divided, but rather jointly held within Special Purpose Vehicles (SPVs)<sup>33</sup>. Investors welcomed the news and Bumi's stock spiked 27% over the next two weeks. Yet, Tan's introduction would have far-reaching implications for the company's future beyond anyone's expectations.

## Rothschild Declares War

*"Nat is a very good friend of mine, but he does tend to go straight into the wall head down hoping the wall will break ... You particularly don't do what he did to a bunch of Asian toughies."*

– Simon Murray, Chairman of Glencore International

A mere nine days after Samin Tan's introduction, Rothschild unexpectedly took his grievances public. He leaked a scathing letter addressed to Bumi CEO Ari Hudaya to the Financial Times<sup>34</sup>. The letter called for a clean-up of the corporate governance and balance sheet at PT Bumi, suggesting that the company was over-leveraged because it had extended too many loans out to connected parties. He questioned Hudaya's dual role as CEO of Bumi and PT Bumi, and also accused him of not responding to board queries<sup>35</sup>.

Rothschild's dissatisfaction had probably been brewing for some time. First, PT Bumi had had more than US\$550 million in loan receivables that seemed unrelated to its coal business, raising questions about the transactions and connected parties<sup>36</sup>. Second, PT Bumi had US\$394 million in unspecified business development assets on its books. Third, prior to refinancing, PT Bumi had maintained all these monetisable assets<sup>37</sup> while paying an exorbitant 19% annual interest rate on US\$600

million in debt to the China Investment Corporation (CIC). Rothschild believed this imprudence was corporate governance-related.

Bumi's poor share price performance probably compounded Rothschild's unhappiness. Even after Samin Tan's welcomed intervention, Bumi was still trading at 15.4% below IPO price on the date of Rothschild's letter<sup>38</sup>. Despite a good operating performance in the first half of the fiscal year, the share price was overwhelmed by a maelstrom of worrying macroeconomic factors. These included the Eurozone sovereign debt crisis, as well as the peaking and subsequent decline of Indonesian coal prices<sup>39</sup>.

Rothschild's letter caused irreparable damage to his relationship with the Bakries. Though a new debt collection schedule was agreed, the Bakries and Tan actively sought to remove Rothschild from the board. After they threatened to call an EGM, Rothschild eventually agreed to step down as Co-Chairman on 27 March 2012. He remained as a non-executive director, while Samin Tan assumed Chairmanship. CEO Hudaya and CFO Andrew Beckham were also axed and replaced by Nalin Rathod and Scott Merrillees respectively<sup>40</sup>.

## **Financial Irregularity, Share Price Calamity**

Bumi's FY2011 results were mixed. Despite a US\$280 million operating profit, finance costs and tax expenses had pushed the company into an overall loss of US\$282 million. Other troubling questions had also arisen. In August 2011<sup>41</sup>, Bumi wrote off all US\$390 million<sup>42</sup> of PT Bumi's exploration assets. The 2011 Annual Report released in early 2012 also revealed that the company had written off US\$247 million<sup>43</sup> and US\$75 million<sup>44</sup> of PT Bumi's and Berau's business development funds respectively.

On 24 September 2012, the company announced that it had become aware of "potential financial and other irregularities" at its Indonesian operations<sup>45</sup> and commissioned law firm Macfarlanes LLP to conduct an independent investigation<sup>46</sup>. It was a crushing blow for the company, which had already been struggling under the weight of collapsing coal prices. That day, share price fell 23% to an all-time low of 147.6 pence, 85% below IPO price.

## The Bakries Offer A Way Out

Not long after, on 11 October 2012, the Bakries boldly proposed to separate themselves from Bumi by cancelling their shares and buying out the company's stakes in PT Bumi and Berau<sup>47</sup> in a deal worth 430 pence per share<sup>48</sup>. The proposal was conditional on Rothschild returning the 16.1 million bonus shares he had received. Rothschild resigned from the board four days later<sup>49</sup>.

Rothschild publicly criticised the board, insisting that the proposal had short-changed minority shareholders. He also alleged that Samin Tan had had a side-deal with the Bakries to be reimbursed at his original buying price of £10.91 per share. Tan's lieutenant Alexander Ramlie did not deny these claims, arguing that Tan would not have dissolved the jointly-held SPVs if he had not been compensated<sup>50</sup>.

Bumi's independent directors were put on the spot. Senior Independent Director Sir Julian Horn-Smith rebutted Rothschild's accusations, labelling Rothschild an "activist investor"<sup>51</sup>. Horn-Smith insisted that the board was evaluating the proposal carefully and their priority was to remove the Bakries from the company at a value-adding price. The entire board seemed united over the need for a separation from the Bakries. Eventually, the company rejected the Berau stake sale but remained in discussions to exit PT Bumi.

## Concert Parties And Musical Chairs

December 2012 saw the exodus of several board members. Five days before the Macfarlenes' findings were due<sup>52</sup>, Co-Chairman Indra Bakrie resigned, followed by CEO Rathod. Samin Tan was left as sole board Chairman while Head of Investor Relations Nick von Schirnding was appointed as new CEO.

The Takeover Panel<sup>53</sup> then released a significant ruling on 19<sup>th</sup> December that the Bakrie Group<sup>54</sup> Tan's PT Borneo and Roeslani's PT Bukit Mutiara were technically a concert party, reducing their collective voting rights from 43.3% to 29.9%. This was welcomed news for Rothschild. Subsequently, Roeslani stepped down from the board.

## Rothschild's Political Crusade

Rothschild made his move in January 2013, requisitioning a general meeting to replace 12 of the 14 directors on the board with his own nominees<sup>55</sup>. He felt that the existing board lacked independence and had taken too long to deal with Macfarlenes' findings and the Takeover Panel ruling. In the lead-up to the vote, Rothschild and the board would be embroiled in some very public mud-slinging.

The main targets of Rothschild's attack were CEO Von Schirnding and the Concert Party trio. He accused Von Schirnding of falsifying his law and accounting qualifications<sup>56</sup>. He also revealed that the Macfarlenes investigation revolved around a leaked<sup>57</sup> due diligence report commissioned by Samin Tan prior to his Bumi share purchase. The report suggested that Tan had been aware of the alleged irregularities at PT Bumi and Berau before he joined the board. Rothschild also accused Tan of failing to fulfil his fiduciary duties as a director to deal with these issues.

The board and the Concert Parties returned fire. The board dismissed Rothschild's attempt to wrest control, citing the Bakries' relationship agreement with Bumi that ironically had been brokered by Rothschild's own Vallar Advisors LP. The Bakries placed the blame for the Takeover Panel ruling squarely on Rothschild, accusing Vallar Advisors of poor due diligence on whether they constituted a concert party. According to them, Rothschild had benefitted significantly from some US\$15 million in advisory fees paid to Vallar Advisors.

Voting alliances were also being forged as the highly-anticipated vote loomed near. Rothschild and his associates had amassed 25.2% of voting rights<sup>58</sup>. However, former supporter and 2.2% stakeholder Standard Life<sup>59</sup> threw its support behind the board<sup>60</sup>. Proxy advisory firms also weighed in on the issue. The UK's PIRC backed Rothschild's proposal to replace Von Schirnding and advised investors to sack all directors with "conflicts of interest"<sup>61</sup>. Institutional Shareholder Services (ISS) disagreed with most of Rothschild's proposals, only agreeing that Nalin Rathod, Scott Merrillees and Alexander Ramlie should be removed from the board.

## The Shareholders Have The Last Word

It looked like a dead heat. However, three days before the 21<sup>st</sup> February vote, Rothschild was blindsided. Roeslani sold his entire 10% stake in Bumi to three separate investors – none deemed to be in concert with the Bakries or Samin Tan. This made it harder for Rothschild to garner the majority votes he needed<sup>62</sup>.

The final verdict was resounding: Rothschild had lost this battle. Nineteen of his 22 proposed resolutions<sup>63</sup> were rejected. He only managed to remove two directors and had also failed to be elected. The shareholders favoured a clear split from the Bakries, but nobody could say for sure why. Perhaps they thought Rothschild had done too much damage, or that Bumi just needed a fresh start. Or maybe after fifteen months of losses, investigations, accusations and boardroom politics, they were just a little tired of it all.

## Epilogue

On 17 December 2013, shareholders voted to change the company's name from Bumi plc to Asia Resource Minerals plc (ARMS), and on 25 March 2014, the Bakrie family officially severed ties with ARMS in a US\$501 million separation deal<sup>64</sup>. On 7 May 2014, it was revealed that former chairman Samin Tan and other investors had “indicated a clear wish” for ARMS to be wound up, which would allow for a cash return of more than US\$500 million to shareholders<sup>65</sup>. On 19 May 2014, however, these plans for ARMS to be de-listed from the London stock exchange were shelved, and instead an arrangement to return US\$465 million to investors entered into<sup>66</sup>.

## Discussion Questions

1. Using Bumi and other examples, discuss the pros and cons of reverse takeovers for shareholders. Should Rothschild have been responsible for conducting due diligence on the two Indonesian companies before the formation of Bumi?
2. What are some of the key corporate governance issues in a joint venture like Bumi plc?
3. Many UK public companies possess a diffused share ownership structure. However, in Bumi, voting power was concentrated with the Concert Party trio, who sat on the Board as well. Discuss how this affects the board's independence and how effectively they can govern.
4. What lessons can be drawn from the case about governance issues in companies with controlling shareholders and multiple substantial shareholders?
5. Rothschild believed that the imposition of Western standards of corporate governance into Bumi plc would make it a very successful company. Why did he fail?
6. What challenges do regulators face in overseeing companies like Bumi plc, where major shareholders, management and operations are based overseas?
7. Discuss the role that activist investors like Nathaniel Rothschild play in the corporate governance of a company. Do you think they are good for the company and minority shareholders?

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# Pacific Brands: A Wrong Brand of Remuneration

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## Case Overview

Amidst the global economic crisis of 2008, the Chief Executive of Pacific Brands, Sue Morphet, announced the 2010 Transformation Programme, which was set to lay off 1,850 employees. This resulted in an uproar from the Australian union and government, who could not understand how government grants of AUD\$17 million to Pacific Brands failed to protect these jobs. Adding fuel to fire was Morphet's remuneration package, which almost tripled in the year of massive layoffs. This triggered an investigation by the government into executive remuneration in Australia, and resulted in new legislation that allowed for 25% of shareholder votes to effect change. These events finally saw Morphet and the then-Board Chairman to resign, leaving a crisis management expert to helm Pacific Brands. The objective of this case is to allow for discussion on issues such as executive remuneration, and whether different parties (i.e. regulators, shareholders, Board of Directors, general public) have the ability and legitimacy to influence remuneration packages.

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This is the abridged version of a case prepared by Ju Li, Loy Shing Wei, Geraldine Tan, Priscilla Wong, and Yi Xin under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Amanda Aw Yong under the supervision of Professor Mak Yuen Teen.

# **Pacific Brands: A Story of Public Perception Down Under**

*“It was tough.”*

Sue Morphet paused, recalling the public relations meltdown that transpired over the past five years when she helmed Pacific Brands as Chief Executive. The interview on the Australian Broadcasting Network’s *One Plus One* weekly programme aired on 22 February 2013, and was the first time that Morphet stepped back into media limelight since her resignation from Pacific Brands in August 2012. Morphet’s resignation came on the heels of reported losses amounting to AUD\$450 million for the financial year-ending June 2012 – an exponential dip from the already-upsetting previous year loss of AUD\$131.9 million. These losses, along with the massive layoffs approved by Morphet herself, jarred with the wallet-fattening remuneration packages that Morphet and other senior executives received over her five-year tenure as Chief Executive Officer (CEO). Putting these pieces together, one could see how Pacific Brands set itself up for a perfect PR storm.

## **About Sue**

Morphet spent her first years in the workforce teaching science in a Catholic girls’ secondary school<sup>1</sup>. This career trajectory took a change when Morphet’s father passed away, leaving several businesses to his wife and children. Already married with two children, Morphet left her teaching career to manage the family’s businesses<sup>2</sup>. Noting the success of her personal businesses<sup>3</sup>, Pacific Brands hired Morphet in 1996. She performed well in the company, taking special credit for the successful rebranding of *Bonds* underwear, and rose up through ranks until she was eventually appointed CEO on 31 December 2007<sup>4</sup>.

## **The Weight Upon Sue’s Shoulders**

Pacific Brands’ story goes back to the founding of Dunlop Pneumatic Tyre Co. Ltd in 1889<sup>5</sup>. This company had an Australian branch that was eventually sold to become a separate company, Pacific Dunlop. Pacific Dunlop began diversifying into the business of consumer goods, establishing Pacific Brands in 1985 as a division to consolidate these consumer goods businesses. Business difficulties prompted Pacific Dunlop to divest Pacific Brands in 2001<sup>6</sup>, and ownership changed hands until Pacific Brands was listed on the Australian Stock Exchange (ASX) in 2004. Through

it all, Pacific Brands continually strengthened its position in the consumer goods market through the acquisition of Australian household brands such as *Bonds* and *KingGee*, as well as the Australian licenses for international brands such as *Clarks* and *Hush Puppies*<sup>7</sup>.

## **To Save A Sinking Ship: The Pacific Brands 2010 Transformation Programme**

With the global economy still reeling from the global financial crisis<sup>8</sup>, Pacific Brands dragged its feet into 2009, announcing a half-year net loss of AUD\$149.95 million. Morphet had taken on leadership at a tough time, but was ready to take tough measures to restore profitability. These tough measures were packaged as the “Pacific Brands 2010 Transformation Programme”, which was an audacious restructuring plan that included “making redundant” some 1,850 jobs. Pleased to hear of promised “cost-savings” and “higher efficiency”, the Board gave Morphet the green light<sup>9</sup>.

## **Becoming Australia’s Punching Bag: Public Relations Down Under**

With the Board behind her, Morphet announced the plan in February 2009. Morphet explained how the programme would lower costs through “job redundancies” and restore Pacific Brands to profitability<sup>10</sup>. The euphemism did little to prevent the predictable outrage of employees who would be made redundant. These employees rallied together in hundreds, staging protests outside the company’s factories in Sydney and Melbourne. As unions led a public condemnation of the company, and politicians fuelled the flames with critical comments - Federal Industry Minister Kim Carr said that he was “profoundly disappointed” by how Pacific Brands acted without first consulting the public<sup>11</sup>, while Prime Minister Kevin Rudd denounced Pacific Brands for slashing Australian jobs despite receiving Government grants worth AUD\$17 million over the previous two years<sup>12</sup>. This political support gave the angered unions more ammunition for their outrage, with Transport Workers Union Secretary Tony Sheldon stating that failure to provide job security despite such heavy funding from the Government was “tantamount to theft”<sup>13</sup>. Within days of Morphet’s announcement, one of Australia’s most iconic companies had become the national punching bag, taking blow after blow from unions, politicians, and members of the public who sympathised with Pacific Brands’ employees.

## **The Song of Angry Workmen: Morphet Faces The Music**

*“If you are going to be angry then I am the person that you are going to be angry with.”*

– Sue Morphet, in an interview with 60 Minutes<sup>14</sup>

Morphet stood her ground, explaining that her decision would protect the remaining 7,000 jobs at Pacific Brands. She further highlighted that Australian consumers themselves had a role to play as they always opt for cheaper foreign-made alternatives over Australian-manufactured products<sup>15</sup>. The then- Board Chairman, James MacKenzie, stepped forth to express the Board’s support for Morphet. Speaking at the annual general meeting in October 2009, MacKenzie reiterated that Australian-based manufacturing was no longer a viable option as competitors were all outsourcing their production to cheaper overseas locations. MacKenzie further highlighted that affected employees would be provided with retraining support from Pacific Brands, and had been given up to 18 months’ notice - well ahead of legal requirements<sup>16</sup>. Other observers suggested that Pacific Brands was not the only one with difficulty, and that more manufacturing job losses were to be expected<sup>17</sup>. The unions, however, had no care for these prophecies, and had only one immediate concern, which was to keep Pacific Brands’ manufacturing jobs within Australia. And they were prepared to use any means necessary.

## **A Perfect PR Storm: Morphet’s Payoffs Amidst The Layoffs**

The unions found their means in using Morphet’s very own pay package to put her integrity in question. Morphet’s appointment as CEO had effectively raised her remuneration from AUD\$0.69 million to AUD\$1.86 million for the financial year ending 30<sup>th</sup> June 2008. Unions denounced these figures as obscene in light of the massive layoffs approved by Morphet herself. This juxtaposition of Morphet’s remuneration with the layoffs tarnished Morphet’s reputation, just as the unions planned. Riding on their success, the unions wasted no time, rousing the public to condemn Morphet as a greedy corporate fat cat<sup>18</sup>. Political forces rubbed salt into the wound, with Treasurer<sup>19</sup> Wayne Swan saying that it was “frankly sickening” to see a privileged few doing so well at a time when thousands of workers are being retrenched<sup>20</sup>. Pacific Brands attempted to justify these numbers, stating that Morphet’s pay rise was

appropriate given that she was promoted from a Division-level Manager to CEO<sup>21</sup>. Chairman MacKenzie explained that Morphet's remuneration was already much lower than the industry benchmarks in Australia<sup>22</sup>. These attempts to reason and explain, however, proved futile; the unions were relentless in pursuing one goal – to keep Pacific Brands' manufacturing jobs within Australia. With a PR crisis engulfing her, Morphet only had the support of the Board and shareholders, for they were counting on her to reverse losses and turn profits.

## **Walking On Thin Ice: Keeping The Shareholders Happy**

Shareholders waited eagerly, hoping to see the fruits of the restructuring effort. The financial year-end of 30 June 2009, however, brought no good news. Shareholders were presented a disappointing reported full-year net loss of \$AUD234.3 million - the company's first loss since its ASX listing in 2004. Further frustrating the shareholders were the ballooning restructuring costs that exceeded initial estimates by AUD\$19 million. Morphet came out to justify these unsightly numbers, citing more layoffs than expected and thus higher retraining expenditure to help "redundant workers" transit to their next jobs<sup>23</sup>. Putting up with the reasons and gritting their teeth, the shareholders gave Morphet more time to turn profits. Morphet was finally able to take some credit when Pacific Brands reported a full-year net profit of AUD\$52.7 million reported in August 2010. Reassuring shareholders, Morphet stated that Pacific Brands was "beginning to realise the positive impacts" of their strategy<sup>24</sup>. But even then, she was treading on thin ice – overall sales were declining, and the full restructuring plan still had a long way to go. Appeasing shareholders with yet another year of net profits would be no easy feat.

## **Curbing Feline Obesity: The Government Intervenes**

Pacific Brands allowed Morphet to take home annual remuneration of AUD\$1.07 million and AUD\$2.30 million for the financial years 2009 and 2010 respectively, and the unions certainly had a field day citing these numbers to label Morphet a greedy corporate fat cat. They looked on triumphantly as politicians and the media added fuel to the PR firestorm engulfing Morphet. With enough heat, they would be able to strong-arm Morphet into withdrawing her decision to offshore Australian jobs – or so they thought.

As it turns out, Morphet refused to budge, and things went off on a different tangent. With Sue Morphet as a starting point, public attention shifted towards the issue of executive remuneration across corporate Australia as a whole. Public discussion heated up as investors pointed out the exponential growth of executive remuneration levels<sup>25</sup>. This resulted in the Government fearing a loss of public confidence in the corporate sector that would cripple capital market activity, and further set back the already-declining economy<sup>26</sup>. Eager to uphold investor confidence, the Australian Government Productivity Commission launched a public inquiry into executive remuneration in Australia on 30 September 2009<sup>27</sup>. So began the health check on corporate Australia's fat cats.

## **Doctor's Prescription: The Two-Strikes Law**

The Commission published their findings on 4 January 2010, putting forth their key recommendation of introducing a Two-Strikes legislation<sup>28</sup>. This legislation would give shareholders a greater say over executive remuneration by allowing them to call for a Board spill<sup>29</sup> should they vote against the executive remuneration packages for two years in a row - thus the name Two-Strikes. The Government approved the legislation, incorporating it into the Australian Corporations Act. The Two-Strikes legislation thus took effect in early 2011, requiring just 25% of shareholder votes against the remuneration package to mark a "Strike"<sup>30</sup>. This set warning alarms ringing over the heads of Pacific Brands' directors; no longer could Chairman MacKenzie step out to defend Morphet's unpopular actions and justify her remuneration - all it took was 25% of shareholder votes against him, and every directors' seat on the boardroom would be in jeopardy.

## **A Scape Goat Too Small: Manufacturing Job Losses As A National Challenge**

Sue Morphet gave unions a name to blame when she first announced Pacific Brands' restructuring in February 2009. But as time went on, Morphet no longer sufficed as a scapegoat to accommodate the unions' mounting anger. Manufacturing job losses had become a nation-wide phenomenon due to a myriad of factors, including falling exports due to currency appreciation, falling consumer spending in the wake of the global financial crisis, and the loss of talent and capital to the booming mining industry<sup>31</sup>. This phenomenon culminated in the loss of 50,000 manufacturing jobs in 2011 alone<sup>32</sup>. Weighed down by bad PR, Pacific Brands plodded on with its

restructuring programme, shedding off a further 100 office jobs<sup>33</sup>. By then, the unions had run out of gas to burn Morphet with. It dawned upon them that even if Morphet wanted to keep the jobs, the hurting economy did not. This, however, brought no comfort to Morphet and the Board, who now had to deal with the newly instituted Two-Strikes legislation.

## **Look Ma, ‘NO’ Hands: Shareholders Use Their Newfound Weapon**

The October 2011 annual general meeting would be particularly tough for MacKenzie and his Board - not only did they have to explain the full-year net loss of AUD\$131.5 million to shareholders, the newly instituted Two-Strikes legislation meant that he needed shareholders buy-in to the remuneration package for Morphet and her fellow senior executives. The shareholders however, were shaking their heads. They could not reconcile the failure to hit performance targets, the reported net loss, and the AUD\$2.89 million of short-term incentives awarded to senior management. AUD\$0.9 million of this amount went to Morphet, bumping her full-year’s remuneration up to AUD\$2.75 million, which is the highest in her tenure as CEO. MacKenzie’s explained that the management had delivered AUD\$150 million in cost savings a year ahead of schedule, and had missed the required earnings hurdles by only 2% . He added that substantial remuneration was required to retain “top-calibre people” like Morphet<sup>34</sup>. The shareholders however, could not buy MacKenzie’s story, and showed their displeasure through their newfound weapon – the Two-Strikes legislation. 52.9% of the 316.7 million votes were in disapproval of management’s remuneration packages<sup>35</sup>, leaving MacKenzie in deep thought as the meeting adjourned. He had to plan the next move carefully, for the first strike had been cast.

## **That’s My Bush: A New Chairman Brings Change**

If MacKenzie was waiting for profits to bring saving grace, it did not come. Pacific Brands reported a half-year net loss of AUD\$362 million in February 2012<sup>36</sup>, prompting MacKenzie to give up any thought of appeasing shareholders. Even if the Board cut management’s remuneration, they would still be hard-pressed to explain the net losses to shareholders. More importantly, MacKenzie did not believe in penalising management for economic factors that were beyond their control. Faced with this dilemma, MacKenzie took a third alternative, announcing his resignation

as Chairman of the Board in May 2012. He was succeeded by Peter Bush, former managing director of McDonald's Australia Limited, and a reputed "expert" in crisis management<sup>37</sup>. The financial year-end of June 2012 saw a full-year reported net loss of AUD\$450 million. Bush exercised his touted abilities, cutting director fees by 25%, and imposing a salary freeze on senior management<sup>38</sup>. The Board further reduced management's maximum short-term incentives by 50%<sup>39</sup>, and refused to award any short-term incentives for the year as performance targets were unmet. The net effect for Morphet was a reduction of her total remuneration package by 14.9% to AUD\$1.6 million<sup>40</sup>. With these changes, Pacific Brands managed to avoid the second strike.

## **Fresh Eyes and New Energy: Morphet Passes the Baton**

*"It is time for a fresh set of eyes and new energy to take this great company forward."*

– Sue Morphet, addressing the public as she announced her resignation<sup>41</sup>

Five years of public hatred, a net loss of AUD\$450 million, and a reduced remuneration package – these were enough reasons for Morphet to step down. And she did, announcing her resignation in August 2012. Her successor was John Pollaers, ex-Chief Executive of Foster's Group. Pollaers filled Morphet's shoes carefully, accepting a remuneration package of AUD\$1.4 million - an amount safe enough to avoid flak from shareholders and the public<sup>42</sup>.

## Discussion Questions

1. Based on the events that have transpired, were the remuneration packages awarded to Sue Morphet reasonable? Why do you think the Board gave her “obscene” pay rises despite the huge losses reported during her tenure?
2. Consider Member of Parliament and Treasurer of Federal Government of Australia Wayne Swan’s comment:

*“To see that a privileged few are doing so well at a time when thousands of workers are being retrenched is frankly sickening.”<sup>43</sup>*

Pacific Brands remuneration strategy comprises fixed pay and performance-based remuneration. Would corporate governance be improved by special adjustments to factor in significant events like massive layoffs?

3. Consider the OECD’s Principles of Corporate Governance (2004) statement that “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders.”
  - a) Do corporations like Pacific Brands owe a duty of job preservation to its employees as stakeholders? Explore the inherent conflict of interests between employees and shareholders.
  - b) Does the company also owe a duty to other stakeholders such as the Australian community and the Government? Discuss.
4. Comment on the roles of company’s shareholders and regulators in determining remuneration packages. Does the two-strike policy improve Management’s accountability to the shareholders? Weigh its pros and cons.
5. In Singapore, the issue of executive remuneration is generally a contractual matter between the company and the executives. Do you think shareholders in Singapore should have a say in executive remuneration? Suggest possible ways to improve the current situation.

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# SK Group: Too Big to Jail?

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## Case Overview

On 31 January 2013, Chey Tae-won, Chairman of South Korean *chaebol* SK Group was sentenced to 4 years jail for the embezzlement of 49.7 billion won from SK Telecom and several other SK affiliates to make up for futures investment losses incurred in 2008<sup>1</sup>. This conviction came after the restructuring of the *chaebol* in response to an attempted takeover by Sovereign Asset Management earlier between 2004 and 2005. The objective of this case is to allow a discussion of issues such as the corporate governance of family-managed conglomerates in South Korea, fraudulent activities undertaken by these leading companies and the appropriateness of actions taken against them, roles of independent directors, the unique relationship between the South Korean government and the *chaebols*, and whether compliance with corporate governance standards necessarily leads to good practices in companies.

## The Story Of SK Group

SK Group is currently the 3<sup>rd</sup> largest conglomerate in South Korea. Founded in 1953 by Choi Jongkun as a small textile producer named Sunkyung Textiles Ltd, Sunkyung began growing rapidly in the 1970s when it moved into the petroleum sector as part of its vertical integration strategy to take control of the production process and raw materials supply<sup>2</sup>. Rising to become the 5<sup>th</sup> largest *chaebol* in the early 1990s, Sunkyung expanded into the telecommunications sector and was renamed SK in 1998 to create a consistent branding across its network of companies<sup>3</sup>.

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This is the abridged version of a case prepared by Guo Cong, Maria Lim Peiyu, Miao Guannan and See Kai under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Geraldine Tan Juan Juan under the supervision of Professor Mak Yuen Teen.

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As of 2012, SK Group had 124 offices and affiliated companies with more than 30,000 employees worldwide. Its core businesses include energy and chemicals, telecommunications, semiconductor, trading and shipping<sup>4</sup>. With annual revenues exceeding US\$100 billion, SK contributes close to 8.7% of South Korea's total Gross Domestic Product (GDP) and is ranked 65<sup>th</sup> in the 2012 Fortune Global 500<sup>5</sup>.

Since 1998, SK has been headed by Chairman Chey Tae-won, who inherited the company from his late father, who is the brother of Choi Jongkhun. Prior to reforms undertaken in 2005, the Group had a complex ownership structure in which the Chey family owned numerous affiliated companies linked to each other via cross-holdings or interlocking transactions, as seen in Figure 1<sup>6</sup>.

This enabled Chey and his family to gain control of the *chaebol*, despite Chey having approximately only 1% direct shareholding in SK Corporation, which was the de facto holding company of the entire network of companies before a restructuring in 2007<sup>7</sup>.



## 2003 Accounting Fraud Scandal

The 2012 scandal was not Chey Tae-won's first brush with the law. On 23 February 2003, Chey was arrested for his association with a US\$1.2 billion accounting fraud at the group's trading arm SK Global<sup>8</sup>. The fraud involved the overstatement of earnings and understatement of debt levels by Chey and nine other executives as the company's debt exceeded its assets by almost US\$3.6 billion<sup>9</sup>.

The news of the scandal hit SK Group hard. On 19 March 2003, SK Corporation's share price fell to an 18-year low of 6,690 won, as compared to 12,950 won in the beginning of the month. In June 2003, Chey was sentenced to a 3-year prison term by the Supreme Court, though the term was suspended for 5 years, before Chey received a pardon from then President of South Korea, Lee Myung-Bak in 2008<sup>10</sup>.

The depression of SK Corporation's stock price during the height of the scandal sparked huge interest among several foreign investors. These investors sought to take advantage of the potential undervaluation of the company to take control of the network of affiliated SK companies via an increased stake in SK Corporation.

## A Struggle For Control

In April 2003, Sovereign Asset Management ("Sovereign") emerged as the largest foreign shareholder of SK Corporation after the purchase of a 14.99% stake in the company. Following the conviction of Chey, SK Corporation faced multiple attempts from Sovereign to gain control of the company<sup>11</sup>.

Prior to the 2004 Annual General Meeting, Sovereign had contested against the decision by the SK Corporation Board to participate in the bailout of its trading arm SK Global by carrying out a debt-for-equity swap of 850 billion won<sup>12</sup>. However, the Board asserted that the bailout was in the company's interest due to the close business relationship between the 2 companies. The bailout, together with SK Corporation's aid to another scandal-hit affiliate, SK Shipping, led to a 93% drop in SK Corporation's profit for 2003 and Standard & Poor's decision to put the company on the negative watch list<sup>13</sup>.

During the Annual General Meeting in March 2004, Sovereign proposed a number of changes to SK's articles of incorporation, including amendments to allow cumulative voting, to establish a compensation committee, to require annual director elections and to prevent convicted criminals, like Chey, from serving on the board. Sovereign also nominated five candidates to replace incumbent directors whose terms were expiring in 2004<sup>14</sup>. However, Sovereign's proposals failed to win approval, despite the strong support from the other foreign shareholders, and only 1 of the 5 nominated candidates won approval from a majority of shareholders and was elected<sup>15</sup>.

In October 2004, Sovereign filed a petition to the courts after SK Corporation rejected its demand to hold an Extraordinary Meeting to amend SK Corporation's charter to disqualify anyone with a criminal conviction from being a director of the company and to allow Sovereign to elect its directors onto the Board. However, the petition was rejected by the courts on the basis that "continuous instability with respect to management right might bring about the departure of investors and cause the investment value to decline"<sup>16</sup>.

In the 2005 Annual General Meeting in March, an intense proxy contest erupted between Sovereign and SK Corporation. On 9 March 2005, Sovereign launched a full-page advertisement in the major newspapers in Seoul, calling for support from local shareholders to oust Chey and overhaul SK Corporation's overall corporate governance in order to boost shareholder value<sup>17</sup>. However, boosted by the high oil prices and a strong demand from growth in China, SK Corporation recorded its largest-ever profit in 2004. It was thus able to garner support from its local shareholders, such as Korea Investment and Trust Management, Chohung Investment and Trust Management, Samsung Electronics and also the South Korea Chamber of Commerce and Industry, who had launched a campaign to purchase SK Corporation's stocks to prevent a hostile takeover bid by Sovereign<sup>18</sup>. As a result, Sovereign's proposals failed to win approval during the Annual General Meeting. Having exhausted all possible avenues, Sovereign sold its entire stake in SK Corporation in July 2005<sup>19</sup>.

## **Building Up A Defence**

During the tussle with Sovereign, SK Corporation was constantly criticised for its poor corporate governance, particularly on the decision to bail out affiliated companies hit by scandals and the entrenchment of directors who were involved in the accounting fraud, in particular Chey.

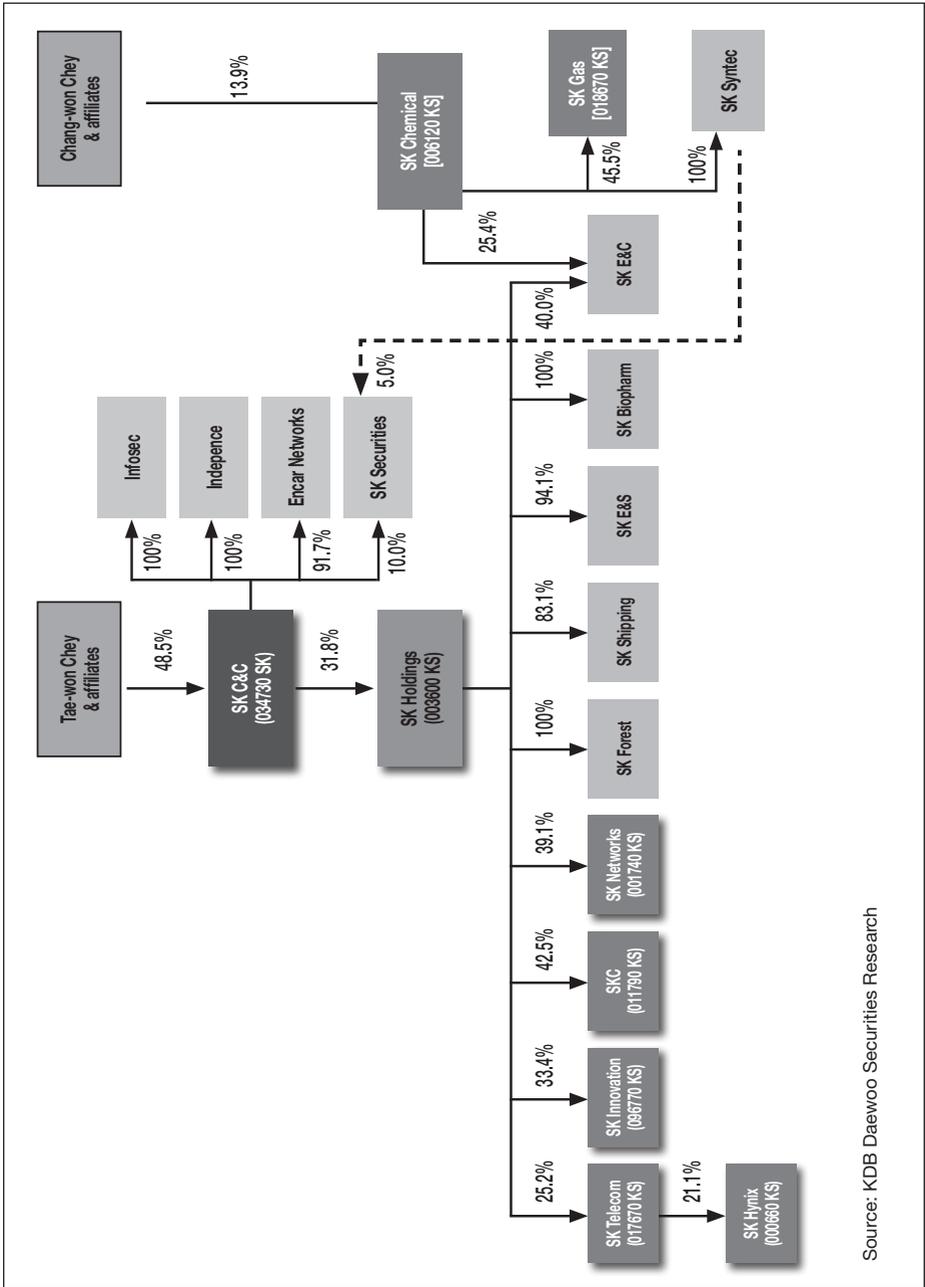
Following the 2005 Annual General Meeting, SK Corporation announced that it would transform its overall ownership structure in an attempt to improve the corporate governance and transparency of the *chaebol*.

Under the new structure, seen in Figure 2, SK Corporation was split into a holding and an operating company, namely SK Holdings and SK Energy-Chemical respectively in 2007<sup>20</sup>. A shareholder with 100 shares of SK Corporation will receive 71 shares in SK Energy-Chemical and 29 shares in SK Holdings, which will be separately traded on the Korean Stock Exchange. The operating company will run SK's main refining and energy businesses and its pipelines. The holding company will have seven major investments, including a 22% stake in SK Telecom, which is Korea's largest telecommunications company<sup>21</sup>.

Kim Kyung-Mo, an analyst from Mirrae Asset and Securities mentioned, "The elimination of cross-shareholding provides transparency in the corporate governance structure, improves efficiency in management and reduces risks as the struggles of one affiliate don't affect others. It also makes it easier for management to push for restructuring or expand businesses"<sup>22</sup>. Before the reform, the company was bound to save any of its underperforming affiliates due to the cross-shareholding structure. Failure of one affiliate may have a drastic negative impact on the whole group's performance. The new holding company structure reduces the risk of one underperforming affiliate dragging down the whole group's performance and makes it easier for the company to eliminate any underperforming affiliates.

## **Other Practices To Improve Corporate Governance**

Following the change in the ownership structure, it appeared that the efforts by SK Group to improve its corporate governance have paid off. Notably, most of the subsidiaries under SK Holdings obtained high corporate governance ratings. For example, SK Telecom was selected as the best company from 2005 to 2010 by Corporate Governance Service and obtained an A+ in ratings<sup>23</sup>. Other key companies including SK Innovation and SK Networks also obtained an A grade in similar corporate governance ratings<sup>24</sup>.



Source: KDB Daewoo Securities Research

Figure 2: SK Group's ownership structure after reform

In terms of Board independence, 3 out of the 8 members are independent outside directors. Their main responsibility is to exercise supervision and ensure that the Board acts in the best interests of the company<sup>25</sup>. Table 1 shows the background of the 3 independent outside directors.

Director	Background
<b>Kwon Oh-ryong</b>	Kwon serves as Non-Executive Independent Director of SK Holdings Co, Ltd and Chairman of the Civil Service Commission. He holds a Master of Public Administration from University of Oklahoma.
<b>Nam San-duk</b>	Nam has been Non-Executive Independent Director of SK Holdings Co., Ltd. since 12 March 2010. He is also a visiting professor of Chung-Ang University, Korea. Previously, Nam was Internal Auditor of Bank of Korea. He holds a Doctorate's degree in Economics from Chung-Ang University, Korea.
<b>Park Sae-hoon</b>	Park is Non-Executive Independent Director of SK Holdings Co, Ltd. He was an advisor in Widerthan Co., Ltd. Park holds a Bachelor's degree in International Trade from Seoul National University, Korea.

Table 1: Profile of SK Holdings' non-executive independent directors<sup>26</sup>

In addition, in compliance with Code of Best Practices for Corporate Governance, the Audit Committee of SK Holdings comprises three non-executive outside directors. At least five meetings are held each year to review the internal accounting management report, auditor's report on financial statements for the fiscal year and evaluation on internal accounting system. The Nominating Committee comprises one inside director and two outside directors to make recommendations of candidates for outside directors<sup>27</sup>. Table 2 shows the details of the three committees.

	<b>Nominating Committee</b>	<b>Transparent Management Committee</b>	<b>Audit Committee</b>
<b>Chairperson</b>	Kwon Oh-ryong	Nam San-duk	Park Sae-hoon
<b>Committee Composition</b>	One inside director Two Outside directors	Three outside directors: Kwon Oh-ryong, Nam San-duk, Park Sae-hoon	Three outside directors: Kwon Oh-ryong, Nam San-duk, Park Sae-hoon
<b>Role</b>	Recommendation of candidate for outside directors	Examination of the clarity of internal transaction between subsidiaries and promotion on ethical management	Financial and performance audit

Table 2: Composition and functions of Board Committees in SK Holdings<sup>28</sup>

## A Case Of Déjà Vu?

In 2011, news emerged that Chey was embroiled in another scandal that involved his brother and Vice-Chairman Chey Jae-Won, and Kim Jung Hong, Chief Executive Officer (CEO) of Venture Capital firm Benex Investment. On 24 December 2011, Chey Jae-won was arrested by the Seoul Central District prosecutors for alleged

embezzlement of 49.7 billion won from SK Telecom and several other SK affiliates to make up for futures investment losses incurred in 2008<sup>29</sup>. Within a week, Chey Tae-won and Kim Jung Hong were also arrested for their alleged involvement in the embezzlement case. In addition, prosecutors also charged Chey Jae-won with breach of trust for causing 20 billion won in damages for Benex by having Benex purchase stock in IF Global, a consulting business he owned under a borrowed name, at 8 times the market price<sup>30</sup>.

On 31 January 2013, Chey Tae-won was found guilty of the embezzlement charge and sentenced to four years in jail, while his brother was acquitted on the charge<sup>31</sup>. Following the conviction, Chey stepped down from the role of Chairman of the entire *chaebol* group in 2012, but remained as Chairman and CEO of holding company SK Holdings, oil refiner SK Innovation and chip maker SK Hynix. On 22 March 2013, Chey was re-elected to the board of its major shareholder of SK Holdings while still serving his term in jail<sup>32</sup>.

## **The Debate On *Chaebols***

A Seoul Central District Prosecutor Office spokesman mentioned that the 2011 SK Group scandal “was a typical example of tycoons’ moral hazard and abuse of power... because the owner family of SK Group ignored the interests of the group companies and used their position to secure funds for their personal investment”<sup>33</sup>. The recurrence of scandals in SK Group highlighted the debate over whether stricter measures should be in place to reduce the power of the *chaebols*, improve corporate governance and punish the convicted leaders<sup>34</sup>.

In the past, the government had attempted to improve the corporate governance of *chaebols*, particularly by encouraging transformation from the complicated cross-holding structure to a holding structure. This was done with the intention to reduce the risk exposure, improve transparency and encourage efficient allocation of resources within the *chaebol*. However, Korea University economist, Professor Jang Ha-sung, who has been leading the calls for *chaebol* reform, mentioned the “irony that the system might actually result in strengthening the control of founding families over their conglomerates.” and “the dominant shareholders are now allowed to strengthen their management control with the backing of government regulations”<sup>35</sup>. This includes the passing of the law by the Korean National Assembly in 2007 to lower the minimum stake a holding company needs to own in an affiliate, from 30% to 20%, which enabled the *chaebol* to retain control over its affiliated companies. Past

measures introduced by ex-President Lee Myung-Bak included reducing corporate tax rates and unwinding of group transaction limits which actually contributed to the growth of these conglomerates<sup>36</sup>.

In addition, the court's rejection of Sovereign's petition to disqualify directors with a criminal conviction in 2004 on the basis of economic development seems to signal to minority shareholders that the court has a predetermined stance to protect *chaebols* regardless of their proposals' validity. The leniency granted towards *chaebol* leaders embroiled in criminal convictions by the government also raises the question of whether the government is more interested in preserving the stability among the *chaebol* leadership in order to maintain their economic contribution to the economy, rather than uphold corporate governance. This is especially since the top 10 *chaebols* contribute to almost 80% of the entire GDP of South Korea<sup>37</sup>.

## Moving Forward

In 2013, the newly elected President Park Geun-hye announced that the new government will adopt a "economic democratisation" plan, which aims to (1) crack down on the unfair business practices and *chaebols*' dominance in the industrial and other sectors of the economy (2) create a fairer business environment and (3) hold the *chaebols* accountable for malpractices committed<sup>38</sup>. However, whether the new government is able to tackle the issues with the *chaebols* remains to be seen.

## Discussion Questions

1. Would the change from a circular or cross-ownership structure to a holding company structure help to improve corporate governance in a company? Evaluate the effectiveness of the reform introduced by SK in 2005.
2. Why did the shareholders reject the proposals made by Sovereign even though it appeared to be favourable to them?
3. In what way would Sovereign's attempted takeover be different if the case occurred in the U.K.? Discuss.
4. Does abiding by the code of corporate governance and achieving good corporate governance ratings necessarily imply good corporate governance practices?
5. What is the role of the Korean government in influencing the corporate governance of *chaebols* like SK Group in Korea?
6. Imagine that you are an expert in corporate governance and the newly elected Korean government approaches you for advice to improve the corporate governance within *chaebols* such as SK Group. What are some recommendations you will propose?

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# Sun Hung Kai: Brothers (Up) in Arms

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## Case Overview

In early March 2011, Sun Hung Kai Properties (SHKP) received the 2011 Asiamoney Best Corporate Governance in Hong Kong accolade<sup>1</sup>. A few weeks later, the Independent Commission Against Corruption (ICAC) launched an investigation into SHKP for involvement in bribery. Soon after, SHKP made headlines in Hong Kong regarding the arrest of the billionaire brothers, Raymond and Thomas Kwok. The news caused SHKP shares to plunge the most in 14 years, losing US\$4.9 billion in market value<sup>2</sup>. The objective of this case is to allow discussion of issues such as corporate governance in the context of family-controlled businesses, board composition and director independence, as well as bribery and corruption.

## Background Of Corporate Governance In Hong Kong

In 2011, Hong Kong broke the record to become the first Asian financial centre to top the World Economic Forum's fourth annual *Financial Development Report*, surpassing the U.S. and the U.K.. Hong Kong's position as an international economic and financial centre has been attributed to its exemplary corporate governance<sup>3</sup>. The Hong Kong government has long acknowledged that good corporate governance is fundamental to improving corporate competitiveness and to attract foreign investment.

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This is the abridged version of a case prepared by Liow Wei Quan, Tracey Ng Meiyue, Ong Wei Xiang, Stephanie Bay Tan Hui Huang and Glen Tan Wei Jie under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Geraldine Tan Juan Juan under the supervision of Professor Mak Yuen Teen.

With Hong Kong's various authorities and regulatory bodies emphasising transparency and accountability for listed companies, Hong Kong was ranked second by Asian Corporate Governance Association for corporate governance among 11 Asian countries in 2012, trailing closely behind Singapore<sup>4</sup>. Hong Kong also has the reputation of being one of the world's least corrupt countries. Transparency International ranks Hong Kong at No. 12 out of 182 countries<sup>5</sup>. One reason for this is the presence of the ICAC, which acts independently of government. Nevertheless, it is common for the government and big businesses to work closely together. In fact, the government's single biggest source of revenue is from land sales to property developers<sup>6</sup>.

## **The Story Of Sun Hung Kai Properties**

SHKP was founded in 1963 by Kwok Tak Seng, together with Fung King-Hei and Lee Shau Kee. SHKP's core business is the development of property for sale and investment. SHKP is also involved in complementary business activities related to hotels, property management, construction and insurance, and has investments in telecommunications, information technology, transportation, infrastructure and other businesses. In 1972, SHKP became publicly listed on the Stock Exchange of Hong Kong<sup>7</sup>.

Over the years, SHKP became the world's second-largest property company with a market capitalisation of US\$32 billion. Together with its rival Cheung Kong (Holdings), they dominate Hong Kong's home-building and office-development industries. During FY2011, SHKP recorded revenues of HK\$62,553 million (approximately US\$8,038.1 million), an increase of 88.4% over FY2010<sup>8</sup>.

## **Awards And Accolades**

In a recent poll conducted by Asiamoney in 2011, SHKP emerged in the top position for Best Corporate Governance in Hong Kong. In attaining this recognition, SHKP had portrayed an outstanding image of upholding high standards of corporate governance in the company. On top of that, SHKP has received several other corporate governance awards from FinanceAsia and Corporate Governance Asia over the years<sup>9</sup>.

## Ownership Structure

The Kwok family is one of Asia's most powerful families. The Kwoks, with estimated wealth of US\$18.3 billion according to Forbes magazine, ranked locally in wealth only behind Asia's richest man, Li Ka-Shing, founder of Cheung Kong. The brothers and their family are ranked as the 27th richest in the world. The three brothers, Walter Kwok, Thomas Kwok and Raymond Kwok, as well as their mother Kwong Siu-hing, sat on the board in 2011<sup>10</sup>.

Kwong Siu-hing was the largest shareholder of the company with a shareholding of 42.17% in 2011, through the control of the family trust set up by the late Kwok Tak Seng<sup>11</sup>, who founded the company in the 1963. The three brothers also had deemed interest in the family trust, which meant that there was an overlapping of shareholdings among the family.

## The Board

As of 30 June 2011, the Board of Directors was made up of 18 Directors (excluding the alternate Directors), out of which 7 were Executive Directors, 7 were Non-Executive Directors and 4 were Independent Directors<sup>12</sup>. There were four board committees – Executive Committee, Audit Committee, Remuneration Committee and Nomination Committee. Among the Non-Executive Directors were former executives of SHKP such as Walter Kwok and Michael Wong. Although there were 18 directors in 2011, Chairman Kwong Siu-hing was instrumental in many of the company's decisions and had great control by virtue of her shareholding and status in the family.

## Board Diversity

Another characteristic of the Board was its lack of female representation other than the Chairman. In addition, a large percentage of the Board members had similar backgrounds, either in the banking or property industry. For example, Woo Po-shing was concurrently a director of Henderson Development Limited<sup>13</sup>, which is also a leading Hong Kong property developer, while Yip Dicky Peter and Donald Leung were from the banking industry.

## Independent Directors

One of the Independent Directors, William Fung, concurrently held a non-executive directorship with HSBC bank. Based on the shareholding disclosed, HSBC Nominee Bank was the second largest shareholder with over 42.09% of the SHKP's shares being held in its name. SHKP held the view that William Fung was independent by virtue of the fact that William Fung did not control the HSBC Trustee's voting decision, as disclosed in the Annual Report<sup>14</sup>.

In addition, the Independent Directors also sat on numerous Boards. As disclosed in the 2011 Annual Report, Richard Wong sat on a total of 7 boards; another Independent Director Li Ka-cheung also sat on a total of 7 boards and William Fung sat on 8 boards.

## Family Dispute

In 2008, animosity started breeding in the Kwok family when Walter had an intimate relationship with a female confidante, Ida Tong, which rocked the relationship with his brothers. The brothers had felt that Ida was exerting undue influence on the company. Subsequently, Walter, who had been Chairman since 1990, was ousted with claims of him being unfit to serve the board, and his mother, Kwong Siu-hing, then took over as Chairman from May 2008 to December 2011. Raymond and Thomas claimed that their eldest brother Walter had bipolar affective disorder and was unable to fulfil his duties. In a court order seeking to prevent his removal, Walter denied his brothers' claims. To further exert their power over Walter, Kwong Siu-hing, as head of the Kwok household, took him out of the family trust in 2010<sup>15</sup>. In December 2011, Raymond and Thomas were appointed as Joint-Chairmen of SHKP<sup>16</sup>.

The Kwok family dispute has not been resolved ever since. Traces of the family dispute, which led to the removal of Walter Kwok as the Chairman and Chief Executive of the company<sup>17</sup>, were evident in the 2011 Annual Report. Walter Kwok disclosed that he "had recently been given certain information about his share interest in the Company which he found to have serious discrepancy with what his understanding is and that his share interest in the Company is under dispute"<sup>18</sup>. His failure to attend any Board of Directors' meeting in 2010 and 2011 and the lack of involvement in sub-committees of the Board reflected minimal interest in the company affairs.

## “King Strategist”

Rafael Hui Si-yan, whose nickname is “King Strategist”, had been friends with Thomas Kwok and Raymond Kwok since childhood through family connections. According to sources close to the family, he was also trusted by the Kwoks’ mother. In 2005, Rafael Hui was appointed as the Chief Secretary for Administration for Hong Kong, which is the second highest position of the Hong Kong Government. Upon taking up office, Rafael Hui declined to move into the colonial mansion on Victoria Peak reserved for the chief secretary. Instead, he chose to stay in his luxurious 5,000 square feet apartment, situated in the Leighton Hill complex, a Sun Hung Kai development. Rafael Hui pledged to pay HK\$160,000 (US\$20,600) per month in rent to remain in the apartment<sup>19</sup>. That decision sparked criticism that Rafael Hui would be placed in a position of conflict of interest in his public role because of his dealings with the Kwok family. As Chief Secretary, Rafael Hui’s connections with SHKP came under public scrutiny after he took on an oversight role of the billion dollar project, West Kowloon cultural district, which SHKP had bid for. Over the years, Rafael Hui provided both political and business advice to SHKP. This benefited SHKP greatly as a developer in a city where land supply is regulated by the government<sup>20</sup>.

## The Fall

On 19 March 2012, one of the longest serving executive directors, 66-year-old Thomas Chan Kui Yuen, was arrested by the ICAC in connection with a bribery investigation<sup>21</sup>. Despite this bad news, the shares in SHKP only fell slightly by 2.4%. Many analysts attributed the mild market reaction to his retirement age and that the arrest was unlikely to affect the company’s long term operations<sup>22</sup>. John Chan, an analyst at Standard Chartered, wrote in a report that investors would only be concerned if the allegations were extended to the company and other senior management<sup>23</sup>.

On 29 March 2012, Joint Chairmen Thomas Kwok Ping Kwong and Raymond Kwok Ping Luen were arrested in connection with bribery involving Rafael Hui. The company’s shares were halted from trading early Thursday morning, shortly after the market opened. When it resumed trading the next morning, its shares plunged by 15%. The decline in the stock price and unusually high trading volume were the results of stock downgrading by at least four banks and brokerages, including Citigroup Inc. and Barclays Plc. In addition, Standard & Poor’s also placed the

company's A+ debt rating on negative credit watch. By 30 March 2012, SHKP's market capitalisation had shrunk by US\$4.9 billion<sup>24</sup>.

Just over a month later on 4 May 2012, former Chairman and current non-executive director Walter Kwok Ping Sheung was also arrested on suspicions related to an anti-bribery ordinance<sup>25</sup>. On the same day, the company's shares were suspended from trading together with those of its unit SUNeVision Holdings Ltd. By 4 May, SHKP shares had fallen by 17% compared to a 2.1% decline in Hang Seng Property Index over the same period. By 28 May 2012, SHKP had lost a fifth of its market capitalisation since the arrests on 29 March 2012<sup>26</sup>.

Even though the ICAC had commenced legal actions against the senior management of SHKP, the company was not a party under any direct legal action. With regards to board and management, two independent non-executive directors were appointed to strengthen the board, and two deputy managing directors were appointed to assist the co-Chairmen as alternate directors in the event of their absence from board meetings. Investors viewed this news positively as was evident from the increase in stock price and trading volume. However, analysts from Barclays, Bank of America Merrill Lynch and CreditSights were still uncertain about the future of SHKP, citing problems of corporate governance and succession planning<sup>27</sup>.

On 13 July 2012, SHKP requested for a suspension of trading of its securities pending the release of an announcement which was price sensitive. On the same day, Thomas Kwok, Raymond Kwok and Rafael Hui were formally charged with offences linked to bribery and misconduct by Hong Kong's ICAC<sup>28</sup>. SHKP resumed trading on 16 July 2012.

## **The Charges**

The charges that the two Kwoks and Rafael Hui faced include providing false information, misconduct in public office, conspiracy to commit misconduct in public office, and offering an advantage to a public servant. In total, it was alleged that Mr Rafael Hui accepted approximately HK\$34 million in cash and unsecured loans as well as exclusive rent-free use of two luxury apartments in Happy Valley between June 2000 and January 2009.

According to the ICAC,

- Rafael Hui received “the rent free use of two flats and three unsecured loans totalling HK\$5.4 million” from a Sun Hung Kai subsidiary and did not disclose or declare this to Hong Kong government and the Mandatory Provident Fund Authority (MPFA).
- Rafael Hui, during his tenure as Chief Secretary, accepted “HK\$5 million from Thomas Kwok for remaining favourably disposed to Thomas Kwok and/or his interests.”
- Rafael Hui, during his tenure as Chief Secretary, accepted “HK\$4.125 million through a company owned by Hui from SHKP for Hui’s remaining favourably disposed to Raymond Kwok and/or his interests.”
- Rafael Hui and Raymond Kwok both face “one count of furnishing false information on an invoice to purportedly show that the payment of HK\$4.125 million was for settlement of consultancy services provided by Hui.”
- Rafael Hui and Raymond Kwok conspired “to offer Hui the annual extensions of an unsecured loan of HK\$3 million advanced by the [Sun Hung Kai] subsidiary . . . as a reward for Hui to remain favourably disposed to Raymond Kwok and/or his interests.”
- Rafael Hui, during his tenure as Chief Secretary, accepted “a series of payments totalling HK\$8.35 million from Thomas Kwok, Thomas Chan and Francis Kwan for Hui’s remaining favourably disposed to Thomas Kwok and/or his interests.”
- Rafael Hui, Thomas Chan and Francis Kwan conspired “to offer Hui a series of payments totalling HK\$11.182 million from Chan and Kwan as a reward for Hui to remain favourably disposed to Chan and/or his interests”<sup>29</sup>.

As of May 2014, the Kwok brothers and Hui pleaded not guilty to the charges, including misconduct in public office and furnishing false information<sup>30</sup>. More charges continue to be added to the case; for instance, Raymond Kwok faces additional charges for conspiracy with Hui to commit misconduct in a public office<sup>31</sup>. The trial is estimated to last until the end of September and possibly into October 2014, and SHKP issued a statement that the case has not and will not affect the company's operations<sup>32</sup>.

## **In The Public Eye**

The SHKP case is seen to be the highest-profile case involving alleged corruption in Hong Kong. This case has attracted great public attention not only because the Kwoks are some of the most prominent, influential and wealthy businessmen in Hong Kong, but also because the arrests coincided with the election of the new Chief Executive of Hong Kong, Mr Leung Chung-ying. Further, with this being the first arrest of anyone who has held such a high post in the government sector, and with the involvement of the Kwok family, it certainly jolted Hong Kong society's view on the relations between the government and private sector<sup>33</sup>. As mentioned by Joseph Wong, a former senior government official, "this is not good for the image of Hong Kong, which used to have a high reputation for integrity"<sup>34</sup>. This incident will only raise more doubts about corporate governance in Hong Kong and the ethics of its senior government officials.

Another concern which surfaced relates to the appointment of Adam and Edward Kwok to the board. Peter Churchouse, Chairman & MD at Hong Kong-based property investment company Portwood Capital, suggested that this appointment may cast some doubt for investors as they may question if Adam and Edward Kwok, aged 29 and 31 respectively, are "really equipped to be running a US\$32 billion market cap company at this tender age"<sup>35</sup>.

The economic slowdown in China and the uncertain global economic landscape are already starting to affect the property sector in Hong Kong. Now, with the bribery charges and family strife at SHKP, the leadership at SHKP faces a tough challenge of guiding the company out of this corporate governance crisis.

## Discussion Questions

1. What were the problems with the board structure of SHKP in 2011?
2. In relation to the case, what are the corporate governance issues that family owned businesses face?
3. Suggest some improvements to the corporate governance of Sun Hung Kai.
4. What are some of the key similarities and differences in the Code of Corporate Governance governing Singapore and Hong Kong? Could such a scandal happen in Singapore?
5. What are the mechanisms in Hong Kong that help to prevent corruption? Does Singapore have similar mechanisms?

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# BP and Russian Roulette

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## Case Overview

Russian oil company TNK-BP was established in 2003 as the result of a strategic partnership between oil company BP and a group of Russian businessmen represented by the Alfa Access Renova (AAR)<sup>1</sup>. Corporate disputes broke out in 2008 due to differing opinions that BP and AAR held concerning TNK-BP's corporate governance structure and future strategy<sup>2</sup>. While tensions died down in 2010, BP's attempt to go into partnership with Russian state-owned company Rosneft in 2011 – which would have violated its TNK-BP contractual obligations– worsened relations once more. In 2013, following the failed partnership, Rosneft acquired TNK-BP shares from both BP and AAR. The objective of this case is to allow a discussion of issues such as those relating to corporate governance and shareholder disagreements in joint ventures, the role of independent directors in joint ventures, state involvement in corporate governance, minority shareholder rights and corporate governance in an emerging market.

## The TNK-BP Joint Venture: An Emotional Rollercoaster

*“This is a historic day for BP in Russia. BP has invested in Russia for more than 20 years and for a decade we have been Russia’s largest foreign investor through our involvement with TNK-BP. We aim to continue that success with today’s transaction, which increases our stake in Rosneft and gives us a wonderful opportunity to forge a new partnership with a great Russian oil company”<sup>3</sup>.*

– Bob Dudley, CEO of BP plc

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This is the abridged version of a case prepared by Beatrice Sim Tze Ching, Kong Choong Lee and Ng Xi Lei under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Chloe Chua under the supervision of Professor Mak Yuen Teen.

## **BP PLC (“BP”) in Russia**

Based in London, BP was established in 1909 with roots as the Anglo-Persian Oil Company<sup>4</sup>. Today, it is one of the largest multinational oil and gas companies in the world, engaged in a myriad of activities within the oil and gas industry from oil exploration and production, to distribution and marketing as well as power generation. In addition, its operations extend to the field of renewable energy<sup>5</sup>.

BP entered and began operations in Russia from the beginning of the 1990s. It made its major entry into the country in 1997 when it acquired a 10% stake in Sidanco, one of Russia’s leading oil companies at that time (the stake was later increased to 25% in 2002)<sup>6</sup>. Subsequently, BP made greater advances in Russia, including embarking on a joint venture with Rosneft, a large Russian state-owned oil company. BP also engaged in a number of projects in Sakhalin<sup>7</sup> before its next milestone event in 2003, when the TNK-BP joint venture was established in collaboration with the Russian consortium, Alfa Access Renova (AAR).

## **The Three Musketeers: Alfa Access Renova (“AAR”) Consortium**

AAR Consortium, comprising the Alfa Group, Access Industries and the Renova Group, was formed to oversee their interests in the impending joint venture, TNK-BP, with BP. Access Industries and Renova Group each held a 12.5% share in TNK-BP while the Alfa Group held 25%<sup>8</sup>. Their stakes in the company were to serve as the voice for the Russian shareholders in this business venture. AAR was headed by Mikhail Fridman, alongside other oligarchs German Khan, Len Blavatnik and Viktor Vekselberg<sup>9</sup>.

## **The TNK-BP Joint Venture**

Formed in 2003, the TNK-BP joint venture dealt in oil and gas production in Russia and was the third largest oil producer in Russia then, only trailing behind Rosneft and Lukoil. It accounted for 16% of Russian oil output production with annual net income of US\$5.8 billion in 2010 and US\$6.8 billion in 2011. The joint venture was owned by BP and AAR, with 50% shareholding each<sup>10</sup>.

Both AAR and BP stood to gain from the collaboration. The joint venture would help BP fortify its growth in the long run by securing new reserves and production regions, and allow BP to gain a foothold in the local markets and strengthen its relationship with its Russian partners. On the other hand, the joint venture would present AAR with new business opportunities, such as technology and knowledge sharing, expansion into the global market, and access to international capital markets<sup>11</sup>.

### **Board And Shareholding Structure Of TNK-BP**

TNK-BP's board was composed of ten directors<sup>12</sup>, with five members nominated by AAR and five by BP respectively. The board chairman Mikhail Fridman was nominated by AAR while president and chief executive Bob Dudley was appointed by BP<sup>13</sup>. In a corporate restructuring programme in 2005, TNK-BP Holding was formed with 95% shareholdings by TNK-BP and 5% by minority shareholders<sup>14</sup>.

## **A Joint Venture Problem**

TNK-BP's oil and gas production rose sharply by 24% from 2003 to 2005<sup>15</sup>. The instantaneous success was momentary as tensions between the British and Russian shareholders began to surface. First, the 50:50 shareholding structure of the joint venture made the resolution of disagreements difficult whenever there was a corporate governance deadlock<sup>16</sup>.

Second, AAR and BP had entered into the joint venture with polarised opinions on the strategic direction of TNK-BP and its corporate governance structure. Under the management of CEO Bob Dudley, BP managed TNK-BP like a subsidiary. AAR on the other hand was more ambitious as it saw TNK-BP as a vehicle to invest beyond the Russian borders. BP was reluctant to expand TNK-BP's operations abroad as the joint venture would be in direct competition with BP on an international scale. This angered AAR's New York-based chief executive, Stan Polovets, who exclaimed, "We never had an agreement with BP stipulating that TNK-BP would refrain from activities outside of Russia"<sup>17</sup>.

Apart from disagreements over corporate strategies, the oligarchs Fridman, Vekselberg and Blavatnik were unhappy with BP's representative Bob Dudley, who exerted more control than he apparently had in his capacity as the CEO of TNK-BP in running the business of the joint venture. Furthermore, Dudley's practice of bringing in BP expatriates to TNK-BP was faced with resentment from the Russians as it was perceived as unnecessary and expensive<sup>18</sup>.

### **Outbreak And Resolution**

The tension between both parties worsened when Gazprom, the Moscow-based, state-owned gas producer came into the picture. In 2007, financial disagreements within the TNK-BP joint venture broke out when both parties were unable to agree on whose shares of the Siberian gas field Kovykta should be sold to Gazprom and at what price<sup>19</sup>. BP was also alleged to be seeking Gazprom as its new partner to replace AAR in the joint venture. Despite the inconclusive result of the BP-Gazprom talk, AAR was offended, as its partner was side dealing without its involvement<sup>20</sup>.

The TNK-BP situation was aggravated when 148 BP secondees were recalled from Russia due to visa irregularities<sup>21</sup>. Although BP managed to reinstate the employees' visas, Tetlis, a minority shareholder of TNK-BP Holding, successfully lodged a lawsuit one month later against the joint venture over the agreement of allowing technical specialists from BP to be transferred to TNK-BP and demanded BP to return all payments received from TNK-BP<sup>22</sup>. In addition, Bob Dudley faced many investigations and was accused by a group of Russian managers at TNK-BP in a separate lawsuit filed in July 2008 for discriminating against local staff by overpaying BP expatriates<sup>23</sup>. Consequently, Dudley was forced to leave the country as he was denied an extension of his work visa<sup>24</sup>.

The corporate clash reached its zenith when the Russian shareholders of the joint venture called for the resignation of Bob Dudley. In December 2008, Bob Dudley stepped down as the CEO of TNK-BP<sup>25</sup> and both parties agreed that each would have four board representatives and three independent directors on the board. Both BP and AAR also decided that TNK-BP should start acquiring assets beyond Russia and the joint venture would be run by an independent CEO<sup>26</sup>.

### **Tipping The Scales?**

By 2009, the three independent directors had been appointed: Alexander Shokhin, President of the Russian Union of Industrialists and Entrepreneurs; Gerhard Schroeder, Former German Chancellor; and James Leng, the incoming chairman

of Rio Tinto mining group. While Leng was nominated by BP and Shokhin was nominated by AAR, both Shokhin and Schroeder had close relations to the Russian state. Analysts noted that this essentially meant a majority representation for the Russian shareholders on TNK-BP's board<sup>27</sup>.

## Partnering With Rosneft (2011)

### Lost Opportunities – Unsuccessful Arctic Deal

The Russian Arctic has vast oil and gas resources. The Russian state-owned company Rosneft had the rights over these fields, and BP wanted access to these resources. Thus, in January 2011, amidst the corporate disputes with AAR, BP entered into a US\$16 billion share swap agreement with Rosneft for the exploration of the Arctic, without the approval of TNK-BP. The intensity of the conflict between BP and AAR had been diminishing since 2009, but the Arctic deal reignited the dispute and provoked a huge backlash from the oligarchs. They successfully sought a legal injunction against BP in carrying out the deal.

Subsequently, BP attempted to buy out AAR's stake in the joint venture, so that it could partner with Rosneft to proceed with the Arctic exploration deal. However, this was unsuccessful for two reasons. First, even though a price to buy-out AAR's 50 per cent stake had already been settled on, the most influential of the oligarchs Mikhail Fridman refused to sell as he wanted a hand in this huge deal<sup>28</sup>. Second, the presence of political pressure from then Russian President Dmitry Medvedev greatly hindered the finalisation of the buy-out agreement, as he was intent on limiting then Russian Prime Minister Vladimir Putin's control<sup>29</sup> over the energy sector<sup>30</sup>. During BP's negotiations with AAR, Rosneft began looking for other partners for the joint exploration deal. BP eventually lost a tremendous potential source of revenue as Rosneft partnered BP's competitor, ExxonMobil<sup>31</sup>.

In the same year, decision-making in the joint venture came to a standstill due to the absence of a quorum<sup>32</sup> for board resolutions, since the two independent directors who left in May<sup>33</sup> had yet to be replaced<sup>34</sup>. In relation to the failed Arctic deal, the Russian shareholders of TNK-BP claimed that BP had been hindering the process of filling up the board seats so as to prevent TNK-BP from possibly suing itself for up to US\$10 billion in damages for breach of contract over this deal<sup>35,36</sup>.

## **Fridman's Dual Role As Chairman And Interim CEO**

After the resignation of Bob Dudley<sup>37</sup>, Maxim Barsky, the executive vice president for strategy and business development at TNK-BP was nominated to be the new deputy CEO, with Mikhail Fridman taking over as interim CEO before the official appointment of the former. At that juncture, Fridman was not only the chairman and co-founder of the Alfa Group, but also the executive chairman of the TNK-BP board. Barsky's tenure as a deputy CEO was short-lived; he resigned nine months after his appointment, citing the corporate conflict between BP and AAR as the main reason<sup>38</sup>. Thereafter, Fridman was to resume his role as interim CEO until the end of 2013.

In 2012, Fridman resigned as interim CEO while retaining his position as chairman of the board. AAR publicly announced that Fridman's resignation was a result of disputes within the board and consequently interrupted operations of the joint venture. For instance, no dividends were being paid out due to the absence of a quorum for board resolutions<sup>39</sup>.

## **Latest Developments**

### **State Pressure On The Energy Sector**

After its failed proposed partnership with Rosneft, BP began looking for buyers to take over its stake in the joint venture. Due to political reasons, Rosneft was again identified as a potential buyer – this time for BP's stake. BP had to stay in the Russian market if it aspired to remain as an internationally competitive oil and gas company. Selling its stake to other Russian oil companies would be tantamount to abandoning its foothold in the Russian energy sector. Entering into a transaction with Rosneft, however, would grant BP access to Russia's Arctic resources. Furthermore, Rosneft is a powerful entity backed by current Russian President Vladimir Putin; by refusing an offer from Rosneft, BP risked offending the state and this might be detrimental to BP's long-term operations in Russia.

From AAR's perspective, a Rosneft buy-out of BP's stake in the joint venture would likely leave it with two options: allow AAR's remaining 50% stake in TNK-BP to be taken over by Rosneft or continue operating under political pressure. The Kremlin's aim in expanding its influence in the energy sector would gradually or even forcefully take over AAR's stake in TNK-BP. It was just a matter of time<sup>40</sup>.

## The Rosneft Takeover

In March 2013, BP sealed the deal with Rosneft to sell 50% of its stake in TNK-BP for US\$16.7 billion cash and 12.8% of Rosneft's shares. Shortly after, BP acquired an additional 5.7% of Rosneft's shares from the government-owned holding company, Rosneftegaz. Along with BP's existing shareholdings in Rosneft, these new shares meant that BP owned a total of 19.75% of the state-owned company, becoming the company's second largest shareholder. In addition, BP was promised two seats on Rosneft's board of directors as part of the consideration of the entire transaction<sup>41</sup>.

Concurrently, AAR sold its 50% stake in TNK-BP to Rosneft for US\$27.7 billion. The TNK-BP acquisition thus amounted to US\$55 billion and Rosneft became the largest listed oil producer in the world. Through TNK-BP, Rosneft owned 95% of TNK-BP Holding, which was subsequently renamed as RN Holding<sup>42</sup>.

## Tying Up Loose Ends: Buying Out The Minority Shareholders

After the transaction, RN Holding's share price plummeted by 40% toward the end of March 2013. This was likely due to Rosneft's refusal to buy out the 5% minority stakes in RN Holding, followed by its decision to borrow US\$10 billion from RN Holding to repay the loans taken for the US\$55 billion TNK-BP buy-out deal, as well as the termination of the dividend policy<sup>43</sup>. Minority shareholders were still doubtful about the new owner despite Rosneft's public announcement reassuring the repayment of the US\$10 billion loan. Some were skeptical that Rosneft would share its profits with them and felt uncomfortable with the termination of the dividend policy. These circumstances also made it difficult for the international minority shareholders to find buyers for their stakes.

Despite the dissatisfaction among the minority shareholders, Rosneft CEO Igor Sechin was not afraid of offending them due to Rosneft's strong backing by the state<sup>44</sup>. Sechin declared that the company had no obligation to buy out the minority stakes as he claimed Rosneft was not a "charity fund"<sup>45</sup>.

This issue led to many foreign investors criticising the standard of corporate governance in Russia. Hence, at an investment conference in September, current Russian Prime Minister Dmitry Medvedev proposed to Igor Sechin that Rosneft buy out the minority stakes, since the company had the finances to do so and it "would improve the investment climate in the case of this company"<sup>46</sup>. This also prompted current Russian President Vladimir Putin to urge Rosneft to buy out the minority shareholdings at market price, in an attempt to improve foreign investors' impression of corporate governance in Russia<sup>47</sup>.

## **Take It Or Leave It**

These “suggestions” from top politicians pressured Rosneft to make an offer to buy over the 5% minority stake – except that the quoted price was much lower than what was offered to BP and AAR. The offer that Rosneft announced amounted to US\$2.07 per share, which was a total of US\$1.5 billion for the entire minority stake. However, the four oligarchs of AAR received an amount close to US\$3.70 per share for their 50% stake in TNK-BP. On this basis, the value of the minority shareholdings should have been approximately US\$2.8 billion.

The offer was criticised by the minority shareholders and other public figures. Notably, as stated by Chris Weafer, senior partner at the international consultancy firm Macro-Advisory, “This is a bad offer... the price they are offering to the minorities is almost half what Rosneft paid to BP and the oligarchs... and it sends a negative message”<sup>48</sup>. It is now up to the minority shareholders to accept the offer.

## **Epilogue**

On May 25 2014, it was reported that Rosneft and BP had officially entered into an agreement to “jointly explore hard-to-recover oil in Russia” at the St. Petersburg International Economic forum<sup>49</sup>. President Putin was also in attendance at the forum.

## Discussion Questions

1. Consider some good public company governance practices with respect to board structure and independence of board from shareholders and management. How applicable are these practices to joint ventures?
2. Based on your answer in question one, assess the old and new board of directors. Are there any improvements in corporate governance after the board restructuring?
3. Comment on the introduction of the independent directors into TNK-BP. How independent are they likely to be? What are the challenges faced by independent directors in a joint venture?
4. Comment on the corporate governance issues surrounding the position of the CEO in TNK-BP.
5. What are the issues with shareholder involvement in joint ventures? Suggest some ways to improve on these issues.
6. The TNK-BP case saw many instances where the Russian state interfered in the affairs of the business. What are the implications for corporate governance?
7. How important is it for the government to protect minority shareholders? Put yourself in the shoes of the minority shareholders at RN Holding (formerly known as TNK-BP Holding). Would you accept Rosneft's offer? Explain.

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# Cadbury: Opening Pandora's Chocolate Box

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## Case Overview

In 2013, it was reported that the Cadbury group had concocted ingenious schemes aimed at reducing their group tax liability by setting up subsidiaries in tax havens that pass the vigorous inspection of regulators. It was also alleged that records and accounts were manipulated. The objective of this case is to discuss issues such as compliance with the letter of the law versus ethics, the interests of shareholders versus other stakeholders, and the impact of tax avoidance on a company's reputation.

## Football And Chocolates?

*"And the FIFA Ballon d'or 2012 goes to...Lionel Messi".*

–The Telegraph<sup>1</sup>

The little Argentinian paces up the stage and collects a record-breaking fourth consecutive World Player of the Year Award<sup>2</sup>. With his scintillating soccer ability on the pitch, along with his humble demeanour, there is no question why Lionel Messi is a role model to many aspiring footballers. Off the pitch, Messi is highly involved in charity work and causes. He is a UNICEF International Ambassador and has his own Leo Messi Foundation, which is a charity supporting access to education and health care for vulnerable children<sup>3</sup>.

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This is the abridged version of a case prepared by Jeremy Lye Kuo Leong, Daniel Long Jicheng, and Jesse Leow Choon Ern under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. This case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees. This abridged version was edited by Lim Jin Ying under the supervision of Professor Mak Yuen Teen.

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September 2013, however, sees another side of Messi, as he exits a court after testifying in an alleged tax fraud case. Incomplete income tax returns and the use of companies in Uruguay, Belize, Switzerland and the United Kingdom (U.K.) to hide income from the sale of Messi's image rights were alleged to have enabled Messi to avoid taxes of more than 4 million euros between 2006 and 2009<sup>4</sup>. However, Messi and his father denied any wrongdoing, stating they have always complied with the rules.

So what does a football legend, with a previously pristine reputation for sportsmanship and charity work, have to do with chocolates? In this case we shall explore this seemingly unexpected connection.

## **Tax Avoidance Versus Tax Evasion**

*"It involves operating within the letter, but not the spirit of the law."*

–Tackling Tax Avoidance – Issue Briefing, HMRC<sup>5</sup>

There is a fine line between tax avoidance and tax evasion, and it is often difficult to distinguish between the two. Tax avoidance refers to using legal methods such as deductions to reduce one's tax liability. However, it may involve bending the rules and finding loopholes within the tax system in an attempt to gain a tax advantage. On the other hand, tax evasion refers to using illegal means such as deliberately under-declaring income to the tax authorities to arrive at a lower tax liability.

## **Genesis – The Story Of Cadbury**

Cadbury was founded by John Cadbury in Birmingham, U.K. in 1824 as a retail business selling biscuits, tea and various confectionery products<sup>6</sup>. As a Quaker, he believed that alcohol was the main culprit for social ills. John had a vision of providing chocolate drinks to the masses, which he felt was the perfect alternative to reduce the consumption of alcohol. With this belief, Cadbury expanded rapidly over the years before eventually becoming one of the world's most recognised household names in chocolate and confectionary products<sup>7</sup> as well as one of the biggest with revenues of £5.3 billion in 2008<sup>8</sup>.

## **Cadbury: A History Of Good Corporate Responsibility**

*“Ethical business sits at the heart of Cadbury. It always has. It is part of who we are, our values, our heritage, our policies and the way we behave.”*

– Cadbury’s 2008 Corporate Responsibility and Sustainability (CSR) report<sup>9</sup>

In its 189 years of history, Cadbury has had a number of illustrious milestones of excellent corporate responsibility. This included the pioneering of the Bournville project, which was exemplary in its revolutionary provision for workers’ rights<sup>10</sup>. Cadbury also effectively used its profits to benefit and develop the local community. This was a first at that time and Cadbury quickly became renowned for its community involvement.

To this day, Cadbury continues to demonstrate its accountability to the society through a slew of CSR initiatives<sup>11</sup> dedicated to helping the poor as well as the rural community. The Cadbury Cocoa Partnership, formed in 2008<sup>12</sup>, committed £45 million to cocoa farming in Ghana, India, South-East Asia and the Caribbean over the next 10 years. This was to support sustainable cocoa and improve the lives of millions of cocoa farmers and their families.

## **American Cheese Eats Up U.K.’s Chocolate**

Kraft Foods Inc (now known as Mondelez International following a demerger in 2011), well known for their cheese products, is an American multinational confectionary, food and beverage conglomerate. On 19 January 2010, Kraft Foods bought over Cadbury in a controversial deal worth £11.5 billion after a 5-month long takeover battle.<sup>13</sup> Many people in the U.K. were against the takeover as they felt that 186 years of U.K. heritage would disappear under Kraft and jobs would be lost.<sup>14</sup>

## **Shifting To Zurich**

*“Cadbury goes Swiss to avoid British tax: Move by U.S bosses will cost Treasury £60m a year.”*

– The Daily Mail<sup>15</sup>

In early December 2010, barely 11 months after the acquisition of Cadbury, Kraft announced a restructuring of Cadbury's operations and plans to shift its headquarters to Zurich, Switzerland, where the corporate tax rate was lower than the U.K.'s.<sup>16</sup> This move angered the British public as they saw it as a manoeuvre by Kraft to avoid paying taxes in the U.K. Unite, a union representing Cadbury workers said, "It is disgusting that companies that make billions of pounds of profits from sales in Britain are able to avoid paying corporation tax in this way"<sup>17</sup>.

## **Lifting The Lid On Pandora's Chocolate Box**

However, the tax authorities in the U.K., Her Majesty's Revenue & Customs (HMRC)<sup>18</sup>, discovered that this manoeuvre by Kraft did not make as big a dent in the tax revenue collected from Cadbury as expected. On 21 June 2013, after thorough investigations into Cadbury's tax accounts, the U.K. Financial Times exposed several of Cadbury's aggressive tax avoidance schemes<sup>19</sup>.

In the 10 years before Kraft's takeover, Cadbury's British confectionery made an average of £100m in annual profits. Therefore, applying the standard U.K. corporate tax rate, this would have resulted in a tax liability of £30m each year to HMRC. However, it was reported that Cadbury paid an average of only £6.4m tax to HMRC, approximately one-fifth of the amount calculated above<sup>20</sup>. It emerged that Cadbury have been using schemes involving low-tax jurisdictions such as the Cayman Islands and Ireland to avoid paying taxes.

## **Heaven In Tax Havens**

The Cayman Islands is a renowned tax-haven. Companies incorporated there are not subjected to direct corporate tax<sup>21</sup>. Cadbury established two subsidiaries in the Cayman Islands to take advantage of this off-shore financial centre. From 1997 to 2002, the Cadbury group transferred £400m of interest-free funds from the U.K. to the Cayman Islands<sup>22</sup>. The Cayman Island subsidiaries in turn transferred the money back to the U.K. by lending it to the Cadbury U.K. financing company at an annual interest rate of 7%<sup>23</sup>.

According to the Financial Times, the Cadbury group managed to avoid £9m in U.K. tax through this method<sup>24</sup>. To add insult to injury, Cadbury managed to escape punishment from HMRC by exploiting loopholes in its anti-avoidance tax rules.

They did so by selling the two subsidiaries in the Cayman Islands to Allstate (a U.S. insurance company) just before their first financial year ended<sup>25</sup>. It is also worth noting that only a small proportion of the £400m loan had been repaid at that point in time<sup>26</sup>.

## Across The Irish Sea

Ireland differs starkly from Britain in terms of corporate tax rates. In 2013, U.K. corporate tax stood at 23% whereas Ireland's rates were at 12.5%<sup>27</sup>. In a bid to lower tax liability, the Cadbury group diversified their Irish operation so that it lent and received royalty income from countries outside Ireland such as the U.S.<sup>28</sup>. The objective was to shift profits from America to Ireland in the form of inter-company interest payments, which would still be significantly below the 40% tax rate in the U.S. These ingenious schemes had names like "Martini" and "Chaffinch", and were able to reduce Cadbury's tax on U.K. operations to an average of £6.4m (7.5m) a year, even though Cadbury had U.K. profits of £100m (117m). Had these schemes not been aggressively engineered, Cadbury U.K. would instead have paid about £30m (35m) in tax each year using the standard rate<sup>29</sup>.

## Winning The Battle

*"Cadbury Schweppes was entitled to take advantage of Ireland's more favourable tax arrangements"*

– European Court of Justice Ruling<sup>30</sup>

Even though these dealings caught the attention of the HMRC and initiated a series of lawsuits, Cadbury Schweppes won an important ruling on 12 September 2006<sup>31</sup>. The HMRC had argued that Cadbury had illegitimately set up two financial subsidiaries in Dublin to avoid British tax. However, the European Court of Justice (ECJ) held that the Cadbury Schweppes subsidiaries were genuine, or at least not "wholly artificial". This essentially meant that Cadbury did not breach the anti-avoidance measure, known as the Controlled Foreign Company Rule.

## More Sticky Situations In Other Parts Of The World?

Starting as a chocolate importer in India as early as 1948, Cadbury India became a market leader like its European counterparts with over 70% of the domestic market share<sup>32</sup>. In 2003, the Indian government gave a 10-year tax break<sup>33</sup> to factories which began production before March 2010 to encourage local employment as well as support the domestic economy. Arguably, this was when Cadbury took things too far in an attempt to reduce taxes, crossing the line into tax evasion.

### Crossing The Line

*“Two cases of tax evasion by Cadbury India Ltd have been detected by the Directorate General of Central Excise Intelligence...”*

– S.S. Palanimanickam, Minister of Finance (India)<sup>34</sup>

According to the relevant administrative records from the Indian government, Cadbury India received permission for making confectionery products in their existing Baddi plant only in January 2011. However, investigations by the tax authorities alleged that the executives of the company went on to falsify backdated papers to show this plant had begun manufacturing confectioneries in March 2010 in order to qualify for tax rebates<sup>35</sup>.

Another independent report concluded that Cadbury had put aside 50 lakh (US\$8,200) for bribes to get the necessary approvals from the state government<sup>36</sup>. These bribes were used to pay government officials through the contractors who were working at their Baddi plant<sup>37</sup>. As a result of this classification, the tax evaded amounted to approximately US\$46 million from the sales of US\$592 million worth of products<sup>38</sup>.

Besides the fiasco at its Baddi plant, there was also another false declaration. Initially, there were plans to build another plant in the town of Himachal Pradesh so as to qualify for a tax exemption. However, the cost was found to be too high and the plan was subsequently scrapped. Instead, Cadbury India added a second floor to its existing Baddi plant in 2009 while providing the registration number of an adjoining plot so it would appear that the expansion was a separate plant eligible for the tax exemption<sup>39</sup>.

# Everybody Is Doing It!

*“We were no worse than many multinationals in those days.”*

– A former Cadbury executive<sup>40</sup>

The practice of using creative and aggressive tax avoidance schemes is not a rarity. Multinational Corporations (MNCs), such as Starbucks<sup>41</sup>, Google<sup>42</sup> and Amazon<sup>43</sup>, are some of the other major “culprits” that have been named. Globalisation, competition and increased mobility of international funds contribute to a state of flux where corporate decisions may be critical to operations, cash flow management and taxation liabilities.

## Mondelez’s Cold Response

In response to the exposure of Cadbury’s aggressive tax avoidance schemes by the Financial Times, Mondelez International, who now owns Cadbury, declined to comment or provide any explanations. Its excuse was that Cadbury was running as an entirely independent business (prior to Kraft’s takeover in 2010) when the tax avoidance schemes took place (1997 - 2010)<sup>44</sup>.

## The NGOs React

The Methodist Tax Justice Network<sup>45</sup> was vocal in its discontent. In June 2013, they organised a protest outside Cadbury World in Birmingham, one of the two extensive museums created and ran by Cadbury to tell the Cadbury story<sup>46</sup>, to call for a change in its tax approach. They also distributed flyers and leaflets<sup>47</sup> educating the public on the consequences of tax avoidance, and encouraged them to boycott Cadbury’s products.

Other MNCs facing tax avoidance allegations have certainly had their own share of protests too. In December 2012, Starbucks saw several of its stores being forced to close due to tax justice protests<sup>48</sup>. On May 2013, British students organised a “Google Free Day” in protest against Google’s tax avoidance efforts<sup>49</sup>. Similarly in July 2013, HSBC’s bank branches across the U.K. were forced to close by tax justice protestors<sup>50</sup>.

## G8 Summit

"We [should] not allow or encourage any multinational enterprises to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions." -G8 Declaration, June 2013

This was a declaration of the June 2013 G8 summit held in Lough Erne<sup>51</sup>. David Cameron, Britain's Prime Minister, attended the summit with an intention to push for the development of a worldwide set of standards on the exchange of information between tax authorities, in a bid to clamp down on tax avoidance and evasion by companies. He vowed to curtail such legal (tax avoidance) or illegal (tax evasion) schemes, which are estimated to cost billions of pounds in lost tax revenues<sup>52</sup>. As at 2013, the tax gap<sup>53</sup> of corporation tax collections stands at approximately 7%<sup>54</sup>.

## Closing The Lid On Pandora's Chocolate Box

The Kraft takeover has seemingly accentuated the pervasive tax avoidance issues throughout different jurisdictions and corporations. Cadbury is certainly not alone in being entangled in this tax row, as illustrated by other MNCs and even Lionel Messi<sup>55,56</sup>. With no silver bullet to eradicate this issue, corporations like Cadbury ought to decide on their best move forward, maintaining accountability to stakeholders, while keeping their competitive edge. Just as how addictive chocolates can be to the sweet-toothed out there, entirely shutting out these ingenious tax liability limiting schemes can be tough. Perhaps companies which are using tax avoidance schemes, even if they are legal, ought to consider whether they are ethical and whether such tax avoidance will hurt them in the long run.

*"To be ethical is profitable, but to be ethical because it is profitable is not ethical. And, one might add, it is also not profitable in the long run."*

– Peter Koestenbaum<sup>57</sup>

## Discussion Questions

1. What are the main differences between tax avoidance and tax evasion? In your opinion, were Cadbury's tax schemes in the Cayman Islands and Ireland tax avoidance or tax evasion? Explain why. How about those in India?
2. "Companies have a fiduciary duty to maximise shareholder value and should not pay 'voluntary' tax." Do you agree with this statement? Is there a divergence of interests among different stakeholders in this regard?
3. Consider how multinationals manage their tax liability in different jurisdictions and discuss the potential complications faced by the board. Given that other multinational corporations, including competitors, may also be using schemes to minimise taxes, does this leave companies like Cadbury with no choice but to do what others are doing?
4. The case mentioned David Cameron, the Prime Minister of the U.K., expressing his concerns and his push for more collaboration among nations to clamp down on trans-national tax avoidance and evasion issues. However, complexity arises when nations with differing political and economic motivations struggle to strike a balance between attracting businesses and playing by global rules. Do you think this issue can be reconciled?
5. Given Cadbury's strong reputation for good governance and philanthropy, what factors do you think may have contributed to this apparent aberration in corporate behaviour? What impact might this episode have on the company's reputation and business?
6. The apparently aggressive tax avoidance schemes were engineered to reduce Cadbury's U.K. tax liability. This practice is in fact not a rarity in the current business context. Hence, if you were the head of taxation of Cadbury, would you have agreed with the aggressive tax avoidance schemes? Explain your opinion from an ethical and corporate governance viewpoint.

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# Chesapeake Energy: All is Well?

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## Case Overview

Aubrey McClendon had established a good reputation for himself by successfully leading Chesapeake Energy as its Chief Executive Officer (CEO) to become the second largest natural gas producer in the United States (U.S.). However, starting from 2008, his unusual and generous compensation package began drawing the attention of shareholders, as the economic downturn affected the company's financial performance. Allegations of extravagance, misuse of corporate funds and related party transactions involving McClendon and board members prompted the Securities Exchange Commission (SEC) to launch a full-scale investigation into the company. Subsequently, shareholder activists led the charge to oust McClendon from the company he founded. The objective of this case is to allow a discussion of issues such as executive compensation, board independence, conflict of interest and shareholder activism.

## Carl Icahn's Tempestuous Vendetta

Carl Icahn took a sip from his warm cup of coffee and placed it on his mahogany table. It was only a few days ago that he became aware of Chesapeake Energy's questionable corporate governance practices and he gave a call to CEO Aubrey McClendon to assuage his worries. Lately, McClendon had been making headlines for several personal loans that collateralised his stakes in the company's wells, his apparently exorbitant executive compensation, and other alleged shenanigans. Icahn was concerned that McClendon's role as CEO might be detrimental to shareholders' interests.

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This is the abridged version of a case prepared by Michelle Lee, Tan Wan Sun, Gilbert Neo, John Lee and Zhang Yaowen under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. This case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lim Jin Ying under the supervision of Professor Mak Yuen Teen.

Having just increased his stake in Chesapeake, Icahn, filled with fire in his belly, prepared his case for the upcoming annual general meeting (AGM) during which he would be challenging the company on several corporate governance issues. As a precursor, Icahn decided to craft a letter to the Board<sup>1</sup>, listing down all his concerns. Although it might worsen the already fragile relationship that he had with the board, he did not want to give up on his demands. After all, with his increased stake in the company, there was no turning back.

## **History of Chesapeake Energy and Aubrey Kerr McClendon**

During the 1980s, many energy experts believed that oil and gas reserves in America were depleted. Although there were still considerable energy reserves that were buried deep underground, the extraction process was too arduous and expensive<sup>2</sup>. All these changed when a revolutionary new technique, known as hydraulic fracturing, was discovered. McClendon realised that this new technique offered an attractive opportunity to break into the energy market. He then incorporated Chesapeake Energy with co-founder Tom L. Ward in 1989, with only a US\$50,000 initial investment, to tap on these unconventional gas reserves<sup>3</sup>.

Throughout his years in the company, the charismatic McClendon was extolled as one of best-performing corporate leaders in the country<sup>4</sup>. However, he became embroiled in several scandals, which came to beleaguer his career and threatened to cast him in a bad light. A frosty relationship with the shareholders culminated in the removal of his chairmanship on the Board<sup>5</sup>. More skeletons in his closet continued to be exposed by the media, which then triggered civil actions and criminal investigations.

## **“A Shameful Document” – Chesapeake’s Lacklustre Oversight Of Executive Pay Packages**

“I sat in silence for ten minutes contemplating my 25-year career in the investment management business... I have never seen a more shameful document”, lamented Jeffrey Bronchick, an investor whose asset management firm owned a stake in Chesapeake, in response to the company’s 2008 proxy statement that contained information about McClendon’s generous pay package<sup>6</sup>.

Against a backdrop of a tumultuous 2008, during Chesapeake's stock had plunged nearly 60% and the company's profits slashed by half, McClendon's pay had multiplied fivefold to around US\$114 million. The compensation package comprised a US\$77 million bonus, and US\$1.8 million in "all other compensation", which included US\$577,113 for accounting support and US\$648,096 for personal use of company jets, among others<sup>7</sup>. This lavish pay package gave McClendon the unceremonious distinction of being the best paid CEO in the U.S.<sup>8</sup> and raised eyebrows amongst shareholders.

From 2009 through 2011, Chesapeake also paid US\$13.3 million in total compensation to 10 non-executive board members<sup>9</sup>. Such corporate largesse was frowned upon by investors, with many crying foul over what they perceived as a flagrant breach of fiduciary duties<sup>10</sup>.

## **Perquisites – A Requisite To Attract, Motivate And Retain Talent?**

*"Chesapeake is Exhibit A not just for corporate governance failings generally, but particularly for corporate jet abuse."*

– Hung G. Ta, a New York attorney for Gilberta S. Norris, who sued Chesapeake for the abuse of corporate jets<sup>11</sup>

### **Frequent Flyers – Alleged Misuse Of Corporate Perks**

According to a filing with the U.S. SEC, Chesapeake allowed each non-executive board member to clock 40 hours of flight per year on the company's leased aircraft<sup>12</sup>. Current Chairman of the Compensation Committee Merrill "Pete" Miller and Chesapeake's former lead independent director and former Oklahoma governor Frank Keating took US\$160,000 and US\$175,000 worth of free personal flights respectively in 2011<sup>13</sup>. These were more than twice the amount they spent on business flights in that year<sup>14</sup>. In comparison, other companies with similar or larger market capitalisation have limited corporate jet plane usage.

However, McClendon's use of corporate jets was unparalleled. His employment contract allowed him to take unlimited business flights, as well as personal flights with friends and family, for free. In 2010, McClendon logged a total of 155 business charters costing US\$2.25 million, with his family members tagging along on at least

17 of these trips. In the same year, the McClendon family took at least 75 personal flights, including family vacations to Europe and the Bahamas on Chesapeake-leased aircraft, costing an estimated US\$850,000<sup>15</sup>.

The excessive personal usage of the corporate jets resulted in two proxy advisory firms advising shareholders to vote against the company's compensation plan<sup>16</sup>. "This perquisite does not provide shareholder(s) with any tangible benefits and serves to further inflate director pay," Institutional Shareholder Services wrote, advising shareholders to vote against Chesapeake's compensation plan in 2011<sup>17</sup>.

### ***Aubrey Kerr McClendon (AKM) Operational Unit***

More furore erupted when the existence of an eponymous informal unit called AKM Operations was leaked out to the media. It was housed in the company's campus and employed six full-time employees to manage McClendon's personal life. In 2010, 15,000 hours and US\$3 million were spent working on McClendon's personal projects, according to internal records<sup>18</sup>. To aggravate matters, in 2011, another document showed that almost US\$3.2 million of company's funds was spent on McClendon through the AKM Operations. Some of AKM Operations' tasks included overseeing repair work for hailstone damage to a home McClendon owned, helping McClendon put a ranch up for auction and doing many other miscellaneous tasks that were adjudged to have benefited McClendon throughout his years in the company<sup>19,20</sup>. Although McClendon reimbursed the company for all but US\$250,000 of this spending at the end of each year, as required by his contract, it was still widely seen as self-serving and disingenuous by many<sup>21</sup>.

### ***Founder Well Participation Program (FWPP) – All Is Well?***

Another peculiar perquisite offered by Chesapeake Energy is the Founder Well Participation Program (FWPP). This 10-year term program was approved by the shareholders in June 2005<sup>22</sup>. The FWPP was administered by the Compensation Committee of the Board<sup>23</sup> with the aim of aligning the interests of McClendon with that of the company<sup>24</sup>. Some reports even pointed out that Chesapeake was the only large public energy company that allowed its CEO the opportunity to take a direct stake in the wells drilled<sup>25,26</sup>.

Under this program, McClendon could have chosen to participate in all or none of the wells drilled by or on behalf of Chesapeake during a calendar year. The maximum interest McClendon could have in the wells was capped at 2.5% and if Chesapeake's interest in the wells was ever reduced below 12.5% due to the former's participation,

McClendon would be disallowed from continuing in the program<sup>27</sup>. As at April 2012, McClendon had continually participated in the FWPP since the company's initial public offering in 1993, except during a five-quarter period from 1 January 1999 to 31 March 2000. By personally investing in the wells, McClendon had a payoff that was linked to the performance of these wells. As revealed in several company statements, the company posited that this move will incentivise him to drive the company forward<sup>28,29</sup>.

However, McClendon frequently borrowed money by pledging his wells' stakes as collateral. The loan proceeds were subsequently used to further finance his stake in the FWPP<sup>30</sup>. A Reuters report on 18 April 2012 which highlighted that three of these loans from 2009 to 2012 amounted to US\$1.1 billion inevitably caught the attention of the media and regulators<sup>31</sup>. In a statement, Chesapeake said McClendon's securing of such loans had been "commonplace" during the past 20 years<sup>32</sup>. However, this incurred the ire of shareholders and skepticism from analysts. "If he hasn't had to put up any of his own money, how is that alignment?" asked Mark Hanson, an analyst with Morningstar in Chicago<sup>33</sup>.

There was also a concern that the interests of shareholders may be compromised due to the sharing of lenders between the CEO and Chesapeake<sup>34</sup>. EIG Global Energy Partners, one of the biggest lenders for McClendon, was also a capital provider for Chesapeake<sup>35</sup>. This personal financing transaction increased EIG's effective exposure to Chesapeake and thus, could have affected the company's financing terms<sup>36</sup>. Furthermore, there were claims that the preference share dividends paid by Chesapeake to EIG were artificially inflated<sup>37</sup>.

In addition, a clause in the loan terms requires McClendon "*to take all commercially reasonable action*" to ensure that other owners and operators of the wells - including Chesapeake - "*comply with...covenants and agreements*" of the loans<sup>38</sup>. Should there be a case in which the interests of the lenders are different from those of the shareholders, whose interests will McClendon act in<sup>39</sup>?

The loan saga also caught the attention of the regulators. After the Reuters report, the SEC initiated an informal inquiry on the FWPP on 26 April 2012<sup>40,41</sup>. The SEC stance on related party transactions requires that companies make disclosure of the pledging of the company's stock as collateral for loans made to employees. Thus, McClendon's situation was not directly caught as the loans were backed not by stock but by stakes in the company's wells<sup>42</sup>. Nonetheless, this initial SEC probe culminated into a full-scale investigation on 1 March 2013<sup>43,44</sup>.

## **Personal Hedge Fund – Over The Edge**

Alongside his position as CEO of Chesapeake, McClendon simultaneously ran a US\$200 million hedge fund called Heritage Management Company LLC, which trades in natural gas futures that were based on the same underlying commodities that Chesapeake produces. Strikingly, there was no disclosure of McClendon's involvement in this hedge fund in any public filings<sup>45</sup>.

Being the CEO of Chesapeake, which produces five percent of the U.S. natural gas production, McClendon could determine the natural gas output of Chesapeake. These output decisions would affect the price of natural gas and eventually the price of the natural gas futures. Thus, he was in a position to use Chesapeake's operating decisions for personal gain in his hedge fund<sup>46</sup>. This, however, remained only a possibility, as there has yet to be evidence that McClendon used his insider knowledge from Chesapeake to profit in the hedge fund<sup>47</sup>.

## **Basketballs, Restaurants And Maps – A Medley Of Related Party Transactions**

Besides leaving an indelible impression on the oil and gas industry, McClendon managed to amalgamate Chesapeake with almost every of his varied interests, ranging from basketball to restaurants and even maps, using his position as CEO of Chesapeake. This has led some onlookers to question whether there were any blurring of lines between McClendon's personal transactions and the company<sup>48</sup>.

McClendon indirectly holds a 19.2% stake of an National Basketball Association (NBA) team called Oklahoma City Thunder. In 2011, Chesapeake agreed to sponsor the team for 12 years, paying US\$3 million per year on average. On top of that, Chesapeake agreed to pay more than US\$60 million for a decade-long arrangement, in which the Oklahoma City Thunder's home stadium would be named as "the Chesapeake Energy Arena" as part of the deal<sup>49</sup>.

McClendon is also an avid collector of antique maps and his collection made the headlines when he sold them to the company for a reported US\$12.1 million<sup>50</sup>. Shareholders were outraged, with many calling the sale disclosure in the proxy statement the "worst footnote of 2009"<sup>51</sup>. Investors sued McClendon and the lawsuit was eventually brought to a close in November 2011, when the latter agreed to refund the purchase amount back to the company<sup>52</sup>.

## The “Independent” Board

Besides McClendon’s related party transactions, the independence of the directors has also been scrutinised by external parties for their business ties with Chesapeake<sup>53</sup>. On the one hand, the company has disclosed its board independence status regularly in its SEC filings, in which the Nominating Committee declared that all but McClendon were considered independent<sup>54</sup>. On the other hand, the same sentiments were not shared by outside observers such as Bloomberg, which provided evidence raising questions about their independence of the independent directors..

For instance, National Oilwell Varco, where Chesapeake board member Miller is the Chairman and CEO, was paid more than US\$343 million by Chesapeake for supplying drilling equipment. In addition, ex-director Frank Keating had two relatives working for Chesapeake in land acquisition and real estate roles. A company filing disclosed that his son, Chip Keating, received US\$251,515 for his role in real estate development for Chesapeake. Furthermore, Oklahoma State University, where former Chesapeake director Burn Hargis is the President, had received more than US\$10 million from Chesapeake to fund, among other things, a natural gas training centre and student scholarships<sup>55</sup>. Burn Hargis is also a director of BOK Financial Corp, a financial services company that has existing business dealings with Chesapeake<sup>56</sup>.

Last but not the least, there has been much controversy about the loans McClendon received from other board members directly or indirectly. They have neither been illegal nor broken any exchange rules, but have sparked concerns about board independence from corporate governance observers<sup>57</sup>.

## “Termination Without Cause” – A Cause For Concern

After a troubled year in which the company was repeatedly excoriated about its governance practices and liquidity crunch, on April 1, 2013, McClendon departed from the company, leaving Chief Operating Officer (COO) Steve Dixon to helm the executive team as interim CEO<sup>58,59</sup>. McClendon’s departure was treated as a “*termination without cause*”, entitling him to some of the most lavish benefits laid out in his employment contract, which identified a wide range of severance scenarios<sup>60</sup>. His severance package valued at US\$53 million comprising US\$11.7 million in total cash compensation based on his salary and bonus, restricted stock awards valued at US\$33.5 million, deferred compensation of US\$0.8 million and up to US\$7.2 million worth of personal use of corporate jets over four years<sup>61</sup>.

## Epilogue

In February 2013, an internal review by the board of Chesapeake cleared McClendon of any intentional wrongdoing<sup>62</sup>. Subsequently, in April 2014, the SEC advised the company that it had concluded its investigation and did not intend to recommend any enforcement action<sup>63</sup>. Hence, despite the success of the shareholders' revolt in ousting McClendon from the company, it appears that McClendon will continue to be closely entwined with the company he founded. His severance package still entitles him to receive analyses from Chesapeake's engineers on his well stakes under his FWPP option to invest in its wells, and to use its corporate jets<sup>64</sup>. In addition, McClendon seems to be staging a comeback – in April 2014, McClendon's new venture, American Energy Partners, even hired Chesapeake for well drilling works in Ohio<sup>65</sup>. Whether his desire to associate closely with his former company will end favourably for him remains to be seen, as McClendon can surely bet that Chesapeake's institutional shareholders like Carl Icahn will continue to intensely scrutinise his actions, even when the storm seems to have passed.

## Discussion Questions

1. How can executive compensation schemes aid in ensuring good corporate governance? Discuss the trade-offs involved and how they could have applied to Chesapeake. (You can examine the unique nature of a founder-company)
2. How can board independence play a part in strengthening corporate governance at Chesapeake?
3. Discuss how the different conflicts of interests could be detrimental to stakeholders' interests in Chesapeake. Suggest ways to mitigate these conflicts of interests.
4. Carl Icahn, along with other large shareholders, exerted pressure on the board to replace directors in 2012 and succeeded. Evaluate the pros and cons of shareholder activism in improving corporate governance and how it can protect the interests of various stakeholders.
5. Moving forward, suggest other possible actions that Chesapeake can adopt to improve corporate governance and re-instil investor confidence in Chesapeake.

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# The (Un)Social Network: The Facebook IPO

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## Case Overview

Amidst media fanfare, Facebook went public with an Initial Public Offering (IPO) at US\$38 per share on NASDAQ on 18 May 2012 and raised about US\$16 billion. On the first day of trading, glitches in the NASDAQ system and trading delays caused confusion among investors and brokers. Facebook's share price started to fall below its IPO price within the first few days of trading. Irate shareholders commenced class action lawsuits against Facebook and its underwriters, alleging insider trading and insufficient disclosure on material matters. By the end of the first week, Facebook's share price had dropped by 16% to US\$31.91. The objective of this case is to allow a discussion of corporate governance concerns such as dual class share structures in a founder-managed company; director independence, board leadership and accountability; enforcement of securities law and regulations on insider trading and prospectus requirements; and the equitable treatment of shareholders.

## The Social Network

Facebook is an American multinational social media internet company headquartered in Menlo Park, California<sup>1</sup>. It was incorporated in mid-2004, with entrepreneur Sean Parker as President<sup>2</sup>. Its mission is "to make the world more open and connected"<sup>3</sup>. As of 31 December 2012, the website had over a billion monthly active users<sup>4</sup>. Its products include the Facebook mobile application and website, Messenger and Instagram<sup>5</sup>.

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Facebook is currently the leading social networking site based on monthly unique visitors<sup>6</sup>. The site had 618 million Daily Active Users (DAUs) for the year ended 2012<sup>7</sup>, outstripping all other competitors such as Twitter, Google+, LinkedIn, etc<sup>8</sup>. In terms of regional internet markets, Facebook dominates English-speaking countries; its penetration is 69% in North America, 58% in Latin America, and 57% in Europe<sup>9</sup>. Its immense popularity has led to the coining of new verbs, such as “facebooking” and “unfriending”. The Facebook story had also been taken to the big screen in “The Social Network”, a 2010 drama film directed by David Fincher about the company’s origins<sup>10</sup>. However, despite the hype, Facebook’s revenue growth has been on a steady decline since 2006, registering 37.13% for the year ended 2012, which is a sharp decline from 2011’s 87.99% growth<sup>11</sup>.

Under founder and Chief Executive Officer (CEO) Mark Zuckerberg, the company had for years resisted taking the company public. Zuckerberg also reportedly rejected a US\$750 million offer from Viacom in 2006<sup>12</sup> and turned down Yahoo!’s US\$1 billion offer in the same year<sup>13</sup>. However, he changed his tune in late November 2011. In an exclusive interview with broadcast journalist Charlie Rose, Zuckerberg explained, “We’ve made this implicit promise to our investors and to our employees that... [they will] be able to trade their equity for money”<sup>14</sup>. Other reasons floated by analysts include a Securities Exchange Commission (SEC) rule from 1964 that requires private companies with 500 or more shareholders to comply with the same financial disclosure requirements as public companies<sup>15</sup>.

## Form S-1 SEC Filing

Facebook declared its plan to proceed with an IPO and filed its S-1 form with the SEC on 1 February 2012<sup>16</sup>. It was revealed in the SEC filing that Facebook was to have a dual class share structure – Class A shares with one vote per share and Class B shares with ten votes per share<sup>17</sup>. According to the S-1, holders of Class B shares would collectively exercise control of the company through a majority of combined voting power, and thus control all matters requiring shareholder approval<sup>18</sup>.

Facebook also declared in its S-1 that it had elected to take advantage of the “controlled company” exemption to the corporate governance rules for public-listed companies<sup>19</sup>. As such, it was not required to have a majority of independent directors on the board, a compensation committee, or an independent nominating committee. Facebook also planned to adopt a staggered board, where only one class of directors would be up for election at each annual meeting<sup>20</sup>.

In addition, Facebook named their underwriters in the S-1 form, with Morgan Stanley as the lead underwriter. Other underwriters include J.P. Morgan, Goldman Sachs, Merrill Lynch and Barclays<sup>21</sup>.

## **The Board And Their Interests**

In addition to Zuckerberg as Chairman, Facebook's board consisted of Marc L. Andreessen, a co-founder; Erskine B. Bowles, President Emeritus of the University of North Carolina and member of the board of directors of Morgan Stanley; James W. Breyer, a Partner of venture capital firm Accel Partners, who was one of Facebook's early investors and lead independent director of Wal-Mart Stores, Inc.; lead independent director Donald Graham, CEO of The Washington Post Company; Reed Hastings, CEO and Chairman of the board of directors of Netflix, Inc.; and Peter A. Thiel, Partner of Founders Fund and co-founder of PayPal, Inc<sup>22</sup>.

Facebook noted in its S-1 form that The Washington Post Company and its related companies purchased US\$0.6 million, US\$4.8 million, and US\$4.2 million, of Facebook advertisements during 2009, 2010, and 2011 respectively<sup>23</sup>. Netflix also made similar purchases of advertisements worth US\$1.9 million, US\$1.6 million, and US\$3.8 million, during 2009, 2010, and 2011 respectively<sup>24</sup>.

Other Facebook partners include Wal-Mart, eBay and PayPal, and Walt Disney's ESPN. In October 2011, Wal-Mart and Facebook unveiled a partnership to launch My Local Walmart, a page that connects Wal-Mart's nine million Facebook followers with alerts on the retailer's new products and discounts<sup>25</sup>. In addition to the Wal-Mart partnership, Facebook and eBay also announced their partnership to develop a suite of new e-commerce applications with social networking features<sup>26</sup>. In March 2012, ESPN.com began rolling out Facebook's Open Graph product on select news pages, allowing users to alert their Facebook friends to articles they are reading on the site<sup>27</sup>.

## **The Management**

### **The "One-Man" Show: Acquisition Of Instagram**

It was on the Sunday morning of 8 April 2012 that Zuckerberg first informed the board of Facebook, via email, that he was going to purchase Instagram – a popular photo-sharing service<sup>28</sup>. The rationale for the acquisition was that Instagram's staggering user base growth on the Android platform could potentially increase Facebook's mobile presence<sup>29</sup>. The deal occurred over three days, at Zuckerberg's

US\$7 million five-bedroom home in Palo Alto, where Zuckerberg single-handedly negotiated the US\$2 billion opening number down by half, closing the deal at US\$1 billion with counterpart Kevin Systrom, Instagram's CEO<sup>30</sup>.

According to an insider, the board "was told, not consulted"<sup>31</sup>. Zuckerberg reportedly informed Chief Operating Officer (COO) Sheryl Sandberg of his intentions on Thursday; however, she was not directly involved in the negotiations. Board member Marc Andreessen turned up at Zuckerberg's home at 6pm that day for a regular meeting and was surprised when Systrom walked into the meeting an hour later. Though the board also purportedly voted on the deal, it was largely symbolic<sup>32</sup>.

### **The Wall Street Road Shows**

The Facebook road shows kicked off on 7 May 2012 and the first stop was Sheraton New York Hotel on 7<sup>th</sup> Avenue in Manhattan<sup>33</sup>. COO Sheryl Sandberg and Chief Financial Officer (CFO) David Ebersman hosted an hour-long presentation in Wall Street-worthy suits while hoodie-clad CEO Mark Zuckerberg made a brief 10 minute appearance to field questions about Facebook's advertising-heavy business<sup>34</sup>. The first matter on the plate at the lunch meeting was the preliminary pricing, followed by a roadshow video "that was light on information but heavy on emotional impact"<sup>35</sup>.

Three days into the road show, analysts at the underwriters (Morgan Stanley, J.P. Morgan, Goldman Sachs and Bank of America) cut their revenue estimates<sup>36</sup>. The company had filed an amended prospectus on 9 May 2012, to disclose interpretations of certain trends in Daily Active Users (DAUs) for the second quarter of 2012. The week before, Facebook had also amended its prospectus to include a grant of about US\$796 million restricted stock units to employees<sup>37</sup>. Subsequently, after the filing, a Facebook executive was reported to have individually called 21 sell-side research analysts to discuss the contents of the amendments<sup>38</sup>. The underwriters then informed large clients of the declining revenue prospects<sup>39</sup>.

Two days before the IPO, the company announced that it would be expanding its IPO with an additional 83.8 million shares<sup>40</sup>. Most of the shares being sold come from existing stockholders; other additional shares were sold by the IPO underwriters. Facebook altered the greenshoe option in its prospectus, granting underwriters the right to purchase 63 million additional shares to cover over-allotments<sup>41</sup>.

## The Largest Internet IPO Ever

On 17 May 2012, Facebook priced its IPO at US\$38 per share, valuing the company at US\$104.2 billion<sup>42</sup>. Its IPO is the third largest in the United States of America (U.S.)'s history at US\$16.08 billion, behind Visa and Enel, and the largest Web IPO, but trumping Google<sup>43</sup>.

The journalists were having a field day in the months leading up to Facebook's IPO. The number of mentions of Facebook in The New York Times over the previous year had risen to unprecedented heights as compared to other technology companies, with the exception of Twitter<sup>44</sup>. As the IPO date drew nearer, The Times frequently reported a "frenzy" over the demand for the company's stock, going as far as linking Zuckerberg to "a line of revolutionaries stretching back to Gutenberg"<sup>45</sup>. With the media creating a circus around the Facebook IPO, several analysts warned of overpricing that would lead to an IPO bubble, which would pop in the short term after the launch<sup>46</sup>.

## NASDAQ Trading Delays And Glitches

Zuckerberg rang the celebratory NASDAQ opening bell remotely from Facebook's headquarters in Menlo Park, California on 18 May 2012, approximately an hour before trading was to commence<sup>47</sup>.

The Facebook shares were supposed to begin trading at 11:00 a.m. However, the time came and went with no sign of trading. At 11:28am, an unidentified NASDAQ staffer announced that trading would open in approximately 2 minutes. NASDAQ also said that they were still processing orders and cancellations<sup>48</sup>.

At 11:30am, Facebook shares began trading at US\$42.05 per share<sup>49</sup>. Within the first 30 seconds, more than 80 million shares had changed hands<sup>50</sup>. Chaos reigned as market makers struggled to complete or cancel orders on NASDAQ. By midday, brokers were making futile attempts to get NASDAQ to halt trading, and were kept in the dark as to their exposure. After reaching its peak of US\$45, the stock began its plunge toward the issue price of US\$38; finally closing at US\$38.23 as lead underwriter Morgan Stanley attempted to defend the level<sup>51</sup>. The fiasco caused Citigroup, UBS, Knight Capital Group and Citadel Securities to lose around US\$115 million among them<sup>52</sup>. By the close of the day, two top financial regulators, SEC and the Financial Industry Regulatory Authority (Finra), had caught wind of the botched IPO opening and announced that they would review the issues<sup>53</sup>.

NASDAQ's board convened the next day to discuss the offering. The exchange blamed "poor design" in the IPO software, which caused the exchange's systems to be overwhelmed<sup>54</sup>. On the Monday following the IPO, NASDAQ released a blow-by-blow account of what happened with Facebook's opening<sup>55</sup>. The massive order volume overwhelmed NASDAQ's systems such that orders took too long to process, causing a "loop" which resulted in the system being unable to establish an opening price. Exchange officials had to manually intervene to allow the auction to occur at 11:30 a.m. NASDAQ's CEO Greifeld expressed his disappointment with the results, stating that the IPO software "didn't work" and that they were "caught by surprise" despite testing 1 billion in trading volumes under "a hundred scenarios" to anticipate problems<sup>56</sup>. Nevertheless, Greifeld defended his team on the system failure, saying, "As much as we didn't test for cancellations fully on scenarios, the team was well-drilled, and we know our products and we responded accordingly. [Our team] performed flawlessly"<sup>57</sup>. NASDAQ's peace offering – a US\$40 million *mea culpa* to market makers and brokers only<sup>58</sup>.

## Irate Investors And Insider Trading Allegations

Within the first week of trading, Facebook saw its share price slump to US\$31.91, 16% lower than the offer price. Search engine giant Google tracked more than 40,000 online news articles on the botched IPO in a 24-hour period on Wednesday<sup>59</sup>. Allegations of insider trading started to surface merely days after Facebook's IPO listing, with reports alleging that Facebook and its underwriters did not disclose the fact that Facebook had slowing revenue growth<sup>60</sup>. There was also increasing anger from investors who alleged that Facebook's banks preferentially helped large customers by revealing only to them financial information which were not made known to the public<sup>61</sup>. This was worsened by the fact that Zuckerberg managed to prevent losses of more than US\$170 million by letting go of some of his shares early<sup>62</sup>. At least 3 lawsuits were filed, charging that Facebook's IPO documents were not properly done and there was insufficient disclosure on material and important matters<sup>63</sup>.

Facebook maintained that the accusations were groundless and that it would do its best to fight against these allegations. Democratic and Republican parties' lawmakers sought for more information regarding Facebook's soured IPO<sup>64</sup>. The turn of events also attracted the attention of U.S. regulators which started to look into the allegations for any possible wrongdoing by Facebook and its underwriters<sup>65</sup>.

## Aftermath

On 25 June 2012, Facebook appointed COO Sheryl Sandberg, its first female director, to its board of directors, in response to mounting pressure to increase board diversity<sup>66</sup>. In addition to Facebook, Sandberg also served on the boards of Starbucks and The Walt Disney Company.

Within five months of the IPO, Facebook insiders reportedly made US\$775 million by selling more than 241 shares valued at more than US\$9 billion<sup>67</sup>. The company's executives had also managed to get U.S. District judges to toss out four shareholder lawsuits tied to the IPO on 13 February 2013<sup>68</sup>. The last remaining claim pertaining to the botched IPO by an investor against trading platform SecondMarket was dismissed on 27 February 2013 by a New York state appeals court<sup>69</sup>.

On 25 March 2013, SEC approved of NASDAQ's US\$62 million compensation plan for firms that lost money in the Facebook IPO debacle<sup>70</sup>. Regulators declined to comment as to whether NASDAQ may have violated federal securities laws in the Facebook IPO<sup>71</sup>.

## Discussion Questions

1. Explain the benefits and drawbacks of dual class share structures for controlling and non-controlling shareholders. What types of companies are more inclined to adopt such share structures?
2. A single Chairman-CEO is the norm in many U.S. companies. Are there any merits or problems in having such a form of board leadership for shareholders? Explain.
3. Analyse Facebook's IPO process. Could the company have done more for the retail investors in terms of disclosure? Could NASDAQ have done more for investors regarding the "technical error" on the Facebook IPO day?
4. Analyse the treatment of institutional investors and individual investors by Facebook. Was it equitable?
5. Who do you think should be blamed for the botched Facebook IPO, if any? Why?

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# Formula One: A Race To The Bottom?

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## Case Overview

In early 2012, Formula One Group (F1) made public its intention to list on the Singapore Exchange (SGX). Approval for the Initial Public Offering (IPO) was granted by SGX in May 2012, with the Group proposing to raise S\$3.8 billion<sup>1</sup>. However, the European Debt Crisis and allegations of bribery involving Chief Executive Ecclestone delayed the IPO. Plagued by all these issues, the proposed IPO was repeatedly shelved, and the Group has yet to list at this time.

The objective of this case is to highlight the various issues faced by F1 in its proposed listing, with a specific focus on the bribery allegations faced by its Chief Executive. This case also brings to light other related issues such as potential conflict of interests faced by stock exchanges, as well as key man risks and the importance of succession planning.

## Formula One Dissected

F1 is a group of companies responsible for promoting the FIA F1 World Championship, which is the world's premier auto racing competition. The Group has a complicated structure with a total of 31 entities<sup>2</sup>. Bernie Ecclestone has been at the helm since 1978, when he became the chief executive of the Formula One Constructors Association.

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This is the abridged version of a case prepared by Jin Jianqing, Law Chun Fung, Melody Lim, Oh Wei Ying, and Tay Guang Liang, under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Amanda Aw Yong under the supervision of Professor Mak Yuen Teen.

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## Board Of Directors

In planning for the upcoming listing on SGX, the F1 group intends to restructure its current Board to eventually comprise 16 directors post-listing. This new board would be headed by the newly-elected Chairman Peter Brabeck-Letmathe, and will consist of representatives from various interest groups.

Prior to his appointment as Chairman of the F1 board, Peter Brabeck held various positions on boards such as L'Oreal, Credit Suisse and Nestlé. In May 2012, he announced his acceptance of a supervisory role in F1 as an Independent Non-executive Director<sup>3</sup>. In contrast with Ecclestone's operational focus in F1, Brabeck would focus on business succession. Current Chief Executive Ecclestone, having spent 50 years working for F1<sup>4</sup>, will continue to manage the company after the proposed IPO.

## Singapore Independent Directors

Singaporeans Liew Mun Leong and Kwa Chong Seng were slated to sit on the board to satisfy the requirements specific to foreign issuers (i.e. two Singapore Resident Independent Directors)<sup>5</sup> in the SGX listing rules. Liew Mun Leong has been an Independent Director of SGX prior to the approval of F1's flotation. He also sits on both the Audit and Remuneration Committees of SGX<sup>6</sup>. Kwa Chong Seng was Deputy Chairman of Temasek Holdings Pte Ltd until May 2012<sup>7</sup>. Temasek owns SEL Holdings, who in turn had a 23.5% stake in SGX<sup>8</sup>. Up till his retirement in July 2012, Kwa was also an Executive Director of the DBS Group Holdings Ltd and DBS Bank Ltd, one of the advisors for F1's IPOs<sup>9</sup>.

## Road To Listing

In March 2012, news of F1 preparing for a US\$1 billion flotation on an Asian Stock exchange (likely to be either Singapore or Hong Kong) began spreading<sup>10</sup>. The reason cited was to tap on the "Asian enthusiasm for international sporting brands"<sup>11</sup>. Ecclestone recommended Singapore as the best place to float to CVC Capital Partners (CVC)<sup>12</sup>. CVC was a substantial shareholder of F1, holding 42.5% of its shares in January 2012<sup>13</sup>. Ecclestone, holding a far less substantial ownership, thus had to gather the support of F1's largest shareholder.

A month later, SGX appeared to have beaten the Stock Exchange of Hong Kong (SEHK) to the listing, and the IPO process was ready to kick-start. The IPO was expected to be valued at US\$1.5 billion and was tentatively planned for July 2012<sup>14</sup>.

Goldman Sachs and UBS were revealed to have been appointed as joint global coordinators<sup>15</sup>.

In late April 2012, Ecclestone, with the bosses at CVC, gave a presentation to a room of analysts, indicating that the IPO plans were being stepped up. Morgan Stanley was revealed to be the third lead book runner. The F1 group was valued at US\$10 billion, with up to 30% being publicly offered, with the majority ownership remaining with CVC. Most of the share issue was to come from the Lehman Brothers Estate, which held 15.3%. Furthermore, CVC apparently secured US\$7.1 billion of revenue, which were mostly from long-term racing contracts. With refinancing in mind, CVC undertook another loan of US\$2.3 billion. From this loan, US\$1.1 billion would be paid out to Delta Topco, which is the holding company of the F1 group<sup>16</sup>.

By May 2012, however, things were not looking good. Even though SGX had given the approval for the share sale<sup>17</sup>, instability in the global markets slowed the progress of the plan. The European Debt Crisis and huge trading losses that JPMorgan Chase had incurred contributed to this<sup>18</sup>. Given that F1 holds almost half of its yearly races in Europe, this uncertainty in the Euro zone would significantly affect its IPO valuation<sup>19</sup>. In addition, an agreement with Mercedes had yet to be reached with regards to its long-term future in the sport. Without Mercedes' commitment, the flotation would unlikely to be able to proceed<sup>20</sup>.

On 23 May 2012, it was announced that shares to be sold would be stapled with a loan note, which is first of its kind in Singapore. The purpose of this was purportedly for F1 to enjoy tax benefits in the UK, which allows interest expense on shareholder loans to be tax deductible<sup>21</sup>.

In late May, Brabeck, the then newly-appointed Chairman, expressed that F1 had yet to decide whether to list or not. Reasons cited by others included the failure of Facebook's listing (which involved both Goldman Sachs and UBS) among others<sup>22</sup>. Facebook's failure was notable as it was similar overhyped<sup>23</sup>. Finally in September, Ecclestone conceded that the float was not going to happen in 2012<sup>24</sup>. In October, CVC postponed the flotation to 2014, in light of market turmoil and the ongoing bribery case Ecclestone was implicated in. Ecclestone similarly commented that 2014 was the more likely date<sup>25</sup>.

In March 2013, Ecclestone changed his position, stating that within the next three months, a decision would be made as to whether the listing will occur at the end of 2013<sup>26</sup>.

## **Allegations Of Bribery**

In June 2012, former Bayerische Landesbank's (BayernLB) Chief Risk Officer, Gerhard Gribkowsky, admitted to receiving bribes from Ecclestone in 2006 when the sale of shares in F1 Group took place between BayernLB and CVC. Gribkowsky claimed that Ecclestone offered him US\$44 million in bribes to facilitate and approve the sale of 47.4% shares in F1 to CVC<sup>27</sup>. This confession was ostensibly prompted by the possibility of a shorter prison term in exchange<sup>28</sup>. Gribkowsky was officially sentenced to eight and a half years in jail for his charges on 27<sup>th</sup> June 2012<sup>29</sup>.

### **Motivation For Accepting Bribes**

According to Gribkowsky, he had accepted the bribe from Ecclestone because he was unhappy that his employer, BayernLB, did not grant him a bonus he believed he deserved for the successful sale, as well as for his hard work over the years. Thus, when Ecclestone presented him the offer, he accepted it without hesitation<sup>30</sup>. In addition to the bribe, Gribkowsky also claimed that Ecclestone offered him a job as a consultant in F1 upon the conclusion of the sale to CVC<sup>31</sup>.

### **What Ecclestone Stood To Gain**

The reason Ecclestone was so concerned about the sale of BayernLB's stake in his company lies in the belief that Ecclestone wanted BayernLB out of F1. Ecclestone was in fact sued in London over changes of corporate governance rules in the company that limited BayernLB's influence. The resulting animosity had a clear part to play in Ecclestone's desire to hasten the sale of BayernLB's stake.

In addition, CVC had an agreement with Ecclestone that would retain him as the Chief Executive after they become the largest shareholder of F1. Even though another bidder – Bluewater Communications Holdings (Bluewater) – presented an offer higher than that of CVC's, CVC remained Ecclestone's preferred choice and the bribe was thus presented to Gribkowsky to steer the sale toward CVC.

## **Ecclestone's Side Of The Story**

In contrast to Gribkowsky's allegations,, Ecclestone maintained that the US\$44 million paid to Gribkowsky was not a bribe, but rather, a payment in response to the latter's blackmail.

According to Ecclestone, Gribkowsky had “strong designs” on replacing him as the boss of F1. Once Gribkowsky realised he had little chance of fulfilling his F1 ambitions, he began to repeatedly blackmail Ecclestone that he would disclose unfounded accusations to the UK tax authorities about possible tax violations of Bambino, which is a trust set up by Ecclestone and run by his ex-wife<sup>32</sup>. He threatened to report to the UK tax authorities that Ecclestone was the sole controller of the multi-billion Bambino trust. Fearing that the accusation would make him liable for about £2 billion of back taxes, Ecclestone tried to silence him with US\$44 million<sup>33</sup>. He weighed that paying the money was more convenient and less financially harmful than risking a costly investigation by the tax authorities<sup>34</sup>. Hence, a scheme was arranged to funnel US\$44 million to Gribkowsky through contracts and off shore companies<sup>35</sup>. In 2008, however, Ecclestone received a letter from the UK tax authority that he was cleared of any involvement with the trust<sup>36</sup>.

## Other Lawsuits

Aside from the main bribery case, Ecclestone also faced lawsuits from Bluewater and BayernLB. The former filed a lawsuit against Ecclestone, BayernLB and CVC, to compensate for its lost revenue from F1 had they bought over F1’s stake in 2006 successfully. Bluewater claimed it was prepared to offer more than other bidders for the 47.4% F1 stake, yet Ecclestone steered the sale to CVC so that he could retain his CEO position. BayernLB, on the other hand, sought US\$400 million in damages from Ecclestone<sup>37</sup>, claiming that if the bank had known about the bribery, it would not have paid Ecclestone and his family trust any commission for being the middleman of the successful sale to CVC.

In response to these lawsuits, Ecclestone told Reuters he was surprised as he had never heard of Bluewaters<sup>38</sup>. A spokesman from BayernLB also said that the sale of shares to CVC complied with all relevant procedures and the commission fee paid to Ecclestone was reasonable. As a result, it might be hard to claim the losses from Ecclestone.

## IPO On The Horizon?

Embroided in these various high profile lawsuits, serious doubts were cast on the ethics and image of the company, especially the alleged bribery case involving its Chief Executive. If Ecclestone is found guilty, F1 may have to remove him and

business operations might be disrupted. With this potential change in leadership and loss of such a prominent leader, would F1 remain profitable? Would shareholders and investors continue to invest in the sport? In light of these problems, it remains to be seen if the planned IPO re-launch would proceed smoothly. All eyes will be on Ecclestone as the market awaits his official announcement in the coming months.

## **Epilogue**

According to a news article on the listing environment in Singapore, F1 has yet to make headway with regards to its IPO as of May 2014. When interviewed, Ecclestone said that they would go ahead “when [they] think the time is right”<sup>39</sup>. Until then, whether the IPO would be successful remains to be seen.

## **Discussion Questions**

1. Discuss the potential conflict of interests for an exchange like the SGX.
2. Should SGX have approved F1's flotation in May 2012 when the alleged bribery case of Ecclestone was still ongoing and his personal integrity called into question?
3. F1 was planning to sell ordinary shares stapled with a loan note for its proposed IPO in Singapore. What are the possible reasons for F1 issuing stapled securities rather than selling them as separate securities? Are there corporate governance concerns with such stapled securities?
4. Ahead of the proposed listing, F1 invited two Singaporean directors to sit on its board in order to fulfill the listing rules for foreign issuers. Do you think there are any possible conflicts of interest resulting from this?
5. To what extent is Ecclestone indispensable to F1? What are the potential ramifications on F1 for relying too much on Ecclestone?
6. What kind of succession plans would you recommend for a company like F1? Evaluate the succession plans of F1, if any.

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# GlaxoSmithKline: The Etiquette Of Bribery

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## Case Overview

*“This is shameful. And personally, it is deeply disappointing.”*

– Andrew Witty, Chief Executive Officer (CEO) of GSK

The business of GlaxoSmithKline (GSK) is a noble one. Its company's mission statement states: “Our mission is to improve the quality of human life by enabling people to do more, feel better and live longer.” Yet, the Chinese saying “金玉其外，败絮其中” (the appearance may look good, but what lies beneath is far from good) seems to aptly describe GSK. The company has been embroiled in many scandals, including the largest healthcare fraud case in the U.S. which required a settlement amounting to US\$3 billion<sup>1</sup>. In June 2013, reports emerged alleging that senior executives of GSK China were involved in the bribery of doctors and government officials. The objective of this case is to allow a discussion of issues such as the responsibility of the board over corporate governance, the obligation of GSK to properly govern the activities of its foreign subsidiaries, and the difficulties of enforcing good corporate governance in countries where corrupt or unethical practices in the industry may be considered a norm.

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This is the abridged version of a case prepared by Chen Xinyi, Cheryl Liew, Ng Wai Chuan and Thia Hui Ting under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. This case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lim Jin Ying under the supervision of Professor Mak Yuen Teen.

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## China: A Breeding Ground For Corruption?

*“Distinguishing between money spent on corruption with money spent on developing relationships can be difficult, as it is a significant part of the way business is done in China.”*

– Lucinda Chow, media commentator<sup>2</sup>

*Guanxi* is a key part of the Chinese business environment. It is characterised by the formation of close and informal relationships between individuals and institutions with great reliance within the network for support, cooperation and subsequent transactions. *Guanxi* practices have flourished in China, forming the basis of many transactions entered into amidst lax regulations. The presence of such cultural norms has created much subjectivity in judging the substance of transactions, especially from a legal standpoint<sup>3</sup>.

Despite recent policy revisions in the Chinese regulatory environment, the current system is still perceived as one that lacks fair and consistent enforcement, with a lack of independence in the judiciary process, especially in litigation involving state-controlled organisations<sup>4</sup>.

## The Good, The Bad And The Ugly

China's highly regulated environment means that the state fixes the costs of operations. In addition, costs of many medicines are capped, leaving hospitals little room to top up the wages of their staff. A newly-graduated doctor in Beijing earns about 3,000 yuan (US\$490) a month including bonuses, approximately the same as a taxi driver<sup>5</sup>. Compensation under the current medical system involves two tiers, where doctors are paid a low base salary and a variable wage, depending on the number of prescriptions made to patients<sup>6</sup>. Bribes are thus seen as essential income supplements, in some cases making up to 80% of a doctor's monthly pay<sup>7</sup>, as doctors are unable to survive solely on their salaries.

Notwithstanding tight regulations, the Chinese healthcare system has remained consistently underfunded. With the government reducing public healthcare spending, provision of healthcare services falls largely to the private sector. The autonomy granted to private companies has fuelled opportunities for corrupt practices such as extensive back-door payments to doctors by pharmaceutical firms to ensure doctors prescribe their products<sup>8</sup>.

## **GSK, The Healthcare Giant**

GSK was formed in 2000 following the merger of Glaxo Wellcome and SmithKline Beecham. The company deals mainly in pharmaceuticals, vaccines and consumer healthcare, and is one of the global leaders in healthcare research and development<sup>9</sup>.

Headquartered in London, GSK is listed on the London Stock Exchange and the New York Stock Exchange. The pharmaceutical giant has an established presence worldwide, with offices in over 115 countries<sup>10</sup>. GSK has sizeable operations in China, with eight subsidiary companies and a total investment exceeding US\$500 million<sup>11</sup>.

Despite the challenges of internationalisation, GSK has remained largely profitable throughout, turning in annual net profits averaging £4.32 billion in the last five years<sup>12</sup>.

## **The People Running The Show**

In 2012, the Corporate Executive Team consisted of 16 individuals, led by Chief Executive Officer (CEO) Sir Andrew Witty. The organisational structure was both functional and geographical, where executives either oversaw particular regional units or areas of focus<sup>13</sup>.

The Board comprised of 15 members. Sir Christopher Gent, who had been on the Board for the past nine years and Chairman for over eight years, led the Board. Out of the 15 members on the Board, three directors were executive, with the remaining directors being non-executive. The three executive directors, Sir Andrew Witty (CEO), Simon Dingemans (CFO) and Dr Moncef Slaoui (Chairman of Global R&D and Vaccines), sat solely on the Finance Committee. Out of the three executive directors, Slaoui has been serving for the longest period, at 8 years<sup>14</sup>.

All the 12 non-executive directors were deemed to be independent in accordance with the United Kingdom (U.K.) Corporate Governance Code. In addition, there was also a Senior Independent Director (SID), Sir Robert Wilson, whose role was to 'act as a sounding board for the Chairman and a trusted intermediary for the other Directors'<sup>15</sup>, and 'as an additional point of contact for shareholders'<sup>16</sup>. GSK also had a strong female board representation at 33%, after the additional appointments of Lynn Elsenhans and Jing Ulrich as non-executive directors in July 2012<sup>17</sup>.

Currently, the Board comprises of six committees, namely the Audit & Risk Committee, Corporate Responsibility Committee, Remuneration Committee, Finance Committee, Nominations Committee and the Corporate Administration & Transactions Committee.

The Board has strived to ensure that its non-executive directors are drawn from a wide range of industries including pharmaceuticals and healthcare, medical research and academia, and retail and financial services, with appropriate experience and global reach<sup>18</sup>.

## **Corporate Governance In GSK: Actions (Should) Speak Louder Than Words**

*“We put the interests of patients and consumers first and are driven by our values ... in everything we do.”*

–GSK Corporate Governance Report, 2012

According to GSK’s annual report, corporate governance in the company is founded upon the twin tenets of integrity and transparency. All employees in GSK are governed by its code of conduct, which has recently been streamlined and simplified by the company<sup>19</sup>. The code reminds GSK employees to “be mindful of acceptance and provision of entertainment and gifts”<sup>20</sup>. Through its guidelines, it also seeks to avoid corrupt practices, while serving as a tool to prevent and detect fraud.

GSK’s numerous corporate governance disclosures serve to highlight its tough stance towards bribery and corruption, with the company describing itself as having a “zero-tolerance approach”<sup>21</sup>. GSK also has a whistleblowing policy with a global confidential reporting line that allows employees to report suspected cases of misconduct<sup>22</sup>.

All these measures put in place have helped GSK ensure its compliance with the U.K. Code. However, while GSK has corporate governance mechanisms that are detailed, abundant and comprehensive<sup>23</sup>, the enforcement of those mechanisms appears questionable. In 2002, the company came under scathing criticism for its blatant disregard of a whistleblower’s claims, amidst allegations of management’s attempts to cover up drug manufacturing defects, in what has been described as a “gross failure of governance”<sup>24</sup>.

## What Lies Beneath The Façade

*“I want to make it very clear that we share the desire of the Chinese authorities to root out corruption wherever it exists. We will continue to work together with the MPS (Ministry of Public Security) and we will take all necessary actions required as this investigation progresses.”*

– Abbas Hussein, GSK’s President of Europe, Japan, Emerging Markets & Asia Pacific (EMAP)<sup>25</sup>

In June 2013, GSK was accused of funneling bribes to government officials and doctors by transferring money through travel agencies. Bribes were allegedly given in the form of arranged travel and cash payments to doctors as “lecture fees”, though no training schedule was provided during the trips. The case surfaced when police investigations uncovered that Shanghai Linjiang International Travel Service’s annual turnover escalated from millions to hundreds of millions despite low business, and it was later observed that the agency had conducted business dealings with GSK since 2007<sup>26</sup>.

In July 2013, GSK’s headquarters in Shanghai was raided, following which a number of GSK China executives were detained. These included two vice presidents, a legal affairs officer and a business development manager, all of whom reportedly gave bribes of up to RMB 3 billion<sup>27</sup>. One of the executives later appeared on state television to confess to the allegations<sup>28</sup>. Huang Hong, general manager of GSK’s operations in China, revealed that GSK set high annual sales growth targets of up to 25%, which was 7% above the industry growth average. Such high targets coupled with the variable salary structure were alleged to have encouraged “dubious corporate behaviour”<sup>29</sup>. The Chinese police then began investigations to find out if GSK indeed had a structured bribery programme, despite GSK’s denial and shifting of blame to individual executives who the company said had “acted outside of processes”<sup>30</sup>.

Four travel agencies were allegedly used to funnel bribes, some of which also offered sexual favours to GSK’s senior executives to preserve business ties<sup>31</sup>. In addition, documents revealed that once GSK had established relationships with doctors, sales staff gave them cash incentives of 100 yuan per prescription, as well as continuing-education credits to help meet hospital requirements<sup>32</sup>. Huang also admitted that GSK had a separate team which was allocated an annual budget of 10 million yuan to maintain ties with key hospital executives<sup>33</sup>. This resulted in doctors relying on a high prescription of drugs to raise their incomes. In an interview,

Shanghai-based doctor Zhang Qiang revealed that it was customary for doctors in his country to receive *hongbao* payments from pharmaceutical representatives<sup>34</sup>.

## GSK's Response

In response, CEO Andrew Witty ordered Europe, Japan and EMAP President, Abbas Hussein, to lead negotiations with the government, along with a team of senior lawyers and auditors. GSK's internal probe uncovered evidence that the detained executives had received cash through the fraudulent use of special VAT invoices and issued false invoices in violation of PRC tax rules<sup>35</sup>. Ernst & Young was later engaged as an external independent auditor<sup>36</sup>.

Hussein subsequently issued a statement in which he apologised, and communicated that GSK was disappointed by the ethical misconduct of its executives as well as its third party contractors and agencies. Hussein expressed GSK's desire to cooperate with the Chinese police to root out corrupt practices, and pledged that the company would lower prices to make its medicines more affordable<sup>37</sup>. CEO Witty also expressed his "disappointment" in the event, adding that talks were already in place with U.S. and U.K. regulators<sup>38</sup>.

To tighten governance within the company, GSK appointed one of its top European executives Herve Gisserot, senior vice president for Europe, as the new head of operations in China. Mark Reilly, the current head of operations, was slated to remain as a senior member of the management team. Gisserot was tasked with ensuring minimal disruptions to GSK's China operations amidst the ongoing investigations<sup>39</sup>.

GSK's response drew mixed reactions from the public. According to China analyst Andrew Hupert, the Chinese prosecutors had wanted it to issue a "Chinapology", which was "a brief, to-the-point admittance of guilt and expression of sorrow over one's misdeeds in public"<sup>40</sup>. However, doing so would be a violation of the U.S. Foreign Corrupt Practices Act and the U.K. Bribery Act, both of which governed GSK and were applicable to acts of bribery committed abroad. Faced with this quandary, GSK never fully admitted to its wrongdoings in China<sup>41</sup>.

## Impact On Business

GSK has seen its sales in China dip by 60% since investigations began in June<sup>42</sup>. Major hospitals refused entry to GSK's sales representatives. In September 2013,

rumours surfaced that GSK was considering pulling out of China, a market which generated 3.6% of GSK's revenues, despite seeing double-digit sales growth in recent years<sup>43</sup>. A senior industry figure in China revealed that GSK's reason for pulling out of the country could be the size of the fine (potentially £2 billion) it faced, as well as the severance of ties with major local hospitals, leading to increasing difficulty of doing business<sup>44</sup>.

## What's Next? The Aftermath Of The GSK Fiasco

*"We very clearly recognise there is a profound need to earn the trust of Chinese people again. We will take every action to do so."*

– Andrew Witty, CEO of GSK<sup>45</sup>

In October 2013, CEO Witty insisted the pharmaceutical giant would not pull out of China despite the lurid corruption scandal that had wiped out two-thirds of its business in the world's second-largest economy<sup>46</sup>. GSK China remains a "multi-hundred million pound business" despite the fall in sales, making it unlikely that this lucrative market will be given up<sup>47</sup>. While the GSK scandal will inevitably increase compliance costs, the industry will look back at this moment as a necessary step forward in the effectiveness of China's healthcare system and the measures they will need to put in place to avoid future recurrences of such incidents.

## Discussion Questions

1. Discuss how the relationship-based (i.e. *guanxi*) business model affects GSK's corporate governance in China.
2. Discuss the various factors that led to the GSK bribery scandal. To what extent is the Board of Directors culpable for the alleged corruption?
3. Evaluate the adequacy of GSK's responses to the alleged bribery.
4. The GSK corruption scandal has raised questions over the ability of multinational companies to effectively implement their code of conduct throughout the group. In light of this, how can companies expanding into new markets improve their governance of foreign subsidiaries?

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# Goldman Sachs: Hello Lloyd, Meet Blankfein

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## Case Overview

The duality of the Chairman and CEO roles is a longstanding controversy in corporate governance. Having been at the helm as Goldman Sachs' Chairman and CEO since 2006, Lloyd Blankfein has drawn much flak from shareholders concerned with the independence of the board. The rise of shareholder activism in recent years has put pressure on Goldman Sachs to review its leadership structure and generous executive compensation. The objective of this case is to enable a discussion of issues such as Chairman-CEO duality, shareholder activism as a corporate governance mechanism, executive remuneration, and the possible measures that can be taken to ensure good corporate governance.

## Background

Founded in 1869 by Marcus Goldman, the bank was named Goldman Sachs & Co. after his son-in-law Samuel Sachs became part of the firm in 1882 and Goldman's son, Henry and another son-in-law Ludwig Dreyfuss, joined in 1885. The firm carved a name for itself as originators of commercial paper within the money markets, listing on the New York Stock Exchange in 1896. Through the years, Goldman Sachs grew from being the firm that completed one of the biggest IPOs (of Sears, Roebuck and Company) in 1906 to becoming a public company in 1999, renaming itself Goldman Sachs Group Inc. In the same year, Henry Paulson assumed the role of Chairman and CEO. In 2006, Lloyd Blankfein took over the reins as Chairman and CEO after Paulson left the post to become the U.S. Treasury Secretary.

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This is the abridged version of a case prepared by Chan Rui Qi, Baldwin Choy Ching Fai, Nicole Lim Sing Rong, Zhao Pengcheng under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Ng Jun Yan under the supervision of Professor Mak Yuen Teen.

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The firm is no stranger to high performance. Goldman Sachs is one of the World's Most Admired Companies, ranked 39<sup>th</sup> by Fortune<sup>1</sup>, and 2<sup>nd</sup> amongst the megabanks in 2012. The firm has, through its 144-year history<sup>2</sup>, portrayed itself as being superior to its competitors. It paints an image as being more intelligent, more internally symbiotic, and as one of the best at money-making. It has traditionally prided itself on its business model known as "The Goldman Way", which rests fundamentally on hiring the "most talented" and then engaging these talents in Goldman's tough corporate environment where these hires learn to embrace the firm's "14 Principles", for instance, that "our clients interests always come first".

A series of changes in leadership, mergers and acquisitions, and changes in the financial environment have shaped its current structure, with its main divisions of investment banking, securities, investing and lending and investment management, and offices in more than 40 locations across the globe. In 2012, Goldman ranked 80<sup>th</sup> on Forbes Fortune 100 list, with revenue of US\$36.79 billion and profits of US\$4.44 billion<sup>3</sup>.

## **2013: Withdrawal Of Shareholder Proposal To Separate The Chairman-CEO Role**

It was 11 April 2013. CtW Investment Group had just confirmed the withdrawal of its shareholder proposal after Goldman had agreed to widen the authority and responsibilities of James Schiro, its board's lead independent director. Schiro will determine the board's agenda at future meetings and pen his own statements to shareholders within the annual proxy statement to be issued.

Four months earlier, CtW Investment Group had sent a letter to Goldman Sachs asking for the company to separate the roles of Chairman and CEO by appointing an independent Chairman – one who has been neither an executive officer nor has had other relations with the investment bank<sup>4</sup>.

Lloyd Blankfein won the battle for him to retain both the Chairman and CEO roles - for the third time in a row since he was appointed to both positions in June 2006<sup>5</sup>. The year before, the American Federation of State, County and Municipal Employees (AFSCME), a labor union pension fund, had put up a similar proposal to separate the roles of Chairman and CEO of the bank, only to drop its proposal after Goldman compromised, agreeing to reorganise its board structure by introducing a

lead director<sup>6</sup>. This year marked yet another victory for Blankfein, but with the rise of shareholder activism over the years, an uphill battle lies ahead.

## **Board Of Directors**

At the end of 2012, Goldman Sachs had 13 directors, of whom 10 were independent<sup>7</sup>. While the average tenure of each director was approximately five years, three had held their directorships for more than 10 years. Two of the directors on the board at that time, David Viniar and Stephen Friedman, were also previous employees of Goldman Sachs.

## **Remuneration**

The issue of remuneration has undoubtedly been one of the most hotly debated corporate governance issues in financial institutions<sup>8</sup>. Blankfein was compensated with US\$13.3 million in restricted shares in 2012, alongside a US\$5.7 million cash bonus and a US\$2 million salary. This was US\$9 million more than the previous year. At its peak in 2007, his total compensation was US\$68 million. Blankfein was on a long-term incentive plan, which would pay him shares depending on his performance. The shares were worth approximately US\$5 million as of January 2013. Blankfein was known to be the best-paid banker across the globe. His lavish paycheck had earned him the title of “Most Outrageous CEO” in a 2009 Forbes ranking<sup>9</sup>.

## **Rise Of Shareholder Activism**

Shareholder activism has been apparent in many U.S. companies in recent years. A point of contention between shareholders and financial institutions is the lack of separation between the Chairman and CEO roles. As at November 2012, only 43% of firms listed on the Standard & Poor’s 500 index had split Chairman-CEO roles, and only 18 firms had policies in place necessitating such a split<sup>10</sup>.

Goldman Sachs has clearly not been absolved of this trend. Shareholders have been proposing to split the Chairman-CEO role of Lloyd Blankfein since 2010, citing the potential conflict of interests.

## **2010: Beginning Of The Call For Separation Of The Chairman-CEO Roles**

In 2010, Goldman Sachs was faced with two proposals from shareholders, Christian Brothers Investment Inc. and Needmor Fund, calling on the firm to split the roles of Chairman and CEO<sup>11,12</sup>. This came at a time when the Securities and Exchange Commission (SEC) had filed a civil fraud suit against the firm for bilking investors in the mortgage deal, Abacus 2007-AC1, merely weeks before the shareholder meeting<sup>13</sup>. The deal was one of 25 mortgage-backed securities in Goldman's "Abacus" program. Goldman had structured and marketed synthetic collateralised debt obligations (CDOs) that relied on the performance of subprime mortgage-backed-securities, and allegedly defrauded investors by not disclosing how the bank had worked with Paulson & Co., a hedge fund, in selecting the portfolio and that the same fund had intended to short the CDO. Goldman received fees of US\$15 million from Paulson & Co. for its work<sup>14</sup>.

The proposals came with the belief that it was the duty of the Board of Directors to act independently when overseeing management, and a conflict of interest existed since Blankfein was essentially chaperoning his own duties as CEO in his capacity as Chairman. It was also argued that separating the two roles would improve Goldman's image following the subprime mortgage crisis<sup>15</sup>.

At the shareholders meeting, few shareholders queried the Goldman Board over the SEC suit, and the Board recommended voting against the separation of Chairman-CEO role. Eventually, one of the proposals was removed from the proxy for being a duplication and the other was voted down. Blankfein retained both his roles.

## **2011: The Second Call For Separation Of Chairman-CEO Roles**

On 14 September 2011, AFSCME<sup>16</sup>, a labor union with assets of more than US\$850 million, which held 7,101 Goldman shares at that time<sup>17</sup>, launched a proxy proposal for Goldman to split the Chairman and CEO roles through the appointment of an independent Chairman.

To back its proposal, the union cited the 2010 SEC suit over the "Abacus deal" which eventually cost Goldman US\$550 million in penalties, contingent liabilities of up to US\$3.4 billion in law suits according to a March 2011 10-K filing, and the 2011

Levin-Coburn Report on the Subprime Mortgage Crisis, which pointed that conflicts of interest was the driving force behind Goldman putting its own monetary interests in front of its customers'. The 2011 Levin-Coburn Report noted how during the tenure of Paulson and Blankfein, Goldman's business focus had turned to that of a trading house from its fundamental investment banking role. Under Paulson's tenure, Goldman had canvassed regulators to exempt investment houses from having to keep reserve funds, which would have played the role of limiting the firm's leverage and risks undertaken. AFSCME thought the exposure to risks was potentially detrimental to the bank's stock price, and that the adoption of its proposal could mitigate such risky behavior, serving the long-term interest of investors<sup>18</sup>.

On 28 March 2012, the AFSCME announced that it had withdrawn its proposal the month before, after talks with Goldman's Board Secretary, John Rogers. It was agreed that Goldman would put in place a lead director, allaying concerns over the dual role of Blankfein<sup>19</sup>.

On 3 April 2012, James Schiro was appointed lead director of the Goldman board. Schiro had been on the board since 2009. A Goldman spokesperson told *The Huffington Post* that the independent directors decided to elect Schiro. There was no involvement on the part of management, and that Goldman was confident Schiro would "serve shareholders well"<sup>20</sup>.

AFSCME was not satisfied with Goldman's decision to appoint Schiro, and claimed Goldman went against its recommendations regarding the candidates that would be "less desirable" on its board. Schiro was the former CEO of Goldman's auditor, PricewaterhouseCoopers. He also sits on the board of PepsiCo Inc., a firm that has received much flak over the years for its CEO compensation practices. A lead independent director was undoubtedly not as compelling as having an independent chairman. "This is a step in the right direction. But it remains to be seen if it is enough," commented Lisa Lindsley, AFSCME's director of capital strategies on Goldman's appointment of a lead independent director<sup>21</sup>.

## **2012: The Third Call For Separation Of Chairman-CEO Roles**

On 13 December 2012, CtW Investment Group sent a letter to Goldman Sachs with regard to its proposal to separate the roles of a Chairman and CEO for inclusion in the year's proxy statement. It recommended putting in place an independent

chairman, one with no current or prior executive role or having any other affiliation with Goldman. CtW is an investment firm that advises union pension funds, had US\$200 billion in assets and 5.5 million members<sup>22</sup>, and owned 25 Goldman shares<sup>23</sup>. According to CtW,<sup>24</sup>:

*“The chairman should be an independent director to promote the robust oversight and accountability of management, and to provide effective deliberation of corporate strategy, something we believe is difficult to accomplish when the most senior executive also serves as the board’s leader. Even with robust responsibilities, we believe the position of a lead independent director is inadequate to this task because competing or conflicting responsibilities for board leadership remain with the chairman/CEO”<sup>25</sup>.*

CtW went a step further, defining “independence” as follows:

*“A chairman cannot have had a financial relationship with Goldman Sachs valued at more than US\$100,000 annually in the last three years, been employed by a public company at which a Goldman Sachs executive serves as a director, or be a direct relative of a Goldman Sachs director”<sup>26</sup>.*

Following CtW’s proposal, Goldman Sach’s Associate General Counsel, Beverly O’Toole, sent a letter to the SEC on 16 January 2013 seeking approval for the proposal to be excluded from its proxy statement because the bank thought it was “inherently vague and indefinite” on six counts, including how the term “affiliate” was not clearly defined and could take on more than a single meaning<sup>27</sup>. The firm also questioned the clarity of the fourth independence criterion proposed by CtW. That is, whether a director had a ‘business relationship with Goldman Sachs worth at least US\$100,000 annually”. Goldman Sachs rebutted that it was overarching, blankets all business relationships worth a minimum of US\$100,000, and that the type of business relationship and measurement of the US\$100,000 was not defined.

On 12 March 2013, the SEC replied, refusing Goldman’s request on grounds that it did not concur with Goldman’s view that CtW’s proposal was “inherently vague or indefinite”<sup>28</sup>.

*“We are unable to conclude that the proposal is so inherently vague or indefinite that neither the shareholders voting on the proposal, nor the company in implementing the proposal, would be able to determine with any reasonable certainty exactly what actions or measures the proposal requires. Accordingly, we do not believe Goldman Sachs may omit the proposal from its proxy materials.”*

On 11 April 2013, Goldman Sachs reached an agreement with CtW. The company would widen the authority and responsibilities of James Schiro, its board’s lead independent director. Schiro will determine the board’s agenda at future meetings and pen his own statements to shareholders within the next issue of the annual proxy statement<sup>29</sup>. The board would also increase the frequency of its independent director annual meetings, from 2 to 4. In return, CtW withdrew its proposal. Blankfein kept his dual roles once again.

Governance experts like independent governance analyst Paul Hodgson and Amy Borrus, deputy director at the Council of Institutional Investors in Washington, believed that the shareholders had achieved significant progress considering the high percentage of Goldman shares owned by its employees<sup>30</sup>. As of 1 February 2013, partners of Goldman Sachs, who were its most senior staff, owned approximately US\$57.8 million, or 11.6% of the company’s shares.

## **Epilogue**

After the SEC had turned down Goldman’s request to keep CtW’s proposal off as an item to be voted upon, Goldman’s lead director met with CtW. There, CtW executive director Dieter Waizenegger laid out concerns as to whether Schiro would act as an effective balance of power to Blankfein. The latter appeared attentive toward shareholder interests. German-born Waizenegger shared common ground with Schiro who served as the CEO of Zurich Financial Services from 2002 to 2009. Waizenegger told the Reuters that CtW has a commitment to continue the dialogue and engage with Goldman in the future, including discourse over other environmental and social issues<sup>31</sup>.

With regards to CEO compensation issues, Blankfein's 2013 remuneration saw an overall 11% increase from 2012. The restricted shares held by Blankfein were worth US\$14.7 million as of January 2014, and his cash bonus was US\$6.3 million<sup>32</sup>. His raise comes in a year when many at Goldman Sachs took a pay cut, with an estimated 4% drop in the average worker's salary<sup>33</sup>. In view of the flak Blankfein has received over his pay, this latest increment is set to rile critics and attract objections from corporate governance pundits.

## Discussion Questions

1. Shareholder activism has often been argued to be an important corporate governance mechanism. Do you agree?
2. Do you think CEO duality is necessarily bad corporate governance? What are its pros and cons, if any? How different are codes or regulations over the Chairman-CEO role for U.S, UK and Singapore firms?
3. What is your view about CEO duality in the case of Goldman Sachs? What has its impact been for Goldman shareholders? Can CEO duality be justified with Goldman's good financial standing?
4. Amy Borrus, deputy director at the Council of Institutional Investors in Washington had said "It's a significant improvement...Persuading a board to take away the chairmanship from a CEO-Chair is one of the hardest 'asks' in corporate governance". Should AFSCME and CtW have withdrawn their proposals after a compromise with Goldman Sachs rather than allow shareholders to vote on them?
5. What do you think are possible measures that can be taken by stakeholders (e.g., regulators, board of directors and shareholders) or management in curbing the perceived problems of CEO duality, if any?

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# HP: Paying the Price for Autonomy

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## Case Overview

August 2011 saw one of the biggest takeovers in the technology industry when Hewlett-Packard (HP) acquired Autonomy for US\$11 billion. Léo Apotheker had wanted to invest in the software industry since he was appointed CEO nine months ago, and this was the perfect opportunity. HP's Board, more than half of which was new, had unanimously voted in favour of the acquisition. However, shareholders were concerned if the deal would truly add value. Apotheker was subsequently asked to leave and board director Margaret Whitman was appointed in his place. A year later, Whitman accused Autonomy of 'accounting improprieties', writing down US\$8.8 billion of the acquisition. This reinforced what shareholders had earlier suspected: the Autonomy acquisition was a poor decision. The objective of this case is to highlight several important corporate governance issues such as the segregation of the board and management, director appointment and responsibilities, rights of shareholders, role of auditors and advisors in due diligence, accounting-related cross-border takeover issues and conflicts of interest for both the board and management.

## HP: The Tower Of Technology

HP founders Bill Hewlett and Dave Packard are among the fathers of Silicon Valley<sup>1</sup>. Over seven decades, HP has grown into one of the most important technology companies in America, offering printing, personal computing (PC), software, services, and enterprise infrastructure, achieving US\$126 billion in fiscal 2010 revenues<sup>2</sup>.

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This is the abridged version of a case prepared by Sarah Cheang Kah Yen, Kenneth Leong De-An, Lim Rui Wen, Lim Yejie and Charmaine Lin Minyi under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Ng Jun Yan under the supervision of Professor Mak Yuen Teen.

## Lane-Apotheker Reign Begins

After five and a half years of growth, then Chairman-CEO-President Mark Hurd resigned on 6 August 2010 for violating HP's standards of business conduct<sup>3</sup>. CFO Catherine Lesjak was appointed interim CEO while Board Director John Hammergren chaired a Search Committee for a new Board Chair and CEO<sup>4</sup>, engaging global executive search firm Spencer Stuart to assist in finding someone who could take HP forward<sup>5</sup>. Before long, with directors outside the search committee never meeting the candidates<sup>6</sup>, HP announced on 30 September the selection<sup>7</sup> of Apotheker as CEO and Raymond Lane as Non-Executive Chairman, both effective 1 November<sup>8</sup>.

Although he has over 20 years of software experience in Germany's SAP, Apotheker was a surprise choice<sup>9,10</sup>. However, HP believed he could accelerate their strategy of growing enterprise business revenues<sup>11</sup> and help grow HP globally<sup>12</sup>, despite his inexperience in managing a company of HP's size<sup>13</sup>. Apotheker's performance at SAP was mixed, with a rocky final seven months as CEO<sup>14</sup> during which SAP saw its first revenue drop since 2003 and a customer revolt which dampened employee morale<sup>15</sup>. Lane was "excited" to work with Apotheker, having "known and admired [him] for almost 20 years"<sup>16</sup>. Besides his software experience as a former Oracle COO and President, Lane could leverage his venture capitalist networks<sup>17</sup>.

## Overhauling The Board

In January 2011, HP enlarged the board to 17 members with five new directors<sup>18</sup>, and announced that four incumbents<sup>19</sup> would not stand for re-election at the March annual meeting<sup>20</sup>. These new directors had significant business relationships with, and were thus all seen to be close to, Apotheker<sup>21</sup> and/or Lane<sup>22</sup>. The new directors were also proposed by an *ad hoc* committee including Apotheker, Lane and Hammergren<sup>23</sup>, instead of HP's usual practice where the Nominating Committee identified candidates<sup>24</sup>. Many raised concerns, with proxy advisory firm Institutional Shareholder Services (ISS) among them<sup>25</sup>.

Amongst the new directors were Margaret Whitman, former eBay CEO and Republican candidate for Governor of California in 2009-2010. In March 2011, within a week of HP's 2011 annual meeting that re-elected all 13 directors, Whitman was appointed part-time special advisor at Lane's Kleiner Perkins Caufield & Byers (KPCB), a prominent venture capital firm in Silicon Valley. HP also publicly dismissed rumours that it would sell its PC business<sup>26</sup>.

With organisational changes including Ann Livermore joining the Board in June 2011<sup>27</sup>, eight of the Board's 14 directors had served for less than a year<sup>28</sup>, and were therefore unfamiliar with working with each other in overseeing such a huge company<sup>29</sup>.

From May to July 2011, HP's Board had to consider two critical initiatives, which led to the Board splitting into two teams, codenamed Hermes and Tesla<sup>30</sup>. Hermes considered spinning off their PC business. While it was profitable and generated US\$40 billion or almost a third of HP's annual revenues in 2010, it had lower-margins than other segments<sup>31</sup>. Tesla evaluated working with Autonomy. With only half the directors involved, Apotheker could schedule meetings more conveniently to lobby in favour of acquiring Autonomy, by arguing that growing software rather than hardware would improve HP's profitability<sup>32</sup>. Sources say the deal was later brought to the full board directly, bypassing<sup>33</sup> the review and approval processes of the finance committee<sup>34</sup>.

## Apotheker's Autonomy Acquisition

Before settling on Autonomy, Apotheker considered other software firms like Comverse Technology, Amdocs, and Tibco<sup>35</sup>. However, these were rejected by the Board's finance committee, or did not go through due to disagreements on price<sup>36</sup>.

Apotheker claimed Autonomy was ideally suited to aid the strategic repositioning of HP as a service-oriented company<sup>37</sup>. Autonomy's innovative applications would rejuvenate and complement HP's existing portfolio and the acquisition of analytics platform provider Vertica in March 2011<sup>38</sup>. Financially, Autonomy's consistent double-digit revenue growth and 43% operating margin in 2010 would boost HP's earnings<sup>39</sup>. Such favourable results persisted through Q1 2011<sup>40</sup>.

## Doing Due Diligence

HP staff, led by then Chief Strategy and Technology Officer Shane Robison, evaluated Autonomy's business and interviewed top executives<sup>41</sup>, with support from investment bankers Perella Weinberg Partners and Barclays<sup>42</sup>. These were among 15 legal, accounting and financial advisory firms who collected US\$68.8 million from advising either HP or Autonomy in the deal, none of whom spotted anything amiss<sup>43</sup>. HP and KPMG reviewed Autonomy's 2010 Deloitte-audited financial statements<sup>44</sup>,

when it was revealed that an Autonomy finance executive had alleged improper accounting. However, KPMG's review concluded the allegation was unfounded. This was neither pursued by HP's team, nor escalated to Apotheker and the board, who believed everything was in order<sup>45</sup>.

However, the amount of data reviewed seemed incommensurate with the deal size, with only 25 sales contracts examined<sup>46</sup>. Autonomy, citing U.K. takeover rules requiring equal information disclosure to all potential buyers, did not release documents that supported Deloitte's audit to HP<sup>47</sup>, until after the deal in November when HP's auditors Ernst & Young reviewed Deloitte's work<sup>48</sup>.

Despite this information shortage, HP's due diligence team was reassured by Autonomy's status as an audited public-listed company for years. Also, the team felt it was common that not all documents requested were provided in acquisitions, which some analysts concurred with<sup>49</sup>.

## Pushing The Deal Forward

Board meetings in July 2011 reviewed the due diligence on Autonomy<sup>50</sup>. The board approved a bid of up to £25 a share, despite some being doubtful over the cost. When Autonomy rejected the £25 a share bid, Lane arranged a conference call on 17 August to eventually authorise an additional 50 pence<sup>51</sup>. All directors agreed despite CFO Lesjak reiterating that HP could not afford the purchase, after she earlier argued it was too expensive and was not in HP's best interests<sup>52</sup>. On 18 August 2011, HP announced poor Q3 results, a weak outlook, and confirmed discussions it was considering spinning-off its PC business. That evening, HP offered to acquire Autonomy for US\$11 billion or £25.50 per share, a huge premium over Autonomy's £15.58 closing share price two days ago<sup>53</sup>. Overnight, HP's share price dropped 20% and six analysts downgraded HP stock<sup>54</sup>. With a market growth of 8%, investors felt that the price of 11 times sales grossly overvalued Autonomy<sup>55</sup>.

Amidst speculation that deep-pocketed Microsoft and Oracle may be interested in Autonomy, Oracle claimed Autonomy tried to sell itself in April. Lynch denied this, arguing that his friend Frank Quattrone, of boutique investment bank Qatalyst Partners, independently proposed the idea<sup>56,57</sup>. Oracle CEO Larry Ellison ultimately refused the deal because he felt that at US\$6 billion, Autonomy was overpriced<sup>58</sup>. Michael Dell, CEO of the PC giant named after him, revealed after the write-down in

2012 that Autonomy had been shopped to them back in 2011 too, but he passed because it was “obviously overpriced”<sup>59</sup> – a conclusion “any reasonable person” would draw<sup>60</sup>.

Lane consulted shareholders and discovered that many did not support the Autonomy acquisition; they had invested in HP for stability, not growth<sup>61</sup>. Realising that the deal potentially did HP more harm than good, Lane considered backing out. He was advised that U.K. takeover rules made that impossible unless HP could prove financial impropriety, but did not attempt to pursue this<sup>62</sup>.

## **Sackings And Quittings: Board And Management Reshuffling**

During the offer period for Autonomy, HP’s board ousted Apotheker on 22 September 2011, believing HP needed a leadership change<sup>63</sup>, while observers pointed fingers at the board<sup>64</sup>. Immediately, HP installed Whitman as CEO and Lane was made Executive Chairman, with HP promising to appoint a lead independent director soon<sup>65</sup>.

Shareholders were unhappy with Apotheker’s decision to discontinue webOS devices and his indecision on spinning-off HP’s PC business, evident from HP’s stock price dropping 47% in his tenure<sup>66</sup>, and rising 7% when news leaked he may leave<sup>67</sup>. Furthermore, his 11-month tenure saw HP thrice cutting financial targets and consistently underperforming, with no sign that things would improve that quarter<sup>68</sup>. Nonetheless, Apotheker still took home at least US\$13 million on leaving<sup>69,70</sup>.

Analysts questioned the hasty Whitman appointment without a formal CEO search and whether she could manage HP’s size and multiple divisions<sup>71</sup>. Although she led eBay through its IPO and expansion<sup>72</sup>, it was much smaller than HP. Lane strongly supported her appointment, believing that she was the best candidate<sup>73</sup> and possessed the right skills<sup>74</sup>. Analysts remained unconvinced, and questioned her appointment to the board in January and relationship with Lane<sup>75</sup>, particularly since she agreed on condition that Lane would be her special advisor as Executive Chairman<sup>76</sup>. On appointment, Whitman promoted the Autonomy acquisition and promised a quick decision on the future of HP’s PC business to remove uncertainty<sup>77,78</sup>.

HP gained control of Autonomy on 3 October 2011<sup>79</sup>, and confirmed it was keeping its PC business on 27 October 2011<sup>80</sup>. On 17 November 2011, HP appointed activist shareholder Ralph Whitworth of Relational Investors to the Board and designated Rajiv Gupta as lead independent director<sup>81</sup>.

However, integration issues and HP's bureaucracy soon led to Autonomy's finance, marketing and sales chiefs resigning progressively, culminating in Lynch's resignation around May 2012<sup>82</sup>. HP countered that Lynch had disagreements with other executives and there were claims of Lynch massaging financial results<sup>83</sup>.

## **The Write-Down And Cross-Border Accounting**

After Lynch's resignation, Autonomy senior management came forward alleging accounting malpractice, leading to PricewaterhouseCoopers' forensic investigation overseen by HP's general counsel John Schultz<sup>84</sup>.

In announcing its full year results in November 2012, HP claimed they found accounting improprieties, misrepresentations and disclosure failures that inflated Autonomy's financials<sup>85</sup>. HP argued that this accounted for over US\$5 billion of a US\$8.8 billion write-down<sup>86,87</sup>, which roughly represented the entire goodwill paid<sup>88</sup>. This caused its stock-price to slide to a ten-year low, more than 50% down from January<sup>89</sup>. HP said that actions of former staff "appear to have been a wilful effort...to mislead investors and potential buyers... and severely impacted HP management's ability to fairly value Autonomy at the time of the deal"<sup>90</sup>.

HP argued that Autonomy masked some low-margin hardware sales under higher-margin software revenue, and that some product costs were recorded as marketing expenses instead of cost of goods sold<sup>91</sup>, indicating misclassification that changes operating profits but not net profits<sup>92</sup>. Autonomy also allegedly inflated revenues by early recording of software sold to value-added resellers, and structured multi-year software subscription contracts to accelerate revenue recognition<sup>93</sup>. Since Autonomy used IFRS<sup>94</sup> while HP applies U.S. GAAP<sup>95</sup>, HP's board and advisors should have known to adjust for them in valuing Autonomy<sup>96</sup>. This is particularly so for revenue recognition<sup>97</sup>. Autonomy would apply the principles-based IAS18 when eventual sales are probable, while HP would have to apply more prescriptive rules on vendor-specific objective evidence<sup>98</sup>. Even so, analysts and Lynch<sup>99</sup> say these cannot fully explain the full write-down<sup>100</sup>. Schultz said that misclassified or false revenues only amounted to US\$200 million<sup>101</sup>.

Following the write-down, some questioned Whitman's agenda. They noted her practice of taking big baths<sup>102</sup> and writing down investments to record higher future profitability. Earlier in August, she wrote-down US\$8 billion on EDS<sup>103</sup> acquired by HP for US\$13.9 billion<sup>104</sup>. When Whitman was CEO of eBay and acquired Skype for US\$2.6 billion, she also wrote down US\$1.4 billion<sup>105</sup>. Such behaviour may be driven by her compensation structure that hinges mainly upon her ability to increase HP's stock price<sup>106</sup>.

## Lynch Launched A Livid Defence

In London, Lynch categorically denied HP's allegations. In an open letter to HP's shareholders and board, they claimed HP's mismanagement of Autonomy led to the write-down, and "refused to be a scapegoat for HP's own failings"<sup>107</sup>. Lynch substantiated this with examples, including the fact that HP salespeople were paid more commissions to sell competing products than Autonomy products<sup>108</sup>.

Lynch set up a website, detailing that Autonomy had provided HP with all documents from October 2011. It states that Autonomy accounts were reviewed by the HP finance team and later Ernst & Young, with HP continuing with Autonomy's accounting practices for a year after the takeover. It also claimed that HP engaged an independent third party to value Autonomy's assets in January 2012, and analysed Autonomy's tax structure and transfer pricing, and sought to optimise revenue recognition for U.S. GAAP<sup>109</sup>.

## Lawsuits Claimed Legal Liability

Multiple lawsuits have since been filed against HP, Apotheker, Lynch, Whitman and former officers and directors, accusing them of grossly overpaying for Autonomy<sup>110</sup>. The defendants were also alleged to have concealed material information, made false statements about the Autonomy acquisition, breached fiduciary duties, wasted corporate assets, and engaged in unjust enrichment. This included allegedly causing HP to repurchase its stock at inflated prices from August 2011 to October 2012<sup>111</sup>.

Lawsuits, filed by shareholders under derivative action on behalf of the company, were also filed against Deloitte, KPMG, Barclays and Perella Weinberg Partners for "consciously disregarding numerous red flags" that alerted them to Autonomy's potential accounting improprieties and the resulting overvaluation<sup>112</sup>. With Sarbanes-

Oxley restricting auditor's services in the U.S. more than in the U.K., questions also arose regarding Deloitte's independence<sup>113</sup> as Autonomy's auditor given its non-audit fees of US\$1.2 million compared with its audit fees of US\$1.5 million in 2010<sup>114</sup>. Deloitte maintained it adhered to professional standards, KPMG insisted it was engaged on a consulting basis, while HP's auditor Ernst & Young had no comment<sup>115</sup>.

## Turnaround With HP Next

From February 2013, proxy advisors ISS<sup>116</sup> and Glass Lewis<sup>117</sup>, pension advisor CtW Investment Group<sup>118</sup>, and the New York City Pension Funds<sup>119</sup>, all recommended or committed to vote against Hammergren and Kennedy Thompson, directors who were with HP since Hurd's era. However, Gupta defended them, saying they had laid a solid foundation for HP's turnaround and ejecting them would be destabilising<sup>120</sup>. CtW also called for HP's auditor Ernst & Young to be replaced<sup>121</sup>.

Despite the opposition, all 11 board members were re-elected at the March 2013 annual meeting<sup>122</sup>. With slim majorities of 53-59%<sup>123</sup>, Lane decided to step down as chairman<sup>124</sup>, with Whitworth stepping up as interim non-executive Chairman<sup>125</sup> on 4 April. In the same statement, HP announced that Hammergren and Thompson would resign from the board after its next meeting in May<sup>126</sup>. On 13 April, Meg Whitman admitted that HP overpaid for Autonomy, with the improper accounting now under investigation by the Serious Fraud Office and Financial Reporting Council in the U.K., and the Securities and Exchange Commission and Department of Justice in the U.S.<sup>127</sup>.

HP Next was launched in April 2013 to improve communication with shareholders, partners, customers and employees<sup>128</sup>, with senior management and the board<sup>129</sup> sharing their views and providing updates on HP's turnaround<sup>130</sup>. While this may go some way in enhancing HP's external image, it remains to be seen if the new campaign will be matched by internal improvements.

## Discussion Questions

1. Consider the relationships between Lane, Apotheker and Whitman. How could this have influenced the decision to pay such a premium for Autonomy, only to write down 80% of the investment later?
2. Consider how directors are elected to the HP Board. What are the implications of re-electing the full board annually through majority voting? In light of the March 2013 annual meeting and subsequent resignations, would you recommend any changes to the process?
3. What are the roles and responsibilities of the board of directors in a takeover situation? Did the HP Board adequately discharge their duties in the takeover offer?
4. Are the changes in HP's share prices around the various announcements reflective of shareholder's views relating to the decisions? In major corporate transactions like HP's acquisition of Autonomy, should shareholders have more say? How should the regulators balance the interests of the board and different shareholders?
5. Discuss the roles of auditors, deal advisors, and regulators in HP's acquisition of Autonomy, the write-down, and subsequent investigations. Do you think they performed their roles effectively?

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# HSBC: The World's Local (Laundry) Bank

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## Case Overview

In December 2012, banking giant HSBC was fined US\$1.92 billion by the U.S. authorities over allegations of money laundering and partaking in illegal financial activities. This was following the release of a detailed investigation report in July 2012 by the U.S. Senate Permanent Subcommittee on significant lapses in HSBC's counter-terrorism financing systems and anti-money laundering programme. Despite having been issued several warnings to reinforce its anti-money laundering programs over the past seven years, HSBC failed to make the proper adjustments. The US\$1.92 billion penalty was at that time the largest fine ever in a case involving a bank and also brought significant reputational damage to the company. The objective of this case is to examine corporate governance issues such as the effectiveness of whistle blowing policies and ethical codes in preventing fraudulent behaviour amongst employees as well as the relationship between sound internal control and good corporate governance.

## The Making Of A Fall

*"The HSBC settlement sends a powerful wake-up call to multinational banks about the consequences of disregarding their anti-money-laundering obligations"<sup>1</sup>.*

– Senator Carl Levin<sup>2</sup>

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This is the abridged version of a case prepared by Amanda Aw Yong Zhi Xin, Eunice Tan, Yoke Si, Kang Zheng Yang, Kenneth Ling, Puah Yee Kai under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Ng Jun Yan under the supervision of Professor Mak Yuen Teen.

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HSBC has over 7,200 offices in more than 80 countries and reported US\$20.6 billion of profits before tax in 2012<sup>3</sup>. It was ranked as the world's third largest bank in terms of market capitalisation in 2013<sup>4</sup>.

Although HSBC had a code of conduct and a whistle blowing policy that served as a guide for doing business, its poor compliance culture led to numerous accusations of money-laundering violations over the years.

In the 340-page report produced by the U.S. Senate Permanent Subcommittee on Investigations, it revealed that at the root of HSBC's money-laundering practices was a confluence of factors – structural inadequacies of HSBC's Anti-Money Laundering (AML) Program, as well as the Office of Comptroller Currency's (OCC) failure to enforce regulations to prevent HSBC's wrongdoings<sup>5</sup>. Moreover, the investigation report also illustrated the means through which HSBC's money-laundering practices were carried out - through its dealings in Mexico, bypassing the U.S. Treasury Office of Foreign Assets Control's (OFAC) filters, as well as its persistence in trading with terrorist-affiliated counter-parties<sup>6</sup>.

## **The Risky Mexico Affiliate**

*“It was a financial institution with inadequate AML resources, inadequate AML systems and controls; and AML leadership”*

– U.S. Senate Committee Report

HSBC USA (HBUS) has correspondent accounts with hundreds of affiliates located in over 80 countries. These accounts can be used for cashing in US\$ instruments such as travelers cheques, and account for “63% of all US\$ payments processed by HBUS”<sup>7</sup>. One such affiliate is HSBC Mexico (HBMX), which handles almost US\$2 billion in assets and over 8 million clients<sup>8</sup>.

Prior to HSBC's acquisition of the Mexican affiliate, the U.S. State Department had already alerted HBUS to the fact that Mexico was a place with “high incidents of drug trafficking” as international money launderers used it as a vehicle to introduce their drug proceeds into the “global financial system”<sup>9</sup>. Despite this warning, HBUS still classified HBMX as a “low-risk” affiliate through its country-specific risk assessment process<sup>10</sup>.

Other than operating in a high-risk location, HBMX also had a history of severe AML deficiencies. Its problems included a pervasive lack of Know Your Customer (KYC) information in client files; database of high profile clientele connected to drug trafficking allegations; and a huge backlog of accounts earmarked for closure due to suspicious activities<sup>11</sup>.

## From Local Bank To Laundry Bank

*“These traffickers didn’t have to try very hard...They would sometimes deposit hundreds of thousands of dollars in cash, in a single day, into a single account, using boxes designed to fit the precise dimensions of the teller windows in HSBC Mexico’s branches”<sup>12</sup>.*

– U.S. Assistant Attorney General Lanny Breuer<sup>13</sup>

Since HBUS previously categorised HBMX as a low-risk affiliate<sup>14</sup>, the AML monitoring system failed to detect US\$881 million of suspicious dealings<sup>15</sup>.

During the five-year period from 2005 to 2010, the OCC (Office of Comptroller Currency) – whose job is to supervise and regulate national banks<sup>16</sup> - conducted over four dozen AML examinations and highlighted at least “83 AML matters requiring attention”<sup>17</sup>. Despite this, the OCC took no formal or informal enforcement actions, thus allowing HSBC’s AML deficiencies to fester. Further findings of the investigation also revealed that HBMX were fully cognizant of these money-laundering activities.

## Circumventing OFAC<sup>18</sup> Filters

In 2001, HSBC European Union (HBEU) proposed to use its correspondent account with HBUS to clear U-turn transactions involving Iran’s Bank Melli<sup>19</sup>, and was approved upon review<sup>20</sup>. HBEU then requested all U-turn transactions to be done via bank-to-bank transfer, and structured to hide the origins of transactions, so that information about the origins would not trigger the OFAC filter<sup>21</sup>. Even though HBUS’ Compliance Head rejected this request<sup>22</sup>, HBEU instructed Bank Melli to make “cover payments”<sup>23</sup>, which effectively concealed Bank Melli’s role in laundering money through HBEU into the U.S. financial system.

*“HSBC knew what was going on, but allowed the deceptive conduct to continue”*

– Senator Levin

Although HBUS’ compliance executives consistently reminded HBUS to require full disclosures of Iranian transactions<sup>24</sup>, HBEU and HSBC Middle East (HBME) repeatedly sent U-turn transactions through U.S. dollar accounts at HBUS without disclosing the Iranian links<sup>25</sup>. Some HBUS officials even pretended that they knew nothing about processing these deceptive U-turn transactions<sup>26</sup>.

## **Disregarding Links to Terrorism – Al Rajhi Bank (ARB)**

ARB has US\$59 billion of assets and is the largest private bank in Saudi Arabia<sup>27</sup>. For more than 25 years, HSBC provided ARB with a large variety of banking services, including providing US dollars through a Banknote account. In 2002, U.S. agents revealed that Sulaiman Al-Rajhi, one of the Bank’s founders, provided finances to Osama bin Laden’s “Golden Chain<sup>28</sup>” terrorist activities.

Because of ARB’s alleged terrorism links, the U.S. placed the bank under inspection and included it in the OFAC filter list<sup>29</sup>. Upon subsequent recommendations by HSBC Group’s Compliance Chief, HBUS decided to sever ties with ARB in 2005<sup>30</sup>. Just four months after the declaration to terminate business relationships with ARB, HSBC Group Compliance made another announcement that HSBC affiliates were allowed to resume business with ARB<sup>31</sup>. Meanwhile, ARB threatened to stop dealing with HSBC entirely if their Banknote account was not reinstated<sup>32</sup>. Hence, HBUS Compliance approved the recommencement of business between HBUS with ARB in December 2006.

HSBC only decided to exit the business of selling U.S. banknotes<sup>33</sup> after the OCC’s criticism<sup>34</sup> in 2010, thus ending its contentious relationship with ARB.

## Aftermath – Changes In HBUS

*"We accept responsibility for our past mistakes. We have said we are profoundly sorry for them, and we do so again"<sup>35</sup>.*

– HSBC Group Chief Executive Stuart Gulliver

To reduce future money-laundering risks, HBUS has embarked on a variety of measures to strengthen its internal controls. These include the implementation of stricter KYC standards<sup>36</sup>, and the subjecting of non-U.S. group affiliates to similar due diligence as non-affiliates. In addition, to further reduce its exposure to high-risk transactions, HBUS terminated 109 correspondent relationships. New monitoring systems for wire transactions and improved customer risk rating methodology have also been developed<sup>37</sup>.

As a means of internal disciplining, HBUS clawed back bonuses from their AML and Compliance Officers. It also increased spending on AML controls by nine times to address the inadequate staffing and also to reorganise its AML department<sup>38</sup>.

## Too Big To Jail

*It's a dark day for the rule of law.*

– New York Times Editorial, 11 December 2012

Upon the conclusion of the investigation by the U.S. federal and state authorities, it was decided that no charges would be pressed against any of the HSBC officials<sup>39</sup>. Despite the gravity of the matter, HSBC would only have to pay a US\$1.92 billion settlement<sup>40</sup>, which is insignificant relative to the US\$20.6 billion profit before tax HSBC earned in 2012<sup>41</sup>.

The decision not to prosecute HSBC was driven by the fact that HSBC employs nearly 16,500 workers in the U.S. Should the bank faces criminal charges, it would necessarily lose its license and cost thousands of Americans their livelihood<sup>42</sup>. Therefore, it was purportedly for society's good that the bank was not prosecuted<sup>43</sup>.

Although Columbian drug traffickers who took advantage of HSBC's lax regulations were charged with time in prison, the HSBC employees who allowed for such poor regulations escaped unscathed<sup>44</sup>. Even with the fine of an unprecedented amount of US\$1.92 billion, the passing of a no-jail sentence begs the important question –

are global banks really too big to jail? Nobody, not even Senator Carl Levin, has an answer to that, at least not for now.

## **Discussion Questions**

1. What were the ethical dilemmas in the case? Evaluate based on the three scenarios provided in the case.
2. HSBC had a code of conduct, code of ethics and whistle blowing policy, but did not implement them effectively. Why do you think this was so?
3. Comment on the regulatory actions and behaviour with respect to HSBC's wrongdoings. Were there red flags that should have been raised with the regulator?
4. What were some of the key lapses in internal controls within HSBC's anti-money laundering program? Do you think the new internal control and AML policies implemented by HSBC will help to mitigate these issues?
5. What are the consequences of such money-laundering cases for banking companies? Was the Department of Justice's decision not to press criminal charges the right thing to do – from an ethical point of view?

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# JP Morgan and The London Whale

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## Case Overview

In 2012, media released the story of the “London Whale”. Two traders had used an atypical trading strategy which greatly increased the size and risk of the portfolio they were handling. This trading strategy was later described as flawed, complex, poorly reviewed, poorly executed, and poorly monitored, by the group’s CEO. More than US\$2 billion of mark-to-market losses in relation to these trades were reported.

But who was to blame? The risk committee which was responsible for monitoring the entire company’s transactions, the regulator – the Office of the Comptroller of the Currency, or the management of JP Morgan? A Task Force was set up to investigate these losses. The objective of this case is to allow for a discussion of how JP Morgan handled this case and issues such as how the various stakeholders could have played a part in preventing the massive loss.

## Company Profile

JP Morgan Chase & Co. (NYSE: JPM) is a leading global financial services firm and one of the largest banking institutions in the United States. It began as JP Morgan & Co, a commercial bank founded in New York in 1871. A series of mergers and acquisitions subsequently led to the formation of JP Morgan Chase today<sup>1</sup>.

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This is the abridged version of a case prepared by Benjamin Chua Kok Lee, Lian Jiahui, Lim Meei Shin, Vanessa Poh Yun Han and Jason Tan Jia Shen under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Trina Ling Tzi Chi under the supervision of Professor Mak Yuen Teen.

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JP Morgan Chase's businesses are organised into six major segments – Investment Banking; Retail Financial Services; Card Services & Auto; Commercial Banking; Treasury & Securities Services and Asset Management; as well as a Corporate/Private Equity segment which comprises Private Equity, Treasury, the Chief Investment Office (CIO), and corporate staff units and expense functions that is centrally managed<sup>2</sup>.

The CIO was spun off as a separate unit within the bank in 2005. The primary responsibility of the CIO is to invest the bank's excess deposits and to hedge trading risk in other parts of the bank. Ina Drew served as the bank's Chief Investment Officer from 2005 to May 2012. In 2007, CIO launched the Synthetic Credit Portfolio (SCP), which sought to provide protection against credit risk and adverse credit default events in the market<sup>3</sup>.

## **How The Scandal Unravelled**

The head of credit trading of CIO, Javier Martin-Artajo, and the credit derivatives trader Bruno Iksil, generated billions in profits on a portfolio that featured bets on certain corporate credit indices from 2007 to 2011<sup>4</sup>. They were instructed by executives to reduce Risk Weighted Assets (RWA) in late 2011. Rather than dispose of the high risk assets in the SCP, which is the typical action taken by CIO, they purchased additional long credit derivatives to offset its short derivative positions in January 2012. This trading strategy eventually increased the portfolio's size, risk and RWA, as well as eliminated the hedging protections<sup>5</sup>.

Despite the fact that the SCP's derivative holdings were increased, the portfolio was losing value. Hedge fund insider, Boaz Weinstein of Saba Capital Management, found that the market in credit default swaps was probably being affected by aggressive activities in February 2012<sup>6</sup>. Ina Drew suspended trading in the portfolio on 23 March 2012<sup>7</sup>.

In early April, the media broke the story of the "London Whale" and unmasked JP Morgan Chase's CIO as the entity behind the large positions in the market. The market for the credit derivatives in the SCP was small and had limited players; thus CIO's large positions and trades became very visible. According to CIO's analyses, the SCP was generally "balanced", the market was dislocated, and mark-to-market losses were temporary and manageable. JP Morgan Chase's Group Chief Executive Officer (CEO), Jamie Dimon, agreed that the publicity surrounding the SCP was a

“tempest in a teapot” and the Chief Financial Officer (CFO), Douglas Braunstein, stated that the firm was “very comfortable” with its positions in a 13 April analyst call<sup>8</sup>.

When losses continued to increase after the analyst call, non-CIO personnel were directed to review and take control of the SCP in late April. It was then revealed that the portfolio’s exposure was much greater than previously reported by the CIO and the market’s knowledge of the CIO’s positions would make it even more difficult to reduce losses and close out their positions. A review of the valuation of positions in the SCP concluded in consultation with PwC that the SCP complied with U.S. Generally Accepted Accounting Principles (GAAP)<sup>9</sup>.

On 10 May 2012, Dimon disclosed that the trading strategy for the SCP was flawed, complex, poorly reviewed, poorly executed, and poorly monitored. More than US\$2 billion of mark-to-market losses in relation to these trades were reported. A Task Force was formed shortly after 10 May to investigate these losses<sup>10</sup>.

JP Morgan Chase stated that it was no longer confident that the 31 March valuations reflected good-faith estimates of the fair value of all the instruments in the SCP after consulting with PwC for the second time. Cumulative losses of US\$5.8 billion and a restatement of first quarter net income (a downward adjustment of US\$459 million) were announced on 13 July <sup>11</sup>.

## **Mismarking Of Derivative Valuations (Internal Control)**

Corporations that own derivatives, such as those held in JP Morgan’s SCP, are required to determine their fair values at the end of each day in accordance with U.S. GAAP. However, GAAP allows some subjective judgement in determining what prices are most representative of fair values<sup>12</sup>. While most entities use the midpoint price of the daily range (bid-ask spread) as their valuations, or “marks”, CIO began to deviate from this policy in the later part of the first quarter of 2012 to hide fair value losses on the credit derivatives in its SCP<sup>13</sup>.

The traders managing the SCP were themselves in charge of providing the daily accounting valuations, based on the “marks” they had chosen to use. Julien Grout, a junior trader on the SCP team, would then send out a daily communication to key CIO personnel on the profit-and-loss performance of the portfolio as per bank

practice. In order to show a more favourable picture by hiding some of the unrealised losses, the traders began using marks that differed from the midpoint<sup>14</sup>.

For five days in the middle of March, Grout began recording on an internal spreadsheet the difference between the values they were reporting to the bank and the midpoint valuations. On 16 March, this difference representing unreported losses reached US\$300 million, and Grout later stated that it could grow to US\$1 billion by the end of the month<sup>15</sup>. These differences would only begin to significantly reverse toward the end of the first quarter, as the traders decided to report larger and larger losses by reporting valuations closer to the midpoint, gaining significant attention from senior management.

Under U.S. regulations, banks were required to have an internal process to verify the accuracy of asset values reported. In JP Morgan, the CIO's Valuation Control Group (VCG), which reported directly to the CFO of CIO, fulfilled this requirement by conducting a review at the end of each month, which included a check on the derivative valuations in the SCP by using data from independent pricing services, actual transactions and market quotes. In the month-end reviews during the first quarter of 2012, VCG approved CIO's valuations for the SCP as the bank's policy allowed some degree of subjective judgement, and also because the marks used were still within the bid-ask spread and the range set by the oversight group<sup>16</sup>. Thus, no requests were made for the SCP traders to cease using their own favourable estimates or to revert to the midpoint valuations from these reviews. The CIO would only do so when ordered to in May, arising from the discovery in March that the Investment Bank, a separate line of business in JP Morgan, was assigning different values for the very same credit derivatives also held by CIO.

## **Breaches Of Risk Limits (Risk Management)**

In relation to its trades, the CIO used five different risk metrics to monitor its risk exposure – the Value-at-Risk (VaR) limit, Credit Spread Widening 01 (CS01) limit, Credit Spread Widening 10% (CSW10%) limit, stress loss limits, and stop loss advisories<sup>17</sup>. From January to April 2012, all of these limits were breached more than 330 times in total<sup>18</sup>.

Under the firm's policy, breaches of these limits had to be reported to their respective signatories, as well as the CIO Risk Committee, and the Market Risk Committee or Business Control Committee. When a breach occurs, "the business unit must take

immediate steps to reduce its exposure so as to be within the limit, unless a one-off approval is granted”<sup>19</sup>. The one-off approval represents a temporary allowable increase of the relevant limit. The Value-at-Risk (VaR) of the SCP was an estimate of the maximum daily mark-to-market loss. As early as January 2012, the VaR had already begun to exceed its limits<sup>20</sup>. In response, Jamie Dimon and John Hogan, the CEO and Chief Risk Officer (CRO) of JP Morgan respectively, approved exactly such a one-off increase from US\$125 million to US\$140 million until the end of January<sup>21</sup>.

At that time, CIO then implemented a new VaR model which instantly reduced the VaR by close to half the previous amount, thus allowing it to end the limit breach via new calculation methodology. Subsequently on 10 May, the bank reverted back to the old model, with CEO Jamie Dimon announcing that the new model it had adopted was inadequate in portraying risk<sup>22</sup>.

The Company later admitted during the Senate inquiry that the new model was rushed through internal approval – the Model Review Group (MRG) of the bank had found problems with the new model and requested action plans to resolve the issues. However, these were never completed<sup>23</sup>.

The continuing increase in the size of the portfolio also led to breaches in the other metrics, as the large position taken by CIO meant that small variations could translate to larger losses in the SCP<sup>24</sup>. These breaches were apparently ignored by management or handled by having their limits raised.

## **CIO Risk Committee<sup>25</sup>**

Prior to the first quarter of 2012, the CIO risk committee was subjected to less scrutiny than other critical lines of business and this resulted in weak risk controls and pervasive infrastructures that performed ineffectively within CIO. In addition, the committee itself was understaffed. This was made worse when the risk function of the firm did not place any emphasis on hiring more risk personnel for CIO. Even if the risk personnel were hired, they were seemingly more accountable to the CIO management, instead of the firm’s risk function. As such, some of the risk managers did not feel independent enough from the business operations of CIO to criticise the trading strategies used. In essence, no meaningful checks could be done on the activities of CIO.

Other than the fact that the Committee only met three times in 2011, the composition of the attendees was poor, as it mainly involved only key members of CIO. As such, along with its passiveness, the committee could not update the risk structure and risk limits for CIO in time. As the SCP increased in size and complexity, these inherent weaknesses in CIO's risk management became more critical. The threats posed by these weaknesses, such as permitting the pursuance of risky trading strategies, grew in significance with the size and complexity of the SCP.

Even though a new CRO, Mr Goldman, was hired for the CIO in January 2012 to build risk controls and to improve practices, it was all too late to develop structures that may curtail the losses in CIO. Furthermore, he lacked sufficient experience in risk management.

## **Risk Committee<sup>26</sup>**

Unlike the other largest U.S. lenders, the risk committee of JP Morgan lacked directors with the relevant banking and financial risk management experience. The only one with the requisite experience had not been employed in the industry for more than 25 years. Despite the severe lack of relevant financial risk management experience, the composition of the risk committee had not changed since 2008. The committee that was headed by James Crown, with members Ellen Futter and David Cote, was also relatively small.

The severe lack of Wall Street experience made it almost impossible for the committee to pose critical questions to the CIO CRO to eliminate any potential risks in the trading strategy. Having met for only seven times in 2011, coupled with the lack of relevant experience, the committee simply gave the bank's risk-appetite policy the green light.

## **Other Controls, Oversight Committees And BOD<sup>27</sup>**

As with the case of the CIO risk committee, the CIO VCG faced operational shortcomings in its reviews that were accentuated as the SCP grew in size and complexity. At the time, they were also under criticism from JP Morgan's internal audit group relating to issues of inadequate price and valuation testing. Within the firm, there was no practice of circulating daily trading activity reports, which would

have allowed for easier detection of issues. In particular, the CFO should have noted the significant financial risks that resulted from the firm's lack of control over traders.

Furthermore, the process of approving and implementing the new VaR model was haphazard. The CEO, Jamie Dimon, appeared to have provided an approval in writing without much thought, as he would later testify that he could barely recall giving the approval<sup>28</sup>. Consumed by the idea that the operational and risk infrastructures were robust, reviews carried out by the Model Review Group that uncovered operational and mathematical problems with the new model were largely ignored, with no corrective actions taken before implementing the model in late January.

## **Office Of The Comptroller Of The Currency**

A key regulator for JP Morgan Chase is the Office of the Comptroller of the Currency (OCC), whose primary mission is to charter, regulate, and supervise all national banks and federal savings associations<sup>29</sup>. Prior to the media reports of the "London Whale" trades in April 2012, almost no information regarding the SCP was disclosed to OCC. The lack of disclosure provided by JP Morgan precluded effective OCC oversight and hence, no reviews were conducted on the SCP prior to 2012<sup>30</sup>. However, there were red flags which signalled the increasing risk taken up by the CIO. In 2011, the bank had filed risk reports with OCC, which disclosed that the CIO had repeatedly breached its stress limits in the first half of 2011. This should have warranted attention and follow-up from the OCC. However, the OCC did not take further action. Furthermore in 2012, the CIO took up a US\$1 billion high risk derivative bet, which resulted in a US\$400 million gain to the CIO. The OCC was aware of the US\$400 million gain, but had failed to enquire on the reason and the extent of the trade going on at the CIO.

The role of SCP was further downplayed in January 2012. The CIO misinformed the OCC claiming that it will decrease the notional size of the SCP. However, the notional size of the SCP was tripled over the course of the quarter instead<sup>31</sup>. Furthermore, in the following months, JP Morgan began to omit key CIO performance data from its reports to the OCC. The OCC did not notice the missing reports and did not request for a new CIO management report from JP Morgan. In addition, various VaR breaches were disclosed in JP Morgan's risk reports to the OCC. However, the OCC did not review the reports or question the trading activities which resulted in the breaches to occur. Following the media reports on the "London Whale" trades, the OCC subsequently conducted a review on its own missteps. In October 2012,

the OCC released an internal report that concluded that they had failed to monitor and investigate multiple risk limit breaches by the CIO and improperly allowed JP Morgan to submit aggregated portfolio performance data that concealed the CIO's involvement in high-risk trading activities<sup>32</sup>.

## **Implications On The Volcker Rule**

The Volcker Rule, introduced as part of Dodd-Frank Wall Street Reform and Consumer Protection Act, "is intended to reduce bank risk by prohibiting high risk proprietary trading activities by federally insured banks, their affiliates, and subsidiaries"<sup>33</sup>. However, the Volcker Rule allows hedging activities to continue.

On 13 April 2012, CEO Jamie Dimon dismissed the media reports about the SCP as "a tempest in a teapot". In addition, JP Morgan Chase Chief Financial Officer Douglas Braunstein reassured investors, analysts, and the public that the SCP's trading activities were made on a long-term basis, transparent to regulators, had been approved by the bank's risk managers, and served a hedging function that lowered risk and would ultimately be permitted under the Volcker Rule whose regulations were still being developed.

However, on the day prior to the earnings call, Ina Drew wrote to Mr Braunstein, stating that "the language in Volcker is unclear," a statement that presumably refers to the fact that the implementing regulation was then and still is under development<sup>34</sup>. In addition, the bank had earlier written to regulators expressing concern that the SCP's derivatives trading would be "prohibited" by the Volcker Rule.

Misstatements and omissions about the SCP's transparency to regulators, the long-term nature of its decision-making, its VaR totals, its role as a risk-mitigating hedge, and its supposed consistency with the Volcker Rule, misinformed investors, regulators and the public about the nature, activities, and riskiness of the CIO's credit derivatives during the first quarter of 2012.

## **Impact On JP Morgan Stock Price**

The announcement of the trading losses on 11 May 2012 sent the stock price down by more than 9% (US\$40.74 to US\$36.96)<sup>35</sup>. It also prompted a law firm, Finkelstein Thompson LLP<sup>36</sup>, to investigate claims on behalf of the shareholders of JP Morgan's

with regards to the losses. By 4 June 2012, JP Morgan's share price had dropped by 33% from its high of US\$46.27 set on March 28 2012 to US\$31.00<sup>37</sup>. On the following day, 5 June 2012, it was reported that the U.S. regulators would be reviewing the possibility of clawbacks from the staff involved in the trading losses<sup>38</sup>. Investors were largely supportive of this as they took the view that it would help cover a portion of the losses, sending the stock up slightly over 3%. On 13 July 2012, at the same time second quarter earnings were reported, JP Morgan restated its 2012 first quarter earnings and announced to the public that the problems reported in the media had been fixed<sup>39</sup>. Investors, upon receiving the information, were happy that measures had been taken to avoid further losses and this brought about a 6% increase in its share price during its day trade<sup>40</sup>. Following the announcement of the results for the second quarter, the stock price of JP Morgan had been back on the rise again, rising back to the pre-11 May level by mid-September and back to its 28 March-high in early January of 2013.

## **In The Wake Of The Whale: Aftermath And Post-Developments**

Since the trading scandal was exposed, changes have been seen in the management at CIO. Ina Drew, Chief Investment Officer, stepped down and retired from her position and also voluntarily returned two years of her compensation to the company<sup>41</sup>. Several other CIO personnel, including Martin-Artajo, Iksil and Grout, saw their employment terminated as well<sup>42</sup>.

Following the announcement of the trading losses in May 2012, several official inquiries have been set in motion to examine the factors that led to such events. JP Morgan set up a task force to examine the errors and proposed measures to prevent a repeat of the events<sup>43</sup>. The U.S. Senate also publicly investigated the issue, subpoenaing internal evidence and key personnel from the bank, and subsequently issued a comprehensive report on the matter<sup>44</sup>.

## Discussion Questions

1. What are the key corporate governance issues with JP Morgan? What can be done to improve the risk management and internal control in JP Morgan? Contrast this with another financial institution in the United States.
2. Evaluate how JP Morgan communicated with stakeholders following the trading scandal.
3. What should be the role of government in regulating financial institutions? Compare this in the context of United States and Singapore.
4. Should the non-executive and independent directors be held accountable for the trading losses in JP Morgan's CIO? On hindsight, if you were one of the directors on the Board, what would you have done before the scandal was made public in May 2012?
5. "The tone at the top significantly influences a company's corporate governance." To what extent is this related to the trading losses suffered by JP Morgan? Explain.
6. The breach in the regulations could have potentially been avoided. If you were the trader, what would you have done? How do you think a whistleblowing policy may help prevent this?

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# The Price of Friendship: The KPMG Insider Trading Scandal

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## Case Overview

The 2012 KPMG insider trading scandal involving the sharing of confidential information of a number of companies was one of the biggest cases of insider trading the U.S. had ever seen. The case involved a senior KPMG partner, Scott London, who shared confidential information obtained from his KPMG audits, which he personally supervised, with a friend. The unfortunate lapse in judgement cost him his 30-year long career at KPMG and his credibility as a professional in the public accounting industry. This case study aims to allow for a discussion on issues such as insider trading and its consequences, as well as the issue of professional ethics.

## Who Is Scott London?

Scott London was the KPMG Southern California Regional Audit Partner-in-Charge and worked as a partner in KPMG since July 1995<sup>1</sup>. He was involved in managing audit engagements for KPMG's Pacific Southwest region, which included Southern California, Arizona and Nevada.

After graduation from California State University, London began his 30-year career at KPMG, where he supervised approximately 53 audit partners and hundreds of CPAs in the firm. In his role as audit partner, London personally handled and supervised

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audits for major KPMG clients, including Herbalife Ltd., Skechers, RSC Holdings, Pacific Capital Bancorp, and Deckers Outdoor – all of whose shares were publicly traded on either the NYSE or NASDAQ. Because London handled and supervised the audits of these companies, he had access to material non-public information about each company before that information was disclosed to the investing public<sup>2</sup>.

## **The Friendship**

London and Bryan Shaw met in 2005, shortly after Shaw joined the country club where London was a member. The golfing buddies met frequently and socialised with each other's families<sup>3</sup>. When Shaw's family-owned jewellery business fell into hard times due to the financial crisis in 2009, London offered some help – information about the companies that he was in charge of auditing – to enable Shaw to make some profits from trading in their stock<sup>4</sup>. Motivated by a misplaced intention of helping out a friend in need, London started his path down the slippery slope.

## **The Tip-offs**

The story began in October 2010 when London started providing Shaw with insider information about publicly traded companies that Shaw could use to his advantage as an investor<sup>5</sup>. On top of that, London also provided advice to Shaw on how to structure the purchases of securities in order to conceal their illegal activities<sup>6</sup>. Detailed below are some of the information London had provided to Shaw, as well as an account of Shaw's gains from these confidential information provided to him.

### ***Deckers***

Before the earnings announcement for Deckers' first quarter 2012 results, there were at least five telephone conversations between London and Shaw. Shaw purchased 222 put options for Deckers common stock between 19 April 2012 and 26 April 2012. After Deckers' earnings announcement on 26 April 2012, the stock price declined by 25.38%. This insider trading transaction earned Shaw gross profits of at least US\$714,389<sup>7</sup>. This was only one of the many incidents in which Shaw acted on tipoffs provided by London. In total, London had disclosed inside information regarding at least 14 confidential company earnings reports and impending acquisitions involving KPMG clients<sup>8</sup>.

### ***Pacific Capital***

On 9 March 2012, UnionBanCal Corporation announced that it was acquiring Pacific Capital for US\$46 per share through a transaction worth a total of US\$1.5 billion. London provided Shaw with material information regarding the merger, which was yet public. Between 8 February 2012 and 9 March 2012, Shaw purchased 12,225 shares of Pacific Capital common stock and 120 call options in advance of the merger announcement. Shaw ultimately realised a profit of US\$365,000 when Pacific Capital's stock increased by 57%<sup>9</sup>.

Shaw made an overall profit of US\$1.27 million. In exchange for London's provision of insider information, Shaw gave London tens of thousands of dollars in cash. These transfers of cash in bags containing US\$100 bills wrapped in bundles of US\$10,000 typically occurred on a side street near Shaw's business location<sup>10</sup>. Apart from that, London received a Rolex watch valued at US\$12,000 and several pieces of expensive jewellery for his wife<sup>11</sup>. Shaw routinely covered the costs of dinners and concerts the two men shared, along with their families. In total, the benefits that London received totalled approximately US\$50,000<sup>12</sup>.

## **The Scandal Unfolds**

The insider trading scheme started to unravel in July 2012 when Shaw's brokerage firm, Fidelity Investments, discovered his suspicious trading activity and froze his account<sup>13</sup>. According to London, that was when both Shaw and London halted their insider-trading activities<sup>14</sup>. The Securities and Exchange Commission (SEC) was alerted and Shaw received a subpoena to appear before the SEC in December, where he confessed. In addition to forfeiting his ill-gotten gains, he faced a maximum of five years in prison and a fine. Prosecutors agreed to recommend a reduced sentence if Shaw agreed to provide substantial assistance during the investigation<sup>15</sup>.

Shaw began cooperating with the Los Angeles division of the Federal Bureau of Investigation (FBI) in February 2013, months after he and London had last engaged in any insider trading activity<sup>16</sup>. Shaw approached London for more information. Unbeknownst to London, it was a set-up orchestrated and photographed by the FBI<sup>17</sup>. Shaw secretly recorded phone conversations between him and London, during which they discussed trading on non-public information from the companies whose audits London oversaw. Shaw also met with London in a parking lot to hand him an envelope full of cash as payoff for London's tips, while being watched by FBI

agents<sup>18</sup>. With the substantial evidence collected, the FBI confronted London<sup>19</sup>, who confessed.

The following are some of the key events which followed the confession by London to the FBI:

5 April 2013: London informed KPMG that he was under investigation by the SEC and criminal authorities for insider trading in the securities of several of KPMG's clients. He was promptly terminated<sup>20</sup>.

8 April 2013: KPMG announced that it was resigning from the audits of two clients, Herbalife and Skechers, after concluding that the firm's independence had been impacted as a result of London's behaviour. They also informed those companies that it was necessary to withdraw their auditor reports and did so for the previous two fiscal years<sup>21</sup>.

9 April 2013: Both companies filed Form 8-Ks announcing this news and there was a temporary halt in the trading of securities of both issuers that day. London publicly released a statement in which he expressed his regret for his "actions in leaking non-public data to a third party regarding the clients [he] served for KPMG"<sup>22</sup>.

11 April 2013: KPMG Chairman and CEO John Veihmeyer issued a press release criticising the actions of London<sup>23</sup>.

20 May 2013: Shaw pleaded guilty to one count of conspiracy<sup>24</sup>.

2 July 2013: London admitted to one count of securities fraud. He faces a conviction carrying a maximum term of 20 years<sup>25</sup>.

## **Picking Up The Pieces**

Almost immediately after the incident, KPMG reached out to inform their other clients regarding the incident, and even tracked down a client in Tokyo. KPMG issued a public news release with the message: London was a rogue partner who flouted its rules, an isolated case that was not reflective of the firm<sup>26</sup>.

## Court Ruling

On 27 September 2013, Scott London was barred from practising as an accountant on behalf of any publicly traded company or regulated entity<sup>27</sup>.

In the U.S., the federal charge of conspiracy to commit securities fraud via insider trading carries a statutory maximum term of five years in prison and a fine of US\$250,000 or twice the gross gain or gross loss resulting from his offence<sup>28</sup>. The United States Probation Office has recommended that London receive a 36-month sentence and a US\$100,000 fine<sup>29</sup>. However, his attorney argued that the sentence was too harsh and felt that the sentence should be no more than a 18 to 24-month jail term and a fine of US\$25,000. First, London had already lost his US\$900,000-a-year job as well his closest friends at KPMG who were banned from communicating with him. Furthermore, London was not aware of the US\$1.27 million that Shaw had earned from the tips London had provided, and only anticipated a total profit of about US\$200,000, based on the amount of cash and gifts he received from Shaw<sup>30</sup>.

As for Shaw, he agreed to pay back the US\$1.27 million in stock trading profits he made from tips he had received from London. He was scheduled to be sentenced on 23 January 2014<sup>31</sup> and faces a maximum of five years in prison<sup>32</sup>.

## Impact On KPMG

Just a day after KPMG's disclosure of the insider trading scandal, KPMG resigned as auditor of Herbalife Ltd and Skechers USA Inc., the two clients that were most directly affected by London's act of disclosing their confidential information to Shaw. Although KPMG was not directly culpable, the firm's independence was nevertheless impaired<sup>33</sup>. Deckers, however, decided that KPMG would continue to be its auditor. The audit committee of Deckers was satisfied that since London was acting as KPMG's "account executive" and did not participate directly in the audit process, London's actions did not, in any way, affect KPMG's judgement when rendering its audit opinion on Deckers<sup>34</sup>.

For KPMG, the most immediate cost would be to pay for another firm to re-audit several years of financial statements for the two clients, Herbalife Ltd and Skechers USA, for which London was the lead audit partner. Such arrangements are standard industry practice in cases where there are violations of auditor independence<sup>35</sup>.

KPMG would have to return audit fees, which is believed to amount to millions of dollars, as well as any other damages, if the court determines that the firm was in any way negligent in monitoring and supervising London<sup>36</sup>. KPMG would also need to decide if they should resign from other audit assignments that London was, in one way or another, involved in<sup>37</sup>.

Apart from the potential financial losses from possible lawsuits and having to resign from its prestigious clients, the reputation of KPMG's professionalism and integrity is at risk. The insider trading involving London is not the first controversy KPMG has landed itself in. Throughout the last decade, KPMG has been involved in a number of corporate accounting scandals. For example, in 2005, KPMG narrowly avoided a criminal indictment for marketing fraudulent tax shelters by agreeing to pay US\$456 million in a deferred prosecution settlement with U.S. authorities<sup>38</sup>. In addition, KPMG partners have been the only ones so far to be sued by the SEC in connection with the global financial crisis<sup>39</sup>.

Fortunately, KPMG's swift response to the incident avoided any major damage to its reputation. In fact, KPMG has not lost any audit clients in the Pacific Southwest region, the place where London headed the audit firm's practice. Many of KPMG's 40 clients publicly reiterated their support for KPMG by issuing proxy statements recommending that shareholders ratify the company's continuing use of the firm<sup>40</sup>. As observed by Charles Elson, a corporate governance expert at the University of Delaware, "as long as it appears to be one-off, a rogue employee, they're not going to take a hit"<sup>41</sup>. Furthermore, the fact that London came clean quickly once he was exposed and did not contest the case reduced the uncertainty for clients and enabled KPMG to protect itself.

## **Issues Of Professional Ethics**

As lead KPMG audit partner, London owed fiduciary duties of trust and confidence not only to KPMG but also to the client companies he was auditing. The clients had shared confidential information about their earnings and financial results to allow KPMG to conduct its audits and reviews of their financial results. However, London had breached this duty when he provided Shaw with the material non-public information<sup>42</sup>.

KPMG's responded promptly to the revelations about London by issuing a statement condemning his rogue actions, stating that he had acted with deliberate disregard for KPMG's longstanding culture of professionalism and integrity<sup>43</sup>.

All partners at audit firms are expected to be clear about ethical obligations especially after the lessons learnt from the aftermath of financial frauds in the late 1990s and early 2000s (e.g., WorldCom and Enron). KPMG generally has quality controls in place to prevent compromises to their audit independence but in this situation, failed to detect London's wrongdoing. As a senior partner, London had almost absolute discretion and power to hide his breach of insider trading in KPMG and clearly, London was undeterred by the policies at KPMG.

Government action against the former KPMG partner would add to the recent push by prosecutors and securities regulators to root out insider trading, a campaign that has yielded about 180 civil actions and more than 75 criminal prosecutions. While the majority of the prosecutions have involved Wall Street traders and corporate executives, a number of those charged have been advisers to companies – bankers, lawyers, accountants and consultants – who are entrusted with secret information by their clients. This shows a growing importance in the ability of such professionals to maintain their independence and observe high standards of ethics so that the interests of stakeholders are protected.

## **Epilogue**

Shaw was sentenced to five months in prison on 2 June 2014. He had a month and a US\$3,000 fine shaved off the prosecution's original recommendation. Shaw wrote about his cooperation in a written statement sent to the judge before the sentence was passed: "To me it was the only path... In the end I knew that cooperating with the government was part of me making things right..." and after the sentence told the judge, "I assure you that you will never, ever see me again." As for London, he was sentenced to 14 months in prison, as well as a US\$100,000 fine, in addition to losing his job<sup>44</sup>.

## Discussion Questions

1. If the Scott London case had occurred in your country, what laws and regulations are there in place to sanction against the individuals involved?
2. Discuss the issue of professional ethics with regards to Scott London's duties as a lead audit partner at KPMG for the companies involved.
3. Did current U.S. corporate governance practices play a part in the events leading to the incident? How can these practices be improved to prevent similar incidents from recurring?
4. Do you think the penalties are sufficient to reinforce upon individuals the importance of upholding professional ethics and corporate governance? If not, what other measures should be introduced?
5. How can a corporation reduce the risk of insider trading by individuals within the organisation?

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# Manchester United: Red Devils or Daredevils?

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## Case Overview

After nine months of delay, Manchester United (MU) decided to ditch its plan to get listed on the Singapore Stock Exchange (SGX) in June 2012. Even though the approval to get listed on SGX in the form of stapled securities was obtained in September 2011, the Glazer family, owner of MU, postponed the listing decision due to market turmoil. MU subsequently filed an application with the U.S. Securities and Exchange Commission (SEC) on 3 July 2012. On 10 August 2012, MU listed on the New York Stock Exchange (NYSE) using a dual-class share structure. After the listing, the Glazer family remained the ultimate controlling shareholder with 98.7% of total voting power and the issue raised a net amount of US\$110.25 million for the club to repay its debt. The objective of this case is to allow for discussion of several corporate governance issues such as the pros and cons of a dual-class share structure, the competition among exchanges, and the protection of minority shareholders' interests in the presence of a controlling shareholder.

## The Story Of Manchester United: The Red Devils

Founded in 1878 and playing in the Premier League, Manchester United Football Club (a.k.a. MU) is one of the most popular football clubs, with an estimated over 300 million fans worldwide<sup>1</sup>. Its popularity is backed by its string of dazzling

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This is the abridged version of a case prepared by Cheryl Pong Shi Hui, Chia Hui Chen, Xu Sichao, Yu Yidan and Zhang Jia under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Trina Ling Tzi Chi under the supervision of Professor Mak Yuen Teen.

achievements, including 19 FA Premier League trophies, 11 FA Cup trophies and three European Cup trophies<sup>2</sup>. The club's nickname – the Red Devils –appropriately captures its formidable presence in the football arena.

MU was originally funded by the Lancashire and Yorkshire Railway Company and became a limited company in 1892. In June 1991, MU became listed on the London Stock Exchange. From 2003 to 2005, Malcolm Glazer, an American businessman, initiated an attempt to acquire the famous English club. During these three years, his stake in MU through his investment vehicle Red Football LLC gradually increased to 98%, which triggered a compulsory buy-out of the remaining 2%<sup>3</sup>. He subsequently chose to delist MU from the London Stock Exchange and took it private. In essence, the club became wholly-owned by the Glazer family. All of Malcolm Glazer's six children sat on the board of directors of MU<sup>4</sup> with his sons, Avram Glazer and Joel Glazer, also acting as Executive Co-Chairmen<sup>5</sup>.

However, the buyout became very controversial as it was highly leveraged, with a substantial portion financed from loans secured against the club's assets. While the total consideration paid amounted to £800 million, over £500 million was financed using debts, and the associated interest was about £60 million a year<sup>6</sup>.

MU's fans were fiercely opposed to Glazer family's highly leveraged buyout. While diehard fans of the club were simply unhappy that the traditional English club was owned by American businessmen, many mourned over the Glazer family turning MU into a money making machine<sup>7</sup>. Throughout the years, the Glazer family had entered into many controversial related-party transactions with MU. In November 2008, MU lent in aggregate £10 million to the Glazers at an interest rate that was significantly lower than the commercial rate<sup>8</sup>. In three and a half years, Glazer family had taken a total of £22.9 million in the form of management fees, consultancy fees and borrowings from the club<sup>9</sup>.

## **Glazers Eyed Hong Kong Listing For IPO**

In early 2011, the Glazers decided to list the company in Hong Kong to repay its debt. With nearly two-thirds of its 300 million fans living in Asia, this region would be an important future growth area<sup>10</sup>. Moreover, the Stock Exchange of Hong Kong (SEHK) was renowned for listing many big brands such as Prada and Samsonite<sup>11</sup>. Consequently, Hong Kong was seen to have a huge appetite for share offerings involving issuers like MU.

It was said that the business was valued at around £1.7 billion on SEHK, which was significantly higher than that in London<sup>12</sup>. Hence, more funds could be raised to pay off the mounting debt.

## **Singapore Favoured Over Hong Kong**

Despite the enormous speculation of a Hong Kong listing, MU subsequently preferred Singapore as its IPO destination in August 2011<sup>13</sup>. The application for the proposed US\$1 billion IPO was lodged with SGX on 18 August<sup>14</sup>.

On 30 August 2011, Asian Wall Street Journal published an article titled “Structure Key to Man U Listing”, stating that SGX was chosen over SEHK because the former allowed dual-share structure for MU’s IPO<sup>15</sup>. Since 1991, SEHK’s Listing Rules have not allowed companies to issue shares with voting power that is disproportionate to the equity interest, unless a waiver is given<sup>16</sup>. In other words, the Glazers gave up the bourse of choice in Hong Kong as they wanted to retain a firm grip on the club even after the IPO.

In addition, it was reported that the CEO of SGX, Mr Bocker, agreed to provide special concessions to the club, including acceleration of the listing process, which was to be completed within four weeks. A successful IPO in Singapore generally takes up to three months<sup>17</sup>.

## **Why SGX Wanted To Attract Manchester United’s Listing**

While many high-profile multinational companies were entering Asia to raise funds, most of them preferred Hong Kong to Singapore. If the high-profile football club were to launch a successful IPO on SGX, it would have become one of the biggest listings in Singapore. It was believed that SGX hoped that MU’s listing would help to attract other global brands to list in Singapore and eliminate the general conception of it being a bourse mainly for penny stocks and China-based firms<sup>18</sup>. Nevertheless, the proposed listing of MU with a dual share structure had raised governance concerns and sparked off wide public debate.

## **SGX's Clarification Over Manchester United's Proposed Share Structure**

Under the Singapore Companies Act (Revised Edition 2006), each ordinary share is entitled to “one vote and one vote only”<sup>19</sup>. The controversial dual-share shareholding structure had raised several corporate governance concerns such as the protection of minority shareholders' interests. On 1 September 2011, Professor Mak Yuen Teen from NUS Business School published a commentary, requesting for SGX's clarification on the matter – whether dual-class share structure was indeed allowed for MU's listing<sup>20</sup>.

On 8 September 2011, Mr Bocker, took the step to spell out that companies are not allowed to issue ordinary shares with different voting rights under SGX's listing rules. However, they can choose to issue non-voting preference shares. Mr Bocker also commented that he did not see any reason for SGX to make any changes to its existing listing rules for new listings<sup>21</sup>.

## **SGX Approved Manchester United's Listing Proposal**

On 16 September 2011, it was reported that SGX had approved MU's IPO application, which had been lodged in August. However, marketing to investors had not yet begun and there was no timetable for the IPO after the approval due to market volatility and continued uncertainty over the price and structure of the share offering<sup>22</sup>.

According to the source, the offering would be in the form of stapled securities that bundled the preference shares with ordinary shares. Stapled securities would be treated as one security as they cannot be traded separately<sup>23</sup>. Currently, there are only three securities listed on SGX that are considered as stapled securities<sup>24</sup>.

On 20 September 2011, SGX released a regulatory guidance article to clarify the confusion among investors and public pertaining to MU's proposed share structure. While SGX clarified again that companies were not allowed to list dual-class voting shares in Singapore, it also emphasised that the stapled securities structure of MU's proposed listing was substantially different from a dual-class share structure<sup>25</sup>.

According to SGX, the criticisms that the listing would dilute Singapore's corporate governance regime was the result of "imprecise terms used in public commentaries"<sup>26</sup>. However, the structure of stapling ordinary and preference shares together in an IPO was no different in nature from a dual-class share listing, according to Professor Mak Yuen Teen<sup>27</sup>.

It was known that the Glazers wanted to maintain significant control over the business. Singapore regulations stipulate that at least 12% of voting rights of a listed company with market capitalisation of at least S\$1 billion, must be in public hands<sup>28</sup>. Hence, the Glazer family would still be able to retain the majority of control by floating the voting shares just over the threshold that was required by SGX. Given that preference shares would enable the Glazers to raise funds without diluting control, there were incentives for them to bundle preference shares with ordinary voting shares in the IPO.

## **Manchester United Moves Away From Singapore**

In June 2012, MU was said to have ditched its plan to be listed on SGX, and started preparing for a listing in United States<sup>29</sup>. MU subsequently filed an application with SEC on 3 July 2012<sup>30</sup>. It was also reported that the proposal to list in Singapore had been scrapped due to the long delays in final signoff from SGX and market turmoil. MU's underwriters for the Singapore listing declined to comment<sup>31</sup>.

It appeared that the switch to a U.S. stock exchange was a move to take advantage of the less stringent regulations in the U.S. According to section 313.00 of the NYSE Listed company manual, listed companies are allowed to issue shares with different voting rights. In addition, under the Jumpstart Our Business Startups Act (JOBS Act) signed into law on 5 April 2012<sup>32</sup>, MU would qualify as an emerging growth company, which would be exempted from large parts of the Securities Exchange Act requirements such as filing of quarterly reports and having a board composed mainly of independent directors<sup>33</sup>. Nevertheless, the truth behind the change in listing remained unclear to outsiders.

## **Manchester United's Dual-Class Share Listing On NYSE**

On 10<sup>th</sup> August 2012, MU opened for trading under the ticker “Manu” and listed 16,666,667 Class A shares on New York Stock Exchange (NYSE)<sup>34</sup>. The opening price was US\$14.05 and it closed at US\$14 flat<sup>35</sup>. It was nevertheless below the US\$16 to US\$20 range originally marketed to investors<sup>36</sup>. The company received total proceeds of US\$110,250,000, net of underwriting costs and discounts after the issuance<sup>37</sup>.

After the company was listed on NYSE, the Glazer family remained as the ultimate controlling shareholder through a complicated arrangement with its investment vehicle Red Football LLC. As of 10 August 2012, they owned 23,019,033 (57.80%) of Class A ordinary shares with one vote per share and 124,000,000 (100%) of Class B ordinary shares with ten votes per share<sup>38</sup>. As a result, the family retained 98.7% of the total voting power<sup>39</sup>.

The public was not satisfied with the fact that Glazer family retained their control over the company after the IPO. In addition, while the initial intention for the IPO was to raise capital for debt repayment, the Glazer family eventually pocketed half the proceeds. Besides, many analysts believed the share was over-priced<sup>40</sup>. The share price did not perform well, falling below US\$12.30 per share during the three-month window period of the IPO<sup>41</sup>.

## **The Road Ahead: Amendment Of The Singapore Companies Act**

Two months after MU's listing on NYSE, the Singapore Ministry of Finance said on 3 October 2012 that they would accept the recommendations put forward by the Steering Committee to amend the Companies Act. As such, “Companies will be allowed to issue non-voting shares and shares carrying multiple votes if their articles allow it and subject to certain safeguards”.

Such amendments would allow public companies incorporated in Singapore to have dual-class share structure. However, SGX has not yet decided whether to allow listed companies to issue shares with multiple voting rights and they would seek advice from the Monetary Authority of Singapore. This amendment to the Companies Act is nevertheless being considered as paving the way for the local stock exchange to compete for new listings<sup>42</sup>.

## **Discussion Questions**

1. “Relaxed listing rules and regulations can be used as a tool to attract listings.” Do you agree with this statement? Why or why not?
2. Discuss the similarities and differences between dual-class share structure and “stapled” securities structure.
3. What are the pros and cons of having a dual-class share structure? Do you think SGX should allow dual-class share for listed companies in Singapore? Explain.
4. In the case of Manchester United, what do you think are the possible effects on different stakeholder groups of having a controlling shareholder in a company? What measures can be adopted to reduce the possible downside of such a situation?

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# Shell in Nigeria: “Safe Sex?”

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## Case Overview

Since 1998, OPL245 – one of Nigeria’s massive offshore oil blocks – has been changing hands between (1) the Federal Government of Nigeria (“FGN”), (2) Royal Dutch Shell plc (“Shell”) and (3) Malabu Oil and Gas Ltd (“Malabu”), a shell company widely believed to be controlled by the former oil minister from the corrupt Abacha-era regime, as well as convicted money launderer – Chief Dan Etete.

In 2011, Shell and its partner ENI eventually reached an agreement with the FGN to take ownership of the block from Malabu for an inflated price of US\$1.3billion. However, this was not the last of the OPL245 controversy. The tripartite arrangement between buyer, seller and FGN sparked international debate about FGN’s ambiguous role in the transaction, as well as the legitimacy of the Malabu shell company. Consequently, Shell’s willingness to carry on such shady dealings catapulted its ethical stance into the media spotlight, with industry analysts and the relevant authorities questioning if Shell in fact used the government as a “condom” - a protection layer to distance themselves from the secrecy and illegitimacy shrouding this shadowy deal with Malabu. The objective of this case is to allow for discussion of issues such as money laundering, the effect of countries’ corruption on multi-national corporations’ transparency and reporting, and possible measures to prevent these corporations from taking advantage of weak governments to reap profits.

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This is the abridged version of a case prepared by Ho Wen Jun, Nicolette Lye Lijia, Artons Pang Qi Liang and Tan Cheng Yee under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Geraldine Tan Juan Juan under the supervision of Professor Mak Yuen Teen.

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## In a Nut(Shell)

Shell is a holding company that owns, directly or indirectly, investments in the numerous companies constituting Shell<sup>1</sup>. Shell is engaged worldwide in the oil and gas industry and also has interests in chemicals and other energy-related businesses<sup>2</sup>. It is incorporated in the U.K. and headquartered in Netherlands, with its shares traded on London Stock Exchange (primary listing), Euronext Amsterdam and New York Stock Exchange<sup>3</sup>.

## Organisation Structure

The structure of Shell may be viewed in terms of a share-ownership perspective or a management perspective. The management structure of the Shell Group does not correspond strongly to its formal ownership structure.

In terms of ownership structure, only two companies are directly held by Shell – Shell International Finance B.V. (which provides funding to other members of Shell Group) and Shell Petroleum N.V.<sup>4</sup>. Besides these two companies, there are 177 other significant subsidiaries in more than 70 countries, most of which have 100% share capital held indirectly by Shell<sup>5</sup>. The exact linkage and percentages of ownership between the Shell and its subsidiaries are not known, as many of these subsidiaries are private companies with undisclosed financial information. Hence, looking at its management structure might shed more light on this complex group.

Shell has a unitary board of directors and a Chief Executive Officer (CEO) at the group level<sup>6</sup>. Its businesses are separated into 3 divisions – Upstream (which is further divided into two geographically focused divisions – Upstream Americas and Upstream International), Downstream, and Projects and Technology, while its non-operating businesses go under the Corporate division<sup>7</sup>. These operating and non-operating divisions are each headed by an executive director. Also, the Upstream International and Downstream divisions are split further into the different countries the businesses operate in and each country has a Country Chairman. Shell's subsidiaries are categorised under Upstream, Downstream and Corporate and are subsumed under these divisions. Each subsidiary also has its own management team.

## Shell And Ethics

Shell purports to have a set of three core values - “integrity”, “honesty” and “respect for people”<sup>8</sup>. To demonstrate its commitment to these values, Shell established three sets of employee guidelines, namely Shell General Business Principles<sup>9</sup>, Code of Conduct<sup>10</sup> and Code of Ethics<sup>11</sup>.

## Corruption In The Oil Industry

In sharp contrast with Shell’s purported strong commitment to ethics and business integrity, the oil industry is often associated with corruption. Transparency International’s Corruption Perception Index (CPI) indicates that many oil-rich regions are high in corruption<sup>12</sup>.

However, corruption in these oil-rich countries is not the sole contributor to the alleged widespread corruption in the oil industry. Many oil and gas companies, both big and small, often do not include country-specific financial information in their financial statements, thus allowing secret payments made to corrupt leaders to go undetected<sup>13</sup>.

## Nigeria And Corruption

One of the countries where Shell operates in is Nigeria. Nigeria, situated in the resource-rich continent of Africa, accounts for 2.9% of the world’s oil and gas reserves<sup>14</sup>. The country, like many other oil-rich ones, is no stranger to corruption – since the release of the CPI in 1998, Nigeria has consistently scored way below average.

## Did Shell Practise “Safe Sex” In Nigeria?

### ***1998: Award Of OPL245 To Malabu***

The story of OPL245 began in 1998. Under the Abacha administration, Nigeria’s then-Minister of Petroleum, Dan Etete, awarded the OPL245 concession to Malabu<sup>15</sup>. Malabu was a company registered on 24 April 1998, just 5 days before the award<sup>16</sup>, had no employees or assets, and had three shareholders, including one Kweku Amafagha. The price for the oil block was a “signature bonus” of US\$20 million, but Malabu only ever paid US\$2 million of this required US\$20 million<sup>17</sup>. Three months

later, Abacha died, ending 16 years of military rule and a new government took power in 1999 under the administration of Olusegun Obasanjo<sup>18</sup>.

### **2001: "Farm-in" Agreement Between Malabu And Shell**

Although Malabu had secured the rights to OPL245, it had problems extracting the oil within. OPL245 was an ultra-deepwater block<sup>19</sup> populated with many deeply-submerged oil wells. Only top global oil companies like BP, Chevron and Shell had the Specialised deepwater drilling technology to access such oil wells<sup>20</sup>. Malabu, on the other hand, was an empty holding company with no deepwater drilling capabilities. Moreover, Malabu did not want to assume all the development risks involved. Thus, in March 2000, a representative from Malabu approached Shell Nigeria Ultra Deep Limited (SNUD), a subsidiary of the Shell Group, with a proposal for a "farm-in" agreement, under which the owner of a working interest in a natural gas and oil lease assigns the working interest to another party (the "farmee")<sup>21</sup>, in return for a share of the income generated from the farmee's activities<sup>22</sup>. In this case, Malabu proposed to give Shell a 40% equity stake in OPL245<sup>23</sup>.

As part of due diligence for the transaction, Shell made enquiries with the Assistant Director of the Department of Petroleum Resources (DPR), Andrew Obaje, on 31 March 2000. Obaje confirmed to Shell that the map of allocated concessions indicated that OPL245 had been owned by Malabu since April 1998 and was currently in good standing<sup>24</sup>. He also explained that the FGN did not intend to revoke the allocation since Malabu had dutifully paid the required "down payment". In addition, Shell received verbal assurances from the then-Vice-President of Nigeria that there was no objection from the FGN to Shell acquiring an interest in OPL245<sup>25</sup>.

Therefore, after extended negotiations, the OPL245 Deed of Agreement between Malabu and Shell was finally effected in early 2001<sup>26</sup>.

### **2001: Withdrawal Of Concession To Malabu**

However, on 2 July 2001, the new FGN under President Obasanjo suddenly transferred ownership of the block to Nigerian National Petroleum Corporation (NNPC). Shell and ExxonMobil were informed that they would be formally invited to bid for the role of contractor in a production sharing agreement (PSA) with NNPC<sup>27</sup>.

Although Malabu retaliated by threatening to commence legal proceedings against the FGN to assert its proprietary interest in OPL245, the FGN continued with the bid solicitation process. On 23 May 2002, Shell won with a bid of US\$210 million<sup>28</sup>.

### **2006: Reinstatement Of Malabu As Owner**

In 2006, the FGN took yet another U-turn and reinstated Malabu as the owner of OPL245. This reversal by the FGN took Shell by surprise. However, with Shell already incurring a significant amount of expenses with respect to the oil block<sup>29</sup>, Shell was unwilling to relinquish their rights to operate in OPL245 and thus instituted legal action against the FGN<sup>30</sup>.

In addition to instituting lawsuits, Shell also tried to deal directly with Malabu's representative, Dan Etete. Both Shell and ENI, an Italian oil giant, had separately tried to broker a deal directly with Etete regarding OPL245. However, both Shell and ENI admitted that direct dealings with Etete broke down as they felt that Etete was "impossible to deal with"<sup>31</sup>.

It is also noteworthy that during Shell's ensuing negotiations with Etete, Etete was convicted for money laundering in French courts in 2007, and in 2009, his court appeal was rejected<sup>32</sup>. Despite knowing about Etete's conviction, Shell did not break off dealings with him. It was revealed in court that Shell officials had lunch and 'lots of iced champagne' with Etete even subsequent to his money laundering conviction<sup>33</sup>.

### **2011: Shell And ENI's Joint Partnership**

Due to the failure of Etete's direct negotiations with Shell and ENI, Malabu hired Ednan Agaev to act as the middleman. Agaev in turn subcontracted Emeka Obi, a Nigerian from Energy Venture Partners<sup>34</sup>. After a series of discussions facilitated by Obi and Nigeria's attorney general, Mohammed Bello Adoke, Shell and ENI eventually agreed on 29 April 2011 to jointly share ownership of OPL245. In addition, it was decided that Shell and ENI would pay US\$1.3 billion to the FGN<sup>35</sup>, who would in turn deduct Malabu's unpaid signature bonus of US\$210 million before remitting the remainder – about US\$1.1 billion – to Malabu<sup>36</sup>.

### **2011: Malabu's Legal Troubles**

Despite reaching an amicable settlement with Shell and ENI with regard to OPL245, Malabu was once again put under the legal spotlight towards the end of 2011 when it was sued by its middlemen, Obi and Agaev. Although the real beneficial ownership of Malabu was not an issue of contention, the hearings uncovered a lot about the matter. It was revealed that "Kweku Amafagha" was in fact just Etete's alias, and that not only was Etete the company's main negotiator and its representative in the High Court, he was also the sole signatory on its bank accounts. All these evidence pointed to Etete being the real beneficial owner of the company, despite his assertions that he was merely a consultant to the firm.

To exacerbate Malabu's legal troubles, Nigeria's Economic and Financial Crimes Commission (EFCC) launched an inquiry into Malabu in 2012 due to allegations made by Mohammed Abacha that he was a founding shareholder who had been illegally cut off. EFCC's investigations were presented in a report stating, "Investigations conducted so far reveal a cloudy scene associated with fraudulent dealings. A prima facie case of conspiracy, breach of trust, theft and money laundering can be established against some real and artificial persons"<sup>37</sup>.

In addition, documents from the EFCC reports showed that out of the US\$1.3 billion transacted in the deal, US\$800 million was paid in 2 tranches into Malabu accounts, which were then transferred to 5 Nigerian anonymous shell companies suspected to be owned and controlled by cronies of current FGN officials. In fact, it was discovered that one such person was Abubakar Aliyu, an individual known for shady business deals and close ties with the current President Goodluck Jonathan<sup>38</sup>. This lack of disclosure of the recipients of the payments has raised concerns as to who truly benefitted from the deal<sup>39</sup>. However, EFCC investigations were unofficially ceased when President Jonathan got wind that Aliyu was involved<sup>40</sup>.

### **2012: Shell's Legal Troubles**

The EFCC's discovery that monies were routed to Malabu led the British Metropolitan Police's Proceeds of Corruption Unit to question whether Shell is guilty of money laundering and this potentially makes Shell liable under the U.K. Bribery Act.

However, Shell insisted that it bought OPL245 legitimately from the FGN, and did not make corrupt payments to Malabu or other parties. Nevertheless, many critics argued that it was a two-part transaction, and an intentional and deliberate scheme by Shell to interpose the FGN as a "protective layer" between the company and Malabu. As Global Witness campaigner Tom Mayne said, "It's obvious...that they agreed that the deal be structured in such a way that it went through the government...a 'safe-sex' transaction, with the government acting as a 'condom' between the buyers and seller." To date, Shell vehemently denies having any knowledge that Etete and Malabu were corrupt, and hence maintains that there was no intention to use the FGN as a conduit to launder money for Malabu.

## What Is Happening Now?

*“From its incorporation and at all material times, Etete had a substantial beneficial interest in Malabu.”*

– Justice Elizabeth Gloster, U.K. Judge for Malabu court case

### **Updates On Legal Struggles**

There have been important developments in the lawsuits involving Malabu. The case raised by Agaev was recently settled behind closed doors, while the U.K. High Court passed a ruling on 17 July 2013 that Obi should be paid at least US\$110.5 million by Malabu. It was also conclusively held by the U.K. judge, Justice Elizabeth Gloster, that Etete was in fact a hidden beneficial owner of Malabu “from its incorporation and at all material times”<sup>41</sup>, thus confirming that Etete had corruptly awarded OPL245 to himself back in 1998. In February 2014, an ad-hoc committee of Nigeria’s House of Representatives set up to investigate the sale of OPL245 to Shell and Eni recommended that the government revoke the oil block license granted to Shell<sup>42</sup>.

### **The Transparency Movement**

The movement towards a global standard of transparency in the extractives sector (oil, gas and mining companies) has been gaining momentum in recent years. With the adoption of the European Union (EU) Accounting and Transparency Directive in June 2013<sup>43</sup>, all 28 EU Member States are required to introduce payment disclosure legislation for extractive companies by July 2015<sup>44</sup>. Under these legislations, oil, gas and mining companies listed on EU stock exchanges will be required to report payments they make to governments on a country-by-country and project-by-project basis with no allowance for exemptions. Canada, Norway and Switzerland have also recently announced plans to enact similar legislation<sup>45</sup>.

This new global standard of a common, mandatory reporting regime for extractive industries will allow citizens of resource-rich countries and civil society to identify what deals are being made on their behalf for their natural assets, thus helping to combat cases of corruption in which the country’s natural resources are misappropriated by the government<sup>46</sup>.

### **Shell’s Commitment To Transparency**

Despite Shell’s public statements and internal codes indicating their support for transparency, Shell was a key protagonist in efforts to water down the transparency laws under the EU directive.

In addition, Shell (under the auspices of the American Petroleum Institute) also filed a legal challenge in America claiming that laws in countries such as Angola and China ban revenue payments disclosures<sup>47</sup>, and hence payments in these countries should be exempted from disclosure. This is in spite of the fact that oil companies have failed to prove their claim that payment disclosure is outlawed in any oil-producing country<sup>48</sup>.

Are these actions justified? Or is it just a bid to keep deals with corrupt countries secret? This issue has definitely raised concerns and questions for oil companies like Shell and their commitment towards the global transparency movement. As Brendan O'Donnell from Global Witness advocates, "Shell, BP and others should stop swimming against the tide of transparency and rescind their effort to kill off similar legislation in the U.S."<sup>49</sup>.

## Discussion Questions

1. Given the facts of the case and subsequent investigations conducted, form an opinion as to whether Shell is liable to be charged under U.K.'s Bribery Act and explain the reasons for your conclusion.
2. Assuming the corruption charges against Shell are upheld, how do Shell's actions:
  - a) Depart from its business principles and ethical values? How does this reflect on the effectiveness of these internal codes?
  - b) Compare with the OECD Principles of Corporate Governance?
3. What could Shell have done instead in this situation regarding OPL245? Do take into account the fact that Shell is a multi-national company that operates in many countries and exerts a significant amount of influence on governments and other companies in the oil and gas industry.
4. Could ineffective corporate governance be a cause of the problem(s) in the case? What are the common corporate governance problems that global multi-national companies like Shell face? What possible solutions can you offer to mitigate these problems?

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# UBS: All Bets Are On

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## Case Overview

Swiss banking giant UBS shocked the world when it came to light that, Kweku Adoboli, a member of its Global Synthetic Equities (GSE) Trading team in London, had engaged in unauthorised trading that resulted in an estimated loss of US\$2 billion. For committing one of the biggest frauds in UK's history, Adoboli was jailed for 7 years<sup>1</sup>. This scandal revealed persistent weaknesses in UBS' internal controls and highlighted the excessive risk-taking culture for which UBS received heavy criticism from regulatory bodies. This incident also shook investors' confidence in the capital market and has raised public concerns about corporate governance in UBS and other financial institutions. The objective of this case is therefore to facilitate a discussion of issues such as board and management accountability, risk management and internal control, and corporate governance of financial institutions.

## The Story Of The Swiss Banking Giant

As the largest Swiss bank and a leading financial service provider, UBS has a global presence in more than 50 countries with approximately 60,000 employees providing investment banking, asset management and wealth management services<sup>2</sup>.

Since 1998, UBS has been the world's largest manager of private wealth assets<sup>3</sup>. Following its formation, the bank quickly proceeded to pursue its ambition of becoming a global power in investment banking by expanding rapidly into the U.S. market. By 2003, UBS Investment Bank had become the fourth largest investment bank in the world, and was among the top fee-generating investment banks globally<sup>4</sup>.

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This is the abridged version of a case prepared by Ma Yan, Ng Wai Hong, Nie Yile and Su Liwen under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Chloe Chua under the supervision of Professor Mak Yuen Teen.

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By the end of 2007, UBS was purportedly the most-leveraged major bank worldwide, with its assets far exceeding its total equity<sup>5</sup>. Later on in mid-March 2007, the bank's channeling of more than US\$100 billion into asset-backed securities led to massive losses during the subprime mortgage crisis. UBS then received a substantial financial bailout from the Swiss government and one of the bank's largest shareholders, Government of Singapore Investment Corporation (GIC), further injected US\$9.7 billion into the bank<sup>6</sup>. On 6 March 2009, the share price of UBS hit a record-low of US\$7.72.

## Oswald Grübel, The CEO

On 26 February 2009, Oswald Grübel was named Group CEO and was tasked with leading UBS out of its crisis<sup>7</sup>. The move was well received by traders on the Zurich exchange as UBS' share price rose 14.85% to open at 11.60 Swiss francs (US\$9.99) for the day.

Grübel's performance, to a large extent, met expectations. In his first year at UBS, he managed to stave off huge losses and in 2010, Grübel led UBS to even greater recovery as he returned UBS into profitability<sup>8</sup>. The organisational culture of UBS also changed under the leadership of Grübel, who said in a statement, "I'd actually like to see us put more risk on the table"<sup>9</sup>.

## The Scandal: Further Erosion Of Confidence

UBS suffered an enormous dip in investors' confidence in 2008 after the subprime mortgage crisis and the multi-million-dollar tax evasion controversy in the U.S. However, the worst had yet to come.

On 15 September 2011, UBS became aware of a massive loss, estimated at US\$2.3 billion, arising from unauthorised trading allegedly conducted by Kweku Adoboli, an employee in UBS' GSE Division. Adoboli was a director on UBS' GSE Trading team in London on the Exchange-Traded Funds (ETF) Desk and had been responsible for a portfolio of companies with assets totaling US\$50 billion. To maintain his 'star' status in the bank, he started increasing his risk exposure for greater profit, which resulted in greater losses when his bets failed. Using the knowledge and skills he had obtained from his time as an analyst in the "back office", Adoboli began to engage in unauthorised trading, entering false information into the computer systems to

conceal the risks he took. The increasingly risky trading resulted in volatile earnings and losses that he concealed using a range of prohibited mechanisms. These included one-sided internal futures positions, the delayed booking of transactions, fictitious deals with deferred settlement dates, and a concealment mechanism he termed the “umbrella”. Eventually, losses snowballed to hit US\$2.3 billion<sup>10</sup> before anyone was any wiser.

When the scandal became public, UBS’ stock price fell from US\$12.68 to US\$11.41, a 10% fall in value in one day<sup>11</sup>. The scale of UBS’ losses led to renewed calls for the global separation of commercial banking from investment banking while media commentators suggested that UBS should consider downsizing its investment bank.

## **The Gatekeeper: Board of Directors**

The Swiss banking law requires UBS to operate under a strict dual board structure comprising the BOD and the Group Executive Board (GEB), with clear separation of duties and responsibilities. The BOD is responsible for overseeing the Group’s direction and monitoring and supervising the business. The GEB is responsible for the executive management and is accountable to the BOD for the overall financial results of UBS<sup>12</sup>.

As at 31 December 2011, the BOD comprised a total of 11 directors with diversified backgrounds, ten of whom were independent. The exception, Chairman Kaspar Villiger<sup>13</sup>, was the former Swiss Minister of Military and Finance. He had come out of retirement to guide UBS back on track<sup>14</sup> despite public concerns of whether his capabilities could be extended to places outside of the ministries, particularly in a bank like UBS.

Under the UBS BOD, there were 5 board committees covering audit, corporate responsibility, governance and nominating, human resource and compensation, and risk. The Risk Committee (“RC”) was responsible for reviewing the bank’s risk management and control framework. The Group chief officers and CEOs of the different banking divisions were to be present at meetings with the committee to ensure they were kept updated on the execution of risk management and controls. The RC had the duty to make reasonable enquiries into the possible deficiencies detected in the bank’s control and monitoring mechanisms, and to raise these concerns during these meetings<sup>15</sup>.

## A Riskier Culture

*“If a bank doesn’t take any risk, it is incredibly hard to make money, and that is our job. Grübel thought there was room for more market risk, which in general was a view I agreed with.”*

- Phil Allison, UBS AG’s Head of Global Cash Equities<sup>16</sup>.

Under Grübel’s charge, the bank undertook riskier business activities in order to increase profits, including proprietary trading which seeks opportunities with higher leverage using the bank’s own resources. In the Investment Banking Division, risk limits were increased, and punishment for excessive risk taking was overlooked in favour of generating profit. In particular, UBS was accused of rewarding traders who had breached compliance rules relating to personal account dealing and spread betting with increased remuneration and bonuses, as well as enrolment into higher-level management programmes<sup>17</sup>. This sent out the signal that excessive risk taking and non-compliance of rules were acceptable for profit, thus incentivizing such risk-seeking behaviour.

There were also signs that senior management neglected the importance of controlling and monitoring functions in the bank organisation as evidenced by the lack of control infrastructure realignment during the transfer of ETF desk from the Cash Equities (CE) Division to the GSE Division<sup>18</sup>. Responsibilities over Product Control continued to be held by the CE team despite the transfer. On many occasions, senior management sacrificed the effectiveness of controls for efficiency of processes.

## UBS’ Failed Risk Management And Internal Controls

### **Where Were The Controls And Monitoring?**

The ETF trading desk was controlled and monitored by three separate back office functions – Operations, Product Control (PC) and Market Risk (MR), and the line managers who supervised traders. The key responsibility of the Operations unit was to ensure that trades at the Desk were accurately recorded and properly processed. The PC unit was tasked with performing checks and ensuring correct reporting of profit and loss (P&L) of each trader. The MR department was responsible for daily market risk reporting and analysis. The line managers ensured that the risk limits were adhered to and reported any breach to the management.

However, over time, breaches of compliance instructions remained unchallenged and warnings went uninvestigated. The Operations unit did not raise any doubts even though there were unresolved reconciliation errors followed by suspicious and unsatisfactory explanations. PC personnel simply accepted the traders' explanations for anomalies without sufficient analysis. It went completely unnoticed that the PC unit had not generated an important control report for a few months<sup>19</sup>.

Furthermore, UBS did not impose an approval threshold or require evidence for adjustments of P&L, thus providing traders with the opportunity to conceal their losses. The market risk system for the ETF Desk also did not automatically monitor trading positions in relation to pre-set risk limits. Line managers were uncertain of what their functions and responsibilities were in monitoring the ETF desk. Following a re-organisation, no specific arrangements were made for transferring responsibility for monitoring. System alerts failed to reach the new direct line manager in New York, and ended up instead with the previous manager who acknowledged them, despite it no longer being his responsibility.

### ***Too Much Trust?***

The relationships between traders and supervisors were characterised by a high degree of trust. Supervisors often did not question traders sufficiently regarding unusual increases in proprietary trading revenue as per guidelines. On numerous occasions where risk limits were breached and brought to the attention of the Desk's line manager, no further investigation was made. Explanations were usually accepted without further verification<sup>20</sup>.

UBS' operational risk department also placed a high degree of trust on the front office and their self-assessment of risks. Based on their internal framework of risk assessment, the operational risk department did not impose requirements for evidence or substantive testing to be done in order to validate self-assessment results. In addition, self-assessment was only done on an annual basis, hence presenting the possibility of control deficiencies going undetected for a long period of time.

### ***Question Of Competencies***

Personnel in the control functions were allegedly incompetent and had a poor understanding of ETF-related trading activities. They saw their role as a support function rather than as a control mechanism. Moreover, the poor definition of certain roles and responsibilities and a lack of proper training essential to navigating the

complexities of the ETF trading desks exacerbated the supervisors' confusion, and compromised the supervisors' ability to effectively carry out their duties.

### ***Growth Of Synthetic ETFs: The Need For Regulation***

By European bank conventions, no confirmation of positions from the bank's finance, risk-control and audit functions is required before proceeding with the trade<sup>21</sup>. Investigators found that Adoboli had exploited this loophole in the regulations of ETFs to distort the true magnitude of risk exposure arising from the trade. This then allowed him to conceal his violation of stipulated risk limits and thus advance his fictitious trades.

This incident has prompted global banking and securities regulators to increase scrutiny on ETF regulations<sup>22</sup>. Regulators are contemplating strict new rules dictating the amount and quality of collateral ETF providers need, and could impose requirements for fund managers to disclose a greater degree of detail in relation to their counterparties<sup>23</sup>.

## **Cleaning Up The Mess**

In the aftermath, CEO Oswald Grübel and the co-heads of Global Equities at UBS, Francois Gouws and Yassine Bouhara, resigned to assume responsibility for the trading scandal. Sergio Ermotti was appointed as the Group CEO on an interim basis.

Investigations took place over an eight-month period to pinpoint the causes of the incident. Significant changes were made to UBS's infrastructure and controls, including changes to processes and monitoring capabilities. Changes to their internal control system, such as the escalation process for daily adjustments over defined thresholds and a supervisory signoff process, were implemented. Monitoring became more robust in UBS' Equities business, and there was better information flow to supervisors and risk managers.

UBS also aimed to reinforce accountability by the clarification of supervisory roles, reiteration of trading mandates and how employees' performance reviews were done. A new supervision structure was implemented to ensure that supervisors are suitably experienced, while management information was improved with clearer prioritisation of information.

On 20 October 2012, UBS announced its intention to transform the firm by restructuring business activities. In particular, UBS wanted to sharpen its focus in Investment Banking, and to exit fixed income business lines, proprietary trading and other lines and products that were overly complex and which did not deliver stable and attractive risk-adjusted returns under new regulatory rules.

## **A Post-Mortem: Problem Resolved?**

In late 2012, however, UBS was involved in yet another trading scandal<sup>24</sup>. UBS traders Tom Hayes and Roger Darin were charged for taking part in a multi-year scheme to manipulate LIBOR and other benchmark interest rates. UBS was fined US\$1.5 billion – the second largest fine ever imposed on a bank– by regulators in United States, UK and Switzerland. Along with UBS, many other banks, such as Barclays and RBS, were also fined for their involvement.

The persistent occurrence of banking scandals in financial institutions reflects a significant failure to address the core issues facing the whole financial sector. Despite the repeated revamp of internal control systems and changes in company leadership in individual banks, banks continue to grace headlines in shocking reports concerning new schemes involving fraud and manipulation. This points toward one overarching question: Can such issues in financial sectors ever be truly resolved?

## Discussion Questions

1. What were the controls and monitoring mechanisms in UBS before the scandal took place? Comment on the effectiveness of these mechanisms and how such inadequacies provided opportunity for the trading scandal to happen.
2. Discuss how the risk-taking culture in UBS could have given incentive to the traders to circumvent the controls.
3. Should the board of directors have been held responsible along with UBS's CEO? What should the Risk Committee have done before the scandal fully developed? What are some possible challenges faced by the committee in pre-empting such scandals?
4. Were the measures implemented by UBS to remedy the faults sufficient? How else could UBS improve corporate governance and internal control?
5. What were the regulatory loopholes that contributed to the unauthorised trading? Could regulators play a bigger role in the governing of financial institutions with heavy trading activities?

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# Wynn Resort's Boardroom Brawl: Cowboy Versus Samurai

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## Case Overview

The Wynn Resorts boardroom brawl was centred on the unravelling of the alliance between its co-founders Steve Wynn and Kazuo Okada. With Wynn's entrepreneurial vision of designing awe-invoking places and Okada's deep pockets, the two friends came together to establish a world-class gambling resort that redefined luxury in the casino industry.

Trouble ensued in August 2008 when Okada tried to persuade Wynn Resorts ("the company") to invest US\$2 billion in a Philippines casino project undertaken by Universal Entertainment Corp ("Universal"). Okada, who had always played a passive role, gradually began to shed his former silent self. He became more outspoken at board meetings, commenting on the company's financial strategies and how the Philippines casino project would be profitable for Wynn Resorts. Disputes between Wynn and Okada then escalated into a legal war with charges and counter charges in multiple courts. Wynn Resorts' Board of Directors and its corporate governance also came under media and public scrutiny. The objective of this case is to allow for discussion of issues such as the separation of Chairman and Chief Executive Officer (CEO) positions, related party transactions between Wynn Resorts and Steve Wynn's family, and shareholder activism.

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This is the abridged version of a case prepared by Fadhilah Abdul Rahman Zamawi, Karishma Kaur, Ng Jun Yan and Sasha Bao Cheng under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Geraldine Tan Juan Juan under the supervision of Professor Mak Yuen Teen.

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## The Start Of The End: A Pachinko-Billionaire Gone Rogue

Wynn Resorts Chairman Steve Wynn had once remarked that there was hardly anything he would not do for Okada, the billionaire famous for his Pachinko empire in Japan and who co-invested in Wynn Resorts after a hostile takeover of Wynn's previous venture in 2000<sup>1</sup>. With Okada's financing and Wynn's casino know-how, the duo had opened casinos in both Vegas and Macau in a span of 6 years<sup>2</sup>.

In the summer of 2007, Okada started to travel around Asia, seeking investors for the waterfront casino he had conceptualised with Universal – a company of which Okada is a 67.9% shareholder and Chairman of the board<sup>3</sup>. With the global economic slump and a decline in Universal's pachinko business, Okada proposed that Wynn develop the project with him, but the latter cautioned its riskiness. By August 2008, Universal had obtained a gaming license issued by the Philippines government, but had trouble covering the US\$2 billion in cost, as potential investors were wary of Universal's pachinko business, which operated on an ambiguous area of Japan's anti-gambling laws. Okada hinted at Wynn Resorts' involvement in the project to downplay this disadvantage, and investors pursued his stake in the company as collateral<sup>4</sup>. Wynn initially showed some support for Okada's idea to have Wynn Resorts partner Universal in its Philippines venture. Universal employees were granted permission to review data (such as floor plans and visitor estimates) from Wynn Resorts as well as photograph the interiors of Wynn Resorts casinos<sup>5</sup>.

However, Wynn refused to amend the shareholders' agreement to allow Universal's wholly-owned subsidiary, Aruze USA, Inc. ("Aruze"), to sell or pledge its shareholdings in Wynn Resorts as collateral for capital. This shareholders agreement, which also conferred Wynn voting rights on all of Aruze's shares, was signed because Wynn feared losing control of his casino empire should Okada ever sell his shares or lose charge of Aruze<sup>6</sup>. He nonetheless granted a personal loan of US\$60 million to Universal in early 2009<sup>7</sup>.

On 7 July 2010, Okada's deputy sent Wynn an email detailing Okada's right as the company's largest beneficial shareholder, to be kept in the know of Wynn Resorts' current and future activities<sup>8</sup>. Okada effectively became the largest shareholder after Wynn lost half his shares to ex-wife Elaine as part of a divorce agreement in January 2010, which reduced his ownership stake to 10%<sup>9</sup>. The email also expressed

Okada's wish to have authority to nominate board members and proposed that Okada receive additional compensation on the grounds that he was trying to boost Wynn Resorts' presence in Asia<sup>10</sup>.

## **The Burgeoning Bribe And Disputed Donation**

The board was cautious about partnering Universal following an internal independent study which revealed widespread corruption in Philippines' casino industry<sup>11</sup>. When Okada suggested giving gifts to Philippines' officials at the board meeting on 24 February 2011, the board voted against Wynn Resorts' involvement in Universal's casino project to prevent potential violation of the Foreign Corrupt Practices Act ("FCPA") and risk losing Wynn Resorts' casino licenses<sup>12</sup>.

The final wedge in the tycoons' friendship came in September 2011. An article in Hotels Magazine showed that Okada was still portraying the Philippines venture as a cooperative partnership between Wynn Resorts and Universal despite the February 2011 board resolution. In addition, the proposed casino's design bore a striking resemblance to the design of Wynn Resorts' Las Vegas and Macau casinos. Wynn Resorts' lawyers accused Okada of breaching his director fiduciary duties by getting involved in a business venture that could potentially compete with the company's Macau subsidiary. In another attorney meeting, Wynn accused Okada of misappropriating Wynn Resorts' intellectual property and falsely implying the company's involvement in the venture by handing out his Wynn Resorts business card to potential investors<sup>13</sup>. Before the meeting ended, Wynn exclaimed that Okada should step down from his directorial position<sup>14</sup>.

Okada retaliated by filing a lawsuit in January 2012 with the allegation that Wynn's proposed US\$135 million donation to the University of Macau ("University") during the Wynn Macau board meeting was 'inappropriate'<sup>15</sup>. Based on Wynn's proposal, US\$25 million was to be donated in May 2011, with annual US\$10 million contributions made from 2012 to 2022 – the exact period covered by Wynn Macau's existing gaming licence. The University's Chancellor was also the governor of Macau, who had a final say in the region's gambling policies<sup>16</sup>. Okada was the only director who opposed it. He also sued for access to the company's financial records detailing the donation as well as transactions involving his earlier US\$120 million investment after his requests were repeatedly denied by management<sup>17</sup>.

By this time, Wynn Resorts had already hired Freeh Sporkin & Sullivan LLP ("Freeh") to conduct a private investigation on Okada's behaviour in the Philippines<sup>18</sup>. The investigation determined that Okada had given US\$110,000 in hotel stays, dining and gifts to Filipino gaming regulators and their entourage. He had also allowed them to stay in Wynn Macau's Villa 81, a 7,000 square feet palatial accommodation retailing at US\$6,000 per night, for free<sup>19</sup>.

## Ousting Okada

On 18 February 2012, based on the findings of Freeh's report, the board unanimously voted to redeem Aruze's shareholdings in Wynn Resorts. This was in accordance with Section 2(a) Wynn Resorts' articles of incorporation that allows the company to redeem shares of members and affiliates who were found to have engaged in unsuitable behaviour<sup>20</sup>. The share buyback was based on the risk Okada posed to the renewal of Wynn Resorts' casino licenses, now that he was found to have potentially violated the FCPA. The shares were to be bought back at a 30% discount and would take the form of a promissory note due in 10 years<sup>21</sup>. The next day, Wynn Resorts filed a lawsuit in Nevada state court against Okada, Universal and Aruze alleging that Okada had breached his fiduciary duties<sup>22</sup>.

Universal responded with a countersuit on 12 March 2012 to obtain a court order against the redemption of Aruze shares<sup>23</sup>. The filing contained the allegations that the share buyback was unjust since the shareholders agreement between Aruze and Wynn Resorts contained a clause that precluded any redemption of Aruze's shares. It was also contended that Aruze shares was purchased prior to the insertion of the Section 2(a) redemption clause and therefore should not be bound by it<sup>24</sup>. Universal questioned the credibility of the investigation report it had not received and asserted that it was carried out in a haphazard manner devoid of substantial proof as well as corporate governance principles and standards. In addition, the credibility of the valuation was brought into question; as it was conducted by Moellis & Co – one of Wynn's personal financial advisors<sup>25</sup>.

The countersuit included other allegations as well. Wynn and Wynn Resorts General Counsel Kimmarie Sinatra were touted to have engaged in fraudulent and racketeering behaviour (e.g. acquiring properties and signatures under false pretences) that were in violation of Nevada's RICO statutes<sup>26</sup>. As quoted from the filing, "Wynn Resorts, for all its accomplishments, is not a corporation in any ordinary sense. Rather, Wynn Resorts' flamboyant chairman, Mr. Wynn, has run Wynn Resorts as a personal

fielddom, packing the board with friends who do his personal bidding, and paying key executives exorbitant amounts for their unwavering fealty”<sup>27</sup>. Wynn Resorts subsequently released a press statement highlighting that “the Okada response” had nonetheless not denied the conclusions of Freeh’s investigation<sup>28</sup>.

## **Injection Of Independence**

Okada continued to push his case by issuing an open letter to Wynn Resorts shareholders through Aruze on 17 September 2012. The letter reiterated the stand that the share buyback was to silence Okada after he had posed questions regarding the US\$135 million Macau donation<sup>29</sup>. In the letter, Okada also used Elaine’s opinion that Wynn Resorts was effectively not in any danger of losing its casino licenses as a basis to argue that the share buyback was flawed<sup>30</sup>. He cited proxy firm ISS’s remark that having 58.3% of the board as independent directors (7 out of 12 board directors holding office then) was a low level of independence given the amount of influence that Steve Wynn had as both CEO and Chairman of the Board<sup>31</sup>. This was despite the fact that the number of independent directors fulfilled NASDAQ listing requirements<sup>32</sup>. It then proceeded to analyse Wynn Resorts’ “D” corporate governance rating, attributing it to the board lacking independence from Wynn and the management<sup>33</sup>.

Consequently, the filing proposed to nominate two “highly qualified independent nominees” for election at Wynn Resorts 2012 Annual General Meeting. Each nominee was paid a one-time fee of US\$50,000 for agreeing to be nominated<sup>34</sup>. Wynn Resorts retorted that Okada had no authority to nominate directors seeing that he was no longer a shareholder due to the share buyback. Okada attempted to get a court order to restore the voting rights on the redeemed shares in time for the 2 November 2012 meeting but was denied by Nevada state court judge Elizabeth Gonzalez<sup>35</sup>.

## **D For Corporate Governance**

The slew of lawsuits attracted public scrutiny. The media focused its magnifying glass on the empire’s blemished corporate governance scorecard, this time revealing company transactions involving Wynn and his family. Not only are Wynn and Elaine leasing apartments at Wynn Resorts Las Vegas properties, they are also leasing artworks to the casino empire, with the company liable for all expenses incurred in

exhibiting and safeguarding the pieces (such as taxes and terrorism insurance). A GMI Ratings report released in March 2012 revealed that Elaine's brother and sister-in-law were employed as hosts for one of Wynn Resorts Las Vegas hotels. Salaries and severance packages paid to Elaine's relatives totalled US\$2.4 million in 2010. If Wynn himself was to be dismissed, he would be entitled to a severance package worth four times his current annual compensation rate, much higher than most of the 1,775 largest companies in USA<sup>36</sup>.

These transactions involved the company management as well. Linda Chen, then Chief Operating Officer of Wynn Macau, was offered a US\$10 million bonus contingent on her staying with the company until 2021. Further, Wynn Resorts had purchased a house valued at US\$5.4 million meant for Chen, which she then purchased from the company at US\$1 million. It is unclear if this is part of her employment incentives. At the same time, Wynn Resorts employs Chen's husband, paying him a yearly salary of US\$572,000 as of 2010<sup>37</sup>. Various press releases seem to point at Chen as Wynn's desired successor. In reply to a question regarding who he had in mind as Wynn Resorts' next CEO, Wynn had reportedly said, "There are a score of young people who are very smart and very healthy, in Nevada and Macau. Incidentally, Linda Chen is on the board of the parent company. So if you ask me who could do it? A Chinese woman"<sup>38</sup>.

## **Adding Fuel To The Fire**

The boardroom skirmish drew the fury of several shareholders as well. Louisiana Municipal Police Employees Retirement System ("Louisiana") filed a lawsuit on 27 March 2012 against all 12 Wynn Resorts directors claiming that their recent conduct had harmed the company<sup>39</sup>. By 4 April 2012, there were three other lawsuits filed by various shareholders, which contained similar allegations to those Okada had made against Wynn Resorts and its remaining directors<sup>40</sup>. The claims against Okada were related to his alleged corruption practices whereas the claims against each of the 11 directors were regarding the donation to University of Macau. The plaintiffs asserted that the donation was a waste of corporate assets and further exposed the company to FCPA violations.

Although the Louisiana court case was dismissed in October 2012<sup>41</sup>, the shareholder amended and submitted a second litigation on 18 March 2013. Charges were dropped against Okada on the grounds that he had voted against the University of Macau donation during the board meeting. Multiple litigations centred on the

assets spent (more than US\$1.9 billion) to redeem Aruze shares, the potential loss of licensing opportunities as well as reputational injury<sup>42</sup>. The winner of the boardroom battle was not Louisiana's prime concern. As quoted from the filing, "Regardless of who ultimately prevails in the Wynn Resorts boardroom battle, it is the company that has, and will, lose the most." Since October 2011, Wynn Resorts shares had already lost 24% of their value<sup>43</sup>.

## **Not Game Over Yet: The Saga Continues**

In December 2012, Wynn Resorts took actions to streamline the board, decreasing the size of the board to nine members, including six independent directors<sup>44</sup>. Two non-executive directors and two insider directors, including Linda Chen, were asked to step down while a new independent director was appointed. At the same time, Wynn Resorts announced its intention to expel Okada from the board in a special shareholders' meeting on 22 February 2013. The reason given was that Okada had not been acting in the company's best interests with his gifts of cash and presents to Filipino casino regulators. One day before the special shareholders' vote was to be held, Okada resigned from the board<sup>45</sup>. He was deeply jaded by how the board was functioning and its actions against him. In a statement, Okada criticised the "unethical" behaviour of the board which he felt was occurring "under the dictatorship of (Wynn)"<sup>46</sup>.

Many of the lawsuits highlighted earlier are still ongoing, with countersuits being launched. On 22 March 2013, an independent review commissioned by Okada's lawyers found the independent report Wynn hired Freeh to conduct to be flawed. Freeh's report had found Okada guilty of bribery, which also formed the basis for the forced buyback of Okada's shares from Wynn Resorts. The review commissioned by Okada uncovered that Freeh's law firm "viewed itself as an advocate first and an impartial investigator second" in preparing the report<sup>47</sup>. With Okada and Wynn's reputation at stake, the boardroom tussle has seemingly evolved into a battle of deep pockets and vast resources.

## **Epilogue**

In April 2013, U.S. prosecutors first secured a six-month "stay on discovery" on the civil proceedings to allow it to work on a criminal investigation regarding payments of US\$40 million made by Universal affiliates to a politically-connected consultant

in the Philippines in 2010. By stopping discovery for another six months in October 2013, the civil case had again been prevented from proceeding until 5 May 2014<sup>48</sup>. As such, there was no progress on the cross-allegations of illegal conduct between Okada and Wynn until early 2014. On 24 April 2014, Universal and Okada filed a complaint with the Tokyo District Public Prosecutors Office, accusing Wynn Resorts and Wynn of “defamation, harm to public trust and circulation of rumors” as they had published an investigation into Universal’s conduct in the Philippines<sup>49</sup>. In May 2014, the U.S. prosecutors again sought an extension of the “stay on discovery” but was rejected by Clark County District Judge Elizabeth Gonzales, who said the U.S. Government had been given enough time<sup>50</sup>. This implies that the legal battle between Okada and Wynn could finally progress and the outcome of this fallout remains to be seen.

## **Discussion Questions**

1. Comment on the composition, structure and independence of Wynn Resorts’ Board of Directors.
2. Identify the major stakeholders in the case, and explain the impact the legal tussle has on them. Which stakeholder(s) has/have been affected the greatest? (Hint: Read Wynn Resorts’ Articles of Association regarding the removal of directors)
3. To what extent do the various related party transactions constitute as poor corporate governance?
4. The lawsuit allegations of bribery and corruption highlight a clash in Eastern and Western business practices. How does culture impact the definition of good corporate governance and ethical business practices?

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