A blue-tinted photograph of two men in business suits and glasses, engaged in a conversation. The man on the left is gesturing with his hands while speaking, and the man on the right is smiling and listening. The background is a bright, out-of-focus indoor setting.

CORPORATE GOVERNANCE CASE STUDIES

VOLUME FOUR

Edited by **Mak Yuen Teen**

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Corporate Governance Case Studies

Volume four

Mak Yuen Teen, PhD, FCPA (Aust.)

Editor

Contents

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Foreword

Strong corporate governance is the bedrock of sustainable performance by companies over the long term. This is even more important as the fast-changing business landscape continues to present new and ever more complexities for boards and senior management.

In recent years, there have been many efforts by regulators, industry and professional bodies to help raise standards of corporate governance in Singapore. Indeed, many companies have made much progress in their corporate governance practices. But, as with everything else, there is always room to improve; expectations never stand still.

The Singapore Exchange, the local market regulator, has noted that companies with high disclosure standards and sound corporate governance practices will rise above the competition and benefit from trust and confidence by stakeholders, the outcome of which is a better capital market. Boards and management are therefore continuously challenged to embrace the highest standards of governance to meet the increasing expectations of their stakeholders.

As a professional accountancy body with more than 155,000 members worldwide, CPA Australia is a leading advocate of sound corporate governance. We believe that good governance has to do with maximising long term value creation with integrity and accountability.

Preface

In Singapore, CPA Australia is proud to support this meaningful project to champion better governance standards. Since 2012, we have partnered Associate Professor Mak Yuen Teen FCPA (Aust.) of the NUS Business School to publish this annual collection of teaching case studies. Now into its 4th volume, the Corporate Governance Case Studies series has been an important resource for boards and management in Singapore, Asia-Pacific and beyond. We thank Prof Mak for his meticulous efforts in editing the case studies and the students of the NUS Business School for their work in researching and producing the cases.

We hope the issues raised in this edition will continue to result in rich discussions to raise the bar on governance and transparency across companies and markets. We trust you will find this publication useful in your professional work.

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

October 2015

What started as an idea to develop case studies in corporate governance, especially Asia-centric ones, has really taken a life of its own and we are now into the fourth volume of an annual collection.

This volume contains 22 cases – 6 Singapore, 7 Asia-Pacific and 9 global cases. However, many of the cases transcend borders. For example, the Jardines case discusses regulatory and governance issues relating to the Jardine companies which have secondary listings in Singapore, but those issues were triggered by actions taken by the Jardine companies in London. The China Minzhong case involved a Chinese company listed in Singapore facing an attack from a U.S.-based shortseller. One of the Asia-Pacific cases, Leighton Holdings, involves allegations of bribery in Iraq against the Australian company which has a European controlling shareholder. The Tiger Asia Management case deals with enforcement actions for insider trading by the Hong Kong regulator against a U.S.-based hedge fund. Two of the global cases are about corporate governance challenges faced by companies venturing into Asia.

Through the four volumes, there are some common issues addressed in the cases, but no two cases are identical in terms of the corporate governance issues they raise.

The positive feedback and the requests for permission to use cases that we have received over the years have encouraged us to continue with this annual publication. They have been used in undergraduate and executive MBA programs and in programs for accountants, directors, executives and regulators all around the world.

I would like to thank CPA Australia for its support over the years; the NUS BBA (Accountancy) students who wrote the cases; the student assistants who edited them; and especially Amanda Aw Yong Zhi Xin, who recently graduated with a First Class Honours degree in BBA (Accountancy) and a second degree in Communications and New Media at NUS and who was my editorial assistant for these last two volumes.

Everything I do would not be possible without the strong support of my family
– Linda, my amazing wife of 25 years, and my wonderful children, Lucinda and
Dillon.

Associate Professor Mak Yuen Teen, PhD, FCPA (Aust.)
Department of Accounting
NUS Business School
National University of Singapore

October 2015

BACK INTO THE FOLD: CAPITALAND'S PRIVATISATION OF CAPITAMALLS ASIA

Case overview

CapitaLand's decision to privatise CapitaMalls Asia (CMA) in 2014, barely five years after its listing on the Singapore Exchange (SGX), came as a shock to many analysts. It started on 14 April 2014, when parent company CapitaLand moved to buy out CMA's remaining shareholders with an initial offer of S\$2.22 per share. Dissatisfaction amongst the shareholders due to the low premium of the offer price over its IPO price quickly led CapitaLand to revise its offer to S\$2.35 per share. Both offers were reviewed and confirmed by CMA's Independent Board Committee and Independent Financial Adviser to be fair and reasonable. By 5 June 2014, CapitaLand had crossed the 90% threshold needed for CMA's delisting, having acquired a 92.7% stake in CMA. However, the independence of the Board came into question given the connections that CMA Directors had with the parent company, CapitaLand. The objective of this case is to allow a discussion of issues relating to the conflicts of interest arising from directorships in parent and subsidiary companies; role of different players in a privatisation; methods and rules governing privatisations; and valuation of privatisation offers.

This is the abridged version of a case prepared by Chua Hui Chee, Chua Weiyi, Daryl Chan Kum Weng, Low Ying Xiu Sarah and Ong Shuyi Andrea under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Chloe Chua under the supervision of Professor Mak Yuen Teen.

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The CapitaLand group

CapitaLand's story began when DBS Land and Pidemco Land merged in November 2000. CapitaLand is one of Asia's largest real estate companies with its focus on Singapore and China. CapitaLand's listed real estate investment trusts (REITs) through its subsidiaries CapitaLand Singapore, CapitaLand China, CapitaLand Mall Asia and The Ascott Limited, are: Ascott Residence Trust, CapitaLand Commercial Trust, CapitaLand Mall Trust, CapitaLand Malaysia Trust and CapitaLand Retail China Trust¹. Of CapitaLand's subsidiaries, CapitaLand Mall Asia is one of the largest shopping mall developers, owners and managers in Asia by total value of property assets and geographic reach².

[Note: In May 2015, the CapitaLand group went through a rebranding exercise by using the common "CapitaLand" name for its REITs, trust managers and subsidiaries. For example, CapitaLand Mall Asia was previously called CapitaMalls Asia. For the remainder of this case, the old names of the CapitaLand-related entities are used.]

The listing of CMA

Lim Beng Chee had started his career in CapitaLand in various senior positions, going on to become deputy CEO of CapitaMall Trust, CEO of CapitaRetail China Trust and eventually CEO of CapitaMalls Asia (CMA) in November 2008³. Subsequently, CMA sought to raise funds through a public share issue. Within a year, CMA became Singapore's biggest IPO in the last 16 years⁴.

Adieu to CapitaMalls Asia on the Singapore Exchange

Less than five years after it was first listed, CMA moved back towards being privatised. On 14 April 2014, its parent company CapitaLand offered to buy out CMA's remaining shareholders at S\$2.22 per share⁵, a 4.72% premium above CMA's IPO price of S\$2.12⁶ and a 31.5% premium over the adjusted share price of S\$1.79 on the previous full trading day of 11 April 2014⁷. According to CapitaLand, the decision to take CMA private was to streamline CapitaLand's operations in the integrated projects it carried out with CMA, to unlock shareholder value and to achieve synergies⁸.

Appointment of the adviser

"Delistings or takeover offers present perplexing choices to minority shareholders. The advice of the company-appointed independent financial advisor is supposed to be a good guide but can end up controversial." – Robson Lee, Partner at legal firm Shook Lin & Bok⁹

In response to CapitaLand's offer, CMA formed an Independent Board Committee (IBC) to advise minority shareholders¹⁰. These directors bore no direct relation to anyone in CapitaLand or any of its other subsidiaries that would have rendered them incapable of providing independent opinions on the Offer. CMA also appointed Deutsche Bank AG (Singapore Branch) as its Independent Financial Adviser (IFA) in accordance with the Takeover Code, to advise the IBC by providing a professional and objective analysis on the fairness and reasonableness of any proposed offer¹¹.

With regards to the offer price of \$2.22, the IFA issued a 'fair and reasonable' opinion given that the transaction had not resulted in a change in control¹². Subsequently, the IBC reviewed and concurred with the advice of the IFA.

CapitaLand's response to disgruntled shareholders

The response to CapitaLand's Offer Price was lukewarm, with shareholders dissatisfied with the small premium of the offer price over its IPO price. Furthermore, shareholders' demands for a control premium were unlikely to be met, considering how the offeror CapitaLand's controlling stake in CMA effectively discouraged potentially higher offers from competing firms¹³.

By 9 May 2014, the possibility of CapitaLand's privatisation of CMA seemed bleak with only a five percent increase in the total number of CMA shares acquired to date¹⁴.

The Securities Investors' Association (Singapore) (SIAS) then organised a closed-door discussion between shareholders and CapitaLand's management¹⁵. Subsequently, on 16 May 2014, CapitaLand made an increased revised offer price of S\$2.35¹⁶. Shareholders who had previously agreed to sell at S\$2.22 per share had their price revised to the new price. The IFA again concluded that the revised offer of S\$2.35 was 'fair and reasonable' on 23 May 2014¹⁷.

Does fair value equate to good value for shareholders?

“The most dangerous word to minority investors is “fair”... Minority investors desire and should demand “full” value for their shares. But who is in charge of advocating, negotiating and demanding full, not just fair, value?” – Michael Dee, former regional CEO of Morgan Stanley¹⁸

The fairness of CapitaLand's offer price and the usefulness of the IFA report in CMA's delisting continued to be contentious¹⁹. Critics argued that given the inherent limitations faced by the IFA in arriving at its 'fair and reasonable' opinion, the opinion itself would unlikely be useful to minority shareholders²⁰.

Moreover, more than four years after its public listing, the premium of the revised offer price over CMA's IPO price was only 10.8%²¹. Naturally, shareholders were unhappy as they were not being rewarded a risk premium for their equity investment. Given that the Straits Times Index grew by about 15%²² during the same period, the revised offer price was argued to be still clearly inferior to what other investors had received from the market during the same period.

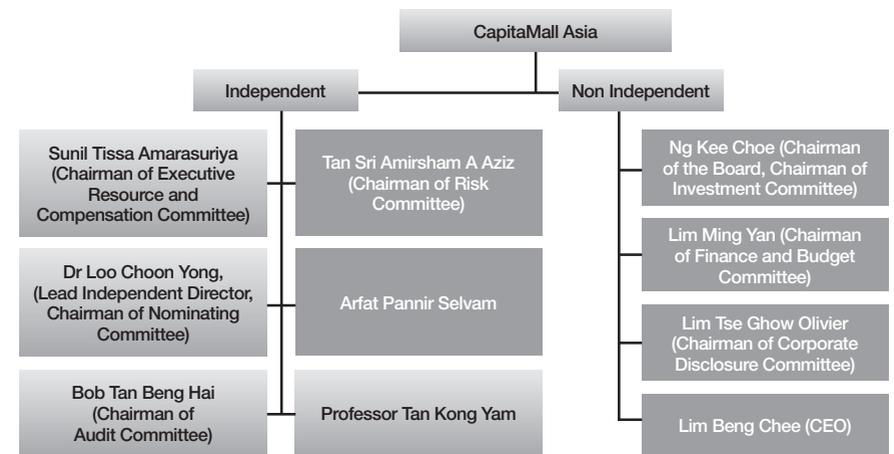
Furthermore, the company's potential for future growth as evidenced by substantial increases in CMA's profit and equity since its IPO was not reflected in the offer price²³. Some minority shareholders were also adamant that the offer price (1.26x book value) did not justify their initial investment during CMA's IPO (1.55x book value)²⁴.

Crossing the final hurdle

CapitaLand eventually acquired a 92.7% stake in CMA, finally crossing the 90% threshold needed for CMA's delisting on 5 June 2014²⁵. An application to SGX to take CMA off the Mainboard was successfully submitted and on 17 July 2014, CapitaLand also obtained the right to acquire the remaining shares since it had reached the minimum threshold of acquiring 97.1%²⁶ of CMA's total shares. The delisting of CMA was complete and the company was officially removed from the SGX and The Stock Exchange of Hong Kong on 22 July 2014²⁷.

The low offer price that had led to its successful delisting could have been a result of CMA Board's ineffectiveness in protecting its minority shareholders' interests. While the directors within the IBC were independent in position, the true independence of the independent directors on CMA's board may be questionable.

A peek into CMA's Board²⁸



*Dark grey boxes indicate CMA directors that hold director/ managerial positions in CapitaLand.

Based on CMA's latest Annual General Meeting held on 17 April 2014²⁹, the Board comprised ten members – one Executive Non-Independent Director (CEO Lim Beng Chee), three Non-Independent Directors (including Board Chairman Ng Kee Choe), and six Independent Directors.

Despite the impressive profiles of CMA's board of directors, issues such as multiple directorships plagued the board³⁰.

In particular, the presence of several CMA directors who also held director and senior management position(s) in CapitaLand was a major concern:

- CMA Board Chairman Ng Kee Choe was also the Chairman of CapitaLand
- CMA Chairman of Finance and Budget Committee Lim Ming Yan also helmed CapitaLand as Group Chief Executive Officer (CEO) and President
- CMA director Lim Tse Ghow Olivier, Chair of the Corporate Disclosure Committee, was also CapitaLand's Group Deputy CEO
- CMA CEO Lim Beng Chee also held a senior management position in CapitaLand
- While six directors were labeled as "Independent", two of them (namely Tan Sri Amirsham A Aziz and Arfat Pannir Selvam) actually served on CapitaLand's Board concurrently as Independent Directors. Arfat Pannir Selvam was reported to have retired from CapitaLand's Board on 25 April 2014.

While the Securities Industry Council (SIC) exempted these directors from being members of the IBC, the presence of an IBC may not necessarily mean that the CMA Board is able to protect minority shareholders' interests in the deal between CMA and CapitaLand.

Revision of the offer - The big picture

"The speed with which CapitaLand raised its offer says clearly the initial offer was a lowball price and the improved offer still provides plenty of value to CapitaLand. It likely has more room to pay more to minority shareholders, even if it says it won't." – Michael Dee, former regional CEO of Morgan Stanley³¹

Despite CapitaLand's firm stance that the final offer price would not be revised further, a number of shareholders still felt that the offer was undervalued. At the dialogue session with CapitaLand's management, some shareholders opined that an offer price between S\$2.45 and S\$2.55 would have been more appropriate³². The rationale for the formulation of the revised price was also not explained in detail. The only reason explicitly mentioned was to increase the probability of success for delisting³³. Many questions were left unanswered even as CMA's delisting saga came to a close.

Looking forward

"I think what is important is, we need to continue to focus on communicating very consistently and very frequently to our stakeholders. Especially in these markets now, it's very volatile, ... I think as a result stakeholders will appreciate the fact that we're open, we have a very open channel of communication with them." – Arthur Lang, CapitaLand Group CFO³⁴

Bearing in mind CapitaLand's focus on maintaining open consistent communication with stakeholders in their corporate governance approach, one may question if there is a contradiction between what CapitaLand professes and how it handled disgruntled CMA shareholders during the delisting process. Perhaps this, among other reasons discussed above, may explain Lim Beng Chee's sudden resignation from CMA.

Furthermore, market observers noted with concern the series of resignations³⁵ – that of CapitaLand Residential Singapore Chief Executive Wong Heang Fine, CapitaLand Deputy CEO Olivier Lim, and CMA Deputy Chief Executive Simon Ho³⁶ – prior to and following Lim's departure, with the concern that it may be the start of a possible brain drain. Despite the promise of CMA's privatisation, the string of resignations may effectively leave CapitaLand CEO Lim Ming Yan steering an empty ship heading towards uncertain waters.

Discussion questions

1. Examine CMA's Board of Directors. What are the key corporate governance issues that could have compromised the Board's effectiveness? What could be done to address these issues? How might CMA shareholders' interests be compromised given the composition of the Board of Directors and their links to Capitaland?
2. Should independent directors of parent companies who serve on boards of subsidiaries be considered independent directors on the subsidiary boards? How do the corporate governance rules in your country deal with such situations in general and in the specific situation of a privatisation?
3. What is the role of the Board of Directors of the target firm, the Independent Financial Adviser and regulators, in a privatisation?
4. What are the methods that can be used to privatise a listed company in your country? Do the rules governing such privatisations need to be strengthened and, if so, how?
5. (a) With reference to the IFA Practice Statement issued by Singapore's Securities Industry Council (SIC) on 25 June 2014 to provide guidance on conditions that apply to an IFA's opinion in relation to takeover offers, examine the role of the IFA, and the limitations they work under. How might these limitations have affected the IFA's valuation of CMA?

(b) How do you think the role of the IFA can be improved given the limitations identified in part (a)?
6. With regards to this privatisation episode, to what extent might the revision of offer price be due to pressure from minority shareholders? Why?

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CHINA MINZHONG VERSUS GLAUCUS

Case overview

Between 2007 and 2010, many Chinese companies listed in Singapore (often called “S-chips”) were involved in accounting and other scandals. Subsequently, these S-chips came under heavy scrutiny. In 2013, an S-chip, China Minzhong, was attacked by Glaucus Research Group California LLC, an American research firm and short-seller. Glaucus published a 49-page report accusing China Minzhong of sales fabrication, overstatement of capital expenditure, non-disclosure of related parties and other improprieties. In response to this attack, China Minzhong published a rebuttal. Unfortunately, it did not do much to prevent a halving of its share price. The objective of this case is to allow a discussion of issues such as whether short sellers are positive or negative from a corporate governance standpoint; the regulation of short-selling; a company’s response to a short seller’s attack and pre-emptive measures that companies can take to minimise the risk of such attacks; and risks associated with companies, particularly Chinese companies, listed on overseas exchanges.

This is the abridged version of a case prepared by Chow Sue Shyan, Inez Cintya Wijayanti, Kevin Eka Putra, Tee Zi Wei and Verdiana under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Yeo Shi Min Shermaine under the supervision of Professor Mak Yuen Teen.

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Background of the company

Founded and based in the People’s Republic of China (PRC), China Minzhong Food Corporation Limited (China Minzhong) business involves the cultivation, processing and sales of vegetables. It is headquartered in Putian City, Fujian Province, PRC and has been operating since 1971. China Minzhong has a diversified and complementary product portfolio with its products being categorised into processed vegetables and fresh vegetables produce¹.

China Minzhong has an integrated demand-driven operation, with its cultivation and processing schedules based on advanced sales orders received from its customers. This operation allows China Minzhong to have a stable supply of products as well as to establish better control over costs by meeting its customers’ requirements and market demand. As a result, China Minzhong can develop long-term relationships with its customers.

Glaucus’ allegations

On 26 August 2013, Glaucus Research Group California, LLC (Glaucus), a short-seller, published a 49-page report² questioning the credibility of China Minzhong. In the report, Glaucus stated that China Minzhong had misled investors through fraudulent reporting of sales, overstatement of its capital expenditure and other improprieties. Glaucus recommended a “strong sell” and claimed that China Minzhong was worthless³. In just two hours, China Minzhong’s share price plummeted by 47.8% to 53 cents⁴. Trading volume shot up to ten times its average, amounting to 24 million shares⁵.

Fabricated Sales and Suspicious Capital Expenditure

China Minzhong was alleged to have created false sales documents to fabricate sales. The identity of its two largest customers, Hong Kong Yifenli Trading Co. Ltd (Hong Kong Yifenli) and Putian Daziran Vegetable Produce Co. Ltd (Putian Vegetables), was questioned.

First, according to the data from the Hong Kong Companies Registry, Hong Kong Yifenli, which was China Minzhong's largest customer during the pre-IPO period from 2007 to 2009⁶, was incorporated only in November 2009. This suggests that Hong Kong Yifenli did not exist during China Minzhong's pre-IPO period as stated in its prospectus. Second, China Minzhong's second largest customer Putian Vegetables, had reported zero revenue and cost of goods sold (COGS) and no change in inventory for 2009 in its financial statements⁷. This indicates that Putian Vegetables did not make any purchase during that period, further implying that there were no sales from China Minzhong to Putian Vegetables. These issues sparked investors' concerns of whether they had been misled⁸.

Aside from alleged fabrication of sales, Glaucus also accused China Minzhong of overstating its capital expenditure. According to its China's State Administration of Industry and Commerce ("SAIC") filings, China Minzhong recorded RMB1.2 billion for the construction of a "Putian Industrial Park" for FY2011 and FY2012. However, in the financials of Fujian Minzhong, a subsidiary of Minzhong, this amount was only RMB203 million. In addition to the construction, Minzhong had secured a bank loan of RMB616 million through personal guarantees and a supplier⁹, which was highly unusual as loans are usually backed by hard assets.

Undisclosed Related Party

Glaucus discovered that the Chairman and founder of China Minzhong, Lin Guo Rong, was also the co-founder of Putian Vegetables in 2002. In addition, the legal representative of the China Minzhong subsidiary Sichuan Minzhong Organic Food, Lin Guo Ping, was appointed as the supervisor of Putian Vegetables from 2007 to 2010. However, its prospectus stated that directors and shareholders were independent of its customers¹⁰. Although China Minzhong stated that Lin Guo Ping had no influence over the customers¹¹, there were questions about the independence of his role as a supervisor, as his main responsibility was to monitor financial activities that were carried out in Putian Vegetables. Glaucus felt that there was a need for the disclosure of this relationship and argued that failure to disclose was a violation of Singapore securities law¹².

Revocation of Supplier's Business License

An SAIC filing showed that China Minzhong's largest supplier, Chengdu Shufeng Agriculture (Chengdu Shufeng), did not have a business license two months before China Minzhong's IPO as it had not filed for annual inspection for more than two consecutive years. Moreover, Chengdu Shufeng was only incorporated on 6 April 2006, just two months before China Minzhong's FY2007. This raised two possible issues: either Chengdu Shufeng was the largest supplier during the pre-IPO period and coincidentally collapsed after China Minzhong went for IPO, or Chengdu Shufeng was incorporated only for the purpose of China Minzhong's IPO to increase its reported profitability¹³.

Financial Cover Up and Fictitious Financial Performance

In early 2011, several S-chips collapsed due to accounting scandals, which caused their share prices to plummet. During this period, China Minzhong switched to local accountants and appeared to have made amendments to its subsidiaries' historical balance sheets and income statements, namely those of Sichuan Minzhong and Putian Minzhong, to show greater consistency with its financials filed on the Singapore Exchange (SGX) on SGXNET. According to the SAIC filing in 2011, the amounts recorded for its financial statements for FY2010 showed major discrepancies from the previous SAIC filings in 2010 before the amendments for both subsidiaries. Glaucus alleged that China Minzhong was attempting to cover up discrepancies its historical financial statements, and highlighted that this was even more dubious because Lin Guo Rong was the one who signed both documents.

Glaucus found China Minzhong's reported financial performance to be highly suspicious. First, according to China Minzhong's financial statements, its EBITDA margin on fresh products was 66% on average. Given its business model that involves selling unprocessed vegetables within China to processing agents, and subsequently buying them back before selling them again to distributors or customers at a cheaper price, China Minzhong should not have such a high pretax margin.

Second, China Minzhong's reported receivables increased significantly even though there was no change in credit terms. One possible explanation was that the inflation of the receivables was used to hide the false sales figures. In addition, Glaucus raised questions about China Minzhong's negative free cash flow figures since its incorporation, despite having high revenues, thus hinting at possible poor underlying performance of the company¹⁴.

China Minzhong's rebuttal

On 1 September 2013, China Minzhong released a 19-page rebuttal report¹⁵ and strongly refuted the allegations by Glaucus. In the report, China Minzhong stated that the allegations by Glaucus were "mischievous and calculated to cause panic and impose maximum damage on the price of the company's securities for their own benefit"¹⁶. In addition, China Minzhong believed that Glaucus had not considered the differences in financial reporting standards between China and Singapore¹⁷.

Fabricated Sales and Suspicious Capital Expenditure

China Minzhong provided supporting documents to show that the sale transactions had existed. Relevant documents included valid sales contracts, as well as official invoices printed, distributed and administrated by the PRC tax authority. These documents are mandatory for taxpayers to provide to its customers for every sale transaction. In addition, tax filings were obtained from Putian Vegetables for FY2009, which showed a COGS figure of RMB 227.4 million¹⁸, indicating that the business transactions between China Minzhong and Putian Vegetables did indeed occur.

As for the accusation regarding suspicious capital expenditure, China Minzhong argued that Glaucus did not consider the differences between PRC and Singapore Generally Accepted Accounting Principles (GAAP). China Minzhong said that Glaucus failed to include the prepayments that were made towards the capital expenditure. China Minzhong also highlighted that the prepayments and long-term deferred expenses would be classified as non-current assets under Singapore Financial Reporting Standards (SFRS). In comparison, under PRC GAAP, prepayment and long term deferred expenses would be classified as non-current assets only upon the receipt of the relevant tax invoices¹⁹. In addition, China Minzhong claimed to be in possession of all the relevant supporting documents and photographs to prove that such capital expenditures had indeed been incurred for the construction of Putian Industrial Park.

Undisclosed Related Parties

China Minzhong argued that the transactions between China Minzhong and Putian Vegetables did not meet the definition of a related party transaction under the Singapore FRS.

Essentially, China Minzhong claimed that both its Chairman Lin Guo Rong and executive director Lin Guo Ping had no direct or indirect shareholding interest in Putian Vegetables²⁰. Both of them were not involved in the day-to-day operations and management of Putian Vegetables. Hence, they did not directly or indirectly control Putian Vegetables.

In 1997, when Putian Vegetables' was incorporated, Lin Guo Rong held a 10% stake in Putian Daziran Food Limited, which was the company that set up Putian Vegetables. However, he sold his stake a few years later.

In the case of Lin Guo Ping, China Minzhong stated that it had earlier disclosed that he was a non-executive supervisor of Putian Vegetables from September 2007 to September 2008, and was not involved in the daily management of Putian Vegetables²¹.

Revocation of Supplier's Business License

China Minzhong explained that it was not informed of the revocation of the business license of its supplier, Chengdu Shufeng, in February 2010. Hence, it continued trading with Chengdu Shufeng until October 2010, but stopped when the quality of their mushroom spores failed to meet China Minzhong's requirements²².

Financial Cover Up and Fictitious Financial Performance

China Minzhong defended itself by saying that it had always been handling its own tax filings, but had outsourced SAIC filings to an external agent before 2011. However, the company decided to handle its own SAIC filings after 2011. In its 2011 tax filing with the PRC Tax Authority, it had used audited accounts and its own tax filings as a basis. The 2010 comparative figures were based on its own prior tax filings whereas the external agent doing the SAIC filings had used different figures²³.

As for the allegation regarding its high EBITDA margin compared to the industry average, China Minzhong argued that the computation of EBITDA margin by Glaucus was inappropriate. Glaucus' computation of EBITDA margins included gains on fair value adjustments which China Minzhong did not include as they are non-cash in nature²⁴.

With respect to Glaucus' claim of the suspicious increasing accounts receivables, China Minzhong explained that the increase in receivables in FY2012 was due to the weather patterns during the year and credit tightening in PRC. The operating peak season of China Minzhong shifted from the months of December to April in normal years to January to May in FY2012. This meant that the trade receivables traditionally collected in the financial year had to be pushed back. The company also emphasised that all receivables in FY2012 were collected by the end of the second quarter of FY2013²⁵.

In addition, China Minzhong explained that their cash flow from operations had always been positive. Nevertheless, net cash flows from operating and investing activities were negative for FY2011 and FY2012 due to its expansion activities and the increase in capital expenditure after the IPO. However, net cash flows from operating and investing activities were again positive for FY2013 at RMB359 million.

The revival of China Minzhong

Just a few months before Glaucus started its short-selling attack on China Minzhong, Indonesian instant noodle producer PT Indofood Sukses Makmur Tbk ('Indofood') had launched a number of bids to acquire a majority stake in the company. In February 2013, Indofood became the single largest shareholder of China Minzhong, with a 29.3% stake. The Government of Singapore Investment Corp (GIC) sold its entire stake (14.4%)²⁶ in China Minzhong to Indofood²⁷. The bid was viewed by the management to be beneficial for China Minzhong as it could expect certain synergies, such as strategic integration in both fast growing consumer staple markets in Indonesia and China as well as knowledge transfer between the two companies.

On 2 September 2013, Indofood launched a mandatory cash offer for the remaining shares of China Minzhong, at a price of \$1.12 per share²⁸. The share price a day prior to the offer was \$0.53. By December 2013, Indofood had acquired 82.88% of China Minzhong's issued shares.

After the takeover, investor sentiment on China Minzhong was highly positive, with credit rating agency Moody's upgrading China Minzhong's corporate family rating from Ba3 to Ba2, with a stable outlook in January 2014²⁹. Analysts believed that China Minzhong could leverage on Indofood's strong financial and credit profile to potentially expand its business network in China and overseas, particularly in a fast-growing economy like Indonesia³⁰.

Epilogue

A year has passed since China Minzhong's takeover by Indofood in December 2013. On 16 January 2015, Indofood decided that it would sell 347 million of its shares in China Minzhong at \$1.20 per share to China Minzhong Holding Ltd, an investment vehicle that is controlled by the food processing company's senior executives, including the chief executive³¹. This sale was expected to be completed by June 2015, which would raise US\$314 (S\$416.4) million for Indofood and reduce their original stake of 82.88% to 29.94%. The reason given was that China Minzhong Food required a longer than expected time to reach targeted results due to the current investment sentiment level in China. Indofood would make a profit of 7.1% through the sale, having acquired the shares at \$1.12 per share.

Discussion questions

1. Discuss whether short sellers such as Glaucus are a boon or bane from a corporate governance standpoint.
2. Some countries had temporarily banned short-selling during the global financial crisis period from 2008 to 2009. For instance, The United States' Securities and Exchange Commission (SEC) prohibited short selling on all stocks from 19 September 2008 to 8 October 2009. Explain the reasons. Why were these bans ultimately lifted? Have the regulators in your country introduce any rules regarding short selling and, if so, what is the main thrust of these rules?
3. Comment on the company's actions to minimise the damage from the attack by Glaucus. Do you think the response from China Minzhong was sufficient to regain investors' confidence towards China Minzhong?
4. As a short-seller, Glaucus' strategy is to reap profits from targeted stocks' shortfalls. In retrospect, what factors may have led Glaucus to specifically target China Minzhong? What actions can companies take to minimise the risk of attacks by short sellers?
5. What are the key risks associated with foreign companies listed on overseas exchanges? In the case of Chinese companies such as China Minzhong, what are the key accounting-related risks?

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GRP: A DIRECTOR'S CONVICTION

Case overview

On 3 September 2013, GRP Ltd (GRP), a company listed on the Singapore Exchange (SGX) Mainboard, announced the appointment of Peter Moe as an independent non-executive director of the group. Soon after the announcement, the SGX queried the company for appointing an independent director who had been previously disqualified while being a director of another company also listed on the SGX Mainboard. Moe had also received a complaint regarding alleged professional misconduct. A letter in the business newspaper questioned the company's response to the SGX query and sought further clarification. The objective of this case is to allow a discussion of issues such as the selection and appointment of directors; role of the Nominating Committee; the influence of controlling shareholders in the appointment of independent directors; and the role of minority shareholders and regulators in the appointment of directors.

This is the abridged version of a case prepared by Noor Zawanah and Lim Yi Han Danielle under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

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Background

GRP is a Singapore-based company listed on the Mainboard of the SGX. The company has been serving the onshore and offshore, marine, pharmaceutical and petrochemical markets for over 30 years. In October 2013, GRP obtained the approval of its shareholders to expand its business to include property development¹. They intended to acquire and develop overseas properties including those in countries such as Myanmar, Malaysia and China.

Reconstitution of the Board and Board Committees

GRP announced a reconstitution of its Board and Board Committees on 4 March 2013². Kwan Chee Seng (Kwan) was appointed as an executive director on 1 March and was mainly responsible for the group's business development. William Teo (Teo) resigned as an independent director. After the appointment of Kwan and resignation of Teo, the board consisted of two executive directors, two independent directors and one non-independent non-executive director. The other executive director was Iris Sim (Sim). Goh Lik Kok (Goh) and Roger Stuart Mitchell (Mitchell) were the independent directors and Chen Wei (Chen) was the non-executive director. The Nominating Committee (NC) was chaired by Goh, with Sim and Mitchell making up the other members.

The catch

After the resignation of Teo as an independent director, the company sought potential candidates to fill the vacancy, bearing in mind GRP's plan to diversify into property investment and development.

Peter Moe (Moe) was officially appointed as an independent director of GRP on 1 September 2013³. The announcement of his appointment dated 3 September 2013 included disclosure of a number of enforcement and legal actions against him. Following the announcement, SGX issued a query to the company, which responded in an announcement on 9 September⁴. In its response, the company said that the Board and NC were fully aware that Moe had been convicted under the Companies Act and had been fined S\$5,000 and disqualified for failing to use reasonable diligence in the discharge of his duties as an independent director of Chuan Soon Huat Industrial Group Ltd (CSH); has had a complaint of professional misconduct against him; and had faced civil proceedings involving allegations of misrepresentation and misuse of position of trust and confidence.

The company stated that the Board and NC had examined all the disclosures about enforcement and legal actions involving Moe "intensively" and had concluded that the matters were of no concern. With regard to the criminal conviction and disqualification, the company said that there was no "moral turpitude" and Moe did not receive any benefit. Further, his disqualification had been reduced from two years to one year upon an appeal to the High Court. The NC was "of the view that the conviction will make Mr Moe a more experienced director and Mr Moe has resolved to become more vigilant to safeguard the interests of the Company especially in the areas of governance and compliance". On the complaint of professional misconduct to the Law Society, the NC noted that the complaint was dismissed. On the civil proceedings which were related to the complaint to the Law Society, the case was "amicably resolved through mediation".

The company's response prompted Associate Professor Mak Yuen Teen of the National University of Singapore Business School to publish a letter in The Business Times on 13 September asking GRP to further clarify the controversial appointment of Moe. Professor Mak sought greater transparency and disclosure of the nominating process and questioned how the NC had specifically assessed Moe's suitability to take on the role⁵ giving the past enforcement and legal actions against him.

GRP issued a four-page response to Professor Mak's letter on 18 September which attempted to address two major issues raised by him: how the NC could have properly assessed the civil proceedings against Moe which were resolved through mediation, since parties to mediation hearings are bound by strict confidentiality; and how Moe was identified as a candidate and whether he was nominated by particular shareholders.

GRP stated that the NC had done a proper assessment⁶ which took into account three main factors:

1. Prior experience as an independent director

Moe had over a decade of experience in three companies listed on the SGX: PSL Holdings Ltd, CSH, and Air Ocean Ltd.

2. Qualifications

Moe is a law graduate with an Honours degree from the University of Kent, Canterbury, United Kingdom. He was admitted as an advocate and solicitor in Singapore more than three decades ago and is still a practising lawyer.

3. Professional experience and credentials

Moe had 30 years of legal practice and had handled a variety of legal work including civil litigation, corporate advisory and real estate work, amongst others. A large part of his experience was in conveyancing and real estate legal work including residential, commercial and industrial property sales.

GRP also described its search and nomination process in detail. It stated that it tapped on the social and business network to identify potential board candidates. In the case of Moe, he was introduced to the NC by Kwan, who is a controlling shareholder of GRP, owning just under 30% of the shares of the company⁷. It was disclosed that Kwan had known Moe for about 10 years and had past dealings with him, although none since 2005.

GRP's responses to the queries about the appointment of Moe triggered no further action from the regulators. At its annual general meeting (AGM) on 29 October 2013, Mitchell and Sim decided not to seek re-election as directors⁸. Mahtani Bhagwandas was elected as a director and joined the Board as an independent director and a member of the Audit Committee.

Discussion questions

1. Evaluate the composition of the GRP Board as at 1 March 2013. How might the presence of Kwan Chee Seng as a controlling shareholder and executive director affect the corporate governance of GRP?
2. What are the essential elements of a robust search and nomination process for directors? Evaluate the approach used by GRP in appointing Peter Moe to the Board against "best practice" in a search and nomination process.
3. Do you think the Board should have appointed Peter Moe given his qualifications and experience, despite the enforcement and legal actions that he has faced? Evaluate the explanations given by the company in response to queries about the appointment of Peter Moe.
4. What is the role of the Nominating Committee (NC) in the appointment of directors? Do you think the NC discharged its role effectively in the case of GRP? What challenges does the NC face in companies such as GRP? How can the nomination process be improved?
5. There have been instances of directors who have been caught for legal, ethical or moral infractions that are not directly related to their role as directors. For example, one director was convicted of a criminal offence for cruelty to his dog, which he had left exposed to the elements for several days. Another was reported in the overseas and social media as having had a secret rendezvous with an overseas actress, while he was overseas with his wife. Should such personal infractions matter when it comes to assessing the suitability of a director for appointment? Explain. If you were on a board and one of your fellow directors finds himself in this situation, what actions, if any, do you think the nominating committee and board should take?
6. Should minority shareholders have more say in the appointment of independent directors? Should regulators intervene in the appointment of directors, such as in the case of the appointment of Peter Moe?

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JARDINES: PLAYING BY THEIR OWN RULES

Case overview

The UK Financial Conduct Authority (FCA) published a consultation paper on 5 November 2013¹ recommending reforms to rein in controlling shareholders and enhance protection of minority shareholders' interests. This was in response to rising concerns² in the investment community regarding the governance of premium listed companies on the London Stock Exchange (LSE) with controlling shareholders. The Jardine Group of companies listed on the LSE (Jardines) fits the definition of companies with controlling shareholders³ and would be adversely affected by this change in the Premium Listing rules. They had to either comply with the new Premium Listing Rules, or downgrade to a Standard Listing. The Boards of the Jardine companies often lacked an independent element, and would have to undergo re-structuring before it could comply with the new Premium Listing Rules, which had a strong emphasis on board balance and independence. The objective of this case is to explore issues of corporate governance of family firms; controlling shareholders' influence; non-separation between shareholders, the board and management; compliance with corporate governance guidelines for family-controlled companies; regulation in different countries; conflict of interest of stock exchanges with dual roles; and listing of overseas companies.

This is the abridged version of a case prepared by Low Hui Ping, Nicole-Ann Leong, Song Xiaotian and You Xixi under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Yeo Shi Min Shermaine under the supervision of Professor Mak Yuen Teen.

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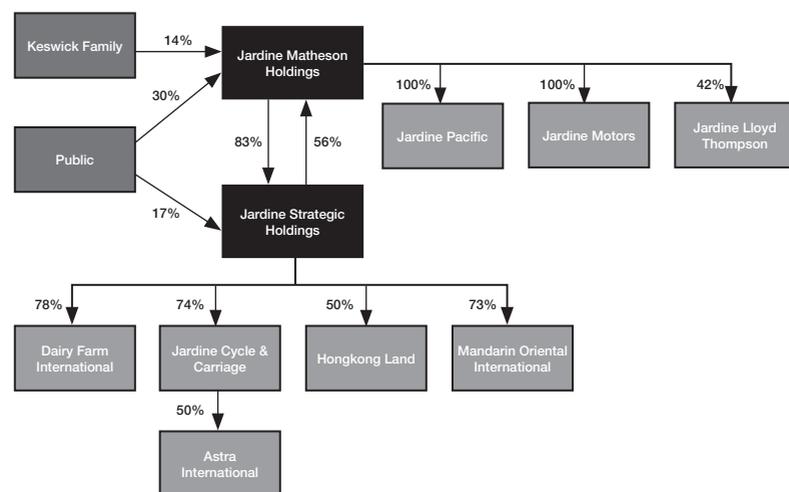
Background

The Jardine group of companies (Jardines) began in 1832 as one of the earliest foreign trading houses, and was largely involved in the opium trade. Jardines grew throughout the years into one of the biggest diversified conglomerates in the world, spanning many businesses including retail, logistics, real estate, financial services, hospitality and automobiles⁴.

Jardines has left a legacy in its principal operating area of Hong Kong, with several landmarks such as Jardine's Bazaar and Jardine House. However, after a foiled takeover attempt by Hong Kong billionaire Li Ka-Shing in the 1980s, the group was left drained⁵ and was eager to seek safer pastures in which to manage Jardines. After their incorporation in Bermuda, many parts of the conglomerate became listed on the London Stock Exchange (LSE), including Jardine Matheson, Jardine Strategic, Hongkong Land, Dairy Farm International, and Mandarin Oriental⁶. In 2013, both Jardine Matheson and Jardine Strategic were placed among the top 200 publicly-traded companies globally by market capitalisation⁷.

Jardines' controlling shareholder is the Keswick family, and members of the Keswick family also play key board and management roles in the different companies within the group.

Exhibit 1: Simplified Jardines Crossholding Chart⁸



Note: Figures show effective ownership of Jardines as at 30 September 2014

Building the fortress

With a three percent stake in Jardines, rumours were rife in the 1980s that Hong Kong tycoon Li Ka-Shing was about to launch an outright takeover bid for Jardines⁹. Jardines would be unlikely to be able to survive Li Ka-Shing's advances even if the takeover did not happen¹⁰. The top management at Jardines was wary of Li Ka-Shing's real business motive. Coupled with fears of takeover from Mainland interests, Jardines' principal shareholders erected a system of fortifications to render themselves raider-proof¹¹. Thereafter, Jardines shifted its headquarters over to Bermuda in 1984, which affected Li Ka-Shing's attempt at a takeover¹². After this foiled takeover attempt by Li Ka-Shing, Jardines sought to strengthen itself further against forced takeovers by implementing complex cross-holding structures that made the companies virtually takeover-proof¹³. Under Bermudan law, subsidiaries could vote shares in their parents, and the Bermudan cross-shareholding allowed the Boards of these companies to lock themselves in by voting the cross-shareholdings to re-elect the directors at any Annual General Meeting¹⁴.

A catalyst for change

The Financial Conduct Authority (FCA) is responsible for regulating the conduct of financial firms and maintaining the integrity of the UK financial markets to enhance consumer confidence and trust. Its consultation paper published on 5 November 2013 aimed to further enhance investor confidence in Premium Listings on the LSE by instituting a series of reforms to further restrict controlling shareholders, by seeking to regulate their influence over the operations and management of Premium listed companies¹⁵.

“Active engagement by all shareholders is essential to make markets work well. By safeguarding minority interests from abuse by controlling shareholders, these changes will promote market integrity and empower minority shareholders to hold the companies they invest in to account.” – David Lawton, Director of Markets in a press release by FCA¹⁶

Many of these reforms had adverse effects on Jardines. Premium-listed companies were required to be run independently from the controlling shareholder and independent shareholders were empowered to veto related party transactions¹⁷. One guideline for carrying on an independent business required the controlling shareholder to be unrelated and unable to influence the operation of the Premium listed company, even with material shareholdings in its significant subsidiaries¹⁸. The controlling shareholder was also required to have a legally binding agreement with the company to ensure that certain independent provisions were complied with, including those related to transactions with the controlling shareholder and/or its associates and ensuring that they were being conducted at arm's length¹⁹. The FCA was also imposing a dual voting structure for the appointment and reappointment of independent directors, which required the approval of both independent shareholders and shareholders as a whole²⁰. The new reforms placed renewed emphasis on the presence of an element of independence²¹ to protect minority interests, but Jardines' Boards did not harbour much semblance of independence²².

Jardines would no longer be able to sustain its current form of governance under the new set of Premium Listing rules, with the reforms specifically directed at restricting controlling shareholder's influence on management and promoting the element of independence. Meanwhile, the reforms in the paper were near their final iteration and would likely come into effect in 2014²³, forcing Jardines to act.

The reforms also enhanced the voting power of minority shareholders whenever a Premium listed company with controlling shareholders wished to cancel or transfer its listing from the Premium to Standard Listing²⁴. Prior approval must be obtained from the majority of independent shareholders, on top of getting a special majority on the resolution during the general meeting²⁵. If Jardines wished to downgrade its listings on the LSE, the reforms would pose difficulties when they come into effect.

Developing countermeasures

Jardines had historically been unable to comply with the UK Corporate Governance Code (the Code). Although Jardines claimed to commit to high standards for governance, it frequently differed from the form envisaged by the Code²⁶.

For example, the Board of Jardine Matheson contained ten executive directors and four non-executive directors²⁷, deviating from the principle of board balance under the Code²⁸, which recommend a at least half the board being made up of independent non-executive directors, excluding the Chairman (except for smaller companies). Furthermore, none of Jardine Matheson's non-executive directors were deemed independent²⁹. Jardines was also unable to comply with other "independence" guidelines such as those relating to the Chairman having to be independent at the time of appointment, and the audit committee. The Board also had no nomination or remuneration committees, and several non-executive directors have sat on the board for decades³⁰.

Jardines' approach had not been compatible with the FCA's proposals and many provisions of the Code. Since 2005, as overseas companies, the Group Companies had in their annual reports set out the differences of their governance practices from those contained in the Code, and since 2010, had been required to explain non-compliance with the Code. Jardines does not consider the Code to be as appropriate a governance model for the Group³¹.

"The Company attaches importance to the corporate stability that is fundamental to the Group's ability to pursue a long-term strategy in Asian markets. It is committed to high standards of governance. Its approach, however, developed over many years, differs from that envisaged by the UK Corporate Governance Code."³²

As compared to the governance requirements of a Premium Listing, a Standard Listing would require much less. A Standard Listing would no longer be subject to the Code, but only to European Union-wide governance directives³³. Rules governing significant transactions and related party transactions for Premium Listings would also not be applicable. Similarly, rules regarding pre-emption rights for Premium Listings would not affect Jardines³⁴.

With the toughening of the rules to require all controlling shareholders of Premium-listed companies to keep an 'arm's length' distance from the company and not interfere with daily control³⁵, Jardines had to downgrade their Premium Listings to Standard Listings to maintain their current governance structure. Through this, the group might then "maintain its existing structure and governance model", which were "well suited to Asian conditions and have enabled each group company to take a long-term view in the development of its business and to produce sustained growth in shareholder value"³⁶.

Bracing for impact

On 6 March 2014, after months of review and consideration, Jardines officially announced their intention to downgrade the listings of Jardine Matheson Holdings Limited, Jardine Strategic Holdings Limited, Dairy Farm International Holdings Limited, Hongkong Land Holdings Limited and Mandarin Oriental International Limited from Premium to Standard Listings on the LSE, although the decision was still contingent on shareholder approval afterwards³⁷.

Jardines believed that shareholders would be comfortable with the proposal, as they would have deemed the move to simply be a measure to maintain governance arrangements that were previously put in place, which had “proven successful in creating shareholder value”³⁸. Indeed, Jardines had vastly outperformed the market during the decade leading up to the announcement, producing total equity returns of 23% each year³⁹.

Nonetheless, some shareholders were surprised by the decision to downgrade the listings, even though most shareholders have long accepted Jardine’s non-compliance with UK governance norms. Although negative investor sentiment was not widespread, there were several dissenting views voicing concerns over the decision⁴⁰. Some also felt that the downgrade implied that shareholders were required to trust the subsequent generations of the Keswicks, and that they were to become good management as well⁴¹.

“It’s unfortunate. Here’s a company that for years has not ticked the boxes in terms of corporate governance, and we’ve all said ‘fair enough’ given their treatment of minorities. Now they are asking to remove the boxes altogether.” – Anonymous Investor⁴²

Share performance remained robust after the announcement, and investor outlook was rather stable⁴³. However, the decision was still contingent on shareholders’ vote, to decide whether the listing downgrade would eventually be approved. The proposal required the passing of a special resolution by each company, with at least 75% agreeing, in order to be approved⁴⁴.

The complex shareholding structures in Jardines meant that at least 70% of the shares in each Jardine company seeking the downgrade was controlled by the family, with the exception of Hongkong Land Holdings at 50%⁴⁵. The passing of the proposal with a special resolution was almost certain for all the Jardines companies except for Hongkong Land. The Special General Meeting (SGM) to vote on the proposal on 8 April 2014 was fast approaching⁴⁶, and to ensure certainty in the downgrade of listing, some shareholders still needed to be convinced.

In a bid to placate investors, Jardines based its credibility on its effectiveness at generating supernormal returns for shareholders. In order to bring about such profits, Jardines argued that they had to diverge from the norms of its governance structures, as they were highly suited to their operating domains, which allowed Jardines to utilise long planning horizons to generate value⁴⁷. Certain investment experts had also echoed such sentiments, and attributed Jardines’ returns to their ability to plan over long-term horizons, and exercising good judgment when choosing assets⁴⁸. Research studies have demonstrated that family-owned publicly traded firms do possess certain advantages that allow them to generate supernormal returns, and some attribute this to their ability to plan over a longer time horizon⁴⁹, and operate with lower agency costs⁵⁰. The allure of retaining a governance structure that has evidently proven to be successful for Jardines may be enough to tilt the vote in favour of the downgrade. Certain governance experts also felt that the proposals would be pushed through without much resistance⁵¹.

On 8 April 2014, the SGM occurred and the special resolutions were passed for all firms seeking the downgrade⁵². Jardines would not be subject to the FCA’s proposed reforms. The formal approval would take further time to enact, and on 27 May 2014, the LSE published the notice stating that the five companies had downgraded their listings on the LSE from Premium to Standard⁵³.

The fallout elsewhere

The controversial decision to downgrade the Jardines listings sparked debates away from home, including Singapore, where the Jardine companies which had downgraded had secondary listings. Professor Mak Yuen Teen, a corporate governance advocate in Singapore, raised concerns publicly to the Singapore Exchange (SGX), over issues of the secondary listing requirements of SGX in light of the Jardines' downgrading. He questioned if "the Jardine group of companies still satisfy the requirements for a Secondary Listing on the SGX."⁵⁴ He also pointed out that while the downgrade of the Jardine companies to a standard listing on the LSE meant that they would no longer qualify for inclusion in any of the FTSE indices there, three of the Jardine companies are included in the "blue chip" FTSE Straits Times Index (STI) in Singapore. He questioned whether their inclusion in the STI should also be reviewed.

SGX replied that it was in on-going discussions with Jardines to determine how to go forward in their proposals⁵⁵, as part of due diligence in their regulatory role. A company with a Secondary Listing on SGX need not comply with SGX's listing rules as long as the company complies with the requirements of the home exchange where it has a Primary Listing, and with a few other conditions imposed by SGX⁵⁶. Yet, requirements for Standard Listings on the LSE were far below SGX Primary Listing requirements⁵⁷.

SGX classified Jardines' Standard Listing on the LSE as a Primary Listing, but concerns were put forth that "it would appear that the LSE itself does not consider a Standard Listing to be equivalent to a Primary Listing on the LSE"⁵⁸, citing evidence that the UK Secondary Listing was replaced by the Standard Listing on the LSE website. The contention still remains unresolved, although a recent SGX consultation paper concluded that a LSE Standard Listing would still constitute a Primary Listing⁵⁹. In contrast, the Hong Kong Stock Exchange (HKEx) has determined that a Standard Listing on LSE is not considered a Primary Listing and, therefore, would not satisfy the requirements for a Secondary Listing on HKEx⁶⁰.

Aftermath

Although debates were intense, opinions were wide-ranging and coverage was wide, Jardines quickly dropped into the background after the downgrade decision passed. Jardines emerged from the entire ordeal relatively unscathed, with investors barely reacting. This was evidenced by only minor fluctuations of its share prices on SGX⁶¹ and LSE⁶². The surrounding debate had mostly died down, although it has left many questions hanging.

Discussion questions

1. The FCA reforms were a response to governance concerns over controlling shareholders. Consider the implications of these concerns in practice, and evaluate the pros and cons of restricting the influence of controlling shareholders.
2. Jardines' decision was successfully implemented through the board and shareholder resolutions they controlled. Consider the effects of non-segregation between the board, management, and ownership. Discuss the pros and cons of this.
3. Examine the factors that contributed to the successful downgrading of Jardines, without negatively affecting the share price. In your answer, consider the board and shareholding structure of Jardines, and characteristics of family-owned firms.
4. Jardines is a family-owned conglomerate that has historically enjoyed strong performance. Evaluate the viability of such alternative governance structures that deviate so widely from the UK Corporate Governance Code. Do you agree with the approach adopted by the Code?
5. Jardines argue that departing from independence and other guidelines in the UK Corporate Governance Code allows their companies to take a long-term view in decision-making. Do you agree with this argument? What are the risks associated with such departures?
6. In light of Jardines' response, evaluate the effectiveness of the FCA's proposed reforms. Do you think other companies might follow Jardines in circumventing new Premium Listings regulations?

7. In your view, how have Jardines' actions raised questions about the dual role of a stock exchange, such as the SGX? How might the conflict between the commercial and regulatory roles of the SGX have affected its action (or inaction) in response to the Jardines' downgrade and its formulation of rules for secondary listings? How can such conflicts be resolved?

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SEE HUP SENG: THE SURVIVOR

Case overview

The date 22 July 2013 would soon become a turning point for the management of See Hup Seng (SHS). A storm had been brewing within SHS due to an internal struggle for leadership between two company founders. Conflict between the two arose due to differences in opinions on the direction of SHS's future growth as well as in their respective areas of expertise. What started as Jimmy Tan's plan to oust Thomas Lim soon saw the tables turned, with Lim garnering shareholder support to remove Tan and re-instate himself. At the Extraordinary General Meeting, Lim was re-appointed to the Board and Tan was removed as managing director. The objective of this case is to allow a discussion of issues such as conflict between major shareholders; advantages and disadvantages of different shareholding structures; and removal of directors.

This is the abridged version of a case prepared by Leo Sheng Jin Valerie, Tay Jie Xin Joyce, Junice Lim Zi Ni and Tay Joon Kit Daniel under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Yeo Shi Min Shermaine under the supervision of Professor Mak Yuen Teen.

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The day of reckoning

Thomas Lim (Lim) was confident that 22 July 2013 would signify the day of his triumphant return back to the company, See Hup Seng (SHS), which he founded and groomed to be an industry leader. Over a span of 43 years, SHS grew to be at the forefront of both the corrosion prevention (CP) and refinery petroleum (RP) businesses, two of its major business segments. It is widely known not only in Singapore, but also across Asia¹. Establishing itself as the “resident contractor for premier shipyards”² in Singapore, SHS offers wide-ranging services, and has gained a strong position in “specialised tank coating services, and large-scale plant operations”³. However, despite its strong industry track record in terms of its performance, the same cannot be said about how SHS dealt with its internal affairs. Just three months ago, Lim had to step down as executive chairman due to a boardroom brawl. This was not the first time a Board tussle has led to such a messy debacle, but Lim firmly believed that he would be able to manoeuvre through this tussle just as he successfully did the year before⁴.

The trouble begins

It all started in 2012, when Jimmy Tan (Tan) was appointed as Managing Director of SHS and a member of the Nominating Committee. At that time, Tan was the Chairman and co-founder of TAT Petroleum Pte Ltd (TAT), a wholly-owned subsidiary of SHS. SHS first acquired 51% of TAT in 2008, and subsequently bought the remaining 49% in 2010⁵. TAT offers refinery services and products ranging from blending and packaging of refined petroleum products into drums, pails and other intermediate bulk containers, to storage and distribution of these products to customers around the region⁶. Based on his in-depth knowledge of the petroleum industry, Tan was also put in charge of SHS’s RP distribution, while Lim headed the CP business arm⁷. Nonetheless, the differences between the two executives were not limited to their expertise and roles in SHS, but also their perspectives on SHS’s future growth, which foreshadowed the impending boardroom tussle.

The first spark was ignited when Tan objected to a US\$10 million (S\$12.7 million) investment through a minority stake in Energy Ventures IV, Energy Drilling and Globalfund Capital, an offshore drilling firm. Lim advocated for the investment. Tension between the two further heightened when both individuals had diverging opinions on the usage of SHS’s large amount of cash and cash equivalents of S\$34.6 million to drive the company’s growth⁸.

In March 2013, things took a turn for the worse when the two sparked yet another boardroom row. In the heat of the argument, Tan castigated Lim and threatened not to vote for his re-election at the next Annual General Meeting (AGM) to be held in April 2013⁹. Tan secured the support of 33% of shareholders’ votes in a bid to oust Lim in the upcoming April AGM and pressured Lim to either resign or risk being ousted¹⁰.

Threatened by Tan’s actions, Lim had no choice but to consider resigning. But he was not going to give up without a fight. This turn of events was all too familiar to Lim. Just over a year ago, another former board member Tan Ong Huat, a non-executive director, together with a few shareholders, had also called for an EGM to remove Lim¹¹. This led to a tit-for-tat move by Lim, which ultimately led to the voluntary resignation of Tan Ong Huat¹². Having been burnt by the fire once, Lim knew what he had to do to resolve the matter.

The calm before the storm

During the AGM on 29 April 2013, Lim signaled his intention to step down as Chairman and did not seek re-election¹³. Ang Keng Boon (Ang), the Deputy Chairman of TAT who reported to Tan, was recommended by the Nominating Committee and appointed as an executive director¹⁴. Nevertheless, this arrangement did not last long.

What soon transpired was a series of events that caused Tan to regret his decision in ousting the founder of SHS. After his resignation, Lim reduced his stake in the company and transferred his shareholdings to his son, Terence Lim. On 23 May 2013, Terence, Chew Hoe Soon and Singaport Cleanseas Pte Ltd, representing more than 10% of SHS’s shareholdings, filed for a requisition to hold an EGM¹⁵.

Four resolutions were to be considered and voted on:

1. Remove Managing Director Tan from office
2. Reappoint Lim back onto the Board
3. Appoint Ng Keng Seng (Ng) as an executive director
4. Cancel the general share issue mandate approved at April's AGM

To add insult to injury, the requisitioning shareholders had already garnered close to 30% of shareholders' support in removing Tan and re-appointing Lim¹⁶. Tan tried on several occasions to reconcile with Lim and indicated his support for Lim in his re-election¹⁷. To his dismay, he was met with a cold shoulder. Tan also called for TAT to be listed on the Catalist Board and to split the refined petroleum arm from SHS, but allowing current SHS shareholders to hold the same stake. Although the Board had initially approved of the proposal, Tan subsequently withdrew it after the requisitioning shareholders indicated that they would not support the move¹⁸. It appeared that Tan was at his wit's end, and pressuring Lim to leave had eventually backfired on him.

Accepting the consequences

As the fateful day of the EGM loomed, Tan had begun to reduce his shareholdings in SHS as a sign of resignation to his fate at the EGM. An earlier threat to leave SHS was made by three management personnel (Chief Operating Officer Timothy Callery and Business Unit Directors Winson Tan and Dave Wong) and other key personnel from TAT, on the grounds that they were afraid that their jobs and TAT's future would be in jeopardy if the company removes Tan. This proved to be futile and Tan's fate seemed to be further sealed¹⁹. Although Tan felt that he was the right man to lead SHS and TAT in the RP business, he knew that ultimately, it was up to the shareholders to determine the final verdict on whether he would be able to continue as director after the EGM.

"If I'm voted out, I'll probably take a break for two years, and wish the group all the best," – Tan in his interview as he continued to reduce his shareholdings from 6.6% to 2.7%²⁰.

For many, losing either Tan or Lim would be a major concern for business continuity. The long-term growth prospects for both SHS and TAT would also be affected, as both were experts in their own fields. In addition, since the start of the boardroom tussle, there had been much uncertainty in the leadership of SHS, resulting in confusion for both the company and for shareholders²¹.

Knowing that he would most likely be asked to leave SHS at the EGM, Tan had acknowledged that he would relinquish his control over TAT, and would "naturally be upset if he loses his 'baby'²². Tan's primary worry was the future of the petroleum distribution arm as it relies significantly on networking and personal connections, and is an industry that is not easy to penetrate. His departure might mean a step backwards for TAT. Hence, in the months leading to the EGM, Tan went to suppliers and business associates, assuring them that TAT's management was familiar and well-versed in the operations, in a hope to alleviate their unease with the change in leadership if he was to be voted out²³.

Boardroom brawls don't come cheap

Board tussles can impact business operations and SHS was no exception. Power struggles at the top seem to be a frequent occurrence for businesses, and the uncertainties that arise can undermine the firm's share price²⁴. Scuffles at the top could also dampen "staff morale and business confidence"²⁵. Unsurprisingly, tussles also plague "companies worldwide, from the professionally managed European business to the family-run zaibatsu of Japan"²⁶, and are not just confined to the shores of Singapore.

"If [a boardroom tussle is] a disagreement in operational affairs, I feel it happens all the time due to the democratic decision-making process. However, if boardroom tussles are related to the intention to remove certain directors, then the frequency is a lot less" – Munawir Mohamed, Chief Executive Officer of Phillip Mutual Bhd²⁷

These tussles usually stem from the company's controlling parties and as a result, minority shareholders are pulled into this messy affair. Corporate governance professionals have been quoted that, "minority shareholders are pretty powerless to do anything," although fortunately, there has been "increased activism by minority shareholders and independent directors"²⁸. Whether they are able to effect change or prevent board tussles is a whole other issue. But it seems that the only way to resolve board tussles is either for one party to depart or for an amicable solution to be accepted by both parties²⁹. Unfortunately, for SHS, this tussle meant the former - the removal of Tan from SHS.

Return of the King

Lim entered the room where the EGM was due to start in a few moments. The votes were cast and the results of the resolution were announced; Tan was removed by 93% of the votes and Lim had been re-appointed as Executive Managing Director and Chairman³⁰. Along with Tan's removal, Executive Director Ang, who was previously nominated in April, and CEO of TAT, Chan Huan Yong (Chan), also announced their resignation. In place of them, newly appointed Ng, would manage the operations at TAT³¹.

Chan said that he resigned because the requisitioning shareholders made no attempt to acquaint him with Ng or to familiarise themselves with TAT's business. In addition, he also claimed that he was not informed of their future plans for the company and therefore felt that he would no longer have any influence in board matters and decisions with Ng's appointment³².

Fireproof?

The boardroom tussle brought confusion and instability to SHS. With SHS's own officers expressing concern about its murky fate, it was of no surprise that investors shared similar sentiments, with a significant change in ownership among institutional and individual investors³³.

However, in spite of drawing bad publicity to SHS, the tussle did not hinder its momentum. After the resignation of Tan, Lim proceeded to buy HETAT Holdings (HETAT), providing yet another revenue base for SHS³⁴. The acquisition would allow SHS to bid for larger contracts and cross sell its CP services. HETAT's strong

working relationship and expertise were just as valuable, enabling it to tap into the construction industry where demand continues to remain strong and was expected to be between S\$20 billion and S\$28 billion annually for 2014 and 2015³⁵.

The improvement of SHS's business position was further substantiated by its financial figures. FY2013 third quarter results proved market sentiments wrong, as revenue increase by 14% year-on-year to S\$73.3 million. The increase was achieved largely through an increase of S\$6.2 million in sales of RP products and S\$2.5 million in CP services³⁶. At that time, the acquisition of HETAT had yet to be completed. Hence, this increment would be seen as a reflection of SHS's true organic growth.

Lim beamed with satisfaction over SHS's recent success. Indeed, it had not been an easy fight, but he had emerged victorious, and the company was back in good hands. But who is to know how the future will unfold? Although some might opine that SHS's situation seemed to be changing for the better, would it be premature to conclude that the tussle was beneficial for SHS? Will there be yet another boardroom brawl after the recent reconstitution of the Board?

Epilogue

Since the settlement of the boardroom tussle, Lim has led SHS to greater heights, with an after-tax profit of S\$7.96 million and S\$15.65 million for FY2013 and FY2014 respectively³⁷. In addition, tax exempt, one-tier dividends of Singapore 0.93 cents per ordinary share were paid to shareholders on 20 May 2015, similar to FY2013, and an increase from dividends of Singapore 0.50 cents for FY2012³⁸. Furthermore, existing shareholders were awarded a one-for-two bonus warrant, with an exercise period of five years that expires on 17 December 2019³⁹.

A new identity was also established with the segregation of the CP business into a wholly-owned subsidiary, See Hup Seng CP Pte Ltd, and the renaming of SHS Limited to SHS Holdings Ltd to reflect the listed company's positioning as an investment holding company. Under Lim's leadership, SHS Holdings Ltd has made two new investments in the energy sector, and has incorporated a new subsidiary Sinergy Pte Ltd (80% ownership) under its wholly-owned subsidiary, HETAT, in February 2015⁴⁰.

It does seem that the boardroom tussle that occurred two years ago is a blessing in disguise for SHS after all.

Discussion questions

1. Identify any corporate governance deficiencies or potential conflict of interests in See Hup Seng's (SHS) Board of Directors before the tussle.
2. The Code recommends that the Nominating Committee (NC) should assist the board in avoiding any undue disruption from changes to the composition of the Board and board committees. In this case, do you think the NC effectively discharged its duties? Why? What could the Board have done to prevent the tussle from becoming such a public affair?
3. What are the advantages and disadvantages of a company having different substantial shareholders without any one being able to exert more control than the others? Is it better for a company to have a single controlling shareholder or multiple substantial shareholders? Explain.
4. In the case of SHS, do you think the boardroom tussle was ultimately good for the company and its shareholders? Explain.
5. What steps can the founders of companies take to protect themselves from being ousted? What are the tradeoffs involved?
6. For a public company like SHS, how can directors be removed from the Board?

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XPRESS HOLDINGS: RUNNING OUT OF PAPER

Case overview

Xpress Holdings Limited has been struggling with both internal and external difficulties over the past few years. Since its failure to deliver favourable financial results in 2012, Xpress has suffered the wrath of creditors, investors and regulators. On the one hand, SGX raised several queries about its accounts receivable and disclosures. On the other hand, Xpress had multiple creditors filing winding-up petitions against it for outstanding amounts owed. Within Xpress, there were multiple busy directors and also criticism about an independent director appointing an alternate director. Furthermore, its Board and Management experienced extensive and repeated changes, with the cessation, appointment and re-appointment of directors and senior executives. The objective of this case is to examine issues such as board composition; alternate directors; multiple directorships; insider trading; disclosure breaches; and corporate governance of founder- and family-managed companies.

This is the abridged version of a case prepared by Shua Siew Hoon, Boon Pei En and Tay Wan Ting under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lim Kai Ting Grace under the supervision of Professor Mak Yuen Teen.

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About Xpress Holdings

Xpress was incorporated in Singapore in 1986 by Fong Kah Kuen (Fong) to provide printing services. Before becoming what it is today, Xpress has had its troubles and glories. In a bid to expand into internet kiosks¹, the company was renamed as I-One.Net International Ltd on 25 May 1999. Unfortunately, the investment was a failure and Xpress exited the internet kiosk industry with Fong stepping down as CEO. The new management, who renamed the company as “Xpress Holdings Ltd”² (Xpress) on 3 December 2001, refocused on the print media industry. Subsequently, Xpress was named the Overall Winner of the Established Brands Award category in 2009 and Regional Brands Category in 2010.

After stepping down as CEO in 2001, Fong was welcomed back as Chief Operating Officer (COO) in 2006 to oversee Xpress’ marketing and sales operations in China. He was based in Shenzhen and was responsible for general management of the Group and expanding the Group’s operations in China. In 2010, Fong was re-appointed as CEO and Executive Director of the Group. He was a substantial shareholder of Xpress, owning about seven percent of the shares.

Several of Fong’s relatives were involved in the management of Xpress and its subsidiaries, including Fong Sau Kwan, Managing Director of Xpress Print Ltd; Fong Sow Peng, Operating Director of Xpress Print Ltd; Fong Sau Chun and Fong Sau Lan, both Directors of Xpress Print (Australia); Adelene Lim Hwee Lim, account manager of Xpress Print (Australia); and Khoo Choon Meng, Sales and Marketing Managing Director of Xpress (Asia outside of China)³.

Auditors raise concerns

Things went awry in 2006 when concerns about Xpress' accounting were raised over the acquisition of Precise Media Group (PMG)

Xpress' auditor, Deloitte & Touche (Deloitte), raised a number of issues, including the recognition of revenue, recording of goodwill and its internal controls⁴. Xpress then hired Foo Kon Tan Grant Thornton (FKT) to conduct a special audit and to give a second opinion on its financial results. FKT acknowledged the validity of Deloitte's concerns, and Xpress added that these "observations should be read in conjunction with replies from RSM Nelson Wheeler Hong Kong (the auditors for PMG) and the management of Xpress and in the context of the business environment in the People's Republic of China"⁵. FKT was appointed as auditor of Xpress and most of its subsidiaries following the termination of Deloitte, which had refused to sign off on the company's accounts for the 2006 financial year (FY).

Financial woes, Regulator calls

In FY2012, Xpress experienced a drastic drop in its net profit - from S\$5.26 million in FY2011 to a net loss of S\$4.58 million. This came after the company set aside S\$8.2 million of trade receivable provisions in view of the challenging economic environment.

Prior to this, the Singapore Exchange (SGX) had issued a query asking the company to explain the S\$7.11 million increase in trade receivables between FY2011 and Q3 of FY2012, when revenue dropped by S\$3.19 million between Q2 and Q3 of FY2012⁶.

In FY2013, a net profit of S\$2.7 million was recorded. However, SGX issued a similar query regarding the 39% increase in trade receivables despite a 1.1% decrease in revenue⁷.

Similar reasons were provided by Xpress for both years. The company attributed the significant increase in trade receivables to the common industry practice of extending long credit terms in China, ranging from 180 to 360 days⁸. In addition, Xpress explained that most of the payments were due after the interim or financial year end, resulting in higher trade receivables. At that time, the company said that it did not foresee any significant collectability issues.

Board in turmoil

A Legitimate Alternative?

In FY2010, Ong Wui Leng (Ong) was appointed as alternate director to the Christopher Chong Meng Tak (Chong), an independent director who concurrently held four directorships.

After Associate Professor Mak Yuen Teen (Mak) of the National University of Singapore published a commentary criticising the appointment of alternate directors for independent directors, a debate escalated between Chong and Mak⁹. The Board felt that Ong's experience and expertise would benefit Xpress¹⁰. Chong further expressed the view that Ong's appointment was to aid Xpress with a possible secondary listing in Taiwan^{11,12}. However, the listing did not happen.

When the Code of Corporate Governance was revised in 2012, it provided guidelines on the appointment of alternate directors and recommended that alternate directors should only be appointed under certain situations and for a limited period.

Board Re-Shuffling

Between FY2013 and FY2014, five of Xpress' Board members resigned from their Board positions, namely, Wang Kai Yuen (Wang), Chong, Jerry Lin Yin Chia, Lee Tsu Der and Victor Khoo Choon Meng (Khoo), and leaving behind only four directors on the Board.

Chong, who was appointed as independent director in December 2001¹³, resigned in November 2012¹⁴. On 29 November 2013, the Board Chairman and independent director, Wang¹⁵, resigned after serving 14 years on the Board¹⁶. Wang was first appointed as independent director of Xpress in June 1999 and subsequently became its Chairman in March 2002. During his tenure, he sat on the Audit, Remuneration, Nominating and Investment Risk and Management Committees, and chaired at least two of these committees at any point of time¹⁷. At the time of his resignation, Wang had a total of 10 directorships¹⁸ in companies such as ComfortDelGro Corp Ltd, Cosco Corp Singapore Ltd and China Aviation Oil Singapore Corp Ltd¹⁹. A new independent director, Yip Kean Mun (Yip), was then appointed during this period. Yip had many years of experience in commercial banking and investment and had been involved extensively in transactions in Southeast Asia and China²⁰.

Following Wang's resignation, Fong, the then-CEO of Xpress, was appointed as the new Board Chairman²¹ on 29 November 2013. On the same day, Khoo also stepped down as executive director. He was re-designated as the Managing Director to focus on sales and marketing in Asia²², but excluding China which was being managed under Darlington Tseng Te-Lin (Tseng)^{23,24}.

Creditors come calling

In recent years, Xpress has clearly faced some rough patches, but none was as potentially catastrophic as what transpired in mid-2014.

“Several creditors have commenced legal proceedings against the Company and our subsidiary Xpress Print Ltd, for sums due and owing, in an aggregate of approximately S\$2.4 million.”

The above statement was publicly announced by Xpress on 23 July 2014. The creditors included HSBC Institutional Trust Services (Singapore) (HSBCITS), which had filed a winding-up application against Xpress as a corporate guarantor of its subsidiary (Xpress Print), in relation to rental arrears of about S\$400,000. United Overseas Bank Limited (UOB) also filed a winding-up application against Xpress Print for an outstanding loan of S\$1.2 million. In addition, the ASEAN Finance Corporation Ltd (AFC) issued Xpress a writ of summons on 8 July 2014²⁵, with regards to an outstanding amount of S\$700,000.

Efforts were made to rescue the company from its crisis. Unfortunately, the negative publicity surrounding these developments sparked concerns about Xpress' cash flow situation and its ability to remain as a going concern.

As of 30 April 2014, Xpress' cash holding was negative S\$1 million against its debts of S\$7 million. On 18 September 2014, Xpress stock price plummeted to an all-time low of S\$0.007²⁶.

Questionable disclosures and trading

On 25 July 2014, the Business Times published a letter from Mak that raised questions about Xpress' disclosures and unusual share trading²⁷. Mak pointed out that on 1 July, SGX had issued a query to Xpress for unusual volume movements in the company's shares. The number of shares traded that day was 184 million, compared to the usual daily trading volume of a few million shares.

In response to SGX's queries, the company had replied that it was not aware of any information which had not previously been announced relating to the company, its subsidiaries or associated companies that may explain the unusual trading, or any other possible explanation for the unusual trading. It had also confirmed its compliance with the listing rules, particularly rule 703 on the disclosure of material information.

Further, on 4 July, the company announced that the executive chairman's deemed interest had decreased by 29 million shares on 2 July due to a disposal of shares.

On the morning of 22 July, Xpress Holdings had asked for a trading halt. This was followed after midnight by an announcement on the above legal proceedings, the appointment of a financial consultant to assist with formulating a settlement with creditors, and a proposed placement of 480 million new shares. Mak suggested that regulators should revisit the company's responses to the SGX's query on 1 July and determine if the relevant rules have been complied with.

Deal or no deal?

With creditors hot on its heels, Xpress agreed to private placement deals with two investors in July 2014 to raise approximately S\$9,480,000, with 55% of the amount used to repay Xpress's creditors²⁸. In August 2014, both HSBCITS²⁹ and AFC³⁰ withdrew legal proceedings against Xpress. Unfortunately, shortly after, the plan for the private placement fell through when its subscribers failed to complete the subscription procedures as required³¹.

A change of ship captain

Amidst the legal proceedings against Xpress in September 2014, Fong resigned as CEO and Chairman to focus on Xpress's sales and development as a non-executive director. Sam Chong Keen (Sam)³², the lead independent director, took over Fong's role as the Non-Executive Chairman. In the absence of a CEO, an Executive Committee was set up to oversee the management of the company³³. The committee was led by the independent director Yip.

Other members of the committee consisted of Sam (lead independent director)³⁴ and Tseng. Yip was also the chairman of the audit committee with Sam and Tseng as its members³⁵.

Rocks ahead....or land in sight?

Following the news of the unsuccessful private placement exercise, Xpress warned its shareholders on 16 September 2014 of the expected significant net loss for FY2014, based on preliminary review of its unaudited financial results for FY ended 31 July 2014, due to the difficulty in recovering its receivables and the impairment of goodwill³⁶.

Subsequently, Xpress revealed that its subsidiary, Xpress New Media, had partnered with global logistics firms to provide new services³⁷. Such services include the completion of airway bills, shipment invoices, as well as tracking services until the shipment reaches its 8 → 8 Biz Butler outlets or its flagship outlet in the Central Business District.

Two weeks later, on 1 October 2014, Xpress made a separate public announcement, declaring that it will be applying to Singapore Exchange Securities Trading Limited (SGX-ST) and the Accounting and Corporate Regulatory Authority (ACRA) for an extension to release the full year financial results of 2014 and to postpone its Annual General Meeting for the financial year ended 31 July 2014. Xpress explained that the company was still "in the process of raising funds to settle the outstanding audit fees"³⁸.

New or false dawn?

In January 2015,³⁹ Xpress gave fresh hope of a new investor when it announced that it had signed a placement agreement with Ma Wei Dong (Ma) to raise up to S\$23 million. Under the agreement, Ma will be able to appoint one director on the signing of the placement agreement, and to appoint the Chairman and additional directors to form the majority of the Board on completion of the placement.

On 9 July,⁴⁰ Xpress announced yet another series of changes to its board and senior management. Sam stepped down as Non-Executive Chairman but remained as the lead independent director. Ma was appointed as Executive Chairman and CEO. Yip resigned from the Board. A new independent director, Chu Hongtao, was appointed. She became Chairman of the Audit, Nominating and Remuneration Committees. Fong resigned from the Board and assumed the position of Chief Operating Officer. The fourth remaining Board member was Tseng, a non-executive director. On 21 July, Xpress announced the completion of the subscription of shares by Ma, who became the largest shareholder, owning more than 30% of the total outstanding shares.⁴¹

On 21 May 2015, SGX issued warnings to Xpress over a failure to make immediate disclosures when served with two winding-up petitions in July 2014. Warnings were also issued to the former executive Chairman and CEO of Xpress, Fong, in relation to the breaches.

The reason for the late disclosure, in the words of Fong, was that "he felt (the winding-up applications) were either frivolous or legally flawed"⁴². Such explanations were apparently deemed inadequate for SGX as SGX replied that any such objections did not preclude Xpress Holdings from observing the listing rules⁴³.

In addition to the tardy disclosures with regards to the winding-up petitions, Mak also raised issues of possible insider trading. Thus far, the issues of unusual share volume movements and the former Chairman's disposal of 29 million shares in Xpress in July 2014 remain unaddressed⁴⁴.

Would the entry of the new investor herald a new beginning for Xpress? Or is this yet another false dawn for the company?

Discussion questions

1. Evaluate the composition of the Board in Xpress at the following points in time: (a) before the resignation of the five directors in FY2013, (b) after the resignation of the five directors and (c) after the completion of the placement agreement in July 2015.
2. Comment on the relationship between the shareholders, Board and management of Xpress before and after the entry of the new investor. What are the key corporate governance issues relating to this?
3. What is generally the role of an Executive Committee? Is an Executive Committee desirable from a corporate governance standpoint? Are there concerns regarding the establishment and composition of the Executive Committee in the case of Xpress? Discuss with reference to the different roles the Board and the Management should assume in a company.
4. Comment on the appointment of an alternate director in Xpress. What are the concerns regarding the appointment of alternate directors?
5. Comment on the disclosures, responses to SGX queries and unusual trading in Xpress shares. Are there possible breaches in listing and securities laws in Singapore, and if so, what are the possible breaches?

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ALIBABA: OPEN SESAME

Case overview

In 2013, Alibaba Group Holdings Limited (Alibaba) wanted to go for an Initial Public Offering (IPO) and was contemplating the viability of three stock exchanges– Hong Kong Exchanges and Clearing Limited (HKEx), New York Stock Exchange (NYSE) and NASDAQ. Their first choice was to list on HKEx. However, their application was turned down because Alibaba's unique 28-man partnership structure did not meet HKEx's listing requirements, and was similar to a dual-class structure. Alibaba's failed listing on the HKEx then kick started regulatory and public debate about potential changes to existing listing rules, for fear of losing more future listings. The purpose of this case is to allow a discussion of issues such as dual-class share structure; mismatch between share ownership and control; and the tension between regulatory and commercial motivations of stock exchanges.

Background

"Nobody wanted to believe Jack Ma."- Jack Ma¹

Not even HKEx when Jack Ma, Chairman of Alibaba, brought an attractive proposal to the table in 2013 – listing his wildly successful e-commerce brainchild Alibaba. After weeks of intense negotiation, the listing was rejected on the premise that its unique 28-man partnership structure did not meet HKEx's listing requirements.

This is the abridged version of a case prepared by John Don-Degan Oei Jing Wei, Chua Wen Hui Sarah, Ong Hui Zhu, Doralyn, and Jerry Goh Shi Bin under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Amanda Aw Yong under the supervision of Professor Mak Yuen Teen.

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Ma was now faced with a tough decision. Change the partnership structure that has worked so well for the US\$168 billion e-commerce giant²? Or abandon his dreams of a Hong Kong (H.K.) listing and head for greener pastures on the NYSE or NASDAQ?

The birth of an E-commerce hero

Jack Ma began his career as an English tour guide in Hangzhou, China³, and had no experience with computers or any technology-related equipment. This changed when he discovered that internet searches brought up no information about China⁴. Ma realised that this was his opportunity to fill a gaping hole on the internet, and proceeded to set up China's first commercial website, China Pages⁵.

Ma's business competed with China Telecom and when the state-owned company offered to embark on a joint venture, Ma found the offer too good to refuse⁶. Although Ma was a director, he had no control over the five-man board and his ideas were turned down and outvoted time and again⁷. With his hands tied and no way to move his ideas forward, Ma decided that his best option at that point was to resign.

In early 1999, Ma decided to give his entrepreneurship dream another chance. He envisaged a global e-commerce company and shared this dream with the 18 others he had gathered in his apartment⁸. That night turned out to be the turning point in Ma's e-commerce journey. With just US\$60,000 to its name, Ma and his 18 partners started the company, Alibaba, a name chosen for its simple spelling and its association with the well-known "Open Sesame" command⁹.

Ma believed in his approach to create a successful business for the Chinese context – global vision, local win¹⁰. Unlike many other Chinese entrepreneurs who adapted successful U.S. internet business models¹¹ that managed Business-to-Consumer (B2C) and Consumer-to-Consumer (C2C) transactions¹², Alibaba created its own business model. It focused on the Business-to-Business (B2B) sector and connected small and medium sized companies with one another¹³.

The Alibaba Group

Today, Alibaba is the largest provider of online and mobile marketplaces in China, making up 80% of China's B2C and C2C markets. Alibaba also accounts for more than 70% of the parcels delivered in China and its dominance in parcel delivery continues to grow¹⁴. On a global basis, Alibaba has outperformed both eBay and Amazon in terms of gross merchandise value, which generated US\$67.8 billion and US\$87.8 billion respectively in 2012¹⁵.

Alibaba has several key lines of business - Alibaba.com, Taobao, Tmall and Alipay. Alibaba also offers cloud computing and other peripheral services¹⁶.

Alibaba.com

Alibaba.com was the Group's first foray into the e-commerce sector in 1999. It is a B2B online portal connecting Chinese manufacturers with buyers all around the world. Alibaba.com's business model is based on two observations of the Chinese market. First, the Chinese are cost-conscious. This led Alibaba.com to provide basic services¹⁷ to both its buyers and sellers at no cost¹⁸. To cater to sellers who are slightly less price sensitive, Alibaba.com offers extra services¹⁹ and online advertising options²⁰. Second, Chinese consumers are concerned about the reliability of sellers. To address this matter, sellers listed on Alibaba.com can opt to have their claims reviewed by independent third parties through its Independent Verification Service (IVS). To date, Alibaba.com has more than 4.4 million registered users from over 200 countries and territories²¹.

Taobao and Tmall

In 2003, the Group launched Taobao, the Chinese equivalent of eBay, becoming the market leader in China's C2C market within two years of its commencement²². In 2010, Alibaba launched Tmall.com, a spin off from Taobao. It has since become China's most popular B2C online shopping platform. In 2012, Taobao and Tmall.com generated a combined gross merchandise volume of RMB1.1 trillion (US\$171.2 billion)²³.

Alipay

Alipay is China's leading online payment service, dominating 80% of China's online transaction market share, and close to US\$150 billion in FY2013 reported revenue²⁴. The Alipay system supports all of Alibaba's online transactions. This system allows sellers to collect money for goods up front and places the amounts in an escrow account, ensuring buyers do not default on payment²⁵.

28 men at the helm

Alibaba has a 28-man partnership structure, consisting solely of founders of the company and key senior executives²⁶. These 28 partners do not sit on the board of directors but they have the power²⁷ to nominate a simple majority of the directors²⁸.

Although nominations are primarily made by the 28 partners, all shareholders have the right to vote for or against the nomination according to their shareholdings. The 28 partners hold a combined 13% of Alibaba's total shares, while Yahoo! Inc. (Yahoo!) and SoftBank Corporation (SoftBank) hold 24% and 37% respectively²⁹. The remaining shares are held by dispersed minority shareholders. However, if the nominated candidates are rejected, the partners are able to nominate other suitable candidates³⁰. This process repeats itself until the board of directors is formed.

The purpose of this partnership structure, according to Ma, is to ensure that the company is operated by "a group of people who are passionate about the company and are mission-driven."³¹ This view is supported by Joe Tsai, Group Executive Vice-Chairman, who believes the partnership structure helps to preserve the company's innovative culture even if the initial founders leave the company, assuring the company of a long-term strategic focus rather than myopic or short-term gains³².

Alibaba's genie lamp - A Stock Exchange listing

Alibaba has been successful in the e-commerce industry over the last decade, as evidenced by the twelve different valuation estimates compiled by Bloomberg in 2014 that put its value at about US\$168 billion³³.

Listing was the next logical step for Alibaba. The Group wanted to be listed on a stock exchange in order to raise capital for further expansion in the promising mobile shopping and social media sectors³⁴.

A Tale of Two Cities – Pearl of the Orient or The Big Apple

In July 2013, Alibaba was ready for an IPO but was still deliberating between the three stock exchanges it had shortlisted – NYSE, NASDAQ and HKEx³⁵. At the heart of it, Alibaba's decision boiled down to a simple dichotomy between two countries – H.K. or the United States (U.S.).

A U.S. listing has several advantages over a H.K. one. First, the U.S. stock exchanges allow for Alibaba's existing partnership structure³⁶. On the other hand, HKEx adopts a "one share, one vote" principle and does not allow Dual Class Share (DCS) structures except under exceptional circumstances³⁷.

Second, the world's largest technology firms, such as Facebook and Amazon, are listed on the U.S. stock exchanges, with most of them listed on NASDAQ³⁸. In contrast, H.K. does not have many "high-tech" or "internet"³⁹ companies listed.

Third, western investors have a better grasp of the technology sector, boosting the accuracy of their valuations of tech companies⁴⁰. Furthermore, NYSE and NASDAQ are the world's largest stock exchanges in terms of market capitalisation⁴¹.

Fourth, NASDAQ does not require companies to have earned a profit for three years before going public⁴², unlike H.K. which has the requirement⁴³.

On the other hand, a U.S. listing also has its disadvantages over a H.K. listing. The U.S. has a litigious culture⁴⁴ which may be a problem for Alibaba if it does not provide timely disclosures, as they would face potential lawsuits⁴⁵. This is a concern for Alibaba as Taobao has faced problems with counterfeit goods in the past⁴⁶ and had tried to resolve the problem but to no avail⁴⁷. Conversely, H.K. does not have a class-action legal system⁴⁸.

In addition, the U.S. also scrutinises its financial markets more closely than any other country in the world⁴⁹. U.S.-listed companies face higher compliance costs due to the additional regulations required by the Sarbanes-Oxley Act⁵⁰.

Next, Chinese companies listed in the U.S. are undervalued⁵¹. There have been many accounting irregularities, frauds and scandals in the U.S. by Chinese companies over the past decade, leading to lower investor confidence⁵² towards this class of companies.

Last but not least, it would be easier for Alibaba to maintain status quo even after listing because H.K. has a similar culture, uses the same language, and enjoys geographical proximity to China⁵³. This is particularly relevant as Alibaba's revenues are mainly generated in China.

In September 2013, Alibaba decided on a H.K. listing and submitted its application to HKEx. In order to list, Alibaba would have to gain the approval of both the Hong Kong Securities and Futures Commission (HKSF) and the Stock Exchange of Hong Kong (SEHK).

The genie's lamp shatters

In late September 2013, just weeks after submitting its application, negotiations with HKEx fell through⁵⁴.

The reason for their rejection stems from Alibaba's listing proposal which grants additional powers to the 28 partners at the helm. HKEx claims that such powers undermine the "one share, one vote" principle as it closely resembles a DCS structure that grants more power to a small group of people who hold fewer shares⁵⁵.

Charles Li, CEO of HKEx, reinforced this stand by explaining that HKEx adopts a "one share, one vote" principle and does not allow DCS structures unless under exceptional circumstances⁵⁶. Li also highlighted that the exchange is not ready to "bend existing rules just for one applicant"⁵⁷.

Between a Rock and a Hard Place – HKEx's Dilemma

***"It is very important for HKEx to not make exceptions and to maintain market integrity, especially in light of what has happened with Chinese companies in recent years... There are plenty of companies in Hong Kong and China that would want to do similar things, so making an exception creates a very difficult scenario."*⁵⁸ – Arjan Van Veen, Analyst at Credit Suisse.**

***"Losing one or two listing candidates is not a big deal for Hong Kong; but losing a generation of companies from China's new economy is. And losing it without a proper debate is even more unacceptable."*⁵⁹ – Li, CEO of HKEx**

Although it might seem that Alibaba's proposed IPO should have been a straightforward accept or reject situation, the deliberation process was anything but simple.

Painful Deliberation Process

Throughout the year leading up to the rejection of the IPO, Alibaba and HKSF held private discussions related to the listing. During this period of negotiation, HKSF opposed Alibaba's proposed partnership structure and both parties could not come to a consensus⁶⁰. Reportedly, HKEx submitted a consultation draft to HKSF regarding changes in listing rules. HKSF has since sent back the paper with a series of adjustments⁶¹.

In late September 2013, HKEx rejected Alibaba's IPO. However, the following month, HKEx's listing committee kick-started a discussion about the types of shareholding structure that the exchange should offer.⁶² They decided that a public poll may be required in the near future to decide on the appropriate direction on the matter⁶³ and on any issues that require public input. The relevant authorities have repeatedly emphasised that their debates regarding share structures were not a result of the Alibaba IPO incident but a response to the ever-changing economic climate in H.K.⁶⁴.

Yet at the same time, Li said that the "Alibaba's proposal has propelled the management to review" their existing operating model, and that "the eventual loss may be even larger" if they do not "undergo reforms"⁶⁵.

A Mix Up of Motivations

Being the regulator and front line enforcer of stock exchange listing rules, the regulatory arm of HKEx has to ensure companies abide by their listing rules. These powers and responsibilities extend to taking action against companies that flout any rules or regulations so as to maintain the financial integrity of the country's financial system⁶⁶, and to make sure that the listing directives and procedures are duly followed.

On the other hand, the business promotion arm of HKEx is charged with the task of attracting more companies to list on their exchange. HKEx has to identify profitable companies with growth potential and maximise the revenue generated through the stock exchange. Ultimately, HKEx is a business with bottom line considerations and has its own set of financial duties and obligations to deal with. It has to consider both the benefits of potential listings, and attract these profitable companies to list on the stock exchange, which in this case is Alibaba.

Should the listing of companies such as Alibaba⁶⁷ be construed as a violation of listing rules and a regulatory lapse or as a means of promoting their business⁶⁸?

A new pasture

With no further progress apropos any changes to the listing framework in H.K., Alibaba issued a statement on 16 March 2014 about its decision to embark on a U.S. listing⁶⁹. They returned to the drawing board and were expected to file an IPO with either NYSE or NASDAQ within the next few days.

Epilogue

Following the announcement of Alibaba's intention to list on a U.S. stock exchange, NYSE and NASDAQ stepped up their wooing efforts, in a bid to attract the largest tech listing⁷⁰. Finally, NYSE emerged the winner, and Alibaba launched its IPO on 21 September 2014. The listing held the record of biggest IPO, and raised a total of US\$25 billion. On its first trading day, the stock soared more than 35% over its IPO price of US\$68⁷¹ to close at US\$93.89⁷², and fell just slightly below US\$90 on the second trading day⁷³. On the other hand, after the consultation drafts exchanged between HKSF and HKEx, the HKEx decided to further the discussion on listing rules changes. After a comprehensive round of public consultation, it appears that the Exchange would allow for weighted voting rights structures, with more details to be released in the third or fourth quarter of 2015⁷⁴. However, on 25 June, the HKSF said that it opposes the plan to offer dual-class shares⁷⁵. This probably killed the proposal.

Discussion questions

1. Briefly discuss dual class shares and how such a structure is similar to or differs from Alibaba's 28-man partnership system. Does Alibaba's partnership system increase stakeholder value?
2. Why might the major shareholders, Yahoo! and Softbank, be willing to approve the 28-man partnership structure?
3. Are there some companies that are more suited for a dual class share structure and other companies that are less suited for it? List some examples of companies that have run into trouble as a result of such models and some examples of companies that have been highly successful at implementing dual class shares.
4. Did HKEx do the right thing in rejecting Alibaba? Do you think it is advisable for HKEx to re-look at revising its rules on dual class share structures?
5. Singapore is amending its Companies Act to allow public companies to issue dual class shares. This may open the door for companies with dual class shares to list on the SGX. Discuss whether it is advisable to permit the listing of dual class share companies in Singapore. If so, what safeguards, if any, would you propose?

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BOSHIWA INTERNATIONAL HOLDING: THE STUFFED FROG

Case overview

In March 2012, Hong Kong-listed Harry Potter licensee, Boshiwa International Holding Limited (Boshiwa), saw its share price plunge after its auditors resigned. The auditors, Deloitte Touche Tohmatsu (Deloitte), had concerns about matters pervasive to financial statements, including the commercial substance of transactions with certain suppliers. This led to the suspension of the trading of Boshiwa's shares on the Stock Exchange of Hong Kong (SEHK). In response to the resumption conditions imposed by SEHK, Boshiwa appointed PricewaterhouseCoopers Consulting Hong Kong Limited (PwC) to investigate issues raised in Deloitte's resignation letter, which brought to light several mismanagement issues. The objective of this case is to allow discussion of issues such as board composition; the role of auditors; and corporate governance challenges of foreign listings.

This is the abridged version of a case prepared by Chee Xinhui Celine, Daryl Emmanuelle Ong Sze Hann, Hoang Thu Thuy, Ryan K Heng and Wan Yi under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Thng Wan Ying under the supervision of Professor Mak Yuen Teen.

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The birth of Boshiwa: Road to IPO

When Harry Potter mania gripped consumer markets, one company had the foresight to secure the license for the brand, adding to its existing licensing portfolio of popular football brands Manchester United and Barcelona¹. That company was Boshiwa, a leading fast-growing developer and retailer of branded children's products in China. Boshiwa was incorporated as Shanghai Boshiwa in 1997, with its head office situated in Shanghai, China, despite its principal place of business being in Hong Kong². Boshiwa started off primarily providing original equipment manufacturer (OEM) production and processing services for children's apparel and accessories. It subsequently overhauled its business model and began developing its own brands with the goal of creating a well-known national children's apparel and accessories brand with significant market share in China³. Key aspects of this process include the development of retail networks across cities in China, distribution agreements with authorised third-party retailers, and self-managed retail outlets.

In 2005, Boshiwa registered its own brand, Dr. Frog, in Hong Kong and Japan, and expanded its operations from promoting self-owned brands to carrying licensed brands such as Harry Potter, Bob the Builder, and Manchester United⁴.

Boshiwa's OEM business remained until 2008, when it divested all its manufacturing facilities as part of restructuring efforts. As a result, the production of children's apparel and accessories under Boshiwa's self-owned and licensed brands was outsourced⁵. Boshiwa also began procuring other children products from domestic and overseas suppliers to supplement its inventory.

On 24 March 2009, Boshiwa, in its current incarnation, was incorporated in the Cayman Islands to act as the ultimate holding company of the subsidiaries in the group⁶. Over the years, Boshiwa gained great success, with its brand being recognised as one of the "Top 10 Brands in Children's Apparels" in 2007 and 2010⁷.

On 29 September 2010, Boshiwa successfully raised HK\$2.49 billion by selling 500 million shares at HK\$4.98 each in an initial public offering (IPO) on SEHK. The IPO was jointly underwritten by UBS AG, Credit Suisse Group AG, BOCOM International and Deutsche Bank AG⁸ and was a success, with HK\$120 billion in subscription applications coming from 80,000 retail investors⁹.

The Boshiwa Board

As at 15 March 2012, the Board comprised of eight members, of which there were four executive directors, one non-executive director and three independent non-executive directors¹⁰. The Chairman, Zhong Zheng Yong, who was also the chief executive officer (CEO), sat on the nominating committee as chairman and on the remuneration committee as a member.

Boshiwa extended the position of honorary chairman to one of the executive directors, Chen Pei Qi, “for better corporate administration and business operation” as he was one of Boshiwa’s controlling shareholders¹¹. Ted Tak-Tai Lee, the then audit committee chairman, resigned on 15 April 2012 and was replaced by another independent non-executive director, Chong Cha Hwa, 20 days later¹². In July 2013, executive director Wu Ge resigned due to ill health¹³.

Owners and ex-owners

As at 15 March 2012, Boshiwa’s ownership resided largely in four companies and public investors, among which Joyork International and TB International owned 29.03% and 26.99% of issued share capital respectively, making them the controlling shareholders of the company¹⁴.

However, before this current structure was established on 8 September 2010, there were substantial changes, including the transfer of equity interests among different related parties as well as major acquisitions and founding of new companies. This process can be summarised into three main stages¹⁵.

1997 - January 2008:	Shanghai Boshiwa was founded, and its equity interests were transferred among a few companies.
January 2008 - July 2008:	Great Dragon (wholly-owned by Chen Pei Qi) gradually took over Shanghai Boshiwa and became its sole shareholder, following which it transferred all its shares in Shanghai Boshiwa to Pacific Leader.

March 2009 - September 2010: Boshiwa was founded and through many levels of ownership (including Pacific Leader) acquired Shanghai Boshiwa as one of its wholly owned subsidiaries in addition to Boshiwa Enterprise and Rongchen Consulting.

Chen Pei Qi’s unique situation within the shareholding structure was also noteworthy. He owned a majority of Jovork International, and TB International supported him financially in a prior acquisition. In addition, his “long term friend” who wholly owned Fame Trend Investment Limited, held 6.06% of Boshiwa’s shares¹⁶.

Frog leaps towards IPO

In 2010, Boshiwa’s diversified sales channels developed rapidly. The total number of retail outlets increased from 890 to 1,555, an increase of 74.7%. Revenue increased by 123.5% to RMB 1,409.2 million, while profit before tax more than doubled to RMB 367.8 million¹⁷, an increase of 115.4%.

Slippery roads ahead

Boshiwa continued with its plan of aggressive expansion post-IPO. The number of retail outlets increased from 1,555 stores as at 31 December 2010 to 1,724 stores as at 30 June 2011¹⁸, an increase of 10.9%. According to Deutsche Bank, it was expected that Boshiwa would add 428 stores in total in 2011, bringing the total number of stores to 1,983 at year-end¹⁹.

For the six months ended 30 June 2011, revenue increased by 47.4% to RMB 876.7 million and profits increased by 11.9% to RMB 130 million²⁰ over the corresponding period last year. However, net cash flow from operating activities was negative RMB 923.6 million for the six months ended 30 June 2011, compared to a cash surplus of RMB 18 million in the same period in 2010²¹, as the value of inventories increased to RMB 711.5 million. Receivables also ballooned by 40% to RMB 676 million. Boshiwa attributed these to the rapid and continuous expansion of stores. Yet, the inventory turnover period increased to 201 days for the six months ended 30 June 2011 from 117 days for the year ended 31 December 2010 even as the firm launched more promotions²².

The tipping point

“It’s another example of questionable corporate governance because we don’t know exactly why their auditor resigned. The trouble is once you have one of these cases where auditors resign, bad news comes out afterwards.” - Andrew Sullivan, principal sales trader at Piper Jaffray Asia Securities Limited in Hong Kong, 15 March 2012²³

On 15 March 2012, concerns over a falling share price were compounded as Boshiwa was subjected to intense scrutiny after its auditor, Deloitte, tendered its resignation with immediate effect²⁴. Boshiwa also announced a delay in release of its FY2011 earnings owing to the need for a new auditor and the formation of a special investigation committee to look at issues raised by Deloitte. This delay constituted non-compliance with Rules 13.46 and 13.49 of the Hong Kong Listing Rules²⁵ relating to the announcement of the Annual Results and the despatch of the Annual Report.

Following these announcements, Boshiwa’s share price dived from HK\$2.58 to HK\$1.50 (41.9%) within a single morning²⁶, ultimately closing at HK\$1.68²⁷ before trading of Boshiwa’s shares was suspended in the afternoon²⁸. Boshiwa’s market value shrunk from HK\$15 billion²⁹ on IPO day to HK\$3.5 billion³⁰ on the announcement of a potential breach of listing rules.

Deloitte’s resignation letter

Controversially, as Rule 13.51(4) of the Hong Kong Listing Rules only required the announcement of an auditor resignation be done as soon as possible³¹, Boshiwa was seen to have complied with the rules despite only publishing part of Deloitte’s resignation letter within two days of the resignation.

Corporate governance activist David Webb criticised this seemingly common practice among Hong Kong-listed firms of publicising only part of the auditor’s resignation letter. In contrast, according to Webb, United States-listed firms would usually publish the entire auditors’ resignation letter. He asserted that “it would be better to change the listing rules to require Hong Kong-listed companies to publish the full letter when the auditor resigns,” as “auditors are supposed to be independent of company management, and their reasons for resignation should be fully given to shareholders and not be filtered by management.”³²

The published portion of Deloitte’s resignation letter revealed “concerns about matters pervasive to the financial statements”³³. These included the existence and commercial substance of recorded prepayments of RMB 392 million to one of Boshiwa’s suppliers; the existence of specified OK card distributors, merchandise distributors and trade suppliers of Boshiwa; as well as the commercial substance of recorded transactions with these entities³⁴. Deloitte also claimed to be unable to complete the audit as certain information requested was outstanding and explanations provided by Boshiwa were unsatisfactory³⁵.

The pressure is on

To deal with the situation, on 5 April 2012, Boshiwa established an internal Special Investigation Committee (SIC) consisting of all three independent non-executive directors, to investigate the matters raised in Deloitte’s resignation letter and make recommendations to the Board on appropriate actions to be taken³⁶.

On 31 October 2012, SEHK issued a letter stating five stock trading resumption conditions for Boshiwa³⁷, which included the following:

1. Conduct an independent forensic investigation on the matters raised in Deloitte’s resignation letter
2. Inform the market of all information about the matters necessary for it to appraise the Group’s position, including their implications to the Group’s assets, financial and operational position
3. Demonstrate that there is no reasonable regulatory concern about management integrity which will pose a risk to investors and damage market confidence
4. Publish all outstanding financial results and reports, and address any concerns raised by the Company’s auditors in their report
5. Demonstrate that the Company has put in place adequate financial reporting procedures and internal control systems to meet the obligations under the Listing Rules

Boshiwa's SIC subsequently announced on 8 November 2012 that PwC had been appointed as an independent professional adviser to carry out the forensic investigation and would compile an investigation report for the SIC's consideration, in order to enhance transparency of information to shareholders and investors³⁸.

Sifting through the mist

PwC's investigation report was released on 26 April 2013³⁹, with its main focus on the existence of Boshiwa's business counterparties and the nature of their relevant dealings. The report highlighted that requests to perform site visits on three counterparties and to interview their representatives were rejected by those parties. In addition, a large number of original records relevant to the investigation were unavailable, with only copies of those documents available for review.

With regard to the OK card and merchandise distributors, PwC, accompanied by Boshiwa's management, visited a majority of the counterparties at their operating addresses and noted that these entities appeared to be operating. However, in PwC's independently arranged visits during office hours on two different working days, it noticed that the operating address of one of the merchandise distributors (Shanghai Rongbai Trade Co., Limited.) appeared to not be in operation. Certain key written documents in relation to transactions between Boshiwa and the OK card distributors were also not kept. In clarifying the transaction details, Boshiwa's management advised that the increase in sales to specific regional distributors was due to the planned set up of a large number of new stores by these regional distributors in late 2011. However, management was unable to provide details such as the contact number and location of these new stores to be set up. Relevant transfer agreements also stipulated the sale of fixed assets, such as decorations in the stores, to the regional distributors. However, the said agreements did not provide details such as the list of assets or value of fixed assets to be sold. Boshiwa's management advised that the sale of fixed assets did not actually take place and could not explain how the staff and contracts of these stores were transferred to the distributors.

PwC's report also revealed that the supplier relating to the prepayment of RMB 392 million⁴⁰ was Shanghai Ronghua Textile Dyeing Garments Co., Limited (Ronghua). Of the total prepayments of RMB 1,155 million made by Boshiwa to Ronghua Textile during 2011, Boshiwa's management was unable to provide any documents such as procurement contracts to substantiate about RMB 32 million of such payments. They advised that due to such overpayment, Ronghua Textile refunded RMB 45.6 million to Boshiwa in December 2011, yet there remained an unexplained outstanding discrepancy of about RMB 13.6 million. In addition, a number of contracts signed with Ronghua had issues such as cancellation, extended delivery period, and duplicated contract numbers. Boshiwa's management advised that Boshiwa did not keep a record on contract numbering until late 2012 and the contracts using duplicated contract number were results of clerical mistakes, and contracts deemed to be mistakes were subsequently cancelled. The report noted that over 90% of Ronghua Textile, as well as other counterparties such as Shanghai Rongchen Knitting Co., Limited and Rongbai Trade, did business with Boshiwa in 2011.

PwC also highlighted that three of the investigated counterparties were former subsidiaries of Boshiwa and were controlled by individuals who were former Boshiwa employees and that there were documents which suggested that there were interactions between Boshiwa and these entities outside of the normal course of trading business. Boshiwa's legal department helped two of these entities prepare documents regarding the change of their shareholders. Boshiwa's management explained that they helped to prepare such documents because of the long-term personal relationships between the management and the owners of these entities. It was also questioned why certain shareholders and employees of these entities appeared to be included in Boshiwa's 2009 and 2010 payroll records. The custodian of the documents claimed that she had no idea why these documents were found in her computers. However, in a second interview, she admitted that she did not tell PwC the truth in the first interview and that these documents were related to an arrangement in 2008. Under this arrangement, Boshiwa agreed to provide RMB 2 million of financial support to the management of disposed subsidiaries in order to mitigate the social impact of the disposal of these subsidiaries in preparation for Boshiwa's IPO.

A streak of bad luck

In response to the fifth resumption condition by SEHK, Boshiwa announced on 15 March 2013 that it had engaged PricewaterhouseCoopers Consultants (Shenzhen) Limited's Shanghai Branch (PwC Shanghai) "as an independent professional adviser to perform an independent review over specific areas of the financial reporting procedures and internal controls"⁴¹. In addition, on 12 March 2014, Boshiwa appointed Optimal Capital Limited as the company's financial advisor with respect to the suspension and resumption of trading⁴².

However, the publication of financial statements had been delayed since Deloitte's resignation. As of 31 March 2014, there was still no release of financial reports due to the non-completion of audit work for the annual results for the year ended 31 December 2013 and the outstanding financial results and reports⁴³. During the interim period, Boshiwa's auditor, Zenith CPA Limited (Zenith), resigned and Crowe Horwath (HK) CPA Limited was appointed as a replacement auditor. Reasons cited for Zenith's resignation included the explanation that due to Boshiwa's special circumstances, the standard of the audit work "needed to be performed [were] comparatively higher and more extensive than a normal audit process"⁴⁴.

Boshiwa issued profit warnings following the preliminary assessments of its unaudited management accounts on 28 December 2012 and 5 November 2013, forecasting declines of after-tax profits with the following stated reasons⁴⁵:

1. Underperforming economic environment in China
2. Decrease in operating revenue
3. Administrative expenses and operating costs remained high

Happily ever after remains a dream

"Few recover once the auditor resigns. Boshiwa's stock plunged 42% before trading was suspended. I will be surprised if it ever trades again."
- Dr. Paul Gillis, Professor of Practice at Peking University's Guanghua School of Management⁴⁶

Alarmingly, Boshiwa's case seemed to be indicative of a trend in which profit warnings, auditor disputes and de-listings involving Chinese companies trading on foreign exchanges not only led to investor distrust, but also wiped out valuations and poisoned the market for new listings. "Investors have been concerned: Are these companies accurately portraying themselves?" said Kevin Pollack, a fund manager at Paragon Capital LP in New York, who invests in U.S. listed Chinese stocks⁴⁷. In 2012 alone, at least six disputes have broken out between auditors, investors and Chinese companies listed in Hong Kong.

More than a quarter of the 56 Chinese firms that raised a combined HK\$32 billion in Hong Kong in 2010, including cellulose producer Sateri Holdings Limited and manganese-mining company Citic Dameng Holdings Limited, have lowered forecasts, saying they expected "significant" or "substantial" declines in revenue⁴⁸. This compared with less than 10% of non-Chinese companies that had IPOs there that year. As of 2012, the 180 Chinese firms that went public in New York, Hong Kong and on other global exchanges since the start of 2010 were trading on average 21% below their offer prices. In contrast, the MSCI World Index (MXWO) has gained 10% in the same period, with the 407 initial public offerings in the U.S. since the beginning of that year have advanced on average 4.4%⁴⁹.

Needless to say, this would be a worrying trend as China was poised to become one of the world's key and largest economies in the coming years.

Epilogue

After the release of the investigation report by PwC, trading in Boshiwa shares on SEHK remained suspended and results announcements were further delayed. The non-executive directors and joint company secretary also resigned. All of these continued until a winding-up petition was filed in January 2015⁵⁰. The Grand Court of Cayman Islands appointed the provisional liquidators on 11 February 2015 and ordered the winding-up petition be set down for trial at the first available date starting from 18 September 2015.

Discussion questions

1. Comment on Boshiwa's board composition, giving consideration to relevant corporate governance codes and rules. Does Boshiwa's board composition correspond to your idea of an "ideal" board composition? If not, how can its board composition be improved on?
2. Consider Boshiwa's shareholding structure, relationship between Boshiwa and its shareholding companies as well as your earlier comments on Boshiwa's board composition. What complications might possibly arise from such a corporate structure?
3. What is the role of external auditors in the corporate governance of companies? What are the red flags raised by auditor resignations? Did the auditors act appropriately in the Boshiwa's case?
4. What is the role of the board, management and external auditors with respect to internal controls over financial reporting and the preparation of financial statements?
5. Comment on the regulator's actions with regards to the Boshiwa's accounting scandal. Was it appropriate?
6. What concerns do investors and regulators face with regard to foreign listings?
7. Comment on the trend of overseas-listed Chinese firms such as Boshiwa tending to under-perform after their IPO. Discuss the possible factors that may have contributed to such a trend.

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COMMONWEALTH BANK OF AUSTRALIA: ROGUE ONE

Case overview

Commonwealth Financial Planning Limited (CFPL), the financial planning arm of Commonwealth Bank of Australia (CBA), was involved in a huge fraud scheme from 2003 to 2012. Rogue financial planners at CFPL manipulated their clients' files and forged documents to invest their clients' monies in extremely high-risk investments, with the aim of earning higher commissions and bonuses. Such fraudulent financial advice caused hundreds of Australians to lose their life savings, some running into millions. Despite tipoffs by whistleblowers within CFPL, the Australian Securities and Investments Commission (ASIC) was criticised for being inexplicably slow and inadequate in its response. Meanwhile, CFPL's efforts to compensate the victims were also lambasted as covering up for their rogue planners while trying to bully their victims into settling for minimal compensation. The objective of this case is to allow a discussion of issues such as the impact of "pay for performance" on behaviour; governance in company groups; management's and directors' roles in ensuring compliance; role of regulators and the media in corporate governance; whistleblower protection; and ethics.

This is the abridged version of a case prepared by Tan Joel, Wee Wei Liang, Aaron Koh and Chua Han Lin under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Toh Jia Yun under the supervision of Professor Mak Yuen Teen.

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Dark undercurrents

Commonwealth Bank of Australia (CBA) is the largest of the big four Australian banks, holding 29% of all household deposits in Australia¹. Commonwealth Financial Planning Limited (CFPL) is a subsidiary that falls under the wealth management division of CBA, and was helmed by the Head of Wealth Management, Grahame Petersen, from 2006 to 2011². In February 2008, as part of a surveillance program by the regulatory body, the Australian Securities and Investment Commission (ASIC), a warning notice was sent to CFPL, indicating that 38 of its planners had been classified as a “critical risk” for non-compliance with appropriate financial planning advice protocols³. That was when Jeff Morris, a newly hired financial planner at the Chatswood, New South Wales branch, sensed something amiss in the bank.

The legend of dodgy Don

One of the 38 names highlighted in the warning notice, Donald (Don) Nguyen, was hauntingly familiar to Morris. Don was a fellow financial planner who sat just a couple of feet away from Morris at the Chatswood Branch. He was one of the top writers of CFPL, amassing 1,300 clients⁴ who had invested their money with him. In 2007, Don was top on CFPL's Financial Planners league table, managing portfolios worth A\$39,064,657 for the bank that year alone, grossly exceeding his annual target by more than three-fold⁵.

But Don's ascent to the peak was a tad dubious. Better known by his colleagues as “Dodgy Don”⁶, he had a sinister reputation of notching sales through unscrupulous means. After personally witnessing some of Don's dishonest acts, an outraged Morris alerted his team's Financial Planning Manager⁷. To his disbelief, the manager brushed the issue aside. Morris' colleagues later explained that Don held the aegis of management protection due to his status as a top writer in CBA⁸.

You get what you pay for

More than half of a CBA financial planner's total annual remuneration depended on short-term incentives such as bonuses. Commissions were pegged to the risk levels of investment assets sold, hence financial planners had an incentive to encourage their clients to opt for as risky an investment portfolio as possible⁹. Furthermore, the tone at the top was unforgiving - meet your sales targets, or surrender your rice bowl¹⁰. Such was the “boiler-room” culture CBA had nurtured through an aggressive sales-driven and excessively short-term remuneration incentive scheme - one driven by a myopic chase of bonuses with little place for honesty.

First-class cover up

Clients soon started to see the value of their investment portfolios plunge to almost nothing within a short span of months, and started inundating the bank with complaints. Against the backdrop of a global financial meltdown, it made no financial sense for the clients, especially the retirees, to opt for such aggressive and risky investment portfolios. Sensing something amiss, Morris took the matter to middle management, but once again, the response he got was one of nonchalance and evasiveness¹¹.

However, growing public pressure forced CBA into a formal investigation, and it was discovered that Don had secretly manipulated the risk profiles of his clients into adopting hyper-aggressive investment portfolios for his own benefit of drawing higher commissions¹². In particular, an extraordinary number of clients' files “requested” a 50% portfolio allocation to Listed Property Trusts¹³, an extremely risky investment asset. Don had deceived and manipulated his clients into thinking their monies were lost because of misfortune. In September 2008, Don was suspended for fraud and compliance failures.

Meanwhile, complaints from clients of other planners in CFPL, most notably Christopher Baker¹⁴ and Rick Gillespie¹⁵, continued to flood in. To make matters worse, many of Don's frustrated clients who were left without a planner constantly barraged the bank for explanations. CFPL needed someone to douse the flames - someone who could discourage the clients from pursuing their complaints. Incredulously, on 15 October 2008, not only was Don reinstated, he was also promoted to the position of a Senior Financial Planner¹⁶.

Morris soon came to the realisation that an internal resolution to the matter would never succeed as the management themselves were covering up for the planners' fraudulent acts. Yet Morris wanted to keep his cover as he lacked faith in the regulator's whistleblower protection policies, and required more time to continue gathering evidence against Don's wrongdoing. On 30 October 2008, together with two other long-serving colleagues, Morris finally spilled the beans on Don. Under the alias of "The Three Ferrets"¹⁷, they faxed a report to ASIC, voicing the need for urgent action.

However, months passed and there was no sign of ASIC taking decisive action to obtain evidence from CFPL, despite the whistleblowers' tip-off that the clients' files were already being sanitised. Instead, ASIC opted for discussions with CFPL in December 2008, which resulted in the joint solution to "closely supervise" Don and subject his advice to "vetting before approval"¹⁸. Exasperated, "The Three Ferrets" then decided to take the issue to Darin Tyson-Chan, a journalist of the trade journal *Investor Daily* in May 2009¹⁹.

Breaking Don

A series of articles spelling out details of Don's fraudulent acts was published by *Investor Daily* from May to June 2009. It was brought to light that CBA knew of "at least 14 cases of forgery as early as October 2008"²⁰, yet did nothing to remedy the problem. CBA attributed the fraud to "a few bad apples", rather than the lack of compliance within the bank, or any conflicts of interest in their financial planning arm. In fact, to prevent certain documents from being accessed in the likely event of a client lawsuit, senior management arranged for these documents to be processed by the legal department so that these would be given protection of legal privilege²¹. CBA also allowed some of the fraudulent financial planners to resign and move on to other companies instead of giving them the boot²², so as to avoid "bad press".

The whistleblowers also sent an anonymous email to CBA Group Security and CBA's Senior Management²³, alleging CFPL management's attempts to cover up for its rogue planners. This time, it succeeded in triggering a massive knee-jerk response within the bank. CBA Group Security launched a thorough investigation within CFPL, where it was found that an alarming number of Don's client files were missing.

On 3 July 2009, Don resigned citing ill health, which allowed him to draw a lifetime A\$70,000 payout per annum under CBA's group insurance policy²⁴. To make matters worse, the annual bonuses of Chief Risk Officer, Alden Toevs, and Head of Wealth Management Division, Grahame Petersen, increased by approximately A\$4.5 million and A\$2.1 million respectively from 2008 to 2010²⁵. All these came amidst dismal media stories of terminally ill victims who had lost their life savings due to the rogue planners, and were struggling to seek any reasonable form of compensation from CBA.

At the same time, Morris felt immense pressure from the top management, which resolved to identify the source of leaks to the media. With their covers blown and yet no action by ASIC in sight, The Three Ferrets were left defenceless.

On 24 February 2010, 16 months after the first anonymous fax Morris had sent to ASIC, the whistleblowers finally stormed through the doors of the ASIC office, demanding that client files be seized and decisive action be taken. "They told me I had Whistleblower Protection from that day. He then went on to say, basically, that it wouldn't be worth much," recalled Morris of his conversation with one of the frontline officers in ASIC²⁶. Ironically, Australia had just revised her Corporations Act in 2004 to provide stronger protection for whistleblowers. However, Morris was not surprised by this - it was a common view in the finance industry that ASIC was not the most trustworthy of regulators²⁷.

Divide and conquer

On 24 March 2010, ASIC issued an order to CFPL, giving them two weeks to hand over client files undergoing investigation, marking the first sign of confrontation between ASIC and CFPL. CBA was also pressured to devise a compensation scheme to pacify the affected clients. In November 2010, CBA finally proposed a voluntary compensation scheme for the victims. The strategy, however, was to divide and conquer - each victim was isolated so they would have limited knowledge of the greater scheme of things²⁸, allowing CBA to incur minimal expenses in the compensation²⁹.

Janice Lee Braund and her husband Alan were two of Don's most famous victims. In 2002, the couple entrusted A\$1 million of their retirement savings to Don, on hearing of his reputation as the "star planner" of CBA. Yet Don only had his eyes fixed on maximising his commissions. Ignoring the couple's clear instructions of preserving capital, Don forged Braund's signature to transfer their capital to high-risk products that were eventually wiped out when the financial crisis struck in 2009.

Under the compensation scheme, Braund was initially offered A\$200,000. With good fortune, she had a note that indicated that "the Braunds had a conservative profile and they were extremely concerned and did not wish to use any of their capital in retirement."³⁰ Using this note as a bargaining chip for negotiation, her compensation quantum was raised to A\$215,000 and subsequently A\$880,000³¹. Unfortunately, not all victims had such great bargaining power; most received a less than satisfactory amount of compensation.

Fair facts through Fairfax

ASIC's investigation confirmed the frauds of Don and other financial planners in CFPL. On 26 October 2011, CBA entered into an Enforceable Undertaking (EU) with ASIC for two years. The EU was targeted at reviewing CBA's risk management systems, its internal risk profiling, and the monitoring of its financial planners. During this time, three other financial planners were required to "remove themselves from the industry"³².

At the same time, Braund's patience was running out with the inadequate responses to her complaints at CBA and ASIC. Despite Braund being granted interviews with ASIC to tell her story, she was adamant that not enough was being done to appease the anger and anguish of the victims. Her repeated complaints to CBA and ASIC had generally fallen on deaf ears, and she was disgusted at CBA's ostensible attempts to cover up. She finally decided to take her story to Fairfax Media³³. The Fairfax reports triggered a Senate Inquiry the following month, on 20 June 2013, centering on two key issues - the misconduct of financial advisers in CFPL and ASIC's general poor performance.

The final report of the Senate Inquiry was released on 26 June 2014. It contained scathing criticisms of both ASIC and CFPL. "There was forgery and dishonest concealment of material facts," as reported in the inquiry³⁴. Committee chairman Senator Mark Bishop said CFPL's actions were "facilitated by a reckless, sales-based culture and a negligent management, who ignored or disregarded non-compliance and unlawful activity as long as profits were being made³⁵". He also commented that "ASIC appears to miss or ignore clear and persistent early warning signs of corporate wrongdoing, or troubling trends that place the interest of consumers or investors at great risk"³⁶. Among a whole host of findings with regard to ASIC and CFPL, one was to demand for a royal commission into the saga, though it was eventually rejected.

Emerging from his shell

The negative publicity from the Senate Report that slammed CBA's financial planning arm created ripples around Australia. Seven days later, on 3 July 2014, Ian Narev, CEO of CBA, who had made an effort to stay inconspicuous, was forced to issue a public apology for the first time and propose a new compensation scheme for the victims³⁷. The compensation scheme, titled the Open Advice Review Program, which became operational in mid-August 2014, offered an assessment of any received financial advice³⁸. After the assessment, a compensation offer would be made by an "independent customer advocate" funded by CBA. If victims still felt that compensation offers were inadequate, they would be able to appeal to an independent panel, chaired by former High Court judge Ian Callinan, whose decision would then be binding³⁹.

Yet, questions had been asked about whether the review process was truly independent⁴⁰, as the first stage of this process was still conducted by CBA. Morris even went so far as to dismiss CBA's new scheme as "first-class window-dressing", and disagreed with the 'pull' nature of the review process. "The problem with the process is [that] customers have to complain," Morris said, adding, "I suspect very few will"⁴¹.

Business as usual

Paradoxically, the share price of CBA did not experience any sustained adverse impact during the saga. The only period during which the share price saw a substantial drop was from 20 May 2013 to 10 June 2013, when the price dipped 11.5% from A\$73.49 to A\$65.02⁴². Since then, the stock has grown from strength to strength to close at A\$80.48 as of 31 October 2014. An analyst report by Richard Wiles of Morgan Stanley even showed calculations of both the financial impact of compensation and the potential impact on revenues due to reputational damages⁴³ with an eventual price target of A\$87.20.

One step back, two steps forward

The reputational damage borne by CBA was coupled with uncertain financial repercussions. Customer satisfaction ratings of CBA have suffered a drastic drop. Under Roy Morgan's "most-favoured institution" satisfaction assessment, CBA slipped from first place at the start of 2014 to third place in September 2014. This would cause management to lose one quarter of their long-term bonuses⁴⁴. The introduction of CBA's new compensation scheme also led to new claims surfacing daily. At present, A\$52 million in compensation has already being paid out, with up to A\$250 million possibly required⁴⁵ eventually.

In light of the CFPL scandal, questions have been asked about the integrity of the financial planning sector, with a lack of customer protection being a major concern. The Australian government has quickly responded by putting new measures into place, including a proposal to establish an enhanced, industry-wide public register of financial advisers to increase transparency in the industry. Additionally, in September 2014, a Corporations Amendment Regulation with regard to the Statements of Advice was made to increase clients' accessibility to information and to minimise possible conflicts of interest.

ASIC has also responded quickly to the criticisms of its role in the Senate Report, establishing an Office of Whistleblower to allow quicker response to whistleblowers and commencing an organisation-wide improvement process of its communications and transparency⁴⁶.

Discussion questions

1. Describe the actions taken and behaviour displayed by senior management throughout this saga. Discuss if these actions and behaviour were inappropriate and whether they aggravated the situation. If you were in the position of Ian Narev, the CEO, what would you have done differently during the crisis?
2. *"Show me a company's various compensation plans, and I'll show you how its employees behave"* - Jack Welch, Former CEO of General Electric

Examine the key areas of concern in CBA's remuneration plan. To what extent do you think these influenced the corporate culture and employee behaviour in CBA? What changes, if any, would you make to the remuneration plan?

3. In the Senate Inquiry Final Report, ASIC was described as *"waiting for complaints, investigating a minute proportion of them, and prosecuting even fewer."* Critically evaluate the actions taken by ASIC throughout the course of the financial planning scandal, while highlighting difficulties ASIC might have faced during its investigations.
4. The media played an important role in exposing the fraud in CFPL. Discuss the role of the media in promoting good governance in your country. Are there factors which limit its effectiveness?
5. Briefly discuss the importance of a good whistleblower protection policy. Do you think the policy sufficiently protected Morris and his fellow whistleblowers? What further improvements can be made to encourage those who are aware of wrongdoings in an organisation to come forward, instead of remaining silent?
6. CBA had an excellent reputation amongst its customers but CFPL severely damaged it. What are the challenges faced by an organisation like CBA in promoting ethical behaviour, compliance and good governance throughout the group?

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LEIGHTON HOLDINGS: BUILDING BRIBERY

Case overview

Allegations relating to a culture of corruption, bribery and cover-ups involving the world's 12th largest contractor by revenue, Leighton Holdings (Leighton), shook the Australian corporate landscape in October 2013¹. It was reported that company executives of the Australian construction empire had known of various kickbacks paid to secure projects, and that payoffs made to Leighton employees had happened as early as 2009. Early warning signs that executives may be involved in rampant corruption and mismanagement had been observed. Other internal company documents also revealed a corporate culture that accepted and rewarded corruption, leading to a scrutiny of excessive remuneration packages paid out to former senior executives. The Leighton saga placed regulatory bodies in the spotlight, as the media and politicians heavily criticised regulators' lack of prompt and thorough investigations, which allowed the incident to manifest. The objective of this case is to allow a discussion of issues such as corruption and bribery; the response of the board, management and regulators to bribery allegations; the role of tone at the top; remuneration and other corporate governance practices in reducing bribery and corruption risks; and corporate governance in company groups.

This is the abridged version of a case prepared by Dalton Sim Daoheng, Nicolette Rachel Mei Long, Then Co Mint and Zhao Binru Bryan under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Thng Wan Ying under the supervision of Professor Mak Yuen Teen.

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Leighton on the rooftops

Leighton is a project development and contracting group headquartered in St. Leonards, Australia. Leighton's principal subsidiaries comprises of Leighton Contractors Pty Ltd, Thiess Pty Ltd, Leighton Asia Limited, John Holland Pty Limited and Leighton International Limited (Leighton International) and operates in Australia, Asia, the Gulf region and Africa². Leighton provides engineering, building construction, facilities management and contract mining services.

The bricks of bribery laid

"I asked did Wal K approve this? And he said 'yes'." - Memo by David Stewart, then acting Chief Executive³

A series of articles by Fairfax Media in Australia that began on 3 October 2013 revealed the existence of a handwritten memo by the acting Chief Executive of Leighton, David Stewart, on 23 November 2010⁴. According to the memo, David Savage, former Managing Director of Leighton International, and Wal King, who was the Leighton CEO for 23 years, were aware of and approved an A\$42 million kickback paid to a Monaco-based company, Unaoil, which was "nominated by Iraqi officials who selected Leighton for a A\$750 million oil pipeline contract"⁵. The payments were called "project support" fees in the contract. The fees were to be reviewed by the Board of Leighton International, including King, who was also part of the Board. However, these fees had "mysteriously disappeared... when they were revised by top Leighton's staff one month later"⁶.

"He [Savage] said less than 50% of the payment." - David Stewart's memo on questioning the proposed payment and the real value of the work to extend the Iraqi contract⁷.

Court documents between Unaoil and Leighton also revealed the existence of Memorandum of Agreements in early 2011 between the two firms to guarantee a minimum payment of US\$55 million for "construction and marketing fees in the event that the Iraqi government awarded Leighton with a second pipeline contract" that was worth US\$500 million⁸. Of this US\$55 million, marketing-specific fees were specified to be "no less than US\$25 million", even though no actual marketing services were required⁹.

Stealing steel

A specific incident involving Gavin Hodge, senior project manager for the building of an Indonesian barge, revealed senior executives' mismanagement of the impropriety, which may have enabled the culture of corruption and cover-ups to take root all across Leighton.

In early 2009, a whistleblower informed the top executives that Hodge had allegedly diverted A\$500,000 of steel from Leighton to build a barge for an Indian company, Adani, in a black-market project¹⁰. A company legal report indicated that Russell Waugh, a Leighton executive who was also Savage's right-hand man, had approved of this transaction. Waugh later ordered internal investigations, which concluded that Hodge's actions "had no material benefit to Leighton" and put the company "in a position of potential compromise of integrity"¹¹. Despite these findings, Waugh merely gave Hodge a stern warning. A second inquiry by the company's accountants then failed to find further evidence of these illicit payments and the matter was put to rest. Despite this, Waugh rewarded Hodge in appreciation of his "efforts over the last year", giving him an A\$40,000 bonus and salary increments upon closure of the incident¹².

"If you go quietly, you'll be back in three months." - Phone conversation between Waugh and the whistleblower who shed light on the Hodge incident¹³

The persistence of the whistleblower eventually led to a launch of a third inquiry, this time independent of Waugh and carried out by a newly appointed Leighton executive. It was revealed that the investigations carried out previously were sorely inadequate. Reference was made to Waugh paying out a bonus to Hodge and also directing the investigations when he himself was in a potential conflict of interest, since Waugh himself signed off and approved the steel transaction¹⁴.

In response to criticisms, Leighton eventually dismissed Hodge and initiated legal proceedings against him to recover the money he allegedly stole. In Leighton's media release to shareholders in response to the allegations by Fairfax Media, it was mentioned that this incident also led Leighton to "strengthen and improve its corporate governance and risk management processes", such as the revision of its comprehensive Code of Business Conduct as well as a "5 gate tender review and approval process"¹⁵.

Building a stonehouse

"Savage and Leighton International had extraordinary autonomy compared to the rest of the operating companies ... One of our major concerns here was that there was very little corporate governance within Leighton International." – Leighton witness to the Australian Federal Police (AFP)¹⁶

A lack of corporate governance and excessive autonomy within Leighton International also created the opportunity for Savage and fellow executives to use confidential information to establish a private business venture. All these were carried out via the company's internal email system¹⁷, at a time when Leighton International was facing probes on corrupt practices.

A review of Savage's confidential emails revealed that he had covertly launched "Project T", which sought to lure Leighton senior officers to a private firm in order to compete directly against Leighton so as to win projects¹⁸. This was evident as Savage's new venture "emphasised resource projects and offshore shallow-water projects", which was very much similar to work he had been helping to win for Leighton¹⁹.

Towering remuneration packages

Amidst the corruption scandals and a time of heightened media attention, the excessive compensation packages of executives that came to light enraged the public further.

During King's tenure, he was criticised for receiving excessive executive pay, collecting at least A\$100 million in remuneration since 2004, including a A\$14.7 million compensation package in 2010, which was the year of his departure²⁰. Moreover, King's remuneration package was not strongly linked to shareholder returns and mainly in the form of cash rather than equity. His short-term incentive was also substantially above his counterparts at similar-sized companies – in a year that Leighton suffered a fall in profits²¹.

A closer scrutiny of Leighton's remuneration structure revealed its heavy emphasis on financial measures in its Key Performance Indicators (KPIs). More specifically, the company's profitability played a crucial role in determining the amount of remuneration. Executives' short-term incentives, such as cash bonuses, were directly linked to achievement and outperformance of profit targets, while medium-term deferred incentives hinged on profitability over a three-year period. Likewise, 50% of the long-term incentives were only achievable with substantial growth in earnings per share, which in turn depended on earnings and profitability²². In 2009, King's and Savage's short-term variable bonuses constituted 65.6% and 62.9% of their respective total remuneration²³. This was noticeably higher than all other executives. Moreover, in 2009, performance against financial KPIs was also significantly weaker compared to previous years. On average, key executives only obtained 58% of the maximum remuneration payable to all eligible employees²⁴.

The Board's grounds of defence

Throughout Fairfax Media's numerous allegations, the Board had maintained the directors had "at all times executed their duties with the appropriate care and diligence, and in the best interest of each company [within Leighton]"²⁵.

Yet, the signature of former Leighton senior executive David Savage appeared on a preliminary tender document that includes an alleged A\$42 million kickback to win a lucrative project in Iraq²⁶. In defence of the Board's approval of the Iraq Project in October 2010 despite the alleged A\$42 million bribe, a former director claimed that the bribe was deliberately disguised by Leighton's management as an "onshore and security payment" to avoid raising the suspicions of the Board. He also added that there were no discussions of potential "agency" payments of bribes. Instead, the A\$42 million payment was portrayed as necessary by the management due to security concerns in Iraq. The evidence suggests that the Board approved the project without further inquiry despite knowing that the deal was carried out in a corruption-prone country²⁷. It was also revealed that a six-month audit in early 2011 had prompted Board members to "examine bribery-prone practices with necessary details", but this appeared to have been responded to with inaction²⁸.

In a leaked Australian Federal Police (AFP) interview transcript, a former top executive said that he "never got the sense that the Board was excited by this stuff [due diligence, upholding corporate governance standards etc.]. The way Leighton International had been managed was an absolute disaster from a commercial perspective"²⁹.

Fire alarms kept silent from authorities and shareholders

Despite uncovering appalling evidence of serious misconduct and corruption, the media reported that Leighton had withheld the memos and files detailing corruption and failed to notify authorities. The company had waited a year before it called the Federal Police in 2011³⁰. It also took a further three months of delay till February 2012 to notify shareholders that an investigation was underway about the work in Iraq, and that the company had voluntarily notified the AFP of the alleged breach of its Code of Ethics³¹.

In response to these accusations, the Board has maintained that upon their knowledge of the matter, they had immediately reported it to the AFP. The reason that the market and shareholders were only notified in February 2012 was due to the confidential nature of the investigation³².

A Board facing constant shake-ups

In the midst of the alleged corrupt deals in 2010, Leighton's controlling shareholder, the Hochtief Group, faced a takeover bid by Spanish Group ACS³³, and the hostile takeover was eventually successful³⁴. The stage was set for a new wave of power struggles within Leighton, with Hochtief engaged in a takeover bid to increase its stake in Leighton from 58.8% to 74%³⁵.

With five out of 10 seats on Leighton's Board already controlled by either Hochtief or ACS, the threat of a potential overhaul arising from the takeover was very real³⁶. According to former Chief Financial Officer Scott Charlton, the Board's preoccupation with its internal struggles could have hurt governance and placed issues of potential corruption low on the agenda³⁷.

In addition, the Board had been facing a flurry of changes to its pool of directors. An examination of the composition of the Board indicates that the Chairman of the Audit Committee changed every year between 2009 and 2011³⁸. Further, in Financial Year 2011, David Stewart held the post of CEO for a mere nine months, and then left along with six other directors. Clearly, the Board had pressing changes to deal with³⁹.

In 2014, Hochtief ousted CEO Hamish Tyrwhitt and CFO Peter Gregg and replaced them with M Fernandez Verdes, CEO of Hochtief and former ACS executive, further cementing ACS' control over Leighton and its Board⁴⁰.

Regulatory bodies with weak foundations

“I would be surprised if the federal police or ASIC have the expertise or technical knowledge to undertake investigations of this nature.” - Former top executive Stephen Sasse, in an interview with Fairfax Media⁴¹

The AFP and the Australian corporate watchdog, the Australian Securities and Investments Commission (ASIC) were also in the spotlight, with numerous reports published by Fairfax Media alluding that the AFP and ASIC had been slow to conduct thorough investigations. It was highlighted that “almost two years have passed since the AFP agents were first called in and they have still not spoken to key witnesses and suspects”⁴². Similarly, ASIC had also been reported to not have had reached out “to even a single witness”⁴³.

The AFP was overwhelmed by the case, due to reasons such as a lack of experience, technical knowledge, funding and manpower, and their “lack of urgency” was said to “stem from resourcing issues”⁴⁴, as revealed by former Leighton officials during interactions with the federal police.

ASIC was also under fire for not proactively fulfilling its duties as the corporate watchdog. In a bid to defend themselves, Greg Medcraft, Chairman of ASIC, told Federal Parliament's economics legislation committee that the agency was working to improve the handling of foreign bribery cases⁴⁵. They also asserted that ASIC's enforcement record had always been “solid”⁴⁶. However, media reports referred to past instances of ASIC's tardiness in handling whistleblower information, including a poor handling of serious misconduct within Commonwealth Bank's financial planning division⁴⁷.

ASIC also defended that they had to wait until the Police referred the case to them, and that the Police faced constraints as well, since there were laws in place to prevent the Police from sharing information with ASIC⁴⁸. It was only until 2 April 2014 that ASIC confirmed its launch of a formal investigation allowing them to exercise the powers of the Star Chamber to question the witnesses and also demand for documents. Upon hearing this, the Australian Senate criticised ASIC for their delayed efforts of investigation, claiming that formal investigation came two years late from the time ASIC had first known about the allegations in November 2011⁴⁹. Consequently, questions have been raised if Leighton corruption could have been mitigated if ASIC had stepped up on its investigations earlier.

Upon pressure by the media and politicians, ASIC and AFP have since begun to find better ways of working together, starting with the signing of a memorandum of understanding⁵⁰ between both parties in October 2013. Furthermore, a proposal to the Senate has also been drafted to allow parallel inquiries to be conducted and there has also been a call for legislative reform to allow the AFP to share information with ASIC for such offences⁵¹.

Investors scramble for the emergency exit

Leighton's share price dipped when shareholders caught wind of its work in Iraq; this was the first piece of public information received by investor community regarding the possibility of a breach of ethics and law⁵².

The share price fell a further 10.4% in a day when the reports were published by Fairfax Media, wiping A\$688 million from its market capitalisation⁵³. Hochtief Group's share price fell 7.9%, its largest single-day share price loss in more than two years. The following day, Leighton's share price fell another 4.6%, resulting in a cumulative total loss in market capitalisation of almost A\$1 billion. Further, it was estimated that the legal and reputational damage resulting from this scandal could amount to as much as A\$562 million⁵⁴, as Leighton faces possible fines under the Commonwealth Criminal Code and losses of future contracts or cancellations of existing ones.

In an unusual turn of events, on 20 February 2014, Leighton declared profits for the year 2013, up 13% from the previous year. Investors reacted positively to this earnings announcement, with the share price going up by 6.5% – or by A\$1.07⁵⁵ – as Leighton was profitable even against the gloomy backdrop of a mining sector downturn. However, the share price of A\$17.48 was still slightly shy of the almost A\$20 pre-scandal share price. Leighton’s former CEO Hamish Tyrwhitt remarked that “to get investor confidence back Leighton really needs to resolve those [corruption] issues”⁵⁶.

Epilogue

In an attempt to distance themselves from the corruption allegations, the construction group’s new Spanish owners, ACS, decided to change Leighton’s name⁵⁷ to Construction, Infrastructure, Mining and Concessions (CIMIC). Even so, the stock price has only risen to around A\$20, still far from its former glory⁵⁸.

Discussion questions

1. Using Leighton and other similar scandals, discuss the importance of tone at the top and remuneration policy in contributing to, or preventing, corruption.
2. To what extent did the Board’s internal struggles contribute to its failure to detect that a bribe had been concealed in the proposal they approved? What would constitute “appropriate care and diligence” for directors in preventing bribery and corruption?
3. What more, if anything, could have been done from the time of detection of the bribery that could have potentially prevented what happened to Leighton?
4. It was said that “Leighton International had extraordinary autonomy compared to other operating companies” in the Leighton Holdings group. What are the key issues involved in the governance of subsidiaries within a company group? How can the corporate governance of company groups be improved?

5. The media and politicians have heavily criticised ASIC’s lack of speed and action in the handling of Leighton’s case. Is the enforceability of corporate governance limited by the regulatory environment?
6. Upon the announcement of company profits, why did investors bid the share price up, despite the unresolved issues facing Leighton? Should shareholders continue to have faith in the company’s ability to ensure good corporate governance and to deliver long term shareholder value?

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MIZUHO FINANCIAL GROUP: DOING BUSINESS WITH THE YAKUZA

Case overview

Mizuho Financial Group (Mizuho), the second largest financial services group in Japan, was embroiled in a case of illicit loan financing to the Japanese mafia through its affiliate, Orient Corporation (Orient Corp). Early warnings by Japan's regulatory authority, the Financial Services Agency (FSA), about such business dealings were initially labelled as an isolated event, but the dealings were later exposed to be done with the knowledge of the Mizuho Bank's President and CEO. The slow response of the Board and Mizuho's failure to fulfil its promise to tighten internal control resulted in persistent tolerance of lax screening and allowed illicit loan financing to go undetected in Orient Corp. Gaps in management oversight and the lack of streamlined control following Mizuho's birth from a merger of three banks allegedly contributed to lacklustre efforts to enforce compliance. The scandal left Mizuho with a tarnished reputation and led to an urgent call to revamp its board structure to institute greater independence and transparency of board processes. The objective of this case is to allow a discussion of issues such as board independence; board effectiveness; directors' oversight role in ensuring compliance; corporate governance and management challenges resulting from a merger; governance of entities such as affiliates in a complex group; and the Japanese system of corporate governance.

This is the abridged version of a case prepared by Tan Ze Shan, Chan Yu Wei, Lee Xian En Paul and Wu Jiaying, Louisa under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Toh Jia Yun under the supervision of Professor Mak Yuen Teen.

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Looking back and looking forward

As Yasuhiro Sato, President and CEO of Mizuho Financial Group (Mizuho), made his customary Japanese bow to apologise and acknowledge his mistakes, the recovery of the Group was only at its beginning. The decisions and penalties were announced one by one – suspension of parts of Mizuho's operations, issuance of a business improvement order, management changes, and pay cuts. For the second time in three months¹, Mizuho was penalised for loans to organised crime groups.

Why did the issues persist for so long? How did Mizuho end up in this predicament? What more could be done to improve the situation? The curtain may have fallen for the time being, but Mizuho's problems were far from settled.

The first sign of trouble

On 1 October 2011, the *Boryokudan Haijojorei*² was formally written into Japanese law, signifying the country's renewed effort to keep the Japanese mafia, more commonly known as Yakuza, out of Japanese society. Under the organised crime exclusion law, any forms of financing or payment to Yakuza are criminalised. Regrettably, not all within Mizuho heeded the message.

The fiasco began with a routine inspection between December 2012 and March 2013 by the FSA, which oversees banking, securities and exchange, and insurance in Japan³. The inspection uncovered 230 loan transactions with Yakuza-linked entities or individuals with loan amounts exceeding ¥200 million (approximately US\$2 million) over more than two years⁴. Although it was established that most of the loans were auto loans taken out via its consumer-finance affiliate, Orient Corp, Mizuho was the ultimate entity financing these loans⁵.

The Yakuza: An entrenched social element

The history of the Yakuza dates back to the 17th century, when they controlled construction and dockside labour in addition to other unsavoury businesses such as prostitution, gambling and liquor distribution⁶. From the 1980s, the Yakuza expanded their reach beyond the underworld to infiltrate the Japanese corporate world and financial system, in areas of real estate development and stock market manipulation⁷.

In 2012, a new revision was made to the *Boryokudan Haijojorei* to allow “police to designate organised crime groups as “extremely dangerous” and arrest any member of that group, without issuing a cease and desist order, if he (or she), makes unreasonable or illegal demands towards ordinary citizens”⁸.

Despite these measures, the Yakuza is still pervasive in many areas and echelons of Japanese society, with 63,000 known members in Japan currently⁹. They are known to cover their tracks well through the use of front companies and other disguises, making prosecution difficult due to the lack of evidence. The banking sector has suffered from the Yakuza’s penetration and influence as well. For instance, Citibank Japan lost its private banking license in 2004 due to high-ranking Yakuza members holding numerous accounts with the bank¹⁰.

A financial powerhouse

Mizuho is a bank holding company headquartered in the temachi district of Chiyoda in Tokyo, with a primary listing on the Tokyo Stock Exchange (TSE)¹¹. It is one of the largest financial institutions in the world, offering a wide range of financial services, including banking, trust and securities, and asset management services¹². Mizuho Holdings, Inc. was established in September 2000 through the merger of three banks – Dai-Ichi Kangyo Bank (DKB), Fuji Bank (Fuji) and the Industrial Bank of Japan (IBJ). Mizuho Financial Group was then established in January 2003 as the parent company of Mizuho Holdings, Inc, and became its sole shareholder¹³.

In Japanese, “mizuho” means “a fresh harvest of rice”. This expresses Mizuho’s commitment to “offer highly fruitful financial products and services to all customers, both in Japan and abroad”¹⁴. Mizuho’s brand slogan, “One Mizuho: Building the future with you”, indicates their commitment to become “The most trusted financial services group with a global presence and a broad customer base, contributing to the prosperity of the world, Asia, and Japan”¹⁵.

Big bank, big trouble

On 27 September 2013, Mizuho received a Business Improvement Order from the FSA regarding their illicit transactions with “anti-social elements”, a euphemism for organised crime groups such as the Yakuza¹⁶. It was a warning for Mizuho to tighten its processes and procedures in accordance with the law, which prohibits transactions with organised crime. In response, Mizuho vowed to “implement its improvement plan in relation to this problem and also work with utmost effort towards further improvement and reinforcement of its internal control systems”¹⁷.

Initially, Mizuho claimed that the loans were traced to a rogue compliance executive; ergo it was not pervasive through the ranks¹⁸. However, this stand was reversed three days later when Mizuho admitted that top management, including Mizuho Bank President and CEO Yasuhiro Sato had been kept in the loop long before the scandal unfolded¹⁹.

In response, the FSA called for an additional detailed report to be submitted, including the names of all executives who knew about the loan. Shortly after, on 25 October, Mizuho announced that it would punish 54 executives in connection with the illicit loans²⁰. In addition, Sato would forfeit six months of salary²¹. Takashi Tsukamoto, the Chairman of Mizuho Group and Mizuho Bank, would step down as Chairman of Mizuho Bank. However, at that time, he was allowed to remain as the Group’s Chairman²².

On 5 November 2013, the FSA began to conduct additional probes, resulting in a more punitive administrative order being meted out to Mizuho on 26 December, involving suspension of its loan business with consumer-credit affiliate firms for a month and a requirement to submit a mandatory business improvement plan by 17 January 2014²³.

Furthermore, on the same day, Tsukamoto announced that he would be stepping down as Group Chairman in March 2014 to take responsibility for the Yakuza loans scandal. In addition, Sato would extend his no-pay period from six months to one year²⁴.

Following Mizuho's loan scandal, FSA began inspections of Japan's two other largest banks, Mitsubishi UFJ Financial Group (MTU) and Sumitomo Mitsui Financial Group (SMFG), to ensure compliance with regulations regarding transactions with organised crime²⁵.

Failing from within

“Executives from the former bank defended their own fiefdoms ... even from the outside, we can see they are not well-informed, from the top to the bottom.” - Kanji Tanimoto, Professor in Corporate and Social Responsibility at Waseda University²⁶

The formation of Mizuho through the merger of the three banks did not result in any dominant party, and thus created a problematic lack of coordination and synergy within the Group and opened gaps in its governance structures. For instance, on Mizuho's first day of business on 1 April 2002, it experienced “the biggest banking system failure in history” due to the many transaction errors relating to its Automated Teller Machine (ATM) system²⁷. This was mainly because the three banks could not come to a unanimous decision on the adoption of a single computer system. Eventually, instead of deciding whose computer system to use, the three banks decided to bridge the existing systems of each bank. However, this also did not work out as Mizuho ATMs had to be shut down in March 2011 due to a system overload, delaying the processing of more than one million money transfer orders²⁸.

Lack of overarching oversight on captive loans

More significantly, some loans made through Orient Corp, Mizuho's consumer-finance affiliate and the entity predominantly funding Yakuza-linked entities, were carried out without stringent due diligence and background checks²⁹. In such a “captive” lending situation, Orient Corp extends and guarantees a loan while Mizuho finances it. However, the customer screening process responsibility was outsourced to Orient Corp, instead of applying the more stringent screening conducted by Mizuho for conventional loans. Orient Corp's lax screening system allowed Yakuza-linked loans to be approved with minimal identification checks³⁰. Despite calls from the FSA to enhance internal controls in order to curb loans tied to Yakuza as early as 2003, Mizuho did not perform its own customer background check for affiliate-linked customers until seven years later³¹. Mizuho's management did not provide oversight on the corporate governance and internal controls of its affiliated companies³², and the scandal showed that the conduct of its affiliates would have as great an impact on Mizuho as if it were making the loan itself.

Failure to take action and address anti-social loans

Perhaps what was more damaging was that the former banking unit President, Satoru Nishibori, did not take action although he was made aware in July 2010 of the loans made to the Yakuza. After stepping down a year later, he did not inform his successor, Tsukamoto, of the illicit loans, and also did not inform Sato, CEO and President of Mizuho, of the issue. Sato claimed that he only knew of the issue in March 2013, after a regular FSA inspection raised red flags³³. Due to the lack of coordination and communication within Mizuho, the issue was only dealt with in 2013 although the former President, Nishibori, already had knowledge of this issue in 2010³⁴.

Mizuho's failure to address the issue for nearly two years after uncovering the transactions highlighted the ineffectiveness of the Board in ensuring compliance with legislation and ethical standards. At Mizuho, the legal compliance department was in charge of overseeing financial transactions with Yakuza members and other questionable dealings³⁵. At that time, Masakane Koike was the executive director acting as the head of both the risk management and compliance departments. While the departments failed to take appropriate measures to address the issue, the Board as a whole failed to oversee and ensure that Koike carried out his duties properly and diligently.

Board independence

Before the scandal, Mizuho's Board comprised 12 members, consisting of Chairman Tsukamoto, eight executive directors and three 'outside' directors who did not engage in day-to-day management³⁶. Yet, under Tokyo Stock Exchange listing rules, companies should have at least one independent director³⁷. A lack of independence of the Mizuho Board still persists today, with the majority being executive directors. This issue is common and prevalent in Japan, where most Board members are company insiders³⁸.

Reputation matters

In absolute terms, the controversial loans amounting to US\$2 million would not have any material impact on Mizuho's earnings and financial performance. Furthermore, the FSA merely ordered Mizuho to strengthen its internal control and compliance without imposing any monetary penalties. The month-long suspension of business with its affiliates should not have material financial consequences as well. However, the business improvement order was seen as a public spanking and placed Mizuho in a bad light, thus adversely affecting the Group's reputation.

Unsurprisingly, Mizuho's investors and shareholders reacted negatively to the news. On the first trading day after the FSA released its findings on 27 September 2013, Mizuho's shares fell 4.1%, the most in three months, while the benchmark index retreated one percent³⁹. Over the next few weeks, Mizuho shares declined to a low of ¥203 on 10 October from a high of ¥222 on 27 September. Correspondingly, Mizuho's market capitalisation fell from ¥5.37 trillion to ¥4.91 trillion, a decline of over ¥400 billion that far exceeded the direct economic consequences of the scandal. However, Mizuho share price recovered to its previous level within two months and continued with an upward trend till early 2014.

Similarly, Orient Corp's share price fell from ¥283 on 27 September to ¥238 on 7 October. However, Orient Corp's share price did not recover to its previous level as of early 2014.

Mizuho's response

In response to its compliance failure, Deputy President Toshitsugu Okabe replaced Koike as head of compliance on 30 September 2013⁴⁰. With the aim of strengthening the holding company's ability to oversee subsidiaries and affiliates and to achieve greater transparency, Mizuho announced that audit, nominating and compensation committees will be formed as advisory bodies of the Board, and Mizuho will pick an outsider to lead its Board after the departure of the Group Chairman, Tsukamoto. With this, Mizuho will be the first among Japan's three biggest banking groups to have its management supervised by three committees consisting largely of outside directors⁴¹, allowing for a clearer separation between management oversight and business operations, improving Group-wide governance⁴². This plan was approved at a general shareholders' meeting in June 2014⁴³.

A pressing issue: Repairing a tarnished reputation

While rivals Mitsubishi UFJ Financial Group and Sumitomo Mitsui Financial Group continue to aggressively expand overseas, Mizuho's primary concern for now will be its problems with corporate governance and company culture⁴⁴.

Mizuho has undergone management shake-ups in the wake of the scandal, which seem to have been met with shareholder approval, based on its rapid share price recovery. The latest shake-up was announced on 14 March 2014, consisting of changes in executive positions across the Group. On 1 April 2014, Nobuhide Hayashi, a 56-year-old deputy president of Mizuho, replaced Sato as CEO of Mizuho Bank. Sato remains as President of Mizuho, focusing on revamping the corporate culture of the Group⁴⁵.

Epilogue

Since the saga, Mizuho has led the way in governance overhaul in Japan with the transformation to a more U.S.-style board. In a recent report released on 25 June 2015 endorsed by President Sato, it was stated that "the Board of Directors has started off well" in its first year after the transformation. Six out of thirteen directors in total are outside directors and five out of these six directors are independent⁴⁶. The Chairman is also an outside director⁴⁷. This represents a significant improvement in the overall independence of the Board. Mizuho's share price has also been on the rise in the aftermath of the reform, marking a positive turnaround for the troubled bank.

Discussion questions

1. Why do you think that the Mizuho Board, after being made aware of the illicit business dealings, chose not to take any action against the illicit loans?
2. Evaluate Mizuho's Board composition before the fallout from the loans scandal.
3. Discuss whether the penalties meted out by the FSA were sufficient in light of the severity of the scandal.
4. Has Mizuho taken appropriate steps to improve its internal control and governance structure?
5. With reference to Mizuho and other examples, what are the corporate governance and management challenges that may arise from a merger?
6. What are the unique challenges relating to governance of group entities, such as Orient Corp in Mizuho's case?
7. Evaluate the Japanese corporate governance system in terms of the existing legislation and codes (or lack thereof). Are there certain cultural or business norms which may have contributed to these issues?

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SHANGHAI JAHWA: BATTLE OF TWO CHINESE TIGERS (一山容不得二虎)

Case overview

In 2011, after Ping Pu Investment (Ping Pu) acquired Jahwa United (Jahwa), various issues started to surface. It began with the disagreement in investment plans, which eventually led to Ge Wenyao (Ge), Chairman and CEO of Shanghai Jahwa Co. (SJ Group) and Chairman of its listed subsidiary Jahwa, being relieved of his positions in the Group. Not long after, allegations against the Chairman and other executives of Jahwa involving embezzlement of company funds were made. These allegations resulted in a dip in the share prices of the companies involved, and China's State-owned Assets Supervision and Administration Commission (SASAC) stepped in. However, the situation worsened when copies of an anonymous letter alluding to the mismanagement in Jahwa was sent to the media. The letter pointed out irregular related party transactions between Jahwa and Hujiang, Jahwa's largest accounts receivable customer, which Ge denied. The objective of this case is to allow a discussion of issues such as state ownership of companies in China; conflicting objectives of different investors and between investors and management; role and power of shareholders; and related party transactions.

This is the abridged version of a case prepared by Alena Wan, Alfred Tong Wei Rong, See Toh Sin Yee Eileen and Teo Xin Ying under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Thng Wan Ying under the supervision of Professor Mak Yuen Teen.

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Igniting the fuse (先见之明)

In November 2009, Ge was in the middle of a press conference to launch Jahwa's newest product when he was asked to give his thoughts on Jahwa's status as a state-owned enterprise (SOE).

Without any regard for political correctness, Ge expressed his dissatisfaction with the way the Chinese government had managed its SOEs, saying that government interference and mismanagement had caused Jahwa to be in a critical state thrice in the past two decades. He also made a strong stand for the need to reform this area¹. Unbeknown to him then, his comments would foreshadow significant overhauls in the ownership structure of Jahwa in the very near future.

The seasoned warrior: Shanghai Jahwa (身经百战)

Emerging from the dying embers of the Qing Dynasty², Jahwa originated as a manufacturer of the female cosmetic brand, *Twin Sisters*. Over its 116-year history, the company established itself as the largest domestically-owned Chinese manufacturer of cosmetics and personal care products³.

Jahwa's journey to become one of China's elite cosmetic brands was fraught with tough competitive and environmental challenges. For the large part of its developmental years, Jahwa, unlike many of its present-day multinational competitors such as Unilever and Procter & Gamble, has remained a SOE under the Chinese socialist government. Jahwa's status as a SOE made it difficult to attract foreign talent as management struggled to produce the competitive remuneration packages required⁴.

Despite its difficulties, Jahwa is an indisputable modern-age Chinese success story. In 2012, it remained the only domestic player with a credible chance of breaking into the top 10 selling cosmetic brands in China; an industry that is worth approximately RMB 60 billion per year⁵. In addition, the company continued to set its sights higher, as it sought to penetrate the high-end cosmetic market in 2011 with a rebranding of its iconic *Twin Sisters*⁶ and the introduction of its mid-tier cosmetic label, *Herborist*, into foreign markets in 2012⁷. Today, Jahwa provides personal cleaning and care products, cosmetics, household cleaning products and perfumes, with well-known domestic brands such as *Liushen*, *MAXAM*, and *Herborist*⁸.

The well-deserved reputation of Ge Wenyao (名不虚传)

Few would dispute Ge as the driving force behind Jahwa's accelerated success after the turn of the century. Having joined Jahwa in 1984, he rose quickly through the ranks and was promoted to factory manager after a year, and continued to be steadily involved in management for 28 years after⁹.

Ge was well regarded as a man with foresight and a strong understanding of market forces and consumer behaviour. When he took the helm of Jahwa in the 1980s, he knew that China would eventually have to open its doors to foreign investments and that SOEs would have to make way for privatisation.

In spite of Ge's best preparations, the influx of foreign brands in the 1990s led Jahwa to lose ground against its more well-equipped and established foreign competitors. This was exacerbated by Ge's short-lived joint venture with the American company, Johnson and Johnson, which did not end well for Jahwa or himself¹⁰. Despite these mounting challenges, Ge did not give up or jump ship, but instead, with renewed vigour, he put the company through intense restructuring that gave fruition to some of Jahwa's most famous and loved brands. Under Ge's leadership, Jahwa became the industry leader¹¹.

A generous boost of power (如虎添翼)

Amidst the booming economy, the Chinese government began to take notice of the growing public dissatisfaction regarding its management of SOEs. In 2008, the municipal government of Shanghai issued guidelines regarding plans to restructure SOEs to ‘improve efficiency and eliminate business overlaps’, with a target of 90% of state-owned industrial conglomerates in Shanghai going entirely public or having core assets listed. In a meeting on 13 January 2011, SASAC specifically stated that it hoped to raise the securitisation rate of local SOEs to 35% (from 30.5%) by the end of the year¹².

Jahwa was one of the companies selected to undergo the reform, and unsurprisingly, Ge responded positively, indicating that such a transformation would be beneficial for both the government and Jahwa itself.

With its high profits and strong growth, Jahwa was an attractive investment, and the bids began pouring in. Interested companies included many international names such as Unilever, Singapore’s sovereign fund Temasek Holdings, and major domestic groups such as Ping An Insurance and Fosun Group (Hong Kong). Ge eventually rejected foreign bids as he wished to establish Jahwa as a domestic enterprise. He also refused bids from investment funds. He felt that such investors were likely to sell their shares once certain target yields were reached, which would be detrimental to his vision for Jahwa¹³.

By the time the final decision was to be made, there were only two bidders left – Ping Pu (a subsidiary of Ping An Insurance) and Hainan Airlines (HNA). Ge was rumoured to favour Ping Pu, which had a post-merger plan to expand into more domestic markets such as watches and fashion, rather than HNA, which planned to expand current businesses internationally. Furthermore, it was reported that HNA might be facing a credit problem due to its rapid expansion over the past 10 years¹⁴. In what many deemed to be an attempt to eliminate HNA from the competition, Jahwa instituted new rules to block ownership transfer for five years, and vowed no re-financing plans for three - measures which would foil bidders planning to use Jahwa as a fundraising tool¹⁵. Subsequently, Ge announced on 8 November 2011 that Ping Pu had won the bid, bringing with it promises of access to an extensive sales network and online retail presence, as well as RMB 2 billion of investment for the acquisition of high-end brands and expansion to other industries¹⁶.

An apparent case of self-inflicted misfortune (引狼入室)

It seemed that Ge got exactly what he wished for – relief from state ownership and an ideal investor whose goals were aligned with his vision of expansion. The numbers were certainly encouraging, with sales, net profits, and share price all increasing significantly between 2011 and 2012. Jahwa appeared poised to be a model of success in economic reform.

Yet, not all was smooth sailing internally. Almost immediately after the acquisition, Ping An suggested hiring McKinsey & Co. to evaluate Jahwa’s present operational strategies. Ge vehemently objected as he was wary about providing information to a consulting firm that had knowledge about, and access to, multiple firms internationally, some of whom could be Jahwa’s competitors¹⁷. Furthermore, some large firms that had adopted McKinsey’s recommendations still failed eventually, and he was doubtful about the wisdom of such a decision.

The consultants were never hired and the issue was laid to rest; however, this first conflict revealed underlying tensions between Ping An and Ge. Ping An felt that this brought to light potential problems in Jahwa’s management, while Ge felt that Ping An was seeking an excuse to restructure the company’s capital and organisation¹⁸.

The next kerfuffle arose in November 2012 when Ge expressed interest to invest in Tianjin-based luxury watchmaker Sea-gull Watch Manufacturing Group. Despite the fact that the company’s sales had been declining steadily since its heyday in the 1980s, Ge believed that it had the potential to become internationally renowned in five to 10 years if management and marketing styles were changed. However, in a shareholder’s meeting on 18 December 2012, the suggestion was rejected by Ping An. Following this rejection, Ge often took to his Weibo micro blog to post his views on Sea-gull’s future potential, and occasionally even publicly expressed his dissatisfaction with Ping An¹⁹.

Observers suggest that this demonstrated a fundamental difference between Ping An's and Ge's development plans for the company; the former was more focused on short-term profits, while Ge had ambitions to make Jahwa an international fashion group²⁰. Ge also made public his frustration that Ping An was going back on promises that it made upon the acquisition, as one of the terms of the initial agreements was that Ping An would support Jahwa's plan for strategic expansion²¹.

Ge finally decided to stop showing his discontent online, by writing another post on 21 January 2013, stating that he had spoken enough about Sea-gull, and suggested that observers take note that he (and his views on the company's potential) would be proven right in two years' time²². Thus, it appeared that another conflict had tentatively been put to rest.

Elation turns into sorrow (乐极生悲)

Yet, just as dormant volcanoes would eventually erupt, the clash between Ge and Ping An soon escalated. On the morning of 13 May 2013, Ge resumed venting his increasing frustrations by writing on his Weibo that "Jahwa is suffering from a political disturbance" and that "Ping An has continually sold assets of Jahwa after the acquisition"²³. Ironically, after all he had done to ensure that Jahwa was not sold to other bidders, Ge's fear of having an owner who did not share the same vision for Jahwa appeared to be brought to life by his own doing.

Not long after Ge's public outburst on his Weibo, Ping An issued a press statement declaring that during the board meeting on 11 May, SJ Group's shareholders have decided to relieve Ge of his posts as chairman and general manager of SJ Group²⁴. However, Ge would remain as the chairman and chief executive of Jahwa.²⁵

In the press statement, Ping An purported that Ge and other group executives have been embezzling company funds²⁶. Ping An further elaborated that it had been receiving tip-offs since March from whistleblowers within Jahwa, claiming that the group's management had set up secret coffers and pocketed illicit gains by exploiting the pension scheme set up by Ge in 2007²⁷. It further alleged that the amounts were huge, and said that internal investigations were underway.²⁸

Both Jahwa and Ge vehemently denied these allegations via their respective Weibo accounts. Jahwa posted a statement clarifying that Ge's compensation was based on strict company rules, and that during his tenure, Ge had been a loyal servant of Jahwa who had never taken a single cent more than what he was given²⁹. Ge responded likewise, adamantly stating that Jahwa did not engage in any illegal activity even as the company grew exponentially through the years³⁰. While he acknowledged that the company did occasionally 'play it close to the edge', he claimed that such actions were required to ensure Jahwa's survival³¹.

Ge tried to build the defence against the embezzling of funds³². According to him, the funds were legally set aside for an employee incentive mechanism which was necessary to attract and retain talent under the then SOE's rigid salary structure³³, and to boost pay-outs for retired employees who he felt ought to have a share in the company's current success³⁴.

To aggravate matters, after Ge's public airing of the company's 'dirty laundry', media outlets caught wind of the issue and reported news of the conflict between the controlling shareholder and the chief executive, thus causing Jahwa's share price to plummet, as investors cast doubt on the corporate governance of the two companies³⁵. Jahwa's share price fell 15.3% over 13 and 14 of May, reducing the company's market capitalisation by RMB 4.89 billion to RMB 29.2 billion³⁶.

Amid public outcry by small investors who had suffered heavy losses due to the plunge in Jahwa's share price³⁷, the Shanghai SASAC stepped in to mediate. Guangzhou-based Time Weekly cited an anonymous insider saying, "Shanghai SASAC asked Ge to keep a low profile and the local media not to sensationalize the news"³⁸. A short while later, Ge stopped posting on his Weibo account³⁹.

In what appeared to be an attempt at ending the debacle, a shareholders' meeting was held on 16 May 2013 for Jahwa, which set the stage for reconciliation, not just between Ge and Ping An, but also between Jahwa and its other investors⁴⁰. There, Ge expressed his apologies for mishandling the relationship with Ping An and causing losses to the shareholders. He also emphasised his renewed commitment to cooperate with Ping An for the wellbeing of Jahwa⁴¹. It seemed as though an agreement had finally been reached between Ge and Ping An, and the conflict was finally coming to an end.

The tall tree catches the wind (树大招风)

However, the reprieve was a fleeting one. On 20 May 2013, just days after the agreement, multiple media outlets throughout China reported receiving copies of an anonymous letter that alluded to mismanagement in Jahwa. The letter claimed that Jahwa had a secret account, unrelated to the retirement benefits fund that had previously been reported. This secret account was supposedly not subject to any supervision and therefore faced a high risk of corruption. It was alleged that Huijiang Household Chemicals, a major Jahwa supplier, managed the secret account⁴².

In particular, the letter pointed out irregular related party transactions between Huijiang and Jahwa. From 2009 to 2011, Jahwa made consistent prepayments of RMB 4.7 million to Huijiang. Yet, in early 2012, Huijiang was listed as Jahwa's largest accounts receivable customer, to which Jahwa owed a sum of RMB 37.97 million⁴³. These inconsistencies, according to the author of the letter, suggested that Jahwa's managers had been siphoning profits from the company through Huijiang.

Mountain or molehill? (小题大作)

A few hours after the media uproar, Jahwa defended itself by releasing an official statement denying all allegations.

In the statement, Jahwa justified that, to maintain product quality, it purchased its raw materials from a designated supplier before selling it to a third party for processing, and the processing company then resells the finished products back to Jahwa. This practice thus resulted in both a receivable and a payable account attributed to Huijiang, the processing company in this case. The statement also expounded that the discrepancy where prepayments in one year mysteriously became receivables in the next was due to differing requirements for disclosure in the two years. In 2011, the requirements for disclosure excluded receivables and included payables, while the converse was required in 2012. Finally, Jahwa affirmed that the selection of suppliers was legal and done according to relevant rules and regulations. In the case of Huijiang, a separate committee was used to determine all processing fees, and management did not have a role in designating Huijiang as the processing company or determining the processing fees. Jahwa stressed that all figures with regard to Huijiang were regular and legal, and would invariably withstand further investigation⁴⁴.

To defend himself against the allegations in the letter, Ge broke his silence on Weibo, questioning the letter's source, and expressing his displeasure with the lack of evidence brought forward. He made reference to an audit ordered by Ping An and conducted by a team of seven members in April 2013. He explained that such action was in violation of Jahwa's Articles of Association⁴⁵ and the company's management team had previously decided not to pursue further action against Ping An as a sign of their goodwill. However, Ge's series of Weibo posts and the timing of his declaration about Ping An's unauthorised audits on Jahwa led many to conclude that Ge believed the anonymous letter to have originated from Ping An, rather than from a whistleblower within the company.

An inevitable parting of ways (不欢而散)

When an unstoppable force meets an immovable object, one eventually has to give way. On 17 September 2013, approximately four months after settling into yet another uneasy truce, Ge announced that he would be stepping down as the Chairman of Jahwa, citing health and age as reasons for his retirement⁴⁶.

Throughout this turbulent period, Ge held the public's sympathy in the dispute with Ping An, as his outstanding contributions to Jahwa over 30 years placed him in a position of unquestioned public trust, and his defence that the secret accounts were meant to reward long-serving employees upon retirement further won him public approval. However, on 19 December 2013, this trust was found to have been possibly misplaced, when Jahwa announced that the company had indeed failed to disclose related party transactions with Huijiang, in which SJ Group and Jahwa together held a 48% stake. These transactions were worth RMB 2.42 billion, and occurred over a period of five years under Ge's management. The share price predictably fell with the release of the news⁴⁷.

While this piece of news displaced Ge from his figurative pedestal, it helped to justify Ping An's claims of mismanagement and poor operations in Jahwa. With the conclusion of this series of unfortunate events, both companies were finally able to get the closure they desperately needed to move forward into an uncertain, though hopefully bright, future.

Discussion questions

1. During the privatisation process of Jahwa, Ge took actions to deter and block bids that he felt were detrimental to Jahwa based on his vision for the company. From a corporate governance perspective, were Ge's actions justifiable?
2. According to Ge, 'Ping An has continually sold off assets of Jahwa after the acquisition'. In your opinion, if the controlling shareholder feels that it is in his best interest to divest the company's assets, should the management be able to decide otherwise? Explain.
3. Consider the role activist investors like Ping An play in the corporate governance of a company. Do you think shareholder activism is good for the company and its minority shareholders? How much say should such investors have on the way the company is run?
4. State-owned enterprises (SOEs) in China have been criticised for their poor corporate governance practices. To what extent do you think the privatisation of Jahwa has helped to reform or improve the company's corporate governance structure, and is one form of ownership necessarily better than the other?

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TIGER ASIA MANAGEMENT: TAMING THE TIGER

Case overview

In 2013, Bill Hwang, the owner and controller of Tiger Asia Management LLC (Tiger Asia Fund), one of the most successful hedge funds in the world, was fined by the Hong Kong Court for insider trading involving two Chinese-based banking stocks. As part of its efforts to crack down on insider trading activities, the Securities and Futures Commission (SFC), Hong Kong's regulator, commenced legal proceedings against Tiger Asia after investigations. A prolonged legal battle ensued, revolving around issues of extra-territorial jurisdiction and enforceability of actions involving an offshore fund that had no business presence in Hong Kong. The objective of this case is to allow a discussion of issues such as insider trading; enforcement of rules and regulations on foreign entities; and regulation of hedge funds and offshore funds.

This is the abridged version of a case prepared by Ian Ong, Ji Yanjun and See Jia Jia Pearl under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Toh Jia Yun under the supervision of Professor Mak Yuen Teen.

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The Tiger Cubs

Founded in 2001, Tiger Asia Management LLC (Tiger Asia Fund) was a financial investment advisory firm headquartered in New York. Owned and managed by its founder, Sung Kook Bill Hwang, who was once a star at Tiger Management run by billionaire investor Julian Robertson, Tiger Asia Fund specialised in the trading of Chinese, Japanese and Korean stocks¹. With a portfolio of US\$10.5 billion, it was the second largest hedge fund in the world in 1997². Although Tiger Management closed in 2000 due to huge losses incurred during the Asian financial crisis and dot-com boom, Robertson continued his investment by helping former employees set up their own hedge funds, known as "Tiger Cubs"³. Bill Hwang was one of those given support and finance from Robertson to start up Tiger Asia in 2001.

Bill Hwang and his Tiger Asia Fund delivered exceptional performance since its establishment in 2001 and was regarded as the crown jewel of "Tiger Cubs". Known for his expertise and proven track record in trading stocks in the fast-growing Asian markets, Hwang became one of Wall Street's most highly-regarded investors.

The insider trading spree

The success of Tiger Asia Fund did not last long as it was later embroiled in a series of insider trading scandals and litigation in both Hong Kong and the United States.

On 20 December 2013, Tiger Asia Fund and Bill Hwang were charged with insider trading and ordered by the Court of First Instance in Hong Kong to pay HK\$45 million to investors of two Hong Kong-listed banking stocks, namely Bank of China (BOC) and China Construction Bank (CCB)⁴. In addition, SFC sought to freeze Tiger Asia Fund's assets in Hong Kong and impose a ban on its trading activities.

Under Section 270(1) of the Securities and Futures Ordinance of Hong Kong, insider dealing occurs when a person connected to a listed corporation, is aware of insider information, and deals in the listed securities of the corporation or a related corporation. Insider trading also occurs if a person counsels or procures another person to deal in such listed securities knowing that the other person will deal in them⁵.

On 6 January 2009, Tiger Asia was approached by an investment bank placement agent (IBPA)⁶ about its interest in participating in the proposed private placement of CCB shares. Tiger Asia was given access to sensitive information such as the size and the discount range of the placements, provided Bill Hwang and other senior officers of Tiger Asia Fund agreed to be “wall-crossed”⁷. This puts them under the obligation to keep the disclosed information confidential and refrain from trading until the placement is completed or cancelled. Based on the agreement, Raymond Park, Hwang’s head trader, was then provided specific details and information of the transaction and conveyed the material and price-sensitive nonpublic information to Hwang.

However, Hwang did not honour the agreement with the IBPA. After the market opened on the same day, Park short-sold 93 million CCB shares on the Stock Exchange of Hong Kong (SEHK) prior to the public announcement of the placements. The next day, he covered his short position with the stocks he purchased at a discount under the placement arrangement and made a profit of HK\$29.9 million.

In a separate case that took place on 18 December 2008, the IBPA informed Park that the investment banks, UBS AG and Royal Bank of Scotland, intended to sell off their BOC shares on 31 December at a discount to the market price, which was again under the “wall-crossing” agreement⁸. When the IBPA enquired about Tiger Asia Fund’s interest in purchasing the shares, Park declined to give a definite answer until he received instructions from Hwang.

Three days later, on 21 December, Hwang instructed Park and his assistant trader, William Tomita, to short-sell around HK\$40 million of BOC shares, and added another HK\$40 million several days later⁹. Meanwhile, Park had received and affirmed the email reminder from the compliance department in IBPA stating that he has agreed to be “wall-crossed” – he had “agreed on behalf of Tiger Asia to ... not engage in any trading activities regarding any security of Bank of China”¹⁰.

On the same day, Park told the IBPA that Hwang intended to buy “around [HK]\$50 million at between 10-15 [%] discount”¹¹. He subsequently confirmed his intention to purchase on 30 December under Hwang’s order. Tiger Asia was allocated 199 million shares of BOC, which was used to cover the short position it had taken and made a profit of HK\$8.2 million¹².

However, the insider-trading spree did not end there. On 11 January 2009, Park received another invitation from the IBPA for a second private placement of BOC shares. Hwang and Park once again made moves similar to the two earlier cases (short-selling and covering with allocated shares at a discount) but incurred a loss of about HK\$10 million.

In all the three insider trading cases, Park did not disclose to the IBPA that Tiger Asia had breached the wall-cross agreements.

The court order of repayment to affected investors by Tiger Asia Fund and related parties (Hwang and Park) was in pursuant to Section 213 of the Securities and Futures Ordinance, which requires Tiger Asia Fund to restore the affected parties into the positions before the insider trading was entered into¹³. Hence, it had to pay what amounted to the difference between the actual price of the transactions and the value of the shares.

On the other hand, William Tomita, was not charged under Section 213 as he was a junior staff who only acted on orders from Hwang and Park and had no knowledge of the insider trading scheme.

The downward spiral

Besides insider trading, Tiger Asia Fund was also charged with manipulative trading on the SEHK during 2008 and 2009. Hwang and Park manipulated the month-end closing prices of several Chinese stocks in which Tiger Asia Fund had taken a large short position, in an attempt to suppress the price and increase the value of their position. As such, they managed to reap an additional HK\$496,000 in management fees as it was paid based on the month-end net value of the fund’s portfolio¹⁴.

On a separate occasion, Tiger Asia Fund was also heavily fined by the Japanese securities regulator for its alleged manipulative trading of stocks of Yahoo Corp (Japan)¹⁵.

Earlier in 2008 before the series of trading scandals broke out, Tiger Asia was already suffering from the financial market meltdown and eventually hit an annual loss of as much as 23%¹⁶. The media and many analysts attributed Hwang’s market misconduct to his pressure to maintain his initial success and turn around his miserable performance¹⁷.

The legal battle

SFC's victory over Tiger Asia Fund only came after a prolonged legal battle. After SFC filed the proceedings, Tiger Asia appealed against it and SFC's application for an asset freeze. This was later supported by the Hong Kong Court's ruling that the SFC did not have jurisdiction "to find contraventions of the insider dealing and market manipulation laws"¹⁸ and hence had no power to make orders to freeze assets and ban trading without criminal guilt being established.

The SFC appealed to the Court of Appeal in early September 2011, on the basis that "S213 of the SFO provides for a free-standing remedy and that the legislation intended remedial and preventative orders to be available separately from criminal or deterrent sanctions"¹⁹. Hence, the proceedings should be allowed. Tiger Asia continued to fight by presenting the argument made in the court ruling earlier. However, the Court of Appeal overturned the ruling and gave the go-ahead to SFC to pursue legal action against Tiger Asia Fund, as it held that "S213 was put in place to help the SFC protect the interests of public investors"²⁰. In this ruling, which was regarded by SFC as "landmark", SFC was granted a greater power to "seek claims for investors against wrongdoers"²¹ and it had far-reaching implications on its scope of responsibilities especially in a few other similar ongoing market misconduct-related cases.

The Securities and Exchange Commission (SEC) in the United States also charged Tiger Asia Fund for the same insider-trading offences involving the BOC and CCB shares. Interestingly, it pleaded guilty in the U.S. court and agreed to pay US\$44 million as civil settlement while putting up a tough fight against SFC of Hong Kong. Hwang said, in a statement he made after the settlement, "Tiger Asia regrets the actions for which it accepts responsibility today and is grateful that this matter is now resolved and behind it in the United States"²².

Julian Robertson, who seeded the Tiger Asia Fund, showed strong support for Bill Hwang and his fund despite the legal woes. "He has always been a great partner, a great person and a great friend," Mr. Robertson said. "I continue to hold him in the highest regard"²³.

No safe haven

The case of Tiger Asia Fund was one of a series of criminal prosecutions against insider trading initiated by the SFC since 2009 in a bid to clean up its market, after enjoying a reputation as a "safe haven for insider trading" for a long time. Du Jun, a Morgan Stanley banker, was among the first to be sentenced to prison following a criminal conviction of insider trading in 2009, sending a strong deterrence message to other market players in Hong Kong.

The charges against Tiger Asia in the U.S. are also part of the government's effort to eliminate illegal trading that has been rampant in hedge funds. Since 2009, federal prosecutors have convicted around 80 hedge funds²⁴ and their executives of insider trading. These include the famous cases such as Raj Rajaratnam, the former head of the Galleon Group hedge fund and SAC Capital. The SEC and prosecutors have stated that "insider trading is rampant"²⁵ and "the investigation and prosecution of illegal insider trading has been, and will remain, a top criminal priority"²⁶.

The enforcement dilemma for foreign funds

Bill Hwang and his Tiger Asia Fund were considered "lucky" as they only had to repay the investors and avoided other more severe criminal penalties.

Even though a favourable Court of Appeal ruling was obtained, SFC still faced several practical limitations in its extra-territorial legal battle against Tiger Asia Fund. Under the current legislation, SFC could pursue either a civil or criminal proceeding. Although the Hong Kong Department of Justice has repeatedly expressed its preferences for criminal cases²⁷, a criminal proceeding and arrest of Bill Hwang or other staff were hardly possible as Tiger Asia Fund was not registered or based in Hong Kong, nor did its employees have any physical presence there. Instead, SFC initiated a civil proceeding and pursued an injunction order on its assets in Hong Kong.

As the legal battle unfolded, the media in Hong Kong and China raised questions regarding the effectiveness of SFC as the financial market watchdog. The deterrence effect of existing regulations also seem to be undermined by the practical limitations exposed in the case of Tiger Asia Fund, considering that almost half of the equity trading activities in Hong Kong are based offshore²⁸. Most of the offshore funds avoid registration and licensing in local markets unless absolutely necessary to drive down potential legal risk exposure.

In light of the rise in illegal cross-border trading activities, SFC has stepped up its collaboration with overseas regulators in areas such as exchange of information to assist in investigations. According to the press release, its collaboration with SEC in the U.S. had been very useful in expediting its legal actions against Tiger Asia Funds.

The final verdict

Following the order to pay investors affected in Hong Kong, a hearing at the court of Hong Kong (Market Misconduct Tribunal) was scheduled in May 2014 in relation to SFC's application for a cease and desist order. If the MMT found the existence of market misconduct, it could make a range of court orders including prohibiting Tiger Asia Fund from dealing in securities, futures contracts or leveraged foreign exchange contracts in Hong Kong without leave of the court for a period of up to five years.

On 9 October 2014, the MMT determined that Tiger Asia Fund, Bill Hwang and Raymond Park had engaged in market misconduct and accordingly banned Tiger Asia Fund and Bill Hwang from trading securities in Hong Kong for four years. Tiger Asia Fund agreed to a settlement of HK\$45.3 million to affected Hong Kong investors and US\$60.3 million for US criminal and civil settlements as a result of the legal battle started in 2009. Tiger Asia has since renamed itself as Archegos Capital Management LLC after the saga and turned into a family office²⁹.

Discussion questions

1. Do you think the actions taken by the SFC against Tiger Asia Fund were adequate and effective?
2. Given the spate of recent cases of insider trading cases like SAC and Galleon Group, why do you think such insider trading activities continue to happen in hedge funds? Is regulation the answer?
3. If this case happened in your country, what would be the relevant legislation and sanctions?
4. To what extent do you think insider-trading regulations are effective in detecting and curbing insider trading activities? Discuss the importance of enforcement is curbing insider trading.
5. What potential problems might your country face in enforcing relevant regulations (such as corporate and securities laws and regulations, and listing rules) on foreign entities, including companies listed on the local exchange and foreign funds operating in your country?

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BANCO ESPÍRITO SANTO: THE FALL OF A FAMILY EMPIRE

Case overview

In August 2014, the Portuguese government engineered a rescue of Portugal's largest-listed bank, Banco Espírito Santo, after it was entangled in a series of heavy debts with its parent company, Espírito Santo International. These two entities formed part of the larger Espírito Santo conglomerate, which was controlled by members of the Espírito Santo family. Through a complex transatlantic scheme involving multiple jurisdictions, the Espírito Santo group allegedly set out to defraud the bank's clients. Statutory auditors and Portuguese regulators were also alleged to have failed in preventing the problems of the Espírito Santo companies from escalating. The objective of this case is to allow discussion of issues such as complex ownership structures; family-controlled enterprises; board independence; auditors' responsibilities and independence; and regulatory complexities when companies have dealings across multiple jurisdictions.

The fall of Ricardo Espírito Santo Salgado

Just a few months ago, Ricardo Espírito Santo Salgado (Salgado), 70, was patriarch of Portugal's richest family and the family empire's top executive. He held

This is the abridged version of a case prepared by Dawn Chan Hui Yeng, Emily Zhang Yixuan, Goh Si-Huey Janson and Lim Pei Qi under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lim Kai Ting Grace under the supervision of Professor Mak Yuen Teen.

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positions as the Chief Executive Officer and Vice-Chairman of the Board of Banco Espírito Santo (Portugal) (BES), Chairman of the Board of Espírito Santo Financial Group S.A. (Luxembourg) (ESFG) and was an executive member of Board of the Espírito Santo Financial (Portugal). As someone at the helm of the family empire that spanned across all industries and services, Salgado was given the moniker "Dono Disto Todo"¹ - the owner of everything.

As Salgado takes in the view from his new office at a high-end hotel in the coastal resort town of Estoril, he vividly recalls the spark that ignited the rapid collapse of his empire. In a forensic audit hastily ordered by the Bank of Portugal (BOP) in December 2013, independent auditors KPMG uncovered "material irregularities"² in the accounts of Espírito Santo International's (ESI) - the family's holding company. Subsequently, BOP alleged that there were "seriously harmful acts of management"³ in BES, and Salgado was accused of "tax fraud and money-laundering"⁴.

Under immense pressure from all quarters, Salgado and his family agreed to step down from the Board and relinquish leadership of the bank. On 3 August 2014, Salgado received the heart-breaking news that the bank founded by his great-grandfather a century ago had been forcefully taken over by the government in a €4.9 billion bailout⁵, thereby ending its life under private ownership as Portugal's largest listed bank. Following the announcement of KPMG's findings, the bank's share price plunged by 88% from €1.021 on 20 May 2014 to €0.12 on 4 August 2014.

Sowing the seeds of destruction: Banco Espírito Santo

The Espírito Santo empire's humble birth in Portugal's financial sector dates back to 1869, when Salgado's great-grandfather bought and sold credit securities and lottery tickets. Since then, the Espírito Santo Group has evolved into a "sprawling global empire"⁶ with BES as one of its main subsidiaries under the purview of ESFG. While the family rapidly amassed wealth over the years, reaching more than €3 billion in the second quarter of 2007 based solely on its stake in BES⁷, the group's intertwining shareholdings and directorships eventually sowed the seeds of its destruction.

Concealment of power: Overlapping ownership

“The origins of the idiosyncratic BES affair also offer a more fundamental lesson: family-controlled banks can be problematic; but large, systemically important banks that are managed by family owners can be very problematic.” - Patrick Jenkins, a Financial Times journalist⁸

The multiple roles played by Salgado within the group enabled him to be on top of it all, thereby obtaining effective control of all major decisions concerning the group. Besides having control over the management as the CEO of BES, Salgado exerted much influence on the Supervisory Board as its Vice-Chairman as well as a major shareholder in the ultimate holding company. Additionally, with a 17.05% stake in Espírito Santo Control (ESC)⁹, Salgado was able to amass significant control of BES and its subsidiaries, although directly owning less than five percent of the bank, due to the complex and long trail of intermediate corporate entities in Espírito Santo¹⁰. The corporate structure is shown in Figure 1 below:

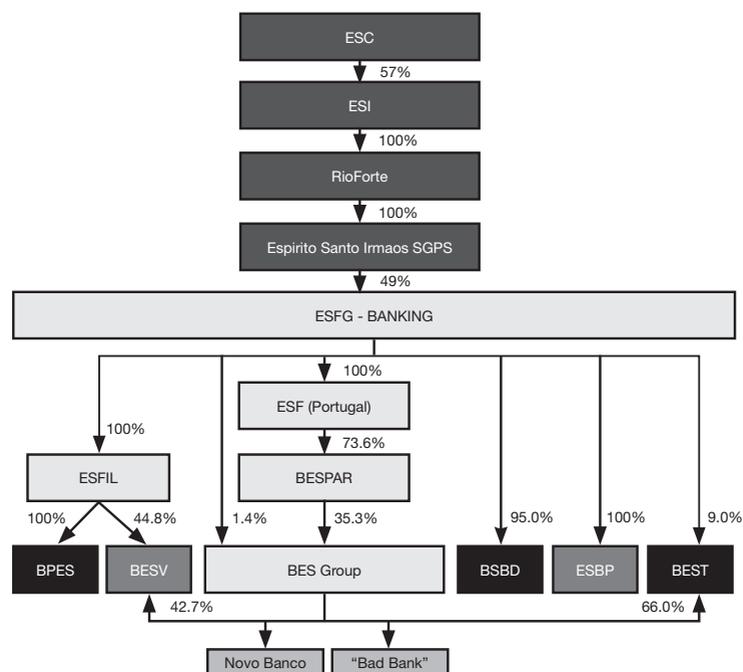


Figure 1 - Corporate Structure of Espírito Santo Family Companies^{11,12}

Salgado and the Espírito Santo family owned 88.4% of ESC^{13,14} and controlling stakes in all the corporate entities in Figure 1. Having family members as controlling shareholders and significant players in both the supervisory and management boards thus obfuscated the ownership structure and governance of Espírito Santo.

Ostensible independence and shadow control

In addition to the powers wielded by Salgado through the various family companies, he also had significant intra-company control.

As at 31 December 2013, the BES Board consisted of 25 members - 10 were executive and 15 were non-executive directors. Of the 15 non-executive directors, seven were considered by the Board's Corporate Governance Committee to be independent¹⁵. The day-to-day management of the company was delegated to an Executive Committee chaired by Salgado, comprising 10 members¹⁶, three of whom were part of the Espírito Santo family¹⁷.

The independent directors occupied positions in the Audit Committee, Corporate Governance Committee and Remuneration Advisory Committee, as well as the Chairman of the Board of Directors. BES stated in its 2013 Annual Report that they had complied with the Corporate Governance Code in that the company had an adequate number of independent directors on its Board¹⁸.

In addition, disclosure for non-independence of family directors was made in the 2013 BES Annual Report. The main reasons for non-independence were attributed to the following: (i) the director being a member of the Executive Committee (10 members), (ii) the director also being in the Board of Directors of related companies, specifically, ESFG or ESI (two members), (iii) or the director being a board member in, or being employed by one of the shareholders and related entities of BES (six members)¹⁹.

If one were to delve deeper into the corporate affiliations between family members and companies outside of BES, it would become apparent that there is much entrenchment of control by the Espírito Santo family in these various related companies and groups. For Salgado, he was Chairman of ESFG and a director in ESI, apart from holding directorships and chairs in other BES companies and Espírito Santo companies.

Reaping the fruits of its (In)securities

Beginning of the End

In 2011, Portugal obtained an international bailout when it fell into recession. As part of the bailout scheme, BES, like any other Portuguese bank, was no longer allowed to pay dividends to its shareholders²⁰. This came as a huge blow to the Espírito Santo family, which had a major stake in BES, as it effectively eliminated a significant source of income. The family's hotel, property and other businesses also bore the brunt of the recession. To avoid having the family sell its assets or lose their controlling stake in BES, the family devised a plan to sell bonds in order to finance ESI. At that time, out of all the other companies under the Espírito Santo umbrella, ESI was under the greatest financial distress. By leveraging on its complex structure and controlling shareholding in ESC, the family was able to make use of BES to purchase these bonds and sell them to its clients. By the end of 2013, an astonishing € 1.7 billion worth of short-term debt had been sold to the retail clients of BES²¹. Evidently, the family had mixed up the affairs of the family and company, implicating BES in the process.

Little did Salgado know that this was only the beginning of BES' endless debt spiral as ESI's disease slowly infected the rest of the Group. BOP's 2014 review of Portugal's largest banks also uncovered BES's heavy loans to its family companies. This elicited a "special purpose limited review"²² by KPMG into ESI's accounts which revealed material irregularities²³ in the company's books, namely, its grossly overvalued assets and omission or under-reporting of financial liabilities and risks. However, Salgado fought hard against the central bank and voted against the public disclosure of the audit results, convincing the board to allow him to deal with the situation²⁴. These irregularities surfaced concerns of the potential "reputational risks" on BES since it had sold debt issued by ESI to its own retail clients²⁵.

The Underhanded Debt Shuffle

"The group amassed too much debt. It kept on postponing the problems by rolling over debt with short maturities and at high interest rates." - Ricardo Cabral, an Assistant Professor of Economics at the University of Madeira²⁶

Due to the immense pressure from BOP to protect the affected creditors and investors, ESI scrambled to repay BES' clients while embarking on an arduous journey to refinance it. New bonds with substantially shorter maturity dates were issued through complex transatlantic schemes, which ultimately ended up in the hands of BES clients. This involved ES Bank Panama (ESBP), another family-linked firm, and BES' special-purpose entities²⁷ in the tax haven of Jersey. These special-purpose vehicles were located in the Channel Islands for an important purpose - to hold and re-engineer debt for BES, allowing the group to keep it off their balance sheet²⁸.

Furthermore, these special entities were not properly accounted for in the books of BES and therefore masked the additional liabilities incurred. This fraudulent accounting method violated Portuguese financial regulations and caused BES to incur a hefty fine of € 1.1 billion²⁹, contributing significantly to the €3.6 billion loss in the second quarter, which was more than five times its market value³⁰.

Despite Espírito Santo's escalating debts and the diagnosis of financial sickness within ESI, Salgado personally signed letters to major clients to assure them of BES's ability to repay its holding companies' debts. One of the two letters was addressed to a Venezuelan state oil company, which had bought US\$400 million in bonds from the family companies³¹. By promising that the bank stood behind the holding company's debt, Salgado defied an explicit directive from BOP to stop mixing the bank's affairs with the family business.

Under Salgado's leadership, BES continued to lend money to the family companies, which was often done without exchange of securities and collaterals. To enable Rioforte to meet payment obligations on commercial paper, BES lent € 190 million in exchange for securities despite rumors of Rioforte bordering on bankruptcy³². Ultimately, Rioforte failed to repay its debts. To add to the series of misfortune, ESFG's promised collateral used to secure the loan of € 120 million from BES also failed to appear³³.

By the end of June 2014, BES's debt exposure to the Espírito Santo companies amounted to € 1.57 billion and it further owed customers another € 3.1 billion³⁴. During this period of turmoil, ESI still continued to issue € 1 billion of new shares. Against this backdrop, it came as no surprise when the news of the investments being wiped out³⁵ broke out two months later.

Guardians of Portugal: Regulators and auditors

Inspection by External Auditors

After the financials and inner-workings of BES came under fire, the competence, independence and objectivity of the external auditors, KPMG, were placed under close scrutiny. KPMG had been the appointed auditor of BES since 2002. Due to this long-working relationship, Portugal's market regulators had encouraged BES to switch to a new audit firm in 2011 in accordance with non-binding guidance. However, BES dismissed the order and appointed KPMG for yet another four-year term. The explanation that the bank's Audit Committee gave was that continuing with KPMG would allow for "the maintenance of the profound knowledge accumulated by KPMG about operations and risks of [the bank], making the auditing more efficient and productive"³⁶, especially since KPMG's Portugal team was also auditing at least 60 other Espírito Santo entities, on top of BES.

KPMG had been auditing two of the three special-purpose vehicles, and only took over the last of the three special-purpose vehicles, Poupanca Plus Investments, after its auditors, PwC resigned in 2013³⁷. Being the auditor of both the vehicles and the Espírito Santo entities, experts argued that KPMG should have been able to identify the bank and its special entities' close relationships and illegal activities earlier³⁸.

In response to this financial scandal, KPMG admitted that although they audited both BES and the special-purpose vehicles, they belonged to different jurisdictions and were legally separated from Espírito Santo. KPMG Lisbon's auditors claimed that they were not aware of the existence of the vehicles, which were separately audited by the KPMG team in Jersey. In a statement released by its spokesperson in August, KPMG affirmed its professionalism and quality of audit work³⁹.

Regulation by Governmental Bodies

Throughout the years, Salgado had kept close ties with political leaders. A total of 25 ministers and secretaries of state had links to Banco Espírito Santo or Grupo Espírito Santo since 1976⁴⁰.

Due to the scale and power the Espírito Santo empire possessed, governmental regulation was presumed, by the common man, to have been present. However, this proved to be overly optimistic as Salgado was allowed to run the empire as he deemed fit, with minimal regulation from the authorities. During this crisis, Luxembourg's regulator Commission de Surveillance du Secteur Financier (CSSF) did not supervise any holding companies of the Espírito Santo family, while Portugal's BOP claimed that it had no responsibility for supervising the entities of Espírito Santo⁴¹. Antonio Roldan, an analyst for Portugal and Spain, said that "Portugal was supposed to be under very close supervision" by international authorities, namely the European Union, the European Central Bank and the International Monetary Fund, as a condition for the €78 billion bailout of the Portuguese state⁴². This supervision was evidently lacking.

The Espírito Santo companies were mostly incorporated in Luxembourg while BES, their main asset, was incorporated in Lisbon, Portugal. It was reported that "little information was exchanged between regulators in the two countries"⁴³. The Espírito Santo fiasco further highlighted the deficiencies of the Luxembourg and Portuguese regulators, and the potential loopholes that can manifest when companies span across multiple jurisdictions.

Portugal bailout: The end of Banco Espírito Santo

In a final bid to regain consumer confidence, ESFG, under the direction of BOP, replaced Salgado and family members with a team of outsiders – Vitor Bento, as BES's next CEO, José Honório as Vice-President and Joao Moreira Rato, as Chief Financial Officer. While officials rejected Salgado's previous request of a €2.5 billion loan to cushion the collapse of the bank, the €3.6 billion losses in the second quarter eventually triggered a €4.4 billion state bailout, ending its position as a private bank on 3 August 2014⁴⁴.

It was announced that BES will be restructured by splitting into two entities – its debts and toxic assets will be put into a 'bad bank' to be wound up, while a new bank created from its healthy assets, Novo Banco, will be managed by Bento and his team⁴⁵.

Recent developments

On 17 October 2014, it was reported that two of the family's main holding companies, Rioforte and ESI, would go into liquidation. The Luxembourg court had denied controlled management, a kind of creditor protection⁴⁶, thus effectively bankrupting the century-old Espírito Santo family empire.

More recently, on 28 May 2015, it has been reported that BOP has fined the ex-Banco Espírito Santo Officials €4 million for misleading investors. It was alleged that Salgado and his team intentionally provided false information, among other accusations, in a bid to win over financing for the companies controlled by the family, at the expense of shareholders' interests and equity. According to his spokesperson, Salgado will be contesting these accusations⁴⁷.

Discussion questions

1. With reference to the Espírito Santo group, discuss the pros and cons of family ownership and management of corporations generally, and of banks in particular.
2. Discuss the ownership and corporate structure of the Espírito Santo group. What are the corporate governance risks associated with the ownership and corporate structure?
3. Under Portugal's Code of Governance, BES had adopted the suggested guideline of having independent directors. Discuss whether the company's full compliance with a Code of Corporate Governance truly reflects good corporate governance.
4. Discuss the scope of the external auditors' responsibilities in the Espírito Santo debt shuffle.
5. Discuss the pros and cons of having the same external auditors for different entities within a company group. What are the key safeguards for ensuring auditor independence in your country and are these safeguards adequate? Should there be a mandatory rotation of external auditors?
6. Are the regulators and governmental bodies responsible for the inspection of multi-jurisdictional transactions? How could they have better enforced checks and balances on these companies' transactions?

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THE TROUBLED METAMORPHOSIS OF CATERPILLAR

Case overview

When Caterpillar Inc. (“Caterpillar”) first acquired ERA Mining Machinery (“ERA”) in June 2012, the transaction was heralded as a triumph for the company, and a milestone in its strategic expansion into the world’s largest coal industry, China. However, barely five months later, Caterpillar discovered accounting irregularities that led to a goodwill impairment charge of US\$580 million¹ – 86% of the value of the deal². While Caterpillar maintained that the acquisition was the right move, it continued to be embroiled in lawsuits and struggles with getting the acquired company back on its feet. Furthermore, despite decades of investment, China still accounts for only three per cent of Caterpillar’s worldwide sales³. The objective of this case is to allow a discussion of issues such as board composition and structure and their impact on board effectiveness; the role of different stakeholders in ensuring proper due diligence of acquisitions; the challenges of doing due diligence especially for acquisitions in markets such as China; challenges faced by multinational companies entering foreign markets; and the business culture in China and the challenges of managing cultural differences.

This is the abridged version of a case prepared by Deng Qing, Luo Yilin, Selena Tan Rui Zhen, and Toh Wei Ni under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Chloe Chua under the supervision of Professor Mak Yuen Teen.

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The World is wide open

Caterpillar, founded in 1925 and headquartered in Peoria, Illinois, is one of the world’s most renowned manufacturers of construction and mining equipment, diesel and natural gas engines, industrial gas turbines and diesel-electric locomotives⁴. It has four main operating segments in Construction Industries, Resource Industries, Power Systems and Financial Products. When Douglas Oberhelman took over as CEO of Caterpillar in July 2010, he shifted the company’s strategic focus to emerging markets, particularly China⁵.

We have got to win in China

Oberhelman announced a plan to quadruple the production of excavators in China within four years by leveraging on the extensive operations and broad dealer network established in China in the past 30 years⁶. As part of its long-term business strategy to enter China and to support the growing base of Chinese customers, it embarked on aggressive organic and acquisition growth strategies⁷.

China produces almost half of the world’s coal and the industry is forecast to have further growth over the next several years. Having lost out on opportunities to gain market share in construction machinery in the past, Caterpillar did not want to miss the chance to ride on the wave of the boom in China’s coal mining equipment industry⁸.

Why ERA?

However, while China’s coal industry is the largest in the world, its distinctive feature lies in being extremely insular, as local companies, particularly state-owned enterprises, are loyal to domestic machinery brands. Therefore, to carry out an effective expansion into the coal mining equipment market, tying up with a Chinese company was an essential step⁹.

ERA primarily designs, manufactures, sells and supports underground coal mining equipment in mainland China through its wholly owned subsidiary Zhengzhou Siwei Mechanical & Electrical Equipment Manufacturing Co., Ltd (“Siwei”)¹⁰. Being a former state-owned enterprise, Siwei has the advantage of having close ties with the Chinese government¹¹. An additional advantage was that ERA was listed on the Stock Exchange of Hong Kong (SEHK), which made it much easier for a foreign company like Caterpillar to acquire it.

Another factor that boosted Caterpillar management’s confidence in pushing for the acquisition was the fact that they trusted Siwei’s major shareholders who had American connections¹². However, it was later revealed these shareholders were only responsible for strategic decisions of the group and had limited participation in Siwei’s daily operations.

Takeover bid

On 10 November 2011, Caterpillar and ERA jointly announced the pre-conditional voluntary offer by Caterpillar, through its wholly own subsidiary Caterpillar (Luxembourg) Investment Co. S.A., to acquire all the issued shares of ERA. The offer represented a 33% premium over the ERA stock price at that time¹³.

Four months later, Caterpillar announced the successful completion of its tender offer for ERA, after the approval from the Ministry of Commerce of the People’s Republic of China (“MOFCOM”)¹⁴.

The game is up

However, in the course of the integration process, Caterpillar began to notice inventory discrepancies during a physical inventory count, which led to an internal investigation¹⁵. In November 2012, only five months after the completion of the milestone acquisition, Caterpillar discovered serious accounting fraud at Siwei after hours of grilling Siwei’s Chairman and CEO, Wang Fu. The investigation revealed inappropriate accounting practices –such as improper cost allocation that overstated profit, and early and unsupported revenue recognition– practised by Siwei’s management years before the completion of the takeover¹⁶.

Red flags missed

Caterpillar’s failure to spot the danger signs at Siwei raised doubts about the way it did business abroad. In the scramble to “win in China”, did Caterpillar executives lose sight of the risks?

Public Listing Through Reverse Takeover

Prior to the Caterpillar takeover, ERA was listed in the Growth Enterprise Market (GEM) of SEHK, which had been designed to accommodate companies with a higher risk profile¹⁷. It had acquired Siwei through a reverse takeover in 2010, a corporate maneuver that had previously created controversy in the U.S. following a series of accounting scandals involving small U.S.-listed Chinese companies¹⁸. This should have raised an alarm regarding the risks of the acquisition and called for greater due diligence to be undertaken.

*Questionable Loans From Directors*¹⁹

Another red flag was the fact that ERA had borrowed more than US\$9.5 million from four directors at loan rates that were among the most expensive on its balance sheet, given that the interest rate paid to directors was eight percent compounded annually, while the interest rate that commercial banks charged ERA was only between 4.9% and 7.4%. This resulted in estimated interest payable of US\$500,000.

While company loans to directors in the U.S. are not permissible, loans from directors to companies are a grey area. Not only was this a questionable business move, it was also doubtful whether the transactions were on an arm’s length basis.

*Other Red Flags*²⁰

Siwei had also issued the first of two profit warnings in March 2012 before the acquisition took place²¹. While Caterpillar sought explanations regarding the profit warning from ERA executives, they nevertheless decided to push forward with the deal without further questioning. Other red flags that should have surfaced during the acquisition process include asset reshuffling, issues with working capital and unusual increases in inventory²².

Due diligence

In August 2013, Caterpillar's shareholder Michael Wolin sued two Caterpillar executives and 14 board directors for breaches of fiduciary duties in relation to the Siwei scandal^{23,24}. In his suit, he claimed that the defendants had failed to heed the warning signs that were present in Caterpillar's financial documents and had continued with the acquisition process even though Siwei's financial position did not warrant its asking price.

A risk consultant who advises U.S. corporations in Asia said that key executives might have overlooked the risks of the acquisition because they were too personally invested to pull the plug²⁵.

CEO

Within the first five months of being appointed as CEO of Caterpillar, Oberhelman completed US\$9.4 billion in deals. In stark contrast, his predecessor Jim Owens had only made US\$1.9 billion in transactions during his tenure of more than six years²⁶.

In addition, in 2010, Oberhelman also stepped up to become the Chairman of Caterpillar, while retaining his role as CEO, further cementing his power within Caterpillar²⁷.

Board of Directors²⁸

Reuters reported that the Board's attention was diverted away from the ERA acquisition due to a larger acquisition during the same period²⁹. There was also evidence indicating that Caterpillar's board of directors did not ask for the results of the due diligence investigation for the ERA acquisition. Given the sheer scale of acquisitions that Caterpillar had entered into over the past few years, it may have been advisable for the board to exercise more rigorous due diligence, such as having a committee specifically to assess special projects like mergers and acquisitions. In fact, in 2011, Caterpillar only had four committees – Compensation, Audit, Governance and Public Policy.

Furthermore, there were other signs that Caterpillar's board composition was less than optimal. First, the Board was large, with 15 directors in total. Second, at the time of the acquisition, seven out of the 15 Caterpillar directors had sat on the board for more than a decade³⁰.

Siwei Directors And Shareholders

At the time of the acquisition, ERA's Executive Chairman was Emory Williams, an American who was a pillar in the expat business community in China and who undoubtedly provided a confidence booster for foreign investors who were unfamiliar with business operations in China³¹. Experienced China hands like Williams and Li Rubo (John Lee) were supposedly well-versed in the creative accounting tricks employed by Chinese companies. Hence, although Caterpillar never accused the principals of involvement in the alleged fraud, there were questions as to how such a massive fraud could have been perpetrated under their noses without their knowledge³².

External Consultants

To facilitate the deal, external financial, legal and accounting advisers were engaged. Citigroup Global Markets Asia Limited served as exclusive financial adviser for Caterpillar, while Freshfields Bruckhaus Deringer LLP served as legal adviser. The Blackstone Group (HK) Limited served as the financial adviser for ERA, and DLA Piper served as its legal adviser³³. However, despite the precautions employed to ensure a robust and rigorous acquisition, the accounting misconduct was ultimately concealed until five months later in November 2012.

Aftermath

In January 2013, Caterpillar released a public announcement³⁴ that there had been "deliberate, multiyear, coordinated accounting misconduct" at Siwei, following which, Wang Fu, then CEO of Siwei, was fired along with other key executives³⁵. However, Wang denied the occurrence of fraud and instead claimed that it was merely an incidence of mismanagement.

Furthermore, Caterpillar took a US\$580 million write-down in goodwill for the fourth quarter of 2012, which dented Caterpillar's profit during the quarter to US\$697 million, nearly 55% lower than in the same period the previous year³⁶. Although the size of the charge equated to less than one percent of Caterpillar's market capitalisation, the saga impacted investors' perception of Caterpillar's China growth strategy³⁷.

In May 2013, Caterpillar announced that it had settled the dispute with Siwei's shareholders regarding the consideration for the acquisition³⁸. Four shareholder suits were filed in the U.S. in Caterpillar's home state of Illinois³⁹.

Critics believe that Caterpillar may have been too heavy-handed in its treatment of the ERA scandal. First, they dismissed key executives whose business relationships were key to Siwei's business. Second, they strained their relationship with Li Rubo, one of ERA's key shareholders with extensive ties in the mining community. Altogether, this could negatively impact their prospects in China⁴⁰.

Despite the accounting scandal, Caterpillar had no intentions to "cut off ties" with Siwei. Instead, in November 2013, Caterpillar announced the phasing out of Siwei's brand and the renaming of the company to Caterpillar (Zhengzhou) Ltd⁴¹.

Part of a bigger picture

Caterpillar's scandal was only one of many cases where foreign investors have been victims of irregular accounting practices in China. Why is accounting irregularity so seemingly pervasive in Chinese companies?

One possible reason is the governmental restriction on transfer of the Chinese currency to foreign countries, which may motivate Chinese businessmen to accumulate wealth offshore through foreign stock market listing, thereby window-dressing their companies' accounts to increase their attractiveness to foreign investors⁴².

China also seems unwilling to cooperate with other countries' law enforcers and regulators, and this may send Chinese businessmen a message that accounting irregularities committed outside China may go unpunished⁴³.

Lastly, with regards to due diligence, it is difficult for the auditors, lawyers, and bankers assessing Chinese companies before an overseas foreign investment to spot any accounting discrepancies, especially if they are working in an unfamiliar jurisdiction. In addition, they may possibly bring in local advisers who may be cooperating with the subject of the investigation⁴⁴.

Emerging from the chrysalis

With China's economy slowing and facing increasingly stiff local competition⁴⁵, Caterpillar's prospects in the Chinese market are far from optimistic. Just like how a caterpillar must break down its first form to transform into a butterfly, Caterpillar needs to revamp its business strategy to better adapt to the cultural differences and business reality in China. Only then can it truly become the global industry leader and realise its Chinese dream.

Discussion questions

1. Evaluate the board composition and structure of Caterpillar and whether this may have contributed to the problematic acquisition of ERA.
2. Evaluate the extent of each stakeholder's role in performing due diligence before the acquisition of ERA. [i.e., Caterpillar's management, Caterpillar's board of directors, ERA's shareholders/directors, and external consultants, including bankers, auditors, lawyers]
3. How did the business culture in China contribute to Caterpillar's Siwei scandal?
4. Given the discovery of accounting irregularities in Siwei, do you believe that the acquisition was the right move for Caterpillar? Would you recommend other multinational companies to acquire Chinese companies as an effective way to break into the Chinese market?
5. How can foreign companies manage cultural differences when doing business in China?

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THE CO-OPERATIVE BANK: THE WITHERING FLOWERS

Case overview

On 21 November 2013, Paul Flowers (Flowers) was arrested as part of a drug supply investigation. The drug scandal led to Flowers' immediate suspension from his role as a Methodist Church minister and as a member of the Labour Party. Additionally, it sparked a "root and branch" investigation into how the failing Co-operative Bank, where Flowers formerly held the role of Chairman, was run, and how the Co-operative Group ended up with a £1.5 billion shortfall in capital. It was discovered that the directors in the Co-operative Bank were selected based on the candidates' performance in psychometric tests and on interviews by the Committee which focused more on candidates' knowledge of the Co-op Group than their expertise and experience. Additionally, although Flowers was considered as an independent Chairman, he was actively involved with the Co-operative movement and the Labour Party, both of which have strong ties with the Co-operative Bank. The objective of this case is to allow a discussion of issues such as board structure and composition; the role of different parties (i.e., board of directors, nominating committee, regulators and shareholders) in selecting and approving appointments of directors; director selection criteria; director competencies and independence; responsibilities and critical skills and competencies of the Chairman; politically-connected directors; and ethics.

This is the abridged version of a case prepared by Eugene See Wen Jie, Lan Yingli, Ng Ray Min and Ong Bee Hui under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

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The crystal Meth-odist

Paul Flowers, a Bristol University theology graduate, had been a minister of the Methodist church in Bradford since 1976. He was a long-serving member of the Methodist Conference and was, for a number of years, the Secretary and then the President of the Consultative Conference of European Methodist churches.

Flowers had also been an active member of the Labour Party since he was 16 years old. He served as a Labour councillor in Rochdale from 1988 to 1992, and was elected as Labour councillor in Bradford in 2002. Flowers had also been active in the community, serving on the boards of various community-based organisations, such as the Lifeline Project, which works with substance abuse users. However, on September 2011, Flowers resigned as a Labour councillor after adult content was found on his council laptop.

Planting seeds in the Co-operative Bank

Flowers was appointed to the Board of The Co-operative Bank plc (Co-op Bank) in 2009 following its merger with the Britannia Building Society. In April 2010, he was appointed as Chairman of the Co-op Bank and Vice-Chairman of The Co-operative Group Limited (Co-op Group).

The rise of Flowers through the ranks of the Co-op Bank was not due to any banking expertise as he had a mere four years of employment at National Westminster Bank Plc. Rather, it was due to his political connections and the tradition of the Co-op Group of "appointing a democrat from within its own numbers as the chair of that board"¹.

Ties that bind: Co-operative and labour

The Manchester-based Co-op Group is a mutual society which traces its roots to the Rochdale Society of Equitable Pioneers. In 1927, the political wing of the Co-op Group, the Co-operative Party, accepted a junior role within the Labour Party. Since then, the Co-op Group has been closely aligned with the Labour Party, with £1 million spent annually to fund pro-Labour activities, along with a total of £18 million in “soft loans” over the years at interest rates well below that of the market². This support was reciprocated in the form of advice from Labour politicians, which often shaped the Co-op Group’s business decisions.

Political cheerleading

In October 2008, the Co-op Bank planned to merge with the Britannia Building Society. However, this was dependent upon parliamentary support for a bill that would remove legislation prohibiting mergers between mutuals and co-operatives. In support of the merger, Ed Balls, the then-Secretary of State, Children, Schools and Families, and a Labour-Co-operative member of parliament, supported the bill. He also maintained constant contact with Len Wardle (Wardle), the Chairman of Co-op Group at that time and the “darling of the Left-wing establishment”³, who continually encouraged the merger. The merger between Co-op Bank and Britannia Building Society, lauded by Balls as Britain’s “first-ever ‘super-mutual’”⁴, was completed in August 2009.

Following this, the board of directors had to approve the merger. Flowers, then a director of the Co-op Bank, approved the merger and allowed it to proceed⁵. Flowers’ cooperation eventually led to his promotion to Chairman of the Board of the Co-op Bank.

The Co-operative Bank board structure

The Co-op Bank had only one executive director in its thirteen-member board of directors. Barry Tootell, the Chief Executive Officer and sole executive director of the Co-op Bank, held an executive directorship not only in the Co-op Bank, but also in the Co-operative Banking Group Limited (Co-op Banking Group), CIS Limited and CIS General Insurance Limited, effectively holding four executive directorships within the Co-op Group.

Additionally, the majority of the Co-op Bank’s board was not independent as there were only five independent directors present. This was not congruent with the U.K. Corporate Governance Code’s recommendation that “at least half the board, excluding the Chairman, should comprise non-executive directors determined by the board to be independent”⁶. The Co-op Bank explained in its 2012 annual report that it was taking steps to recruit new independent non-executive directors to “improve the Board’s independence and ensure compliance with the Code”⁷.

Furthermore, only two out of five members on the Co-op Bank’s nominating committee were considered independent, non-executive directors. In this regard, the Co-op Bank yet again fails to comply with the Code that states “a majority of the nomination committee should be independent non-executive directors”⁸. This could potentially have an adverse impact on the Code’s recommendation of “a formal, rigorous and transparent procedure for the appointment of new directors to the board”⁹.

Climbing the Co-operative ladder

The Co-op Bank’s board of directors was drawn from the regional boards of the Co-op Group, each having different backgrounds, ranging from plasterers to horticulturalists. Many directors were also veterans of the Co-operative movement and had former ties with the Labour Party. As David Stanbury, a member of the Co-operative movement, once commented, “How did Flowers and people like him get into their positions? The answer is that a lot of it stems from their positions within the Labour Party.”¹⁰

In 2010, Bob Burlton stepped down as Chairman of the Co-op Bank. The task of appointing a new Chairman fell to the Remuneration and Appointments Committee, which comprised largely of ex-Labour politicians and Co-operative members. In line with the Co-op Group’s tradition¹¹, Wardle, Chairman of the Co-op Group, looked at the Group’s board for a potential successor for the Co-op Bank.

Flowers had ticked all the right boxes. He was a long-serving member of the Co-operative movement, had been an active member of the Labour Party for years, and was known for his robust style of dealing with people who disagreed with his views¹². After being shortlisted, Flowers was subjected to various psychometric tests and interviews by the Committee¹³. Interviewees were quizzed extensively on their knowledge of the Co-op Group, which Flowers easily aced, resulting in a unanimous decision to select him as the next Chairman of the Co-op Bank.

Labour party ties

Out of the 13 directors on the Co-op Bank's board, three directors had direct relationships with the Labour Party. Besides Paul Flowers, Duncan Bowdler was a Labour Party and Co-operative member¹⁴ and was involved in several community organisations in Crumpsall, Manchester. It was speculated that his appointment as non-executive director in the Co-op Group, Co-op Banking Group¹⁵ and Co-op Bank was due to his 37 years of active involvement in the Labour and Co-operative movements¹⁶.

Another director, Wardle, was a former Labour councillor and prominent member of Labour's sister party, the Co-operative Party. Despite the lack of a discernible background in business, he was the Chairman of Co-op Group and a non-executive director of both the Co-op Banking Group and Co-op Bank. He was also the main champion of the merger of Co-op Bank with the Britannia Building Society in 2009, which went through with the help of his allies in the Labour government.

Co-op Group ties

All the directors of the Co-op Bank were also directors of the Co-op Banking Group. On top of their positions in the Co-op Banking Group, nine directors held additional directorships within other branches of the Co-op Group umbrella¹⁷. Peter Marks, the Group Chief Executive of Co-op Group, was the "driving force" in pushing for the acquisition of the Lloyds Banking Group branches despite concerns about overstretching in the financial division¹⁸.

On the push for the acquisition, Andrew Tyrie, the current Chairman of the Treasury Select Committee, criticised the former management of the Co-op Bank, saying that there was "a lack of personal accountability at senior levels, ineffective corporate governance and insufficient experience and expertise among those taking the decisions; this has become a familiar story."¹⁹

The final hurdle

Before Flowers could be officially appointed, he required the approval of the U.K.'s Financial Services Authority (FSA), whose role has since been succeeded by the Financial Conduct Authority from 1 April 2013.

In Flowers' interview with the FSA, the regulators dismissed Flowers' past conviction for gross indecency as irrelevant²⁰. The main issue was, instead, his lack of financial experience. Flowers acknowledged this, and proposed appointing two experienced deputy chairmen to assist him. The regulators accepted this proposal and subsequently approved his appointment as Chairman of the Co-op Bank²¹.

Flowers was officially appointed as the bank's non-executive Chairman on 15 April 2010. However, problems soon surfaced. In July 2011, Flowers approved the planned takeover of 632 Lloyds Banking Group branches despite strong opposition from his deputy chairmen, Rodney Baker-Bates and David Davis²². The progression of the deal, codenamed Project Verde, by the Flowers-led board led to Baker-Bates' resignation²³. Despite losing Baker-Bates, Flowers did not appoint a replacement deputy, and the issue was not pursued by the FSA. This resulted in a lack of checks and balances, which came into serious question when Project Verde eventually fell through and the Co-op Bank was found to have a £1.5 billion "black hole" in its finances²⁴.

The end of Flowers

Flowers subsequently stood down from all his roles within the Co-op Group and the Co-op Bank. Following this, The Mail on Sunday published a video footage of Flowers allegedly boasting about his use of cocaine and other illegal drugs²⁵. The Methodist Church and the Labour Party then suspended Flowers who was investigated by the police and the Commons Treasury Select Committee.

The “nightmare” at the Co-op Bank led to British Prime Minister David Cameron announcing in the House of Commons that he would initiate an inquiry to determine how Flowers had come to be appointed as Co-op Bank’s Chairman²⁶. Not only were questions being asked about Flowers’ credentials and the motivation behind his appointment, but also the process behind FSA’s approval. There was also the issue of how the Co-op Bank spent two years attempting to acquire the 632 Lloyds Banking Group branches, particularly as the FSA would have needed to approve the transaction. One thing is clear – the £1.5 billion black hole was truly a huge price to pay for such a lesson on corporate governance.

Discussion questions

1. Evaluate the board composition and structure of the Co-op Bank.
2. What are the typical responsibilities of the Chairman of a Board? What are the most critical skills and competencies of a Chairman? Evaluate the skills, competencies and the independence of Paul Flowers as Chairman of the Co-op Bank.
3. Evaluate the composition of the Nominating Committee of the Co-op Bank. What is the role of the Nominating Committee in screening Board candidates? How far should the Nominating Committee go in performing due diligence on an individual’s personal character and ethics?
4. Discuss the importance of political connections in the appointment of board members in the Co-op Bank and the corporate governance issues that arise from such political connections. To what extent do political connections matter for appointments to the boards of listed companies in your country?

5. What role should regulators play in approving the appointments to boards of financial institutions? What are the rules in your country regarding such regulatory approvals?
6. Given the prevalence of banking groups in the financial sector (i.e., with a financial holding company and subsidiary bank), do you think this particular structure raises any corporate governance issues? Compare this with banking groups in Singapore and Asia.

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EBAY-ING FOR BLOOD: BATTLE WITH A SHAREHOLDER ACTIVIST

Case overview

In early 2014, Carl Icahn acquired a 2.15% stake in eBay. The shareholder activist then released a statement which accused its two long-serving directors, Scott Cook and Marc Andreessen, of not acting in the best interest of the e-commerce giant. Icahn alleged that the two independent directors had outside commitments which created a material conflict of interest, hence leading to the company's poor governance. In addition, in his letter to the shareholders, Icahn proposed that eBay should spin off its subsidiary, PayPal, and pushed for his nominees to be appointed as eBay's board of directors¹. eBay responded by rejecting Icahn's choice of nominees and proposal to spin off PayPal. However, the proxy fight ended in late 2014 with eBay announcing that it would spin off PayPal into a separate company in the following year to improve its competitiveness and that Andreessen would resign from eBay's board. The objective of this case is to allow a discussion of issues such as shareholder activism; conflict of interest; remuneration; and independence of directors.

This is the abridged version of a case prepared by Bao Zekun, Chew Jia Yu, Thng Corryne Nataline, Wong Shu Xian under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lim Hui Ying under the supervision of Professor Mak Yuen Teen.

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About eBay

On 3 September 1995, Pierre Omidyar founded an auction website in his apartment located in San Jose, California. Within the first year, traffic on his website was sky-high. It continued to see exponential growth from 250,000 auctions hosted in 1996 to two million auctions in January 1997². Together with Jeffrey Skoll, the first president of the company, Omidyar decided to rename the website "eBay" in 1998. They also listed the company on NASDAQ. eBay then grew from a simple auction service website to a fully integrated internet market place. Its major revenue streams come from the global e-commerce platform ebay.com, PayPal and services to its enterprise customers in the form of Commerce Technologies. In a short span of seven years, eBay's net revenue increased from US\$41 million to US\$16 billion in 2013³.

The beginning of the proxy fight

In a letter sent to the shareholders of eBay, Icahn criticised the company's poor governance. He alleged that two of its independent directors, Marc Andreessen and Scott Cook, were in a position where their outside commitments created a material conflict of interest⁴.

Marc Andreessen

Andreessen had been appointed as an independent director of eBay in 2008. He was concurrently leading Andreessen Horowitz, a well-known U.S. venture capital firm that he co-founded^{5,6}. Icahn accused Andreessen of taking inappropriate actions in the sale of Skype by eBay. After buying Skype for US\$2.6 billion in 2005, eBay divested 70% of it to Silver Lake, an investor group which included Andreessen Horowitz, for US\$1.9 billion in cash in 2009⁷. Eighteen months after the acquisition, Silver Lake sold Skype to Microsoft for US\$8.5 billion in cash. Silver Lake made a US\$4 billion profit, hence allowing Andreessen Horowitz to profit from its three percent interest in Silver Lake. Icahn criticised that this sale "cost the stockholders hugely and only benefited private equity firms to the tune of US\$4 billion"⁸.

Another criticism by Icahn was that Andreessen Horowitz had actively advised eBay's direct competitors, such as Coinbase and Dwolla, on strategic matters and industry insights. Due to his capacity as the director, Andreessen had access to sensitive information about eBay and this had put his interests in conflict⁹.

Scott Cook

Scott Cook had been serving as an independent director of eBay since 1998. At the same time, Cook held 4.64% of Intuit's shares and was the controlling shareholder¹⁰. The shareholding interest Cook had in Intuit was more than four times the shares he held in eBay. Icahn claimed that Intuit's Go-Payment had the same consumer payment processing capabilities and hence, was in direct competition with eBay's PayPal Here¹¹. As such, he questioned Cook's ability to exercise independent judgment and act in the best interest of eBay and its shareholders.

Icahn's proposals

Icahn also made two proposals. First, he proposed the separation of eBay and PayPal as he believed that the independence of the two businesses would provide the best opportunity for them to remain competitive¹².

Secondly, Icahn believed that fresh shareholder representation from the board was necessary for eBay's long-term success. He proposed to appoint two nominees, Jonathan Christodoro and Daniel Ninivaggi, to the Board. Christodoro and Ninivaggi had served as the managing director of Icahn Capital¹³ and the director of Icahn Enterprise¹⁴ respectively. Icahn was the majority shareholder of Icahn Enterprise and Icahn Capital operated as an investing arm of Icahn Enterprise.

eBay's response

In response to Icahn's criticisms, Pierre Omidyar, the chairman of eBay, released a statement supporting Cook and Andreessen as world-class directors with impeccable credentials¹⁵. In the case of Cook, CEO John Donahoe refuted Icahn's claim by stating that the competing portion between Intuit and eBay accounted for less than one percent of eBay's revenue¹⁶. In the case of Andreessen, eBay explained that Andreessen was not involved in the divestment of Skype and that the intention of selling Skype was to focus on its core business¹⁷. Andreessen also defended himself and stated that he had disclosed his potential conflict of interests fully and hence recused himself from all deliberations on Skype. He also

argued that the ownership that eBay had retained in the Skype spin-off was 30%, while Andreessen Horowitz only had three percent interest in Silver Lake. The larger ownership gave eBay a bigger role in the decision-making in Skype and a larger profit from the sale to Microsoft¹⁸.

eBay also questioned Icahn's intention of nominating his employees onto eBay's board. Both Christodoro and Ninivaggi lacked relevant leadership and operational experience in technology¹⁹ and were concurrently sitting on four boards. eBay revealed that Christodoro was appointed to four boards due to Icahn's pressure on the companies and had, on average, less than one year of experience on each of the board he had served on. Both individuals were contractually bound and were required to act in a manner that benefits the Icahn affiliates. This is said to hinder them from being truly independent directors²⁰.

Arguing against the proposal to spin off PayPal, eBay contended that PayPal had grown rapidly as part of eBay, with US\$6.6 billion of revenue in 2013²¹. Moreover, a spin-off of PayPal could lead to eBay's loss of important access to transactional data from its 128 million active users. In addition, eBay's stock price had increased 441% in the past five years, outperforming the S&P 500 and NASDAQ Composite. The board attributed this success to eBay and PayPal being kept together²².

The end of proxy fight

On 10 April 2014, eBay made peace with Icahn and ended the proxy fight. In exchange for adding David Dorman to eBay's board, Icahn withdrew both of his proposals to spin off PayPal and to add his nominees into the board of eBay. Dorman had previous executive experience on the Board of Motorola and was added on Icahn's suggestion²³.

Although Icahn temporarily dropped his proposal for the spin-off of PayPal, he continued to believe that eBay would benefit if separated from PayPal, and intended to press his case through confidential discussions with eBay²⁴.

Icahn's ultimate victory

On 30 September 2014, eBay announced that it would spin off PayPal into a separate company in 2015, so as to improve its competitiveness in the fast-evolving payment-processing business²⁵. In response to this announcement, the share price of eBay went up by around seven percent²⁶. John Donahoe explained that a review of the company showed that "keeping eBay and PayPal together beyond 2015 becomes less advantageous to each business strategically and competitively"²⁷. Seven months after making the case against spinning off PayPal, Donahoe sang a different tune²⁸. Moreover, on 20 October 2014, Marc Andreessen announced his resignation from eBay's Board²⁹.

Compensation

As part of eBay's compensation scheme for all senior vice presidents and above, Performance-Based Restricted Stock Unit (PBRSU) awards were granted. The stock units vest over two years, with 50% vesting in the following March, and the remaining 50% vesting one year later. In 2011, eBay amended the vesting period of the stock units granted to the CEO and CFO to one year after the grant was made³⁰.

Deferred Stock Units (DSU) awards were granted to non-employee directors upon election to the board. Twenty-five percent of the DSU vests one year after the date of grant and 1/48th of it vests each month thereafter. Non-employee directors may elect to receive fully-vested DSU on a quarterly basis in lieu of retainer fees at a value equivalent to the amount of fees³¹.

As of 31 December 2013, including DSU granted in lieu of fees, the non-employee directors held the following aggregate number of DSU: Fred Anderson, 36,425; Marc Andreessen, 42,668; Edward Barnholt, 44,476; Scott Cook, 46,970; William Ford Jr, 48,846; Kathleen Mitic, 16,045; David Moffett, 38,118; Richard Schlosberg, 35,307; and Thomas Tierney, 44,807. Each director received US\$220,000 of DSU at the time of each annual meeting. Top executives were also granted options on an annual basis. These options fully vest after four years, in a similar progressive vesting pattern as the DSU award³².

Director independence and ethics

NASDAQ Listing Rule 5605(b) requires companies to have a majority of independent directors. Among the directors that eBay had determined to be independent, Anderson, Barnholt, Cook, Ford, Schlosberg and Tierney have served on the board for nine years or more.

In addition, NASDAQ Listing Rule 5605(c) requires the audit committee to consist solely of independent directors. eBay had complied with the rule by appointing Anderson, Schlosberg and Moffett to the audit committee. Anderson chairs the audit committee and fulfils the definition of an 'audit committee financial expert', as adopted by the U.S. Securities and Exchange Commission (SEC). It was also disclosed in the 2014 Proxy Statement that SEC filed a complaint of improper stock options backdating against Anderson and a former officer of Apple Inc. on 24 April 2007. Anderson was alleged to have failed to take steps to ensure the accuracy of the financial statements. Anderson did not admit or deny the allegations by SEC. Together with a civil monetary penalty of US\$150,000³³, the settlement with SEC required Anderson to disgorge US\$2.95 million of gains and US\$528,107 of prejudgment interest.

Epilogue

On 21 January 2015, eBay announced a deal with Carl Icahn to give one of his nominees, Christodoro, a seat on the board of directors. Christodoro was given the option to move to PayPal's board after the spinoff. eBay also announced a series of new governance rules for PayPal after the spinoff, which Icahn called "a collaborative" exercise between his firm and eBay. The new rules will require PayPal directors to be re-elected by shareholders every year instead of every few years in eBay. In addition, eBay is expected to reduce its global workforce by 2,400, which is equivalent to seven percent, in the first quarter of 2015³⁴.

After the spin-off, PayPal and eBay will continue to share many business relationships. eBay will continue to route roughly 80% of its gross merchandise sales through PayPal for the next five years, and PayPal has agreed not to set up its own e-commerce marketplace³⁵. In addition, all the directors of eBay are expected to either migrate to PayPal, or share their positions in both companies³⁶.

The spin-off left one worse off than the other, where PayPal's revenue grew and topped that of eBay's³⁷. On the other hand, eBay's revenue from its key marketplaces segment fell by four percent in the first quarter of 2015. Nevertheless, on the whole, eBay has beaten analysts' targets for earnings per share and also reported sales which were above expectations.

Discussion questions

1. Consider Carl Ichan's assertion regarding the two eBay directors and the defence provided by eBay. Do you think there is a conflict of interest? Explain. How should such conflicts be addressed?
2. Given the dispersed ownership of eBay, how can shareholders play a role in monitoring the board of directors?
3. Consider the case when Carl Ichan was pushing for his own nominees. Do you think there is a divergence between self-interest and interests of the company when shareholders appoint their nominees to the board of directors? What are the pros and cons from a minority shareholder standpoint, when activist shareholders appoint their nominees?
4. Assess the independence of the independent directors on the eBay board.
5. Discuss the appropriateness of awarding shares in place of fees for non-employee directors.
6. Comment on the vesting of the stock units and options. Is it in the interests of the company? Explain.

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ECOBANK TRANSNATIONAL: TROUBLE IN NIGERIA

Case overview

In October 2013, the board of directors of Ecobank Transnational Incorporated (ETI) Group, backed by institutional shareholders, removed the Chairman, Kolapo Lawson. This followed his failure to properly answer the queries posed by the Central Bank of Nigeria (CBN) on his fitness for office because of debts owed by his company to ETI and the Asset Management Corporation of Nigeria (AMCON). In March 2014, the board removed the Chief Executive Officer (CEO), Thierry Tanoh, over allegations of mismanagement, including firing a whistleblower and attempting to pay himself a large bonus. The objective of this case is to allow discussion of issues such as the impact of the external environment on corporate governance; conflicts of interest; interlocking directorships; whistleblowing; and the roles of institutional investors and regulators in corporate governance.

This is the abridged version of a case prepared by Chua Hsieh Wen, Tan Hun Sheng and Xing Qianqian under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lim Kai Ting Grace under the supervision of Professor Mak Yuen Teen.

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A letter to ethics

On 5 August 2013, Laurence Do Rego, Executive Director (ED) of Risk and Finance of ETI Group, was reviewing for the very last time the petition letter she had written. Many thoughts raced through her mind as she recalled the chain of events that struck the company in recent months, eventually culminating in her suspension that morning.

An ETI employee since 2002, Do Rego had risen through the ranks to become Chief Financial Officer in 2005, and to her current position in 2010. In the process, she was named the 2010 African Businesswoman of the Year by the Commonwealth Business Council.

She pondered over the actions of the Chairman and CEO. Surely, the state of corporate governance at the bank had breached multiple provisions in the code, if not the law itself. But what else could she do?

With a click of the mouse, the letter was sent. As the clock ticked past midnight, Do Rego drew in a deep breath as she braced herself for what was to happen.

Nature or nurture?

The Nigerian economy of 2009 is historically remembered for the region's most prominent banking crisis. Triggered by the 2007 sub-prime crisis, the Nigerian stock market collapsed and many Nigerian banks were on the verge of bankruptcy. In order to stabilise the system and restore confidence, the Central Bank of Nigeria (CBN) was forced to spend NGN\$620 billion (US\$3.88 billion) bailing out financial institutions close to collapse, and replaced the leadership at eight Nigerian banks¹.

Four years on, the Nigerian bankers appeared not to have learnt their lessons. In 2013, the corporate governance scandal surrounding Ecobank once again thrust the Nigerian banking industry into the limelight, subjecting it to intense scrutiny. Observers were quick to point out that failures in corporate governance had once again proven to be the underlying cause of the whole saga. In fact, statistical trends have attested to this. According to the Worldwide Governance Indicators (WGI) report, Nigeria has been performing below average, if not the worst, for all six indicators (voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption) over the period 1996 to 2013².

All these begged the question - was the state of poor governance a “recessive gene” manifesting itself in Nigeria’s banking industry time after time? It certainly seemed so as history was about to repeat itself.

The making of an Empire

Born in Lagos, Nigeria, Kolapo Lawson³ (Lawson) was the son of a highly respected businessman and Queen’s Counsel, Chief Adeyemi Lawson. It was thanks to the vision of Chief Lawson and the other founding fathers that Ecobank was formed in 1985⁴. Kolapo Lawson’s life with Ecobank started when his father asked him to do research and write a paper about the vision of creating an “African bank”. After years of struggle, the dream of an “African bank” slowly took root in the form of Ecobank. Kolapo became a Director of Ecobank Nigeria and Ecobank Togo in 1989 and 1990 respectively. He became a Director of ETI, the group holding company in 1993 and was appointed the seventh Chairman in 2009. Arnold Ekpe, the long-serving former CEO of the Ecobank Group, said “Mr. Kolapo Lawson has been associated with Ecobank since its inception. He has been on the board for the last 16 years and knows the group well”⁵.

Ecobank had since grown into the leading banking institution by footprint in Africa, with a presence in 35 African countries and international offices in Paris, London, Dubai and Beijing. Ecobank is listed on the Lagos, Accra and Abidjan (BRVM) stock exchanges⁶. With US\$22.5 billion in assets and US\$2.1 billion in total equity, Ecobank appeared to be on track to fulfilling its founding fathers’ powerful vision for Ecobank to play a unifying role between French- and English-speaking West Africa.

One man, many hats

Lawson was well-respected in the business world and was at the helm of many corporations. He was the Chairman and CEO of Lawsons Corporation, the Chairman of Acorn Petroleum Plc and Agbara Estates Limited, as well as a non-executive director of three publicly-quoted companies.

Lawson’s multiple directorships did not seem to be a problem until Agbara Estates accumulated “long outstanding” debts of NGN\$1.6 billion (US\$10 million) with Ecobank Nigeria⁷. The lender subsequently assigned the debt to the Asset Management Corp. of Nigeria (AMCON), an agency created to buy lenders’ bad debts in the wake of the 2009 banking crash. Rumour had it that Lawson had fallen behind on the loan repayments.

Leaked memos soon surfaced, suggesting that a boardroom crisis was going on in the Nigerian unit. When these came to CBN’s attention, it wrote to Ecobank Nigeria, castigating Lawson as being unfit to head the group holding company.

Biggest shareholders unnerved

Lawson was adamant that the loan was a non-issue, having been contracted well before he ascended to the post of chairman. ETI’s board had yet to seriously consider the matter. However, on 17 July 2013, South Africa’s Public Investment Corporation (PIC), the biggest shareholder of ETI, sent a confidential letter to the board of directors requesting for an urgent meeting to rectify the issue⁸.

PIC manages ZAR\$1.4 trillion (US\$127 billion) mostly for South African public sector clients, with the Government Employee Pension Fund and Unemployment Insurance Fund⁹ among them. PIC had a 20% stake in Ecobank in April 2012, paying a consideration of ZAR\$1.7 billion (US\$250 million).

At the urging of PIC, Lawson appeared to be working with AMCON to repay the loan owed by Agbara Estates, with AMCON spokesman Kayode Lambo saying in a telephone interview on 2 August 2013 that Lawson was in “good standing” with them¹⁰.

A potential major shareholder of ETI, Nedbank Group Ltd, a South African bank controlled by London-based Old Mutual Plc., had an option to buy 20% of Ecobank in November 2013 based on a convertible loan¹¹. Nedbank refused to discuss the matter of the loan associated with Lawson's business.

The whistleblower's allegations

Lawson subsequently received the "all clear" from CBN on 7 August¹², but ETI found itself rocked by fresh allegations of mismanagement on the part of both Lawson and new CEO, Thierry Tanoh. A day after her mysterious suspension, Do Rego petitioned the Nigerian Securities and Exchange Commission (SEC) on 6 August, stating in the letter copied to bank directors that "[the board] is not operating in the interests of shareholders"¹³.

Do Rego's allegations were of a considerably more serious nature. According to her, Lawson and Tanoh were attempting to sell off non-core assets – a high value building and shares in Airtel Nigeria – at "well below the market value"¹⁴ and she had been asked to manipulate the bank's 2012 results to improve those of 2013 when Tanoh was confirmed as CEO. Additionally, while bonuses were reduced for other senior managers, Tanoh's bonus for 2012 of US\$1.14 million had not been approved under proper procedure and was in fact US\$935,967 in excess of what had been stated in his contract¹⁵.

Do Rego received support from Gerard Leclair, the retired president of a Paris-based accountancy firm where she was once a managing partner¹⁶. Richard Uku, Do Rego's former colleague at Ecobank, now the spokesman for the Commonwealth secretary-general, further acknowledged her reputation as being known "for her rigorous professional and business standards in the African banking industry"¹⁷.

Hero or villain?

In response, Jeremy Reynolds, the bank's spokesman, dismissed all allegations, claiming that "the bank takes the allegations very seriously but they are without any foundation"¹⁸.

According to him, Do Rego had been suspended for lying about her qualifications after failing to present certificates of professional accounting qualifications¹⁹, which she claimed to have lost ten years ago. The issue arose when certificates were requested to be produced for all senior managers, following her inability to perform routine duties assigned by the CEO which in turn raised suspicions about her qualifications.

Tanoh further hinted that Do Rego's allegations were motivated by grievance at being targeted for removal²⁰. According to him, her failure to make specific reference to the managerial pressure she faced, as well as the board's resolution not to dispose of the assets in question in order to preserve value, further undermined the credibility of her allegations.

With regards to the CEO's remuneration, Lawson emphasised that the decision to negotiate bonuses was his prerogative as chairman²¹ and that the raise, approved by the governance committee, was justified in view of new circumstances such as the acquisition of Oceanic Bank.

Big boys join the game

Who should be believed? Nigeria's Securities and Exchange Commission (SEC), in an attempt to unravel the truth, launched an investigation into the allegations of corporate governance breaches at ETI²² in September. The capital market regulator assured that investors would be adequately protected with its "thorough and rigorous" investigation assisted by KPMG's Professional Services²³.

While the investigation was far from reaching its conclusion, Lawson decided to leave Ecobank on 29 October 2013, stating that "in order to give total credibility to [the ongoing corporate governance] reviews, he had decided it would not be appropriate for him to be the person leading this process"²⁴. No major shareholder had yet called on him to resign, but the CBN's questioning of his fitness to lead Ecobank, as well as a call by honorary president Gervais Koffi Djondo, one of the co-founders of the bank²⁵, had put pressure on him to leave.

On 9 January 2014, the SEC announced its findings in a press release. Besides listing corporate governance gaps found in the review, the SEC also hit out at Ecobank's Board, stating that it was deficient in terms of "overseeing the achievement of ethical behaviour"²⁶, amidst other Board-specific weaknesses. Moreover, the SEC ordered Ecobank to convene an Extraordinary General Meeting (EGM) before the end of February to "pass resolutions on the critical findings and recommendations" of the audit, appoint a "substantive Board chairman" who "should have integrity, independence and [no] potential for conflict of interest", and develop a one year remedial plan to address the governance gaps, providing SEC with quarterly progress updates²⁷.

With regards to SEC's findings, Nedbank said it would consider the governance issues before deciding whether to exercise an option to buy a stake in ETI²⁸ but nevertheless maintained its confidence in its potential target.

Uprising from within

Following Lawson's departure, the spotlight now shifted onto Tanoh. Tanoh had given up the controversial bonus, but confidence in his leadership had steadily dwindled.

On 11 February 2014, Albert Essien (Deputy CEO and Executive Director of Corporate and Investment Banking), Evelyne Tall Daouda (Deputy Group CEO and Chief Operating Officer), Patrick Akinwuntan (Group Executive Director for Domestic Banking) and Eddy Ogbogu (Group Executive Director for Operations and Technology) jointly penned an email to interim Chairman Andre Siaka urging Tanoh to step down. Andre Siaka's response was to instruct the company secretary to forward the email to the rest of the board. Notably, all four stood to lose their seats if the EGM approved the downsizing of the board, but not Tanoh²⁹.

A Board meeting was scheduled for 25 February 2014 in Lome, Togo, during which it was widely expected that a vote would be forced on Tanoh's ouster, but it was prevented from convening at the last minute by a court injunction on the application of a lone shareholder that it would be prejudicial to other shareholders' interests to decide on critical issues before the EGM³⁰.

On 1 March 2014, PIC demanded that Tanoh resign, labelling him "technically and morally unfit" in a strongly worded letter to the Board³¹. No less damning was the pronouncement of PIC's representative on Ecobank's Board, Dr. Daniel Matjila: "Tanoh came in to stabilise, extract efficiencies, cut costs and all other things to extract value from the business. We believe he has failed to do so. He hasn't raised even a single cent of capital ever since he came in"³².

The resolutions that were passed at the 3 March 2014 EGM amended the Articles of Association to limit the size of the Board to 15 members, cap directors' tenures at nine years and confer the power to approve acquisitions, mergers and disposals amounting to 20% or more of the company's book value on shareholders³³. This fell short of earlier proposals to shrink the Board to seven members, and it appeared to observers that Tanoh would keep his seat. However, the Board met on 11 March 2014 and finally resolved to dismiss him, appointing Albert Essien in his place.

A new beginning

ETI's stock dropped from NGN15.00 to NGN14.50 on 11 March 2014 when the market received the news of Tanoh's dismissal, and would stay in a rut for the next two months. Interestingly, the group posted a 13% year-on-year growth in total assets in 2013³⁴, a testament to Ecobank's continued ability to attract deposits despite the corporate governance upheaval. A 51-point Governance Action Plan tailored to address the areas highlighted by the SEC and KPMG and adopted by shareholders³⁵ at the EGM was now being rolled out, and a new Search Committee convened to nominate new directors for the Board.

On 31 June 2014, shareholders elected Emmanuel Ikazoboh, previously the CEO of Deloitte for West and Central Africa from 2007 to 2009, as the new Chairman³⁶. Nedbank eventually exercised its option to raise its ownership in ETI to 20%. In the words of CEO Mike Brown, Ecobank had made "enormous progress" in resolving its corporate governance issues³⁷.

Has Ecobank's "trial by fire" turned it into a better institution? Executives and observers alike acknowledged the need for sustainability, but opportunities abound as the demand for financial services continues to grow in Ecobank's markets. Only time would tell if the corporate governance reforms of 2014 would make a difference.

Epilogue

In an interview in Cape Town at the World Economic Forum on Africa, Albert Essien, Group CEO of Ecobank, expressed intentions to settle disagreements with the former CEO, Thierry Tanoh, amicably through an out-of-court settlement. Damages to be pursued are expected to exceed US\$35 million³⁸.

In recognition of his diligence in steering the troubled Ecobank out of choppy waters, Albert Essien was conferred the African Banker of the Year Award at the ninth edition of the African Banker Awards³⁹.

Discussion questions

1. Consider Ecobank's operating environment. Would you expect lapses in corporate governance to be endemic to the Nigerian banking industry? Why or why not?
2. When Laurence Do Rego blew the whistle, she faced personal attacks and questions were raised about her motivation. If you were in her shoes, what would you have done?
3. What are the key elements of a good whistleblowing programme? How should whistleblowing allegations such as those raised by Do Rego be handled by a company? In your view, did Ecobank handle the allegations adequately?
4. Ecobank has since subscribed to an ethics hotline provided by one of the Big 4 accounting firms. It can be accessed at <http://www.ecobank.com/blow.aspx>. Evaluate the ethics hotline service provided by Ecobank and discuss whether you believe it is likely to encourage more employees to report wrongdoing.

5. Compare and contrast the actions of major institutional shareholders Nedbank and Public Investment Corporation. Why did their responses differ?
6. Assuming Ecobank was instead subject to the laws, listing rules and corporate governance code of your country. Would it be easier or more difficult to change management?

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GENERAL MOTORS: SAFETY ON BOARD

Case overview

Investigations relating to vehicular safety sparked off a series of General Motors (GM) product recalls in early 2014. While product recalls are common in the U.S., the fact that the defect had been known to GM for more than a decade prior to the recalls raises serious concerns over the company's management practices. There were questions about the prior connections of directors with GM and number of years served by some of the directors. Diversity of the board of directors was also seen to be poor. The objective of this case is to allow a discussion of corporate governance issues relating to board composition; culture and tone at the top; as well as the role of regulators.

Where the engine started

Based in Detroit, Michigan, General Motors (GM) is a multinational corporation with operations worldwide. The company is one of the world leaders in the automotive, transportation products and related services industries¹.

This is the abridged version of a case prepared by Ang Zheng Ting Justin, Chua Ming Wei Gabriel, Lee Ying Mao Eugene, Ng Hui Li Phyllis, Zhang Zhenjie Justin under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lim Hui Ying under the supervision of Professor Mak Yuen Teen.

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Founded in the U.S., the company underwent rapid global expansion and is currently producing vehicles in 37 countries, under various brands such as Opel and Chevrolet. At its peak, GM dominated more than half of the U.S. market and had led global vehicle sales for 77 years since 1931². GM was also an industry leader known for its innovation in car safety. In 1971, GM was the first company to introduce an airbag system in its cars, which was a significant milestone in the car production history. Today, the airbag system is a mandatory safety feature in all automobiles³.

Manoeuvring the road blocks

In 2009, due to recession and poor credit markets caused by the U.S. financial crisis, GM was forced into bankruptcy. The American government provided the company with a bailout which saw federal taxpayers owning 60% of the company⁴. However, the condition for the bailout was for GM to undergo heavy restructuring to make the company competitive again. As a result, Rick Wagoner, the Chairman and CEO, was forced to resign from the Board under governmental threat of withholding bailout money⁵.

In 2010, the company announced the largest initial public offering (IPO) at that time, raising US\$20.1 billion, which reflected public sentiment and strong investor confidence⁶. GM also posted the highest monthly sales since September 2008 in May 2013 and June 2013^{7,8}.

In December 2013, the U.S. Treasury Department sold off its remaining shares in GM, marking the end of U.S. taxpayer ownership in the company⁹.

However, in February 2014, results from investigations revealed that there were past safety lapses in GM vehicles¹⁰. This prompted the first of its many recalls and the problems appeared to date back to 2001.

The gears that drove the motor

Back in 2001, the Board of Directors in GM consisted of 14 directors, including John F. Smith, Jr. and G. Richard Wagoner, Jr. who held executive positions in the company¹¹.

Smith had been a director of the company since 1990. From 1992 to 2000, Smith held the position of CEO and Wagoner was the CFO. Smith then became the Chairman of the Board and Wagoner became the President as well as the CEO. In 2003, Wagoner took over as the Chairman of the Board and hence became the company's CEO, President, and Chairman of the Board¹².

A Case of Rusty Gears?

GM's Board had five different committees – Audit Committee, Directors and Corporate Governance Committee, Executive Compensation Committee, Investment Funds Committee and Public Policy Committee. Each committee was chaired by a different independent director, except for the Audit Committee and Investment Fund Committee which were both chaired by Eckhard Pfeiffer¹³.

Some of the directors had been sitting on the Board for more than 10 years, with some having prior connections to GM. For instance, E. Stanley O'Neal worked for GM as a treasury analyst, and was under the company's scholarship while pursuing his MBA¹⁴.

More than half of the 13 independent directors had worked with Wagoner since he joined the Board in 1998. As of 2008, eight of the independent directors had worked with Wagoner since he was appointed as the Chairman of the Board in 2003. Most of the directors were of similar age and had similar working experiences, especially those who had served the longest on the Board¹⁵.

Hitting road bumps

"I'm truly sorry for your loss," said Mary Barra, the present CEO of GM at a meeting with the victims' families on 31 March 2014¹⁶. Barra had been appointed CEO in January 2014. Her words were meant to comfort the families of those who had lost their lives due to the faulty mechanisms in GM manufactured vehicles, or more specifically, the Chevrolet Cobalts. At that time, it was confirmed that an ignition switch fault had caused at least 31 crashes and 13 deaths¹⁷.

Yet, the defect issue did not arise during Barra's time as CEO. In fact, the problem dated back to more than a decade ago in 2001. During the pre-production testing of the Saturn Ion, GM detected an ignition switch defect which automatically turned off the car engine and prevented the airbag from deploying. This issue was seemingly resolved when a service technician closed the inquiry in 2003, after changing the key rings and noting that the problem was fixed¹⁸.

In 2004, the defect resurfaced when GM replaced the Chevrolet Cavalier with the Cobalt. A new inquiry was launched by GM engineers to address this issue. However, the proposal to fix the problem was rejected, with the reason that it was too costly and time-consuming. GM also rejected another proposal by one of its engineers to redesign the key head¹⁹.

A year later, an ignition switch engineer advised that due to the fragility of the switch, further changes to the switch would result in mechanical and/or electrical problems. The case was again closed with no action taken. High costs, lead time and uncertainty of success were cited as reasons for not proceeding with any change. An official of Delphi, who supplied the switches, had also once mentioned that the ignition switch torque was below the original specifications set by GM during the sample testing stage. GM nevertheless approved that part²⁰.

The ignition switch defect claimed its first fatality in July 2005 when 16-year-old Amber Rose crashed into a tree in her Chevrolet Cobalt. Later that year, GM issued a technical service bulletin alerting dealers of the potential ignition switch problem, but no recall was announced. As these bulletins were non-public and directed only at car dealers, general consumers were oblivious to such an issue²¹.

The traffic police

With the unfolding of problems in GM, actions of the regulator also came under scrutiny.

The National Highway Traffic Safety Administration (NHTSA) is responsible for reducing the frequency and intensity of casualties from motor accidents through public education, as well as enforcing safety performance standards of vehicular components and investigating safety defects. It is also responsible for rating motor vehicles for safety performance²².

In March 2007, the NHTSA informed GM of the issues regarding Amber Rose's death, but neither GM nor the safety regulator launched any formal investigation. Investigations of another fatal crash involving a Chevrolet Cobalt linked the accident to the ignition switch defect, but again, the safety regulator did not conduct any further investigation²³.

In September 2007, an investigation was recommended by the NHTSA to its Office of Defects Investigation (ODI) to look into the failed deployment of airbags in the crashes of Chevrolet Cobalts and Saturn Ions. However, the ODI concluded that there was no correlation between the crashes and the failure of airbags to deploy. This was because the investigation team had an outdated perception of the airbag's functionality and assumed that the airbags were operating normally under the given road conditions²⁴. Hence, NHTSA deemed the investigation unwarranted and ended the proposed probe prematurely. This proposal was raised by NHTSA again in 2010 but ODI again decided against it and dismissed the matter²⁵.

Repair and maintenance

It was later found in an investigation led by an external engineering firm engaged by GM that the defect in the switch accounted for at least 13 lives lost in 31 accidents²⁶. In response, a decade after it first identified the problem, GM initiated a series of recalls on 7 February 2014, starting with about 800,000 Chevrolet Cobalt and Pontiac G5 vehicles. Just three weeks later, GM added about 600,000 Chevrolet HHR, Pontiac Solstice, Saturn Ion and Saturn Sky vehicles to the list of vehicles to be recalled. In March, another 824,000 cars sold in the U.S. from 2008 to 2011 were added into the recall list. In less than two months, GM had recalled a total of 2.6 million small cars due to the faulty ignition switches²⁷. Together with other unrelated recalls, by mid-2014, a total of 28 million cars had been recalled²⁸.

Barra takes the wheel

Barra's immediate challenge was to steer GM out of the myriad of poor publicity and civil actions against the company. In response to public criticism over the recalls, Barra committed the company to an internal review and sought the assistance of external legal firms. The internal investigations led to the dismissal of 15 employees as well as disciplinary action against five others²⁹. Among those dismissed were Michael J. Robinson, the vice president for global regulatory affairs, and William Kemp, the top lawyer who oversaw product-related litigation³⁰. However, the blame was largely pinned on the "incompetent" lower-level employees, while the top executives were largely untouched³¹. Barra and her top lieutenants, including Michael Millikin, the General Counsel who led the internal probe, were cleared of any wrongdoings in the recall. The internal report was criticised by Senator Richard Blumenthal, Democrat of Connecticut, to have "absolved upper management, denied deliberate wrongdoing and dismissed corporate culpability."³² On top of the internal actions taken by GM, the Justice Department stepped in to investigate the delays surrounding the recalls. GM was eventually fined US\$35 million in civil penalty for its inadequacy in handling the recalls³³. With the help of Kenneth Feinberg, a specialist attorney in victim compensation, GM announced a minimum offer of US\$1 million to the families of those who died due to the defective GM vehicles.

Call for Employees to Sound the Horn

In April 2014, Barra launched the "Speak Up for Safety" programme to encourage employees to find innovative solutions to enhance the safety performance standards of GM vehicles. On top of this problem-solving approach, the programme also attempts to remove conversational barriers between employees and their leaders to encourage employees to voice concerns over safety-related issues³⁴.

Steering back on track

The Manhattan U.S. attorney's office has determined GM to have broken the law and will likely extract a fine exceeding US\$1 billion from the company. GM will either plead guilty or enter into a deferred-prosecution agreement. With the company set to face criminal charges, the Federal prosecutors are considering if charges against individual employees are necessary to spur changes in the auto industry, which had never been faced with criminal cases related to product defects³⁵.

With the death toll exceeding 100, GM has set up a fund that to compensate victims of crashes caused by the faulty switches and has fixed about 70% of the cars recalled³⁶. The company has also paid a record US\$35 million civil fine in 2014 and signed a consent order acknowledging its failure to notify the regulators in a timely manner of the defect, as required under federal law³⁷. GM has also gone outside the company to hire a new general counsel, Craig Glidden, who "has had a distinguished career managing complex legal issues around the world, and his broad legal and senior management expertise was said to fit perfectly with GM's strategic priorities and plans for global growth"³⁸.

While GM may be taking some positive steps in handling the problem, there is still much that needs to be done in order for the company to return to its former glory. Barra has stated GM's intention to do "the right thing", but it remains to be seen if merely fixing the mistakes of the past can rescue the company from the ditch that it has driven itself into. Nevertheless, GM is no stranger to recovering from dire situations, and its resilience would be necessary to survive the current crisis.

Discussion questions

1. Discuss the possible corporate governance issues relating to GM's Board of Directors and how it could have contributed to GM's problems. To what extent should the Board of Directors be held responsible for the safety issues? Explain.
2. In the 1990s and early 2000s, GM had a practice promoting the CEO to Chairman when a new CEO was appointed. What are the pros and cons of such a practice?
3. What do GM's actions prior to the recall suggest about the company's culture at that time? Discuss the extent to which the culture at GM could have contributed to its problems.
4. How effective were the regulators in discharging their duty? Due to the bailout, many classified GM as "Government Motors". How might this have influenced the regulators in performing their duties?

5. Given the long-established corporate culture in GM, can the introduction of the “Speak up for Safety” programme achieve its intended objectives? How can a company transform its culture?
6. How adequate were Mary Barra’s actions in handling the crisis and taking corrective steps to prevent future occurrences of such problems? Is there anything that she should have done differently? Explain.

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JP MORGAN: PRINCE UN-CHARMING

Case overview

JP Morgan China was not getting the deals as it would have liked. It believed that other banks were able to secure deals because they were hiring their potential clients' children. As such, JP Morgan allegedly followed suit by hiring several sons and daughters of officials in Chinese state-owned companies, commonly referred to as princelings. The connections from the princelings apparently started to help JP Morgan gain deals just like its competitors. However, the good times did not last. JP Morgan was investigated by the United States Securities and Exchange Commission (SEC) under the Foreign Corrupt Practices Act (FCPA). As a result, it dropped out of two billion-dollar Initial Public Offering (IPO) deals. The objective of this case is to explore issues such as ethics and tone at the top; role of the board in ensuring the appropriate culture in a company; effectiveness of codes of conduct; and whistleblowing policies and the fine line between bribery and "guanxi" in China.

This is the abridged version of a case prepared by Chua Zi Hui Grace, See Xiaowei, Sng Jing Kai and Trina Ling Tzi Chi under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lim Hui Ying under the supervision of Professor Mak Yuen Teen.

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Courting royalty

“You all know I have always been a big believer of the Sons and Daughters programme – it almost has a linear relationship with winning jobs to advise Chinese companies.”

– Fang Fang, former Chief of investment banking, JP Morgan China¹

It was the loss of a key deal to Deutsche Bank (DB) in 2009 that started it all. When Wall Street suffered during the global financial crisis, JP Morgan China was urged to push up earnings. “We lost a deal to DB today because they got chairman’s daughter work for them this summer,”² a fellow executive from investment banking had remarked via email. The replies followed: “I am supportive to have our own hiring strategy”; “We do way, way, way too little of this type of hiring and I have been pounding on it with China team for a year”; “Confidential, just added son of #2 at SinoTruk to my team”³. Even though none of the executives themselves have been implicated or accused of any wrongdoing yet, the carefully detailed spreadsheets specifying appointments of these sons and daughters of prominent people and their resulting effects had been found⁴. Investigations were ongoing, and it was going to be tough.

In November 2013, JP Morgan withdrew as an underwriter for a share sale by China Everbright Bank. The IPO eventually launched in December amounted to US\$3 billion. In January 2014, it also withdrew from a US\$1 billion IPO for Tianhe Chemicals. In March, amidst investigations, Fang Fang, the Chief Executive for investment banking in JP Morgan China, retired. Two months later, he was arrested⁵.

About JP Morgan

JP Morgan Chase and Co, headquartered in New York City, traces its roots back to 1799. In 2000, JP Morgan merged with The Chase Manhattan Corporation and was renamed JP Morgan Chase and Co⁶. The key areas of business include investment banking, markets and investor services, treasury services, investment management, private banking, wealth management and brokerage, as well as commercial banking⁷.

The company serves clients in 100 locations, including the Americas, Asia Pacific, Europe, Middle East and Africa. In 2011, the firm celebrated the 90th anniversary of its presence in China⁸, where it has offices in Beijing, Shanghai, Tianjin, Guangzhou, Chengdu, Harbin, Suzhou, Shenzhen and Zhongshan, which serves corporations, financial institutions and government agencies⁹.

Kingdom rules

JP Morgan’s Code of Conduct is given to all new employees and has a section addressing anti-bribery and anti-corruption. Employees are not allowed to “give, offer or promise (directly or through others) anything of value to anyone, including government officials, clients, suppliers or other business partners, if it is intended or appears intended to obtain some improper business advantage.”¹⁰

Employees are also required to report any known or suspected violations of the Code and this was specified as the responsibility of all employees. Each employee would be assigned a Code Specialist from the Compliance or Legal Department, to answer questions on the Code¹¹.

The chosen ones

The Sons and Daughters Programme was started in 2006 to weed out nepotism and avoid bribery charges in the United States¹². The two-tiered process was originally meant to prevent the controversial hiring of the sons and daughters of senior officials in the Chinese Communist Party and executives in state-owned enterprises, so-called “princelings”¹³. This was done by separating them in the recruitment process. However, the programme ended up fostering the very results it was intended to prevent, with these candidates allegedly facing fewer interviews and sub-par standards¹⁴.

You scratch my back, I'll scratch yours

Such hiring practices were triggered¹⁵ by the loss of a deal to DB, when JP Morgan apparently realised¹⁶ that other American banks in China secured deals through the hiring of princelings¹⁷.

The concept of exchanging favours is deeply etched in China's culture. Big banks often hire sons and daughters of senior Chinese government officials in the hope of creating opportunities and securing deals¹⁸. Relationships or networking, also known as "guanxi", is a fundamental concept to grasp if one wishes to operate effectively in the Chinese economy¹⁹. With the right "guanxi", businesses are able to overcome obstacles and gain new opportunities. Often, it is the power of networking that will determine a company's long run competitiveness in China.

One of the banks which demonstrated the concept of "guanxi" in the hiring of employees was Morgan Stanley. The bank hired Zhang Nan, the son of Zhang Dongsheng, an official of China's powerful economic planning agency National Development and Reform Commission. A list of other princelings allegedly hired by Morgan Stanley was also circulated in the Chinese social media. Some of those included in the list are the son of Xiao Tian, deputy head of China's sports bureau, and the son of Xie Xuren, China's former finance minister and current chairman of the National Council for Social Security Fund²⁰.

Era of the princelings

The loss of the deal to DB dealt JP Morgan a huge blow. In order to prevent history from repeating itself, JP Morgan allegedly followed suit and stepped up its hiring²¹ of the sons and daughters of the elites. This ironically achieved what its initial Sons and Daughters Programme had in fact hoped to prevent. JP Morgan executives in Hong Kong studied the hiring movement of established banks in China and decided to hire Tang Xiaoning, the son of the chairman of China Everbright Group. This apparently enabled JP Morgan to successfully secure deals which had not previously been possible²².

The company continued the streak by engaging Fullmark Consultants, which was owned by the well-connected Lily Chang, the daughter of Wen Jiabao, who was China's Premier at that time. The engagement helped JP Morgan to clinch deals with state-owned Chinese companies during Wen Jiabao's premiership²³. JP Morgan also hired Zhang Xixi, the daughter of an official of China Railway Group who was later arrested on charges of bribery. She was hired around the time when China Railway Group's IPO was facilitated by JP Morgan²⁴.

Tang Xiaoning and Zhang Xixi have since left JP Morgan²⁵.

Clamping down on the giants

It is uncommon for the American authorities to scrutinise hiring practices of banks and such practices have been left relatively unchecked until recently²⁶. In August 2013, SEC began its investigations on JP Morgan's hiring practices in China. JP Morgan was suspected to be involved in the bribery of foreign officials. In exchange for hiring their children, JP Morgan allegedly gained lucrative businesses which were influenced by the officials. The FCPA prohibits U.S. companies from giving "anything of value" to a foreign official to win "an improper advantage" in retaining or attracting business²⁷ and such hiring practices would be a clear breach of the Act.

Despite the relatively low monetary value of the salaries paid, the princelings value jobs in banks as it improves and adds credibility to their resumes²⁸.

Walking a fine line

What made the SEC suspicious was the fact that the hiring of princelings was usually accompanied by large deals from princelings-related companies which the bank never had much dealing with²⁹. For instance, the emergence of China Everbright as one of JP Morgan's prized Asian clients coincided with the time that Tang Xiaoning was hired by JP Morgan. Similarly for Zhang Xixi, JP Morgan clinched the IPO for China Railway Group around the period she was hired.

SEC questioned JP Morgan about their hiring of personnel related to these two companies. In May 2013, SEC's anti-bribery unit asked JP Morgan for documents related to Tang Xiaoning. They also requested for "documents sufficient to identify all persons involved"³⁰ in the decision to hire Zhang Xixi. Aside from these two persons of interest, SEC also inquired about "all JP Morgan employees who performed work for or on behalf of the Ministry of Railways" over the previous six years, which hinted that the investigations were targeted at the broad hiring strategies of JP Morgan's China office³¹.

In addition to the investigation, JP Morgan's Sons and Daughters Programme was hit by whistleblowers as it was not popular among some of the employees. In December 2011, a junior banker from JP Morgan in Hong Kong resigned with an email commenting, "I do not think my family is in a position to help you to the extent as others did; bring their family business to the firm."³² Furthermore, at least two whistleblowers reported to the Hong Kong stock exchange and the U.S. authorities with regards to JP Morgan's hiring practices³³.

Crossing the line

The investigations uncovered a series of emails and confidential documents which seemed to link JP Morgan's business opportunities directly to the hiring of these well-connected employees. The documents showed how JP Morgan referred to the hiring practices of other banks in China³⁴. Spreadsheets listing JP Morgan's history of converting hires into business deals were submitted to the authorities. The spreadsheets also revealed how the Sons and Daughters Programme, which was originally meant to be a preventive measure against unethical hiring, eventually became a means of doing businesses with state-owned companies in China through the hiring of princelings³⁵.

JP Morgan executives in New York were alerted by a bank official in Asia with regards to anonymous accusations about the bank hiring for the purpose of winning investment banking assignments. Email discussions showed that the executives dismissed those accusations and continued to propose revisions to the region's hiring practices which were in favour of the hiring of princelings³⁶.

Domino effect

Following JP Morgan, SEC ramped up the scale of the investigations and issued letters of inquiry regarding hiring in China to several other major banks, including Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs and Morgan Stanley³⁷. The scope of the investigation expanded to non-U.S.-headquartered firms and the hiring practices in the rest of Asia.

Fifty shades of grey

However, SEC has yet to accuse any banks, including JP Morgan, or executives of any wrongdoing. Legal analysts commented that such unethical practices have flourished in the banking industry partly due to the difficulty in pinpointing wrongdoings. Banking is a relationship business, and being well-connected is a big advantage to an individual vying for a position in the top banks. Furthermore, many of the princelings who are employed by the major banks are highly educated and hold degrees and MBAs from top universities around the world³⁸. It is therefore seen to be reasonable for the banks to hire these individuals who, on top of their academic capabilities, can build on their existing relationships to bring in big contracts.

Tainted and bruised

JP Morgan would face substantial legal costs if SEC decides to take enforcement actions against them. Together with other charges and investigations such as the Madoff Ponzi fraud and the 'London Whale' case, the princelings investigation may further tarnish JP Morgan's reputation³⁹.

JP Morgan's stock price fell by 2.7% when the investigation on JP Morgan was publicly announced on 17 August 2013. When the company withdrew from China Everbright Bank's IPO in November 2013, its stock price fell by 0.08%. There was another fall of 5.3% when the IPO with Tianhe Chemicals was dropped. The stock price fell by a further 1.9% when Fang Fang retired in March 2014⁴⁰.

However, as the timing of this investigation coincides with the prosecution of Madoff Ponzi fraud and 'London Whale' cases, the impact on the stock price that was directly related to the princelings issue was unclear.

Too big to regulate?

Some economists have commented that banks like JP Morgan are too large to be regulated⁴¹. The frequency of significant legal cases involving JP Morgan raises questions about JP Morgan's ethical culture. Although the authorities have had some success in acting against unethical or illegal activities and taking enforcement actions against banks, financial analysts have questioned the effectiveness of the legal enforcements on large banks. This is because while the effectiveness of fines is questionable⁴², restrictions on businesses might upset the financial markets to a large extent⁴³.

End of the monarchy

On 29 May 2015, JP Morgan was subpoenaed by SEC for all of the company's communications related to 35 Chinese government officials⁴⁴. Together with the departure of the Vice Chairmen Todd Marin and Catherine Leung, JP Morgan announced a wider reshuffle of senior roles⁴⁵. Even if JP Morgan was found innocent of hiring princelings to secure contracts, the damage done to its reputation would remain. Such hiring practices remains prevalent in other American and European investment banks, such as Bank of America, Citigroup, Credit Suisse, Goldman Sachs and Macquarie. All of these banks have hired relatives of high-ranking Chinese officials over the years to secure deals in China. A thorough investigation would inevitably affect more companies both within and outside the financial sector⁴⁶.

Nevertheless, the authorities in China seem to have stepped up their stand against corruption and bribery in the recent years⁴⁷. The tide may have turned for doing business as the world moves towards a more transparent and fair society.

Discussion questions

1. To what extent should the Board of Directors be responsible for the corporate culture of a company?
2. What do you think is the "tone at the top" for JP Morgan? How did this affect the decision to hire princelings?
3. What do you think JP Morgan (New York headquarters) could have done to prevent the abuse of the "Sons and Daughters" programme?
4. JP Morgan's main defence is that 'every other bank is doing it' and that the princelings are well qualified as well. Do you think this justifies the hiring practices adopted? Explain this using both a legal and ethical perspective.
5. Some economists are of the view that the Wall Street banks are getting "too big to regulate". Discuss whether or not you support this view, taking into account the role and powers of the SEC and other regulators.
6. JP Morgan's Code of Conduct specifically prohibits bribery and corruption. How effective is it in preventing such acts? Whistleblowing arrangements are increasingly seen to be an important component of the corporate governance framework of an organisation. To what extent does having a whistleblowing policy help to mitigate such acts?

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DEAD MEAT: OSI GROUP

Case overview

In July 2014, OSI Group's Shanghai Plant (Shanghai Husi) was reported to have used expired meat in its products. Workers had also allegedly extended and forged the expiry dates on meat packages. The out-of-date meat was later processed into chicken nuggets and sold to leading fast food giants such as McDonald's, KFC, Pizza Hut, Burger King and Taco Bell. Poor handling and implementation of meat production procedures were to blame and were allegedly pervasive across in Shanghai Husi and made worse by infrequent audits conducted by the American managers. Subsequently, many of OSI Group's major customers in China severed business ties. The objective of this case is to allow a discussion of issues such as corporate governance of private companies; subsidiary governance; impact of poor governance and management on other parts of the supply chain; and ethics and compliance.

About OSI

OSI Group LLC (OSI) was founded in 1909 in Aurora, Illinois. The company mainly produces meat-based products such as bacon and hot dogs, catering to the retail and food-service industries. OSI has been serving several prominent names in the industry, including McDonald's, Yum Brands and Starbucks¹. As of October 2014, OSI was ranked as America's 56th largest private company with revenues of US\$6.1 billion and 19,600 employees².

This is the abridged version of a case prepared by Chong Ren Jean, Michelle Ngu, Liew Wen Qi Vivian, Tan Hui Qi, and Toh Kee Yee under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Chloe Chua under the supervision of Professor Mak Yuen Teen.

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Sheldon Lavin serves as the current Chairman and CEO of OSI and President of OSI International Foods Ltd. He is the sole owner of OSI³. Lavin prides himself on the fact that despite the size of their operations, OSI maintains a "family-like" culture that encourages entrepreneurial spirit and enables staff to better cater to the specific needs of each customer⁴.

OSI operates with an emphasis on quality and service, and has built a good reputation for themselves, gaining the trust of customers such as McDonalds for decades⁵.

OSI in China

OSI entered the China market in 1992, with their local subsidiary, OSI China ("Husi Foods"), managing their plants. For 16 years, Husi Foods catered solely to McDonald's, although during the last decade, they began supplying to other brands such as Yum and Starbucks⁶.

OSI has managed to sustain and develop a presence in China by attuning itself to the culture and context-specific issues in the local industry. The company has consistently employed management personnel who are familiar with the business landscape there. Currently, OSI operates 10 plants in China⁷.

The tainted meat scandal

China has consistently been plagued by food and other product safety scandals, including the melamine-laced milk scandal and toxic lead paint in toys scandal, which shook consumer confidence. Despite having taken various remedial actions, China was hit with yet another scandal in July 2014.

On 20 July 2014, Dragon TV (a Shanghai media agency) aired an explosive seven-minute investigative report by a reporter who had gone undercover for two months at OSI's Shanghai factories (Shanghai Husi)⁸. The footage showed workers handling food with their bare hands. Worse, they were captured repackaging chicken breast and chicken skin that had expired 12 days before, doctoring the food production dates and then mixing it with better meat^{9,10}. The chicken meat was then turned into chicken nuggets for leading fast food giants like McDonald's and Burger King. The documentary also caught workers picking up meat that had fallen to the floor and throwing them back into processors¹¹.

When interviewed, the workers seemed to have no qualms about their actions. A worker remarked that "The rules are dead, and people are alive, that's simple"¹². "Dead rules and alive people" is a Chinese metaphor implying that corners have been cut. The same worker related that "We can't let McDonald's or Yum China know that we add (chicken skin). They won't let us do that. Otherwise, we would lose the contracts. Who wants to do business with you if you break your promise?"¹³

Within hours after the broadcast, investigations were initiated by the Shanghai Food and Drug Administration (FDA)¹⁴. Operations at the plant were stopped, while food material and production records were seized. However, upon inspection, no issues were found in the other [then] eight facilities in China¹⁵. OSI Group too carried out an internal investigation of its China plants and agreed to cooperate with the China authorities.

On 22 July, Shanghai FDA released its preliminary report, voicing suspicions that the "illicit behavior" was pervasive across the company, and not just among a few individuals¹⁶. Extensive recalls of possibly affected products originating from Shanghai Husi were initiated¹⁷. Subsequently, on 4 August, the Shanghai authorities detained six employees from Shanghai Husi, including the quality control manager. The detainees were later arrested¹⁸.

After the incident, customers such as KFC and Pizza Hut (operated by Yum), Starbucks and Burger King terminated their relationship with OSI and immediately stopped using the supplies provided by OSI Group, with the exception of McDonald's, which stated at the time that they would continue to use products from OSI's other plants in China's Hebei and Hunan provinces¹⁹.

OSI's "World of Security"

News that OSI had been implicated in such a scandal came as an enormous surprise, especially as they had built a reputation for themselves as providers of safe, high quality food. In fact, most foreign meat processing firms in China had positioned themselves along this line, against the backdrop of a food safety environment known to be weak²⁰.

An article published by Asia AgriFOOD magazine in August 2012 to celebrate OSI's journey in China had detailed rigorous quality-screening procedures implemented at the company's plants. It was reported that products were subject to continuous quality screening by workers who had been trained to understand and enforce standards, and lab-tested to "ensure there was no drift or variance"²¹. OSI's plants in China had also been touted to be in compliance with various health and service protocols such as HACCP, SSOP and ISO2200²².

Furthermore, OSI had poured large investments into China in recent years to further develop its vertically integrated operations, in a bid to increase certainty of food quality by securing "absolute raw material control"²³. By producing its own livestock and feed among other things, OSI intended to overcome uncertainties associated with the long supply chain in China's meat industry, where raw material passes through multiple middlemen²⁴.

OSI's decentralised regime to blame?

In the aftermath of the scandal, the question of whether the event had been precipitated by the actions of errant employees or by distorted company policies remained. OSI's stance, as evidenced in a press release dated 21 July 2014, was that it had been an isolated event²⁵. Various accounts by former employees of the Shanghai Husi plant, nonetheless, paint a different picture. There had been allegations that the malpractices had been ongoing for years under the tacit approval of senior managers, and that the plant had maintained a separate set of doctored food safety records to be shown to inspectors during plant audits^{26,27}. Memories of a lawsuit in 2013 – in which OSI's former quality control manager claimed that the company had forced him to falsify the dates on meat packages – were also brought to the fore²⁸. OSI China had paid little attention to the litigation then, and the case was subsequently dismissed by the district court for "lack of evidence"²⁹.

These allegations cast doubt over the efficacy of OSI's management structure. OSI had structured its operations in China along a decentralised business model, to facilitate better context-specific innovation and decisions. This autonomy was supposed to be exercised within the boundaries of the company's global standards³⁰. To ensure that there was a clear understanding of these standards among personnel in China, OSI had regularly dispatched American technical teams to train new recruits as well as send key local managers to the US to study the operations of their plants there³¹.

Despite their efforts, an article by Fortune contended that OSI had fallen short in their endeavour to enforce company standards at Shanghai Husi. Employees spoke of insufficient audits and monitoring, with American managers rarely visiting³². Furthermore, operating documents had apparently been written in Chinese, rendering them incomprehensible to English-speaking personnel³³.

If the malpractices had indeed been a result of distorted policies at Shanghai Husi, further questions arise as to whether this phenomenon was limited to a single plant in the OSI group, or was something that was prevalent across the organisation. A Reuters article suggests that other OSI plants in China had not been affected by the same problems. Conversations with employees have indicated that while there had been ongoing transgressions in the Shanghai plant, workers at OSI's Hebei plant were strictly required to wear special clothing and were subject to frequent unannounced spot checks³⁴. However, there have been claims that the same food safety violations have been taking place even in OSI's West Chicago plant. Accounts by employees describe detritus such as sweat, hair and gum falling into the products, in addition to meat that had dropped on the floor being thrown back into processors³⁵. This had gone unchecked by the USDA inspector posted at the premises, who was said to rarely emerge from his office upstairs³⁶.

Impact on the supply chain

Big Buyers

Upon the announcement of the scandal, many food retailers were in a flurry to pull products supplied by Shanghai Husi off their shelves. Both McDonald's and Yum suffered a drop in their share prices by 1.5% and 4.2% respectively^{37,38}.

In the wake of the incident, McDonald's had initially chosen to continue its relationship with OSI, believing that sticking with OSI as a supplier would reduce the risk of encountering another scandal in their supply chain if they were to look for a new local supplier³⁹. Subsequently, however, they stopped supplies from OSI completely in favour of switching to alternative meat supply companies such as Keystone Foods in light of the backlash⁴⁰. However, with the increased pressure on alternative suppliers to keep up with demand, and meat shortages faced in McDonald's stores in the region, McDonald's once again reconsidered its relationship with its largest long-term supplier, OSI, deciding instead to suspend OSI as its food supplier, without cutting global ties⁴¹.

In China, food quality and safety issues are often perceived to be the responsibility of retailers like McDonald's and Yum. This is in stark comparison to many other countries whereby manufacturers are the parties usually held liable⁴². Such global retailers that operate on a large scale frequently demand lowly-priced supplies due to the competitive nature of their business⁴³. The scandal has served as a wake up call to the meat and food supply industries in China, forcing them to scrutinise and re-think their supply chains.

In a bid to raise food-safety standards and prevent similar incidents from occurring in their supply chain, McDonalds announced that they would increase the number of surprise audits conducted on suppliers in China, as compared to past practices where suppliers knew of dates of audit beforehand⁴⁴. McDonald's is also pushing for more video monitoring, quality control specialist checks at suppliers' warehouses, and a hotline for food safety whistleblowing. Yum China has also taken similar measures, which include offering rewards to whistleblowers and reviewing their internal inspection process of suppliers⁴⁵.

Regulators

Zhang Yongjian, director of the Research Center for Development and Regulation of the Food and Drug Industry, conceded that the reoccurrence of food safety scandals in China stemmed from a “lack of supervising and monitoring capacity, resources and professionals”⁴⁶. As such, regulators were unable to conduct regular standardised or organised checks for food safety⁴⁷. Food quality and safety standards and regulations in China have likewise been criticised as lax⁴⁸. In light of the scandal, China’s Food and Drug Administration ordered a nationwide check on restaurants that sold food supplied by Shanghai Husi. Food producing and processing companies in the city were also inspected by officials for food quality and safety. In addition, there was a restructuring plan that consolidated the management and responsibility for food safety regulation within three agencies⁴⁹.

In a further move, the Shanghai FDA implemented enhanced disclosure requirements for eateries to facilitate consumer scrutiny. McDonald’s, Yum, Burger King, Dicos as well as other well-known chains were required to make public the names of their suppliers, ingredients used, and food production check results on their official websites⁵⁰.

Consumers

The Chinese consumer community, outraged by the meat scandal news, left 8,000 comments on the online broadcast of the report. Many comments lamented the present difficulty in trusting food sources as both multinational and local food brands faced credibility issues tainted by scandals and problems with supply chain quality⁵¹. A survey by Pew Research on 3,200 consumers in China revealed that 38% felt that food safety was a huge problem in China, 12% higher than the sentiments in 2008⁵².

Corrective Actions

David McDonald, the President and Chief Operating Officer of OSI Group, announced at a press briefing that OSI would be undertaking a slew of measures to improve their operations in China. For one, the company was to revamp its management structure, such that their Chinese arm would no longer function as an autonomous entity, and would instead be integrated with the greater OSI International group under the name OSI International China. Several senior management personnel were to be reassigned from their current posts to the

China Management Team. Brent Afman, a senior vice president and managing director of OSI’s Asia Pacific, Middle East and Africa divisions, also pledged that experts would be brought in to run a quality control centre in Shanghai, to ensure “full compliance with the OSI Group’s standards for quality” across OSI’s plants in China. Moreover, current audit processes would be improved by conducting employee interviews and constant visual surveillance. In addition, plans have been laid for a US\$1.62 million investment in a food education programme in Shanghai⁵³.

Finally, a “Worker Redundancy Plan” was announced on 22 September 2014 to lay off 340 workers from Shanghai Husi who will be provided with career development assistance and a compensation package⁵⁴. Only a small group of employees was retained to assist in ongoing investigations. With these measures, OSI hoped to strengthen its internal governance and become a respectable and trusted global meat supplier once again.

However, even after the implemented measures, the OSI group reported on its China website that in the four months up to 30 January 2015, it had lost hundreds of millions of dollars of revenue due to the food safety scandal⁵⁵.

Discussion questions

1. Evaluate OSI’s strategy in China. Was too much autonomy given to its subsidiaries there? What do you think will be the optimal approach for international companies, such as OSI, to govern and manage its foreign subsidiaries and plants, such as OSI China and Shanghai Husi? Do you think that current rules put sufficient emphasis on corporate governance issues within company groups? Explain.
2. What are the major sources of corporate governance rules, if any, for private companies in your country? OSI is one of the largest private companies in the U.S. with global operations. Should the same corporate governance rules that apply to publicly-listed companies also apply to large private companies such as OSI? Explain.
3. The OSI scandal shows the impact that poor governance and management in one part of the supply chain can have a dramatic impact on other organisations within the supply chain. How can companies like McDonald’s, Yum Brands and Starbucks better manage these supply chain risks?

4. Do you think having a whistle-blowing policy and system in place will help to deter or uncover such unethical practices in an organisation such as OSI? How might the corporate culture and business environment affect the effectiveness of a whistleblowing policy and system?
5. Discuss the actions taken by each stakeholder in response to the scandal. Evaluate the impact of these actions. Do you think they should have done anything differently?
6. To what extent do you think the blame should be put on OSI? Who do you think is ultimately responsible for the saga?

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YAHOO! THE \$100 MILLION MAN

Case overview

In January 2014, Yahoo's Chief Operating Officer (COO), Henrique De Castro, was fired after a mere 15 months on the job. He left the company with an estimated US\$103 million, which included a hefty severance package worth US\$58 million. The compensation package De Castro received was an issue of contention, with commentators questioning the hefty severance package given De Castro's poor performance and his failure to satisfactorily boost Yahoo's advertising revenue. The objective of this case is to allow a discussion of issues such as the roles of the nominating and remuneration committees in the hiring and remuneration of senior executives; design and risks of executive remuneration packages; and the use of golden parachutes.

This is the abridged version of a case prepared by Belinda Soh Baoyi, Leow Yun Hui, Ng Jin Li and Theun Jun Ping under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

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Decline of Yahoo's digital advertising

In 2006, Yahoo lost out to Google in the takeover of DoubleClick and YouTube¹. These two acquisitions became significant contributors to Google's advertising revenue. Recent years have also seen the online advertising industry undergoing a significant redistribution of revenues due to a consumer shift in user platform from desktop to mobile. As a result, more advertisements have been featured in mobile applications to complement traditional display advertisements. This shift in consumer preference bode well for Yahoo's rivals, Facebook and Google. Facebook's advertising revenue rose significantly, with performance advertising (i.e. a pricing model that pays a marketing agency commission per new lead that the agency generates through online advertising) experiencing its largest growth in 2009². Google acquired a mobile advertising company, AdMob, in 2009 to further its foray into mobile advertising. Yahoo, on the other hand, saw a decline in advertising revenue and soon slipped behind its rivals³.

An analysis carried out by eMarketer, an independent market research company, revealed that in 2012, Yahoo had the second largest market share in the U.S. market for digital advertising, when CEO Marissa Mayer joined the company. As of 2013, however, Yahoo slipped to fourth place⁴. Yahoo's decline was forecast to persist while Facebook and Google continue to be the frontrunners in digital advertising. In an attempt to revive Yahoo's advertising segment, which contributed significantly to its total revenue, Marissa Mayer decided to hire Henrique De Castro as COO.

Henrique De Castro

De Castro was poached by Mayer from her former employer, Google, in October 2012⁵. He was put in charge of strategic and operational management of Yahoo's sales, media, business development and operations worldwide.

De Castro's job history includes senior executive positions in leading companies such as Google, McKinsey & Company and Dell, where he was the Sales and Business Development Director in the Western Europe region⁶. Given his extensive experience as a senior executive, Mayer was highly confident about De Castro's capabilities for the role and expressly stated that "his operational experience in Internet advertising and his proven success in structuring and scaling global organizations [in Google] make him the perfect fit for Yahoo as we propel the business to its next phase of growth"⁷.

However, critics had expressed doubts on De Castro's appointment due to changes in his position at Google prior to his departure. De Castro had previously held the title of President of "Global Media, Mobile & Platforms", a position which was described as having "miscellaneous" responsibilities⁸. However, just prior to him leaving Google to join Yahoo, De Castro served as Vice President of Google's Worldwide Partner Business Solutions Group, where his responsibility extended to Google's business partners⁹. He was also reputed to have a difficult personality¹⁰ and thus was not considered to be a suitable candidate for the role of COO, which involves networking with potential advertisers and attracting them to join Yahoo. Despite facing widespread criticism, Mayer maintained her position and went ahead with the hire after receiving board approval.

De Castro's compensation package

On 15 October 2012, Yahoo made its offer to De Castro to serve as the company's COO¹¹. According to the employment offer letter filed with the U.S. Securities and Exchange Commission (SEC), the De Castro's compensation package was developed by Yahoo's Compensation and Leadership Development Committee (CDLC) based on the guidelines of the CDLC's charter. Under the contract, De Castro's compensation package consisted of three main components.

Firstly, De Castro would receive an annual base salary of US\$600,000 and was eligible for an annual bonus set at 90% of his base salary. Both the base salary and the bonus were subjected to annual review by the Compensation Committee¹².

Secondly, he was also entitled to Long-Term Incentive Equity Awards. These included Restricted Stock Units (RSUs) with a targeted valuation of US\$18 million and a vesting period of four years; Performance Stock Options (PSOs) with a similar targeted valuation and vesting period, but with the first performance period being the first half of fiscal year 2013 instead of fiscal year 2012; and a One-Time Make Whole Award in the form of RSUs, worth US\$20 million with a vesting period of four years¹³.

Thirdly, De Castro was awarded a One-Time Make-Whole Bonus of US\$1 million cash to compensate him for forfeiting his previous employment benefits in Google. This bonus was subjected to repayment within the first six months of his term as COO, notwithstanding any potential termination of his employment¹⁴.

The hefty compensation package was intended to provide competitive compensation to De Castro, with one-time awards used as an incentive to join Yahoo, and equity awards as a performance-based reward to align management decisions with shareholder interests. Long-term equity incentives made up the majority of the compensation mix. Such equity grants, as well as cash bonuses (excluding the one-time make whole bonuses), were subjected to the Company's "clawback" policies.

De Castro's short-lived tenure

De Castro served in Yahoo from December 2012 to 16 January 2014¹⁵. After a mere 15 months as Yahoo's COO, De Castro was dismissed by Mayer herself. Analysts speculated that De Castro's dismissal was due to friction between the two executives for at least six months prior to the firing, and a less than satisfactory performance in boosting Yahoo's advertising sales¹⁶.

Yahoo's display advertising revenues fell by seven percent in the third quarter of 2013¹⁷. To make matters worse, Facebook overtook Yahoo in becoming the second-largest seller of online advertisements in the U.S. market, after Google. Once the market leader for online advertisements, Yahoo was trailing behind competitors and had not been able to persuade big marketers to return to its web portal. Analysts have attributed this to De Castro's difficult personality, resulting in the formation of poor client relationships. As a result, he was unable to perform his role of increasing advertising revenues in the U.S. market effectively¹⁸.

The profitable exit

Analysts found it highly ironic that De Castro failed to deliver given the compensation package he was provided with to lure him from Google, calling the decision by Mayer a "misfire"¹⁹. Adding fuel to the fire, De Castro received a substantial severance package upon his termination despite his failure to bring the advertising growth required to boost Yahoo's revenue.

A SEC filing by Yahoo in April 2014 revealed that the package was worth US\$57.96 million. This included cash, RSUs that vested over time, stock options linked to performance, and make-whole RSUs.

The compensation package, which was worth only US\$17 million at the time the employment contract was signed in 2012, was inflated to more than three times at the termination date²⁰.

Observers conjectured that three main factors contributed to the size of De Castro's severance package. The first factor was largely associated with the composition of the severance package. It was structured in a way such that its value would rely primarily on the company's performance and how well its stock performed. The equity component caused a spike in the severance package's value, as Yahoo's stock price had appreciated by nearly 160% from the date of signing of the employment contract to the date of termination²¹.

De Castro's termination occurred when Yahoo's stock price was at its highest in almost 10 years²². Analysts traced the increase in stock price to Yahoo's 24% stake in China's Alibaba Group²³. Such gains had little or no relation to the business acumen of any Yahoo executive. In addition, it was predicted that upon Alibaba going public on the New York Stock Exchange, Yahoo would be able to reap a multi-billion dollar windfall from its holdings in the company. This would further inflate the compensation packages of Yahoo's senior executives.

The second factor which contributed to the size of De Castro's severance package is the fact that Yahoo had to compensate De Castro heavily when he was poached from Google. Of the US\$58 million package, US\$31.18 million was in the form of make-whole RSUs. In Yahoo's 2013 Proxy Statement, it was explained that these one-time make-whole RSUs were to "buy out the compensation value that [the] new executives forfeited when they joined Yahoo"²⁴. The Compensation Committee of Yahoo believed that these make-whole RSUs would "enhance [the executive's] immediate financial stake in Yahoo" and serve as "a retention mechanism"²⁵. De Castro had clearly benefited from this philosophy.

Lastly, De Castro's severance package was widely seen as a golden parachute. These golden parachutes provide a "soft landing" for the executive upon termination²⁶. Such agreements may arise from shareholder pressure and public scrutiny, which may lead companies to structure severance packages to include less cash and more equity²⁷.

Yahoo's Compensation Committee had defended De Castro's large severance package, asserting that "the Board believed at the time De Castro was hired that he had a unique set of highly valuable skills and experiences that would be key to returning the company to long term growth and success"²⁸. Clearly, De Castro's appointment was a mistake and he was well compensated for his failure.

Discussion questions

1. Discuss the role that a company's shareholders should play in determining executive remuneration packages.
2. What factors may have contributed to Mayer's decision to nominate De Castro as the COO?
3. What are the roles of the Nominating and Remuneration Committees in the hiring and remuneration of senior executives such as De Castro?
4. What are the key features of De Castro's remuneration package? What are the key problems associated with the size and structure of his remuneration package?
5. Was the remuneration package awarded to De Castro when he left Yahoo reasonable? Why do companies often make what appear to be excessive termination payments? Suggest some potential best practices in determining severance pay.
6. Discuss the use of remuneration components, such as sign-on bonuses, make whole bonuses and golden parachutes, to attract and retain senior executives.

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About the Editor

Associate Professor Mak Yuen Teen, PhD, FCPA (Aust.)

Prof Mak Yuen Teen holds first class honours and master degrees in accounting and finance and a doctorate degree in accounting, and is a fellow of CPA Australia.

He served on committees that developed and revised the Code of Corporate Governance for listed companies in Singapore. He also served on the Charity Council and chaired the subcommittees that developed and refined the Code of Governance for charities in Singapore.

Prof Mak has previously served as Chairman and Deputy Chairman of two large healthcare charities in Singapore. He was a member of the audit advisory committee for the UN Population Fund, based in New York, for six years. Currently, he is a member of the audit advisory committee of UN Women, also based in New York.

Prof Mak developed the Governance and Transparency Index, a ranking of governance of listed companies in Singapore. He was the Singapore expert in the development of the ASEAN Corporate Governance Scorecard and Ranking. He is an advisor for a new governance evaluation methodology for listed SMEs and an advisor to the Charity Council on a new charity transparency framework in Singapore.

Prof Mak is a regular commentator and speaker on governance issues in the corporate, public and charity sectors. He has been commissioned by the government, regulators, professional associations and private sector firms to lead research and provide recommendations on various corporate governance issues. He has also published extensively in academic and professional journals.

Prof Mak received the Corporate Governance Excellence Award from The Securities Investors Association (Singapore) in 2014, in recognition of his contributions to corporate governance in Singapore.

For more information about Prof Mak's work, please visit his website at www.governanceforstakeholders.com.



About the Editorial Assistant

Amanda Aw Yong Zhi Xin, BBA (Acc) (Hons), BA

Amanda graduated from the National University of Singapore with a First Class Bachelor of Business Administration (Accountancy) (Honours) degree and a Bachelor of Arts (Communications and New Media) degree. She was also part of the University Scholars Program. Amanda has published lifestyle articles in magazines and her news article was also selected to be published in a local newspaper when she was studying in Connecticut, USA. Amanda enjoys acting in theatre productions, skateboarding, volunteering, and backpack travelling.

SINGAPORE

1 Raffles Place
#31-01 One Raffles Place
Singapore 048616

+65 6671 6500
sg@cpaaustralia.com.au
cpaaustralia.com.au



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