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Edited by Prof Mak Yuen Teen

CPA AUSTRALIA

Corporate Governance Case Studies

Volume nine

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Editor

Corporate Governance Case Studies Volume Nine

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Foreword

The COVID-19 pandemic has dramatically changed and disrupted the operating environment for organisations, creating new risks that need to be managed.

Coupled with other factors such as growing global trade tensions, advances in technology, and ever-increasing cyber threats, boards and senior management now have very diverse challenges on their agenda. Achieving good governance and robust risk management under these circumstances have become even more complex.

The release of this 9th volume of Corporate Governance Case Studies comes at a time when COVID-19 is still defining the new business landscape. While traditional issues affecting good governance remain, the pandemic has made it crucial for companies to focus their efforts in strengthening governance.

Strong leadership and sound corporate governance processes are fundamental to a company's ability to survive and thrive. Companies are now expected to be more transparent and accountable to their stakeholders. Therefore, corporate governance structures and practices need to evolve to remain relevant and effective. Good corporate governance is more than just complying with rules and regulations or about legal duties and liabilities of directors.

CPA Australia continues to play a part on the journey towards a better corporate governance culture and is privileged to have partnered Associate Professor Mak Yuen Teen FCPA (Aust.) of the NUS Business School in this successful series of corporate governance teaching case studies since 2012.

We thank Professor Mak for his significant efforts in writing and editing the case studies, and the students of the NUS Business School for their work in researching the cases.

We hope Corporate Governance Case Studies Volume 9 will continue to enhance discussions around governance and contribute to advancing corporate governance standards in Singapore and internationally.

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Preface

When I started this partnership with CPA Australia in 2012 with the publication of Volume 1, the cases were based on abridged versions of those initially prepared by students in my course. The past eight volumes have been well received, with universities and professional bodies around the world using them in undergraduate and graduate courses, and in programs for directors, regulators and other professionals. A number of the cases and several volumes have been translated into Chinese and Vietnamese following interest from overseas markets.

Starting from volume 7, we started including some full-length cases. I became more involved in writing these longer cases. Often, I have written extensive articles on the companies concerned. Abridged versions, while easily digestible, have their limitations as they may lack the necessary depth for the reader to fully appreciate the context surrounding the issues covered. As I used the abridged versions for my own course at the university and in training programs for directors, regulators and other professionals, I found that they were suitable for introductory courses in corporate governance, but may not have sufficient depth for programs targeted at more experienced executives and professionals, such as company directors. Including some shorter and longer versions will provide greater variety and choice depending on the type of programs using them.

In this latest volume, many of the cases are full-length versions. This was partly a result of COVID-19, as staying home meant that I had more time to work personally on the longer versions. Some had considerable content added by me. The aim is to make the cases as comprehensive and up-to-date as possible, covering the issues in depth to allow for richer discussions.

This volume contains 20 cases, with 8 Singapore cases, 2 Asia-Pacific cases, and 10 global cases. The Singapore cases include Best World which currently remains suspended, and following the release of an independent reviewer's report, is pending further action from the company and possible regulatory action. It also includes an older case involving the Ezra group of companies, all currently still under judicial management. This case is based on a series of five articles I wrote this year. As it involves the collapse of three listed companies within the group, all with myriad issues, the case is long.

The two Asia-Pacific cases include Malaysia Airlines. which had the truly unfortunate experience of two airline tragedies within a space of just over four months in 2014, resulting in the loss of more than 500 lives. The tragedies put the spotlight on risk management, crisis management and communications with stakeholders. Malaysia Airlines was subsequently privatised and had two foreign CEOs who did not stay long, also raising issues of governance of government-linked companies and politically-connected boards.

One of the global cases is about Boeing, which has to deal with two airline tragedies of its own as two of its 737 Max jets crashed in October 2018 and March 2019, causing the global grounding of all these jets. More than 400 of these planes which have been manufactured remain undelivered as the future of the plane remains in doubt. It was then faced with the global shutdown of air travel due to COVID-19, causing a collapse in demand for new planes. This case raises issues of corporate culture, board governance, remuneration, risk management, role of regulators, among others.

There is also a comprehensive case on the aborted IPO of WeWork and its flawed business model, charismatic founder with questionable ethics who controlled the company with multi-vote shares, conflicts of interest, related party transactions, board governance, among other issues. Another comprehensive case is about Wirecard, which has turned out to be more than a corporate governance case, as there is now a spy twist involving its former COO who is an international fugitive. The case raises issues such as accounting fraud, role of whistleblowers and the media in exposing fraud, and audit and regulatory failures. New facts continue to emerge even as this case went into production for publishing.

Next year will mark the tenth anniversary of this long collaboration with CPA Australia. Nearly all the cases that have been published in this collection so far have been about companies that have got themselves in trouble. For the tenth anniversary edition, we are hoping to include some positive cases involving companies that have improved their corporate governance following a corporate governance scandal, companies that have a consistent track record in corporate governance and how this has helped them, and companies with good corporate governance helping them to navigate the challenges of COVID-19 or which have been exemplary in its dealings with stakeholders in light of COVID-19.

I would like to thank CPA Australia and the Singapore team for the close partnership over all these years on this and other projects. I would also like to thank the students who worked on these cases who are acknowledged in each case, and my very capable editorial assistant, Isabella Ow, for doing such a thorough job in editing and fact checking and in ensuring that references are complete and accurate.

We hope you enjoy reading and using the cases in this volume.

Associate Professor Mak Yuen Teen
NUS Business School

ALLIED TECHNOLOGIES: WHERE'S OUR MONEY?

Case overview

On 23 May 2019, precision engineering firm Allied Technologies Limited (ATL) made headline news after announcing that JLC Advisors LLP (JLC Advisors) had informed them that S$33.4 million from its escrow account had gone missing, together with JLC Advisors' Managing Partner Ong Su Aun, Jeffrey. Earlier that month, ATL's auditor Ernst & Young LLP, had raised multiple concerns following its audit, and cautioned that ATL might report a net loss due to impairment losses from its two newly acquired subsidiaries, Asia Box Office Pte Ltd (ABO) and Activpass Holdings Pte Ltd. Some of the concerns raised were questionable transactions in ABO; factual errors in the valuation report for ABO; and the escrow account of S$33.4 million under JLC Advisors that served no clear business purpose.

Trouble had, however, long been coming for ATL. ATL had, during the period from 2015 to 2018, exhibited a significant number of warning signs and red flags in corporate governance, disclosure and reporting.

The objective of this case is to facilitate a discussion of issues such as board composition; director and key management turnover; qualifications of directors; director duties; conflicts of interest; rights issues and private placements; board responsibilities in diversification, investments and divestments; differences in rules between Mainboard and Catalist Board; role of the sponsor for Catalist companies; and the role of regulators.

A change in direction

Incorporated in May 1994, Allied Technologies Limited (ATL) is a manufacturer of precision stamped metal parts and provides vertically integrated precision manufacturing services.[1] This includes product design development, prototyping services and metal stamped parts manufacturing for a wide base of customers. Over the years, ATL expanded its footprint to various other countries such as China, Malaysia and Vietnam.[2]

ATL listed on the Mainboard of the Singapore Exchange (SGX) in June 2003. It was subsequently transferred to the Catalist Board in May 2017.[3]

In 2016, in an effort to improve financial performance and reduce risk, ATL embarked on a restructuring plan. ATL divested two immediate subsidiaries and liquidated two other dormant subsidiaries in 2017. Later, it disposed another subsidiary in Suzhou, China, in 2018.[4]

This case was prepared by Tan Pheng Wu, Fu Jincheng, Lou Yong Xin Matthew and Au Lu Yi Kirstin, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been substantially re-written, with information added, by Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees.

However, during this period, ATL also decided to diversify into other lines of business, through a series of acquisitions. This included the acquisition of a 51% stake in both Asia Box Office Pte Ltd (ABO)[5] and Activpass Holdings Pte Ltd (Activpass),[6] although attempts were also made, albeit unsuccessfully, to acquire 8travelpay Intelligence & Technology (Shanghai) Co., Ltd. (8TPS),[7] as well as a construction company Aik Chuan Construction Pte Ltd (Aik Chuan Construction).[8] The Group structure of ATL is shown in Figure 1.

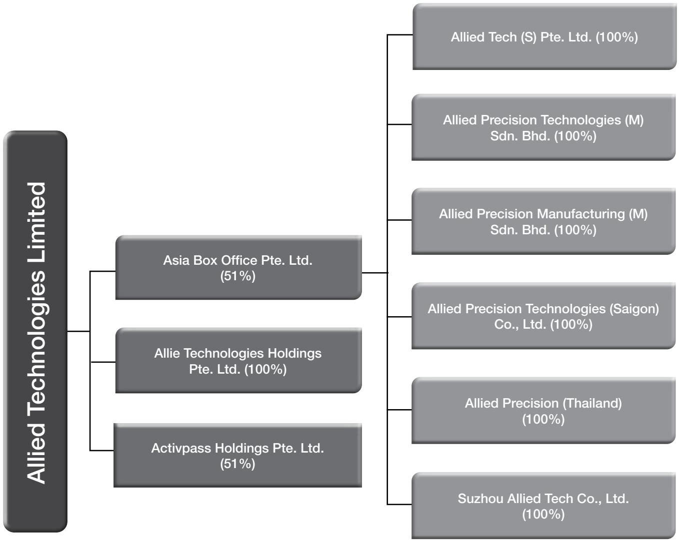

Figure 1: Allied Technologies Group structure[9]

A revolving door

Independent directors

Between 2015 and 2019, ATL had three rounds of independent directors (ID) changes. The first came on 10 October 2015, when ATL's then Chairman, Chief Executive Officer (CEO) and controlling shareholder Hsu Ching Yuh (Hsu), requested that all three of ATL's IDs resign. These three outgoing IDs were Loo Choon Chiaw[10] (Loo), Sitoh Yih Pin[11] (Sitoh) and Chua Tat Seng[12] (Chua). The official reason provided in the cessation announcements is to "enable the company to reconstitute the board, restructure itself, focus on new business opportunities and bring in new shareholders in the best interest of the company".

The IDs replacing them were Woo Say Hock[13] (Woo), Jake Lam[14] (Lam) and Yau Woon Foong[15] (Yau). However, unlike the three outgoing IDs, Woo, Lam and Yau had no previous experience as directors of listed companies. Furthermore, Yau, who was appointed as the lead ID and Chairman of the Audit Committee, had no apparent relevant experience. Notwithstanding that he has a degree in accountancy, his prior experiences were all in the capacity of a director or consultant of private asset management companies in the provision of fund administration services.

Less than two years later, Woo[16] and Lam[17] resigned on 23 March 2017 to pursue their personal interests or ventures. In turn, they were succeeded by Chuang Shaw Peng[18] (Chuang) and Shih Chih-Lung[19] (Shih). Again, neither Chuang nor Shih had experience as directors of listed companies. In quick succession, Chuang[20] and Shih[21] resigned in August and October respectively that same year "to pursue [their] personal interests", less than six months after they were appointed to the board. They were then replaced by Lim Jin Wei[22] (Lim) and Pok Mee Yau[23] (Pok). However, in this case, Lim and Pok had prior experience as directors of listed companies, although Pok is a salaried partner at JLC Advisors LLP (JLC Advisors).

Associate Professor Mak Yuen Teen described such situations of IDs being replaced as a slate when new shareholders show up as a "mockery of the concept of IDs, who are supposed to be independent of major shareholders".[24]

Executive directors and senior management

Besides the high turnover of IDs, there were also changes in the company's executive directors (EDs) and senior management. In December 2017, both EDs of ATL, who had been serving for many years, suddenly resigned within nine days of each other.[25,26] Subsequently, on 15 January 2019, the newly appointed Chief Financial Officer (CFO) Andrew Wong (Andrew) also resigned,[27] merely two months after taking up the appointment. Following his resignation, Andrew raised concerns with ATL's auditors and sponsor about the classification of expenses, documentation processes and the audit of ABO.[28]

Placements and changes in ownership

During an Extraordinary General Meeting (EGM) in April 2017, ATL obtained a general mandate to issue up to 100% of new shares, either on a pro-rata or non-pro rata basis.[29] This entire mandate was fully utilised by October 2017.[30] Had ATL remained on the Mainboard of SGX, ATL would have been able to issue no more than 20% of the new shares on a non-pro rata basis.

In July 2018, the company made another placement of 420 million shares, amounting to 31% of the enlarged outstanding shares.[31] The large share placement would not have been permitted if ATL had remained on the SGX Mainboard.

These share placements contributed to significant changes in ownership of ATL. First, there were four new substantial shareholders after the first share placement on 24 October 2017. They were Danai Udomchoke[32] (Udomchoke), Loo Hui Lin Emily[33] (Emily), Perakiat Siriluethaiwattana[34] (Siriluethaiwattana) and Heng Hui Kiak Robin[35] (Heng). Based on searches of online sources, Udomchoke and Sirileuthaiwattana are both Thai nationals and former professional tennis players.[36,37] Each acquired a direct interest in 64 million shares at market price, translating to a 6.32% shareholding. Six days later, however, these four individuals ceased to be substantial shareholders following a further placement of shares, with each of their stake falling to 4.74%.[38,39,40,41]

In ATL's 2017 annual report, Heng was listed as one of ATL's top 20 shareholders as at 23 March 2018, although he appeared to have sold off about 30% of his shares based on the disclosure. However, Udomchoke, Siriluethaiwattana and Emily did not appear on the top 20 shareholders list even though the 20th largest shareholder held only a 0.71% shareholding.[42] This suggests either these three individuals each sold their stakes resulting in them owning less than 0.71% of the company's shares, or transferred their stakes from direct interest (which is shown in the list of top 20 shareholders) to indirect interest.

Second, Hsu, the former controlling shareholder who resigned as Chairman and CEO on 29 December 2017, sold off his entire stake for just under S$20 million on 1 February 2018.[43] ATL share price started to plummet significantly after he sold his stake.

Third, through a series of market and off-market transactions between November 2017 and April 2018,[44] Lin Tah Hwa (Lin) bought more than 403 million shares or a 29.88% stake, with average cost of just over seven cents each. Less than four months later, he sold off more than 235 million shares at an average price of over 4.7 cents per share within a two-day period.[45]

Lin is believed to be the individual behind the founding of Lin Securities, which went bust shortly after the Pan-Electric Industries debacle in 1985.[46] Assuming Lin still held the remaining 168 million shares – and based on the last reported share price of 1.1 cents – he would have sustained a total realised and unrealised loss of over S$15 million.[47]

Lastly, while the 1.095 billion shares placed out in October 2017 and June 2018 had cost placees approximately S$58.95 million, it would only be worth about S$12.05 million by early June 2019.[48]

Why did these individuals buy large stakes in ATL only to apparently dispose of significant chunks shortly after at substantially lower prices, and not long before the company started embarking on a series of highly questionable transactions which drained the company of its cash?

According to ATL's Statement of Financial Position as at 31 December 2017,[49] the Group had S$59.8 million in cash and deposits. The amount in the cash and bank balances accounted for about 35% of ATL's total assets. Included in the total assets of S$172.5 million was S$54.4 million in assets held for sale. As at 31 December 2018, cash and deposits were about S$14 million and S$34.5 million was an amount due from a law firm.[50]

A "Catalist" for lapses

In May 2017, ATL completed its transfer from the Mainboard to Catalist Board of SGX,[51] where companies are subject to a more lenient set of rules.[52] This includes the absence of a watch-list and higher thresholds before a transaction is considered a 'major transaction'. An example of such a difference which is pertinent to ATL is Rule 1014. Under Mainboard Rule 1014,[53] a transaction will be deemed as a major transaction when any of the relative figures computed under Rule 1006 exceeds 20%. However, under Catalist Rule 1014,[54] this threshold is 75% and 50% for acquisitions and disposals respectively. Shareholder approval is only necessary for major transactions.

While the Catalist was originally introduced to help catalyse the growth of small companies and hopefully lead to an eventual transfer to the Mainboard, companies may switch from the Mainboard to Catalist to take advantage of the less stringent rules and absence of a watch-list.

A study has found that companies which transferred from the Mainboard to the Catalist were typically on the watch-list or headed towards it, and exhibited poorer corporate governance, lower profitability and lower growth potential, as compared to their peers.[55]

In ATL's case, the company was on SGX Mainboard's watch-list[56] and had relatively poor corporate governance.[57] Further, after transferring to Catalist, the company expeditiously sought to undertake six transactions, often relying on the more liberal Catalist rules.

In April 2018, ATL also announced a change of its continuing sponsor,[58] from CIMB Bank Berhad, Singapore Branch to Stamford Corporate Services Pte. Ltd. (SCS). A change in sponsor has also been cited as a key warning sign for Catalist companies.[59]

First transaction: Disposal of ATSU

After the first share placement, ATL disposed its wholly-owned subsidiary, Allied Technologies (Suzhou) Co., Ltd (ATSU) in December 2017.[60] According to ATL's 2017 annual report,[61] the disposal was made as it generated losses for ATL. The Group's unaudited management accounts as at 30 September 2017 showed that ATSU had incurred a net loss of S$956,000.[62] On top of this, ATSU was involved in a solar power project which was plagued by delays due to weather conditions and difficulties in obtaining stakeholders' approval.[63] Collectively, this increased the project's uncertainties.

However, despite the significant losses that ATSU had chalked up and its unprofitable projects, ATL managed to find a buyer for ATSU. The sales and purchase agreement (SPA) for ATSU's disposal showed that the total purchase consideration consisted of an equity consideration of S$20,997,024 and a loan assignment consideration of S$4,002,976. In aggregate, the total purchase consideration was S$25 million.[64]

There was no mention of how the purchase consideration was determined as there was no separate independent valuation of ATSU's assets. Instead, it was stated that the consideration was negotiated at arm's length on a "willing-buyer, willing-seller" basis after considering ATSU's financial and business prospects.[65]

The purchaser was identified as a Taiwanese businesswoman Hong Siou-Jhu (Hong). According to disclosures made in the agreement,[66] Hong is involved in the manufacture and sale of electronic components, and she had bought ATSU with the intention to "expand her business into the PRC". It was also disclosed that Hong knows Hsu personally, and had been introduced to ATL by Hsu, who was then ATL's Chairman and a substantial shareholder. Additionally, it was stated that Hsu did not receive any financial benefits from introducing Hong.

Based on the Group's audited consolidated financial statements for FY2016, if the disposal of ATSU was completed on 31 December 2016, it would have contributed to an increase in the net tangible asset per share of ATL from S$0.0942 before completion of the proposed disposal to S$0.0948 after completion. The EPS of ATL would have also increased from S$0.0020 to S$0.0025.[67]

Given the amount involved, shareholder approval would have been required under the Mainboard listing rules. However, under the Catalist rules, this transaction was to be disclosed but did not require shareholder approval.[68] Notwithstanding this, Catalist rules also provide that shareholders should have a say if a disposal would result in a material change to the nature of the issuer's business.[69] ATSU was arguably strategically important to ATL because it was responsible for ATL's presence and operations in China.[70] Despite this, ATL did not seek shareholder approval for the disposal of ATSU.

Second transaction: 8TPS

Following the disposal of ATSU, ATL signed a binding memorandum of understanding (MOU) to invest in 8TPS. 8TPS, a company incorporated in China, provides payment and technology solutions to the corporate travel market. It has an exclusive contract with Hotel Reservation Service (Shanghai) Co. Ltd to provide solutions in hotel management, as well as consulting and solutions in strategic procurement and optimised payment processes.[71]

In the MOU,[72] ATL stated that the acquisition was part of its business plans to diversify into the technology and services sectors, and to penetrate China's growing corporate travel market. ATL's board believed that these markets have huge potential for growth, and would enhance shareholder value by bringing in additional revenue for ATL. According to the MOU, the consideration for 8TPS included a subscription price and a conversion price of US$2.5 million and US$7.5 million respectively. In aggregate, this would amount to US$10 million.[73]

In line with the terms of the MOU, ATL entered into an investment agreement to subscribe for 10% of the enlarged share capital of 8TPS for US$2.5 million, extended a convertible loan of US$3.5 million (which can be converted to a seven percent interest in the enlarged share capital), and accepted an option to subscribe for a further eight percent of the enlarged share capital for US$4 million.[74]

The valuation of 8TPS as of 31 December 2017 was undertaken by Baker Tilly Consultancy (Singapore) Pte. Ltd. (Baker Tilly), an independent valuer appointed by ATL. In its valuation report, the investment value for 100% of 8TPS's equity was estimated to be between US$26.7 million (approximately S$36.081 million) and US$28.5 million (approximately S$38.514 mllion).[75] Based on the lower end of Baker Tilly's valuation of 8TPS, and ATL acquiring a 25% shareholding in 8TPS, the amount of consideration should be approximately US$6.675 million. Even if the upper end of the valuation of 8TPS was used, the maximum consideration ATL should have paid would be US$7.125 million. ATL's proposed consideration of US$10 million was therefore about 40% above the market valuation of 8TPS. Furthermore, the full subscription price of US$2.5 million would be paid in cash, funded from ATL's internal cash reserves.[76]

Based on the unaudited management accounts of 8TPS as at 28 February 2018,[77] 8TPS' unaudited book value and net tangible asset value was only approximately RMB87,000 (approximately S$18,000). As such, the financial impact of this proposed investment was immaterial on the Group's earnings and net tangible assets per share. Notwithstanding this, the proposed investment constitutes a 'disclosable transaction' pursuant to Rule 1006 and Rule 1010 of the Catalist rules but no shareholder approval was needed. Shareholder approval would have been required if ATL was listed on the SGX Mainboard. However, SGX did issue a query to ATL regarding its 8TPS transaction later on.[78]

In May 2019, the proposed investment was called off by mutual agreement of 8TPS and ATL.[79] No further information was provided by either party on the reasons of the termination.

Third transaction: ABO

In January 2018, ATL announced that it had entered into a separate binding MOU with Platform Internet Capital Pte. Ltd. (PIC) to acquire a 51% stake in ABO, which was valued at S$60 million based on internal estimates.[80] Incorporated in Singapore in March 2016, ABO was "in the business of operating an e-commerce ticketing solutions platform for venues and event organisers, with a focus on sports, entertainment and lifestyle events in Southeast Asia and Greater China".[81]

ABO had unaudited net tangible assets of S$265,000 as at 30 June 2017 and unaudited net profit from incorporation until 30 June 2017 of S$165,000.[82]

ATL commissioned Alternative Advisors Pte. Ltd. (Alternative Advisors) as the independent valuer to assess the fair market value of ABO's shares. In its valuation report, the range of the indicative fair market value was S$57 million to S$62 million for 100% of shareholding in ABO.[83] This would suggest that the consideration for the proposed acquisition of the 51% interest should be between S$28.5 million to S$31 million. This was in line with the actual amount paid of S$30 million.[84]

ATL did not provide any reason for appointing Alternative Advisors to carry out the valuation of ABO. According to Alternative Advisors' website, the firm was set up in April 2008 as an independent boutique advisory firm providing "personalised professional services".[85] It adds that the firm is known for its quick response to any challenges that might surface during assignments. The management team at Alternative Advisors consisted of Wong Joo Wan (Wong), Yong Chor Ken Alex (Yong), and Su Jun Ming Martin (Su).[86] The prior experience of Wong and Yong includes involvement in a number of troubled companies.

Several companies which Wong had previously held directorship in either went into liquidation around the time of Wong's appointment, or came under investigation by Singapore authorities. One such company is KLW Holdings Limited (KLW),[87] where Wong was the Chairman of the Nominating Committee, and a member of the Audit Committee and Remuneration Committee between 12 October 2015 and 4 October 2017.[88] On 26 June 2015, KLW embarked on a special audit, which revealed lapses in internal controls and potential breaches of disclosure rules.[89] Coincidentally, JLC Advisors was appointed as the legal counsel representing KLW in these transactions. Furthermore, KLW is also currently investigated by the Commercial Affairs Department (CAD) regarding an offence under the Securities and Futures Act.[90]

As for Yong, amongst his many appointments, he was a director at Transcorp Holdings Limited (Transcorp). Transcorp had a history of poor corporate governance and faced going concern issues.[91,92]

As the relative figure calculated under Chapter 10 of the Catalist Rulebook did not exceed 75%, the proposed acquisition was a 'disclosable transaction' but did not require shareholder approval.

Fourth transaction: Activpass Holdings

In June 2018, ATL signed a new binding MOU to acquire a 51% interest in Activpass.[93] Activpass was incorporated in Singapore in July 2016[94] and provides software solutions to the fitness, wellness and beauty services industries.[95]

ATL justified its acquisition of Activpass as part of its efforts to diversify business operations and invest in technology solutions which the company believes would have strong potential for growth. In addition, the ATL board also believed that Activpass could add new capabilities and consumer outreach to its recent acquisition of ABO.[96] As in the case of 8TPS, Baker Tilly was appointed to provide an independent valuation of Activpass. Baker Tilly's valuation range for 100% of Activpass equity was between S$57 million and S$60.7 million as at 30 June 2018.[97] Based on these figures, ATL's consideration for its 51% stake was at a discount of approximately between 13.3% and 19.8% to Baker Tilly's valuation.[98]

The relative figures for the proposed 51% stake in Activpass, based on Activpass's 10-month financial period from July 2017 to April 2018 and subsequent extrapolation to a full financial year ended 30 June 2018 meant that ATL's acquisition of Activpass was a 'disclosable transaction' under the Catalist rules. Again, shareholder approval was not required.

The acquisition of Activpass was completed in July 2018 for S$25.2 million. This was close to the total amount funded by the 420 million share placement that same month.[99]

Fifth transaction: Aik Chuan Construction

In April 2019, ATL proposed to acquire Aik Chuan Construction for S$130 million. This was to be satisfied by S$30 million to S$50 million in cash, and the balance through new ATL shares issued at no more than S$0.01 each.[100] By then, ATL shares were trading at just S$0.011.[101] Interestingly, after diversifying into e-commerce and digital payment business, ATL was now seeking to re-enter the construction business.

However, this transaction was cancelled on 22 May 2019, following the revelation of the escrow funds saga which was soon to befall the company.[102] ATL's 2017 annual report revealed that Lim Yew Ming, owner of Aik Chuan Construction, was one of the 20 largest shareholders of ATL.[103] Furthermore, Aik Chuan Construction was embroiled in a lawsuit with JLC Advisors over an outstanding debt amounting to S$3 million from a S$5 million loan that was purportedly made to the latter on the request of Ong.[104]

Bypassing checks and balances

Most of the acquisitions that ATL engaged in or attempted to engage in did not require shareholder approval because they were not considered 'major transactions' under the SGX Catalist rulebook.[105] Furthermore, the company only obtained shareholder approval to diversify into e-commerce platforms and digital payment applications on 26 March 2018, after already announcing its investments in 8TPS and ABO.[106] Had ATL remained on the SGX Mainboard, all three acquisitions would have required shareholders' approval.

On 4 June 2019, ATL intended to hold an EGM to seek shareholders' ratification of the Activpass acquisition, nearly a year after the completion of the said deal.[107] However, on that day, the EGM was adjourned.[108] This EGM was only called after SGX belatedly exercised its discretion and directed the sponsor to aggregate the transactions of ABO and Activpass, which then constituted a major transaction under the Catalist rules.[109]

ATL had undertaken various acquisitions and divestments during a period when there were frequent changes in its board members. To make matters worse, its board also lacked the relevant expertise in the new industries that it sought to diversify into. At various material times, the two EDs, Kenneth Low Si Ren (Low) and Roger Poh (Poh), were arguably the only persons who could be said to possess some prior experience in the fields of e-commerce platforms and digital payment applications.[110] Although the duo had overseen the investments in 8TPS, ABO and Activpass, Poh resigned shortly after the three acquisitions were made "for personal reasons".[111] His tenure lasted only six months.

ATL's external auditors, Ernst & Young LLP (EY), had raised several concerns during the audit of ATL.[112] These included factual errors in the valuation report of ABO and multiple questionable transactions undertaken by ABO. For undisclosed reasons, ABO included Platform Capital Asia (Singapore) Pte. Ltd. (PCA) as a counterparty in its transactions with an event financier, instead of transferring the funds meant for artiste fee deposits directly to the event financier. The event financier is a shareholder of ATL. In effect, ABO first transferred S$1.7 million to PCA. PCA then transferred S$1.68 million to the event organiser. Furthermore, although the concert was subsequently cancelled, the deposit was not refunded to ABO in accordance with the financing agreement. It was noted that while ABO had not charged any interest to the event financier, the event organiser paid the event financier S$102,000 as an interest on the sum of S$1.68 million. However, this amount was then remitted to PCA instead of ABO.[113]

It later emerged that Low, who became ED of ATL on 27 June 2018,[114] had a conflict of interest in the ABO transaction that was completed less than three months before he joined.[115] Low, who was also a director at PCA, had a deemed interest in ABO, held through Klow Ventures Pte. Ltd. (Klow Ventures). Klow Ventures is wholly owned by Low. On 5 June 2018, Klow Ventures acquired 100% interest in Platform Internet Capital Pte. Ltd. (PIC), which has a 49% shareholding interest in ABO. As a result, Low has a deemed interest in 49% of ABO by virtue of his shareholdings in Klow Ventures. ATL acquired the remaining 51% interest in ABO on 4 April 2018.[116]

Straw that broke the camel's back

Escrow fund and significant transactions

ATL had entered into an escrow agreement with JLC Advisors on 23 October 2017[117] to hold proceeds from the proposed placement process. The agreement was approved by the then board of directors compromising Hsu (Group Managing Director and CEO), Soh Weng Kheong (ED and Group Deputy Managing Director), Yau (lead ID), Shih (ID) and Lim (ID).[118] Other than Lim, the rest of the individuals subsequently resigned from ATL board.

On top of the proceeds from the placement process, the balance proceeds for the disposal of equity interest in Allied Machineries (Shanghai) Co., Ltd. and ATSU were also deposited into the account.[119] The escrow account was used to make material payments, including the consideration for the acquisition of ABO, compensation paid to Hsu as part of his termination agreement and an intercompany loan of $3.6 million to ABO (no formal loan agreement existed between ABO and ATL for the loan).[120]

Given that an escrow account is meant as a temporary arrangement to facilitate the payment between two parties for a given transaction,[121] it is peculiar that ATL maintained the huge escrow account with JLC Advisors for a prolonged period when it served no clear purpose, as noted by the company's auditors, EY.[122]

Recovery of funds

ATL subsequently revealed that it had made multiple unsuccessful demands for the release of the escrow fund's balance of S$33,153,416 since 23 March 2019.[123] Although JLC Advisors' Managing Partner Ong had repeatedly responded to ATL's demands by stating that the funds would be released shortly, he failed to do so. This was in breach of JLC Advisors' obligations under the escrow agreement. In fact, ATL's legal counsel Rajah & Tann LLP (Rajah & Tann) revealed that "the last communication from Mr. Ong Su Aun, Jeffrey to the Company was on 13 May 2019, representing to the Company that he would be able to release the escrow funds by 17 May 2019".[124] An ultimatum was issued when the escrow funds were still not released on 17 May 2019. ATL instructed Rajah & Tann to issue a letter of demand that the funds be released by 4pm on 22 May 2019.[125]

On 22 May 2019, hours before the deadline of 4 pm, ATL received a letter from JLC Advisors stating that the funds of "S$33.4 million" have been paid out from the escrow account on the request of Ong and that the payout "might have been unauthorised".[126] At this juncture, ATL highlighted that the amount of funds quoted in the letter was wrong,[127] and that none of its authorised joint signatories had given any instructions to release the funds. This was a breach of the escrow agreement, which stated that any disbursement orders must be in writing and need to be signed by both authorised joint signatories. ATL's authorised signatories for the disbursements of funds at that point consisted of Low and Lim.[128]

Conflict of interest

Following the incident on 24 May 2019, ATL recused three directors from its board of directors and barred them from acting as signatory to ATL or its subsidiaries' accounts. The three directors were Low, due to conflicts of interest arising from his involvement in ABO; Pok, because she was a salaried partner at JLC Advisors; and Lim, because he was a signatory to the escrow account with JLC Advisors since its establishment.[129,130]

Pok's position as an ID and salaried partner of JLC Advisors raised eyebrows. In a subsequent announcement, ATL claimed that the appointment of Pok was based on her qualifications as the board was looking for a female director with legal expertise. Although the recommendation of Pok was made by JLC Advisors at the request of ATL, ATL claimed that it was not concerned by Pok's role as a JLC Advisors partner because it had authorised the escrow agreement before Pok's appointment as ID in ATL. Furthermore, Pok was not a signatory for the escrow account.[131]

A search of Pok showed that she had held multiple directorships at troubled companies such as ecoWise Holdings Limited (ecoWise), Imperium Crown Limited (Imperium Crown), and Transcorp.[132] Following her resignation as an ID at Transcorp, Pok disclosed that the reason for her cessation was due to "increased responsibilities at work and decision to concentrate on her professional career".[133] If this was indeed the reason, it begs the question of why Pok had subsequently accepted the appointment to the boards at ecoWise and Imperium Crown.

Beyond a question of ethics

On 13 May 2019, Ong was asked by the other partners at JLC Advisors to account for unauthorised withdrawals of a client's monies. However, Ong absconded to Malaysia on the same day.[134] He had fled Singapore 10 days before the ATL's SGX filing on 23 May 2019, which brought attention on Ong and his law firm.[135] In the days that followed, Ong took deliberate steps to "throw law enforcement officers off his trail", such as by discarding his mobile phone, avoiding the use of his credit cards, and using a stolen passport. He was eventually caught by the Malaysian police in his hotel room on 29 May 2019 and extradited back to Singapore on 30 May 2019.[136]

Ong was slapped with a total of 26 charges,[137] including multiple criminal breach of trust for conspiring to cheating other companies, as well as the forgery of bank statements. It was revealed that ATL was not the sole victim of Ong. Ong, however, has yet to be charged in relation to ATL's missing escrow funds. Ong was also found to have ties with several companies that are the subject of investigations by the CAD.

SGX subsequently queried how ATL was introduced to JLC Advisors and Ong. In its response, it was disclosed that the ATL board believed that it would be more prudent to engage a more sizable law firm to be the escrow agent as the proceeds of the proposed placement was substantial. ATL claimed that while Low Yew Shen from Elitaire Law LLP (Elitaire) – the small law firm[138] handling the company's then proposed placement exercise with JLC – had only recommended JLC Advisors to act as ATL's escrow agent, a paralegal from Elitaire had in fact attached Ong's details together with JLC Advisors' profile for ATL's review.[139] On 27 May 2019, ATL had received another letter from JLC Advisors claiming that the law firm was unaware of any of ATL's demands or communications with Ong.[140]

Guilty by association?

The ATL saga dragged other companies into the spotlight as well. One of these was Annica Holdings Limited (Annica). Similar to ATL, Annica is also a company with questionable corporate governance. Annica was investigated as one of the entities which Malaysian businessman John Soh Chee Wen (Soh), the key figure in the huge penny stock scandal in Singapore, was involved in.[141] Soh was charged with market rigging that led to the penny stocks crash during the period from 2012 to 2013.[142]

Annica had also experienced sudden changes in IDs. In January 2016, two of the three IDs on Annica's board resigned "to allow more time and attention to his current and anticipated work commitments".[143,144] The new IDs were Su Jun Ming[145] (Su) and Adnan Bin Mansor[146] (Mansor). Again, the two outgoing IDs were replaced with two incoming IDs with no experience as directors of listed companies.

Su, 37, was appointed lead ID, Chairman of the Audit Committee and a member of the Nominating Committee and Remuneration Committee.[147] Mansor, 53, was appointed as the Chairman of the Nominating Committee, and member of the Audit Committee and Remuneration Committee.[148] Ong, the third ID, did not resign. He later served as the acting independent Chairman.[149] However, he eventually tendered his resignation via email on 20 May 2019, when he was on the run.[150]

Yau, one the three new IDs who joined ATL in October 2015, was appointed as an ED of AA Group Holdings Ltd (AA Group) in June 2016[151] but resigned in December 2018.[152] Loo, one of the IDs who was asked to resign at ATL, had also resigned as an ID from AA Group just a month earlier with two other IDs. The two IDs and one non-independent non-executive director who replaced them at AA Group had no experience as directors of listed companies. Like ATL, turnover of directors and key management continued at AA Group, with the new directors all eventually stepping down in a matter of months.[153]

ATL, Annica and AA Group are all listed on the Catalist Board and have the same sponsor – SCS – as did another company, Epicentre Holdings Limited, whose Chairman also disappeared soon after Ong did at Annica.[154] Are these coincidences or are the events at these companies connected in some way?

Aftermath

Following the concerns raised by EY on 8 May 2019, ATL converted the trading halt of its shares imposed earlier on 3 May 2019 to a voluntary trading suspension and undertook a special audit.[155] On 8 May 2019, SGX Regco issued a notice of compliance (NOC) to ATL. The NOC required the company to, among other things, "expeditiously procure the release of the Allied Funds held with JLC" and to place them in an escrow account in an approved financial institution; provide regular updates of the company's cash balance; and for the board composition to remain unchanged.[156] On 23 May 2019, a second NOC was issued, requiring the company to appoint the special auditor by 14 June 2019, requiring the special auditor to report solely to SGX Regco, and expanding the scope of the special audit.[157]

The special audit to be undertaken by PricewaterhouseCoopers Risk Services Pte Ltd (PwC) centers around the escrow funds, ATL share placements, as well as its diversification and acquisitions in the e-commerce business.[158]

As for the escrow fund, following a complaint lodged by ATL, the Law Society of Singapore took control of funds held by JLC Advisors "to protect and safeguard the interests of clients and third parties."[159] ATL also announced that it had lodged a report with the Singapore Police Force[160] and is cooperating with CAD in its investigation.[161] ATL also opened a new escrow account with a local bank.[162]

Low, the ED, had become the subject of investigations by CAD and was asked to surrender his passport.[163] The CEO, CFO and two of the IDs, Lim and Pok, had been asked to provide assistance for the CAD investigations as well.[164,165]

On 10 June 2020, ATL held its Annual General Meeting (AGM), where shareholders voted against the re-election of three of the company's five directors, namely Low, Chairman Chin Chee Soon (Chin), as well as CEO and ED Clement Leow Wee Kia (Leow). Chin was appointed to the board on 15 February 2019,[166] while Leow succeeded Hsu as CEO on 1 March 2019[167] after Hsu resigned in December 2017 to "pursue his own interests".[168] However, SGX RegCo had compelled the board to stay on and assist with the special audit which was still in progress. As such, the three directors have been re-appointed despite strong objection from shareholders. 61.71% of shareholders had also voted against the re-appointment of EY as the company's auditors. It would subsequently be required to hold an EGM to appoint new one. During the AGM, it was announced that the special audit was still on-going.[169,170]

Discussion questions

1. Assess the appropriateness of the board composition at ATL since October 2015. To what extent do you agree with the reasons that ATL had provided for the changes in director within the company? Critically evaluate how has this rapid change of directors affected corporate governance within ATL.

2. It is relatively common for lawyers from legal firms providing services to listed companies to also serve on the boards of these client companies as independent directors. The Code of Corporate Governance does not specifically prohibit this but suggests that independence may be threatened if there are material services or significant payments. What are the risks for the individual, legal firm and listed company concerned? Explore these risks in the case of ATL. Should the Code of Corporate Governance be stricter in this regard and if so, in what way?

3. Evaluate the extent to which the directors have adequately discharged their duties. Consider those directors who resigned, and those who joined and oversaw the questionable transactions.

4. What are the responsibilities of directors in overseeing share issues, investments, acquisitions and divestments? Consider the various transactions undertaken or proposed by the company between December 2017 and April 2019. How might the interests of minority shareholders be harmed by these transactions, if at all?

5. Evaluate the key differences in rules between the SGX Mainboard and Catalist Board. Do you think that ATL took advantage of more lenient Catalist rules? Should a company be allowed to switch from the Mainboard to the Catalist Board and if so, under what conditions? In your answers, you should analyse how the transfer from the Mainboard to Catalist Board may have contributed to the events that have transpired.

6. With reference to the events that took place in ATL, critically evaluate the effectiveness of Chapter 10 of the SGX Catalist rulebook in protecting shareholders' interests.

7. With reference to all the events that had transpired in ATL, discuss the roles that a Catalist sponsor and regulators play in ensuring good corporate governance within a company and critically evaluate their effectiveness in the context ATL

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ASTI & CO: TRIPLE WHAMMY

Case overview

On 8 April 2019, ASTI Holdings Limited, Advanced Systems Automation Limited and Dragon Group International Limited announced that they were bidding farewell to their Executive Chairman and Chief Executive Officer, Dato' Michael Loh Soon Gnee, who had tendered his resignation from all three companies due to "personal reasons". This marked the end of a relationship that started with much promise but created much misery for minority shareholders as the companies plunged into losses, with one of the companies facing a mandatory delisting. Questionable corporate governance in the form of significant director turnover, inter-connected directors and high remuneration plagued the companies as they struggled in the face of significant disruption in their industry.

The objective of this case is to facilitate a discussion of issues such as corporate governance risks of listed companies under common control; board composition; director duties; director turnover; board interlocks; remuneration; and the role of regulators.

The rise of the ASTI trident

With two research and development centres and eight factories located across the world, ASTI Holdings Limited (ASTI) was a major provider of semiconductor manufacturing services.[1] After becoming publicly listed in 1999, it migrated from the then SESDAQ to the Mainboard on the Singapore Exchange (SGX) in 2005.[2]

This case was prepared by Avinash Anand, Isaac Lim Wen Liang, Seah Wei Ren and Zhu Shi Yao, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been substantially re-written, with information added, by Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees.

Figure 1 shows the five principal business activities and group structure of ASTI.

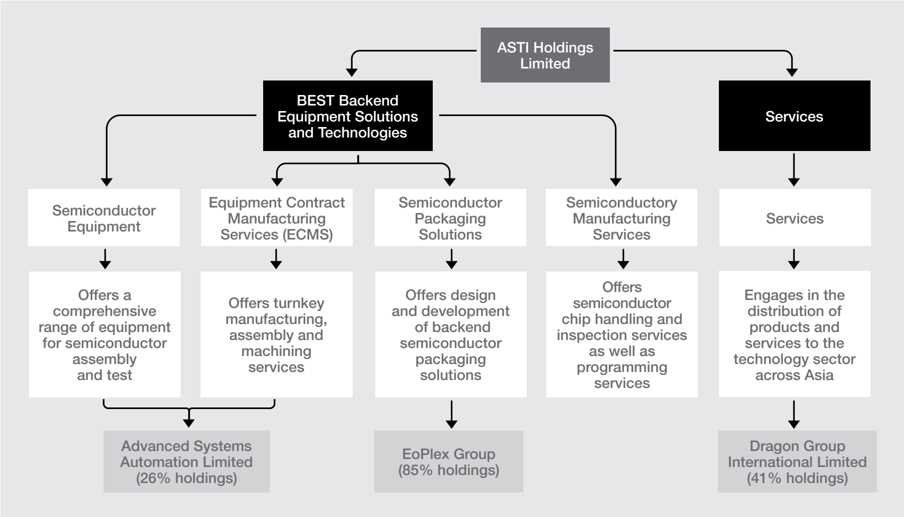

Figure 1: Structure and business activities of ASTI[3]

Dragon Group International Limited (DGI) was founded in 1990 and debuted on the then SESDAQ in September 1994.[4] It moved to the Mainboard in September 1998 and was acquired by and became a subsidiary of ASTI in June 2006.[5] Headquartered in Singapore, DGI has subsidiaries and representative offices across China, Hong Kong and Taiwan.[6] Its principal activities are summarised in Figure 2.

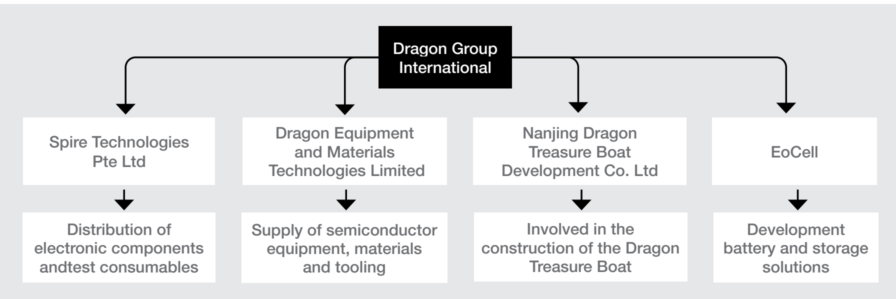

Figure 2: Business activities of DGI[7]

Advanced Systems Automation Limited (ASA) entered the semiconductor industry in 1986 with its core business being the manufacture of automated equipment for the encapsulation of semiconductors.[8] On 22 July 1996, ASA listed on the then SESDAQ.[9] On 16 August 2006, ASTI acquired ASA in order to expand into additional business sectors and hasten its expansion into North Asia.[10] ASA became a part of the ASTI's BEST cluster. ASA's core business activities are shown in Figure 3.

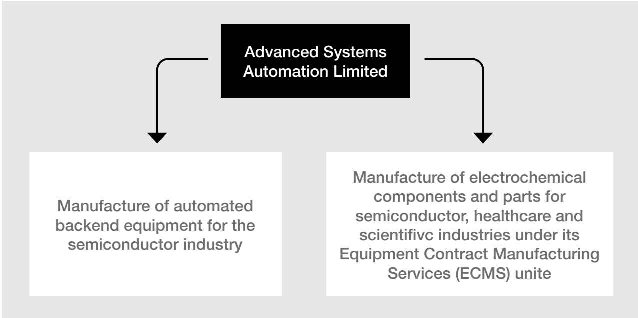

Figure 3: Business activities of ASA[11]

One king, three crowns

Dato' Michael Loh Soon Gnee (LSG) holds a Bachelor of Science degree, with a Double Major in Business Economics & Chemical Engineering from the State University of New York.[12] Having spent 20 years in Silicon Valley, LSG was said to bring with him "practical business experiences" and "a vast network of contacts in the semiconductor industry".[13]

In May 2003,[14] ASTI announced that it had entered into a binding term sheet and a subscription agreement in respect of the proposed investment by LSG in the company. In September 2003, the subscription by LSG of 54,236,000 new ordinary shares at S$0.10 per share was completed.[15] A month later, LSG became ASTI's Non-Executive Chairman, replacing Au Sai Chuen.[16] By 2005, LSG became Executive Chairman (EC)[17] and in 2013, he replaced Charles Cher Lew Siang as company CEO.[18]

In September 2005 – following ASTI's transfer from SESDAQ to the SGX Mainboard earlier in April that year – LSG fully exercised his option to acquire 108,472,000 ordinary shares of the company at S$0.154 per share.[19]

LSG first became a director of DGI on 23 October 2003,[20] and subsequently a director of ASA on 19 July 2006.[21] He was to become EC and CEO of all three companies – ASTI, DGI and ASA. LSG was appointed CEO of ASA in November 2010, and CEO of DGI in July 2008.[22] On 8 April 2018, it was announced that he would transition out of all appointments over the following 12 months.[23]

Three times the trouble

"As we stand today, we are now in a better than ever position to pursue and polish the rough gems we find in the wilderness. Strategically, our long term commercial outlook is very optimistic and we hope to let the diamonds shine in time to come."

– Dato' Michael Loh, on DGI's performance[24]

ASTI started showing signs of trouble in 2012. After posting profits in 2010 and 2011, it reported a net loss of over S$15 million.[25] The CEO at the time, Charles Cher, said that the loss was a result of impairment arising from the proposed divestment of the distribution business, the contribution of losses from ASA and an increase in research and development expenses in relation to semiconductor packaging solutions. However, he remained positive, saying that the company would be working on new solutions and wafer inspection equipment. He was also optimistic about the future of ASA and DGI.[26]

However, Cher resigned as CEO in 2013 after 22 years with ASTI. LSG took over his role, becoming the EC and CEO in the process.[27] Following the change of management, ASTI's troubles persisted.

Prior to the release of financial results for 2013, ASTI issued a profit warning. It mentioned weak market demand for ASTI's equipment, research and development costs, impairment of goodwill, and realisation of reserve upon the Group's completion of its disposal of the distribution business.[28] ASTI posted a loss of nearly S$22 million, with a decline in revenue that was attributed to drop in demand from customers.[29] ASTI was cautious about its performance in the coming years, stating economic uncertainties as well as the cyclical nature of the electronics and semiconductor industries. It also noted that exceptional circumstances such as foreign exchange volatility, intellectual property litigations, product and technology obsolescence, and inventory adjustments could affect ASTI's performance.[30]

In 2014, ASTI issued another profit warning for 1Q2014, citing losses from its subsidiaries and continued research and development costs for the development of semiconductor packaging technologies.[31] For the full-year results, ASTI managed to post an operating profit before tax. However, due to deferred tax liabilities, ASTI still reported a net loss after tax of about S$340,000.[32]

The company recorded a 39.6% increase in revenue due to higher demand for its equipment business. ASTI was optimistic about ASA's new products and ASTI's outlook. However, it was unsure about the outcome for DGI, which was being placed on the regulatory watch-list, and again noted that the ASTI's business was prone to business cycles.[33]

ASTI issued two further profit warnings for the second quarter and full year results in 2015.[34,35] Both warnings cited similar reasons for the expected losses, namely research and development costs, lower demand, and losses from subsidiaries. The final loss for the year amounted to S$46 million, with S$35 million of the losses coming from impairment losses on property, plant and equipment (PPE), goodwill, and receivables.[36] This was explained as being due to China's renminbi and Malaysia's ringgit depreciating, and a drop in crude oil prices. China's slowing growth rate was also cited as a factor in the impairment.[37] ASTI's outlook for the following year was prudent and cautious but it was mentioned that both ASTI and ASA had potential for growth. Meanwhile, DGI was still under the regulatory watch-list.[38]

2016 and 2017 saw a S$7 million loss and a S$14 million loss respectively.[39,40] Operating expenses remained high and the economic uncertainty in China and other parts of the world were cited as reasons for declining profits. Worryingly, DGI had still not exited the regulatory watch-list, even though it had been years since it was placed on it.[41]

ASTI returned to profitability in 2018 with a profit of nearly S$20 million for the year.[42] However, this was due to the disposal of its wholly-owned subsidiary Semiconductor Technologies & Instruments Pte Ltd (STI SG), which accounted for S$42 million of the profit. For its continuing operations, ASTI posted a loss of about S$23 million, continuing the trend from previous years of growing losses.[43] Moreover, there was a 49.3% increase in administrative expenses, growing from S$20 million to S$30 million. The increase was largely due to a bonus pay-out to a director during the year.[44]

DGI started posting losses in 2012 with the primary reason given being simply a decrease in demand from customers.[45] In 2014, a new beginning for DGI was cited as "the Group [continued] to explore investment and business opportunities and [would] make the appropriate announcements in due course."[46] Similarly in 2015, the company was overwhelmingly positive, stating that ASTI's "strategic long term outlook has never been better in more than a decade – filled with opportunities in lucrative and high growth markets." This was despite posting a loss of S$2.5 million, primarily due to "general and administrative costs" with no further explanation given.[47] DGI continued posting losses.[48]

Similar to DGI, ASA was also posting losses. In 2014, ASA disclosed that the successful inclusion of subsidiaries Emerald Precision Engineering and ASA Multiplate would provide ASA with a strong foothold and allow its customer base to expand.[49] Yet, revenue dropped the following year and ASA posted a loss of S$17 million, markedly higher than the S$1 million loss the year before. It said that the poor results were due to a slowdown in growth from China and setbacks in the company's Beijing operations,[50] a sentiment echoed in the following year.[51] Continued losses from its Beijing operations prompted ASA to dispose of it in 2018 and acquire Yumei Technologies Sdn Bhd (Yumei Technologies).[52] Despite this, ASA still ended FY2018 with a loss of S$6 million.[53]

In summary, over the five financial years from 2014 to 2018, each company racked up five successive years of losses from continuing operations, with only ASTI reporting a S$19.7 million net profit in FY2018 due to profit from discontinued operations of S$42.7 million.[54]

ASTI reported cumulative losses from continuing operations of S$98.4 million from FY2014 to FY2018, with accumulated losses on its balance sheet amounting to S$50 million in its latest audited accounts. It closed at S$0.028 on 13 December 2019. It was placed on the Minimum Trading Price (MTP) Watch-list on 5 June 2017[55] and the Financial Watch-list on 6 June 2019.[56]

ASA had cumulative net losses of S$33.5 million from FY2014 to FY2018. Its last traded price was S$0.001 – the lowest price possible on SGX. Its net asset per share was S$0.001. Since it is listed on the Catalist Board, it has been not been placed on any Watch-list.[57]

DGI, listed on the SGX Mainboard, was not quite as lucky. On 11 April 2018, SGX rejected its application for more time to exit from the Financial Watch-list, and it was to be delisted. It had been on the Financial Watch-list since 4 March 2015 and on the MTP Watch-list since 5 June 2017. Its shares had been suspended from trading, and the company or its controlling shareholder was required to make a reasonable exit offer, but none has been forthcoming. It has accumulated losses of nearly US$70 million in its latest balance sheet, with negative equity of US$6.9 million.[58]

Ties that bind

As of 31 December 2016, ASTI held a 37% equity interest in ASA,[59] effectively making it the controlling shareholder of ASA.

In June 2017, ASA undertook a partially underwritten rights issue of up to 13 billion new shares at an issue price of S$0.0009 for each new rights share. Following this, LSG therefore not only served as the EC and CEO of ASA, but also became its substantial shareholder of ASA owning a 28.09% stake. This allowed LSG to vote independently of ASTI. ASTI was thus deemed "to have lost control over ASA", with ASA no longer considered to be a subsidiary of ASTI, and instead being equity accounted as an associate of ASTI.[60]

As SGX began to question the loss-making activities of ASA,[61] it was revealed that despite ASTI being in a loss position, it still made a loan of S$2.4 million to "associates", later confirmed in the SGX query to be ASA.[62] With LSG also concurrently holding the position of EC and CEO of ASTI, the loan to ASA would have been greenlit by the ASTI's board chaired by him.

In April 2018, ASA entered into a S$10 million sale and purchase agreement for Yumei Technologies and its associate companies.[63] While ASA was facing a loss of S$6 million for the year, it still went ahead with the deal. With S$1.5 million having to be paid in cash in the first year upon completion of the deal, the already cash-strapped company was to face further financing troubles.

The deal also came under further scrutiny as Yumei Technologies was wholly owned by Seah Chong Hoe (SCH) and his wife. What was not revealed was that SCH was also the Chief Operations Officer (COO) of ASA,[64] rendering the deal an Interested Person Transaction (IPT), yet this was not disclosed. With SCH having direct interests in the target and acquiring companies, it raised a few eyebrows as to the true nature of this transaction, especially with SCH now becoming the controlling shareholder of ASA with 29.12% ownership.[65]

Based on the 2018 annual reports, LSG owned 19.89% of ASTI.[66] He also owned 19.91% of ASA.[67] As ASTI owned 25.98% of ASA, LSG also had an indirect interest of 5.17% in ASA through ASTI, making his effective total interest 25.08% in ASA. He did not hold any shares in DGI. However, given that ASTI owned 40.98% of DGI, LSG had an indirect interest of 8.16% in DGI.[68]

Selling the family jewel

In 2019, ASTI announced a profit of S$19.7 million for financial year 2018, with a gain of S$34.5 million from the sale of STI SG, a wholly-owned subsidiary, to Shanghai Pudong Science and Technology Investment Co., Ltd. (PDSTI).[69] In the 'key audit matters' section of ASTI's annual report 2018, the auditors, Ernst & Young LLP, highlighted that they had tested the management's assumptions that STI SG would make more than the "profit guarantee" of S$17 million of aggregate profit before taxes in 2018 and 2019, and found the assumptions to be reasonable.[70] Given that ASTI made a loss of more than S$21 million on its continuing operations,[71] the sale of a profitable subsidiary seemed questionable. Coincidentally, the remuneration structure of LSG was also changed to be more performance-based, the very year ASTI stopped being in the red.[72]

In April 2019, SGX queried ASTI regarding its sale of STI SG. With a consideration of S$90 million paid by PDSTI, SGX questioned why over S$17 million was paid to the financial advisor, VSA Capital Shanghai Limited.[73] The company said that such a "success fee" was justified.[74] However, questions still lingered regarding more than 19% of the consideration being payable as fees.[75]

With a profit before tax of S$2,280,000 in 2017, it was uncertain whether STI SG would be able to make at least S$17 million in 2018 and 2019 as specified in the sale and purchase agreement.[76] Furthermore, STI SG was forecasted to reach a Net Asset Value (NAV) of S$69 million by 30 June 2018, despite having a NAV of S$62,724,000 at 31 December 2017.[77] ASTI had recognised a contingent consideration of S$9 million based on its view that the said targets were reasonable.[78]

In its response to the SGX query, ASTI defended its view that the profit and NAV targets were attainable, and even in "extreme unforeseen circumstances" where the NAV target cannot be met, any shortfall "should not be excessive."[79] It was later disclosed in the response that any shortfall in the profit that exceeds the contingent consideration amount would have to be paid by ASTI to PDSTI, amounting to a maximum amount of S$8 million.[80] In total, the maximum possible deduction from the total consideration is S$17 million, should STI SG not be profitable for both 2018 and 2019.[81]

It was also disclosed that LSG would enter into a consultancy agreement with STI SG, and all consultancy fees would be paid to LSG.[82] With this additional commitment on top of his existing duties, it raised questions as to whether he could discharge his duties to the required standards.

The query also sought clarification on the transfer of intellectual property (IP) from STI SG to ASTI. ASTI responded that PDSTI would be performing its due diligence in deciding whether STI SG would need those IP in its operations.[83] Should the IP not be required, the IP would remain under the ownership of ASTI.[84] However, should they be needed by STI SG, the IP would be under the ownership of STI SG. In that case, PDSTI had agreed to grant a "royalty-free, perpetual and world-wide license" of the said IP to ASTI and its affiliates.[85] This is questionable as PDSTI had paid a premium of S$27,276,000 over the NAV of STI SG,[86] which included IP that would be used in STI SG's operations.

All the king's men

In recent years, ASTI, DGI and ASA have had boards with at least half independent directors (IDs). This is compliant with 2012 Singapore Code of Corporate Governance applicable to these companies during the period.[87] Of the 12 directors who have served on the three boards over the recent five years, there were three Dato's and four PhD holders.[88]

A closer look, however, raises questions as to whether the directors are truly independent.

Inter-changeable directors

Prior to 2016, the board of directors for ASTI had remained relatively stable. However, on 18 July 2016, Peter Lai Hock Meng (LHM), an ID, resigned, citing "increasing work commitments outside of the company which will limit the time and effort that he will have to fulfil his role as an Independent Director of the company".[89] He was replaced on 20 October 2016 by Dr. Kenneth Yu Keung Yum (YKY), who was deemed suitable due to his "wealth of experience in technology, product design and management in the semiconductor industry".[90] However, according to an announcement by ASTI on 19 July 2016,[91] the resignation of LHM was on short notice, which resulted in a lack of proper succession planning and a hastened search for another individual to replace him. YKY was already on the boards of both DGI and ASA.[92]

On 1 May 2018, Fong Wai Leong (FWL), who had served 14 years as an ID of ASTI, resigned.[93] YKY also resigned on the same day.[94] YKY cited wanting to "focus on his other projects that will be taking up a substantial amount of his time"[95] as the reason, while FWL said it was "to pursue his other interests".[96] FWL's role of Audit Committee (AC) Chairman was taken over by Dr. Daniel Yeoh Ghee Cheong (YGC), citing "his vast experience in the finance and investment banking industry".[97] YKY's position was taken over by Mohd. Sopiyan B. Mohd. Rashdi (MSB).[98] However, MSB had numerous other principal commitments. Furthermore, like YKY in 2016, prior to his appointment, MSB was also on the boards of both ASA and DGI.[99]

At DGI, Dato' Shaarani Bin Ibrahim (SBI) resigned as an ID on 17 April 2017, citing wanting "more time to focus on family matters as well as his increasing work commitments outside the company".[100] However, similar to the resignation of LHM from ASTI's board, his resignation was on short notice. This caused the number of members on DGI's AC to drop below the minimum of three. As a result, DGI was subjected to the requirement in the SGX listing rulebook which states that "In the event of any retirement or resignation which renders the audit committee unable to meet the minimum number (not less than three) the issuer should endeavour to fill the vacancy within two months, but in any case not later than three months."[101] His role was eventually taken over by YGC on 9 May 2017, citing his "vast experience in entrepreneurial and investment banking."[102]

LHM, who had resigned as an ID of ASTI in July 2016, was appointed as an ID of DGI on 15 May 2017, which cited his "wealth of experience in the financial industry and corporate governance good practices."[103] However, LHM resigned after slightly more than one and a half years later, citing "health reasons".[104]

A few weeks earlier, on 12 December 2018, LHM had resigned as Independent Chairman from another troubled company, Transcorp Holdings, after just four months – "due to medical reasons".[105] However, he did not resign then as lead ID at Delong Holdings Limited. He did so only on 26 September 2019 following its privatisation.[106] Furthermore, on 6 November 2019, he became an ID at another troubled company, Tee International Limited.[107]

On 8 April 2019, LSG, who was serving as the EC and CEO of ASTI, DGI and ASA, announced his resignation from both positions in all three companies. He cited wanting to "reduce his work load and travel commitments due to age and family commitments".[108,109,110] However, LSG would remain as EC and CEO of all three companies until 7 April 2020 to ensure a smooth transition.

Serving different masters

A commentary in The Business Times by Professor Mak Yuen Teen highlighted the conflicts of interest that the directors of the three companies may face.[111] It pointed out:

> "While the Code of Corporate Governance does not specifically deem a non-executive director (NED) serving on multiple related companies within the same group as non-independent, there are real threats to the exercise of independent judgement when these common directors are making decisions that affect the different companies. There are also questions about conflict in duties to different companies."[112]

It cited that in the case of DGI, the external auditors had in their FY2018 auditors' report flagged a material uncertainty relating to going concern. The auditors did not modify their opinion but said that DGI's ability to continue as a going concern is dependent on the continued financial support of ASTI. The auditors noted that ASTI had also undertaken to not recall the amounts due in the next 12 months.[113]

The author pointed out that it may not be in ASTI's interest to continue to provide the support and undertaking. Several of the directors were on both ASTI's and DGI's boards. On DGI's board, all the directors were either currently or until recently on ASTI's board. Before 1 May 2018, three out of five ASTI directors were on DGI's board. He questioned how these ASTI-DGI directors address the different interests in making the decision as to whether ASTI should provide the continued support and undertaking for DGI.[114]

As another example, he added that SGX has asked DGI or its controlling shareholder to make a reasonable exit offer for the delisting. While the DGI directors are expected to get a reasonable offer for DGI shareholders, four of the five DGI directors also owe duties to ASTI and also need to do what is best for ASTI.[115]

Paying a king's ransom

Professor Mak also raised questions about the remuneration of LSG and its disclosures. As EC and CEO of the three companies, LSG received remuneration from all of them. His remuneration also included fees for serving as a director in each of these companies.[116]

Based on the companies' remuneration reports, LSG was initially paid an estimated total of about S$23 million from FY2014 to FY2018 for the three companies (although part of it was subsequently returned). Between FY2014 and FY2018, he received total remuneration of S$875,000 per year for ASA – or S$4.375 million in total. ASA had total assets of less than S$25 million and accumulated losses of S$139 million.[117]

Over the same period, LSG received between S$550,000 and S$1.195 million per year from DGI – a total of S$4.071 million. DGI had total assets of less than US$7.6 million and has since been directed to delist.[118]

For FY2018, ASTI's remuneration report disclosed that LSG was paid S$9.911 million, although this amount included the S$746,000 he received from DGI, which was a subsidiary, but not the S$875,000 he received from ASA, which had been deconsolidated.[119]

At ASTI, he was paid about S$14.6 million over the five year period, with the company having S$50 million accumulated losses, being placed on the Watch-lists, and continuing to face challenging times.

LSG also has a 31-year-old son whose remuneration was disclosed for the first time in ASTI's FY2018 annual report. The disclosure stated that his remuneration exceeded S$50,000 rather than in a band – which is not in accordance with the Singapore Code of Corporate Governance.[120]

His son's appointment (or promotion) was not announced as required under the SGX rulebook, which requires "any appointment of a person who is a relative of a director or Chief Executive Officer or substantial shareholder of the issuer to a managerial position in the issuer or any of its principal subsidiaries" to be announced. The SGX rulebook also requires the full-year results announcement to disclose such appointments. ASTI only disclosed that two of LSG's nephews occupy managerial positions but there was no mention of his son. It was only in a 12 April 2019 response to queries raised by SGX that his son's promotion to "manager, admin/HR/IT" was disclosed.[121]

The curious 'bonus'

Included in the total remuneration paid to LSG was a S$8 million "bonus and management incentive" paid by ASTI for FY2018. This made up 81% of his total remuneration of S$9.911 million that year.[122]

ASTI did not explain the large bonus but it appears to be due to the net profit of S$19.7 million for that year, compared to a net loss of S$14.6 million incurred in the previous year. Profit from discontinued operations of S$42.7 million relating to the disposal of the STI SG was responsible for the reversal in its bottom line.[123]

The S$42.7 million included a S$34.5 million net gain on disposal from a sales consideration of S$90 million, part of which was a S$9 million contingent consideration based on a profit guarantee. ASTI may also need to pay back up to S$17 million if the actual profits of STI SG are less than the profit guarantee. This disposal was queried by SGX in April 2018, including queries about the S$17.2 million success fee paid to VSA Capital Shanghai Limited. Following the sale, LSG was to be a consultant for STI SG.[124]

Remuneration for the top five key management personnel jumped from S$1.98 million to S$4.65 million for FY2018, while other key officers' remuneration increased from S$1.66 million the previous year to S$3.07 million.[125]

ASTI paid out S$16.37 million in dividends in FY2018 – the first time since 2012. The last dividend declared by DGI and ASA was in August 2007 and September 2001 respectively.[126]

According to ASTI's annual report, on 31 March 2019, ASTI's Remuneration Committee (RC) deliberated on the S$8 million bonus that was approved and paid out to LSG following his decision to resign, and later revised the figure to S$2.182 million. This was curious for at least two reasons. Firstly, the bonus was for FY2018 so it is unclear why LSG's decision to resign in 2019, with an effective cessation date as late as 7 April 2020, would affect his bonus for FY2018. Secondly, the company disclosed his decision to resign only on 7 April 2019, when the RC already knew about it by 31 March 2019.[127]

On 2 April 2019, ASTI announced the revised S$2.182 million "one-off bonus" as an interested person transaction (IPT), given that the amount was about 3.5% of the latest audited net tangible assets, above the three percent announcement threshold for IPTs. Chapter 9 of the SGX rulebook on IPTs provides an exception for "directors' fees and remuneration, and employment remuneration" although "golden parachute" payments are not covered by the exception.[128]

As the "one-off bonus" was to recognise LSG's "contributions to the group since he assumed the role of the company's CEO and Executive Chairman in 2003" and in particular the Group's improved performance for FY2018, and may not be contractual entitlements under his service agreement, it arguably would not have been covered under the Chapter 9 exception.[129]

An article in The Business Times by Professor Mak asked: If LSG was not entitled to it, why did the RC and board approve and pay out the S$8 million? How was the S$8 million figure arrived at in the first place? What is the basis for determining the S$2.182 million? Can the board seriously consider LSG to have made significant contributions, given the huge losses and the entry into the Watch-lists? Have whatever contributions he has made not already been amply rewarded already through his remuneration over the past years?[130]

On 18 March 2020, ASTI announced that the profit guarantee for the sale of STI SG was not met. As a result, S$2,118,334 of the S$9 million contingent consideration, which was held in an escrow account, would be paid to the purchaser.[131]

The elusive AGMs

On 15 April 2019, ASTI applied to delay the holding of its Annual General Meeting (AGM) for the financial year ending 31 December 2019 by a month.[132] The AGM was originally due by 30 April 2019. The reasons given had to do with ASA and DGI. ASTI said that ASA had just recently announced its unaudited results, and needed more time to prepare its financial statements in compliance with new financial reporting standards (FRS) and to seek clearance from ASA's auditors. ASA had also recently acquired two companies and would need more time to consolidate their financial statements in accordance with new FRS.

DGI faced difficulties in completing its audit as it had difficulty getting clearance from the auditors for one of its subsidiaries, which auditors were in turn experiencing difficulties obtaining the relevant working papers from the auditors of the Chinese subsidiary of its subsidiary.[133]

ASTI's application was approved. It also received an extension of time from the Accounting and Corporate Regulatory Authority (ACRA) to hold its AGM by 29 June 2019 and to lodge its annual return by 30 July 2019.[134] It subsequently applied for a further extension of time to hold its AGM by 31 July 2019. However, this was rejected by SGX. ASTI said it was preparing to hold its AGM by 15 August 2019, even though it was not granted any further extension by SGX.[135] Eventually, the company's AGM was held on 15 August 2019.[136]

Similar extensions of time were sought for the AGMs of ASA and DGI, with SGX approving a first extension to 31 May 2019, and then rejecting the applications for further extensions. ASA eventually held its AGM on 30 July 2019, while DGI held its AGM on 15 August 2019.[137,138]

The king keeps his throne

On 8 April 2020, DGI announced the appointment of Timothy Lim Boon Liat (LBL), the Group administrative officer for all three companies, as its president and Acting CEO.[139] That same day, YGC, an ID, was appointed Acting Chairman.[140]

Stephen Shen Hing (SH), a former DGI ID, joined ASA as an ID on 5 August 2019.[141] As of 12 May 2020, there has been no further announcement about whether LSG had left by the scheduled date of 7 April 2020 and no announcement has been released about his successor as Chairman and CEO.

However, over at ASTI, there was an unexpected twist. On 29 March 2020, the company announced that LSG was staying on after all. The company said that since the announcement of his resignation nearly a year prior, it had embarked on a search "but has not been able to find a suitable replacement with the right credentials and varied skill sets to meet the challenges of the company's diverse technology businesses and organisational complexity".[142]

It cited the deterioration in the world economy, the U.S.-China trade dispute and the COVID-19 pandemic and said that, given the challenging times, it had requested LSG to stay on. LSG has agreed and his notice of resignation was withdrawn by mutual agreement.[143]

It is unclear whether minority shareholders to let out a collective sigh, and whether it was due to relief or resignation.

Discussion questions

1. What are the corporate governance risks associated with multiple listed companies under common control? How can such risks be mitigated?
2. Amongst the boards of ASTI, ASA and DGI, there were directors who served on more than one board concurrently or who left one of the boards and joined another soon after leaving. What issues might arise from such a situation? What are examples of situations where directors may face difficulties in discharging their duties to the different companies?
3. Comment on the turnover of directors in the three companies. Do you think the directors who left had good reasons to do so and adequately discharged their duties?

4. Dato' Michael Loh was the Executive Chairman and Chief Executive Officer of all three companies, ASTI, DGI and ASA. Furthermore, he is a substantial shareholder for both ASTI and ASA. Discuss the implications of having one individual holding the positions of Executive Chairman, Chief Executive Officer and substantial shareholder in closely related companies. Should an individual be allowed to be Executive Chairman or CEO of multiple listed companies? Explain.
5. Evaluate the remuneration policies of the three companies, and whether Dato' Michael Loh's remuneration was reasonable. How do you think an executive director, who is also a major shareholder, should be remunerated? How might that be different from how professional managers who hold few shares in the company are remunerated?
6. Do you think the regulators were effective in holding the companies and their directors accountable? Give examples of possible breaches in rules that could have triggered regulatory action.

Endnotes

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BEST WORLD: BEAUTY IS ONLY SKIN DEEP

Case overview

On 18 February 2019, Best World International Limited (Best World), a three-time entrant on the Forbes Asia "Best 200 Under a Billion" list and one of the best-performing stocks on the Singapore Exchange (SGX), was alleged in a Business Times report to be using illegal pyramid schemes in China and publishing misleading financial and operational statements. The following month, the company responded by appointing an independent reviewer to review its business and accounting practices. However, it soon faced even more damaging allegations from two short sellers. SGX Regco issued a notice of compliance in May 2019 requiring the company to expand the scope of the review and for the reviewer to report only to SGX Regco. More than a year since the saga started and following the release of the independent reviewer report in July 2020, the company's shares remained suspended from trading. The objective of this case is to facilitate a discussion of issues such as those relating to questionable business models; business, accounting and corporate governance risks associated with companies with significant business in China; board composition; duties of directors; interested person transactions; role of short sellers; and regulatory enforcement.

How the (Best) World began

Best World International Limited (Best World) was founded in 1990 and is a Singaporean company that specialises in the development and distribution of premium skin care, personal care, nutritional and wellness products. The company was first floated on the SGX in July 2004 and expanded into 12 markets in Asia and the Middle East.[1] Best World's key management personnel comprises seasoned industry professionals.[2] The company has also won a slew of awards, including making the prestigious Forbes Asia "200 Best Under a Billion" list in 2007, 2008 and 2018.[3] It had enjoyed a bull run, with its stock reaching a high of S$3.30 per share in February 2019.[4]

Entering the Middle Kingdom

Boasting a consumer base of approximately 1.4 billion people and an economy worth more than US$13 trillion,[5] China is an exciting prospect for companies looking to expand. It is thus no surprise that China is Singapore's largest trading partner, with many Singaporean companies entering the Chinese market to capitalise on opportunities in the Middle Kingdom.[6] Best World was soon lured into the lair of the dragon.

This case was prepared by Enelton Satria, Leow Chung Yong Aaron, Quek Yong Qiang Jamos, Ryan Kwan Kay Tzen and Winni Yeo Jia Qi, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been substantially re-written, with information added, by Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees.

Best World first established its Chinese presence through a direct selling model, whereby its products would be imported by its primary import agent (PIA) and major customer Changsha Best Domestic Goods Trade Co., Ltd. (Changsha Best). However in 2018, it changed its strategy in China, switching from an export model to franchise model.[7] Changsha Best was dissolved, and in its place, Best World set up a Chinese subsidiary called Best World (China) Pharmaceutical Co., Ltd (全美世界(中国)药业有限公司) (BWL China).[8] This purported change in business structure is at the root of the questions it faced.

Best World has 16 subsidiaries in Asia and the Middle East. Most of the subsidiaries, including the two Chinese entities, are wholly owned by the company.[9] BWL China is the main vehicle for managing its 33 Chinese franchises.[10]

Its foray into China was a resounding success. Boosted by its strong performance there which accounted for more than half of its profits, Best World logged a net profit of S$55.7 million in 2017[11]– a 39-fold increase from its 2013 figures.[12] RHB Research initiated coverage with a "buy" call, hailing its ability to be "one of the few local consumer firms that [had] successfully penetrated the Chinese market" and lauding the expansion strategy of its management.[13]

The Business Times also ran several positive articles and wrote that "the group [was] largely immune to labour and rental cost pressures…allowing Best World to scale its business or expand to new markets without incurring huge capex (capital expenditure) or major startup or fixed costs".[14] It appeared that Best World was on the cusp of a major expansion cycle.

Bested by skeptics

But alas, its growth story was undone by a series of exposés on its Chinese operations. The onslaught began on 18 February 2019, with The Business Times launching the first salvo.[15] This was followed by a barrage of attacks by two short sellers – Bonitas Research (Bonitas) and Valiant Varriors.

Bonitas and Valliant Varriors raised the following salient issues:

1. Lack of transparency and alleged misrepresentations in Best World's Chinese business model and the alleged pyramid scheme that it operates;
2. Material transactions with undisclosed related parties;
3. Exponential increase in remuneration of founders; and
4. Lack of policing by independent directors of Best World's Chinese operations.

They detailed alleged pyramid schemes that Best World was using in China, as well as purported misrepresentations of its actual profits and undisclosed related party transactions.[16,17] Unsurprisingly, the shares went into a tailspin, with several trading halts called. By May 2019, more than S$1 billion had been wiped off from the company's market value in three months.[18]

Best World mounted an aggressive defence. It appointed Pricewaterhouse Coopers LLP (PwC) in Singapore to undertake a limited independent review of its Chinese operations, and hired Dacheng Law Offices (Dentons) to ensure the legality of its Chinese business structure.[19,20]

Best World also issued a point-by-point rebuttal of Bonitas' allegations, refuting the claims and questioning the motivation of Bonitas.[21] It also filed a defamation lawsuit against Bonitas.[22]

Best board?

Best World's board of directors comprises three executive directors (EDs) and three non-executive, independent directors (IDs).[23]

Two of the EDs are its founders – Dora Hoan and Doreen Tan – who co-chair the company's board. Dora Hoan is the Group CEO and oversees Best World's management and business development. The company credits her "expertise in direct selling and visionary strategic thinking" as the impetus that helped Best World scale up from a SME to an established Asian enterprise.[24] Hoan holds a Bachelor's Degree in history from Nanyang University, a Master of Business Administration from National University of Singapore, a PhD in Business Administration from Western Pacific University (USA), and an Honorary PhD from Kennedy Western University (USA).[25]

Doreen Tan supervises the technical aspects of the business. The company lauded her "rich professional knowledge of beauty and nutrition, combined with her deep understanding of consumers' needs" as the salient traits which have led her to serve as Best World's key product specialist.[26] Doreen Tan holds a degree in Applied Nutrition from the American Academy of Nutrition, a doctorate degree in Naturopathy from Canyon College (USA), and an Honorary PhD from Kennedy Western University (USA).[27]

A simple online search found no U.S. university by the name of 'Western Pacific University'. However, there was an institution named Pacific Western University which was alleged to be a "diploma mill" where students can buy degrees.[28] Pacific Western University had two campuses, one of which was shuttered in 2006 as part of a six-year legal action by the State of Hawaii against about 70 unaccredited schools.[29] Canyon College, where Tan got her doctorate from, was an online school which shut down after legal action by Idaho State.[30] Its website stated that it is not enrolling students into classes at the moment.[31] Kennedy Western University, where both Hoan and Tan obtained their honorary PhDs, was also known as Warren National University. It closed its doors in 2009.[32] It too was an unaccredited university.[33]

The founders are assisted by Chief Operating Officer and ED, Huang Ban Chin, who "oversees the Group's day to day operations and manages the Group's key functions of finance, product development, information technology, investor relations etc. and is responsible for the execution of the Group's regional business expansion plans". Huang holds a Bachelor of Science degree majoring in biochemistry and microbiology from the National University of Singapore.[34]

Best World's current IDs comprises an accountant, a lawyer and a consultant. Lee Sen Choon is the Lead Independent Director and Chairman of the Audit Committee. He is a partner of UHY Lee Seng Chan & Co., a public accounting firm in Singapore and boasts many years of experience in accounting, auditing, taxation and corporate secretarial work.[35] Lee has been on Best World's board since May 2004.[36]

Adrian Chan Pengee, appointed in January 2018, is the Chairman of the Remuneration Committee. He is a senior partner at Lee & Lee – a premier law firm in Singapore that was co-founded by the late Prime Minister Lee Kuan Yew.[37,38] Chan is also Second Vice-Chairman of the Singapore Institute of Directors.[39]

Rounding up the IDs is Chester Fong Po Wai, the Chairman of the Nominating Committee, who joined the board in February 2019.[40] Fong is a senior advisor at McKinsey & Company with more than 30 years of experience as the Chairman and CEO of Colgate-Palmolive's Greater China businesses.[41]

There have been recent changes to the board. On 22 February 2016, Lee Teck Leng Robson, a lawyer, resigned as ID. It was stated that the resignation was a "mutual decision agreed with Management" and that "there [was] no discord with Management". He had been on the board since May 2004.[42] Ravindran Ramasamy, another lawyer, who also joined in May 2004, resigned as ID on 31 December 2017, with the company citing "board renewal of directors pursuant to corporate governance principles".[43]

Chan Soo Sen, a former Minister of State, joined as an ID in March 2016,[44] but resigned in February 2019 – just three days before the first shot was fired by The Business Times – citing that he wished to "focus on work commitments and responsibilities outside of the Company".[45]

Worst enemies?

While the opening salvo against Best World was launched by Business Times, it was the attack by Bonitas and Valiant Varriors that caused the company to spin off its orbit.

Bonitas is the brainchild of Matthew Wiechert and was incorporated in 2018[46] after the dissolution of Glaucus Research (a well-known research firm founded by Wiechart and his associates).[47] 'Bonitas' is Latin for "honest" and was chosen to be the epithet of the self-declared activist short seller. Its aim is to "identify and expose fraudulent activity that exists in the public capital markets, which [they] believe ultimately makes the world a better place".[48,49] Bonitas makes use of publicly available information, along with hundreds of hours of manual analytical and detective work, to uncover suspected fraudulent activities in companies worldwide. Bonitas claims that this includes rigorous quantitative screening and qualitative forensic analysis to give the best possible understanding of the operations and financial performance of the underlying business, as compared to what is reported by management in a company's public disclosures.[50]

Valiant Varriors are a group of activist investors on the lookout for publicly-listed companies globally which are "priced incorrectly due to the lack of transparency".[51] Not much is known about them as their only online footprint is a website leased from website builder wix.com.

What is underneath all that make-up?

Pyramid schemes and misleading statements

The most material issue highlighted by both The Business Times and Bonitas Research relates to Best World's alleged illegal pyramid schemes in China and its misleading financial and operational statements used to cover up them up.[52,53]

On 18 February 2019, The Business Times published an article that sent shockwaves through the investor community.[54] The article came as Best World's shares were trading at its peak, soaring over 171% on a year on year basis.[55] It was stated that the lion's share of the company's total revenue – 66% of it – came from sales of Best World's DR's Secret line of premium skincare products in China. Analysts were unable to reconcile the stock's value with the transactions the company had recorded and questioned the nature by which Best World was conducting its business in China.[56]

Legality of direct selling business in China

The article by Marissa Lee of The Business Times highlighted two concerns. The first related to the legality of Best World's direct selling business in China. Direct selling can involve two main business models: (1) single-level marketing (SLS), where the direct seller buys products from a parent firm and sells them directly to consumers; or (2) multi-level marketing (MLM), where the direct seller receives profits from direct sales to customers and also earns commissions from new direct sellers reporting to him.[57]

MLM schemes are not legal in Singapore. All persons who participate in MLM would commit an offence, even if they did so unknowingly, and incur a fine of up to S$200,000 or face imprisonment for a term not exceeding 5 years, or both.[58]

Direct selling is a highly regulated activity in China, as part of a broader crackdown on illegal pyramid schemes launched by the Chinese central government.[59] While Best World possesses a direct selling license in China, it is a limited one that only authorised it to conduct direct selling in Hangzhou city for six specific health supplements under the Aurigen brand.[60] Further checks by The Business Times revealed that the Aurigen brand was actually distributed via drugstores and not through direct selling, with the proceeds from Aurigen sales making up only approximately one percent of Best World's revenue.[61] Accordingly, it appeared that the bulk of Best World's Chinese revenue was from unlicensed direct sellers.

Difficulty reconciling sales figures with underlying consumer demand

The second concern was the difficulty in reconciling sales figures with other publicly available data, ostensibly due to Best World's questionable business model. The Business Times article highlighted the challenge in figuring out "just how and where those sales [were] taking place", further citing that other analysts had faced the same issue leading to at least one research house giving up on tracking the stock.[62]

In spite of Best World's claims that it had transitioned to a franchise model in 2018, with 28 franchises spread across 10 provinces, a quick check by The Business Times revealed that not a single franchise was listed on the company's website.[63] Further, inquiries by The Business Times to Best World's subsidiary office in Hangzhou via telephone were met with baffled responses by the company's own employees stating that they were "not sure how to locate the franchisees, and reckoned that they were based in Hunan province."[64] A follow-up phone call to the Best World franchisee in Hunan, purportedly Best World's best performing location and the host of Best World's annual international convention in June 2018, went unanswered – its phone powered off.[65]

Best World had also claimed that it was the "13th largest company in China's premium skincare market, with a market share of 1.6% in 2017 based on retail value of 940 million yuan".[66] Independent verification with Euromonitor by The Business Times was met with "surprise", with the Euromonitor spokesperson stating that "according to our research methodology in 2017, [Best World] was not significant enough to be tracked, so we are lacking a solid source to recognise its market share in the context of premium skincare in China".[67]

Within hours of the publication of the article, Best World's shares fell by 16.6% in the morning, leading the company to request for a halt in the trading of its shares with immediate effect.[68] The trading halt was further extended by two days, until 24 February 2019, as Best World tried to contain the fallout.[69] Best World acted swiftly and decided to "voluntarily" appoint PwC to review its business and accounting practices in order to "provide additional comfort and assurance to shareholders".[70,71] This did little to assuage investor concerns as Best World's stock slid a further 4.06% to S$2.60 per share.[72]

A few days later, Best World was issued a lifeline after its announcement of strong earnings and dividends on 27 February 2019 and saw an increase in its stock price.[73,74] In April 2019, the stock jumped 10% following a series of share buybacks and director acquisitions.[75] However, this reprieve was short-lived.

Heavy-duty make-up remover

On 24 April 2019, Best World was hit by another report which was even more damning. Bonitas Research published a 22-page report, expanding on the allegations in The Business Times article and providing more evidence about Best World's alleged flagrant misrepresentations. Two issues were highlighted – the legality of Best World's operations in China and the misrepresentations it had made in its annual reports and press releases.[76]

In September 2018, Best World was said to have completed its shift from an export model to a franchise model. In the old export model, Best World sold all its products to primary import agents (PIAs) in China, with its biggest PIA being Changsha Best.[77] These PIAs were then responsible for selling the products further downstream. In the new model, shown in Figure 1, BWL China would function as its subsidiary in China and as the point of contact for the other franchisees who would then sell Best World's products.[78]

However, Bonitas claimed the change from direct selling model to franchise model was only a facade. Inquiries made by Bonitas on 22 February 2019, just days after The Business Times article was published, supported this theory.[79]

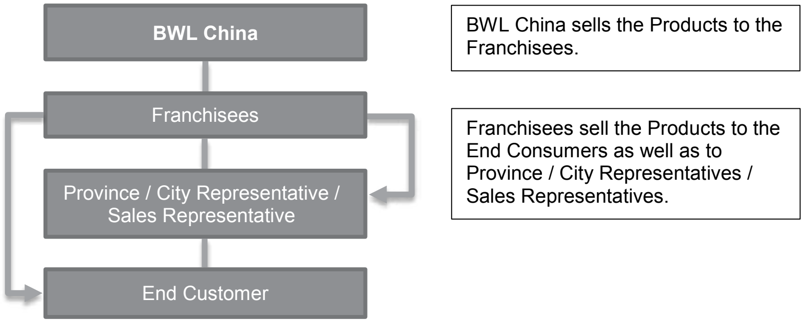

Figure 1: The new franchise model[80]

A call answered by the secretary of its Chinese subsidiary, BWL China, revealed that this "newly formed" entity was merely a new name for Changsha Best – the PIA of Best World in China and one of its "major customers" up until 2018. Further, the secretary assured the callers that the change in name would not have any effect on Best World's services or product quality in China, as the restructuring was purely for cosmetic purposes.[81]

Crucially, when Bonitas visited Changsha Best's previous registered address: 长沙市开福区金泰路 199 号湘江世纪城富湾国际 6 栋 1001 室 on 28 February 2019, it found one of the units (Room 1002) empty and sealed with an official PRC State of Administration Court Order Banner draped over its handles, dated February 2019.[82] This led to the inference that Best World's management was forced to restructure its business in 2018 to circumvent the crackdown on direct selling in China.

Bonitas also concluded that while BWL China was operating under the Changsha Best appellation, the employees of Changsha Best "[thought] of themselves as BWL China employees" and "did not experience any structural operational changes in 2018", even after the change in model.[83]

Evidence on falsification of sales figures

The second substantiation of The Business Times article was with regards to the difficulty in reconciling sales figures to publicly available data on underlying consumer demand in China. Three key pieces of evidence were used to back up this claim.

(i) Sales to the top are sales to them all

Bonitas alleged that Best World's sales were only to its senior hierarchy within its pyramid scheme and not to actual consumers. In its survey of Best World's Chinese franchise operations, Bonitas received from a Fujian-based representative a diagram detailing the structure of Best World's direct selling operations. This structure was circulated by Best World's management in order to ensure that its representatives were in "compliance" with all rules and regulations.[84]

The diagram confirmed that Best World was in fact operating a MLM scheme in China in order to sell its top-grossing DR's Secret beauty product. These sales were occurring outside the ambit of its license for selling health supplements and in direct contravention to Chinese laws and regulations.[85]

Essentially, there were two tiers to Best World's pyramid scheme – a "customer" who was forced to buy products in bulk for her own use, or a "member representative" who would buy a larger quantity of products but sold them on to other representatives below them or "customers".[86]

At the bottom of the chain was the "VIP customer". Qualification as a VIP customer would involve purchasing a product set worth 2,000 internal credits, equivalent to approximately RMB4,000.[87]

Progression to become a member representative involved buying products worth 10,000 internal credits, equivalent to more than RMB20,000. Member representatives could then accumulate credits to receive cash rebates worth 15% to 25% of their procurement amounts. Member representatives were encouraged to further expand the pyramid by recruiting other subordinate representatives or customers to purchase products from them. Where a member representative has her own agents, she receives "a commission on the sales of seven generations of subordinate member reps" as well as an additional system bonus of certain percentages.[88]

Accordingly, Best World was able to secure huge amounts of orders upfront from the member representatives who were at the top of the pyramid, without having to be concerned about the actual disbursement of its products to actual consumers. The understanding of this pyramid scheme is critical to Bonitas' next two pieces of evidence.

(ii) Lifeless lifestyle centres

Bonitas also revealed that minimal actual sales occurred at the BWL Lifestyle Centres. Best World representatives disclosed to Bonitas' investigators posing as prospective clients that the company did not own or operate any offline or online stores in China, leaving their member representatives to take care of the distribution networks instead.

Further evidence gathered by Bonitas in March 2019 showed that eight out of 12 BWL Lifestyle Centres visited did not allow for the purchasing of individually sold products by non-members. Only two out of the 12 visited stores had marketing materials available within the store itself. Many of the centres were not accessible by the average consumer as these units were mostly located within high-rise office buildings.[89]

Employees at the Lifestyle Centres were also said to be acting as though they were not accustomed to interacting with walk-in customers, with one employee even remarking that the Bonitas investigators "were their very first walk-in customers", in spite of the fact that the particular centre had been opened since October 2017.[90]

These findings pointed to the conclusion that Best World's sales did not occur through a franchise model since the stores which were visited by Bonita's researchers were not operating as retail stores, given the clear lack of human traffic. Instead, Bonitas hypothesised that these stores were fronts for the member representatives to hold meetings and trainings for the junior tiers in the hierarchy – a practice typical of MLM modus operandi.[91]

(iii) Curious case of missing online customers

Bonitas also detailed the extent of alleged fake customer activities on Best World's online sales channels. On 18 February 2019, the same day that The Business Times published its article, Bonitas performed a check on the volume of Best World's online transactions. They searched for "晢之密" (the Chinese name of DR's Secret) on JD.com, which listed online vendors by product sales rank. DR's Secret was nowhere to be seen. Switching to a search of customer review counts as a proxy for online transactions, the Bonitas team found that the top four products under DR's Secret had a total of less than 20 reviews between them – highly suspicious for a company that claimed to have a large online retail following.[92]

A second verification was carried out by Bonitas on 10 April 2019. This time, each of the top four DR's Secret bestselling products had changed. Additionally, the review counts from the newly listed products saw a sudden spike from a new vendor. A large majority of the new reviews were attributable to a new vendor named DR's Secret Youshangda (Youshangda). However, the first positive review was posted on 19 February 2019, one day after The Business Times article was published. This same pattern was observed for the other top four products.[93]

Bonitas asserted that Best World instructed its member representatives to post fake reviews and transactions on the online stores maintained by the franchises in order to artificially inflate DR's Secret online footprint and popularity.[94]

Material transactions with undisclosed related parties

Bonitas also highlighted undisclosed related party transactions that accounted for the bulk of Best World's original sales to China. While reviewing Best World's financial statements for 2017, Bonitas uncovered a shocking revelation. Best World's main customer in China for the previous five years, Changsha Best, was not an independent party but an "entity Best World management secretly controlled and exclusively created to be Best World's off-books China counterparty".[95]

In response, Best World released a report on 9 May 2019 refuting the allegations.

> "The Report presents no evidence to establish any link between the Primary Import Agent and the Company, the Directors, the substantial shareholder of the Company or their associates.
>
> The Company confirms that the Primary Import Agent, a company incorporated in China, is independent and not related to the Group. None of the Group, the Directors, the substantial shareholders of the Company or their associates have had any direct or indirect shareholding interests, directorship or management role in the Primary Import Agent."[96]

This rebuttal was short-lived. Within the same day, a separate short seller, Valliant Varriors published a report that contradicted Best World's claims.[97] Through inquiries made with the Chinese administration for industry and commerce, Valliant Varriors discovered that Changsha Best was a wholly foreign-owned company as natural person, whose legal person and shareholder was Koh Kim Chuan.[98]

So close yet so far

In a series of photos obtained from various social media sites, Valliant Varriors pieced together the picture that Koh Kim Chuan was actually the brother-in-law of Hoan – the co-founder and majority shareholder of Best World.[99]

These revelations prompted SGX to issue a set of queries to the company on 9 May 2019.[100] Best World was now forced to provide more information. On 12 May 2019, Best World responded to the SGX queries which confirmed the allegations by Valliant Varriors.[101]

In Best World's statement, it clarified that Changsha Best, its PIA in China, was independently owned by Koh Kim Chuan, who is married to Mary Huan, the sister of Hoan. It clarified that Changsha Best was incorporated by Yan Weijun on 10 July 2014 using US$100,000 from Koh. Yan was introduced to Koh by Jansen Tang, nephew to Hoan, and then Deputy Country Manager of China and Hong Kong of Best World. Tang was said to be responsible for the overall supervision of the Group's operational and business processes in China and Hong Kong.[102]

"Chinese Wall" between the related parties

Even after admitting that the owners of Changsha Best were related parties, Best World still argued for the independence of Changsha Best. Best World claimed that Koh and Huan were not involved in the operation of the PIA or the Group and instead were only passive investors. This is despite the fact that Koh was the sole investor in Changsha Best.[103]

Best World further argued that the appointment of Yan was carried out on an arm's length basis, premised on his expertise and experience in the skin care products distribution market. Best World also claimed that the appointment of Changsha Best as the PIA was made by the Group's Chief Operating Officer Huang and not by CEO Hoan. In response to queries on why Yan was still hired by the new BWL China entity after Best World's shift to the franchise model, Best World said that Yan and his team were hired for a "seamless transition from the export model to the franchise model" after the distribution agreement was terminated on 30 September 2018.[104]

However, questions remain even after the clarifications provided by Best World. Best World's assertion of Changsha Best's independence is highly contentious. Firstly, Changsha Best's sole shareholder is Koh, the brother-in-law of CEO and co-founder Hoan. Secondly, Changsha Best's general manager Yan was only hired because of a strong recommendation by Hoan's nephew, Tang. Both Koh and Yan are separated from Hoan by only two degrees of separation, the first of which involved familial ties.

Letter versus spirit of the law

Incidentally, both relationships narrowly avoided the Chapter 9 SGX Mainboard rules on interested persons. Rule 904(4)(a) provides that "in the case of a company, "interested person" means "(i) a director, chief executive officer, or controlling shareholder of the issuer; or (ii) an associate of any such director, chief executive officer, or controlling shareholder".[105]

The SGX rulebook states that a CEO's associates would include their immediate family members but omits any mention about in-laws. Based on the proximity of relationships of Changsha Best's manager and owner to Best World's co-founder, it is questionable that Changsha Best is an independent PIA and that its dealings with Best World were legitimate or on normal commercial terms. Further, the rehiring of Yan and his team from the PIA Changsha Best to the Group's subsidiary BWL China resembled an internal restructuring process rather than an arm's length appointment in a new subsidiary.

These findings led SGX to issue a notice of compliance to Best World on 13 May 2019, stating: "The revelation of the relationship between Changsha Best and the company's CEO and managing director raises serious concerns about the veracity of the China sales conducted under the export model from 2015 to 2018, and whether these were conducted on normal commercial terms."[106]

The regulator also further ordered Best World to produce the financial information, accounting and corporate records of Changsha Best and other import agents to SGX Regco for further investigations to be conducted.[107]

SGX further indicated that the scope of the PwC review would be expanded, with a special focus on determining whether Best World's sales in China from 2015 to 2018 were "conducted on normal commercial terms". The bourse also instructed PwC to report "solely to SGX RegCo on the scope and all findings of its review", instead of the original directive for PwC to report to both SGX RegCo and Best World's Audit Committee.[108,109]

On 15 July 2019, the company announced the scope of the expanded review that had been approved by SGX Regco.[110]

Various commentators also weighed in on Best World being able to circumvent the rules. In an interview with The Business Times, corporate governance advocate Professor Mak Yuen Teen stated that Best World's responses belied a lack of understanding of the spirit of the rules. He lamented that "unfortunately, our IPT rules are porous (and) Best World could have used a very technical interpretation of the rules as an excuse". Professor Mak further observed that "We have already seen companies like Datapulse Technology drive a truck through these rules. The SGX needs to review the IPT rules and drive home the message that it will enforce the spirit of the rules, not just the letter. Saying that companies must follow the spirit, which the rules say, but not enforcing accordingly, would be pointless."[111]

Designer remuneration?

The final material issue highlighted by the short seller reports was an alleged exponential increase in the remuneration of Best World's founders. In its 24 April 2019 report, Bonitas claimed that “As reward for their fraudulent scheme, Best World’s founders…exponentially accelerated their combined annual take home pay by 20x in five years, earning less than S$2 million in 2013 to receiving over S$40 million in cash in 2018!”[112]

The report asserts that in the three years since implementing the scheme, the co-founders collectively took home S$85 million in cash, while its trade and payables balance were at a record high of S$95 million and its receivables falling to an all-time low of S$5.2 million.[113]

Best World’s financial statements from 2013 to 2017 disclose the remuneration of key executives in bands of S$200,000 to S$250,000,[114] making it possible to track the true amounts that the founders pocketed on a yearly basis, after deducting other payments made to IDs and other key executives.

In response to Bonitas’ allegations, Best World refuted that Bonitas either “miscalculated” or “deliberately misstated” the amounts received by the founders.[115]

Epilogue

Best World is still locked in a bitter dispute with its short sellers. On 22 March 2020, just over a year after the company announced the appointment of PwC as independent reviewer, the company issued an update and said that a full report will be issued to the Audit Committee and SGX Regco after it has completed its work.[116] The company also said that it will continue to work with the auditors and legal advisors on the matters raised in the interim update.

The company has postponed in its Annual General Meeting several times and shareholders will have to wait for the review to be completed.[117] The status of the company’s defamation suit against Bonitas also remains unclear. As of 1 May 2020, the trading of the shares remains suspended, as it has been since 9 May 2019.

On 31 March 2020, Best World released its unaudited full year results for the year ended 31 December 2019, which provided its shareholders with some good news – profit after tax increased to S$88.75 million from S$72.57 million the year before.[118]

On 7 June 2020, the company announced that its external auditor, Ernst & Young LLP, has issued a disclaimer of opinion for its financial statements for the year ended 31 December 2018.[119] Best World eventually held its virtual AGM for the financial year ended 31 December 2018 on 22 June 2020.[120]

On 23 July 2020, the final report by PwC was released, revealing questionable deposits into the personal bank accounts of several individuals by its franchisees and potential breaches of the Companies Act.[121] PwC found unusual relationships between Best World and both its former import agent Changsha Best and the marketing agent Vicstar. Various individuals involved with the past or current import agents had connections with the company or its founders, such as being a former neighbour, current employee, brother-in-law or nephew.

Both Changsha Best and Vicstar contributed to Best World’s revenue, and are ostensibly not part of the Best World group. However, checks by PwC revealed that Best World’s employees were in fact substantially involved in the daily operations and financial activities of both entities.

The Executive Summary indicates that PwC's review was hampered by lack of certain critical information and access to certain individuals. SGX Regco said that the company's shares would remain suspended indefinitely until the company addresses the concerns in the report.[122]

Given the limitation in scope in PwC's review, many unanswered questions remain. It also remains to be seen if the authorities will launch an investigation and hold those responsible accountable.

Discussion questions

1. Critically evaluate the board of directors of Best World, including the integrity, competencies and independence (where applicable) of its directors.
2. Discuss the role that the short sellers played in the troubles faced by Best World. What are some possible conflict of interests faced by short sellers and do you think they play a positive or negative role in corporate governance? Should there be stricter rules against short selling? Explain.
3. Critically compare the old and new business models adopted by Best World and comment on the legality of its Chinese operations.
4. Critically evaluate the issues raised by The Business Times and the short sellers. Do you believe the concerns are real, or due to a lack of understanding of Best World's business? Explain.
5. Discuss the degree of transparency in Best World's business operations with regards to Changsha Best. Do you believe that Changsha Best is an "interested person" under the SGX listing rules and that transactions between it and Best World are interested person transactions? Explain.
6. What are the potential breaches in listing rules or laws by the company or its directors, if any? Do you believe any of the independent directors should be held liable for breach of duties if the allegations turned out to be true? Explain.
7. Critically evaluate the actions taken by SGX Regco in the Best World saga.

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CAMSING HEALTHCARE: AN UNHEALTHY STATE OF AFFAIRS

Case overview

On 9 July 2019, SGX-listed Camsing Healthcare Limited announced that Lo Ching, its Executive Chairman, was being held in criminal custody in China for unknown reasons. The company declared business as usual, and announced that its operations remained stable, despite her disappearance. The shares of Hong Kong-listed Camsing International Holding Limited, which Lo Ching concurrently chaired and was the Chief Executive Officer of, fell by more than 80% when the market re-opened.

Prior to her arrest, auditors had raised various issues to Camsing Healthcare's Audit Committee (AC). The three independent directors, who were also members of the AC, resigned shortly after, earning the ire of the Singapore Exchange, which demanded explanations and also ordered a special audit to investigate the issues raised by the auditors and other issues. Trading in the company shares was suspended.

The objective of this case is to facilitate a discussion of issues such as non-segregation of duties between the board and management; board composition; duties of directors; related party transactions; key man risk; succession planning; and regulatory enforcement.

The modern day Mulan

Lo Ching founded Camsing Global in Hong Kong in 1996[1] with a focus on intellectual property incubation and brand licensing.[2] Over the years, the Camsing Group has developed into a sizeable conglomerate, with business operations in entertainment and healthcare.[3] Known to be a cool-headed and low-profile businesswoman, Lo is a self-made entrepreneur with over 20 years of experience in branding, marketing, promotion, licensing, entertainment, distribution, and healthcare under her belt.[4]

Lo's entrepreneurial efforts have not gone unrecognised. In 2018, she was accorded the Business Mulan Award in the Chinese Women in Business category.[5] According to its FY2016 annual report, Lo held an 83.36% stake in Camsing Healthcare Limited (Camsing Healthcare) through deemed interests.[6]

This case was prepared by Ang Jia Wei, Heng Boon Kang, Low Wei Dong and Winnie Toh, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been substantially re-written, with information added, by Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees.

The Camsing companies

Camsing Healthcare is part of the Group controlled by Lo. It was incorporated in Singapore in 1979. The company has investments in healthcare-related businesses and distributes health supplements and foods in the Singapore and China markets under the brand of Nature's Farm. Camsing Healthcare was listed on the Singapore Exchange (SGX) in May 1980. [7,8]

Nature's Farm Pte Ltd – a wholly owned subsidiary of the Camsing Group[9] – was incorporated as a Singaporean private company in 1982.[10] It is a wholesaler and retailer of a range of health supplements and groceries.[11] The immediate parent of Nature's Farm, William Jacks & Company, was incorporated as a Singaporean private company in 1966. Its principal business activity was mainly related to the administration of loyalty programmes.[12]

The Group also distributes and trades in medical instruments and medical supplies, while also providing logistic services to the healthcare industry in China via the wholly-owned subsidiary Camsing Healthcare (Fuzhou) Medical Instrument Co., Ltd (Camsing Fuzhou).[13]

Camsing-affiliated companies began making aggressive international acquisitions in 2015, funded through the sales of asset-management products.[14] These products were purportedly backed by accounts receivable from business partners of top Chinese retailers such as Suning.com Co. and JD.com Inc (JD.com), according to the Group.[15] For example, Creative Elite Holdings Limited acquired Camsing Healthcare (formerly known as Jacks International Limited)[16] in September 2015. This acquisition was made at a premium of nearly 90.5% over its benchmark price of S$0.42,[17] with the total purchase price amounting to S$20.5 million.[18] Camsing Healthcare forms the healthcare subsidiary extension of Camsing Global.

In October 2015, the Camsing Group acquired Hong Kong-listed Fittec International Group via a HK$535 million investment by Lo. It was later renamed Camsing International Holding Limited (Camsing International) and restructured into the entertainment arm of Camsing.[19]

Figure 1 shows the Camsing Group structure as disclosed in Camsing Healthcare's 2018 annual report.

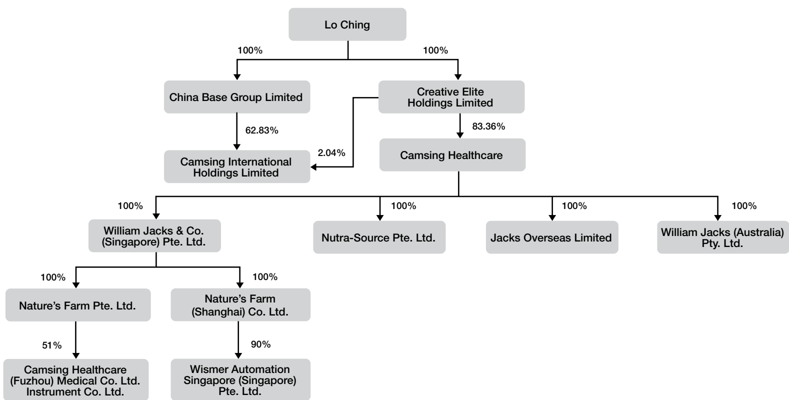

Figure 1: Camsing Group structure[20]

Board of directors

As at 20 March 2019, Camsing Healthcare's board of directors consisted of five members. The two executive directors (EDs) were Lo and Liu Hui, while the independent directors (IDs) consisted of Lau Chin Hock Kenneth Raphael, Maurice Tan Huck Liang, and Ong Wei Jin.[21] Lo was the Chief Executive Officer (CEO) of Camsing International,[22] while Liu was the vice president of Camsing Global.[23]

Lau, the lead independent director of Camsing Healthcare since April 2018, is an ED of a privately-held asset management company and holds a Master of Business Administration degree from INSEAD.[24] Ong is a partner of law firm Eversheds Harry Elias LLP and was concurrently an ID of three other SGX-listed companies – CFM Holdings, China XLX Fertiliser and Luzhou Bio-Chem Technology. His law firm provided corporate secretarial services to Camsing Healthcare, with S$26,000,[25] S$36,100,[26] and S$32,500[27] in fees for such services for FY2016, FY2017 and FY2018 respectively. These services were disclosed as interested party transactions in the company's annual reports. Ong was previously a non-independent non-executive director but was re-designated as an ID on 20 April 2018.[28]

Tan previously held senior positions in general management and in sales and marketing roles across Greater China and the Asia Pacific region and was most recently at a technology multinational corporation, leading its merger and acquisition integration practice in Asia. He holds a Bachelor of Business degree from the National University of Singapore and an Executive Master of Business Administration from China Europe International Business School, and is an adjunct senior faculty member at NUS Business School.[29]

There were three board committees, namely the Audit Committee (AC), the Nominating Committee (NC), and the Remuneration Committee (RC). The three committees were solely comprised of the three IDs, namely Lau, Ong and Tan. Tan held the role of Chairman for both the RC and the NC, and was a member of the AC. Lau was the Chairman of the AC, and was a member of both the NC and RC. Lastly, Ong was a member of all three board committees.[30]

The beginning of the end

According to China's Caixin Global, Lo was arrested in June 2019 following allegations by one of China's largest wealth managers, Noah Holdings Ltd. (Noah), of supply chain financing fraud. Noah manages S$672 million[31] of asset management products for Camsing and had informed the press that eight privately offered funds, sold by its subsidiary Shanghai Gopher Asset Management for Camsing International, were at risk of default. These products were said to be backed by accounts receivables with JD.com, one of China's largest electronic retailers.[32] However, JD.com denied any involvement, with a spokeswoman from JD.com stating that "Camsing falsified JD.com's business contracts, engaging in fraudulent behaviour".[33]

Other events which had occurred in companies under Lo's leadership raised further questions about her character. For instance, Camsing International was embroiled in an intellectual property lawsuit in relation to one of its acquired companies, POW! Entertainment. POW! Entertainment is an American media production company founded by Stan Lee. Lee had filed a lawsuit against Camsing International, alleging that he had been duped into signing his name, identity, and likeness away. Although the lawsuit was eventually dropped, the case was re-opened by Lee's daughter, J.C. Lee, after his death and upon the publication of news of Lo's involvement in fraud allegations.[34,35]

External auditors – The watchdog

During the course of Camsing Healthcare's audit for the financial year ended 31 January 2019, its auditors, Deloitte & Touche LLP (Deloitte), brought several audit matters to the attention of the company. The auditors then wrote a letter dated 13 March 2019 to the company's board of directors.[36]

The audit matters raised related to possible occurrences of related party transactions, retention of risks and rewards of sold products, uncertainty over recoverability and reversal of license fee income, and uncertainty over the Group's ability to meet operating and financing obligations due to the breach of bank covenants.[37]

Distribution and consignment agreements

The first audit matter involved distribution agreements which were entered into concurrently with a consignment agreement. The validity of such sales transactions was in question because the risks and reward in the products sold may not have been truly transferred to customers. The auditors noted that the risks and rewards ultimately remained with Camsing Healthcare.[38]

On 7 December 2018, the auditors informed AC Chairman Lau that certain Chinese customers who were unable to sell the goods previously purchased from Nature's Farm had subsequently consigned the goods back to Nature's Farm. ID Lau then informed Chief Operating Officer Jennifer Wang Lu about such sales and requested for sales information regarding the China distributor.[39]

On 31 January 2019, the auditors highlighted to Lau that they discovered that one such transaction pertained to prior year sales of health supplements to Global Biotech Medical Inc (Global Biotech), an overseas customer, who had sent goods back to Nature's Farm on a consignment basis. This was done via another company – I-Nitra Consulting Ltd – and the consigned goods were to be sold in Nature's Farm stores. Lau then requested the auditors to seek clarification from management and raise the matter formally with the AC.[40]

Such distribution agreements totalled approximately S$9,687,000 for FY2017 and FY2018, making up 32.8% and 25.7% of sales respectively. In FY2019, no sales were made under the distribution agreements while consignment agreements amounted to approximately S$725,000. As at end-March 2019, the company has since received 2,200 of the 6,500 goods under the purchase agreement and continued to receive the remaining goods.[41]

Related party transaction

An alleged related party transaction uncovered by the auditors related to a purchase agreement amounting to approximately HK$15.6 million in FY2019. Nature's Farm CEO Hua Min, on behalf of Nature's Farm, had entered into an agreement with Global Biotech Medical Inc to buy 5,000 units of brainwave detecting headbands produced by BrainCo,[42] a start-up which was caught in controversy over tests on schoolchildren in China.[43]

In 2016, Hua met the founder of BrainCo, Dr. Han Wei, who introduced the smart headband to Hua. Hua later promoted it in a televised interview and said: "With this product, BrainCo has gradually become one of the best brain-computer interface companies in the world".[44]

Camsing Healthcare had made an upfront payment in full shortly after the contract was signed, despite not having yet received the first batch of smart headbands. Further, it was public information that the product was still undergoing trials in China and its commercial viability was questionable. The IDs brought this matter to the attention of Chairman Lo twice in October 2018 and recommended that the purchase be reversed.[45]

After a conference call and a subsequent meeting with the AC in November 2018, Hua finally agreed to modify the terms of the transaction via a supplemental agreement. On 2 January 2019, the AC received the final draft of the supplemental agreement, which laid out, inter alia, a request for a 90% refund of the HK$15.6 million full contract payment. The AC was then informed on 13 March 2019 that Global Biotech would process the refund on 28 March 2019.[46]

The AC was also concerned as to whether the company would receive the refund. The entire matter had dragged on for over two months, with multiple emails and phone calls before the change in contract terms were implemented. At the time of resignation of the three IDs on 20 March 2019, the 90% refund remained outstanding, five months after the issue had been raised to management.[47]

Subsequently, it was announced on 29 March 2019 that the company had received a refund of approximately HK$14,039,650.[48]

License fees

The third audit matter related to the recoverability of license fee income amounting to S$299,000 in FY2018, and the reversal of license fee income amounting to S$294,750 in FY2019 for the nine months ended October 2018.[49] The said amount made up approximately 72% of total license fee income in FY2018.[50]

On 29 March 2019, Camsing Healthcare justified the reversal of the license fees on the grounds of poor performance and lack of sales. As such, the company intended to waive it and search for another distributor.[51]

Going concern issues

The final audit matter related to whether Camsing Healthcare would be able to remain as a going concern. The auditors had noted that the company had breached certain bank covenants for credit facilities in relation to two loans, of which the outstanding amounts totalled approximately S$3.4 million.[52]

Details of the covenants were not made publicly available. On 29 March 2019, Camsing Healthcare announced that one of the loans' bank covenant breaches had been resolved and that relevant banks had not pulled any credit facilities to date.[53]

More related party transactions

In addition to the four audit matters listed, the auditors also raised questions about Camsing Fuzhou.

Camsing Fuzhou was incorporated in Fuzhou, China in December 2017 as a joint venture between Nature's Farm and Fuzhou Zhongxing BaoKang Trading Co (Fuzhou Zhongxing). Camsing Fuzhou has a registered capital of RMB45 million, and a paid-up capital of S$2 million paid entirely by Nature's Farm.[54] Nature's Farm held a 51% interest stake in Camsing Fuzhou.[55]

The other joint venture partner, Fuzhou Zhongxing, specialises in the trading of medical products in Fujian. This joint venture was said to benefit both parties, with Fuzhou Zhongxing gaining access to Camsing Group's variety of health products, while Camsing Group would be able to utilise Fuzhou Zhongxing's local knowledge, business network and other resources in China's Fujiang province.[56]

On 29 January 2019, Camsing Healthcare announced the proposed disposal of its 51% equity interest in Camsing Fuzhou to Camsing Medicare Company Limited. The consideration amounted to RMB12 million. This resulted in a gain on disposal of approximately RMB4.62 million. However, the 51% interest was only valued at RMB7.8 million by Shandong Dao Qin Assets Appraisal Co. Ltd.[57]

There were three main reasons used by the company to justify the proposed disposal. Firstly, the disposal would allow the Group to divert its resources to the expansion of its existing business of distribution and retailing health supplements and goods regionally and in Singapore. Secondly, the continued investment in Camsing Fuzhou would not be viable in the long-term as substantial funding would be required to ensure its profitability. Further, the Group would need to continue absorbing Camsing Fuzhou's losses until it broke even or turned a profit. The cumulative effect of this would have a significant impact on the Group's overall financial performance. Lastly, the purchaser was willing to purchase the 51% interest stake at a price above the indicative valuation of the sale shares.[58]

Both the vendor and purchaser were controlled by Chairman Lo. Lo was the sole beneficial shareholder of Camsing Wellness Co. Ltd, the private company which wholly owned the purchaser in the proposed transaction. This made her an 'interested person' based on the SGX Rulebook, which would then require Camsing Healthcare's AC to review whether the transaction would be at arm's length and whether it would be prejudicial to minority shareholders, and announcing it.[59] No such announcement was made.

Additionally, Deloitte also raised issues in relation to Camsing Fuzhou's purchase of medical supplies from a related party valued at RMB4 million and a loan of RMB1.05 million extended by Camsing Fuzhou to another related party.[60]

We're out of here!

On 20 March 2019, Camsing Healthcare's three IDs abruptly resigned together.[61] All three directors cited the same "personal reasons" and referred to the auditors having "raised certain matters arising from their audit work and pending resolution of those questions are stopping their audit".[62,63,64]

Their abrupt resignation led SGX Regco to issue a notice of compliance directing the company to appoint a special auditor to investigate the matters raised.[65] SGX expressed disappointment that the IDs had "chosen to resign at the point when the Audit Matters were raised by the auditors and the Audit Matters have yet to be resolved". SGX said their resignation "places the company in jeopardy as there is no continuity in the independent oversight of the Audit Matters which took place in the financial period prior to the resignations". It then directed the company to obtain detailed explanations for their resignation.[66]

In addition, SGX said it would assess each of the former ID's suitability to act as a director or executive officer in SGX-listed companies going forward.[67]

In an announcement released on 5 April 2019 responding to the notice of compliance,[68] the three IDs cited several key reasons which led to their resignation.

Firstly, Camsing Healthcare's management took the audit matters lightly and did not offer their full cooperation to the auditors. Both Lo and Liu failed to attend multiple meetings which were organised to address the audit matters raised by Deloitte. In addition, they also provided unsatisfactory responses in writing. Secondly, management was reluctant to take steps that would enhance corporate governance. Thirdly, management was not open to feedback on corporate governance-related issues.[69]

The former IDs collectively said that in order to urge management to put more weight on the resolution of the outstanding audit matters, they had, on 13 March 2019, informed the EDs of their intention to resign if management continued to provide unsatisfactory responses to aid the audit process. Since management ultimately did not cooperate and the auditors remained dissatisfied, the audit was suspended, and the IDs resigned in their joint belief that their resignation would compel management to take action.[70]

Following the resignation of the three former IDs on 20 March 2019, Camsing Healthcare appointed three new IDs the following day, namely Patel Anand Rameshchandra,[71] Lim Heng Huat,[72] and Tay Chiew Sheng.[73] The former two of these IDs had no prior experience as directors of listed companies. On 1 October 2019, the company appointed 30 year-old Zhang Zhen as a non-independent non-executive director.[74] Zhang is the business development manager of Nature's Farm.[75]

The company first requested for a trading halt on 22 March 2019.[76] An extension of this halt was then sought on 27 March 2019, for an additional two market days, pending the release of an announcement detailing the reasons for the halt.[77] It later explained that the trading halt was to facilitate the resolution of the audit matters raised by Deloitte.[78] The shares were subsequently suspended from trading on 1 April 2019[79] and has remained suspended since then.

Minimum leniency for Hua

Hua was appointed as Nature's Farm CEO on 1 June 2018. He is a resident of China, and in addition to managing Nature's Farm, was in charge of leading the business development and profitability of the Camsing Group. His previous working experience was entirely in Chinese companies, including Sinopharm Group, China National Medical Device Co., Ltd, as well as China Instrument Import & Export (Group) Company.[80]

On 29 October 2019, Hua was suspended for three breaches of the Group's delegation of authority protocol. This protocol had previously been drafted by the IDs in a bid to protect the Group's interests. Both his administrative and executive powers were suspended with immediate effect.[81]

The company did not lay out specific succession plans for Hua following his suspension.

Who's looking after the money?

In an SGX announcement dated 24 May 2017 in response to an earlier SGX query, it was disclosed that Camsing Healthcare did not have a Chief Financial Officer (CFO).[82]

In 2018, Camsing Healthcare experienced three resignations for the finance and admin manager of Nature's Farm. Tracey Ang Hwee Sing, who was appointed on 31 August 2007, resigned from her role on 1 March 2018, citing a desire to pursue personal interests.[83] Her replacement, Phoon Kong Foo, was appointed on 1 February 2018. He had prior experience as a financial controller in other companies from 2007 to 2017.[84] However, he resigned a few months later on 13 July 2018, stating that he wished to pursue other career opportunities.[85]

To Seah Chain replaced Phoon on 13 July 2018. He had more than 20 years of experience in finance and accounting related roles.[86] He resigned the same year on 10 December 2018, also citing his desire to pursue other career opportunities.[87]

On 11 November 2019, Camsing Healthcare announced the resignation of yet another finance and admin manager of Nature's Farm, Lee Ren Kiat, after less than a year.[88] He had over 15 years of experience in finance and accounting.[89]

Lo Ching's arrest comes to light

On 5 July 2019, it came to light that Executive Chairman Lo was being held in criminal custody by the Yangpu Branch of the Shanghai Public Security Bureau in China. Four days after, on 9 July 2019, Camsing Healthcare released an announcement about her arrest and explained that the company was unable to ascertain the reasons which led to her arrest.[90,91]

The company provided assurance that the business operations and the function of the board remained stable. It added that there was no material and adverse impact on the company's business, with the board continuing its efforts to protect the interests of its employees and shareholders by ensuring continued operations.[92]

Meanwhile in Hong Kong...

Camsing International's stock crashed 80.4% on 8 July 2019 after news of Lo's arrest broke.[93] Simultaneously, it was facing regulatory action by the Hong Kong Exchange (HKEX).

On 5 July 2019, Camsing International released an inside information announcement on HKEX to disclose that its CEO was held under criminal custody.[94] Another announcement on 18 July 2019 disclosed that the police in China had recently searched Lo's office premises, seizing certain documents related to Camsing International.[95]

On 19 July 2019, Camsing International was granted a trading halt pending the release of its clarification announcement regarding Lo's arrest.[96] Following the trading halt, HKEX issued five resumption conditions to Camsing International on 14 August 2019.[97] These included the disclosure of details of Lo's arrest; quelling of concerns with regard to management integrity; the maintenance of "a sufficient level of operations or assets of sufficient value to warrant the continued listing of their securities" in accordance with HKEX's Rule 13.24[98] to justify the continued listing of its shares; the clarification of the company's shareholding structure; and the announcement of all material information.

On 19 August 2019, Camsing Healthcare announced that the board had resolved to suspend all the administrative and executive duties and powers of Executive Chairman Lo with immediate effect.[99] The announcement also said that the Singapore company was still unaware of the reasons behind Lo's arrest and stated that the board was in the process of ascertaining whether the arrest was related to the Group.[100] It did not lay out any succession plans.

On 4 September 2019, it was announced that a special committee had been formed and a professional adviser appointed.[101] It was disclosed that Lo effectively held 28.1% of Camsing International, consisting of China Base Group Limited's 26.1% ownership and Creative Elite Holdings Limited's two percent ownership, both of which she wholly owned.[102]

HKEX followed up with an added guidance point relating to the publication of outstanding financial results on 2 October 2019.[103]

On 18 October 2019, Camsing International continued to say that it was unaware of the details of Lo's arrest, despite active attempts to make formal inquiries. It also explored reorganising its governance structure to ensure management integrity. Meanwhile, as its accounting records had previously been seized by the Chinese police, it was unable to release its annual results for the FY2019 and had to postpone it.[104]

Quick to borrow, slow to pay

On 2 September 2019, Camsing Healthcare announced that its wholly-owned subsidiary, William Jacks & Company, received a letter of demand from United Overseas Bank (UOB) for the repayment of a S$2.2 million loan, together with any interest owed.[105]

This stemmed from banking facilities granted to Nature's Farm, which had since defaulted in payment following the recall of UOB's banking facilities on 16 August 2019. William Jacks & Company was liable as it had provided a corporate guarantee.[106]

In response to SGX queries, Camsing Healthcare revealed several facts about the loan.[107] Firstly, the S$2.2 million formed part of a larger loan extended to both Nature's Farm and William Jacks & Company. Secondly, Camsing Healthcare did not provide a corporate guarantee to UOB to secure loans taken out by either Nature's Farm or William Jacks & Company. However, UOB was entitled to accelerate repayment of its loans to the Group due to Nature's Farm position as an indirect wholly-owned subsidiary of the company. Thirdly, the board was of the opinion that this had an impact on the operating cash flow of the Group. Fourthly, the Group was actively engaging UOB to agree on a repayment plan as well as to attempt to secure additional equity funding from potential investors. The ability to continue as a going concern would be contingent on the success of these measures.

It was also revealed that the 2016 loan facility was backed by a cash pledge to UOB China, amounting to RMB11,333,400. The pledge was provided by Guangdong Zhongcheng Industrial Holding Company Limited, which was also owned by Lo, together with a Singapore property worth S$1.25 million. Lastly, the board indicated that it believed that information had been disclosed in accordance with the listing rules.[108]

Better late than never, but will it ever happen?

Camsing Healthcare was expected to announce its FY2019 results by 1 April 2019, and convene its Annual General Meeting (AGM) by 31 May 2019. However, it announced on 1 April 2019 that it had applied to SGX and subsequently to the Accounting and Corporate Regulatory Authority (ACRA) for an extension of time to release its financial results and hold its AGM. The company said that it was in the process of appointing a professional firm to resolve the audit matters and propose more effective controls to prevent the recurrence of similar issues.[109]

On 15 April 2019, the company announced that it had obtained approval from SGX for a two-month extension to release its FY2019 financial results and hold its AGM.[110] It announced the appointment of RSM Corporate Advisory Pte Ltd (RSM) as its special auditor on 24 April 2019,[111] about two weeks after the proposed date.

Unable to comply with the first extended deadline to announce its results and hold its AGM, Camsing Healthcare announced on 22 July 2019 that SGX had granted the company a further extension of six months until 1 December 2019 to release its FY2019 financial results, and until 31 January 2020 to hold its AGM. The board's view was that this would allow the auditors to obtain satisfactory responses and resolve the audit matters for the completion of their audit work before the company announced its FY2019 financial results and hold its AGM.[112]

The draft audit report and finalised report would only be available by 2 September 2019 and 14 October 2019 respectively, according to RSM's schedule.[113]

However, on 4 December 2019, the company announced yet another round of applications to SGX and ACRA for extensions to release its FY2019 results by 1 June 2020 and to hold its AGM by 31 July 2020.[114]

Epilogue

Even as she remained in custody, Lo was still trying to influence the affairs of the company. On 18 November 2019, the company announced that it had received a requisition letter dated 23 October 2019 "said to be signed by Ms Lo Ching". It requested the company to convene an Extraordinary General Meeting (EGM) in order for shareholders to consider the removal of the three IDs and one non-independent non-executive director, and to appoint three new IDs in their place.[115] However, on 13 December 2019, the company announced that the requisition letter had been withdrawn.[116]

On 17 December 2019, SGX Regco issued another notice of compliance, this time requiring the company to seek its prior approval for the appointment of any director or executive officer for a period not exceeding three years, and requiring the IDs to continue to report directly to SGX Regco, as well as to provide full assistance for the special audit.[117]

This is one company that appears unlikely to get back into the pink of health.

Discussion questions

1. Camsing Healthcare was highly reliant on Lo Ching as its Executive Chairman. What are the key risks? How can a company mitigate such risks?
2. What are the benefits and risks stemming from the non-segregation of shareholder, board and management? Explain your answer in relation to Lo Ching.
3. Do you think there was adequate succession planning in Camsing Healthcare's case? Discuss how a company may be affected by a lack of succession planning, and what a good succession plan should encompass.
4. The three independent directors of Camsing Healthcare all left on the same day. What is the role of independent directors and Audit Committee members when auditors raise issues discovered in the course of an audit? Discuss whether the independent directors should have acted this way, taking into account the reasons for their departure and SGX's response.
5. What were the key issues identified by the auditors and what impact are they likely to have on the Camsing Healthcare?
6. Camsing Healthcare is part of a Group which has companies incorporated or operating in several different countries. Discuss the corporate governance risks associated with such a group structure. What limitations do regulatory bodies and investors in Singapore face in relation to such companies?

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EZRA AND THE TRI-TANIC

Case overview

Ezra Holdings Limited listed on the Singapore Exchange in 2003 and became an industry darling. Two other subsidiaries were subsequently listed. Things seemed to be going swimmingly well for the Group in the offshore and marine industry until about 2015 when the fall in oil prices led to a severe downturn in the sector. All three companies were subsequently placed into judicial management. Media reports and commentaries about these companies raised issues about its corporate governance and compliance with laws, regulations and rules. The objective of this case study is to facilitate a discussion of issues such as duties of directors; director and management turnover; risk management; financial management; governance risks of chain listings; and regulatory enforcement.

The good old days

Established in 1992 by Lee Kian Soo and his wife, Goh Giak Choo, Ezra Holdings Limited (Ezra) grew from a small family-owned company to become a darling of the Singapore Exchange (SGX).[1]

When Ezra was established, it managed and operated small-scale offshore support vehicles. Riding on the wave of the deep-water exploration and production industry, Ezra began constructing its very first seven support vessels and subsequently expanded its business globally under three main divisions in engineering, construction, marine and production services.[2,3,4]

Ezra went public on the then SESDAQ (now known as Catalist Board) in 2003, debuting at 34 Singapore cents. In late 2005, it moved to the SGX Mainboard. Its future looked bright up until 2015, as it never once saw red from its establishment up to that time. Regular dividends were paid to its shareholders and the company was optimistic about its outlook. Lee Kian Soo's son, Lionel Lee Chye Tek, then joined the business and was appointed a director in March 1999, becoming the Group Chief Executive Officer (CEO) and Managing Director (MD) in August 2012.[5]

Love on the rocks

In September 2014, media reports said that the Ezra co-founders agreed to resolve a six-year legal battle over S$208 million of marital assets that included a stake in Ezra.[6] It was reported that Lee Kian Soo, his now ex-wife, and their elder son Lionel Lee, dropped their challenges

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to a Singapore High Court ruling at the beginning of that year after agreeing to a confidential settlement.

Lee Kian Soo was earlier ordered to pay Goh Giak Choo S$56 million, including a possible transfer of as much as a 6.2% stake in Ezra. Goh Giak Choo had failed in getting a S$40,000 monthly maintenance.[7]

Goh Giak Choo said that her ex-husband and son colluded to dissipate assets after she had filed for divorce, citing "significant differences" including disregard for her Catholic faith and the elder Lee's suspected infidelity. Lee Kian Soo had transferred the Ezra shares at 45 Singapore cents to Lionel Lee in 2009 and 2010, which was at a substantial discount to the then market price. Lee Kian Soo had claimed that the 45 cents price was arrived at because he was born in 1945.[8]

Three years later, it was Ezra's turn in the courts as it filed for Chapter 11 protection with the U.S. bankruptcy court.

What exactly happened?

Expanding the flotilla

In February 2007, EMAS Offshore Limited (EOL) (formerly known as EOC) was incorporated in Singapore as a subsidiary of Ezra. It provided offshore support, accommodation and offshore production services to customers in the oil and gas industry. After listing on the Oslo Stock Exchange (OSE) in October 2007,[9] it obtained a secondary listing on SGX in October 2014 through a public offer of 9.085 million shares and a placement of 39.5 million shares at S$1.21 per share. DBS Bank was the issuer manager, with OCBC Bank joining it as joint book runner and underwriter.[10]

As a company with a primary listing on OSE and a secondary listing on SGX, EOL complied with the listing rules of OSE and was exempted from compliance with the SGX rulebook (except rules 217 and 751). It opted to comply with Norwegian corporate governance standards as set out in the Norwegian Code of Practice for Corporate Governance, instead of the Singapore Code of Corporate Governance.[11]

At the time of its secondary listing, the elder Lee was Executive Chairman and advisor, while his son Lionel Lee was Non-Executive Vice Chairman.[12] Following EOL's secondary listing, Ezra had direct and deemed interest in EOL amounting to 69.15%. Later that same month, EOL reported a FY2014 net profit of US$54 million and said that it was entering FY2015 with "stronger earnings visibility".[13] In March 2015, it announced a US$500 million multi-currency debt issuance programme and seemed poised for growth.[14]

The third piece of the "Tri-tanic", Triyards Holdings Limited (Triyards), was listed on the SGX Mainboard in October 2012 through a 1-for-10 in specie distribution of Triyards shares to Ezra shareholders.[15] After the listing, Ezra held 67% of Triyards shares.[16] Lionel Lee was the Non-Executive Chairman.[17]

Triyards' business was in engineering and fabrication services, with "the capability to undertake large-scale projects to fabricate different components of fixed platforms, as well as vessel conversion and construction".[18] It announced record revenue and profits for FY2012 shortly after its debut on SGX.[19]

The Vikings

Based on the 2015 annual reports, Lionel Lee had direct and deemed interests totaling 23.19% in Ezra, including shares held through Jit Sun Investments Pte Ltd (Jit Sun), which is 100% owned by him. Lee Kian Soo had a 1.54% stake. Ezra had two other substantial shareholders – Credit Suisse AG, which had a deemed interest of 5.27%, and Frontica Global Employment Limited, with 0.34% direct interest and deemed interest in the 7.04% stake held by DNB Bank ASA.[20]

For Triyards, Lionel Lee had direct interest of 5.23%, and deemed interest of 62.03%, including in the 60.91% stake held by Ezra and shares held by Jit Sun. Lee Kian Soo had 1.5 million shares, or less than a 0.5% stake.[21]

Ezra held 75.25% of the shares in EOL but the Lee's did not have any direct stakes in the company.[22]

In other words, the effective beneficial interests of the Lee's in the three companies were 24.73% in Ezra, 21.31% in Triyards, and 18.61% in EOL. However, they effectively controlled all three companies by virtue of their direct and deemed interests, including in shares held by Ezra which controls both Triyards and EOL, as well as through holding key board and senior management roles in all three companies.

Masters of the seas

There were a number of interlocking directors among the three companies, with some directors and key management moving among the three companies.

Ezra Holdings Limited

In FY2015, the board of Ezra consisted of eight directors, namely Group CEO and MD Lionel Lee, Non-Independent Non-Executive Chairman Koh Poh Tiong, five independent directors (IDs), along with the elder Lee himself, who was a non-executive non-independent director (NED).[23] Two of the IDs, Ho Geok Choo Madeleine and Tan Cher Liang, joined the board in 2015. With IDs making up more than half of the board, Ezra complied with the Code of Corporate Governance 2012 (the Code) for companies without an independent Chairman.[24]

Figure 1 shows the board of directors based on the FY2015 annual report.

Name	Age	Year of first appointment	Background	Type of director	Committee
Koh Poh Tiong	69	2011	F&B industry, management	NED and Board Chairman	AC, NC, RC, ERC, EXCO
Lee Kian Soo	70	2000	Founder, shipping and offshore support services industry	NED	EXCO
Lee Chye Tek Lionel	42	1999	Founder's son, drove growth and listing of Ezra	ED	EXCO
Eng Heng Nee Philip	69	2012	Automotive, finance, accounting	ID (lead)	AC, NC (C), RC, ERC (C), EXCO (C)
Ngo Get Ping	57	2007	Property, finance	ID	AC, NC, RC (C), ERC
Ho Geok Choo Madeleine	59	2015	Human resources	ID	AC, NC, RC, ERC
Soon Hong Teck	57	2008	Finance, accounting	ID	AC (C), NC, RC, ERC
Tan Cher Liang	63	2015	Audit, management	ID	

Note: ED = executive director; ID = independent director; NED = non-independent, non-executive director;

AC = Audit Committee; ERC = Enterprise Risk Committee; EXCO = Executive Committee; NC = Nominating Committee; RC = Remuneration Committee; C = Committee Chairman

Figure 1: Ezra's board and board committee composition as at FY2015[25]

The board had five committees: Audit Committee (AC), Nominating Committee (NC), Remuneration Committee (RC), Enterprise Risk Committee (ERC) and Executive Committee (EXCO). While the ERC and AC met four times in FY2015, the NC and RC only met once. However, the EXCO met 14 times.[26]

The directors brought a range of skill sets and corporate experiences, ranging from management and human resources to audit, accounting and finance, as well as across industries such as food and beverage, real estate, and management consulting. However, neither the Chairman nor any of the IDs had any prior experience in the sector.[27] Koh Poh Tiong, the Chairman, was the former CEO of Asia Pacific Breweries (Singapore) Pte Ltd, and then CEO of the food and beverage division of Fraser and Neave, Limited.

Lead ID, Phillip Eng, who held the position of Chairman of the NC, ERC and EXCO, was also the independent Chairman of REIT manager, Frasers Centrepoint Asset Management, and non-independent Chairman of SGX-listed mDR Limited.[28]

Although the company mentioned that remuneration is commensurate with performance, it neither disclosed the indicators used to determine performance, nor how the levels and mix of remuneration were determined for directors. The total remuneration for each director was disclosed in bands of S$250,000 and each component of the pay was disclosed in percentages, with the board citing that they believed that it was not in the company's best interest to disclose the actual exact amounts paid to directors.[29]

Koh Poh Tiong, Lionel Lee, and Lee Kian Soo were the highest paid directors, each earning S$500,000 to S$750,000 in total for the year. Lionel Lee did not receive any variable remuneration component. Lee Kian Soo received 88% and Koh Poh Tiong 56% respectively of their fees in the form of "advisory fees and other benefits".[30]

Triyards Holdings Limited

At Triyards, there was a slate of board changes in FY2015. Lionel Lee, who was Non-Executive Non-Independent Chairman, resigned from the board on 1 May 2015.[31] On the same day, CEO Chan Eng Yew,[32] and Chief Operating Officer (COO) Andrew Mak Yeuw Wah[33] both resigned as EDs but retained their executive roles. Chan has a long history with the Group, and prior to his appointment at Triyards, was CFO of EOC Limited, the predecessor to EOL. Andrew Mak joined the Group in 2012.[34]

Lee Kian Soo succeeded his son as Non-Executive Chairman and chaired the four-member board.[35] Nguyen Van Buu resigned as ID on 1 February 2015 and was replaced by Simon Charles Lockett.[36] After these changes, there was no ED on the board. In fact, the reason given for the resignations of the two EDs from the board was so that the board comprised only NEDs,[37,38] although the company did not explain why this was desirable for Triyards unlike Ezra, EOL, and most other listed companies in Singapore.

There were three committees – AC, NC and RC – all with three members who were IDs. The lead ID of Triyards, Soh Chun Bin, was an equity partner at Stamford Law Corporation, before joining Cedar Strategic Holdings Ltd, followed by Changjiang Fertilizer Holdings Limited, as CEO. He chaired the NC and was a member of the AC and RC. He joined the board in August 2012.[39]

Loy Juat Boey, who joined in September 2013, chaired the AC and was a member of the NC and RC. She retired from Asia Pacific Breweries as director, group finance, in January 2013, after previous stints in Ernst & Young and a packaging company.[40]

Simon Lockett joined the board in February 2015, after a ten-year stint as CEO of an oil and gas exploration and production company listed on the London Stock Exchange and at Shell prior to that. He was also deputy Chairman and independent director at SGX-listed Loyz Energy Limited, later renamed as CWX Global Limited. Lockett chaired the RC and was a member of the AC and NC.[41]

The remuneration of all the NEDs was disclosed in a single band of up to S$250,000, with Lee Kian Soo and Lionel Lee each receiving just under half of their total fees as “advisory fees and other benefits”. For the five EDs and key executives, their remuneration was disclosed within a band of S$250,001 to S$500,000.[42]

EMAS Offshore Limited

Over at EOL, Lee Kian Soo was Executive Chairman of the five-member board. Prior to his resignation as a director in April 2015, Lionel Lee was Non-Executive Vice Chairman.[43] Capt. Adarash Kumar was CEO and ED. He first joined EOL as a NED in August 2014, before becoming an ED in May 2015[44] and CEO in September 2015.[45] Capt. Adarash Kumar has more than 35 years of experience in the marine industry.[46]

The three IDs were Cuthbert I.J. Charles, who chaired the RC and served on the AC and NC; Dr. Wang Kai Yuen who chaired the AC and served on the NC and RC; and Dale Bruce Alberda who chaired the NC and served on the AC and RC.[47]

Charles has more than 30 years of experience in the oil and gas industry in U.K., U.S., Singapore and India, having worked for 33 years with Halliburton Company. Alberda has a background in accounting and finance, and more than 30 years of experience in the finance and maritime sectors. Dr. Wang has a PhD in engineering from Stanford University and was a former Member of Parliament in Singapore. His last executive role was a Managing Director of Xerox Singapore Software Centre. Including EOL, he served on the boards of eight companies listed in Singapore, including China Aviation Oil (Singapore) and Ezion Holdings. He was independent Chairman of Ezion Holdings.[48]

Lee Kian Soo was disclosed as receiving remuneration of above US$500,000, mostly in salary and central provident funds, while the NEDs were disclosed as receiving remuneration of “up to US$250,000”. The remuneration of the five key management personnel was disclosed in bands of “above US$500,000” for the CEO, and “US$250,000 to US$500,000” for the other four.[49]

Breaking waves

In January 2014, Ezra announced that it had appointed J.P. Morgan (SEA) to advise the company on strategic options with the aim of optimising its international profile and the competitive position of its subsea services division, EMAS AMC. Potential options include a listing on a U.S. bourse.[50]

In July 2014, it was announced that the offshore support services business would be consolidated to create one of the Asia-Pacific’s largest offshore services players. That year saw numerous announcements of contracts being awarded to EMAS AMC. In October 2014, Ezra announced record revenue of US$1.5 billion for FY2014, which it said was powered by EMAS AMC’s “sustained operational capability”.[51] The contract wins continued in 2015.

Lionel Lee was appointed Chairman of EMAS AMC in May 2015, after relinquishing his director roles at Triyards and EOL.[52] Two months later, the company announced that it had clinched a six-year long term agreement from Saudi Aramco, with options to extend for another six years, through a consortium of EMAS AMC and Larsen & Toubro Hydrocarbon Engineering (LTHE).[53]

The 50-50 EMAS Chiyoda Subsea Joint Venture (ECS) was announced the following month.[54] With EMAS AMC as the main revenue driver, then Ezra Chairman Koh Poh Tiong said that "it is imperative to devote focused attention on our subsea strategy".[55]

Meanwhile, EOL announced contract wins totaling more than US$200 million between June 2015 and December 2016 following the announcement of its US$500 million multi-currency debt issuance programme.[56,57]

Triyards, which was aiming to expand its product line, announced numerous orders for lift boats, multi-purpose support vessels, chemical tankers and high-speed craft between June 2014 and October 2015 amounting to more than US$700 million.

In 2014, Triyards also announced the incorporation of a number of new subsidiaries and several acquisitions. Contract wins totaling nearly US$200 million were announced in 2015 up till March 2017 for vessels such as oil barges, wind farm support vessels, river cruise vessels, ferries and catamarans, together with successful inroads made beyond the offshore oil and gas sector into renewal energy sector.[58,59,60]

Choppy seas

Things started turning sour when oil prices began to fall in 2014. Figure 2 below shows the Brent crude oil prices over the last 10 years.

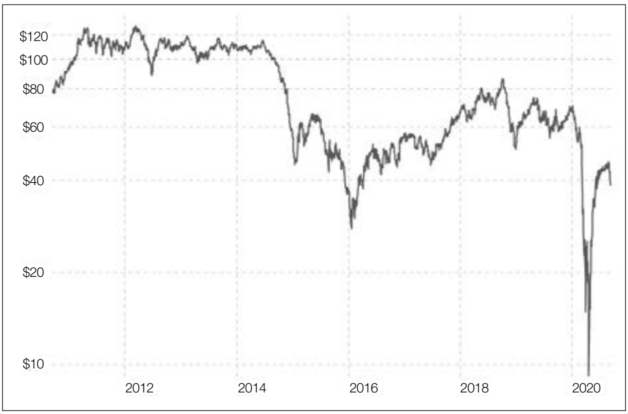

Figure 2: Crude oil price trends over the previous decade[61]

In February 2014, Ezra redeemed US$50 million of convertibles. The following month, it announced a S$95 million 4.75% fixed rate notes issue due 2016.[62] Between the start of September and late November 2014, Ezra's share price had fallen by about 30%, and it had lost half of its value on a year-to-date basis.[63]

In May 2015, it announced a US$300 million rights and convertible bond issue to repay S$225 million of fixed rate notes and S$150 million of perpetual securities.[64]

By late 2015, leverage in oil services companies had steadily risen. According to a report, the median debt to equity ratio of 18 Singapore-listed offshore service vessels (OSV) owners was up by about a third from a year earlier at 1.08 at the end of the second quarter.[65] Charter rates and utilisation of the global OSV fleet had fallen about 20%. The oil and gas sector saw a growing strain on liquidity, as banks were cautious about lending to the sector because of its uncertain prospects. To de-leverage, Ezra sought to sell and lease back its flagship construction vessel, Lewek Constellation, as an alternative to bank lending.[66]

In November 2015 – less than six months after the US$300 million rights and convertible bond issues – Ezra announced a consent solicitation exercise for its S$150 million notes due in 2018 and the S$95 million notes due in 2016. In its circular, it said that the "sustained downturn in oil company expenditure continues to result in lower industry activity and the timing of new awards to market remains uncertain. Consequently, the Company believes that the Company and its subsidiaries (the Group) is likely to face strong headwinds in the foreseeable future."[67] Ezra sought approval for amendments to the "negative pledge, financial covenants, and non-disposal clauses of each of the notes".[68]

By the numbers

All three companies had financial years ending 31 August, and up until 2015, all three had increasing revenues and were profitable.

Ezra had relatively lean returns, with return on equity of around 1.2% in 2013, before increasing to just 4.6% in 2014 and 4.9% in 2015, while return on assets was about 1% in 2014 and 2.9% in 2015. Profit before tax to finance expense fell to 0.91 in 2014 before increasing to 2.8 in 2015, while debt to total assets was consistently above 0.6, with a ratio of 0.67 in 2015 (with perpetual securities of about US$123 million included in debt). In 2015, current liabilities as a percentage of total assets had risen to 50% from about 32% the year before, with current liabilities making up 74% of total liabilities compared to 47% in 2014.[69,70]

In 2014 and 2015, there were rights, convertible bonds and fixed rate note issues amounting to nearly US$400 million by Ezra, with earlier convertible bonds, fixed rate notes and perpetual securities repaid.[71]

In terms of profitability and interest coverage ratios, Triyards and EOL ratios were better, with EOL's total debt ratio comparable to Ezra, while Triyards' was generally lower.[72,73,74,75,76,77]

Triyards placed out 29.5 million shares to institutional investors and accredited investors at S$0.70 each in September 2014. It also issued 29.5 million warrants to Ezion Holdings Limited (Ezion) in November 2014, exercisable at a premium of 9.6% to the then market price, with vesting conditions based on new ship building contracts worth at least US$150 million and contracts for engineering services being entered into by Ezion Group or a party introduced by Ezion, and Triyards or its subsidiaries.[78] While there was no direct relationship between Ezion and Triyards, Ezion's independent Chairman Dr. Wang Kai Yuen was an independent director of EOL.[79]

EOL chose a different strategy to raise more funds – it pursued a secondary listing on SGX in October 2014. DBS Bank was the issue manager, and DBS Bank and OCBC Bank were joint bookrunners and underwriters for the public offer of 9.085 million shares and 39.5 million placement shares at S$1.21 each.[80] It was followed by an announcement of a US$500 million multi-currency debt issuance programme in March 2015.[81]

By the time of the registration of the prospectus on 29 September 2014, the Brent crude oil price had fallen nearly US$20 from its peak that year of US$114.02 on 17 June 2014 to US$95.70. The multicurrency programme was announced when the price had fallen further to about US$60.[82]

Within about 15 months of the secondary listing, EOL announced a net loss for FY2016 Q1 and never recovered.[83] Its trading on the OSE and SGX was suspended on 4 March 2017,[84] and it was to be delisted from the OSE even though that is still being appealed.[85]

Still healthy on board…but getting a little seasick

All three companies were audited by Ernst & Young LLP (EY).

Even though Ezra announced a consent solicitation exercise on 9 November 2015, [86] both the directors and external auditor gave the company a clean bill of health in the annual report for the year ended 31 August 2015. In the directors' statement dated 23 November 2015, the directors said that "at the date of this statement, there are reasonable grounds to believe that the company will be able to pay its debts as and when they fall due." Similarly, the independent auditor's report dated the same day gave an unmodified opinion, with no emphasis of matter.[87] However, the company was about to report its first quarterly loss for the quarter ended 30 November 2015 less than two months later, on 14 January 2016.[88]

Likewise, the directors and external auditor of Triyards gave the company a clean bill of health – not only for the financial year ended 31 August 2015 but also for the following financial year.[89,90]

However, all the major financial indicators for Triyards for FY2016 were getting worse – return on sales had about halved; return on equity had fallen from 13% to eight percent; return on assets had fallen from seven percent to four percent; net profit before tax to finance expense had fallen from six times to four times; cash flow from operations had turned from positive S$58 million to negative S$30 million; bank borrowings, notes and other payables increased from S$103 million to S$150 million; and the ratio of bank borrowings, notes and other payables to total assets had risen from 0.23 to 0.31.

Over at EOL, the directors' statement and independent auditor's report dated 12 November 2015 for the financial year ended 31 August 2015 indicated that all was well. The FY2015 results were boosted by a huge "other income" amount of US$154.7 million relating to "bargain purchase arising from the reverse acquisition" (negative goodwill) – to provide some perspective, total revenue for FY2015 was US$247.2 million and gross profit was US$29.4 million. Note 6 on page 97 of the annual report provides more information on this. It states:[91]

> "Following the completion of the Business Combination on 3 October 2014, the Acquiring Group have been consolidated as a reverse acquisition. For the purpose of the reverse acquisition, the cost of acquisition of the legal subsidiaries listed under the Acquiring Group is recorded as equity. The cost of acquisition is determined using the fair value of the issued equity of the Group before the acquisition, being 110,952,502 shares at the market price of Norwegian Kroner 5.09 (equivalent to US$0.78) per share at the date of acquisition. It is deemed to be incurred by the Acquiring Group in the form of equity issued to the holding company. The Business Combination has enabled the Group to become a full-service offshore support service provider and to create cross-selling opportunities derived by leveraging on the enlarged operating platform and client bases, hence generating economies of scale. The bargain purchase arose as a result of the lower share price at the completion date."

Revenue had fallen from US$285 million the year before to US$247.2 million, gross profit from US$50 million to US$29.4 million and the ratio of bank borrowings, notes and other payables to total assets was 0.98 in FY2014 and 0.89 in FY2015.[92,93]

Leaky vessels

Serious trouble was just a ship length away.

EOL started reporting quarterly losses in January 2016 – just 15 months after its secondary listing on SGX. By October 2016, there were more signs that Ezra was in serious trouble. On 30 October 2016, it made its first announcement that it had applied for an extension of time to announce its results for FY2016.[94] On 22 December 2016, it announced that it had been granted an extension of time to hold its Annual General Meeting (AGM) for FY2016.[95] Further applications for extension of time to announce FY2017 Q1 results and to hold the AGM were sought. There has been no further annual report and audited financial statements published by the company after FY2015, and no AGM for FY2016 or after. On 20 March 2017, trading in Ezra's shares was suspended and it has remained suspended since.[96]

Triyards was still announcing contract wins to build new vessels until the first half of 2017, with a contract to build two ferries for Scottish and Asian customers worth US$20.64 million in March 2017,[97] as well as seven tugboats and one crew vessel worth US$32.90 million in April 2017.[98]

For EOL, the FY2015 Q4 results showed a 19% decrease in revenue compared to the previous corresponding quarter, and gross profit had fallen from US$10.2 million to negative US$1.4 million.[99]

On 11 January 2016, EOL announced a US$3.2 million loss for the quarter ended 30 November 2015, compared to a profit of US$148.4 million for the corresponding quarter the previous year.[100] This was followed by losses of US$140.5 million, US$23.2 million and US$98.5 million for the last three quarters of FY2016. The 2016 annual report was issued more than a year late on 26 January 2018.[101] The directors' statement in the 2016 annual report dated 8 December

2017 now painted a different picture although the directors remained positive about the restructuring. It states:[102]

> "…at the date of this statement, the Company has entered into a binding term sheet with potential investors for the injection of an aggregate amount of US$50 million into the Company….as part of the financial restructuring of the Group… and subject to the completion of the Investment and the successful Restructuring, there are reasonable grounds for the FY2016 Financial Statements to be prepared under the assumption of going concern…"

The auditor's report now contained a disclaimer of opinion on the basis that the auditors were not able to obtain sufficient appropriate evidence to provide a basis for an audit opinion. The basis for the disclaimer of opinion relates to the use of the going concern assumption, the carrying value of assets, and the completeness of liabilities and provisions.[103]

Changing crew and jumping ship

Around the time when the three companies started to face challenging industry conditions and were under increasing stress, there were numerous resignations and changes in personnel. At Ezra, IDs Soon Hong Teck[104] and Ngo Get Ping[105] resigned or retired in December that year. On 11 December 2015, it was announced that Non-Executive Chairman Koh Poh Tiong, who had been on the board for just over four years, would retire on 1 February 2016, with Lee Kian Soo taking over as Non-Executive Chairman.[106]

Capt. Adarash Kumar, resigned as ED/COO of Ezra in September 2015, purportedly to concentrate on his role at EOL, where he had been appointed CEO that same month.[107] CFO Eugene Cheng resigned in January 2016,[108] with Chan Eng Yew taking over as interim CFO while remaining concurrently as Triyards' CEO.[109]

On 5 May 2015, it was announced that Lionel Lee had been appointed as Chairman of EMAS AMC in addition to his role as Group CEO and MD.[110] On 1 May 2015, he stepped down from the boards of EOL and Triyards.[111,112]

Over at Triyards, Lee Kian Soo had taken over the reins as Non-Executive Chairman after Lionel Lee stepped down.[113] Chan Eng Yew and Andrew Mak both resigned from their ED roles at the same time but retained their executive roles of CEO[114] and COO[115] respectively.

On 16 December 2015, just five days after it was announced that Koh Poh Tiong would step down as Ezra Chairman, it was announced that the AC Chairman, Loy Juat Boey, would retire as ID[116] to be replaced by Lim Kuan Meng.[117] Loy Juat Boey had served on the board for just over two years. A substantial part of her career was at Asian Pacific Breweries where Koh Poh Tiong had been CEO.

With Lionel Lee's resignation as Vice Chairman of EOL in May 2015, Capt. Adarash Kumar was re-designated from NED to ED,[118] and then appointed CEO in September 2015.[119] CFO of EOL, Jason Goh, resigned in January 2016, replaced by Hsu Chong Pin.[120]

By February 2016, Lee Kian Soo was Chairman of all three companies – Non-Executive Chairman at Ezra and Triyards and Executive Chairman at EOL. Lionel Lee was Group CEO and MD, and Chairman of EMAS AMC, at Ezra.

There was to be another round of board and management changes in the three companies.

Chan Eng Yew resigned as interim CFO of Ezra in March 2017.[121] Philip Eng, the lead ID, finally resigned in August 2019 with the announcement stating that the Chapter 11 plan had been implemented and the company will soon be applying to place itself in judicial management in the near future.[122]

At Triyards, Andrew Mak left on 25 August 2017, although it was only announced on 7 September 2017.[123] CFO Yang Naing Aung resigned in March 2018.[124] ID Simon Lockett, who had joined the board in February 2015, resigned in May 2018,[125] and Chan Eng Yew completed the resignations when he left as CEO in February 2020.[126]

At EOL, ID Dale Bruce Alberda was re-designated to ED in February 2017.[127] CEO and ED Capt. Adarash Kumar resigned with effect from April 2018,[128] while CFO Hsu Chong Pin left in December 2018.[129]

Hitting icebergs

The first Mayday message was sent out by ECS, which filed for Chapter 11 bankruptcy protection in the U.S. on 27 February 2017.[130] This was just eleven months after the agreement between EMAS AMC and Chiyoda Corporation (Chiyoda) for the joint venture was completed.[131]

Ezra's unaudited FY2016 results released on 29 November 2016 showed the carnage.[132] It reported a net loss after tax exceeding US$1 billion. Current liabilities to total assets was 0.8 and current liabilities made up 97% of total liabilities.

In March 2017, Brent crude oil price had recovered to about US$52 a barrel. However, eventually, Ezra followed ECS in filing for Chapter 11 bankruptcy protection in the U.S. on 18 March 2017.[133]

As of April 2017, it was reported that Ezra had US$150 million of 4.875% notes due the following year, and debts of up to US$2 billion. With its worsening financial condition, the founding Lee family was said to have put up a bungalow for sale in 2016.[134]

Following the bankruptcy filing in March 2017, Ezra's management held its first meeting with bondholders on 17 April 2017. However, uncertainty remained as to whether the bondholders could recover their investments. This was because corporate guarantees accounted for 85% of Ezra's total liabilities. It was claimed that these were accumulated over the years when company loans were taken up by Lee Kian Soo. According to KGI Securities analyst Joel Ng, it was possible that shareholders would not recover any investment while creditors might get some equity in return.[135]

Troubles spread like a plague

EOL's wholly-owned subsidiary, Lewek Champion Shipping Pte Ltd (Lewek Champion), was to be wound up following a hearing on 14 July 2017.[136] EOL owed US$68.8 million to Lewek Champion for the financial period ended 30 November 2016. The winding up of Lewek Champion potentially would materially affect the financial position of EOL.[137]

On 29 August 2017, EOL commenced restructuring proceedings in Singapore after entering into a binding term sheet with certain potential investors.[138] Its 2016 audited financial statements, released only in January 2018, showed how deep the hole was. It reported a net loss after tax of US$535 million, the ratio of debt to total assets was nearly 1, and ratio of current liabilities to total liabilities was 0.85.

Triyards was also deep in trouble. Due to the difficulties faced in obtaining new liquidity, it converted from a trading halt to a trading suspension. It was not a going concern unless there was a feasible restructuring plan. This problem was exacerbated after the release of its results for the third quarter ended 31 May 2017 in July 2017, which showed a loss of US$63.27 million compared to a profit of US$4.12 million for the comparative period in the previous year.[139] Triyards faced difficulties in loan repayments and delayed collections from debtors, and sought negotiations with its creditors.[140]

The financial position of Triyards worsened when two shipbuilding contracts were cancelled on 29 December 2017. The cancellations resulted from the company being unable to complete the projects on time due to cash flow problems. As a result, Triyards suffered a fall in revenue, resulting in a loss of US$162.5 million for the financial year ended 31 August 2017. The loss per share amounted to 50.06 U.S. cents. This was a -1,013% change from 2016 when Triyards enjoyed a net profit of US$17.8 million and earnings per share equate to 5.48 U.S. cents. The ratio of debt to total assets had climbed to 0.83, and current liabilities to total liabilities was nearly 1.[141]

Triyards' employees faced delayed salary payments in Vietnam and financing was held back by the banks due to defaults by Ezra. On 6 August 2018, Ocean Energy Ventures filed a claim of US$2.1 million against Triyards. The promised aid of US$5 million from Ferrell Vanguard Fund SPC was thus activated. Ferrell made a cash injection of the balance amount of US$3.8 million[142] and purchased some equipment and tools from Triyards' two Vietnamese subsidiaries.[143]

However, this was not the end. Creditors made claims of approximately US$80.1 million from Triyards. The matter was made worse when a US$15.2 million construction contract was terminated with its subsidiary, Saigon Offshore Fabrication & Engineering Ltd (SOFEL).[144] However, the restructuring plan offered by Ferrell Vanguard Fund SPC gave a ray of hope as it afforded a further US$50 million funds injection in the form of debt or equity into Triyards.[145]

Shy white knights

There was no shortage of potential white knights but none could eventually be convinced to invest as part of the restructuring of the companies.

On 11 December 2017, a new term sheet was entered into between EOL and BT Investment (BTI), a subsidiary of Baker Technology Limited. BTI would inject a minimum amount of US$25 million together with another co-investor. If this co-investor could not be found, then BTI would invest a full amount of US$50 million. With the restructuring plan, EOL and its wholly owned subsidiaries applied for a scheme of arrangement under the Singapore's High Court and was heard on 21 December 2017.[146]

An additional four-month extension for court moratorium was sought by EOL to support the restructuring of its group of companies.[147] However, on 2 July 2018, BTI withdrew its plans to inject funds.[148]

On 26 October 2018, EOL announced a new non-binding term sheet with Udenna Corporation (Udenna) involving an investment amount of US$73.29 million.[149] However, on 13 February 2019, EOL announced that Udenna would not be proceeding with the investment.[150] An application to be placed under judicial management (JM) was eventually approved on 21 October 2019, and the validity of the JM order was extended until 20 October 2020.[151]

Meanwhile, on 18 April 2018, the Stock Exchange Appeals Committee in Oslo repealed the resolution to delist EOL,[152] allowing it to remain listed on the OSE. Following the failed attempt to delist EOL, the Financial Supervisory Authority of Norway (FSA) on 15 August 2018 directed OSE to delist EOL. Accordingly, EOL was to be delisted with effect from 28 September 2018 although the appeal against this decision had been referred to the final appellate body, the Norwegian Ministry of Finance.[153]

Maybe...but no

On 13 March 2018, an application with regard to the cross-border protocol was made by Ezra and approved by the High Court. This was to facilitate the administration of the bankruptcy procedures in the U.S. and restructuring in Singapore more efficiently.[154]

Soon after BTI expressed interest to invest in EOL, Asia Fund Space (HK) Ltd (AFS), a financial consultancy specialist, expressed interest in helping Ezra. Ezra entered into a binding proposal with AFS, which was announced on 1 March 2018.[155]

Under the proposal, all the existing assets would be spun off under a separate trust or a new entity to benefit existing creditors and new businesses would be established. This would allow Ezra to start as a clean shell company so that new equity injected by AFS would be used solely for creating business. Ezra would receive a cash injection of US$1 million in exchange for 92% of Ezra's enlarged share capital after the reorganisation. The remaining eight percent stake would be shared equally between existing shareholders and creditors.

AFS also planned to set up a second holding company for the acquisition of real estate business in Myanmar with a proposed equity amount of US$25 million from investors. As part of the plan, AFS would offer free shares to the stakeholders of Ezra in this new separate holding company.

In order to enforce the reorganisation plans in place, Ezra needed to seek approval from both Singapore and the U.S. courts. Approval from shareholders and creditors was also required with the plans proposed under a scheme of arrangement.[156]

However, on 29 March 2018, Marina Aquata Shipping Pte Ltd, a special purpose vehicle (SPV) owned by Standard Chartered Bank, terminated the bareboat charter of the platform supply vessel with EOL. Ezra had issued a guarantee and indemnity in favour of the owner. This termination followed allegations of repeated breaches of terms and other covenants by EOL and Ezra. Three other SPVs of the bank had also reportedly cancelled agreements with EOL and demanded reimbursement earlier in December 2017 (although no announcement by EOL or Ezra was made at that time).[157]

Two weeks later, Ezra announced that the proposed investment by AFS fell through as AFS failed to meet the agreed requirements.[158] It had failed to list a trust or newly formed entity with the existing assets of Ezra on the Catalist Board of the SGX and buy over the Myanmar property business as agreed. [159]

Between June 2017 and January 2019, Ezra issued a number of scheme of arrangement notices.[160] However, eventually, it applied to the High Court of Singapore on 4 February 2020 to put the company into JM. The hearing for the JM application has been rescheduled several times.[161]

Sinking together

In September 2018, DBS Bank demanded payment of approximately US$43.9 million after Triyards defaulted several times.[162] The winding up application from Ocean Energy Ventures in August 2018 was deemed as a default although the application was withdrawn after negotiations.[163]

Approximately 12 months after trading was suspended and the attempts by Ezra to restructure its debt, creditors lost confidence not only in Ezra but also in Triyards.[164] Despite obtaining a cash injection from Ferrell Vanguard Fund SPC, creditors continued to demand for payment.[165]

On 17 September 2018, DBS Bank appointed a receiver for the Singapore-incorporated subsidiary, Strategic Marine, and other assets. As of 21 September 2018, Triyards' subsidiaries had nearly US$90 million of claims against them.[166] Hong Leong Finance, another principal banker of Triyards, filed for a winding up on 18 September 2018. Besides claims and demands relating to Triyards, further litigation claims and statutory demands were made against its subsidiaries. On 3 October 2018, Tractors Singapore Limited, a creditor of Triyards Marine Services – a subsidiary of Triyards – submitted another winding up petition.[167]

On 5 November 2018, Triyards announced that restructuring proceedings had commenced as statutory demands continued to pile up.[168] On 8 November 2019, OCBC Bank applied to place Triyards into JM and for interim judicial managers to be appointed.[169] Triyards was placed in JM on 13 February 2020,[170] and the JM order has been extended to 12 February 2021.[171]

Underwater – The EMAS Chiyoda Subsea joint venture

Within the “Tri-tanic” Group, there were a number of puzzling investments and transactions. One is the joint venture (JV) between Ezra and Chiyoda of Japan.

The JV was said to have an implied value of US$1.25 billion. A binding agreement was concluded in September 2015, and in March 2016, Ezra and Chiyoda confirmed that Chiyoda had completed its investment into Ezra’s subsea services business, EMAS AMC, to form ECS.[172]

In June 2016, Ezra announced that it was selling 10% of its 50% stake in ECS to Nippon Yusen Kabushiki Kaisha (NYK) for US$36 million while Chiyoda would sell 15% of its 50% stake.[173] The price at which Chiyoda would sell its stake to NYK was not disclosed, but Ezra would incur a net loss attributable to the sale of shares of approximately US$6.652 million.

Further, each of the JV partners was to provide shareholder loans to ECS immediately after completion, but these loans were not proportionate to the shareholdings. EMAS AMC was to provide a loan of US$36 million, which was the amount of the sale consideration, while Chiyoda would provide US$11.67 million and NYK US$8.33 million. Ezra said that the transaction would provide benefits from partnership and synergies, and help unlock shareholder value.[174] Three days later, the company announced that it had entered into a binding agreement, although the transaction was subject to the approval of Ezra’s shareholders. The transaction was completed in September 2016.[175]

In July 2016, Ezra had announced that an ECS and LTHE consortium had won a US$1.6 billion contract from Saudi Aramco.[176] However, within about nine months of the formation of ECS, signs of trouble had emerged. On 20 December 2016, Ezra announced that ECS was in discussion with various parties on its financial obligations.[177]

Then came some startling revelations. Following a series of media articles about the ECS partners – Chiyoda and NYK – taking massive impairments of their stakes in ECS and a claim for arbitration against ECS for US$14.7 million, Ezra issued a “clarification” announcement on 3 February 2017. It disclosed that the “company’s investments in, shareholder loans to and the inter-company balances owed by the ECS Group amounted to US$170 million and the full amount may have to be written down after the company’s assessment. The Group had recorded a net current liability position of US$887,220,000 for the financial year ended 31 August 2016”.[178]

Chiyoda and NYK revealed write-downs totaling S$635 million. The effects of the dire situation were felt as far as Houston, where the workforce was cut by half to about 200 within a year and employees feared losing their jobs. The Houston operation, which provided offshore energy services, was searching for clients, but the Japanese investors had cut off additional funding, apparently losing confidence in a recovery in offshore drilling anytime soon.[179]

U.K.-based offshore operator Bibby Offshore Limited (Bibby Offshore) also filed a case in the Texas Southern District Court against ECS in January 2017. Receivables from ECS to Bibby Offshore amounted to US$14.7 million from the US$18.1 million worth of contracts performed in Trinidad in 2016. ECS had withdrawn from an agreement to mediate on 12 January 2017.

Bibby Offshore was granted the control of subsea vessel Lewek Express by the court.[180] Despite ECS arguing that the vessel was not owned by the company, the judge ruled that the vessel's registered owner, Ocean Lion Shipping Ltd, is a Hong Kong holding company owned entirely, or substantially, by Ezra.[181]

The company said that "the board wishes to clarify that the company has no dispute with Bibby Offshore…Bibby Offshore's claims are against ECS, which the company does not control".[182]

With mounting claims and civil suits against ECS, it eventually filed for Chapter 11 protection on 27 February 2017.[183] The JV had sunk in less than a year.

Unrelated to ECS, the same "clarification announcement" issued on 3 February 2017 also said that a subsidiary of EMAS AMC had defaulted on payment of charter hire for October 2016 but that the vessel owner had agreed not to pursue repayment and had not called upon Ezra as guarantor to repay.[184] However, ten hours later, the company issued another "clarification announcement" that the vessel owner did not agree not to pursue repayment but had instead made demands on the company as guarantor to make payment.[185]

A convoluted affair – Perisai Petroleum Teknologi

Perisai Petroleum Teknologi Berhad (Perisai) was a company listed on the Mainboard of Bursa Malaysia. It described itself as a Malaysia-based upstream oil and gas service provider, offering offshore services and solutions covering offshore drilling, offshore production and offshore support.[186] It was accounted for as an associate of Ezra.

According to Perisai's 2015 annual report, as at 31 March 2016, Ezra had deemed interest of 23.01% in Perisai made up of a 11.18% stake held by Ezra's wholly-owned subsidiary HCM Logistics and a 11.83% held by EOL.[187] Between December 2015 and October 2016, Perisai made private placements amounting to approximately 10% of the existing issued and paid-up capital.[188] As of 29 September 2017, the stake was 22.32%, made up of 10.84% held by HCM Logistics and 11.48% held by EOL, as shown in Perisai's 2017 annual report.[189]

Disclosure of associate's default

On 4 October 2016, Ezra and EOL announced that Perisai had defaulted on its S$125 million 6.875% notes due in 2016.[190] Perisai had on 18 August 2016 announced that it was commencing discussions with noteholders.[191] Subsequently, on 9 September 2016, Perisai announced that it was commencing a consent solicitation process.[192] However, this was not disclosed by Ezra or EOL, and was only disclosed after Perisai announced on 3 October 2016 that the extraordinary resolution tabled at the meeting with noteholders had not been passed, and the notes and interest were immediately due.[193]

On 12 October 2016, Perisai announced that it had triggered the criteria for a Practice Note 17 (PN17) company because of the default and must comply with certain conditions, including the submission of a regularisation plan. Perisai faced suspension in trading of its shares and delisting if it failed to exit the PN17 list.[194] On 13 October 2016, it issued another announcement referring to the previous day's announcement, confirming that it was now a PN17 company.[195] Ezra and EOL only made a further announcement after their 4 October announcements about the developments at Perisai after the close of trading on 13 October 2016. By that time, Perisai had already made five further announcements relating to its default and the triggering of the PN17 criteria.

The default of Perisai shone light on a series of confusing announcements that exhibited the rather convoluted relationship between Perisai, Ezra and EOL, and possible breaches in the listing rules.

A transaction that never was[196]

On 16 December 2015, at 11.31 pm, EOL announced the proposed sale of the 12.13% stake that EOL held in Perisai to Ezra. It explained that the 12.13% stake in Perisai arose out of a previous transaction when EOL sold its stake in a company to Perisai. It also mentioned that Ezra, through HCM Logistics, owned another 11.5% of Perisai's shares. It said that after the transaction, "Ezra and HCM will indirectly own a total of 20.6% of Perisai". This was incorrect as they would own a total of 23.63% of Perisai.

The announcement said: "The current value of EMAS 9.1% stake in Perisai based on its listing price is approximately MUSD 11. The agreed price for the Shares is MUSD 56, which equals a premium of approximately 500% compared to the current listing price. The purchase price is fixed and shall not be adjusted. The price has been determined based on the cost of EMAS' investment at inception. The purpose of this transaction is to consolidate the interest in Perisai in a single entity at Ezra level."[197]

"MUSD" refers to U.S. dollars in millions. The above announcement also erroneously stated that the stake was 9.1%, when it was actually 12.13%. EOL had until 31 December 2016 to sell its stake to Ezra, subject to entering into definitive agreement.

Nothing further was heard about this transaction, with no questions asked by the two stock exchanges on which it was listed (OSE and SGX). Between 14 and 16 December 2016 immediately preceding the announcement, EOL's share price had fallen by 16%.

Leaky call and put options

A series of announcements by EOL highlighted the existence of call and put options that had been disclosed by EOL in the notes to its financial statements, including in note 8 of its 2015 annual report.[198]

EOL had entered into a JV with Perisai (PPT), which resulted from Perisai transferring a 49% equity interest in SJR Marine to EOL on 5 December 2012. SJR Marine owned a vessel called Enterprise 3.

Under a supplementary agreement, the following terms were spelt out:[199]

"(i) PPT grants the Company the right to acquire all of PPT's remaining equity interest in SJR Marine (the "Call Option Shares") from PPT, and the Company may exercise the Call Option at the Call Option Price at any time during the two year period from the completion date of the acquisition of the 49% equity interests in SJR Marine ("Completion Date") ("Call Option Period"). The Call Option Price is fixed at the price equivalent to 51% of the net assets value of SJR Marine at the Completion Date;

(ii) In the event that Call Option is not exercised during the Call Option Period, it says "the parties shall use their best endeavours to procure SJR Marine to sell SJR Marine's vessel, the Enterprise 3, to an interested third party within a period of 12 months from the expiry of the Call Option Period…on terms to be agreed by the parties. Where SJR Marine is unable to dispose of Enterprise 3 within the Enterprise 3 Disposal Period, PPT (Perisai) shall be entitled to exercise its right under the Put Option; and

(iii) The Company grants PPT the right ("Put Option") to sell all of its remaining equity interest in SJR Marine ("Put Option Shares") to the Company. The Company shall acquire the Put Option Shares at the Put Option Price which is equivalent to the Call Option Price. PPT may exercise the Put Option at any time within the period of one month prior to the expiry of the Enterprise 3 Disposal Period ("Put Option Period"). In the event that the Put Option is not exercised within the Put Option Period, PPT's Put Option Rights shall lapse."

The notes also said: "At the reporting date, management has assessed that the Call Option is out of the money".[200]

Based on the dates, the call option should have lapsed on 5 December 2014 and the put option by 5 December 2015. However, in 2016, EOL and Perasai were still in dispute.

On 4 October 2016, EOL issued an announcement about the put option which gave Perisai the right to sell its 51% interest in SJR Marine to the company. It said the value of the put option was US$43 million. The announcement also said that "an indicative offer for financing from a financial institution to SJR Marine" had been received.[201]

On 26 November 2016, EOL announced that it and Perisai have reached an agreement to defer the exercise of the put option which would allow Perisai to exercise the put option "at any time after the close of business on 2 December 2016 but within the Put Option Period… In the event the Put Option is not exercised…within the Revised Put Option Period, the Put Option Rights will lapse."

There was no explanation why EOL would agree to a one-year extension of the put option which could require it to pay US$43 million for the remaining 51% interest in SJR Marine.

On 1 December 2016, EOL announced that it had given a further extension to Perisai, to 8 December 2016.[202] On 8 December, another announcement said that EOL had issued a notice of termination of the original share sale agreement, various supplemental agreements and the shareholders' agreement. It said the put option would be extinguished. It further added that Perisai was required to sell its 51% shares in SJR Marine to EOL on the 30th day from the receipt of the termination notice, based on the terms of the shareholder agreement and following its termination.[203]

Perisai disputed the EOL's right to take the actions announced in the 8 December 2016 announcement, with the latter announcing on 13 December 2016 that Perisai was exercising the put option at the option price of US$43 million. EOL said it was disputing Perisai's claims.[204] On 23 December 2016, another announcement disclosed that a settlement agreement had been reached, with EOL buying the put option shares and paying US$20 million in cash and subject to completion, a total consideration of US$43 million and accrued deferred payment interest. This was subject to various conditions precedent.[205]

Nothing further was heard until 21 April 2017 and 24 May 2017 when EOL announced that Perisai needed more time.[206,207] An announcement on 20 August 2017 said that EOL was seeking legal advice regarding an announcement by Perisai.[208] On 29 September 2017, EOL announced that the settlement agreement had lapsed and that it had paid US$1 to acquire the 51% of SJR Marine, but Perisai had disputed the termination notice.[209]

The Chairman's message in EOL's 2016 annual report dated 8 December 2017 indicated that settlement had not yet being reached.[210]

The annual report also indicated that Perisai owed EOL US$332,000 under "other receivables" while a JV with Perisai (presumably SJR Marine) owed US$8.455 million. It said that the company had commenced legal proceedings against the JV to recover the receivables but that it had provided in full the remaining amounts due. EOL also disclosed that it had impaired its investment in Perisai in full, following the latter's PN17 status.

Failure to disclose interests

On 27 March 2013, Triyards announced that it had incorporated SAV Land Pty Ltd (SAV Land) in Western Australia. On 19 April 2013, it was announced that SAV Land had agreed to purchase a property – Lot 5 Clarence Beach Rd – from Henderson Supply Base Pty Ltd (HSB) for A$6.75 million in Triyards shares and cash, without any valuation. The announcement stated: "None of the directors or controlling shareholders of the Company has any interest, direct or indirect, in the Proposed Acquisition".[211] This transaction was not completed by 31 December 2013 and an announcement about its termination was made on 3 January 2014.[212] No reason was given for the termination.

In July 2014, it announced the incorporation of Triyards Strategic Investments (TSI) and Triyards Strategic Vietnam (TSV), which purchased Strategic Marine (Singapore) (SMS) and Strategic Marine (Vietnam) (SMV) for A$23.3 million from Henderson Marine Base Pty Ltd (HMB).[213] The proposed acquisition was announced on 14 October 2014 and completed the following day.[214] Again, the announcement said that no director or controlling shareholder has any direct or indirect interest.

However, on 20 March 2015, Triyards issued a clarification saying that the board has been informed that Lionel Lee, the then Non-Executive Chairman of the company, has a beneficial interest in all the shares of Geraldton Investments Limited, which held a 20% interest in HMB.[215]

On 20 March 2015, Ezra issued a “clarification announcement” relating to another earlier acquisition announcement made on 5 March 2009. The acquisition was of Admiralty Marine Services Pty Ltd (Admiralty) by Lewek Ruby Shipping Pte Ltd, an Ezra wholly-owned subsidiary.[216] In the “clarification announcement”, Ezra said that the board has been informed by Lionel Lee, the Group CEO and MD, and his father, a NED, that one of the vendors of Admiralty, Moonshine Investments International Limited, was wholly owned by an associate of the two Lee’s.

Trading during blackout period

On 18 January 2016, a news report said that Lionel Lee had drawn the ire of Ezra investors because he sold more than 11 million shares held by his 100%-owned company Jit Sun for S$913,341 on 12 January 2016, two days before Ezra announced a first quarterly net loss of US$55.3 million, a reversal from the US$54.4 million net profit a year ago.[217]

Ezra had earlier issued a profit warning on 8 January 2016 which said that the FY2016 Q1 results would show a net loss as compared to the profit recorded in the corresponding period of the previous financial year.[218]

The sale also took place during the company’s “blackout period”. According to the “Securities Transactions” section in the corporate governance report in Ezra’s 2015 annual report, “dealings in the company’s securities are prohibited one month prior to the release of quarterly and/or full year results.”[219]

An undisclosed related party transaction?

Note 12 in EOL’s 2016 annual report, under “Trade and other receivables” states: “These amounts are unsecured, interest-free and repayable in cash on demand. Included in other receivables is an amount of US$3,500,000 relating to a refundable deposit paid to a company related to a director of the parent company”.[220] The 2015 annual report did not disclose any such refundable deposit.

A review of EOL’s annual reports dating back to 2010 showed no related party transaction that appears to be in the nature of a refundable deposit paid to a company related to a parent company director.

What now?

It seems that Ezra’s cash flow problems had started way before the crunch in the oil market. KGI Securities Singapore analyst Joel Ng noted that Ezra had been reporting negative free cash flows for 10 years, even when oil prices were above US$100 a barrel. This was said to be due to it taking up too many loans during the years when the oil industry boomed. Such problems only surfaced when the oil price fell. Persistent weak free cash flows within the Group led to a “highly unsustainable” balance sheet. Ezra could have been able to manage with the market conditions if it had a healthy balance sheet.[221]

That did not happen and Ezra and the rest of its fleet are now under judicial management. It also remains to be seen whether regulators will step in to investigate if the directors have discharged their duties and rules have been complied with.

Discussion questions

1. Discuss the interests of different stakeholders in an insolvency situation. What are the duties of directors when a company is in an insolvency situation? Critically evaluate the actions of the directors in the case of Ezra, EOL and Triyards.
2. Critically evaluate Ezra’s board of directors in terms of competency and independence, the board committees, remuneration policies and remuneration disclosures.
3. Ezra was listed on SGX together with two of its subsidiaries, EOL and Triyards. What are the potential corporate governance risks associated with such chain listings? What are SGX’s rules relating to chain listings and are they adequate? Compare them with the rules in Hong Kong and Malaysia.
4. The case study shows various transactions relating to subsidiaries, and subsidiaries of subsidiaries. What are the benefits of incorporating a subsidiary compared to having a business as a division or business unit without creating a separate legal entity? What are the potential risks to investors and other stakeholders?
5. Evaluate the main risks faced by Ezra. Did Ezra take on too much risk? Using the ISO31000 risk framework, suggest what could have been done by the board and Enterprise Risk Committee regarding the risk management of Ezra. What are the different lines of defence to help ensure the adequacy and effectiveness of internal control and risk managements and how can that be applied to cases such as Ezra?
6. Discuss the potential breaches in Singapore listing rules and laws for the EMAS Chiyoda Subsea joint venture, Perisai Petroleum Teknologi, the failure of the directors to disclose interests, and the undisclosed related party transaction discussed in the case. Be specific.
7. Consider Lionel Lee’s sale of 11 million shares two days before the announcement of the quarter’s results. What potential rules or laws are breached? How can a board mitigate the risk of its directors or employees engaging in insider trading?
8. It has been several years since Ezra and its subsidiaries had collapsed. Do you think the regulators should have taken action against those involved in the governance and management of these companies? If yes, who do you think they should take action against? What does this case say about the effectiveness of regulatory enforcement in Singapore?

9. In the U.S., companies in distress often file for Chapter 11 bankruptcy protection, as Ezra and its joint venture, ECS, did. In Singapore, companies may undergo restructuring or be placed into judicial management, to stave off a liquidation. Compare these different alternatives and how they operate.

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KIMLY: KOPI-O IN HOT WATER

Case overview

On 29 November 2018, Kimly Limited (Kimly) announced that the Commercial Affairs Department (CAD) and Monetary Authority of Singapore (MAS) have started investigations related to the company. In early December 2018, two executive directors of Kimly – Lim Hee Liat and Vincent Chia Cher Kiang – were arrested by the CAD for a possible breach of Section 199 of the Securities and Futures Act, concerning the announcement of false or misleading statements. They were subsequently released on bail. The arrests and alleged breach were purportedly related to the now-rescinded acquisition of Asian Story Corporation (ASC).

Kimly was hit with further bad news when Pokka Corporation (Singapore) Pte Ltd decided to terminate its manufacturing agreement with ASC, with the board then deciding to rescind the acquisition of ASC. The series of events alarmed the market, causing Kimly's share price to plummet to an all-time low of S$0.23 on 6 December 2018.

The objective of this case is to facilitate a discussion of issues such as director and management duties; conflicts of interest; role of sponsors in the Catalist regime; corporate governance risks relating to acquisitions; interested party transactions; and overlapping directorships on related companies' boards.

You are under arrest

It was unnerving. Lim Hee Liat (LHL) felt a sense of trepidation, as both Vincent Chia Cher Kiang (VC) and him, executive directors (EDs) of Kimly Limited (Kimly), were taken into custody by the Commercial Affairs Department (CAD) in early December 2018, for suspected breach of Section 199 of the Securities and Futures Act (SFA).[1] LHL thought about the success story he had built over the years – "the Kimly coffee shop empire", and its ambitious plans and potential.

Undeterred, he nevertheless submitted himself for re-election at the Annual General Meeting (AGM).[2] In January 2019, Kimly convened the AGM and both LHL and VC were re-elected.[3]

The shares of Kimly were briefly suspended from trading on 22 November 2018.[4,5] The suspension was due to the joint investigation launched by the CAD and Monetary Authority of Singapore (MAS) and the unravelling of the acquisition of Asian Story Corporation (ASC).[6] There was widespread speculation that the probe had to do with the controversial acquisition of manufacturing drinks company ASC.[7]

This case was prepared by Guo Yushan, Ivory Teo Puay Ting, Law En Tian, Michelle Tan Hui Jun, Ng Shi Ya Rachel and Wong Shi Ying, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been substantially re-written, with information added, by Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees.

It was not long before Kimly rescinded the transaction, following the decision by Pokka Corporation (Singapore) Pte Ltd (Pokka) to terminate the manufacturing agreement between Pokka and ASC.[8] The former CEO of Pokka, Alain Ong Eng Sing (AO), was soon thrust into the spotlight as well, following a report by Lianhe Wanbao that he was poached to join Kimly following the acquisition.[9] It turned out that Wang Chia Ye (WCY), the vendor of ASC, shared a complex web of relationship with various parties in the acquisition.[10]

A story with a promising start was not going according to the script.

Menu for growth

"My wife and I used to spend many of our dates at coffee shops. My friends and I would hang out frequently at coffee shops too, and that was what inspired us to start up [one] of our own,"

– Lim Hee Liat, in an interview with The Edge Singapore[11]

The largest traditional coffee shop operator was started by LHL back in 1990 when he was just 24, along with several of his friends.[12] It was second nature for LHL to have his first business venture in the Food and Beverage (F&B) business given that he is a self-professed "kopi kid", whose love for coffee shops prompted him to incorporate the company which would eventually become a major player in the F&B industry.[13] With the opening of his first shop in Yishun, he gradually expanded operations to 121 food stalls, 56 coffee shops, three industrial canteens and five food courts in schools, making Kimly one of the four largest coffee shop operators in Singapore.[14] Out of the 56 coffee shops, five are managed under a third party brand while the rest are managed under the Kimly brand (the master-brand of the LHL Kimly Group).[15] In consideration for the management services, the third party pays Kimly a fixed monthly management fee and a quarterly variable management fee based on certain performance indicators.[16]

Kimly grew its business in two key revenue segments – the Outlet Management Division and the Food Retail Division. Under the former, Kimly is the master leaseholder and is extensively involved in the leasing of food stalls to the vendors who are essentially the lessees. Cleaning, utility and management services are also provided to vendors and third-party coffee shops under the arrangement. As for the latter, it primarily involves the sale of cooked food. Kimly's board and management believe that this diverse portfolio and multiple revenue streams would increase the resilience of Kimly's business and help it maintain stable revenue growth over the years.[17]

Essentially, Kimly manages coffee shops and food courts, which are leased from the Housing Development Board (HDB), private landlords or master lessees. The company then sublets the leased spaces to food vendors. Hence, revenue is largely generated through rental income from the shops which are leased out. To increase growth and performance, Kimly plans to acquire more coffee shop and food court spaces. Kimly acknowledges the stiff competition in this business with competitors such as Koufu. Additionally, Kimly has to grapple with internal factors such as limited capital to fund expansion.[18]

Brewing the recipe for success

"We are very encouraged by the positive response to our IPO from the investors, and we believe their warm reception underscores the strength of Kimly's business fundamentals and our future growth potential."

– Vincent Chia Cher Kiang, executive director of Kimly[19]

In March 2017, Kimly launched its initial public offering (IPO).[20] Kimly engaged PrimePartners Corporate Finance as its sponsor, and UOB Kay Hian as its underwriter and placement agent.[21]

The IPO, priced at S$0.25 per share, was well-received and oversubscribed. The shares started trading in March 2017, opening at S$0.55 – a 120% premium over the offer price.[22]

The IPO was used to raise capital for the expansion of Kimly's business and generate more public awareness to enhance its public image in both the local and international markets. Kimly allocated the total net proceeds of S$43.5 million to four main purposes – business expansion through acquisitions of businesses and coffee shops; refurbishment of existing food outlets; upgrading of headquarters; and investment in information technology capabilities. Approximately 70% of the proceeds were allocated for acquisitions, joint ventures and general business expansion plans.[23,24]

Diluted kopi

Kimly only allocated 3.8 million shares to the public, or a mere 2.19% of the enlarged share capital. This resulted in the public tranche being 336 times oversubscribed.[25] In 2016, eight of 11 Catalist IPOs comprised only of placement shares.[26] A Straits Times report emphasised the importance of having public tranches in order to minimise the disparity in treatment between the large institutional and small retail investors.[27]

The Mainboard public subscription tranche requirements do not apply to companies listing on Catalist Board, given the difficulties that Small Medium Enterprises (SMEs) face when trying to raise capital. Some believe that imposing a minimum public tranche may deter the listing of companies on the Catalist Board.[28]

After the IPO of Kimly, the shareholding of the controlling shareholder, LHL, fell from 51.25%, to 42.42% of the enlarged share capital. The next largest shareholders are co-founders Peh Oon Kee (POK) and Ng Lay Beng (NLB) with 8.60% and 6.68% shareholding respectively.[29]

The chefs

At the time of listing, the board consisted of six directors. LHL was Executive Chairman, VC was ED, AO was non-independent non-executive director, and there were three independent directors (IDs), Ter Kim Cheu (TKC), Wee Tian Chwee Jeffrey (WTC) and Lim Teck Chai, Danny (LTC).[30]

LHL and VC had more than 25 years and 20 years of experience in the F&B industry respectively. AO was deputy group CEO and director of Pokka Corporation Singapore Pte

Ltd and director of Pokka International Pte Ltd. While AO was with Pokka, which was one of Kimly's beverage suppliers, he and a sales representative had paid a visit to Kimly. When Kimly decided to get listed on the Singapore bourse, it identified him as a potential non-independent non-executive director because of his "industry and business knowledge and experience".[31] Following the listing, he joined the board and became a member of the Audit Committee (AC) and Remuneration Committee (RC).

TKC was the lead independent director and Chairman of the Nominating Committee (NC) and member of the AC. He holds a bachelor degree and a master degree in law and has held various legal positions in the public sector. TKC was also an ID of SGX-listed Hong Leong Finance.[32] He had a familial relationship with AO, who is his nephew.[33]

LTC was the Chairman of the RC and a member of both the AC and NC. He has extensive experience as a director of listed companies, and was concurrently on the boards of TEE Land Limited, UG Healthcare Corporation Limited, Stamford Land Corporation Ltd (Stanford Land), and Choo Chiang Holdings Ltd as an ID. He is also an equity partner in the law firm, Rajah & Tann Singapore LLP.[34]

WTC has an accounting and audit background and founded his own public accounting firm. He chaired the AC and was a member of the RC.[35]

Asian Story

"The Asian Story brand has a 7.7% market share and is ranked the No. 3 brand in the Singapore Asian drink market."

– An article by The Edge Singapore[36]

Kimly is no stranger to acquisitions, having previously acquired a chain of Dim Sum stalls which commenced operations in 2008.[37] In the fourth quarter of 2017, the owner of Asian Story Corporation (ASC), Wang Chia Ye (WCY), approached Kimly about his intention to sell ASC. This was evaluated by Kimly from January to March 2018 and a non-binding term sheet was signed in April 2018. From April to June 2018, due diligence was undertaken, an independent valuation was done and the sale and purchase agreement (SPA) was negotiated.[38] RHT Capital Pte Ltd was the financial adviser, Rajah & Tann Singapore LLP was the legal adviser, and BDO Advisory Pte Ltd (BDO) was the valuer.[39] Rajah & Tann Singapore LLP is the firm where LTC, one of Kimly's IDs, is a partner.

In July 2018, Kimly purchased ASC for S$16 million.[40] The valuation by BDO commissioned by the company valued ASC at between S$23.5 million and S$26.2 million.[41]

"Kimly stands to benefit from longer-term growth, profit accretion and increased cash flow."

– RHB Research[42]

ASC is a manufacturer and distributor of beverages in Singapore, with its own line of beverages retailing under its "Asian Story" brand. These beverages include soya bean and bandung beverages, as well as its own bottled water under its "Simply Water" brand. Through this acquisition, Kimly would be able to sell ASC beverages at all its drink stalls and ultimately expand into the F&B industry under the ASC brand. The board expected the acquisition to provide synergistic benefits given that the two businesses are complementary and could also enable Kimly to expand internationally.[43]

However, investors and market analysts soon began to question the S$16 million price tag, given that the unaudited net tangible assets (NTA) of the acquiree was only approximately S$448,000.[44,45] Kimly justified the acquisition as one which would help bolster the Group's expansion strategy as outlined in its offer document.[46] It said the acquisition would help Kimly leverage on not only the manufacturing capabilities of ASC through vertical integration, but also allow it to tap on the expertise and experience of the vendor, WCY, to fully realise the synergies.[47]

No extraordinary general meeting to seek shareholder approval was required based on the Catalist Board rules as the aggregate consideration of S$24 million did not exceed 20% of the then market capitalisation of Kimly, which was S$435 million as at 2 July 2018.[48]

WCY would be entitled to an earn-out payment which is contingent on the level of audited profit before tax (PBT) of ASC. Should the PBT during the period be greater or equal to S$2 million, he would be entitled to an earn-out payment of S$8 million. This earn-out payment is payable by Kimly, with any shortfall in PBT of less than S$2 million to be apportioned to derive the corresponding earn-out payment for WCY.[49]

Truth behind the story

ASC was incorporated on 15 December 2009 by WCY.[50] Seah Li Ling (SLL) became a shareholder of ASC on 13 August 2010 through a new share subscription, after which WCY and SLL each owned 50% of ASC. On 31 March 2015, WCY transferred his shares to SLL, who became the sole ASC shareholder. However, on 13 December 2016, WCY acquired 100% of the shares in ASC from SLL. At the date of the SPA, WCY confirmed to Kimly that he owned 100% of ASC, legally and beneficially.[51]

SLL was also a substantial shareholder of De Tian Holdings Pte Ltd (DTH). DTH had an indirect relationship with Kimly. The directors of DTH were Reeves Tng Hung Kwee (RT), and Koh Peck Chong (KPC), who were among the 20 largest shareholders of Kimly, with 0.77% and 2.63% shareholding in Kimly respectively in FY2019.[52]

DTH was not the only common association. Two other companies, Jin Wei Food Holdings Pte Ltd (JWFH) and Chodee Food Holdings Pte Ltd (CFH), were also part of the picture.

KPC also sat on the board of CFH and was a shareholder in JWFH. Similarly, RT also owned shares in JWFH. Both were also Kimly shareholders with interests in other several business vendors of Kimly.

KPC had interest of four percent to 20% in Kimly's vendors such as FoodClique Pte Ltd and Sengkang 266 Food House Pte. Ltd. RT had interests ranging from 10% to 20% in Kimly's vendors such as Unicafe Pte. Ltd. and Foodclique (Utown) Pte Ltd.[53] Both VC and LHL were also shareholders of JWFH and CFH, with LHL sitting on the board of JWH and CFH.

Apart from the changes in shareholdings in ASC, there were also several changes in the directors of ASC. SLL was the sole director of ASC when it was incorporated in August 2010, until December 2016. After the transfer of her shares in December 2016, she resigned from her director position and was replaced by WCY. Subsequently, VC also became a director at ASC in July 2018 and served until November 2018. His tenure coincided with the acquisition of ASC by Kimly.[54] Following the rescission of the acquisition, he ceased being a director.

Trouble begins

"His contract has since expired."

– A spokesman for Pokka, in reply to The Business Times[55]

Before being thrust into the limelight as the vendor of ACS, WCY was the former marketing director of Pokka, and then became its external marketing consultant from July 2013 till September 2018.[56] Hence, he has experience and a track record spanning several years. However, Pokka did not renew his contract.[57]

WCY was not the only former employee of Pokka who was in the headlines as AO was under close scrutiny as well.[58] AO had previously served on the boards of both Kimly and Pokka,[59] having been on the former board until January 2018.[60] He stepped down from his position at Kimly six months prior to the acquisition of ASC.

AO was subsequently removed from the Pokka's board following an internal investigation, which was followed by a complaint against him.[61] The nature of the complaint was not disclosed. However, it was severe enough for him to be stripped of his Deputy Group CEO position of Pokka in September 2018, although he remained an employee.[62,63] The sudden removal of AO raised questions as to whether the underlying reason was related to Kimly's acquisition of ASC. Several news reports covered the seizure of information technology equipment owned by AO by the authorities as part of its investigation into the potential breach of Section 199 of the SFA.[64]

Not happy ever after

"The relationship is a contractual one. Pokka International is currently the distributor of Asian Story's products and Pokka Corporation is the non-exclusive manufacturer of some of Asian Story's products."

– A spokesman for Pokka, in reply to The Business Times[65]

WCY, as a former Pokka employee and marketing director, was instrumental in putting together the manufacturing contract between ASC and Pokka, under which Pokka was the distributor and the non-exclusive manufacturer of ASC products.[66] WCY had access to the distribution network and know-how of Pokka, which are proprietary trade secrets, especially for companies operating in the F&B industry. Since the distributor of ASC drinks was Pokka, it would seem odd for Pokka to engage with ASC given that ASC neither manufactured nor distributed its own drinks.[67]

The drinks belonging to the ASC brand were sufficiently different from the drinks under the Pokka brand. This was likely to prevent confusion between the brands. ASC had nine different drinks, namely Chrysanthemum, Soya Bean, Winter Melon Tea, Bandung, Herbal Tea, Water Chestnut, Lychee, Lemon Barley and Grass Jelly.[68] In comparison, Pokka manufactures drinks such as flavoured tea, coffee and juice products.[69]

There was no breakdown of the S$448,000 NTA value in the acquisition announcement. Further, there were limited financial results of ASC available since it is an exempt private company and therefore, under no statutory obligation to publish financial results.[70] Hence, the NTA of ASC cannot be definitively attributable to any identifiable assets of the company.

Going once, going twice, rescind!

It all happened within a week. On 22 November 2018, Pokka informed Kimly of its intention to terminate its manufacturing agreement with ASC with six months' notice.[71] Thereafter, Kimly engaged WCY in discussing the potential impact on ASC moving forward, without the manufacturing agreement with Pokka.[72] The acquisition of ASC was rescinded on 29 November 2018, after a request for trading suspension on 27 November 2018.[73]

Following the rescission, WCY had to repay Kimly the total acquisition consideration of S$16 million, with the repayment of S$12 million already completed. He intended to repay the balance over a period of three years.[74]

What's the real story?

On 4 December 2018, Kimly announced the release of the two EDs – LHL and VC – on bail following questioning by the CAD for a suspected offence under Section 199 of the SFA.[75] If found liable, both EDs would be subjected to criminal or civil penalties.[76] ASC was also implicated and was requested to produce financial statements, and records and documents relating to the now-rescinded Kimly acquisition.[77]

The share price of Kimly tumbled to its lowest since the IPO, trading at S$0.23 on 6 December 2018.[78]

The board was questioned by shareholders at its AGM on 30 January 2019.[79] The directors refused to comment on the progress of the investigation and reiterated that the two directors, LHL and VC, "are still innocent until proven guilty". When pressed as to what the board would do if they were found guilty, lead ID TKC said that the directors would be removed from the board and that a succession plan is already in place. However, the directors did not provide further details about the succession plan.[80]

On 29 November 2018,[81] Kimly announced that its Chief Financial Officer (CFO), Karen Wong Kok Yoong (WKY), will join the board and be re-designated as Finance Director.[82] Lau Chin Huat, an accountant who has no experience as a listed company director, was appointed as a new ID on 1 October 2019.[83] On 21 January 2020, TKC did not seek re-election and retired as lead ID "to avoid possible negative perception arising from his familial relationship with Mr Ong

Eng Sing, previously a non-executive and non-independent director of the Company until 23 January 2018, in light of the ongoing investigations by the regulatory authorities…”.[84]

While there have been other companies that have run into problems not long after listing, particularly on the Catalist Board of SGX, Kimly looked like a company with a sound business model and good prospects. However, subsequent events showed relationships involving various individuals and entities that should have raised alarm bells.

Should the issuer manager and full sponsor, PrimePartners Corporate Finance, or SGX itself, or other intermediaries involved in its listing bear some responsibility for failing to spot the red flags?

An appetite for listings

“We are very excited to welcome Kimly, one of the largest and most recognisable coffee shop operator chain in Singapore. The listing of Kimly provides investors with an avenue to invest in Singapore’s growing food and beverage sector.”

– Mohamed Nasser Ismail, Head of Equity Capital Markets (SME) and Capital Market Development at SGX[85]

An IPO would usually involve a public tranche and placement share allocation.[86,87] Placement shares are offered to selected investors or groups (such as institutional investors). According to the SGX Rulebook Part X *Methods of Offering*, the exchange prescribes that admittance to the Catalist Board could involve a public offer, placement, book-building or a combination of methods.[88,89]

The Catalist Rulebook only specifically prescribes that the placement shares allotted to each of the sponsor, underwriter, lead broker, distributor or any connected clients of the issuer, should not exceed 25%. As for the public tranche, it only prescribes that the basis of allocation and allotment should be fair and equitable to all investors. There is no mandatory requirement for Catalist-listed issuers to have a public subscription tranche.[90]

Cheap ingredients?

“The Sponsorship regime on (the) Catalist enables companies to benefit from the sponsor’s guidance and advice on rule compliance and governance matters, …”

– June Sim, SGX Head of Listing Compliance[91]

The listing of Kimly raised questions about the Catalist Board and the role of SGX and the sponsor.

Under the Catalist listing rules, a full sponsor helps prepare a Catalist company for listing, while a continuing sponsor advises and helps ensure that the company complies with listing rules on an ongoing basis.[92]

"There are firms which like the flexibility which Catalist offers them. Thus, even though a few of them can make it to the mainboard, they choose to list on Catalist first."

– Mohamed Nasser Ismail[93]

The Catalist Board is intended to be a catalyst to help companies grow and is intended for fast-growth companies. Catalist companies are subject to less demanding admission requirements and a less stringent regulatory framework, with lower listing and compliance costs.[94]

With the relatively less stringent listing criteria, companies on the Catalist Board are no stranger to criticism of poor quality and underperformance.[95] This is not unfounded given that there is no watch-list for Catalist companies based on either financial criteria or minimum trading price, unlike their Mainboard counterparts.[96,97]

This is compounded by the sponsor-supervised regime, with a full sponsor being responsible for the review of documents in assessing the suitability of the companies to list and a continuing sponsor being responsible for advising and overseeing the company for as long as it remains listed on the Catalist Board.[98] Sponsors may face conflicts of interest and questions about their independence due to the provision of non-sponsor services by the sponsor or its affiliates or interlocking directorships between directors of sponsored companies and affiliates of the sponsors.[99]

What's next?

Despite their arrests and with investigations still ongoing, LHL and VC continue to hold their positions in the company as Executive Chairman and ED respectively. While the company's revenues have continued to grow after its IPO, group profit after tax has declined from S$24.2 million in FY2016, to S$21.4 million, S$21.9 million and S$20.1 million in FY2017, FY2018 and FY2019 respectively.[100] Its share price as at 17 April 2020 was S$0.205, below its IPO price.[101]

On 28 August 2019, The Straits Times reported that Pokka was suing AO, who is actress Vivian Lai's husband, alleging that he was part of a conspiracy that caused Pokka to suffer a S$10 million loss.[102] The news report triggered a set of 16 queries from SGX, and the responses from Kimly shed further light on the events surrounding the acquisition of ASC and the parties involved.[103] Pokka and AO announced on 9 April 2020 that they have settled the lawsuit.[104]

Meanwhile, the market continues to wait and see if the regulators will take any enforcement action against any of the parties involved.

Discussion questions

1. Discuss the key differences between a listing on the Mainboard and Catalist Board of SGX. Why might a company like Kimly choose to list on Catalist even if it is eligible to list on the Mainboard?
2. Critically evaluate the sponsor-based regime for Catalist, and the role of SGX, the full sponsor and continuing sponsor for Catalist listings? What are the potential issues relating to sponsors that may undermine their independence and effectiveness? In Kimly's case, is the sponsor or SGX partly to blame for the issues at Kimly after its listing?
3. Critically evaluate the composition of Kimly's board of directors at the time of its listing and how it may affect its effectiveness.
4. Danny Lim Teck Chai is an independent director of Kimly and a partner of Rajah & Tann LLP, the law firm which advised on the acquisition of Asian Story Corporation. Are there are any potential issues? Should partners or employees of law firms be permitted to serve on boards of client firms as independent directors? What are the rules here and how do they compare with other major countries like Australia, Hong Kong, United Kingdom and United States? How do the rules differ for legal advisers and external auditors here? Should they be different? Explain.
5. Should the acquisition of Asian Story Corporation have been considered an interested person transaction (IPT)? If the acquisition was considered an IPT, what difference could it have made to the acquisition process?
6. What sort of due diligence should be done when making an acquisition such as in the case of Kimly's acquisition of Asian Story Corporation? What is the role of the board of directors in making such acquisitions? In Asian Story Corporation's case, do you think the board of directors adequately performed its role? Do you think the firms that acted as financial adviser, legal adviser and valuer should be held responsible for the debacle relating to the Asian Story Corporation acquisition? Explain.
7. Recently, Alain Ong Eng Sing and Pokka settled their dispute in relation to Asian Story Corporation. What was the dispute about? Do you think regulators should continue to pursue an investigation and who may potentially be liable? What are potential breaches relating to the acquisition of Asian Story Corporation?

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NO SIGN(BOARD) OF GOVERNANCE

Case overview

Established in 1981, No Signboard Holdings Ltd. (No Signboard) was listed on the Catalist Board in 2017. It is known for its No Signboard Seafood chain of seafood restaurants. In 2019, the Executive Chairman and Chief Executive Officer of No Signboard, Sam Lim Yong Sim, was arrested on suspicion of breaching the Securities and Futures Act in relation to false trading, market-rigging and insider trading. In addition, the company restated its net profit to a loss in the first quarter of 2018 and faced recurring losses following its listing. The objective of this case is to facilitate a discussion of issues such as roles and responsibilities of directors; share buybacks; insider trading; restatements of results; and role of sponsors and regulators.

Behind the signboard

No Signboard Holdings Ltd. (No Signboard) started out as a family business in 1981. Sam Lim Yong Sim, the grandson of the founder of No Signboard, is the Executive Chairman and Chief Executive Officer (CEO).[1] His sister, Lim Lay Hoon, is the Chief Operating Officer (COO).[2]

The company has three key business segments – a restaurant business, a beer business and a ready meal business. For the restaurant business, No Signboard operates a chain of seafood restaurants called No Signboard Seafood, alongside a chain of restaurants under different food and beverage brands such as Hawker Asian Burger & Buns, Little Sheep Hot Pot and Mom's Touch Korean Chicken & Burger. The Group also distributes Draft Denmark beer following its acquisition of Danish Breweries, and ready meals under its "Powered by No Signboard" endorsement, which are distributed via vending machines in various parts of Singapore.[3,4]

No Signboard was incorporated as a private limited company on 1 June 2017 with an issued and paid-up capital of S$2 which consisted of two ordinary shares.[5] On 31 August 2017, Singapore Chilli Crab Pte Ltd (SCC) was incorporated as a private company limited by shares with an issued and paid-up capital of S$100 comprising of 100 ordinary shares. SCC operates largely as an investment holding firm.[6]

A restructuring exercise was completed on 31 October 2017 to streamline the Group's structure. This involved No Signboard acquiring from GuGong Pte Ltd (GuGong) – the Lim siblings' investment vehicle[7] – the assets, liabilities, intellectual property, businesses and undertakings of the restaurant business; the entire share capital of Tao Brewery Pte Ltd; and

This case was prepared by Nur Sabrina bte Abu Bakar, Nur Marhaini Bte Erpan, Chong Jin Huang Casper, Ho Hyui Shan Trenna, and edited by Vidhi Killa and Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been substantially re-written, with information added, by Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees.

80% of the share capital of Danish Breweries Pte Ltd, for a total consideration of S$2,315,231. The company issued 2,315,231 shares to the acquiree.[8]

Figure 1 shows the Group structure following the restructuring exercise.

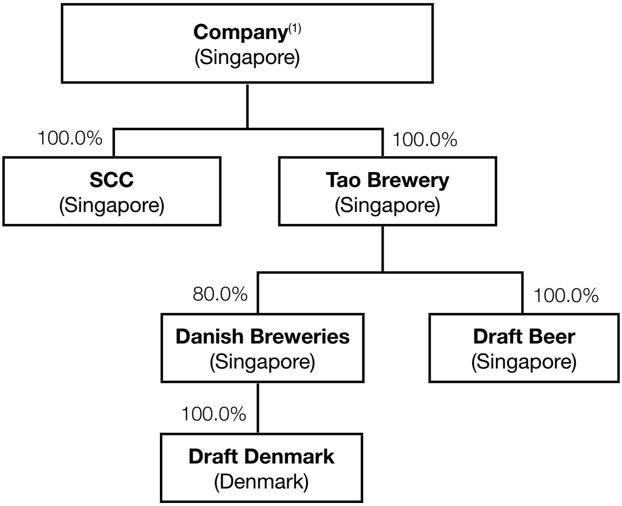

Figure 1: No Signboard's Group structure after the restructuring exercise[9]

On 3 November 2017, GuGong injected S$2,850,000 of cash in exchange for 2,850,000 new shares in the company. The company then sub-divided each ordinary share into 75 shares on 6 November 2017. Following this, the company's issued and paid-up share capital amounted to S$5,165,233 and comprised of 387,392,475 shares.[10]

No Signboard listed on the Catalist Board of the Singapore Exchange (SGX) on 30 November 2017 with its initial public offering (IPO) of 65,734,500 issued shares at S$0.28 per share. The Group said that it had plans to use the net proceeds of about S$18.7 million to establish a new chain of casual dining restaurants, develop its beer and ready meal businesses, and for general working capital purposes.[11]

Leading from the front?

At the time of its listing, No Signboard had a board consisting of three independent directors (IDs) – Ivan Khua, Paul Leow and Robert Tay – and two executive directors (EDs), Sam Lim and Lim Lay Hoon.[12]

After joining the Group in 1998 as a general manager, Sam Lim spearheaded the Group's development and expansion over the next two decades.[13] His responsibilities encompass (i) the formulation of the overall business and corporate policies and strategies of the Group; (ii) oversight of the management of the business and operations of the Group; and (iii) leading the Group's business development strategy and efforts.[14]

The company's FY2018 annual report justified Sam Lim's dual role as both Executive Chairman and CEO, stating that "accountability and independence have not been compromised despite the Chairman and CEO being the same person". It also stated that with a majority of the board comprising independent directors, the board was of the view that "there is sufficient element of independence and adequate safeguards against a concentration of power in one single person". As the Executive Chairman is non-independent, the board appointed Ivan Khua as the lead independent director.[15]

Sam Lim is also a substantial shareholder of No Signboard, with deemed interest in No Signboard's shares held by GuGong, in which he has a 93.64% shareholding. Between mid-March 2018 and December 2018, he increased his shareholding interest in No Signboard from 72.97% to 74.91%.[16]

As the COO, Lim Lay Hoon's responsibilities include overseeing the day-to-day operations and management of the Group. Like Sam Lim, she has been involved with the management of the Group for over 20 years.[17]

Besides being the lead ID, Ivan Khua is also the Chairman of the Remuneration Committee (RC). He is an ID at two other SGX-listed companies, KSH Holdings and MoneyMax Financial Services, and an ED of a private oil and gas servicing company, Hock Leong Enterprises.[18]

Paul Leow is Chairman of the Audit Committee (AC). Having more than 20 years of accounting and audit experience, he is an audit partner at Ecovis Assurance LLP. He is also an ID at SGX-listed Fragrance Group and Asian Healthcare Specialist.[19]

Robert Tay is Chairman of the Nominating Committee (NC). He holds a Bachelor of Law degree from King's College London. With over 15 years of experience in legal and executive positions, he has held positions in various companies before joining the Infocomm Media Development Authority Singapore (IMDA) in 2017. He is currently the cluster director (modern services division) of IMDA.[20]

None of the IDs have prior working experience in the food and beverage industry.

Each of the three board committees consists of the three IDs, with each chairing one of the committees.[21] The Chairman of the AC, Paul Leow, is the only director with an accounting background.

Remuneration

Directors' remuneration was disclosed in bands of S$250,000. Both the CEO and the COO receive a fixed salary plus bonus. The remuneration packages for both these directors include one month of annual wage supplement, with the CEO receiving a performance-linked bonus based on the Group's financial performance, and the COO receiving a discretionary bonus to be determined by the RC and approved by the board.

The CEO's remuneration was disclosed as falling within the band of S$750,000 to S$1,000,000, with his fixed salary and bonus constituting 92% and 8% respectively. Meanwhile, the COO received between S$250,000 and S$750,000 and her fixed salary and bonus constituted 93% and 7% respectively.[22]

The IDs received directors' fees which were disclosed as below S$250,000 for each director.[23]

The key management personnel – excluding directors and the CEO – received an aggregate remuneration of S$508,020 for FY2018. The remuneration of the top five key management personnel (non-directors) was disclosed as below S$250,000 for each individual. Unlike most of the other key management personnel, whose remuneration consisted only or mostly of fixed salary, Soong Wee Choo, the then Chief Financial Officer (CFO) of the company, had a variable pay component of 55% in the form of a bonus, with fixed salary accounting for the other 45% of her total remuneration package.[24]

In addition, the remuneration of employees who are immediate family members of the CEO and COO was also disclosed in bands of S$50,000 in the FY2018 annual report.[25]

As part of No Signboard's long-term incentive plans, the company implemented the No Signboard Employee Share Option Scheme and the No Signboard Performance Share Plan. These represent the variable components of remuneration. However, the company did not disclose key performance indicators used. The aim of these incentive plans was said to be to provide employees an opportunity to participate in the equity of the company and to enhance its competitive edge in attracting, recruiting and retaining talented key management personnel. The company does not have contractual provisions to reclaim incentive components of remuneration from executive directors and key management personnel.[26]

Crab overboard

On 1 February 2019, when the company announced its Q1 2019 loss,[27] it also restated the previously reported net profit of S$1,444,475 for Q1 2018 - which was announced on 14 February 2018 - to a net loss of S$414,727. The company claimed that this was due to the application of the principles of Merger Accounting – instead of Actual Group Accounting Principles – following a reassessment of the Group's accounting principles.[28,29] Almost every item in the company's profit and loss statement was restated. Figure 2 below shows the original and restated results announcement for Q1 2018.

	Group		
	Original 1Q2018	Restated 1Q2018	Variance arising from the Adoption of Merger Accounting
	$	$	$
Revenue	4,137,480	6,683,120	2,545,640
Other income	2,552,965	32,939	(2,520,026)
Raw materials and consumables used	(1,320,281)	(2,289,028)	(968,747)
Changes in inventories	(6,095)	4,492	10,587
Employee benefits expense	(1,376,496)	(1,976,110)	(599,614)
Operating lease expense	(468,448)	(720,990)	(252,542)
Depreciation and amortisation expense	(49,485)	(159,719)	(110,234)
Other operating expenses	(529,368)	(793,142)	(263,774)
IPO expense	(1,120,396)	(1,120,396)	-
Finance costs	(9,857)	(17,232)	(7,375)
Profit (Loss) before income tax	1,810,019	(356,066)	(2,166,085)
Income tax expense	(365,544)	(58,661)	306,883
Profit (Loss) for the period	1,444,475	(414,727)	(1,859,202)
Items that may be reclassified subsequently to profit or loss			
Exchange diferrences on translation of foreign operations	(314)	(522)	(208)
Total comprehensive profit (loss) for the period	1,444,161	(415,249)	(1,859,410)
Profit (Loss) attributable to:			
Owners of the Company	1,442,836	(416,366)	(1,859,202)
Non-controlling interests	1,639	1,639	-
	1,444,475	(414,727)	(1,859,202)
Total comprehensive profit (loss) attributable to:			
Owners of the Company	1,442,522	(416,888)	(1,859,410)
Non-controlling interests	1,639	1,639	-
	1,444,161	(415,249)	(1,859,410)

Figure 2: Original and restated Q1 2018 results[30]

The material restatement prompted SGX to issue several queries. On 6 March 2019, the company responded by explaining the rationale for restating the Q1 2018 results, saying that it was due to a change in basis of preparation of the Group's financial statements. According to the company, during the year-end audit, No Signboard and its auditors, Deloitte & Touche LLP, concluded that "the continuation of the use of the Merger Accounting Principles adopted in FY2017 would be more appropriate to better reflect the Group's financial performance for better comparability between the current year's (FY2018) financial statements and prior year's (FY2017) financial statements (in which merger accounting principles was used)".[31]

The discrepancy in the profit and loss figures was primarily because of the restructuring exercise involving the acquisition of a restaurant and beer business from its holding company, GuGong. Based on the restructuring agreement, the transfer of the legal interest in the restaurant business and its subsidiaries was on 31 October 2017, after the restructuring exercise was completed, whereas the transfer of economic interest was on 1 July 2017.[32]

The Group had originally prepared the financial statements according to the Actual Group Accounting Principles, applied on the basis that the company had obtained control over the subsidiaries on 31 October 2017, i.e., the legal completion date of the restructuring exercise. However, after an assessment by the company and its auditors, Deloitte & Touche LLP, it was decided that the continuation of the use of Merger Accounting Principles adopted in FY2017 was more appropriate, to allow better comparability between the FY2018 and FY2017. The Merger Accounting Principles were to be applied "as if the restructuring exercise had occurred from the date when the merged entities first came under the control of the group of shareholders acting in concert, even though the Group was not yet legally formed."[33]

The company said that the restatement would only affect the first quarter result announcement and not the subsequent quarters. However, the accumulated year-to-date semi-annual, nine months and annual results would be affected as they included the restated results of the first quarter.[34]

In the third quarter of FY2019 (financial period ended 30 June 2019), No Signboard reported a net loss of S$1.4 million due to higher operating expenses incurred for its hotpot and quick serve restaurants, along with a decrease in its revenue. The Group's revenue fell 15% to S$5.9 million from S$7 million in the previous year. This was attributed to a 10% reduction in the average customer spending under its seafood restaurant business and greater competition in the beer industry.[35]

In the same announcement, No Signboard reported a loss per ordinary share of 0.31 cents for the third quarter ended 30 June 2019 compared to the previous Q3 2018 earnings per ordinary share of 0.16 cents.[36]

No Signboard's losses continued as it reported a loss of S$4,851,509 for the full year ended 30 September 2019.[37]

The share buyback

"This was an honest mistake on the part of Mr Lim as he did not notice that the share purchase at prices of up to S$0.14 exceeded the 5% cap above the average closing price of the last five days permitted under the share buyback mandate of S$0.1226 as at 31 January 2019."

– No Signboard, in its reply to SGX queries on 3 February 2019[38]

On 31 January 2019, No Signboard held its Annual General Meeting (AGM) to approve the company's new share buyback mandate.[39] Under this mandate, Sam Lim instructed the company's broker, UOB Kay Hian Pte Ltd (UOBKH), to queue for the purchase of the company's shares at a price of up to S$0.14 each. By 12:12 PM on 31 January 2019, a total of 1,068,700 shares were purchased.[40] This led to a 24% surge in stock price to S$0.15, prompting SGX to query the reason behind the unusual share price movement.[41] No Signboard immediately requested for a trading halt on the same day.[42]

In response to SGX queries regarding the trading activity, No Signboard disclosed that Sam Lim had made an "honest mistake". It claimed that he did not realise that the share purchase at prices of up to S$0.14 compared to a market price of S$0.1226 as at 31 January 2019 exceeded the 5% cap above the average closing price of the previous five days permitted under the share buyback mandate.[43]

It also emerged that at the time of the share buyback, the company had not held its AC meeting and board meeting to approve its first quarter results ended 31 December 2018 (Q1 2019). The share repurchase was done a day before the announcement of the company's first quarter results on 1 February 2019, or during the "black-out" period when dealing in the securities of the company is restricted.[44]

In its FY2018 and FY2017 annual reports, the company disclosed that it adopted the Code of Best Practices on Securities Transactions, which was compliant with Rule 1204(19) of the Catalist rules. Directors and employees are barred from dealing in shares two weeks before the announcement of the company's quarterly financial results and one month before the announcement of the full-year results. They are also not allowed to deal in shares on a short-term basis or when they have price-sensitive information and have to abide by the insider trading laws at all times. All senior managers need to inform the concerned authority regarding their dealings in the company's shares within two market days of a transaction.[45,46]

Were the rules broken?

"While share buy-back serves as a useful capital management tool and is a legitimate commercial activity, share buy-back transactions, like any on-market trading activities, are subject to relevant market conduct provisions of the Securities and Futures Act (SFA)."

– Singapore Exchange Regulation (SGX RegCo) CEO Tan Boon Gin[47]

The share buyback undertaken by Sam Lim breached two Catalist listing rules with respect to dealing in the company's shares during the black-out period and the purchase of shares at a price which exceeded the regulatory limit on share buyback prices. These breaches triggered an investigation by the Commercial Affairs Department (CAD). [48]

The purchase of shares at a price which exceeded the share price cap may also have breached Sections 197 and 218 of the Securities and Futures Act (SFA)[49] which relates to false trading and market rigging transactions.[50]

Under the SFA, a person cannot take any action to create a false or misleading appearance of active trading in any capital market product on an organised market, or the price of any capital market product traded on an organised market. Section 218 of the SFA(Cap. 289) states that if a person associated with a firm possesses information that is not generally available and can have a potential material effect on the price or value of securities or securities-based derivative contracts of that firm, the person must not purchase the securities or securities-based derivative contracts.

The listing rules do not explicitly prohibit share buybacks in any particular period. However, the CEO of SGX RegCo, Tan Boon Gin, advised that firms should avoid share buybacks during the two weeks immediately before the announcement of quarterly financial statements and one month immediately before the annual financial statements. He also recommended that companies refrain from buying shares under a share buyback programme when there are upcoming material developments or unannounced material information which may potentially impact the company's share price or trading volume.[51]

According to the share buyback mandate in the notice of the AGM dated 31 December 2018, the maximum price of shares to be purchased in an on-market share buyback is clearly sated to be 105% of the average closing price. This raises questions about the company's claim of the breach being an "honest mistake" on the part of its CEO.[52]

Dwindling price

"If the price and volume of a security have been artificially interfered with through share buy-back activities, the investing public would be misled and deceived as to the genuine market value of the security. This will undermine the operation of a fair, orderly and transparent market"

– SGX RegCo CEO Tan Boon Gin[53]

Following the share buyback during the black-out period, there was a spike in share price on 1 February 2019. Just after noon that day, the company reported its Q1 2019 results, which included a restatement of its previous Q1 2018 profit of S$1,444,475[54] to a loss of S$414,727, as well as a Q1 2019 loss of S$573,643.[55] No Signboard's share price fell by about 30% from about S$0.12 to S$0.08 over the following three months. It fell by another 25% to around S$0.06 in end-May 2019[56] following the announcements of the investigation by CAD and the arrest of CEO Sam Lim for possible breaches of the SFA.[57,58]

Regulators act

SGX issued a query on 31 January 2019 to the company about unusual trading activity which the company responded to first on 3 February 2019, followed by a further update five days later on 8 February 2019.[59,60]

No Signboard disclosed that the shares purchased by UOBKH on the company's behalf on 31 January 2019, constituting 0.23% of issued shares or 1,068,700 shares, were not approved by the board. The company said that UOBKH agreed that the shares purchased was a mistake made on behalf of the company and that the two mutually agreed to mitigate this error by taking the position into UOBKH's error-in-trade account. The company would thus not bear the cost of this purchase.[61] Notwithstanding the explanation, the company acknowledged that the two breaches had occurred.[62]

The CAD launched a probe into the share buyback on 24 April 2019 and obtained statements from No Signboard's key executives. In an announcement on 29 April 2019, the company said it was "fully cooperating" with the CAD.[63] From 24 April 2019 to 26 April 2019, No Signboard provided the CAD with access to documents in connection with the share buyback. Sam Lim's passport was retained by the CAD. In spite of this situation, the company said that business and operations had not been affected and would continue as usual.[64]

On 30 April 2019, Sam Lim was arrested under reasonable suspicions of breaches of Sections 197 and 218 of the SFA. He has not been charged with any offence and was subsequently released on bail. No Signboard again reiterated that business and operations had not been affected and would continue as usual.[65]

On 2 July 2019, the company announced that it had, in consultation with SGX Regco and its sponsor, RHT Capital Pte Ltd (RHT Capital), appointed Nexia TS Public Accounting Corporation (Nexia TS) as an independent reviewer, based on SGX Regco's directive. In its announcement, No Signboard stated that "the scope of the independent review will include, inter alia, the review of the appropriateness of adopting the Actual Group Accounting Principles in respect of the unaudited Group Financial Statements for 1Q2018 to 3Q2018, and whether it was prepared in accordance with Singapore Financial Reporting Standards". The independent reviewer was to report its findings directly to SGX Regco.[66]

CFO resigns

"Was there really any doubt that September 30 was going to be her last day at No Signboard since her employment contract contains a three-month notice period, which is exactly the period between the date she tendered her resignation and her last day?"

– Associate Professor Mak Yuen Teen, NUS Business School[67]

On 1 July 2019, No Signboard's CFO, Voon Sze Yin, tendered her resignation after accepting a new job offer. However, this was only announced three months later, on 30 September 2019.[68] In the announcement, the company said that even after Voon Sze Yin had tendered her resignation, she agreed with the board to continue working in her role until the independent review was substantially completed, enabling a smooth transition and handover to the new CFO.[69]

Based on Rule 704 of the Catalist rules,[70] SGX requires an immediate announcement of the resignation of key officers, as this is regarded as material information. Therefore, there was arguably non-compliance with Rule 704 since Voon Sze Yin had tendered her resignation on 1 July 2019 when she had accepted a new job offer but it was only announced on 30 September 2019. RHT Capital did not comment on the company's compliance with Rule 704. The independent reviewer, Nexia TS, claimed that her resignation would not impede the progress of the independent review.[71]

The timing of her resignation was questioned by Associate Professor Mak Yuen Teen of NUS Business School. He pointed out that "No Signboard had their CFO resigned around the time that the results that are now significantly re-stated were first announced". [72]

No Signboard's previous CFO, Soong Wee Choo, who was appointed on 1 May 2017 had also earlier resigned "to pursue personal interests" with effect from 1 February 2018.[73] Her resignation was also announced only on her date of departure.[74]

The role of sponsors

"Like Y Ventures and No Signboard, regulators must review the due diligence that was done for these listings, and whether the sponsors and auditors should be held accountable."

– Associate Professor Mak Yuen Teen, NUS Business School[75]

Sponsors are the supervisors of issuers listed on the Catalist Board and their role is to ensure that companies comply with the Catalist rules.

RHT Capital was the full sponsor and issue manager for the listing of No Signboard on the Catalist Board on 30 November 2017.[76] As a full sponsor, RHT Capital can provide corporate finance advisory services to No Signboard for its capital market needs and corporate actions along with being the continuing sponsor after its listing. Under Rule 225(3) of the Catalist rulebook, Catalist issuers must retain their full sponsor as continuing sponsor for at least three years. As No Signboard's continuing sponsor, RHT Capital would have to advise the company on its continuing listing obligations and overseeing its compliance with these obligations.

Affiliates of RHT Capital which are part of the RHT Group of companies may also be providing professional services such as compliance solutions, corporate advisory, share registrar, corporate governance, risk management and investor relations services to issuers sponsored by RHT Capital. RHT Corporate Advisory, which was an affiliate of RHT Capital prior to May 2019,[77] was providing company secretary and share registrar services to No Signboard, while RHT Capital was acting as its continuing sponsor.[78] This raises questions about potential conflicts of interest.[79,80]

In response to the breaches committed by Sam Lim, RHT Capital directed him to attend directors' training to re-familiarise himself with the listing rules and other regulatory requirements. Additionally, No Signboard was directed to immediately develop and implement a comprehensive internal policy and procedure on the share buyback process to prevent any such cases of share buyback in the future.[81]

A murky future

"Singapore continues to be a major market for our Group, and we will continue to explore other opportunities both locally and regionally to expand our business."

– Sam Lim, Executive Chairman and CEO of No Signboard [82]

While No Signboard has continued to try to convey a sense of optimism, its future appears to be fraught with challenges.

On 8 August 2019, No Signboard announced that it was closing its hawker-themed fast food (Hawker QSR) outlets due to unsustainable sales and continuing losses.[83] It was only about a year prior when it announced the launch of its new fast food business 'Hawker'.[84]

The company said it was in the process of re-conceptualising its Hawker QSR brand.[85] Further, as part of the renewal of the tenancy of its Esplanade outlet, No Signboard was required to renovate its premises in the first quarter of FY2020 and this was expected to have a negative impact on its financial results for that quarter.[86]

The company saw its losses balloon in Q1 2020, citing the adoption of new accounting standards with respect to depreciation expenses as the reason. The net loss for the financial quarter ended 31 December 2019 widened to S$1.21 million, from S$574,000 the year before, even as revenue rose by 6.9% to S$5.99 million.[87]

With the slowdown in the Singapore economy resulting in decreased average customer spending,[88] and with the increase in competition in the food and beverage industry, there has been an impact on the Group's seafood restaurant and beer businesses. Following its exit from its Hawker QSR business after less than a year, No Signboard decided to remain cautious by not launching new concepts and dining brands. Having obtained master franchises for Little Sheep and Mom's Touch, the company said that its current strategy is to leverage on its two existing international brands. As part of the Group's overseas expansion plan for its seafood brand, it launched its first overseas No Signboard Seafood outlet in Shanghai.[89] No Signboard added that it would continue to explore suitable opportunities to strengthen its competitive edge in its existing business, while diversifying its food and beverage business at the same time.[90]

The COVID-19 pandemic causing a fall in visitor numbers and lower consumer spending[91] from the quarter beginning January 2020 onwards has added to its woes.

Meanwhile, the threat of regulatory action looms over the company and its directors. On 29 April 2020, the company announced the findings of the independent review by Nexia TS and the publication of the Independent Reviewer Memorandum (including two appendices).[92] The findings were damning as it concluded that the company changed from the use of Merger Accounting Principles, which was used in preparing its financial statements in its IPO offer document, to Actual Accounting Principles for Q1, Q2 and Q3 of FY2018 following its listing, and then back to Merger Accounting Principles again for its full year financial results for the financial year ended 30 September 2018. It had done so without applying the same to the previous corresponding financial quarters. This resulted in non-compliance with FRS for the relevant quarters. It also resulted in, among others, "non-comparability of the financial statements and double-counting of the same financial information in two consecutive accounting periods due to a restructuring exercise undertaken in conjunction with its IPO".[93] SGX Regco said that it "will be reviewing the Nexia report very carefully for possible breaches of the listing rules".[94]

Discussion questions

1. Discuss the key corporate governance issues relating to No Signboard.
2. In your opinion, what improvements in corporate governance and internal controls are needed to help No Signboard turn around its fortunes?
3. Evaluate the effectiveness of the board of directors at No Signboard. To what extent is the board of directors responsible for the problems in the company?
4. What is the role of the sponsor under the Catalist regime? Did the sponsor, RHT Capital, discharge its responsibilities effectively as a full sponsor and continuing sponsor? Explain.
5. Evaluate how No Signboard communicated with stakeholders regarding its corporate governance issues.
6. Explain the breaches and possible breaches in rules committed by Sam Lim and the company. Do you believe the regulators have acted effectively in this case? Explain.

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Y LIKE THAT?

Case overview

On 21 January 2019, Y Ventures Group Ltd (Y Ventures), which is listed on SGX's Catalist Board, announced material accounting misstatements in its unaudited financial statements for the six months period ended 30 June 2018. The announcement was made about five months after the release of the incorrect results, turning the company's profit of US$143,330 to a loss of US$1,160,133, which was more than the loss incurred for the entire FY2017.

Y Ventures' share price plunged 58% from the day of the announcement to the end of January 2019. The accounting restatements prompted questions about the accuracy of financial results released for other periods, including results disclosed in the offer document for its Initial Public Offering, and whether the sponsor and auditors have adequately discharged their duties. There were also questions about the viability of Y Ventures' business model.

The objective of this case is to facilitate a discussion of issues such as the importance of a sound business model; due diligence of companies seeking bourse listing; responsibilities of sponsors, auditors and other intermediaries; accounting restatements; duties of directors; board composition; and role of regulators.

The ventures begin

In 2003, Alex Low studied at the University of Washington and struggled to pay his school fees. He came up with the idea of procuring used textbooks in Singapore at lower costs and selling them on U.S. online marketplaces. Alex shared the idea with his brother, Adam Low, who joined him and contributed the initial S$10,000 capital to start the business. He managed to pay off his school fees from the profits from the sales.[1]

In 2005, the Low brothers started a used textbook buy-back programme, allowing them to buy and sell textbooks in tertiary educational institutions. In 2006, the used textbooks buy-back programme was moved to an online marketplace that was developed for the exchange of used textbooks among Singapore tertiary students. The following year, the business quickly gained momentum, and a company was incorporated to distribute textbooks to wholesalers in the region.[2] During that period, the business leveraged on its "proprietary data analytics software" to identify significant untapped potential in online book retailing, as most publishers had extensive offline distribution channels but lacked the requisite tools and expertise to develop and establish an online presence.[3]

This case was prepared by Tricia Tan Jia Hui, Shao Anan, Shao Pingping and Yap Jia Xin, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been substantially re-written, with information added, by Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees.

Y Ventures was subsequently incorporated in Singapore on 2 January 2013.[4] It described itself as a "data analytics driven e-commerce company"[5] and the first of such companies to be listed on the SGX Catalist Board.[6]

Business model

Y Ventures calls itself an e-commerce retailer and distributor which specialises in online retail data analytics, marketing, distribution and sale of a wide range of merchandise under third party brands and its own private label, "JustNile". Its unique value proposition is the use of its proprietary data analytics capabilities to drive its business. Data analytics is said to be used in various aspects of the business such as analysis of demand trends, pricing intelligence, gaining consumer sentiment and analysis of competition in the market, enabling it to reduce its research and marketing efforts so as to enhance its sales results and improve cost efficiency on online marketplaces.[7,8]

The business insights obtained may also be shared with Y Ventures' brand partners, enabling them to enhance product offerings and improve their sales and pricing strategies. The company also claims that it assists third party brands in expanding globally by facilitating access to key online marketplaces, so that brands can sell their products worldwide. In January 2018, Y Ventures announced that it had secured online distribution rights for over 20 consumer brands.[9] Based on its website, Y Ventures sells products on more than 20 online marketplaces worldwide.[10,11]

E-commerce business

An e-commerce retailer is one that sells goods or services through electronic channels such as the internet.[12] Y Ventures sells its products on e-commerce marketplaces such as Amazon and Qoo10.[13] What differentiates e-commerce retailers from e-commerce marketplaces is that e-commerce marketplaces provides a platform for e-commerce retailers such as Y Ventures to sell to potential buyers on the platforms. By using e-commerce marketplaces, Y Ventures is able to leverage on the strengths and volume of visitors on these e-commerce marketplaces.[14]

Considering the intense competition in the e-commerce retail landscape,[15] Y Ventures needs to be competitive to survive in the long run. The competitors of Y Ventures are companies which sell similar products or provide similar services on online marketplaces. One example would be Synagie[16] – another e-commerce solutions provider which also claims to use consumer data to adjust its marketing strategies and offer such services to its brand partners.

Data analytics capabilities

Y Ventures' proprietary data analytics software first gathers data from both the various e-commerce marketplaces that the company sells its products on, as well as social media platforms. The large amount of data acquired allows it to evaluate demand trends, prices and products of competitors, consumer sentiments and potential market size. This information is then used to determine its pricing strategies and the level of inventory required.[17]

Following the sale of products, Y Ventures collects consumers' feedback and reviews, which is fed into its data analytics software for further analysis. Thereafter, improvements to the products or provision of sales services is made. Y Ventures shares such insights from its data analytics with its suppliers so that the suppliers can use the insights gathered to improve their business. The company also uses its data analytics capabilities to identify consumer trends for its private label brands such as JustNile.[18]

Walkthrough of sales process of a clock:

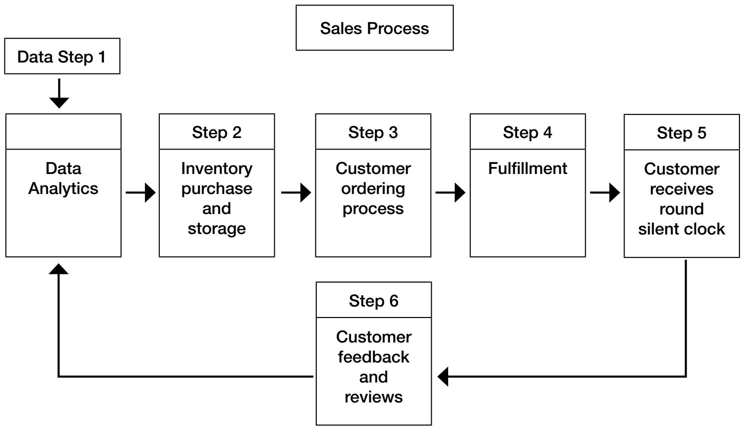

Figure 1: Walkthrough of Y Ventures' use of data analytics capabilities in its sales process[19]

Sources of revenues

Y Ventures primarily derives revenue from three business segments – e-commerce retail and distribution, logistics and freight forwarding services, and waste management services.[20]

The first segment is the e-commerce retail and distribution segment, which involves selling products from third-party brands and private labels. Products marketed and distributed by Y Ventures include books publishing, electronic products, and health and beauty products.[21] Under "JustNile", the company also sell original equipment manufacturer (OEM) merchandises under the home and décor product category. Contributions from the e-commerce segment grew quickly alongside Y Ventures' expanding product portfolio – from approximately 300 SKUs (Stock Keeping Unit) – a unique numerical identifying number that refers to a specific stock item in a retailer's inventory or product catalog – at the end of 2014 to over 5,500 in 2018. In FY2017, this segment accounted for 96.4% of Y Ventures' revenue.[22]

A substantial portion of Y Ventures' purchases are from book publishers, particularly medical textbooks and reference materials from Elsevier Group, a medical publishing house that joined Y Ventures' online distribution network in 2014.[23] In 2017, Elsevier was the only publisher that Y Ventures purchased its books from.[24] Its niche in online book retailing services provided a steady source of revenue and, according to the company, allowed it to command "superior gross margins" of more than 40% from FY2014 to FY2017.[25]

Y Ventures has since secured seven more book publishers in 2018. During that year, Y Ventures focused on increasing sales of books as they fetched better gross margins and had lower inventory risks, as Y Ventures had agreements with book suppliers which allowed for the return of unsold book inventories of up to 30% of the purchased quantity. Books enjoyed sales growth of about 22% and accounted for 81% of the company's revenue in FY2018. As at the end of FY2018, 85% of Y Ventures' inventory consisted of book products.[26]

In addition to distributing books and other merchandises under third-party brands, Y Ventures also sells OEM merchandise of home and decor products on online marketplaces through its private label, JustNile. Examples of OEM merchandise sold through JustNile include wall clocks, mirrors and bathroom accessories.[27] JustNile's virtual store on online marketplace Amazon shows that the bulk of its data-backed product selections have generated positive ratings and reviews.[28] However, there is mixed success on the sale of JustNile's products, depending on the marketplace that the products are listed on. On JustNile's Singapore Shopee store, most products had not been purchased by even a single customer.[29]

Y Ventures' second business segment is the logistics and freight forwarding services segment, which accounted for 0.23% of revenue in FY2018. Y Ventures' inventories are mainly held in third-party warehouses managed by various third-party logistics companies and delivered by last-mile fulfillment service providers in the jurisdictions that the merchandises are sold. Y Ventures' subsidiary, Skap Logistics Pte Ltd, mainly supports its e-commerce retail and distribution business by working closely with these logistics companies and service providers for warehousing and order fulfilment requirements. Skap Logistics Pte Ltd occasionally provides logistics and freight forwarding services to third party customers as well.[30]

The third business segment is the waste management services segment, which accounted for 2.83% of sales in FY2018. Y Ventures provides waste management services through its subsidiary, Skap Waste Management Pte Ltd. Services it provides includes disposal of residential waste and secured disposal of sensitive documents in Singapore.[31]

Revenue recognition

From the annual reports of Y Ventures, the approach for revenue recognition was changed from a "risk-and-reward" approach in 2017 to a "contract-by-contract transfer-of-control" approach in 2018 due to the adoption of SFRS(I) 15.[32] Under the old approach, revenue from the sale of goods is recognised when the goods have been delivered by Y Ventures to its customers. For services provided, revenue is recognised in the financial year that the services are provided.[33] In contrast, under the current "contract-by-contract transfer-of-control" approach, revenue from the sale of goods is recognised when goods have been delivered to the customer, and criteria for acceptance have been satisfied. Typically, goods are sold with a right of return. Hence, the amount of revenue recognised by Y Ventures is the transaction price net of an adjustment for expected returns.[34]

Y Ventures' 2018 annual report also mentions that the transaction price is due immediately to Y Ventures at the point when control of the goods is transferred to the customer, and when the services are completed. For the logistics and freight forwarding services segment, revenue is recognised when control of the goods that are shipped is transferred to the customer. For the waste management services segment, revenue is recognised when the waste management services, which are typically completed within one day, are performed and completed.[35]

The big day: IPO

Y Ventures was listed on the Catalist Board of SGX in July 2017.[36] It initial public offering (IPO) involved the placement of 35,000,000 shares at a price of S$0.22 per share. The first day of trading closed with a 16% increase in the share price, at S$0.255.[37]

The gross proceeds raised from the IPO amounted to S$7.7 million. After deducting listing expenses, the net proceeds of S$6 million would be used for "funding expansion through research and development of data analytics capabilities, advertising and developing its product range and new markets plus general working capital purposes".[38]

Y so many errors?

On 21 January 2019, Y Ventures announced material misstatements in its unaudited financial results for the six month period ended 30 June 2018, which were announced earlier on 14 August 2018.[39]

In the January 2019 announcement, Y Ventures referred to the accounting errors as "administrative inadvertencies" that resulted from inadequacies in its internal controls. The errors made were the overstatement of inventories and property, plant and equipment (PPE) by US$1,453,873 and US$20,453 respectively; as well as the understatement of trade and other receivables, and administrative expenses, by US$172,238 and US$196,869 respectively. The errors resulted in an overstatement of revenue by US$138,521, and an understatement of cost of sales and administrative expenses by US$968,073 and US$196,869 respectively in Y Ventures' income statement. The errors overstated the company's profit and loss position by US$1,303,463, causing its bottom line to swing from a profit of US$143,330 to a loss of US$1,160,133.[40]

Following the announcement, SGX issued two sets of queries to the company. In the first set of queries, the company was asked to identify weaknesses in its internal controls that had led to the accounting lapses. In its response, Y Ventures identified three inadequacies in its internal controls and also steps taken to rectify the inadequacies to mitigate the risk of such errors happening again in the future.[41]

Firstly, the manual entry for unit costs for inventories and reconciliation of inventory done using Excel on a monthly basis had resulted in the entry of incorrect unit costs for inventories and the error not being identified as at 30 June 2018. The reason given by Y Ventures for the use of a less sophisticated inventory management system was that it had only one key supplier at the time of listing, and as such the system was adequate. The company said that it has since developed an in-house computerised inventory management system to track all transactions on online marketplaces on an hourly basis. It believes that the new inventory management system will improve the accuracy in assigning inventory cost and reduce the risk of human errors.[42]

Secondly, Y Ventures attributed the understatement of administrative expenses to errors in eliminating intercompany transactions and balances at Group level as at 30 June 2018 because consolidation of accounts was done on a half-yearly basis. The management has since stopped the practice and the consolidation of accounts would be carried out on a monthly basis going forward so that any discrepancies can be detected in a more timely manner.[43]

Thirdly, the company also identified the lack of manpower and expertise in the Finance and Accounting department to handle increased transactions and expansion in business operations as a reason for the accounting errors. As at 30 June 2018, the Finance and Accounting department had four staff members. Y Ventures had anticipated business expansion and higher transactions after listing as disclosed in its Product Highlights document.[44] Despite that, the company did not sufficiently increase its staff count. The size of the Finance and Accounting department has since been increased from four to six members, comprising of the Chief Financial Officer (CFO), an assistant finance manager, an assistant accounts manager, a senior executive and two executives.[45]

As for the overstatement of PPE by US$20,453, the company explained that it was a one-time error due to erroneous recording based on amount paid to a supplier. However, the management was unaware that the PPE was still not received as at 30 June 2018 as it had not completed its verification check of the PPEs which were received as at 30 June 2018. The corrective action promised by Y Ventures was that its management would ensure that all future PPE additions recorded are physically checked and verified in order to prevent such errors from arising again.[46]

Y late disclosure?

According to the company's responses to SGX queries, the finance department first discovered "administrative inadvertence" during its internal review process and preparation for its full year statutory audit in September 2018. Y Ventures' management then detected "accounting inadvertences" when the Group performed consolidation review for the nine months ended 30 September 2018 in late October 2018. The errors were brought to the attention of the Audit Committee (AC) and the sponsor in mid-November 2018. Between mid-November and late-December 2018, the company worked on checking the restated financial figures, causes of the errors and improving its business processes. The material errors and restated results were eventually announced in January 2019.[47,48]

As noted by Professor Mak Yuen Teen from NUS Business School,[49] the fact that the announcement was made three months after the management, AC and sponsor had become aware of the errors suggests that they decided the information did not warrant the need for immediate disclosure. Catalist Rule 703 requires "immediate disclosure of material information" and Section 203 of the Securities and Futures Act makes it an offence for a person to "intentionally, recklessly or negligently fail to notify the approved exchange of such information as is required to be disclosed by the approved exchange under the listing rules".[50]

Y sell shares?

Before Y Ventures' IPO, Adam Low and Alex Low each owned more than 40% of the company's shares. After Y Ventures' share placement, Prism Investment Ventures Limited (PRIV), a technology-focused private equity fund,[51] together with the Low brothers, were the substantial shareholders, holding more than 10% and 70% of the company's shares respectively.[52]

During the period when Y Ventures' management first became aware of the accounting errors, its substantial shareholder PRIV reduced its shareholding from 11.11% to 4.03% by selling two large blocks of shares at 28 cents and 22 cents respectively.[53] Following the announcement of the accounting errors, Y Ventures' shares fell to around 8 cents on 1 February 2019.[54] PRIV's timely disposal before the announcement raised questions as to whether it had access to publicly unavailable information which led to its drastic reduction in shareholding.[55] The co-founder and CEO of Luminore 8 Pte Ltd (Luminore), a subsidiary of Y Venture, is also the co-founder of PRIV.[56,57]

SGX RegCo steps in

On 12 March 2019, Y Ventures announced that, in consultation with SGX RegCo and its sponsor, RHT Capital, it has appointed Deloitte & Touche Enterprise Risk Services Pte Ltd (Deloitte) as an independent reviewer. The scope of the review includes assessing the adequacy and effectiveness of the internal controls of the Group for periods from 1 January 2014 to 31 December 2018; quantifying and particularising any misstatements in the Group's prior years' financial statements as disclosed in the IPO offer document and to-date as a result of the internal control lapses and misstatements identified; and identifying any possible breaches of the Singapore Exchange Rulebooks, Companies Act (Cap 50) and/or Securities and Futures Act (Cap 289), in relation to the internal control lapses and misstatements identified and identifying the parties responsible for the possible breaches. Deloitte is to report directly to the company's AC, the sponsor and SGX RegCo.[58]

Who is responsible?

When SGX asked Y Ventures about the persons involved and responsible for the internal control lapses, the company responded that "the Finance and Accounting team is responsible for preparation of the announcement of the HY2018 results" without stating the responsible parties for the internal control lapses.[59]

Who is really responsible? Is it the board of directors? Or the management? How about the internal and external auditors? Or the sponsor which helped Y Ventures to list on the Catalist Board? Or perhaps SGX itself, being too hungry for new listings?

Board and management

From the time of Y Ventures' IPO until the announcement of the accounting lapses, the board comprised six directors. Adam Low was the Executive Chairman and Managing Director (MD), while his brother Alex Low was an executive director (ED) and CEO. Adam Low's background comprises of 6 years in the Singapore Armed Forces, which included being a liaison officer with Defence Science and Technology Agency. Before that, he graduated from Temasek Polytechnic in 1999 with a Diploma in Electronic Engineering. In the case of Alex Low, he has "accumulated 14 years of experience in the e-commerce market since 2003 when he first sold second-hand books online", according to Y Ventures' annual report. He graduated from the University of Washington in 2004 with a Bachelor of Science, majoring in Applied and Computational Math, and received his MBA from Peking University in 2010.[60]

There was one non-independent non-executive director (NED) and three independent directors (IDs) on the board as well. Edward Tiong Yung Suh, the lead independent director and Chairman of the Remuneration Committee (RC), is a partner in the litigation and dispute resolution practice group of law firm Allen & Gledhill LLP. His main areas of practice are corporate restructuring and insolvency, banking litigation, commercial litigation and property disputes. He had previously served as an ID and AC member of another SGX-listed company.[61]

Wong Sok Mei, another ID, has a Bachelor of Accountancy degree and has experience in the finance functions of several companies, including regional finance manager roles in multinational corporations. She is Chairman of the AC. Ng Tiong Gee, the third ID, is the Nominating Committee (NC) Chairman. He has an MBA, serves on the board of two other SGX-listed companies, and has management experience in information technology, human resource, estate management and engineering departments in several companies.[62]

Twoon Wai Mun, Benjamin, the NED, has a Bachelor of Business Management degree. He is also the Chief Operations Officer of Fundnel Limited and Fundnel Pte Ltd, and an ID of Sheng Ye Capital Limited, a company listed in Hong Kong.[63]

The three committees – AC, NC and RC – all comprise the three IDs, while Benjamin Twoon also served on the RC.[64]

The company's CFO was Chin Ngai Sung. He left the company on 1 September 2018,[65] only 17 days after the erroneous half yearly report was released. His resignation took effect the day following the date of announcement. The reason provided for the cessation was "to pursue other career opportunities".[66] Professor Mak questioned the circumstances surrounding his resignation. He said that key officers often have notice periods included in their employment contracts, and the sudden and immediate resignation is questionable and worth a closer look despite the fact that the sponsor – RHT Capital – had confirmed that there is no other material reason which led to the CFO's resignation.[67]

On March 1 2019, Benjamin Twoon resigned as NED, citing "to pursue other career opportunities" as the reason for his resignation, even though he had full-time jobs elsewhere. The sponsor said that it was satisfied that there was no other material reason for his resignation.[68] That same day, Adam Low was re-designated from Executive Chairman and MD to MD,[69] and Lew Chern Yong Eric was appointed as Executive Chairman.[70]

Eric Lew was previously an ED at SGX-listed Wong Fong Industries Limited from September 2003 to February 2019. Wong Fong Industries describes itself as "one of the leading providers of land transport engineering solutions and systems headquartered in Singapore with a presence in Malaysia and the PRC".[71] In September 2019, Eric Lew acquired a 10% stake in Y Venture[72] via wholly-owned Amber Blaze Limited – a company incorporated in the British Virgin Islands – the reason given was to align his interests with the company's.[73]

Other board changes were to follow. A new ID, 63 year-old Goh Cher Shua was appointed to the board on 7 May 2019. Goh has prior experience of two SGX-listed companies, including a Chinese company which was sanctioned by SGX regarding announcement of material price-sensitive information and which was subsequently delisted.[74] On 31 May 2019, ID Wong Sok Mei, Chairman of the AC, resigned. Y Ventures gave the reason that she was furthering her studies overseas and the board agreed that her resignation was in the best interests of the company as she would not be able to devote sufficient time and commitment to the company.[75] Another new ID, 56 year-old Tan Jia Kien, was appointed on 14 October 2019. Tan Jia Kien is the MD of Finlab Pte Ltd, has no prior experience as a director of a listed company, and had briefly worked as a business development director at Wong Fong Research and Innovation Centre in 2015.[76]

Subsequently, the CFO who replaced Chin Ngai Sung on 1 September 2018, 37 year-old Joshua Huang Thien En, resigned on 15 July 2019 "to pursue other career opportunities".[77]

In Y Ventures' corporate governance report in the 2017 annual report, the company disclosed that EDs are provided with management accounts on a monthly basis while IDs are updated on a half-yearly basis.[78] It did not provide reasons for the difference in information access between the EDs and the IDs. This was questioned by Professor Mak, who asked whether the IDs asked for the monthly information but were not given or they did not see a need for monthly information, and whether this would hinder the IDs' ability to discharge their duties as directors.[79]

Internal auditor

Before listing on the Catalist Board, PricewaterhouseCoopers Risk Services Pte Ltd (PwC) was appointed to review Y Ventures' internal controls in preparation for its IPO. After listing, Y Ventures outsourced its internal audit function to Crowe Horwath First Trust Risk Advisory Pte Ltd (Crowe Horwath).[80,81]

In response to SGX's queries regarding whether internal controls surrounding inventory balances were adequate, the company said that PwC's internal controls review for the financial period from 1 December 2015 to 30 November 2016 included the review of the inventory management and "all the recommendations from PwC at that time had been adequately addressed and implemented which included the inventory management processes".[82] However, it was unclear what issues PwC had raised regarding Y Ventures' inventory management system and how they were addressed.

According to Y Ventures' response to SGX queries on the scope of internal audits for FY2017, the company said that Crowe Horwath audited bank and cash management, sales, receivables and collections, review of general control environment, and performed follow-up review of prior year's findings. In FY2018, Crowe Horwath's scope of review consisted of the company's human resource management and payroll function, and a follow-up review on prior year's findings.[83]

The company went on to explain that in the two rounds of Y Ventures' internal audit by Crowe Horwath, it focused on areas other than controls already reviewed by PwC as the AC was of the view that those controls were "adequate and sufficient for the company".[84] Inventory controls were thus not the focus. However, Professor Mak pointed out that PwC ought to have also reviewed internal controls in areas such as bank and cash management, yet these were still within the scope of review by Crowe Horwath.[85]

External auditor

The external auditor for Y Ventures is Baker Tilly TFW LLP (Baker Tilly). SGX queried how the lapses had escaped the external auditor's statutory audit checks. The company's response was that "the management had performed a detailed review of the accounting records before finalising the management accounts for the financial year ended 31 December 2017 to prepare for the audit. The external auditor performed their audit and rendered a clean opinion on the financial statements last year. The external auditor did not note any material misstatements in the Group's closing inventories and cost of sales last year upon performance of their audit procedures".[86]

As set out under the section 'auditor's responsibilities' for the Audit of the Financial Statements, the external auditors are supposed to "obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances".[87] Keying in unit costs manually and reconciling inventories using Excel are potentially error-prone. This was not helped by the fact that Y Ventures carried a significant amount of inventories (approximately 62% of total assets as at 31 December 2017) and anticipated increasing transaction volumes and expansion of business operation after listing. Hence, it was uncertain why the external auditors did not identify inventory management as a key audit matter in both FY2017 and FY2018.

The audit opinion for FY2017 was unqualified.[88] However, for FY2018 and FY2019, the audit opinion was qualified and there was a material uncertainty related to going concern.[89,90]

Sponsor

Following the HY2018 accounting errors, SGX RegCo and the public also questioned the accuracy of the company's financial statements issued in prior periods, including those in the IPO offer document.

RHT Capital was Y Ventures' issue manager and sponsor for its listing on SGX Catalist Board and was the continuing sponsor following its listing. Y Ventures was the first company listed by RHT Capital on the Catalist Board as a full sponsor.[91] In preparing a listing applicant for admission on Catalist, RHT Capital is subject to the responsibilities under Catalist Rule 225.[92] The full sponsor is required to perform due diligence in terms of the adequacy of the listing applicant's control systems and procedures. The weaknesses in Y Ventures' inventory management system which resulted in the material misstatements for HY2018 begs the question of whether RHT Capital has adequately discharged its responsibilities. According to Professor Mak, "sponsors and the SGX must do a more robust job in scrutinising the business models and people behind the companies that are listing".[93]

Furthermore, according to Y Ventures' response to SGX queries,[94] the company suspected possible accounting errors in mid-October 2018 and RHT Capital was made aware of the errors in mid-November 2018.[95] Despite Catalist Rule 703 requiring the immediate announcement of material information,[96] the disclosure was only made in January 2019. Considering the late announcement, one may question again whether RHT Capital properly discharged its duties in advising Y Ventures about potential non-compliance with SGX's continuing disclosure requirements.

Y (so many) ventures?

In addition to its main business, Y Ventures has also entered into two joint ventures with other companies. In August 2017, the first joint venture company called Faire Leather Co. (Faire) was formed with a 51% stake held by Y Ventures and 49% by Tocco Toscano, a Singapore luxury men leather products company.[97] Toscano took care of the design, branding and production of the goods while Y Ventures was responsible for using data analytics to maximise sales and the distribution of the products via Faire's official online platform[98] as well as other major online marketplaces.[99] About two years later, Y Ventures sold the majority stake in Faire at a consideration of S$5,000 to the owner of Toscano and exited the joint venture. However, Y Ventures and its wholly-owned subsidiary LYJ International Pte. Ltd. continued to have working capital loans of S$150,000 tied up in Faire, charging either zero or a simple monthly interest of one percent until May 2020.[100]

In July 2018, Y Ventures announced another proposed joint venture agreement with Arke Blockchain Engineering Pte Ltd (Arke) via its subsidiary, Luminore. Y Ventures was to own a 60% stake with Arke owning 40% of Luminore.[101] The aim of this partnership was said to be to develop a blockchain-enabled global buying platform, AORA,[102] that would allow consumers to purchase products from any online store and marketplace using cryptocurrencies or via conventional payment methods. A new cryptocurrency – AORA Coin – was envisioned for use in e-commerce transactions.[103] With a memorandum of understanding signed, Singapore Post also came on board to develop the site, explore possible technological enhancements for the logistic industry and provide logistic services.[104] In addition to its investment amounting to S$120,000, Y Ventures also provided shareholder loans of S$500,000 for Luminore's working capital purposes.[105]

In order to raise funds for the development of the AORA platform, Luminore launched an initial coin offering (ICO) of utility tokens in July 2018. Y Ventures is reportedly the first Singapore-listed company to do so.[106] In Y Ventures' announcement, it warned potential investors of risks involved in the investment. For instance, as AORA Coins do not fall within the definition of securities under the Securities and Futures Act, regulatory safeguards and protection applicable to typical securities would not be applicable for purchasers of the AORA Coins.[107]

Y Ventures is not the first company which tried to launch an ICO in Singapore.[108] However, the complex compliance matters involved and the monitoring of the market activities by the Monetary Authority of Singapore (MAS) have made it difficult for companies to achieve that. In May 2018, MAS issued a public warning to digital token exchanges and ICO issuers to stop doing so due to a lack of clear regulations.[109]

Subsequently, in October 2018, Y Ventures announced a reduction of its stake in Luminore from 60% to 20%, citing factors such as compliance requirements and accounting uncertainty over the ICO.[110] The company stated that the joint venture "requires the management to divert more time and resources than initially considered" to compliance.[111] According to Y Ventures' FY2018 annual report, the remaining 20% equity interest in Luminore is carried at US$1.[112] Under the variation agreement, Arke would be entitled to appoint all of the joint venture company's directors. Y Ventures would no longer be involved in the management and operations of the joint venture company, the ICO and the AORA platform.[113]

In response to SGX query regarding trading activity on 14 October 2019, Y Ventures disclosed the possibility of a third joint venture for the Group, even though no formal agreement had been entered into.[114]

Y no dividend?

While Y Ventures mentioned in its product highlights sheet that it currently does not have a fixed dividend policy, and the distribution of dividends depends on various factors such as earnings and capital needs,[115] the company clearly stated an intention to declare an annual dividend of at least 20% of net profit after tax for FY2017 and FY2018 in its offer document.[116,117]

The product highlights sheet identified "ongoing compliance costs of a publicly listed company,…in respect of a portion of our listing expenses incurred in connection with the Placement" as an uncertainty that may have a material effect on its financial performance in 2017 and in the future.[118] However, it is unclear whether the company has carefully taken this into account when formulating the dividend distribution expectation for 2017 and 2018.

In FY2017, Y Ventures incurred a total loss of US$890,467[119] and therefore no dividend was declared. As Professor Mak pointed out, in the FY2017 annual report, the company had changed its tune about the dividend policy as it now said that "the company does not have a fixed dividend policy. The issue of payment of dividends is deliberated by the board annually, having regards to various factors (e.g., Company's profit, cash flow, capital requirements for investment and growth, general business conditions and other factors as the Board deems appropriate)".[120]

Epilogue

Y Ventures listed in July 2017 at a price of S$0.22. By early January 2020, it was trading at about half its IPO price. Following the COVID-19 pandamic, its share price has continued to fall, and by 8 April 2020, its share price was just S$0.056.[121]

The findings from the independent review, first announced in March 2019, have not been released as of 16 August 2020.

Discussion questions

1. Evaluate the business model of Y Ventures. Would such a business model be more prone to corporate governance and accounting problems? Explain.

2. The co-founders, Alex and Adam Low, were majority shareholders, served on the board of directors, and were part of the management of Y Ventures. Discuss the benefits and risks posed by the non-segregation of shareholder, board and management roles in such cases.

3. Critically evaluate the structure of the board of directors of Y Ventures in terms of its size, leadership and composition at the time when the accounting lapses and internal control deficiencies occurred. Do you think the structure of the board was a contributing factor? Explain.

4. Critically evaluate the board and management changes. Do they raise any concerns? Do you think the board structure has improved? Explain.

5. Who should be held responsible for the accounting lapses and internal control deficiencies? How could the four lines of defence be improved to prevent such problems in the future?

6. A number of the disclosures made by Y Ventures have been viewed to be untimely. Should the sponsor be responsible for this non-compliance? To what extent should a sponsor monitor the company in ensuring the timely disclosure of material information? How can the Catalist-listed companies be better monitored?

7. Y Ventures entered into joint ventures which it quickly exited from or reduced its investment in. What is the role of the board in such decisions? Do you think the board has effectively discharged its role in this regard? Explain.

8. Discuss whether SGX Regco has effectively discharged its responsibiliites on a timely basis.

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INDIA'S LEADING & FINANCIAL SCAM

Case overview

In 2018, India's non-banking financial companies (NBFC) sector was roiled by a series of defaults by the Infrastructure Leasing & Financial Services Limited (IL&FS) group of companies, with Rs848,000 crore of investor wealth vanishing within a few days. Several board members resigned, the CEO of one of its defaulting subsidiaries quit abruptly, and multiple key management personnel were replaced. The Group was further embroiled in money-laundering charges levelled against 14 of its directors. The high-profile scandal led to investors losing faith in India's NBFC sector, which was an important driver of India's economic growth, providing an accessible source of funding for industries such as agriculture and real estate. It also sparked public outcry and scrutiny as to whether enough was done by all parties involved in preventing such a massive meltdown.

The objective of this case is to facilitate a discussion of issues such as board composition; governance of company groups; overlapping directorships on boards of related companies; non-segregation of shareholders, management and the board; risk governance and risk management; financial management; investment governance; remuneration; and the role of the government, regulators, auditors and credit rating agencies.

The rise of IL&FS

Incorporated in 1987, Infrastructure Leasing & Financial Services Limited (IL&FS) was the brainchild of the late MJ Pherwani, the Chairman of the Unit Trust of India (UTI) and the National Housing Bank (NHB) in India.[1] The company was initially advocated by the Central Bank of India (CBI), Housing Development Finance Corporation (HDFC) and UTI, with the objective of providing finance and loans for major infrastructure projects in India.[2] This need was pertinent especially because the only players at that time, the Industrial Development Bank of India (IDBI) and Industrial Credit and Investment Corporation of India Bank (ICICI), were primarily focused on private sector projects. IL&FS was supported by government-controlled entities in the 1980s, including the CBI, UTI and HDFC.[3]

Over the last two decades, the focus in India turned towards infrastructure, and Prime Minister Narendra Modi announced a major program to develop this area. The master plan included the construction of highways, roads, tunnels and affordable housing, as well as renewable power generation across the country between 2014 and 2015.[4] This led IL&FS to utilise its

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first-mover advantage to obtain projects through direct bidding or joint ventures. Its operations quickly spread from Spain to China, with many offices set up worldwide. Businesses ranged from sanitation projects and multilane highways to thermal power projects and solar parks,[5] under a group structure comprising at least 24 direct subsidiaries, 135 indirect subsidiaries, six joint ventures and four associate companies since its inception.[6] Its subsidiaries included transportation network building subsidiary IL&FS Transportation Networks Limited (ITNL), engineering and procurement company IL&FS Engineering and Construction Co Limited, and financier IL&FS Financial Services Limited (IFIN).

Too big to fail?

Until early August 2018, IL&FS scored AAA ratings from credit rating agencies,[7] mostly due to it being central in government infrastructure plans and its impressive list of top shareholders. This helped IL&FS to secure funding from investors but also led to high debt levels. IL&FS' total debt amounted to approximately Rs91,000 crore at its peak, with Rs57,000 crore due to public sector lenders. The amount which IL&FS owed banks was over 10% of the net worth of all public sector banks in India.[8]

The financing came from a variety of sources, with the large majority coming from public sector banks and individuals who invested in its non-convertible debentures. IL&FS also raised financing from other banks, financial institutions, NBFCs, corporations, and state governments. Its subsidiary, IFIN, would then lend these funds as start-up capital to subsidiaries which would partner with Public Sector Units as promoters in Public-Private Partnerships (PPPs).[9]

The PPP model allowed IL&FS to establish a significant presence in India's infrastructure sector, with more than 300 subsidiaries in roads, transport, energy, maritime infrastructure, water, and urban management. However, IL&FS subsidiaries were not just private partners in the PPPs. Some of these subsidiaries were established to provide a range of consulting services to projects financed by the Group, forming an intricate relationship between Group entities.[10]

It was a combination of IL&FS' substantial presence, vast clout, and systemic importance as an NBFC that aided the Group in its planning and execution of scams. IL&FS squandered public finances by being a financial institution which also entered into PPPs, and hired its own subsidiaries as consultants for their own projects. This gave IL&FS the capacity to borrow large sums from public banks and channel the money into joint ventures which it created with public sector units, to form PPPs.[11]

Bubble waiting to burst

The modus operandi of IL&FS was simple: aggressively bag new projects, borrow to fund them, and divert the money to repay lenders to earlier projects. From 2014 to 2018, although its operating profit rose by 43% from Rs5,087 crore to Rs7,267 crore, its debt level rose by 87% – from Rs48,671 crore to Rs91,091 crore. This placed its leverage ratio at 13 times, vis-à-vis what was considered a safe level of three times. The company's high leverage was a result of its sizeable capital requirement across subsidiaries, with a huge interest bill of Rs7,923 crore in March 2018, a doubling from Rs3,970 crore in 2014.[12]

Problems arose when IL&FS piled up too much debt to be paid back in the short term while revenues from its assets were skewed towards the longer term, causing an asset-liability mismatch. The Group first sent shockwaves across the market when it postponed a US$350 million bond issuance in March 2018 due to investors demanding a higher yield.[13]

Under increasing pressure from the Reserve Bank of India (RBI) – India's central bank and regulator of India's banking sector – to identify and deal with bad loans swiftly, India's banks were wary of extending and rolling over loans if the credit risks were high. As a result, IL&FS found it more challenging to refinance its debts as they came due.[14]

IL&FS' net debt to earnings before interest, tax, depreciation and amortization (EBITDA) was approximately 11 times at the end of March 2018. The ratio measures a company's ability to pay debt through its operating income, and analysts considered anything above five as a red flag. This was followed by a series of downgrades in credit ratings starting from June 2018.[15]

When things started going south

June 2018 marked the start of a string of events which led to IL&FS' downward spiral.[16] That was when four out of five subsidiaries of ITNL missed payments on debt due for that month, forcing rating agencies to assign a default rating. Debt worth more than Rs28.5 billion would face a default rating, while the debt for five projects anticipating termination stood at more than Rs43 billion.[17] In July 2018, ITNL continued to face difficulties in making payments due on its bonds.[18] This came after a series of warnings from rating agencies of the possibility of project termination by the special purpose vehicles (SPVs) floated by several companies. Following that, CARE Ratings downgraded ITNL's bank facilities and debt instruments, citing "build-up of liquidity pressure on the Group due to delay in raising funds".[19]

In September 2018, IL&FS and its subsidiaries had defaulted on loans and inter-corporate deposits to other banks and lenders. It had earlier defaulted on inter-corporate deposits to Small Industries Development Bank of India (SIDBI) amounting to approximately Rs450 crore.[20]

On 4 September 2018, it was reported that IL&FS could not repay a Rs1000 crore short term loan from SIDBI. As a result, SIDBI requested for the resignation of Swaminathan Mallikarjun – IL&FS' chief general manager in the risk management department – for the bad debt.[21] SIDBI also threatened to file a case against IL&FS in the National Company Law Tribunal (NCLT) for non-repayment.[22] By mid-September, IL&FS and IFIN had accumulated a combined Rs27,000 crore of debt rated as 'junk' by CARE Ratings and six other Group entities had suffered downgrades with a negative outlook on an additional Rs12,000 crore of borrowings.[23]

Reactions

In late September 2018, IFIN informed the stock exchanges that it had defaulted on a Rs52 crore repayment of short-term deposits and Rs104 crore term deposit. It also failed to repay five other bank loans and associated interest, which further exacerbated its position in the market.[24]

RBI then initiated a special audit on IL&FS and met the three largest investors of IL&FS – Life Insurance Corporation of India (LIC), Japan's Orix Corporation, and Abu Dhabi Investment Authority – to discuss the large-scale defaults.[25] As more debt deadlines loomed closer, IL&FS' credit rating continued to experience sharp downgrades. Credit ratings agencies ICRA and CARE Ratings cut their scores on a number of IL&FS' debt instruments to 'D' on 17 September 2018, indicating actual or imminent default.[26]

At IL&FS' Annual General Meeting on 29 September 2018,[27] the board of directors rushed to pass a motion to raise Rs4,500 crore through a rights issue, to be completed by the following month. The board also raised the borrowing limit from Rs25,000 crore[28] to Rs35,000 crore. The company appointed Alvarez & Marsal as a specialist agency to execute the debt restructuring plan.[29] But is this a case of "too little, too late"? What contributed to its troubles?

Shareholders blindsided

Most of IL&FS' shares were held by Indian state-owned enterprises and private companies. The main shareholders of IL&FS included LIC with 25.34%, Japan's Orix Corporation with 23.54% and Abu Dhabi Investment Authority with 12.56%.[30] These shareholders were found not to be involved in the wrongdoings of the company. In contrast, the manner in which the company was structured and managed by the board of directors and its executives was highly questionable.[31]

Other than the major shareholders mentioned above, IL&FS Employees Welfare Trust also had a substantial stake of 12%.[32] This was a trust fund set up by the company to provide financial assistance to its lower-income employees. However, this trust was found to be a shell company that comprised mainly prominent board members who used their positions in it to bring benefit to themselves, at a cost to the IL&FS Group companies. Less than one percent of the funds that went through the EWT was used for the welfare of needy employees. Further, around 3.1 million shares of IL&FS were distributed to managerial personnel and employees, who were not meant to be the original beneficiaries of the trust.[33]

The Serious Fraud Investigation Office (SFIO), Delhi Police and tax authorities probed into various suspected irregularities of IL&FS. The SFIO alleged that the management of IL&FS hid non-performing loans, falsified accounts and concealed material information for their benefit. The top management also allegedly milked the dividends and substantial sitting fees from artificial profits booked by IFIN.[34,35]

Self-service

Industry observers felt that IFIN was run by IL&FS Chairman Ravi Parthasarathy and Vice Chairman Hari Sankaran like a "personal fiefdom".[36] According to an SFIO official, the "top management used IFIN as a tool for personal gain".[37]

Other than having highly suspicious transactions across the Group, there were also several instances where the board of directors and management had arguably violated their duties by having a conflict of interests. One such instance was when Group entities rented properties from certain employees or their family members and paid rental fees well above the market rates.[38] Other instances include a loan of Rs28.99 crore extended to Indus Equicap Consultancy Pte Ltd, where one of the IL&FS directors was also acting as a director.[39]

Emails between the Group's former management and borrowers showed that IFIN's officials enjoyed additional perks. For example, in 2014, S. Sivasankaran of the Siva Group – one of the beneficiaries of IFIN's sophisticated transaction arrangements – arranged for a helicopter tour and ski resort stay in Norway for Parthasarathy. Viren Ahuja of Flamingo Group also arranged for an internship at Moet Hennessy for the daughter of IFIN's Chief Executive Officer (CEO) Ramesh C. Bawa.[40]

Too big to comprehend

The highly complex structure of IL&FS made it extremely difficult to track the accounts of each of its subsidiaries or associates.[41] The Group was thus able to easily hide fictitious transactions and shift profits around the various Group entities to its advantage, making it virtually impossible to verify the authenticity of its accounts.

Furthermore, IL&FS failed to accurately disclose the number of parties related to the parent company. In its annual report, it was disclosed that the Group had 24 direct subsidiaries, 135 indirect subsidiaries, six joint ventures and four associate companies. However, when thorough investigations were carried out, it was found out that there were in fact 347 companies under parent company IL&FS.[42]

Funds were also found to be diverted across the multiple entities in the Group. According to the report by the SFIO, the Group seemed to operate as a single entity without any proper segregation between legal entities and separate management.[43] This unlawful manipulation of funds was concealed by IL&FS's highly complex business structure[44] and made it extremely difficult for auditors to uncover discrepancies within reported figures in the Group.[45]

Merry-go-round

Intragroup transactions which were carried out by IL&FS were significant, specifically in the form of loans given out by its finance arm, IFIN, to other companies within the IL&FS Group, amounting up to Rs5,728 crore, Rs5,127 crore, and Rs5,490 crore in FY2016, FY2017 and FY2018 respectively – well above the allowable regulatory limit set by the RBI for all three years. The fact that it provided loans above their regulatory limit also suggested that IFIN had insufficient working capital for these years.[46]

Using window dressing, IFIN also raised money through non-convertible debentures and commercial papers. It kept only the minimum necessary cash required by RBI regulations while the remaining profits were ploughed back to IL&FS as dividends. The payment of the dividends back to IL&FS allowed IL&FS to continue showing healthy profits on a year-on-year basis in its books, despite the catastrophic state of its finances.[47]

A few of these transactions occurred across the entire period, including loans of Rs1,500 crore and selling off assets at heavily discounted prices. The loans made to a Group company were routed through eight other companies, deceiving the regulators. Furthermore, it was discovered that an asset was transferred from one entity in the Group to another at a value of Rs30.8 crore based on an independent fair valuation. However, a year later, a committee of directors resolved to sell the same asset to a third party at Rs1 crore.[48] The auditors of IL&FS failed to report these critical findings to the board.

The accounting firm, Grant Thornton, who were the internal auditors, discovered that transactions amounting to over Rs13,000 crore were linked to irregularities such as conflict of interests, inadequate risk assessment and deviation from bank norms. In 29 instances, loans that were to be disbursed were instead rerouted to repay IL&FS' existing debt obligations with IFIN. Additionally, Grant Thornton uncovered advances to entities linked to senior IL&FS executives or directors, resulting in conflicts of interest.[49]

Rules are meant to be changed

In investigating the intragroup transactions, the related party transactions (RPT) policy of IL&FS came under scrutiny. It was found that IFIN had repeatedly diluted its RPT policies such that it could continue lending to fellow Group entities, yet still obtain favourable ratings. While IL&FS had a board-approved RPT policy for lending to Group entities, it made several changes to it between 2015 and 2017 to dilute it.[50]

Under IFIN's RPT policy, there was a list of circumstances under which RPTs were considered to be 'exempt RPTs', and only required approval from a committee of directors. Such 'exempt RPTs', unlike 'non-exempt RPTs', did not need to undergo further review by the Audit Committee or require approval from the board and/or shareholders. In May 2015, the scope of 'exempt RPTs' was expanded, and then further expanded in 2017 without approval from the board.[51]

Another important aspect of handling RPTs was to determine the arm's length pricing. The standard was for the valuation to be conducted by independent valuers. However, IL&FS amended its policy in 2015 to prescribe that valuations should be done by an "empaneled set of independent valuers". These valuers were essentially selected by the company, allowing it to "get favourable reports for the transactions' underlying values". This suggested an element of conflict of interest and was not consistent with having the valuation done independently by a third party valuer.[52]

In 2014, the Audit Committee had highlighted to the statutory auditors the need to review the RPT policy of IFIN. However, this review was instead delegated to the internal auditors, and it was not until February 2016 that the evaluation was finally completed. Meanwhile, proposed changes to the RPT policy were readily accepted by the Audit Committee without much deliberation prior to the completion of the review. To make matters worse, several findings of deficiency in internal controls pointed out by the auditors in February 2016 fell on deaf ears, and no follow-up action was taken.[53]

Where was the board?

"The rest of the board [excluding Ravi Parthasarathy] exists only for decorative purposes."

– Andy Mukherjee, a Bloomberg columnist[54]

IL&FS' 15-member board consisted of a majority of non-independent members.[55] Amongst the five who were declared independent, three have been on the board for more than ten years.[56]

The roles of IL&FS' Group directors also extended to its subsidiaries, with a core group of directors sitting on the subsidiaries' boards. For instance, Ravi Parthasarathy was Chairman of IL&FS Group's board and was on IFIN's board as well;[57] whilst Arun Kumar Saha held the roles of joint Managing Director and CEO of IL&FS Group,[58] as well as director of IFIN. Sankaran, the Vice Chairman of the IL&FS Group board, also concurrently served as a director of IFIN.[59]

The IL&FS board was made up mainly of nominee directors representing the various institutional shareholders. Major shareholders seemed to turn a blind eye in managing their investments in the Group across the years.[60] Ironically, the bulk of the information was uncovered by a probe led by RBI. RBI itself had a nominee director, Bijender Kumar Singal, on the Group's board.[61]

As the empire he built up crumbled in front of his very own eyes, Parthasarathy abruptly left the company due to "medical reasons"[62] on 21 July 2018,[63] along with a handsome retirement package.[64] The public questioned the legitimacy of the reason behind his shock departure, speculating that there was possible mismanagement.

The second shock came with Bawa's resignation as Managing Director and CEO of IFIN on 21 September 2018.[65] On 1 October 2018, the Indian Government issued lookout notices across the country's airports for the two, along with two other IL&FS directors, due to likelihood of them fleeing the country. This came immediately after the government's decision to freeze bank accounts, credit cards and all assets of the various directors involved.[66]

Parthasarathy, through his lawyers, claimed that freezing his accounts was essentially "a situation of life and death", as the costs of his ongoing cancer treatment far exceeded the monthly limit of monies he was allowed to use.[67] He further applied to the government to allow him to travel for continued treatment for throat cancer at a London hospital.[68]

Paper tiger

Since 9 March 2015, the Nominating and Remuneration Committee (NRC) of IL&FS Group consisted of Sunil B. Mathur as Committee Chairman; Harish Engineer (resigned with effect from 15 September 2017), Michael Pinto, and Sankaran (joined in FY2018).[69] After Engineer's resignation, the NRC appointed Parthasarathy as a member.[70]

However, board members not officially in the NRC could influence the appointment of independent directors.[71] In an investigation undertaken by the Enforcement Directorate (ED) against IL&FS CEO Saha (non-NRC member), it was revealed that in an email response to Sankaran (NRC member), he requested the independent director be "non-intrusive" and "obedient".[72] In a separate probe conducted by the SFIO, it was also found that the pay component was also decided by the board of directors, rather than the NRC.[73]

Remuneration – Up, up and away[74]

The annual reports of IL&FS show that the average percentage increase in managerial remuneration was 66% from 2017 to 2018. In comparison, the average percentage increase in the salaries of employees other than managerial personnel in the same period was 4.44%.[75]

In the previous four years, although the net profit of parent firm IL&FS increased from Rs210 crore in FY2015 to Rs450 crore in FY2018, the consolidated net profit of the IL&FS Group declined steeply from Rs80 crore to a loss of Rs2,090 crore across the same period. In fact, the Group has been posting losses for three consecutive years since FY2016. This was attributed to the Group's rapid expansion and inability to monetise its infrastructure assets, resulting in its consolidated liabilities increasing from Rs68,000 crore in FY2015 to Rs99,950 crore by FY2018. The substantial amount of debt was only supported by Rs7,400 crore of equity.[76]

Despite the poor performance by the IL&FS Group, neither nominee directors nor independent directors implemented pay cuts for directors. In fact, the reverse happened.[77]

Parthasarathy's total emoluments shot up by 144% in FY2018 compared to year before, though the bulk of the increase was from retirement benefits. However, his salary component also contributed to this increase, rising from Rs5.806 crore in FY2014 to Rs9.212 crore in FY2018, during a period when the Group's financials were not in good shape. Further, despite him serving on the IL&FS board for only half of the financial year, his FY2018 salary saw a rise from the FY2017 full-year management salary of Rs9.034 crore.[78]

Similarly, between FY2015 and FY2018, Sankaran's total remuneration increased by 61% to Rs7.76 crore, while Saha's increased by 20% to Rs7 crore.[79]

Additionally, there was a performance-related pay component to the remuneration packages which was contingent on the revenue and profit of IL&FS. Parthasarathy's performance-related pay as of March 2018 amounted to Rs6.24 crore despite the loss-making performance of the Group.[80] It was also further revealed that six senior management personnel were paid an aggregate of Rs76 crore as performance-related pay from FY2014 to FY2018. IFIN also continued to pay large commissions and sitting fees to these same individuals.[81]

Risk? What risk?

The role of the Risk Management Committee (RMC) is to review areas such as asset-liability management, credit, liquidity and market risk, capital adequacy and compliance with regulations. Since FY2015, the RMC consisted of Saha, R. C. Bhargava, Michael Pinto, and S. Bandyopadhyay – the LIC nominee and then-managing director of LIC Pension Fund, who resigned from the board on 3 April 2017 – and was succeeded by Hemant Bhargava, managing director of LIC.[82]

Despite its importance and the increased risks and debt levels, the RMC only met once between FY2015 and FY2018. This can be compared to IDFC Bank, another infrastructure finance company, where its RMC met 14 times between FY2015 and FY2018.[83]

When queried about the lack of RMC meetings, a former IL&FS senior director said it was "not necessary". He said that all the issues relating to the risks faced by the company and its impending financial problems were on the key agenda whenever the board of directors met.[84]

Mis-investment

IL&FS had significant exposure in its investments, with IFIN managing most of these investments. IL&FS' investments totaled Rs12,775.4 crore as at 31 March 2018, but it also made provisions of Rs158.5 crore for the diminution in the value of investments. In addition, there were unaccounted additional provisions amounting to Rs3,491.9 crore.[85]

Despite the large investment amounts in IL&FS, the Group did not have a board-approved investment policy, nor stringent guidelines to manage the investment risk across Group entities. In addition, it was stated that business strategies of the Group were "never deliberated from the risk perspective", and that "credit risk and linkage with liquidity risk was never identified in credit and investment decisions".[86]

These lapses in investment risk should have been discussed by IL&FS's Investment Review Committee (IRC). However, this committee had not met for three years since 5 October 2015. In the absence of IRC meetings, investment-related proposals were instead approved by IFIN's Committee of Directors (CoD) of six persons, namely Parthasarathy, Sankaran, Bawa, Saha, Vibhav Kapoor, and Karunakaran Ramchand.[87] In addition, there was no proper system implemented for monitoring the end use of funds.[88]

These observations point to serious lapses in the approval process for investment transactions, which allowed huge loans to be extended to certain entities, even after the risk management team advised against it.[89] Based on a forensic audit report prepared by Grant Thornton, there were 18 instances where the CoD approved loans totaling approximately Rs2,400 crore to borrowers who appeared to be in potential stress, despite adverse assessments by the risk management team. Additionally, there were another 16 cases amounting to Rs1,922 crore where the CoD authorised loans at a negative spread or limited spread, to borrowers which were facing liquidity issues.[90]

Moreover, there were up to eight instances, amounting up to Rs541 crore, where short-term facilities at IFIN were lent out for the long-term instead. These long-term loans went ahead despite the troubles and financial difficulties faced by the company, and no precautionary measures were undertaken by the risk management team to mitigate the inherent risks they were taking on.[91]

The 'yes' men

The IL&FS crisis also called into question the role of the internal auditors who failed to notice the problems that had been developing on IL&FS' balance sheets for several years. The Audit Committee (AC) ignored whistleblower complaints and RBI inspection reports, and failed to make independent and unbiased judgments. Instead, the AC allegedly "chose to live in denial" and were overly dependent on management viewpoints.[92]

In 2017, a complaint by a whistleblower was allegedly covered up by the top management of IL&FS in collusion with the company's independent directors.[93] The whistleblower complaint was received in March 2017, but it was only discussed by the AC nine months later in December 2017. SFIO's investigations found that the AC, instead of inquiring into the allegations made in the complaint, simply accepted the viewpoint of the management and did not make any independent assessment of the allegations.[94]

In addition, the response of the AC to various issues such as the definition of Group companies, calculation of the net owned funds and capital adequacy ratio were all made in tandem with IL&FS management's viewpoints. There was no independent verification or inspection carried out by the AC to challenge these viewpoints.[95]

Most notably, in the third quarterly FY2017-2018 internal audit report, it was found that a facility, Golden Glow Estates which had turned into a non-performing asset was a loan that was in or close to being in default. This needed to be addressed by way of income and interest reversals, but no such action was taken by the AC.[96]

Hiding in plain sight – External audit

"We are not expecting an auditor to detect a needle in a haystack, but if an elephant is in a room, they ought to find it."

– *Injeti Srinivas, Ministry of Corporate Affairs secretary*[97]

The external auditors were affiliates of Deloitte Haskin and Sells LLC (Deloitte), KPMG India, and EY India Ltd. These firms covered the audits for IL&FS and its main subsidiaries – IFIN and ITNL.[98] Deloitte was the statutory auditor of IL&FS between FY2007 and FY2017, while KPMG affiliate BSR & Associates LLP (BSR & Associates) was appointed as a joint auditor for FY2018.[99] Meanwhile, SR Batliboi & Co (SR Batliboi), an affiliate of EY, had also audited accounts of IL&FS.[100]

There were a host of allegations against the auditors, from missing out on the sprawling IL&FS Group structure and not flagging out the asset-liability mismatch on the company's books, to the inappropriate valuation of assets and inadequate recognition of non-performing assets.[101]

However, throughout the audit process, one key issue the external auditors faced was that the prescribed regulations under the Institute of Chartered Accountants of India (ICAI) did not allow the principal auditor to look into the audit of subsidiaries.[102] In the case of IL&FS, ITNL and IFIN, the principal auditors only audited part of the accounts and relied on the opinion of auditors of subsidiaries. Furthermore, 35 different audit firms were engaged to audit more than 300 Group subsidiaries.[103] This resulted in difficulties for the external auditors to identify the exact number of subsidiaries in IL&FS, and they could not comment on the under-reporting due to the lack of direct line of sight. In addition, the limited exposure to subsidiaries prevented auditors from detecting diversion or misuse of funds. In spite of this, it was clear that IL&FS was experiencing a full-blown solvency crisis. Hence, it remains questionable why the auditors did not utilise their professional discretion to raise the relevant questions in a timely manner.[104]

ICAI was prompted to initiate action against BSR & Associates for professional misconduct under the Chartered Accountants Act, 1949.[105] According to the accounting regulator, the auditors had failed to highlight the RBI's inspection report, which had considered IFIN as being over-leveraged. The auditors also did not report IFIN's negative cash flows and adverse key financial ratios.[106] Although BSR & Associates had raised queries in May 2018, at least 17 of the company's loan facilities were being used for evergreening – a tactic used to conceal loan defaults by issuing new loans to help delinquent borrowers repay or pay interest on old loans – the auditors ultimately did not highlight it in their report.[107]

Caught in the act

According to the SFIO, Deloitte had disregarded the RBI's regulations, turned a blind eye to IFIN's evergreening of loans, and failed to cross-check any of the "tutored end-use certificates" the company used to mislead lending banks.[108]

A member of the senior management in Deloitte sent an anonymous letter to the Indian government and revealed that Deloitte was fully aware of all the irregularities going on in IL&FS. Deloitte was paid Rs20 crore yearly for its auditing and consulting work and it was alleged that, in return, Deloitte colluded with the IL&FS management and assisted it to cover up the company's accounts year after year. Deloitte was alleged to have engaged a senior tax advisor to come up with a complex system for IL&FS to evade taxes.[109]

Deloitte was also said to have been awarded advisory contracts by IL&FS in exchange for "giving a favourable view".[110]

(Dis)credit rating agencies

A forensic audit conducted by Grant Thornton discovered that credit rating agencies continued to award high credit ratings to IL&FS despite being aware of the weak financials of the Group.[111]

During its special audit, Grant Thornton noted that credit rating agencies had multiple concerns for the past seven years about the operations of the IL&FS Group, but continued to assign consistently high ratings, only reversing or downgrading them after mid-2018.[112] Two of India's top credit rating companies, ICRA and CARE Ratings, continued to award high credit ratings to the borrowings of IL&FS and its subsidiaries till August 2018.[113] In addition, India Rating & Research Pvt Ltd gave an excellent long-term credit rating for IL&FS even though its subsidiary, ITNL, had already defaulted on its repayment obligations previously.[114]

These three credit rating agencies together helped the IL&FS Group to corner over two percent of all commercial papers, one percent of all corporate debentures, and almost one percent of all banking system loans outstanding at the country level. The Group's aggregate borrowings amounted close to an astounding Rs100,000 crore.[115]

The Enforcement Directorate – the law enforcement agency and economic intelligence agency responsible for enforcing economic laws and fighting economic crime in India – also uncovered that IL&FS' senior management had interfered in the ratings review to upgrade the ratings of its Group entities.[116] They intentionally provided incorrect or incomplete information to the credit rating agencies to avoid rating downgrades. IL&FS also paid large sums to keep ratings private when favourable ratings were not obtained. Lastly, IL&FS management also allegedly exerted pressure on rating agencies by threatening to approach other competitor rating agencies when desired ratings were not given.[117]

A half-asleep giant

The role of the RBI was also called into question by the SFIO, which said that timely intervention by the central bank could have led to early detection of the crisis in the IL&FS Group. The SFIO further highlighted that IFIN – which was at the core of the investigation – was allowed to operate despite RBI raising red flags. SFIO said that the RBI should have instead conducted an internal probe and taken "appropriate action".[118]

RBI had repeatedly pointed out non-compliance with the Group exposure norms and incorrect calculations of net owned funds in its inspection reports from 2015 onwards. Yet, no penalties were imposed during the period and IFIN was allowed to continue business as usual without any corrective actions.[119]

RBI only took action in November 2017 by conveying the proposed necessary changes to IFIN.[120] Hence, in its charge sheet, SFIO suggested that RBI should conduct an internal inquiry with regard to the reason for the delay and thereafter take appropriate action and implement suitable policy measures to prevent such fraudulent activities in the future.[121]

The aftermath

On 15 September 2018, the government appointed former LIC Chairman, Sunil Behari Mathur, as IL&FS Group Chairman.[122] A week later, DSP Mutual Fund's sale of Dewan Housing Finance (DHFL) commercial papers at a high yield triggered panic in equity and bond markets.[123] The stock market crashed by 1,500 points as investors doubted the sustainability of the NBFC business model of financing long-term lending by short-term borrowing. The IL&FS crisis sparked vast outflows in liquid funds in September 2018. There were also fears of contagion in mutual funds, who were major investors in NBFC commercial papers, as shadow banks faced difficulties in raising funding.[124]

Although an announcement was released, the rights issue by IL&FS never materialised due to the Indian government stepping in. On 1 October 2018, an NCLT judgment allowed the Indian government to take steps to take control of the company and arrest the spread of the contagion to the financial markets. The move caught investors by surprise. A new board, led by Kotak Mahindra Bank managing director Uday Kotak, was constituted. However, experts commented that the new board members lack sufficient expertise in the infrastructure sector to effectively rescue IL&FS.[125]

On 5 March 2019, the new government-appointed board of IL&FS charged 14 former directors of IFIN for facilitating money laundering, sanctioning loans in violation of rules and causing "huge financial stress and losses" to the company via the issuance of show-cause notices.[126]

A month later, Sankaran, former Vice Chairman of IL&FS, was arrested by SFIO for causing wrongful loss to IL&FS, as well as on fraud charges. He was accused of abusing his powers in IFIN through fraudulent conduct and in granting loans to entities which were not credit-worthy or were classified as non-performing accounts, causing loss to the company and its creditors.[127]

The ICAI found the statutory auditors of IL&FS and two of its subsidiaries, ITNL and IFIN to be "prima facie guilty" of professional misconduct. These included Deloitte, BSR & Associates, and SR Batliboi.[128]

Rising from the trenches

On 31 October 2018, the newly appointed Kotak-led board submitted a revival plan for the troubled company. Apart from preparing a roadmap to revive IL&FS, the plan also acknowledged that "the mess was a result of greed, mismanagement, and deliberate oversight".[129]

In its second report, the board informed the NCLT of its plan to focus on vertical as well as asset-level resolution. It stated that this was because it was impossible to find a remedy for the Group with the overwhelming Rs91,000 crore debt. The resolution would involve significant capital investment from strong and credible investors, which was not feasible given the current situation.[130]

On the issue of the audit of subsidiaries, international laws have made it clear that the principal auditor is expected to review all the subsidiaries of the company, no matter its size. The Securities and Exchange Board of India was thus prompted to issue a circular, which mandated that listed entities must conduct a limited review of the audit of all the entities which accounts are to be consolidated. This would ensure that, in future, principal auditors of listed companies have a certain degree of weight in the audit of subsidiaries.[131]

So...what next?

A year after the IL&FS scandal, the NBFC sector continues to struggle, especially those geared towards lending to real estate firms.[132] Defaults are continuing to occur, which is a cause for concern for the India economy as many loans go towards construction projects which are highly dependent on them. NBFCs which specialise in home loans have also been slow in disbursement, leading to poor consumer sentiment. The Indian government has announced measures to provide last-mile funding to stuck projects,[133] but experts believe that capital needs to be raised from overseas and systematic reforms are the key to tackling the root cause of this crisis.

Discussion questions

1. Was the collapse of IL&FS due to its business model, poor financial management, weak risk governance and management, poor corporate governance and/or other factors? Evaluate their relative importance to the collapse.
2. Evaluate the composition of the board of directors in IL&FS and discuss why it failed in its oversight responsibilities.
3. IL&FS Group has a complex structure with many subsidiaries and other Group entities. Discuss the challenges from the perspective of the holding company, Group entities and directors within the Group. To whom do directors of these different entities owe duties to in such situations in your country? How can the Group board of directors ensure that there is good governance throughout the Group?
4. Discuss the issues of overlapping directorships and nominee directors in the IL&FS Group. Discuss whether the directors had adequately discharged their fiduciary duties.
5. Critically evaluate the risk governance and risk management of the Group and key subsidiaries based on the four lines of defence.
6. Identify the key conflicts of interest involving directors, management, auditors, ratings agencies and other key players. To what extent did they contribute to the collapse of IL&FS? How can such conflicts be mitigated?
7. Evaluate the roles of different players in the collapse of IL&FS. Who were most culpable? Explain.

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MALAYSIAN AIRLINES: BAD LUCK OR POOR GOVERNANCE?

Case overview

Malaysian Airline System Berhad (MAS), renamed as Malaysia Airlines Berhad (MAB) in 2015 after its restructuring, is Malaysia's national carrier, and is now wholly-owned by the Malaysian government's sovereign wealth fund Khazanah Nasional Berhad. For a long time, MAB was in the news having been on the brink of bankruptcy without financial aid, and it was seeking the government's financial support. The airline industry is highly competitive and affected by many factors such as fuel prices, economic conditions, political stability, trade wars, terrorism, and pandemics.

What worsened the plight of Malaysian Airlines was the twin tragedies in 2014: Malaysia Airlines Flight 370 disappeared in thin air over the Indian Ocean with 239 people on board, and Malaysia Airlines Flight 17 shot down over Ukraine, killing all 298 people on the flight.

The objective of this case is to facilitate a discussion of issues such as state ownership; board composition and independence; risk management; crisis management; and communication with stakeholders.

About Malaysia Airlines

Founded in 1947, the national carrier has been operating domestic and international flights from Kuala Lumpur International Airport and secondary hubs such as Kota Kinabalu.[1] Prior to its delisting, Malaysia Airlines was a big aviation group, with 29 subsidiaries and five associate companies. Now known as Malaysia Airlines Berhad (MAB), it has recently streamlined all its operations under Malaysia Aviation Group Bhd (MAG) which houses four different business segments, namely air transportation services, ground services, aircraft leasing and talent development. Malaysia Airlines is under the division of air transportation services segment, which also includes Firefly – a low-cost regional airline – and MASwings, a domestic airline servicing rural air services in East Malaysia.[2]

Despite winning awards such as '5-Star Airline' by Skytrax[3] and the title of 'Asia's Leading Airline' from the World Travel Awards in the past,[4] MAS has been in a persistent loss-making position in recent years.[5] Its financials took a hit in the early 2000s primarily due to higher fuel costs and airport charges, competition from budget carriers, as well as weakening Malaysian ringgit.[6] Following the launch of the first business turnaround plan in 2006, MAS recorded an

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annual profit of RM851 million in 2007.[7] However, this turned out to be unsustainable as it recorded losses every year since 2011. The primary reason cited was its failure to cut costs as it had been in the red despite year-on-year revenue growth.[8] In its last publicly available annual report in 2013, MAS reported a net loss after tax of RM1.168 billion.[9]

In 2014, Khazanah took MAS private as part of a RM6 billion ringgit restructuring aimed at returning the beleaguered carrier to profit.[10] However, even after MAS' delisting and numerous restructuring efforts, the trend of negative profits continued. MAS disclosed net losses of RM812 million and RM791.71 million for FY2017 and FY2018 respectively. FY2018 saw a 11.4% decrease in total assets and a 15.65% increase in its total liabilities as compared to the year before.[11] Figure 1 shows the financial highlights from 2015 to 2018.

Financial year ended Dec 31	**2015**	**2016**	**2017**	**2018**
Profit/(loss) after tax ('000)	(1,125,858)	(438,869)	(812,107)	(791,708)
Revenue ('000)	3,140,872	8,571,650	8,667,442	8,735,661
Return on equity (ROE) (%)	0.00	-38.10	-132.00	0.00
Gearing ratio	-13.38	4.27	8.39	-7.01

Figure 1: MAB's four-year financial highlights[12]

The disappearance of MH370

"Malaysia Airlines deeply regrets that we have to assume beyond any reasonable doubt that MH370 has been lost and that none of those on board survived…"

– Text messages sent to the family members of MH370 victims[13]

On 8 March 2014, Malaysia Airlines Flight 370 (MH370), with 227 passengers and 12 crew on board, disappeared with unknown cause while flying from Kuala Lumpur International Airport to its destination, Beijing Capital International Airport.[14] Sixteen days later, on 24 March 2014, then Malaysian Prime Minister Najib Razak officially announced that the missing flight had crashed in the Southern Indian Ocean without any potential survivors.[15]

"The challenge you have with crisis communications is not to make it worse, because you can't make it better,"

– Robert Jensen, CEO of Kenyon International Emergency Services[16]

The unprecedented crisis thrust MAS in the global media spotlight. However, the airline failed to provide any specific information, and this resulted in speculation surrounding the cause of MH370's disappearance – from mechanical failure of the plane, to hijack, and even to terrorism.[17] Media coverage was rife with rumours, false reports, ambiguous information and a general lack of clarity.[18]

The perceived lack of transparency,[19] inconsistency of information[20] and failure to provide timely information[21] shone the spotlight on the poor crisis management by MAS and the Malaysian government. There was a series of fumbling news conferences, incorrect details provided by MAS, and a lengthy delay in provision of details on the progress of the search for the missing aircraft. All these led to scepticism and anger among victims' families and raised questions about the credibility of the Malaysian government.[22]

The search for the missing airplane became the most costly as well as the largest multinational search and rescue effort in aviation history.[23,24] Due to existing political tension in the Asia-Pacific region, several countries were unwilling to provide their military radar data on the possible path of MH370, hampering the investigation.[25] Initially, the search was focused on the South China and Andaman seas; the search radius increased from 20 nautical miles to 100 nautical miles, and eventually covered an area of 27,000 nautical square miles. Search efforts were later moved to include the Indian Ocean and the west of Australia as well.[26]

After a search spanning three years and involving 26 countries[27] across 120,000 square kilometres of ocean yielded no tangible results, the Joint Agency Coordination Centre heading the operation suspended its activities in January 2017.[28] A separate search launched in January 2018 by private American marine robotics company Ocean Infinity also ended in May 2018 after failing to locate the missing aircraft.[29]

The downing of MH17

"Either one of these events has an unbelievably low probability. To have two in a just a few months of each other is certainly unprecedented."

– John Cox, president and CEO of Safety Operating Systems[30]

On 17 July 2014, Malaysia Airlines Flight 17 (MH17), enroute from Amsterdam to Kuala Lumpur, was shot down by pro-Russian rebels while flying over eastern Ukraine, killing all 283 passengers and 15 crew members on board. This was a mere four months after the disappearance of MH370.[31]

Earlier on 3 April 2014, the European Aviation Safety Agency, together with Eurocontrol and the International Civil Aviation Organisation (ICAO), had issued a safety bulletin advising that Crimean airspace in southern Ukraine should be avoided. However, the directive did not apply to the airspace of eastern Ukraine, where MH17 was shot down. Although many international airlines – including British Airways, Qantas and Cathay Pacific – had already been making detours to avoid Ukrainian airspace over safety fears, MAS continued to use the route. Liow Tiong Lai, Malaysia's former transport minister, justified this by saying, "The airspace the aircraft was traversing was unrestricted. I think since it's an approved route it is safe and that's the reason why we have been using this route."[32]

On the day of the incident, the airspace over eastern Ukraine was busy as 160 commercial planes flew over the region.[33] At the time of the tragedy, there were three other commercial airplanes flying in the vicinity,[34] including a Singapore Airlines aircraft flying from Copenhagen to Singapore.[35]

Travel agents reported a spike in cancelled reservations following the MH17 incident. With yet another tragedy happening just four months after the disappearance of MH370, the airline's reputation had gone downhill, accompanied by loss of confidence by passengers who "are very, very afraid about anything else happening again [and] they don't want to take risk".[36]

Following the two deadly disasters, nearly 200 cabin crew resigned from MAS, with some citing fears for their safety and 'family pressure' as key reasons.[37]

Crisis management

"In the history of aviation... there's never been an airline that had to go through two huge disasters in the span of four months, so I don't think there's any historical evidence that they can get out of this."

– Mohshin Aziz, research analyst at Maybank Investment Bank[38]

In an attempt to recover, MAS resorted to lowering fares and adding flight capacity.[39] Notwithstanding such measures, seat factor was lowered by 11.5 percentage points to 73% based on the quarterly report for the third quarter ended 30 September 2014. It recorded net losses of RM576 million for that quarter.[40] Following the MH17 incident, the airline also announced that it would refund fares to customers postponing travel or cancelling their tickets, including non-refundable ones.[41]

Three days after the search for the MH370 began, the share price of MAS fell by 16% to 21 sen.[42] It continued to slide, hitting a low of 15.5 sen on 19 May 2014[43] following then Malaysian Prime Minister Najib Razak's comments that "it might be too late to save MAS in its current form"[44] – a record low at that point in time. The MH17 tragedy led to a further 13% fall in share price to 19.5 sen.[45] Overall, the combined impact of the twin disasters in 2014 led to a fall of more than 36% in the share price.[46]

Before the twin 2014 disasters, MAS had already been making a loss of US$1.3 billion over the previous three years due to fierce competition.[47] The increase in passenger cancellations following the disasters and a lower number of bookings contributed to further financial losses in 2014.[48]

What went wrong?

In the MH370 case, the information void and the reporting of inaccurate and sometimes contradictory information released by the Malaysian authorities led to public scrutiny from stakeholders.[49] In the early days of the search for the missing plane, there was confusion with little information available. Malaysian officials struggled to keep up with questions from journalists and their incessant questions.[50] Further, MAS received a lot of flak for taking four hours after MH370 went missing before informing the world.[51] Relatives of the missing aircraft's victims had demanded the release of pertinent information about the missing flight when none was provided by the Malaysian government.[52] Most crisis communication experts agree that transparency is fundamental to gaining public trust. In contrast, the lack of transparency may have destructive effects such as leaving a permanent stain on an organisation's image.[53]

In contrast to its handling of the MH370 disaster, analysts and observers had commented that the Malaysian government had been more sure-footed and timely in handling the MH17 crisis. MAS issued a public statement as soon as it confirmed that contact had been lost with the doomed flight. Instead, the MH17 incident sparked debate on whether the airline could have prevented the plane from flying over eastern Ukraine – a potential warzone – amid safety risk, especially since other airlines had rerouted their flights to avoid the conflict area.[54]

The shining white knight?

"Nothing less will be required in order to revive our national airline to be profitable as a commercial entity, and to service its function as a critical national development entity."

– Khazanah Nasional Berhad, Malaysia's state sovereign fund[55]

In response to the public relations crisis, the sovereign wealth fund of Malaysia, Khazanah Nasional Berhad (Khazanah), saw the critical need for intervention to keep MAS as a going concern. Khazanah rolled out the MAS Recovery Plan[56] to acquire all the shares apart from the 69.37% interest it already owned.[57] At 27 sen per share, Khazanah spent RM1.4 billion to become the sole shareholder of MAS in August 2014, allowing it to privatise MAS for the restructuring. In addition, it injected RM1.6 billion for the retrenchment of excess workforce and the migration of operations to a newly incorporated company, MAB. It was also planned that up to RM3 billion will be injected progressively into MAB, subject to strict conditions, over three financial years.[58]

On 31 December 2014, MAS was delisted from Bursa Malaysia.[59]

According to Khazanah, it was the most suitable candidate to lead the restructuring of MAS not only because of its majority shareholding, but also because of its experience in transforming local government-linked companies (GLCs) into sustainable profitable organisations. Learning from past turnaround failures, Khazanah's MAS Recovery Plan proposed a comprehensive overhaul of the operations, with a heavy focus on adjustment of the cost structure and management of human capital.[60]

The new cost structure would draw reference from industry benchmarks and work practices, with cost savings coming predominantly from renegotiation of supply contracts.[61] Prior to the restructuring, MAS had more than 4,000 supply contracts, most of which contributed to the high operating cost due to redundancy and unfavourable terms.[62,63] Under the recommendation of the then CEO, Christoph Muller, all existing contracts underwent review and renegotiation to reduce the total number of suppliers to no more than 2,000.[64] For instance, the newly established catering agreement between MAB and Brahim's Airline Catering Sdn Bhd allowed MAB to reduce its catering contract costs by 25%.[65]

Another aspect which Khazanah's MAS Recovery Plan focused on was the management of leadership and human capital. MAS employed approximately 20,000 staff while owning a fleet of 151 planes.[66] The issue of over-employment became apparent when compared with AirAsia, a Malaysian budget airline and close competitor of MAS, which had a similar staff count[67] despite operating a fleet of 189 planes.[68] This has led to the decision to retrench 30% of staff, a reduction of 6,000 staff.[69]

A plan or a sham?

"Complete and independent ownership by private parties, free from any political interference, is key to the revival of Malaysia Airlines Bhd (MAB)."

– Professor Dr. Sufian Jusoh[70]

Khazanah's MAS Recovery Plan was not without its critics. Opponents expressed strong disapproval on the basis that Khazanah, a state fund, has sole control of the company. They felt that Khazanah was not suited to restructure MAS for three reasons: lack of access to capital injection and expertise from private investors; Khazanah's inability to manage tension with trade unions; and the underlying political motivation of Khazanah as a state-owned fund.

Khazanah expressed its concerns regarding third-party investors in the article, "The Khazanah Report 2014: Formulating the MAS Recovery Plan".[71] It argued that MAS' recovery from the economic and reputational turmoil is only possible if it is supported by a principal shareholder with the financial capacity as well as the ability to align restructuring efforts with the commercial and social objectives of MAS.[72] Private investors may not have the social interests of MAS in mind, for instance, flying certain routes for national development purposes.[73] However, the capital injection from Khazanah has proven to be insufficient as MAB continued to struggle even in 2019 – its targeted year of return to profitability.[74,75] This begs the question of whether the exclusion of private investors from the recovery plan was truly in the best interests of MAS.

The scepticism surrounding the MAS Recovery Plan also stems from Khazanah's inability to establish cooperative relations with MAS' influential labour unions. In August 2011, MAS entered into a comprehensive collaboration framework with its close competitors, AirAsia and AirAsiaX, which entailed a share-swap agreement. The cross-holding of shares was intended to synergise the two airlines but was called off in 2012 amidst pressure from MAS' labour unions due to fear of possible retrenchments.[76] In order to prevent history from repeating itself, Khazanah decided to curb the influence of the labour unions by dissolving them.[77] This brought backlash from the union office-bearers and members who wanted to mount a constitutional challenge under Article 10 of Federal Constitution if the labour unions were to be dissolved.[78] In response, Khazanah instead chose to replace the existing unions with "collaborative employee engagement" via its Works Council,[79] which would not safeguard the interests of the workers' representatives.[80] The displacement of the influential labour unions was made possible by the fact that Khazanah has sole control over MAB and the decisions of the new management.

Detractors of the MAS Recovery Plan also expressed their disapproval on the grounds that Khazanah had an underlying motivation to spearhead the restructuring. Khazanah justified the state control over MAB based on the popular opinion among the public that MAB serves a symbol of nationalism and patriotism. Many opponents found it to be a trivial justification. Professor Dr. Sufian Jusoh, director of the Institute of Malaysian and International Studies (IKMAS) at Universiti Kebangsaan Malaysia, is one of those who identified with the pro-liberalisation of MAS. Dr. Jusoh explained that there exist many well-established international airlines that are not owned by their respective governments and it is a non-issue whether MAB remains as a national carrier.[81]

The restructuring efforts by Khazanah were harsh and severely impacted the livelihoods of employees who were laid off. Even so, the affected employees were given little choice and could not retaliate. According to the President of National Union of Flight Attendants Malaysia (NUFAM), Ismail Nasaruddin, many of the retrenched employees were allegedly advised against taking legal action against MAS and told that the court was unlikely to address any cases relating to MAS, which no longer existed since the incorporation of MAB. Nasaruddin also revealed that the then Prime Minister, Najib Razak, was involved in some of the controversial retrenchment policies which have deviated from the policies proposed in the MAS Recovery Plan. The possible underlying political motivation raised questions as to whether Khazanah was truly suited to spearhead the MAS Recovery Plan.[82]

Getting your way with power

"If you belong to a culture displaying high power distance, you will tend to view power as a reality of life and believe everyone has a specific place in the hierarchy of power. You will expect that power will be distributed unequally."

– *Geert Hofstede, social psychologist*[83]

Power distance deals with the fact that all individuals in a society are not equal.[84] It concerns the inequality of distribution of power and authority among individuals in organisations. Malaysia has been ranked to have the highest power distance in the world, achieving a score of 104 on the Hofstede comparative power distance index. Its Southeast Asian neighbours – Singapore, Indonesia, and Philippines – had scores of 74, 78, and 94 respectively.[85]

In very high power-distance cultures, subordinates are usually unwilling to go against or stand up against higher authority and will settle for this arrangement as they feel that this is the natural order of things. The party with the higher authority accepts this culture as well, and accordingly metes out consequences for anyone of a lower rank who goes against their decisions.[86] The high power distance suggests that culture in Malaysia is respectful of a complex, nuanced system of titled classes and untitled 'commoners' and tends to grant a lot of power to individuals at the top of an organisation.[87] Some critics voiced that it is such a corporate culture in MAS – one that is "conservative and incredibly structured" and "does not reflect international attitudes" – which is hindering its ability to move forward from the twin tragedies.[88]

Who's in charge?

Although shareholders are in ultimate control over a company, they usually have no practical authority over the management and running of the company. Instead, the greatest shareholder power lies in the control over the composition of the board of directors.[89]

Khazanah's MAS Recovery Plan entailed a search for a new CEO.[90] While the search for a new leader to revive the embittered company went on, then-CEO Ahmad Jauhari Yahya, who was in charge of the crisis management of Flight MH370 and Flight MH17, continued to be at the helm of MAS. Yahya stepped down from his position on 30 April 2015, when Christoph Mueller was appointed as MAB's managing director and Group CEO.[91] Although MAB's contractual period for the CEO is for three years,[92] the two CEOs who followed Yahya each lasted less than two years before resigning.

Christoph Mueller: May 2015 - April 2016

The first CEO appointed under Khazanah's MAS Recovery Plan was Mueller. Mueller, a German, took on the role on 1 May 2015. Less than a year later, in April 2016, he left his position due to "personal reasons". He was known as one of the industry's best "crisis CEOs" following his success in turning around loss-making Aer Lingus, Ireland's flag carrier. Experts had hoped that he would deliver the same magic touch to Malaysia's national carrier.[93,94]

During his tenure, Mueller made radical changes to the airline, including making huge layoffs, transferring all assets to a new company, retiring the entire Boeing 777 fleet, installing a new long haul business class product, entering into a partnership with Emirates for long haul flying, not serving alcohol on short haul flights, and more.[95] He effectively reinvented the beleaguered airline to become a smaller regional carrier.[96] The airline turned in a first monthly profit in years in February 2016.[97] He was thanked for his contributions to the restructuring of the national airline, having "made a significant impact in putting the airline on the desired trajectory towards full recovery".[98] Despite his efforts and contributions to the company, he made the decision to leave after less than a year.[99]

Peter Bellew: July 2016 - October 2017

Peter Bellew, an Irish, also quit prematurely before the completion of his three-year contract. He claimed to have resigned due to love for his home country, Ireland. In fact, he returned to Ryanair, taking on the position as Chief Operating Officer (COO) and calling it a form of "national service".[100] This decision seemed to take MAB by surprise as the company added in a statement that "Malaysia Airlines takes note of the unexpected announcement by Ryanair… regarding CEO Peter Bellew".[101] When asked at a press conference in the presence of both international and Malaysian media outlets on 27 September 2017, regarding speculation that Bellow would consider returning to Ryanair, the reply was that he had publicly "expressed his commitment to Malaysia Airlines".[102] However, a week later, Ryanair contacted Bellew, asking him to consider re-joining the company as COO, which Bellew accepted. Bellew explained "a week later the call came and in life we can really never say never. I am looking forward to being close again to my family and friends 14 hours away in Ireland."[103]

Interference or personal?

For both Mueller and Bellew, the actual reasons for their departure remain unclear. However, a source told New Straits Times (NST) that alleged interference by Khazanah in the running of the national carrier was the reason. NST claimed that Khazanah as the sole shareholder should take the blame for the sudden exit of the CEOs.[104]

Khazanah attempted to downplay Mueller's resignation, making it seem that it was due to personal circumstances. A source added that there were cases where Khazanah had bypassed the MAB board in order to micro-manage Malaysia Airlines. Mueller once said, "My experience is that it is very difficult to create a winning team from existing management," making it more plausible.[105] For Bellew, it is believed that he could not agree on some of the decisions by Khazanah over the overall running of the national carrier.[106]

Déjà vu?

One of the signs of good corporate governance in a company is proper segregation of duties and a healthy balance of power between shareholders, the board and management. However, analysts such as Shukor Yusof from the Malaysian aviation consultancy Endau Analytics, have observed that even before the 2014 tragedies, there had already begun a "long history of mismanagement and government interference" with the airline having been "abused" for twenty years.[107] Former Malaysian Prime Minister Najib Razak was Khazanah's Chairman from 2009 to 2018,[108] from when Khazanah was MAS' majority shareholder with 69.37% ownership to the period when MAB was following through with the Recovery Plan. NUFAM also alleged that "the carrier's financial woes are due to rampant mismanagement over the years – including having paid over US$1 per stick of satay for in-flight meals (competing airlines charge US$4 for five sticks of satay and rice) and purchasing tablet computers at more than three times their retail price".[109]

Furthermore, there was a 2011 saga regarding a share swap agreement which was intended to be entered into to "revive MAS", but it eventually fell through.[110] In August 2011, it was reported that Khazanah and Tan Sri Tony Fernandes had concluded negotiations regarding a share swap agreement between MAS and its rival, AirAsia, which involved Fernandes, the CEO of AirAsia, obtaining a 20% stake in MAS under the deal. Khazanah would then take a 10% stake in AirAsia in exchange.[111] The purpose of the deal was purportedly to "improve synergies between the two", as the two airline companies would be able to share resources and reduce redundancies.[112] The closing of this deal was said to have become "urgent" after MAS poor performance in the first two quarters of 2011.[113]

However, months later in May 2012, it was announced that the deal between MAS and AirAsia, which was "expected to reduce competition and help MAS...return to profitability", fell through due to pressure from the workers' union at MAS, as the union had "concerns that the tie-up may lead to restructuring and job cuts".[114] Commenting on the pre-2014 MAS board's decision to terminate the share swap agreement, analysts said that the decision has raised concerns about how MAS would be able to turn around its dire financial situation,[115] especially since it was "facing turbulent times amid an environment of high jet fuel prices and intensifying competition".[116]

Additionally, analysts raised the possibility of government intervention being a decisive factor in the ultimate termination of the share swap agreement. Mohamad Amirullah Yaacob, an analyst with Kenanga Research, stated that "the unwinding of the share swap appears to be politically driven", rather than driven by "business logic".[117] BBC News reported that the decision to do away with the deal "[came] at a time when the popularity of the Malaysian government has been falling".[118] There was speculation about upcoming elections called by then Prime Minister Najib, which ultimately happened a year later in 2013.[119] The MAS Union boasted about a 15,000 strong membership, which translated to "a big potential source of votes".[120]

Change for the better?

Nearly five years into the restructuring, it is clear that turning around an airline is far more difficult than piloting a plane.

Board changes

Pre-2014, Khazanah had two of its employees sitting on the MAS board of directors, one of whom was the sole executive director (ED). Three other members of the MAS board either held current or past key positions in government bodies. As such, five directors out of the nine-member board were government-linked. Three out of the eight non-executive directors (NEDs) were non-independent, and one of the three was the Chairman. All nine directors were Malaysians with one director below the age of 57.[121]

The board had five board committees, chaired by two directors. David Lau Nai Pek chaired the Audit Committee, Nomination and Remuneration Committee, as well as the Hedging Committee. Meanwhile, Tan Sri. Krishnan Tan Boon Seng chaired the Safety & Security Committee as well as the Tenders Committee.[122]

After 2014, there was a reshuffling of the board and new directors were added. Several enhanced corporate governance measures were also implemented, such as the creation of a new Governance and Ethics Committee to strengthen assurance, integrity and safety functions.[123]

The board had eight male directors, with no female directors. While Lau, Mohamadon Abdullah and Tan were on the board pre-2014, Izham Ismal, Tan Sri Zamzamzairani Mohd Isa, Sheranjiv Sammanthan, Mohammad Izani Ashari and Ahmad Zulqarnain Che Onn were appointed as new directors.[124]

Out of the five new directors appointed, three had held executive positions in Khazanah. This change was not unexpected given that MAB had become a delisted nationalised corporation. However, existing corporate governance issues could potentially be aggravated given that state ownership has increased from 69.37% to 100%. For example, Khazanah had acknowledged that one key issue that contributed to the financial difficulties of MAS was that it had to fulfil certain “national developmental obligations” which were often socially important but unprofitable.[125] Such obligations include developing unprofitable local airline routes that would help contribute to Malaysia’s tourism but may result in significant losses to MAS.[126]

The re-appointment of directors from the previous board was questioned by Khair Mirza, an aviation expert from transport infrastructure consultancy Modalis Infrastructure Partners. Even though the three directors had not breached the 2017 Malaysian Code on Corporate Governance regarding a tenure limit of nine years, Khair was of the opinion that keeping the same members in the board might be detrimental as it could deter new ideas and innovation, which are critical elements in reviving a loss-making company.[127]

“It is also good to have a combination of some with overall airline industry experience (at least two to three years) and some good professionals in finance and law,” said Khair.[128]

Currently, a majority of the NEDs in MAB are equipped with accounting and finance knowledge, having graduated with a degree or with professional expertise and certification in those areas. However, no member on the board has relevant experience in the airline industry.[129]

The previous board had a majority of directors who were either Khazanah appointees or directors with experience in government bodies, whereas the new board have a higher proportion of directors who are Khazanah appointees. There was also little management experience in the private sector among the board members.[130]

Long road ahead

The MAS Recovery Plan promised "continuous communications and stakeholder engagement" by organising public accountability sessions, releasing annual reports and keeping a continuous engagement with the press and public.[131] However, there has been an absence of financial information regarding MAB after its privatisation. The current CEO Izham Ismail only announced that MAB suffered a marginally lower loss in 2018, but exact figures were not revealed. Furthermore, annual reports were not released to the public after the airline was privatised. Despite the restructuring efforts, MAB was still operating at a loss based on the latest financials available in January 2020 and reportedly requires financial assistance of up to RM21 billion to keep its operations going until 2025.[132]

In 2019, the Malaysian government raised the possibility of a MAB buyout deal by private investors to save the struggling airline. In January 2019, Malaysia's then Prime Minister Dr. Mahathir confirmed that MAB had received proposals from five potential airline carriers, namely AirAsia, Malindo Air, Lion Air, Air France-KLM alliance and Japan Airlines.[133,134] Among the potential buyers, home-grown AirAsia was reported to be favoured by MAB management as Khazanah believed the synergy derived from a merger between MAB and AirAsia would amount to about RM1.4 billion yearly, which would be sufficient to cover MAB's operations of RM1 billion per year.[135] Furthermore, a takeover by a Malaysia airline would help keep MAB as a national icon[136] that is a part of Malaysia's identity.

In April 2020, MAB received another takeover proposal from Golden Skies Venture Sdn Bhd, (GSV), a newly established Malaysia private equity firm set up by former MAS employees and private individuals. GSV offered RM11 billion in exchange for 100% equity in MAG.[137] However, the deal was not well received as Khazanah's managing director Shahril Ridza Ridzuan expressed scepticism about its financial resources of a new firm, given the current COVID-19 pandemic-fuelled airline crisis and credit risk aversion.[138]

The current turbulence in the global aviation industry resulting from the COVID-19 pandemic has complicated the sale decision. Aviation consultancy firm Aer Mobi's CEO, Michael Walsh, said that a further cash injection from the government would be necessary prior to any sale.[139] The Malaysian government would have to take into consideration the survival of all the airlines in Malaysia and might have to come up with further rescue plans for them as well. The future outlook of MAB is far from certain.

Discussion questions

1. Explain the importance of risk management, the four lines of defence, and the role of the board and management in risk management. Was lack of proper risk management a factor in the tragedies involving MH370 and MH17?

2. Critically evaluate the company's crisis management and communications following the two tragedies involving Malaysian Airlines Flights MH370 and MH17.
3. What are the roles of major shareholders, board of directors and management in corporate governance? Do you think the problems in MAS/MAB have to do with interference in management by the major shareholder? What can governments which have controlling stakes in companies do to monitor and hold boards and management accountable, without usurping the responsibilities of the board and management?
4. To what extent should the state be involved in business, as major shareholders? What are the pros and cons of such involvement?
5. Comment on the changes in the board of directors of MAB after 2014. Do you think the changes are for the better? Imagine you have been asked to provide advice on putting together a world class board for MAB. What would that look like in terms of size, leadership, independence, skills, experience, diversity and other backgrounds?

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BAYER-MONSANTO: A "KILLER" DEAL

Case overview

The final verdict is in. Guilty. The Oakland jury awarded more than US$2 billion to the Pilliods, a couple who had sued Monsanto Company (Monsanto), claiming that their lymphoma was caused by using the company's Roundup weed killer on their property. This was one of thousands of lawsuits regarding the use of the suspected carcinogenic substance, glyphosate, filed against Monsanto, which Bayer AG (Bayer) had acquired. Bayer, headquartered in Germany, is one of the largest pharmaceutical and life sciences companies in the world. It acquired Monsanto, a leading but controversial producer of genetically modified crops in the U.S., for a hefty sum of US$66 billion.

The objective of this case study is to facilitate a discussion of issues such as responsibilities of the board in acquisitions; due diligence for acquisitions; risk management; powers of boards versus shareholders; shareholder relationship management; executive remuneration; and environmental, social and governance (ESG) considerations in business practices and investment decisions.

From war survivor to conqueror

On 1 August 1863, a dye salesman Friedrich Bayer and a master dyer Johann Friedrich Weskott founded the general partnership "Friedr. Bayer et comp.," laying the foundation for expansion in 1881 by transforming Bayer into a joint stock company.[1] Bayer's initial progress was interrupted by World War I, the Great Depression, as well as World War II, during which Bayer removed itself from the commercial register to merge with a community of interests into I.G Farbenindustrie AG in order to remain competitive and regain access to vital export markets.[2]

Having survived various economic struggles through both World Wars, Bayer rebuilt itself in the midst of the Wirtschaftswunder, or "economic miracle", in Germany in the 1950s.

Between 2001 and 2014, Bayer went through major expansion and restructuring. It issued American Depository Receipts (ADR) in 2007, making it easier for U.S. investors to invest in the German-listed firm.[3] This period also marked the beginning of Bayer's aggressive strategy of expanding and strengthening its diverse businesses with multiple acquisitions.

This case was prepared by Lim Han Hsin, Clemont, Louis Lee Sicong, Marilyn Tan Kai Ting, Ngiam Kee Yong, Joel, Nicholas Teo Kai Jie and Nicolle Choy Rui Wen, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been substantially re-written, with information added, by Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees.

It acquired Aventis CropScience for €7.25 billion in 2001 making it a world leader in crop protection,[4] and subsequently bought Roche's consumer health business unit in 2004 to become one of the world's top three suppliers of non-prescription medicines.[5] It then bought Schering AG, a research-centred German pharmaceutical company, in 2006, as well as Athenix Corp, a privately held U.S. biotechnology company, in 2009.[6] In 2014 alone, Bayer completed three separate acquisitions of Algeta, Dihon Pharmaceutical Group, as well as land management assets of DuPont Crop Protection,[7] consolidating its position as a global pharmaceutical powerhouse. This relentless pursuit of market growth would eventually lead it to Monsanto.

Sowing a seed

The year 2016 saw a wave of mega mergers in the agricultural-chemical industry which began when Dow Chemical Company (Dow) and E. I. du Pont de Nemours and Company (DuPont) announced merger plans, followed by China National Chemical Corporation and Syngenta AG (Syngenta), prompting Bayer to pursue a similar strategy.[8]

On 9 May 2016, Bayer announced its plans to acquire the controversial American agrochemical giant, Monsanto, for US$63 billion[9] – making it one of the largest acquisitions to date. The Big Six – Syngenta, Dow, DuPont, Monsanto, Bayer, and BASF SE – which once reigned the agrochemical industry, were rapidly consolidating into the Big Four,[10] resulting in a handful of powerful producers monopolising the world's food chain.

The Bayer-Monsanto deal was completed on 7 June 2018 following a laborious antitrust review by regulatory authorities.[11] As a result, the inventor of aspirin now owns the world's largest seed and agricultural chemicals maker.[12] However, it was soon described as one of the worst corporate deals in recent history.[13,14]

A bouquet of flowers, maybe?

"We will double the size of our agriculture business and create a leading innovation engine in agriculture, positioning us to better serve our customers and unlock the long-term growth potential in the sector."

– Werner Baumann, Chairman of Bayer's management board[15]

With Bayer's strength in healthcare, the acquisition was seen to offer it a perfect complementary portfolio as Monsanto was the market leader in agricultural seeds. As patents for Bayer's two top-selling pharmaceutical drugs were due to expire in 2023, the acquisition could help shield a potential fall in future pharmaceutical sales.[16] Bayer was very positive about potential synergies, hoping to boost its core earnings per share within the first year upon completion of the merger. It also set an aggressive double-digit growth target for the third year, forecasting growth in annual revenue of approximately US$1.5 billion.

Sceptics, however, pointed out that Monsanto had to repeatedly adjust its earnings estimates downward in the past years, and its return on invested capital amounted to a mere seven percent. Some analysts were not optimistic about the likelihood of Bayer achieving its targets, describing Bayer's projected estimates as "very ambitious".[17] Others were hopeful and felt that demand would grow given the exponential growth in world population.[18]

Or a bad harvest?

When he became the Chief Executive Officer (CEO), Werner Baumann assured shareholders that he did not have any "revolutionary" business plan for the foreseeable future. Thus, the news of the major acquisition caught shareholders off-guard as it occurred just half a month into his term as CEO. A corporate governance expert and Bayer investor, Prof. Christian Strenger, said that the Bayer shareholders "went to bed as pharma shareholders and woke up with glyphosate."[19]

When the buyout was announced, investors expressed their disagreement. Many were furious that they had no opportunity to vote on the acquisition. Mounting waves of cancer and agriculture-related lawsuits against Monsanto –most prominently, relating to the Roundup weed killer – were glaring red flags to many Bayer investors.[20] With Bayer's declining sales, the potential litigation expenses that could arise from the acquisition would further elevate Bayer's debt levels.

Its unpopularity among shareholders was also due to the radical shift in the company's business strategy towards agriculture, and potentially limiting its growth in the pharmaceuticals industry from other deals.[21] Asim Rahman, a European equities fund manager at Henderson, which had a 0.7% share, vented that such an acquisition was "a major departure from a strategy of focus and integration of existing acquisitions".[22] Rahman additionally demanded a vote by shareholders on the acquisition to "restore investor trust and ensure support for Bayer's future strategic directions". He felt that without the support of shareholders, the share price would be adversely affected.[23]

Many investors feared that Bayer would not only be sucked into Monsanto's legal quagmire, but also suffer reputational damage from being associated with Monsanto, potentially damaging Bayer's own sales.[24] Bayer rejected these complaints as meritless, and said that regulatory authorities, as well as over 800 scientific studies, have backed the safety of glyphosate-based weed killers.[25] Activists continued to question the veracity of those studies.[26] In 2015, the World Health Organisation's International Agency for Research on Cancer concluded that glyphosate is "probably carcinogenic."[27] However, similar assessments have not been issued by European Chemical Agency or the European Food Safety Authority.[28]

Despite its critics, Bayer remained confident of the deal. It stood to gain from the entry into the lucrative seed trade and emerge as a key player in a changing landscape where agrochemical companies are racing to consolidate.[29,30]

To address investors' fears, Bayer announced its plans to retire the 117-year old brand name, Monsanto, with Bayer remaining as the company name following the takeover.[31] It also promised to increase its dialogue with society and find common ground with activists and critics. Yet, Adrian Bebb, a campaigner at Friends of the Earth, an international network of environmental organisations across 74 countries,[32] commented that "Bayer will become

Monsanto in all but name unless it takes drastic measures to distance itself from the U.S. chemical giant’s controversial past.”[33]

Bayer’s shares plummeted by more than eight percent following the acquisition announcement.[34] Monsanto’s own share price barely moved following the announcement, trading at 22% below the offer price and even experienced declines several days after.[35]

Stuck in the mud

An American Depositary Receipt (ADR) is an instrument used by non-U.S. companies to offer and trade their shares in the U.S. bourses. Bayer has ADR listings in the U.S. under the Level I ADR program and is not required to comply with the registration and reporting requirements of the U.S Securities and Exchange Commission. Instead, it is subject to compliance with its home country’s listing rules.[36]

Notwithstanding negative investor sentiment surrounding the Monsanto acquisition, Germany’s unique corporate governance structure and law allowed the takeover to proceed without mandatory shareholder approval. German Corporate Law (and the German Takeover Act) does not prescribe for shareholders’ vote for corporate decisions on mergers and acquisitions, regardless of the takeover size.[37] Such codified statutes take precedence over past judicial rulings, as Germany’s legal system follows a civil law system, instead of the common law.[38] German boards have considerable power under German provisions. Instead of shareholder approval, the takeover decision is subject to the scrutiny and review of the acquirer’s supervisory board, under Germany’s two-tier board structure.[39] Therefore, even with much dissent, Bayer’s shareholders appear to have little say in the acquisition.

Shareholders may still able to exert their influence on acquisition decisions, such as through shareholder approval required for further share issuance.[40] Nevertheless, German companies are often granted much autonomy. This is due to a common feature in most German companies – far-reaching general mandates.[41]

Prior to the acquisition, Bayer’s shareholders had granted the company a five-year mandate to increase the number of shares by up to 45%, which soon became a major source of funding for the takeover.[42] On 3 June 2016, Bayer’s management board released a statement that it would issue 74.6 million new shares to existing shareholders at a price of €81 per share, with the intention to utilise the proceeds for the acquisition. According to Baumann, this became “a significant financing component for the acquisition of Monsanto and the final equity measure associated with this undertaking.”[43] Without the need for a new round of shareholders’ approval for the new funds raised, Bayer proceeded with the takeover.

Bayer’s supervisory board was therefore tasked with one of the most important decisions in the history of the pharmaceutical company. After reportedly questioning and deliberating the value creation involved, the acquisition was unanimously approved.[44]

Leading the charge

Bayer has two separate boards: the ‘management board’ and the ‘supervisory board’, as prescribed by the German Corporation Law (Aktienrecht) which came into effect in 1870.[45]

Board of management

Baumann became the new CEO and Chairman of the board of management of Bayer in May 2016. He has been a member of this board since January 2010, with his most recent role prior to his appointment as CEO being the company’s Chief Strategy and Portfolio Officer.[46]

At the end of 2018, following the Monsanto acquisition, Bayer’s board of management comprised seven executive members, including Chairman Baumann and six other members who are in charge of their respective divisions: Liam Condon (Crop Science), Wolfgang Nickl (Finance), Stefan Oelrich (Pharmaceuticals), Heiko Schipper (Consumer Health), Kemal Malik (Innovation) and Dr. Hartmut Klusik (Human Resources, Technology, Sustainability).[47]

Despite the acquisition target being a U.S. company, most executive members do not have experience working in the U.S., with the exception of Nickl – who was a CFO in U.S. IT company, Converge[48] – and Oelrich, who was the vice president of marketing in Bayer’s pharmaceuticals division there from 2003 to 2005.[49]

Supervisory board

At the end of 2018, Bayer’s supervisory board, headed by Chairman Werner Wenning and Vice Chairman Oliver Zühlke, consisted of 21 non-executive members and five committees: Presidial Committee, Audit Committee, Human Resources Committee, Nomination Committee and Innovation Committee.[50]

Despite numerous acquisitions under its belt in recent history, Bayer’s supervisory board does not have an investment committee specifically focused on mergers and acquisitions. Instead, extraordinary meetings are convened in order for the supervisory board to discuss in detail issues relating to acquisitions. In particular, the supervisory board members convened an extraordinary meeting in November 2018 to assess the status of litigation in connection with glyphosate as well as to address the extent to which these risks had been analysed and assessed prior to the Monsanto acquisition.[51]

Before Bayer acquired Monsanto, the majority of the supervisory board comprised of Germans.[52]

You reap what you sow

“Nothing whatsoever has changed in the regulatory status of the product. There is simply very high demand, and has been for many decades for glyphosate. It is an invaluable tool for growers,”

– Liam Condon, the head of Bayer’s Crop Science division[53]

Within a year after the acquisition, Bayer's share price had fallen by 40%[54] as Monsanto's legal woes stacked up, with over 11,000 U.S. lawsuits relating to the controversial use of glyphosate alone as of May 2019.[55] This heightened investors' fears, as Bayer's gamble saddled itself with a large legal exposure. Bayer's net debt had ballooned to €35.68 billion in 2018, from a mere €3.6 billion in 2017.[56] Since the completion of the Monsanto deal, Bayer's market cap had fallen to US$53 billion – less than what was paid to acquire Monsanto.[57]

After losing one of the first Roundup trials in August 2018, Baumann stressed that the jury's verdict was inconsistent with the scientific-driven conclusions by various regulators.[58] Several government agencies, such as the U.S. Environmental Protection Agency, also reaffirmed the safety of glyphosate.[59,60]

Baumann reassured investors that the fall in Bayer's share price had been greatly exaggerated, given that the company's management and its business plans still continued to receive full backing from the supervisory board.[61] Despite the increasing number of Roundup litigation cases, he reiterated that the acquisition "was and is a good idea".[62] Bayer maintained its stance of not reassessing legal risks from Monsanto, saying that Monsanto's conduct was appropriate. It committed to defending all upcoming cases.[63]

However, Bayer soon lost all three trials it was involved in as at end-2019, resulting in a shareholder revolt and further decline in its share price since the first unfavourable verdict in August 2018.[64] With claims adding up to billions of dollars, shareholders became increasingly worried that management did not practise due diligence prior to closing the deal to acquire Monsanto. As of September 2019, the number of plaintiffs had surged past a staggering 18,400.[65]

Bayer's management suffered an embarrassing plunge in approval ratings at the Annual General Meeting (AGM) which was held after the Monsanto acquisition.[66] Investors pressured management to conclude the Roundup litigation cases as soon as possible as they feared the legal and financial implications for the business moving forward.[67]

Lessening the pain

The primary components of the remuneration of members in the board of management of Bayer are fixed annual compensation, short-term variable cash compensation and long-term stock-based cash compensation.[68]

Short-term variable cash compensation became particularly salient in 2018, when there was a decline in the value of the long-term stock-based cash compensation for the members of the board of management after Monsanto's acquisition. This caused CEO Baumann's aggregate pay to fall by 17% to €5.3 million. Bayer's supervisory board approved an increase in his cash bonus by 28% to €1.7 million. The supervisory board justified its decision by maintaining that Bayer's operating performance was good in 2018.[69]

However, Bayer faced the wrath of shareholders.[70] Prof. Strenger, a Bayer investor, filed a motion proposing that members of the supervisory board not be discharged of responsibility for their actions in 2018. Institutional Shareholder Services Inc. (ISS) criticised the company's move to increase Baumann's pay without a shareholder resolution at a time when Bayer faced what ISS described as "unprecedented potential financial and reputational damage."[71]

According to Bayer's FY2018 annual report, the short-term variable cash compensation for the board of management is based on sales growth, EBITDA adjusted for special items, and core earnings per share (EPS). Basing remuneration of members of the management board on core EPS could potentially encourage management to undertake large acquisitions which may drive increases in EPS but fail to measure whether the company is earning a sufficient return.[72]

Moreover, short-term variable cash compensation is also determined by a qualitative measure of agreement of 'personal targets' with each member. Attainment on these 'personal targets' can increase or decrease the payout. Specifically, one of the individual targets agreed to for Baumann, Nickl and Condon as disclosed in the FY2018 annual report included the acquisition and integration of Monsanto.[73]

Exacerbating Bayer's contentious remuneration decision was the early termination of Klusik and Malik at the end of 2019.[74] Both left the board of management without replacements after an announcement that the size of the board would be reduced to five members in order to cut costs – the responsibility of innovation being split among the divisional heads of Crop Science, Pharmaceuticals and Consumer Health, and with Baumann assuming the duty of labour director.[75] As part of the early termination agreement, Malik was provided a severance payment totalling €8.71 million, including fixed compensation of €1.63 million, short-term compensation of €1.71 million, and newly granted stock-based cash compensation entitlements from tranches to be issued in 2020 and 2021 amounting to €2.48 million.[76]

Shareholders' revolt

In the April 2019 AGM, the unhappiness of shareholders was clearly seen from the shareholders' vote of no-confidence. After 12 hours of venting their frustrations, shareholders made Baumann the first CEO of a major German company in decades to lose the support of the majority of shareholders in such a vote.[77] A total of 55.5% of shareholders voted against supporting Baumann and his current team. Voting against "Entlastrung" or discharge is one of the strongest forms of protests for investors under German law. However, the vote is not legally binding. Additionally, only 66% of shareholders voted to discharge the board.[78]

Bayer's largest shareholder, fund manager BlackRock Inc., refused to support Bayer's management,[79] and likewise asset management firm, Deka Investment GmBH (Deka Investment), which was among Bayer's largest German investors. Ingo Speich, head of sustainability and corporate governance at Deka Investment, commented: "The vote is a disgrace. To be gambling away the trust of so many investors within such a short time has historic proportions."[80]

Temasek Holdings (Temasek) – Singapore's sovereign wealth fund – and Norway's oil fund, Bayer's next two largest investors after BlackRock, however, declined to reveal their plans.[81] Proxy advisory firms ISS and Glass Lewis both recommended that Bayer shareholders should not vote in favour of management.[82] Despite the vote being non-legally binding, it made Baumann and his team conscious of the rampant shareholder dissatisfaction. The Chairman of the supervisory board, Wenning, also made it clear that the vote was being taken very seriously by the board and efforts were underway to gain back the trust of the shareholders.[83]

Several reasons were cited for the investor backlash. One explanation was that many investors were of the opinion that Bayer’s management did not conduct proper due diligence prior to the Monsanto acquisition, and subsequently made the wrong call. Shareholders were concerned that the acquisition had burdened the company with years of litigation, thereby affecting its share price.[84] Another grievance was the lack of effort made by Bayer to disclose the standalone performance progress of Monsanto and its crop business pre-acquisition. They further emphasised that information availability and disclosure of non-material information is an area which Bayer could improve on.[85] Yet another explanation was the inappropriate handling of its litigation issues. Bayer focused on discrediting the scientific evidence, rather than adopting a more risk-based approach to minimise losses and regain its reputation.[86] For example, Baumann told employees that Monsanto might be unpopular in Europe, but does not suffer the same bad reputation in the U.S., and that Monsanto is a “very, very reputable company.”[87]

Prior to the acquisition closing, in April 2018, Temasek had acquired an additional 3.6% stake in Bayer, contributing to Bayer’s planned takeover of Monsanto.[88] Baumann attributed the increased Temasek stake to the affirmation of Bayer’s business strategy, the acquisition of Monsanto, and perceived strong growth prospects of Monsanto.[89] The head of Temasek Europe told a German paper that it was interested in making German acquisitions and cited agriculture, pharma and biotech as target industries in August 2018.[90] Further, at a press conference in 2019, Temasek’s head for the Americas and agribusiness, John Vaske, commented that Bayer was taking the litigation “seriously and doing the things that they need to do to be mindful of it”. He also reaffirmed that confidence in Bayer is still high.[91]

Faced with pressure from activist shareholders, a sixth committee of the supervisory board was established in 2019 – the Glyphosate Litigation Committee – in order to deal with the multi-billion dollar glyphosate litigation issue.[92] The Glyphosate Litigation Committee was made up of eight Supervisory board members – Wenning (Chairman), Zühlke, Dr. Paul Achleitner, André van Broich, Dr. Thomas Elsner, Colleen A. Goggins, Petra Reinbold-Knape, and Prof. Dr. Norbert Winkeljohann.[93] While none of the members are legal experts, Bayer hired a high-profile U.S. lawyer, John H. Beisner, to advise the supervisory board.[94]

Bayer announced the appointment of Ertharin Cousin as a new member in its supervisory board on 1 October 2019, succeeding another member, Thomas Ebeling.[95] Cousin, a prominent U.S. agriculture expert, has international recognition in the area of nutrition and agriculture, having served as an executive director of the United Nations World Food Programme for five years. Bayer opined that her appointment gives its supervisory board the added support it required in light of the growing significance of its Crop Science business.[96]

Was the board reckless?

Close to two years after the acquisition, shareholders’ discontent remained. In 2020, a Californian shareholder of Bayer, Rebecca R. Haussmann, sued Bayer’s top executives for a breach of duty of "prudence" and "loyalty" to the company and investors.[97] Defendants included Baumann and Wenning, among other high-ranking management and supervisors.[98] The lawsuit sought compensatory damages for the shareholders and to revert all compensation paid to the managers and supervisors who had a hand in the Monsanto acquisition. Details of the lawsuit included the lack of due diligence by Bayer's management in evaluating the material risk from Roundup and not quantifying the potential financial impact to the company. Even if due diligence was conducted, the plaintiff argued that Monsanto had "every incentive to minimise the Roundup risk"[99] in an effort to ensure that the acquisition materialised, and thus additional risk analysis was required.[100]

Supervisory board chairman Wenning announced that he would resign at the AGM in April 2020.[101] The 73-year-old said that "we have made and continue to make progress in handling the legal issues in the U.S. That's why now is a good time to hand over to my successor."[102] His role would be taken up by Winkeljohann, former head of auditing firm PricewaterhouseCoopers Europe SE.[103] Some shareholders interpreted Wenning's departure as the start of "a new era", as well as a sign that a litigation settlement was near.[104]

Bayer remained adamant that sufficient due diligence and risk assessment was conducted prior to the completion of the deal. In its FY2017 annual report, it published its risk assessment regarding the planned acquisition.[105] However, no litigation risk exposure was explicitly mentioned in the risk assessment.

Bowing to shareholder pressure, Bayer announced plans to undertake a voluntary special audit of Bayer's due diligence procedures in February 2020.[106] The purpose of this special audit was to review Bayer's rules for evaluating mergers and acquisitions, with the company hoping that a favourable outcome would dismiss any due diligence issues on the part of management with regard to the Monsanto acquisition. This initiative was first broached at the 2019 AGM but only garnered 25.7% of shareholders' votes and was hence not accepted.[107] However, with the number of Roundup litigations swelling up to approximately 48,600 lawsuits on 6 February 2020, the management board was pressured to accept the special audit.[108]

The independent audit was conducted by Dr. Hans-Joachim Böcking of the University of Frankfurt.[109] Dr. Böcking mainly specialises in corporate governance, auditing and corporate social responsibility in his research,[110] among others. Following completion of the audit, Dr. Böcking declared that Bayer's "internal specifications and requirements for conducting due diligence in material M&A transactions are appropriate". He also said that the internal reporting lines and due diligence procedures were adequately monitored.[111] Bayer aimed to release the audit report on its website by the end of March 2020,[112] before the AGM in April 2020.

Legal opinions on the role of the board of management with regards to the acquisition also pointed to lack of negligence on the part of Baumann's team. Dr. Ralph Wollburg of Linklaters and Prof. Dr. Mathias Habersack of the University of Munich, who prepared the legal opinions at the end of 2018 and early 2019, concluded that the board of management did indeed act with due care when considering the acquisition.[113]

The enquiry found that Bayer's "board of management complied with their duties as members of a corporate body." In particular, the report stated that "the board of management carried out an extremely in-depth analysis of the information and aspects relevant to the transaction".[114]

The report also claimed that with regards to the specific glyphosate litigation exposure, the “regulatory issues and liability risks in connection with glyphosate, amongst other things, were the subject of these in-depth analyses and discussions”.[115] It also asserted that from a scientific perspective and according to the assessments by regulatory authorities worldwide, there was no evidence of a link between the claimants’ cancers and their exposures to glyphosate. The board of management thus relied on these scientific findings and felt that the liability risks were low. The report said that Bayer’s management board felt that “the considerable opportunities associated with the acquisition of Monsanto were greater than the risk of material liability arising from glyphosate-related lawsuits”.[116]

The report also mentioned that the board of management conducted analysis, and discussed the development of the risks of glyphosate-related lawsuits and the economic performance of Monsanto and Bayer, during the entire period between the conclusion of the merger agreement and the closing of the takeover.[117]

Although the report did not explicitly mention any risk governance framework used to evaluate the acquisition, the report held that proper due diligence was conducted by Bayer’s board of management and that it did fulfil its duties. The independent report was consistent with the risk assessment regarding the Monsanto acquisition published in Bayer’s FY2017 annual report. However, the risk assessments were conducted at a time when only 120 lawsuits were filed, and courts had not given their verdicts on the matter.[118] The number of lawsuits have since ballooned into tens of thousands.[119]

An independent review was also conducted regarding the legal advice which Bayer commissioned prior to the acquisition, concerning the potential litigation risks associated with glyphosate and Monsanto’s Roundup products. The review was conducted by James B. Irwin, a practising lawyer and mass-torts expert. It concluded that the legal opinions sought had appropriately analysed the risks involved.[120]

The results of the above reviews and audits were published on Bayer’s website[121] to appease shareholders.

A green nightmare?

Bayer claimed that “sustainability and business must go hand in hand” in its 2019 sustainability report.[122] It acknowledged the company’s prominence and how its actions could steer the industry towards or away from improving sustainability. With investors placing increasing importance on environmental, social and governance (ESG) factors in their investment decisions,[123] companies are incentivised to take steps to adopt sustainable business practices. Bayer takes pride in having a purpose of “science for a better life”,[124] but that was called into question with its decision to acquire Monsanto, commonly dubbed by critics as “the world’s most evil company”.[125]

In addressing the acquisition of Monsanto in its 2016 annual report,[126] Bayer reaffirmed its continued commitment to sustainability and to the United Nations’ Sustainable Development Goals (SDG).[127]

“Health for all, hunger for none” – deception or reality?

Monsanto is the creator of genetically modified (GM) herbicides and insecticides, many of which have been found to be harmful to bees[128] and responsible for the rapidly declining[129] bee population, despite Monsanto’s claims that its products are harmless to animals. Bayer adopted these claims[130] following its acquisition of Monsanto despite strong evidence to the contrary.[131]

The extensive use of Roundup has also been claimed to have led to the unfortunate birth of “superweeds”,[132] weeds that have developed resistance to herbicides and threaten the survival of crops.[133] The Poison Papers Project details how Monsanto continued to produce and profit from toxic industrial chemicals despite its knowledge of its impact on the environment and human health.[134] In terms of sustainability reporting, Monsanto does not report its greenhouse gas and carbon dioxide emission levels,[135] which seems to contradict Bayer’s declaration of commitment to tackling climate change and provision of green solutions.[136]

Throughout its tumultuous history, Monsanto has been involved in a slew of incidents that solidified its image of a company which is profit-driven at the expense of social responsibility. The release of internal documents showed Monsanto’s prior knowledge of possible carcinogenic properties of its Roundup weed killer,[137] yet it continued to market the product as harmless.

Monsanto requires farmers who buy its seeds to sign an agreement prohibiting them from replanting the seeds after the first harvest, effectively locking in its profits from these farmers.[138] Monsanto has filed multiple lawsuits against farmers who were found to have violated the agreement.[139] It has also been the subject of much criticism for its obsession with monopolising the food market. These events provide a stark contrast from what Bayer claims to value – Bayer asserts its dedication to helping smallholder farmers secure a sustainable source of income through agriculture.[140]

The Monsanto Papers revealed Monsanto’s practice of ghost-writing research articles in order to influence research published about the effects of its products – in particular, the Roundup weed killer.[141] Monsanto was also revealed to have relations with certain individuals in the research field who would help it to publish “independent” articles proving that Roundup is harmless.[142]

Further, Monsanto was found to have established an intelligence centre to disparage journalists and activists who pose a threat to its branding.[143] One well-known case involved Carey Gillam, an investigative journalist who wrote a book to expose Monsanto’s exploitation of its industry. It was discovered through declassified documents that Monsanto manipulated search results and fabricated poor reviews in order to discredit the book.[144]

Bayer’s corporate compliance policy details 10 principles that the company pledges to abide by, including uprightness in business dealings, acting with social and ecological responsibility, and competing equitably.[145] However, Monsanto’s track record goes against much of what Bayer claims to stand for.

Responsible investing or hot air?

When Bayer first announced its plans to take over Monsanto in 2016, several minority shareholders such as Henderson Group were opposed to the high price Bayer was offering and demanded a shareholders’ vote, although it fell on deaf ears. These minority shareholders stated that a shareholders’ vote was necessary to restore investor trust in Bayer and confirm support for its business strategy.[146]

Bayer’s larger institutional investors, in contrast, seemed to have taken a comparatively passive position about the acquisition. BlackRock was Monsanto’s second largest institutional shareholder and Bayer’s largest shareholder at the time of the takeover deal. Its substantial shareholding in Monsanto cast doubt on its genuine commitment to ESG despite being a signatory to the United Nation’s Principles for Responsible Investing (UN PRI)[147] and claims of being guided by sustainability principles.[148] BlackRock is also a signatory of the U.K. Stewardship Code, listing environmental and social issues[149] as one of the key themes in its corporate governance engagement principles. Vanguard Group, Monsanto’s largest institutional investor, is also a UN PRI signatory.[150] It was reported that the Vanguard Group and BlackRock Inc., as Monsanto’s largest shareholders, would net approximately US$3.9 billion and US$3.5 billion, respectively.[151]

Temasek, through its purchase of an additional stake in Bayer in 2018, substantially aided in the funding of the takeover.[152] Its share purchase was a clear affirmation for Bayer’s acquisition, raising some eyebrows as Temasek is government-owned and claims to champion sustainable and ethical investing.[153]

Epilogue

The aftermath of the acquisition is clear – Bayer has been rated a 5 for controversy and ‘severe’ for risk.[154] Bayer is also aware of the negative impact of Monsanto’s tainted reputation, as seen from the management decision that the Monsanto name would not be part of the company’s portfolio.[155] Condon, the president of Bayer’s Crop Science division, cited this removal as part of Bayer’s effort to rebuild public trust in the company.[156] Evidently, Bayer was aware of Monsanto’s troubled image and the acquisition was not a case of acute misinformation.

Fortunately for Bayer, management’s efforts at regaining shareholders’ support seemed to have succeeded. At its 2020 AGM held on 28 April 2020, 92.6% of the valid votes cast were in favour of ratifying the executive board’s business conduct during 2019, despite a settlement with plaintiffs yet to be negotiated.[157]

In May 2020, Bayer reached verbal agreements to resolve a substantial portion of an estimated 125,000 U.S. cancer lawsuits over use of its Roundup weedkiller, as part of a US$10 billion plan. Bayer’s share price increased by as much as 4.6% on 25 May 2020.[158]

In the words of the late world heavyweight boxer Bob Fitzsimmons, “the bigger they are, the harder they fall”. One wonders if Bayer will recover fully from the legal and reputational fallout from the Monsanto acquisition.

Discussion questions

1. What are the key responsibilities of a supervisory board or board of directors in merger and acquisition decisions?
2. What could Bayer's management board and supervisory board have done prior to the acquisition of Monsanto to avoid the issues after acquisition?
3. Has Bayer's shareholder relationship management contributed to the post-acquisition backlash? What should the company have done differently?
4. Discuss the pros and cons of the scenarios in (a) and (b) below, and how companies can practise good corporate governance under these scenarios.
   (a) A lack of requirement for shareholder approval for acquisition decisions and a sole reliance on the supervisory board to approve acquisitions.
   (b) Companies given the power to significantly increase the number of shares without an annual mandate.
5. What are the key risks associated with large acquisitions such as Bayer's acquisition of Monsanto? What additional risks are involved when acquisitions involve companies in different industries and countries?
6. What are the key elements of a robust due diligence process in a major acquisition?
7. Are current efforts by Bayer adequate in improving corporate governance relating to acquisitions? Assess the importance of setting up an investment committee or merger and acquisition committee in Bayer.
8. Evaluate the robustness of Bayer's risk assessment of the acquisition using an ERM framework and discuss the supervisory board's role in this process. To what extent should companies disclose their risk assessment and due diligence for acquisitions to shareholders?
9. Identify the key performance measures used in the remuneration of Bayer's management board and assess their suitability. Is it important for shareholders to have a say in remuneration policies of management or should that be left the board of supervisors? Explain.
10. To what extent do you think institutional shareholders can influence the commitment of a company like Bayer to incorporate ESG factors when making business decisions? Critically evaluate the action or inaction of institutional shareholders of Bayer and Monsanto, and whether they should have done more.

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BOEING: A PLANE WRECK

Case overview

The crashes of Lion Air Flight JT610 and Ethiopian Airlines Flight ET302 astounded the aviation industry, triggered numerous investigations, and resulted in a worldwide grounding of hundreds of Boeing 737 Max jets. The 737 Max is Boeing's newest family of single-aisle airplane and the fastest-selling airplane in Boeing history, accumulating almost 4,700 orders from over 100 customers worldwide. It first obtained approval for commercial service from the Federal Aviation Administration (FAA) in March 2017. The first crash involving this Boeing model happened on 29 October 2018, when a Lion Air flight plunged into the Java Sea 12 minutes after taking off, killing all 189 passengers and cabin crew on board. A second crash occurred on 10 March 2019, when an Ethiopian Airlines flight crashed near the town of Bishoftu six minutes after take-off, killing all 157 people on board. On 13 March 2019, the FAA issued an Emergency Order of Prohibition which prohibits the operation of the 737-8 and 737-9 in the United States (U.S.). Investigators focused on a specific feature, known as the automated Manoeuvring Characteristic Augmentation System (MCAS), which might have forced both planes into a nosedive that brought them down. As investigations delved deeper into the accidents, several corporate governance issues surfaced.

The objective of this case is to facilitate a discussion of issues such as corporate culture; board effectiveness; executive remuneration; risk management; crisis management; and role of regulators.

The ascend of Boeing

Boeing's beginnings can be traced back to 1916, when its founder, William E. Boeing, founded Pacific Aero Products Co. Prior to that, he developed the Boeing Model 1 seaplane with U.S. Navy officer, George Conrad Westervelt. After mechanical engineer James Foley and aeronautical engineer Wong Tsoo developed an improved new model (Model C) and sent to the Navy during World War I, the Navy took interest in it and ordered 50 more units, contributing to the start of Boeing's success. Boeing subsequently changed the company's name to Boeing Airplane Co., and later on, The Boeing Company (Boeing), which is what the company is known today.[1,2,3]

In the 1920s and 1930s, Boeing continued to produce and sell products to the U.S. military. In the late 1920s, Boeing started its airmail services. In 1928, Boeing Airplane & Transport Corp. was formed to merge its manufacturing and airline operations. Under the Air Mail Act of 1934 – which restored competitive bidding but dissolved airline and aircraft holding companies – the

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company was forced to dissolve into three separate companies, forming Boeing Airplane Co., United Aircraft Co. and United Air Lines.[4,5]

Before and during World War II, Boeing developed a few reputable commercial aircrafts, one of which being the Model 247.[6] Boeing's military products played crucial roles in World War II and it continued to contribute to the military post-war.[7] In the process, its rivals, Douglas and Lockheed surpassed them in the commercial sector.

To compete in the post-World War II market, Boeing decided to produce an aircraft that could cross the North Atlantic.[8] In 1958, the Boeing 707 was developed and went into service. Due to its shorter flight time and smoother ride, the Boeing 707 revolutionised air travel and won the hearts of many.[9] Subsequently, Boeing developed new commercial aircrafts, including models 727 and 737. By the end of the 20th century, the 737 model became the most popular commercial aircraft in the world.[10] Boeing monopolised the long-range air travel market segment after another model, 747, went into service as it allowed airlines to provide inexpensive long-range air travel. Over 1,500 units of Boeing 747 have been sold as at February 2019.[11]

Boeing continued to innovate and tailored its aircrafts according to market needs and preferences.[12] In addition, it introduced the concept of commonality in its planes by designing new models to 'feel like' its past models. Pilots who are certified to fly one model could quickly adapt to fly a similar one, thereby streamlining the training process and reducing training costs for airlines at the same time.[13]

As commercial air travel increased globally, the sales for Boeing's new commercial jetliners, the 737 Max and 787 Dreamliner, soared due to increased international orders. As a result, Boeing saw its revenue exceeding US$100 billion for the first time in 2018 and the company's stock price skyrocketed.[14]

Boeing's game plan

Boeing's success did not come easy. It braved through two world wars, the Great Depression, and the merciless environment it operated in before achieving its market leader position after a century.[15] In order to remain competitive, Boeing focused on organic growth and complemented such growth with strategic acquisitions.[16]

In 2018, Boeing broadened its range of services by acquiring KLX Aerospace Solutions. KLX was a major global supplier of aviation parts and services. This acquisition opened doors to the untapped US$2.8 trillion aerospace services market.[17] It also invested in two notable joint ventures in 2018 and 2019 respectively – one was with Safran S.A. to design auxiliary power units and another with Adient plc to create high quality seats.[18,19,20]

In October 2018, Boeing also opened a production facility, Boeing Sheffield, to produce actuation system components for the 737 and 767 aircraft.[21] In February 2019, the company signed an agreement for a strategic partnership with Embraer S.A. (Embraer). Boeing was to acquire an 80% ownership stake for US$4.2 billion in the joint venture comprising the commercial aircraft and services operations of Embraer.[22,23] Additionally, in June 2019, Boeing entered an agreement to acquire EnCore Group aimed at enhancing Boeing's competencies in cabin hardware manufacturing to provide more choices, superior products, enhanced capacity and availability to its clients.[24]

These acquisitions and joint ventures were great additions to complement Boeing's specialty in aircraft development, and allowed Boeing to provide more value to its customers.[25] Boeing even acquired its own suppliers with the intention of taking over certain parts of the manufacturing, which would translate into reduced supplier costs and improved operating margins.[26]

Powering ahead

Between 2014 and 2018, Boeing had a steady increase in revenue from US$90.8 billion[27] to US$101.1 billion,[28] representing a compounded annual growth rate (CAGR) of 2.75%. Its revenue crossed the US$100 billion mark in 2018 due to an unprecedented number of commercial airplane deliveries and higher revenues in defence, space and services. In 2018, Boeing delivered a record 806 and won 893 net orders for commercial airplanes, raising the company's total order backlog to nearly 5,900 airplanes.[29] Boeing's operating margins also improved from 8.2% in 2014 to 11.9% in 2018, with 10.5% attributable to core operating margins. Operating cash flow also increased significantly to a record US$15.3 billion in 2018, with US$8.6 billion maintained as cash and marketable securities, providing strong liquidity to the company.[30] Based on strong cash generation and confidence in the company's outlook, Boeing's board increased the quarterly dividend per share by 20% in December 2018 and replaced the existing share repurchase program with a new US$20 billion authorisation in 2018.[31]

The crew behind the wheels

As of March 2019, Boeing's board of directors comprised of 13 directors with various backgrounds and expertise, with 12 of them being independent. The only non-independent director was the CEO, Dennis Muilenburg.[32] Boeing's Corporate Governance Principles mandates at least 75% of the board to be deemed independent based on the independence criteria under New York Stock Exchange (NYSE) rules.[33]

According to the 2019 Proxy Statement for Boeing, the remuneration mix for independent directors consists of cash, stocks and "other compensation", with cash and equity compensation making up 91% to 100% of the independent directors' total remuneration. Independent directors can choose to defer part or all of their cash fees into stock units under Boeing's deferred compensation plan. The equity compensation each independent director received also includes stock units with a total fair value of US$180,000 per year. These stock units do not grant voting rights and are accumulated into an account which is converted into Boeing shares in full or in annual arrears upon termination of the director's service. Additionally, dividend equivalents from deferred stock units are credited as more deferred stock units, which would generate more dividend equivalents in future, thereby resulting in an accelerated accumulation of stock units over time.[34]

Boeing justified its remuneration policy for independent directors by claiming that it would better align the interest of the independent directors with that of shareholders. Boeing's Corporate Governance Principles also specify that all directors with a tenure of more than three years are mandated to hold stock or its equivalent that has an aggregate value of at least three times the annual cash fees received. Boeing disclosed that all of the directors have surpassed this requirement as at April 2019 and disclosed the aggregate stock units held by each independent director in the 2019 Proxy Statement.[35]

The big Bus

"They weren't going to stand by and let Airbus steal market share,"

– Mike Renzelmann, a former Boeing engineer[36]

The barriers to entry for the commercial aircraft manufacturing industry is high in terms of capital requirements, technical expertise, and customer support. The manufacturing of airplanes is very expensive and complex. A single Boeing 747 reportedly requires six million components pieced together.[37] According to Teal Group, an aerospace market analysis company, Boeing and Airbus SE (Airbus) produced more than 99% of larger airplane orders globally, indicating their dominance in the industry.[38]

The intense competition between Airbus and Boeing put considerable pressure on both companies to deliver quickly and to constantly innovate.[39] In 2011, Boeing's business was challenged by Airbus when the latter released its new A320neo aircraft. Boeing's exclusive customer, American Airlines, was contemplating placing orders for Airbus' latest and more fuel-efficient jet. The loss of American Airlines as its customer could cost Boeing billions in sales and thousands of jobs. Boeing reacted swiftly by changing its original idea of developing a new passenger plane to simply modifying its existing 737 workhorse. In just three months, it launched the 737 Max.[40] Boeing rushed to launch the 737 Max into the market and offered the plane to American Airlines even before obtaining approval for the design from the board.[41]

The unexpected tragedy

Just as Boeing celebrated an extraordinary year of exceptional growth came the shocking news of the Lion Air crash.

On 29 October 2018, Indonesian carrier Lion Air Flight JT610 flying the 737 Max crashed at high speed into the Java Sea, killing all 189 passengers and cabin crew on board. Both the pilot and co-pilot were experienced,[42] but on that fateful day, the pilots had difficulties controlling the aircraft which kept descending against their commands.[43] A "flight control problem" was escalated to the air traffic control just two minutes into the journey. The Manoeuvring Characteristic Augmentation System (MCAS) responded by pushing the nose of the aircraft down despite the pilots' desperate attempts to bring it up.[44] According to the cockpit's voice recording, the captain asked the first officer to check the flight manual to find out why the plane kept lurching downwards. Over 20 attempts were made to rectify the issues but they were all unsuccessful.[45] The Indian-born captain was silent at the end, while the Indonesian first officer said “Allahu Akbar”, the Arabic expression meaning “God is greatest”.[46] Eventually, the controller lost contact with the aircraft and it soon went into a steep dive straight into the sea. The whole tragedy happened within 15 minutes after taking off.[47]

The Lion Air crash saw Boeing’s stock price falling nearly seven percent.[48] However, by early January 2019, the stock price had recovered its losses and climbed to a record high of US$440.62 on 1 March 2019.[49,50]

Preliminary findings

Investigations discovered several problems that occurred during the JT610 flight. Some technical issues discovered include the malfunctioning stick shaker, the airspeed and altitude indicators, as well as the newly added MCAS safety software.[51] Right after the plane took off, the pilots had to radio air traffic controllers for information regarding altitude and speed as the system provided incorrect data of the external environment. The faulty sensor also inaccurately triggered the plane’s stick shaker, which relayed the false information that the plane was at risk of stalling and thereby activating the MCAS, causing its nose to be lowered repeatedly.[52]

It was discovered that this same plane had a near-miss experience just one day before the crash. A flight scheduled from Denpasar to Jakarta on 28 October 2019 experienced a similar problem but was fortunate enough to be resolved by the pilots on board “after running through three checklists.”[53,54] The pilots successfully disabled the aircraft’s flight-control system and landed the plane safely. It was later reported that the earlier flight had encountered the same problems that appeared to have caused it to crash the day after.[55]

Boeing’s and FAA’s response

Boeing issued a statement on the day of the Lion Air crash, pledging their commitment to provide technical assistance to the accident investigation and expressing sympathy towards the victims and their relatives.[56] About a week after, Boeing circulated a safety warning to airlines on the potential malfunction of its flight control software. [57] It also issued a bulletin to help operators learn how to react when a problem happens. [58] However, Boeing was firm in its view that the design of its flight control system did not violate any process or compliance and thus, even if the problem indeed laid with the MCAS, the crew should have been able to save the plane and people on board.[59] A month after the crash, Boeing released yet another press statement expressing its sympathy and extending condolences to the victims’ families. It also reiterated its stance that safety is the company’s core value and top priority.[60]

The Federal Aviation Administration (FAA) – the regulator responsible for aviation safety in the U.S. – issued a new airworthiness directive to the owners and operators of the Boeing 737 Max aircraft model, addressing the issues with the aircraft’s angle of attack sensor.[61] The airworthiness directive required airlines to revise their certificate limitations and operating procedures of the airplane flight manual (AFM). Airlines were given three days to make necessary changes such that flight crew will have horizontal stabiliser trim procedures to follow.[62]

Once bitten, still not shy?

On 10 March 2019, just four months after the first crash, a second disaster involving a Boeing 737 Max 8 occurred. Ethiopian Airlines Flight ET302 with 157 people on board crashed into the ground merely six minutes after taking off.[63] The aircraft was bucking erratically, with an unstable vertical airspeed,[64] again due to the electronic system forcing the nose of the aircraft downwards even though it was far too close to the ground.[65] The captain, Yared Getachew, and his co-pilot failed to regain control of the aircraft after trying to haul back on their control columns with their combined strength.[66]

The second crash caused Boeing's stock price to slump by about 13%, wiping off approximately US$30 billion of the company's value.[67]

Uncovering more issues

The second crash involving Ethiopian Airlines shed more light on the problems with the Boeing 737 Max 8 aircraft's automatic flight control system. Parallels were drawn from both aircraft accidents where the MCAS was activated in response to erroneous angle of attack information.[68] Additional findings revealed that the left and right of the aircraft's angle of attack deviated wildly, which eventually triggered the MCAS security system.[69] Despite the pilots following the prescribed procedures set out by Boeing after the anti-stall system malfunctioned, they were unable to regain control of the aircraft. This cast serious doubts on the sufficiency of instructions issued by Boeing, leaving people to wonder if the fixing of the system was properly carried out.[70]

Crisis? What crisis?

On the day of the fatal Ethiopian Airlines crash, Boeing issued a statement expressing that it was "deeply saddened" and extended its sympathy to families of the victims.[71] Two days after, on 12 March 2019, the board released a public statement reiterating that safety is its utmost priority, claiming that the 737 Max observed high safety standards.[72] On the same day, the FAA released an official statement stating that the review concluded an absence of systemic performance issues with the 737 Max and thus, the 737 Max would not be grounded.[73] Nonetheless, an increasing number of countries and airlines had begun to ground their 737 Max planes.[74,75]

However, the following day, U.S. President Trump's administration ordered the grounding of the 737 Max.[76] FAA followed suit and released a statement following Trump's order and indicated that they have discovered similarities between the two tragedies which prompted its decision to suspend Boeing's 737 Max 8 and Max 9 jets. Consequently, Boeing announced that it recommends the temporary grounding of the 737 Max out of caution, despite having "full confidence in the safety of the 737 Max".[77]

On 26 March 2019, in an open letter to Ethiopian Airlines and the aviation industry, Boeing said that it was "humbled" and that this tragedy would serve as a learning experience.[78] Yet, no apologies were made.

Finally, on 4 April 2019, CEO Muilenburg posted an apology video on the company website and on Boeing's official Facebook page, attributing the cause of both accidents to the MCAS and the inadequate training that pilots received.[79,80]

Boeing faced a number of lawsuits from relatives of the victims of both crashes. Families of the victims were still upset by the delay in apology and the fact that there was no direct communication or support extended to them. The public felt that Boeing's response was slow and defensive. One parent of a victim pointed out that the CEO "talks to other people but not us, the victims' families".[81] Boeing was accused as acting more as a business-to-business company by providing information only to airlines but not to the public on how they were going to get to the bottom of the issues.[82,83]

After the two accidents, Boeing lost the trust and confidence of the public.[84] A survey by UBS Group AG found that 70% of people of those surveyed would hesitate to book a flight on the 737 Max.[85] Another separate survey conducted by Atmosphere Research Group found that at least 40% would book a more expensive or less convenient flight to avoid the 737 Max.[86] Besides passengers, airline companies such as Garuda of Indonesia cancelled US$15 billion worth of orders of the 737 Max jets.[87] Due to the grounding of its Max aircrafts, Boeing delivered only 380 commercial airplanes in 2019, its lowest level since 2007.[88]

The Federal Aviation Administration (FAA)

"The fact is the FAA decided to do safety on the cheap which is neither cheap nor safe and put the fox in charge of the hen house."

– Richard Blumenthal, U.S. senator[89]

As investigations went on, scepticism about FAA's approval procedure came under attention.[90] A system known as the Organization Designation Authorisation (ODA) program provides manufacturers with the authority to ascertain the airworthiness and safety of their new aircrafts.[91] The policy of aircraft manufacturers helping with their products' certification was first endorsed by the U.S. Congress in 2003 to speed up the certification process and cut costs.[92] In 2005, the FAA created the ODA program which expanded the authority given to manufacturers to help certify their own products[93,94] and granted Boeing "in-house oversight for new planes in production and approval of major repairs and alterations".[95] The idea behind the ODA program was that by delegating about 90% of its certification work, the FAA would be able to free up resources to focus on its oversight role, ensuring that tasks are carried out correctly, according to its own rules and procedures.[96] Over the years, the FAA was seen to be increasingly entrusting major decisions to the manufacturers.[97] In view of this, the delegation program and the FAA's oversight role have come under scrutiny.[98]

According to current and former FAA employees, the agency handed substantially all the authority for the certification of the 737 Max, including the responsibility for approval of MCAS, to Boeing to speed up the process of releasing the new planes.[99,100] In the Joint Authorities Technical Review (JATR) report commissioned by the FAA after the two deadly crashes,[101] the panel questioned FAA's utilisation of Boeing's employees in the certification and found signs that Boeing put "undue pressure" on these employees, triggering more questions relating to the quality of the certification done.[102] In addition, critical changes in the 737 Max, such as the MCAS, was not properly reviewed by the FAA. After significant changes were made to the MCAS by Boeing, the agency did not conduct another safety review of the anti-stall system, as the said changes "did not affect the most critical phase of flight, considered to be higher cruise speeds".[103] Furthermore, under the impression that the system was not significant, officials did not require Boeing to tell pilots operating the MAX aircrafts about MCAS.[104]

The JATR report concluded that the FAA was not sufficiently aware of what MCAS was and hence was unable to discharge its oversight duties.[105,106] This was confirmed by some FAA engineers who commented that they did not fully comprehend the system and that the FAA failed to independently analyse the risk associated with the system before the approval.[107] The report further criticised FAA's approval procedures for focusing only on individual improvements and not how these improvements will affect the existing systems or the people operating it.[108]

Experts also raised the possibility of modifying the FAA's certification processes, taking into consideration the complex systems present in today's aircraft, as the current standards were set in a period when aircraft systems were less automated.[109]

Too cozy?

The fact that the FAA, which ensures that new planes are safe to fly in the air, outsources inspections to aircraft manufacturers raised concerns about the close relationship between the two.[110] As Ralph Nader, a prominent consumer advocate mentioned in an interview with the Wall Street Journal, the regulators are no longer in an arm's length relationship with the manufacturers due to the excessive delegation of powers in the certification process.[111]

Concerns over FAA's independence to oversee the work of the manufacturers in the certification process were also highlighted.[112] It was reported that in 2012, the U.S. Department of Transportation received indications from some FAA employees regarding the issue of Boeing having too much authority in the certification process, and that many FAA employees would have faced retaliation if they spoke up.[113] It was uncovered that FAA managers were not always supportive of employees' efforts to hold Boeing accountable. Consequently, employees were uncomfortable in speaking about the issue.[114] The release of similar messages by both Boeing and the FFA after the two 737 Max crashes raised more questions regarding the relationship between the two. Mary Schiavo, a former U.S. Transportation Department inspector general, commented that the FAA "were just parroting what Boeing told them".[115]

Critics also pointed out the "revolving door" phenomenon in the aviation industry where employees change their jobs from the industry to the regulatory agency or vice versa.[116] According to the Project On Government Oversight (POGO), Boeing had hired a total of 84 former officials from the U.S. Defense Department as of 2016. Former U.S. President Barack Obama, recruited Boeing's board members as his Chief of Staff and Commerce Secretary.[117] Current U.S. President Donald Trump also recruited Patrick Shanahan, an ex-Boeing employee who worked for the company for over 30 years, as his acting Secretary of Defense even though Shanahan had no prior military experience.[118] Shanahan was put in control of the Pentagon's US$700 billion budget as the Secretary of Defense and had made comments advocating Boeing while discounting its competitor.[119]

It was reported that Shanahan contributed to Pentagon's US$1.2 billion decision to purchase Boeing's F-15X combat aircraft even though the U.S. Air Force was against it.[120] Former and current U.S. Presidents have also advocated Boeing's interest. For instance, Obama helped Boeing in promoting its aircrafts while Trump implemented policies that benefitted Boeing's business, resulting in a huge surge in its stock price ever since he became president.[121,122]

Trump has always been interested in the aviation industry, having owned his own airline, Trump Shuttle, in the past.[123] After assuming his role as President of U.S., Trump broadened his connections to the industry. This included the CEO of Boeing, Muilenburg, who reassured Trump about the safety of the 737 Max aircraft over a phone call after the Ethiopian Airlines crash. The U.S. was thus among the last countries to ground the 737 Max.[124]

Concerns over Boeing's relationship with the Trump administration was speculated to be the reason behind Ethiopia's decision to send Flight 302's black boxes to France for examination instead of the U.S., which was an unusual move.[125] It was also noteworthy that Boeing was one of the top companies which engaged in lobbying in the U.S., spending up to US$15.1 million in 2018. As a government contractor, Boeing was not allowed to participate in lobbying itself and hence employed about 100 lobbyists to assist with its lobbying activities.[126]

Training to be 737 Max pilots

Boeing has been well known in the aviation world for a design philosophy that gives pilots significant authority over the aircraft's flight controls.[127] One major difference between the 737 Max and its predecessors is the larger engines fitted further forward on the 737 Max aircraft's wings. However, in order to counteract the increased risk that the aircraft could stall if pilots angled the nose too high as a result of the new fittings, Boeing introduced the MCAS, which automatically nudges the aircraft's nose down if its sensors detect that the aircraft was at a risk of stalling.[128] Chesley B. Sullenberger III, a retired pilot, commented that "in creating MCAS, they violated a longstanding principle at Boeing to always have pilots ultimately in control of the aircraft."[129]

One area of focus in the air crash investigations was whether the training procedures for the 737 Max, approved by the FAA, were sufficient for pilots to know how to operate the new aircraft. Bloomberg reported that Boeing engineers repeatedly invited FAA officials to look over their designs in one of the company's simulators to determine whether certain changes made would necessitate 'Level D training', which required more intensive training using a full-scale simulator.[130] By making the aircraft handle like a 737 predecessor, Boeing ensured that pilots would not need to undergo extensive extra training, thus helping airlines to cut costs and giving airlines additional incentive not to defect to its competitors.[131,132] Instead, Boeing expected pilot training to be computer-based.[133] When Lion Air – one of Boeing's first 737 MAX airline customers – indicated that it wanted to exceed Boeing's recommended training and suggested that its pilots have a simulator session, Boeing convinced it that the extra training was unnecessary. Boeing was concerned that such an arrangement would set a precedent for other airlines to follow suit and undermine its sales promise and regulatory lobbying that current 737 pilots required only minimal training to operate the new 737 Max aircraft.[134]

Yet another troubling finding is that many pilots, including those from American Airlines and Southwest Airlines, said that they were unaware of the MCAS before the Lion Air crash. The key change to the system which ran in the background was neither mentioned during pilot training sessions nor part of the flight manual for the 737 Max. They said that the manual did not explain it or provide explicit instructions on how to disable it.[135,136]

To split or not to split

On April 2019, a month after the second tragedy, proxy advisory firms, Institutional Shareholder Services Inc. (ISS) and Glass Lewis, recommended that Boeing separate the roles of the then CEO and Chairman, Dennis Muilenburg, citing reasons such as the importance of having the board play an oversight role.[137]

Further, during the 2019 Annual General Meeting (AGM), a shareholder motion was raised to maintain an independent Chairman and re-nominate an independent Chairman whenever the existing Chairman was deemed to be non-independent. In response to this, the board stated that it believed that the existing leadership structure was in the best interests of its shareholders and held that the board should not be tied down to such a rigid policy as it would hinder its ability to decide on an effective leadership structure. Further, the board felt that the presence of a lead independent director and a highly independent board would provide sufficient management oversight and thus, recommended that shareholders vote against this motion. Moreover, the board stated that "it [was] not aware of any clear evidence that splitting the CEO and Chairman roles is beneficial for companies".[138,139] The shareholder motion failed to go through.

Despite that, the board subsequently announced six months later in October 2019 that Muilenburg would be stepping down from his Chairman position and would be succeeded by David Calhoun, the lead independent director. This move was said to be to allow Muilenburg to focus on bringing the 737 Max back on service.[140]

Risk management of Boeing

For the longest time in Boeing's history, risk management has always been a function under the audit committee. The Chairman of the Audit Committee also came under the scrutiny of Glass Lewis, which felt that Lawrence Kellner should be removed from his Audit Committee Chairman position due to probable shortfalls in Boeing's risk management framework that might have resulted in the crashes.[141] The apparent lack of a specialised risk management committee focusing on aviation safety, coupled with Boeing's close relationship with the FAA, have left many questioning how vigorous the testing processes were before the planes were certified and deemed ready to be in the skies.

In the board of 13 directors, the closest person having some technical expertise relevant to the aircraft manufacturing industry is David Calhoun, who used to be the Chief Executive of GE Aircraft Engines.[142] The next person in line who might have some knowledge about aviation safety is Art Collins, who was the former Chairman and CEO of medical device maker Medtronic. It is, however, arguable whether an understanding of medical devices is a transferable skill set that is applicable to the aviation industry. Furthermore, safety-related experience was not one of the criteria for appointment of directors.[143]

On 25 September 2019, Muilenburg announced the addition of a new permanent fixture at Boeing, the Aerospace Safety Committee, with the responsibility of ensuring that the company's products and services are safe. The committee's main objective is to review policies and processes that were in place for the design and development of the airplanes to ensure safety and recommend any changes or improvements to those policies and procedures.[144] The committee, however, will not investigate the Lion Air and Ethiopian 737 Max accidents due to all the ongoing formal investigations.[145]

The new committee would be led by retired admiral Edmund Giambastiani Jr., former Vice Chairman of the Joint Chiefs of Staff. Giambastiani would lead the three-member committee, whose other members are Boeing directors Lynn Good, Chairman and CEO of Duke Energy, and Lawrence Kellner, President of Emerald Creek Group and former Chairman and CEO of Continental Airlines. After the two catastrophes, Boeing added safety-related experience to the list of criteria it would consider when appointing future directors.[146]

Prior to the formation of the Aerospace Safety Committee, the "Committee on Airplane Policies and Processes" was formed in April 2019 following the two airline crashes. After a five-month independent review of the company's policies and processes for airplane design and development by the Committee, some of the changes recommended by the board included: a new product and services safety organisation to be created which would report directly to senior company leadership and the board's Aerospace Safety Committee; engineers throughout Boeing, including the new product and services safety organisation, would report directly to the chief engineer, who in turn reports directly to the company's CEO; and the establishment of a design requirements programme.[147]

Nose diving deeper into trouble

"This is more evidence that Boeing misled pilots, government regulators and other aviation experts about the safety of the 737 Max,"

– Jon Weaks, president of the Southwest Airlines Pilots Association[148]

Boeing's troubles, however, were far from over. Text messages between Mark Forkner, Boeing's chief technical pilot, and Patrik Gustavsson, another Boeing's pilot, discussing the MCAS in 2016 were leaked. Forkner stated during the exchange that the MCAS was "running rampant", highlighting the fact that the MCAS malfunction was actually discovered two years ago during a simulator test. The FAA, which was responsible for the authorisation of the 737 Max, was deemed to be misled by Forkner, who requested for the MCAS to be removed from the pilot manual. Forkner justified his request by explaining that the need to activate the MCAS will only occur once in a blue moon.[149]

Even though Boeing knew about the text messages, they were not disclosed to the U.S. Department of Transportation and other relevant authorities immediately upon discovery.[150] This came to the attention of the FAA which then published a letter to Muilenburg demanding an explanation for the text messages and asking him to justify Boeing's delay in disclosing them to the safety regulator.[151]

Mystery unravelled?

"I was shocked that in a room full of a couple hundred mostly senior engineers we were being told that we weren't needed."

– Mark Rabin, former Boeing software engineer[152]

When the MCAS malfunction was first discovered, the question as to why a company renowned for its well-designed planes could have made such a fatal mistake leading to not one but two tragedies remained a conundrum. It was subsequently revealed that Boeing was firing experienced software engineers at the development stages of the 737 Max, while pressuring its suppliers to cut costs.[153]

Moreover, Boeing had allegedly relied on outsourcing the development and testing of its 737 Max's software to "$9-an-hour engineers" predominantly from India, where knowledge in the aerospace industry is lacking. These "$9-an-hour engineers" were temporary employees, with some of them being fresh college graduates. These outsourced employees were from HCL Technologies Ltd and Cyient Ltd, India-based software developers engaged by Boeing to develop and test the 737 Max's flight-display software and flight-test equipment software respectively. These codes developed for the software utilised in the 737 Max turned out to be inefficient and prone to errors, according to Rabin.[154,155]

Looking back, Boeing's decision to outsource the development of the 737 Max also paid off in other ways. Due to its contribution to the Indian economy by providing employment opportunities to the local market, Boeing secured multiple orders to supply aircraft to the Indian military as well as to the commercial market, thereby allowing it to gain a stronger foothold in a market previously dominated by Airbus.[156] "I was pleased to learn of an Indian airline's (SpiceJet) recent order of 100 new American planes, one of the largest orders of its kind which will support thousands of American jobs," commented President Trump, after SpiceJet Ltd, an Indian airline company, placed a sizeable order with Boeing.[157]

Boeing's cost cutting culture has also come under scrutiny. Bjorn Fehrm, an aviation industry analyst, claimed that Boeing's preoccupation with cutting corners and profit maximisation is the cause of the dual tragedies.[158] Adam Dickson, a former 737 Max engineer, confirmed that Boeing engineers were put on a tight budget with respect to production costs of 737 Max and because of this cost cutting culture, the resources provided to produce the 737 Max were inadequate.[159] A spokesman for the union representing a group of 737 Max workers also claimed that workers would be labelled as "troublemakers" whenever they highlighted issues during the production process, thus reducing the workers' desire to ensure product quality.[160] Boeing, however, said that Dickson's comments were incorrect, and insisted that it did not cut corners or launch the new aircraft before it was ready.[161]

A whistle-blower, Boeing's own employee, Curtis Ewbank, also emerged following the tragedies. Ewbank was part of a team responsible for analysing past plane crashes in order to draw essential learning points such that future tragedies can be prevented. He highlighted an internal ethics complaint that accused the management of rejecting vital safety recommendations for the 737 Max on the basis of “cost and potential (pilot) training impact”. He added that the rejected safety add-ons had the capacity to avert the dual tragedies.[162]

Will the 737 Max soar the skies once again?

“The recertification of the aircraft is one thing, but the recertification of the trust and confidence is another,”

– Dennis Tajer, a spokesperson for the Allied Pilots Association[163]

The 737 Max grounding has resulted in a backlog of more than 400 planes manufactured but not delivered. Moreover, as airlines are not willing to take possession of too many planes at a time, it is projected that Boeing would need several quarters to clear this backlog. The growing inventory of manufactured planes coupled with various additional costs, including compensation to airlines for their loss in revenue, led to Boeing reporting a US$3.7 billion loss in their second quarter results in 2019.[164]

Boeing was still hoping to get the ban on the 737 Max lifted in January 2020.[165] Muilenburg made promises as to how Boeing was doing everything it could to prevent such an accident from happening again.[166] Boeing redesigned the MCAS by adding a software fix with three additional layers of protection to prevent it from activating erroneously.[167,168] In addition, it also promised to give pilot training and crew manuals a much needed update which would ensure that pilots learn to fly the 737 Max safely.[169] Boeing also established a US$100 million relief fund to help with family and community needs of the crash victims.[170]

However, by April 2020, the grounding of the 737 Max remained in place and is expected to continue until at least June or July 2020. Regulators have said that there is no firm timeline to allow the aircrafts to fly again.[171] Meanwhile, the entire aviation industry has been buffeted by the COVID-19 virus which has led to massive cancellation of flights and many airlines requiring bailouts.[172]

New crew or just changing shift?

In December 2019, Boeing fired Muilenburg as CEO. This was despite Boeing’s Chairman, David Calhoun, saying in November that the board supported Muilenburg.[173] Calhoun was appointed President and CEO, while another existing board member, Lawrence W. Kellner, became Chairman.[174] Calhoun has been on the Boeing board since 2009, while Kellner has been a Boeing director since 2011.[175]

Muilenburg stepped down from his position with over US$60 million in pension benefits and stock, after discounting his forfeited stock worth US$14.6 million. The company also denied him any severance or separation payments.[176]

The new captain

"It's more than I imagined it would be, honestly….And it speaks to the weaknesses of our leadership."

– David Calhoun, President and CEO of Boeing[177]

In an interview with The New York Times, Calhoun threw Muilenburg under the plane. Calhoun said that Muilenburg had "turbocharged Boeing's production rates before the supply chain was ready, a move that sent Boeing shares to an all-time high but compromised quality."[178]

He also said: "I'll never be able to judge what motivated Dennis, whether it was a stock price that was going to continue to go up and up, or whether it was just beating the other guy to the next rate increase…If anybody ran over the rainbow for the pot of gold on stock, it would have been him."[179]

Calhoun said that he and the rest of Boeing's board "never seriously questioned that strategy, in part because before the first Max crash off the coast of Indonesia in October 2018, the company was enjoying its best run in years. What's more, the board believed that Mr. Muilenburg, an engineer who had been at Boeing for his entire career, was so deeply informed about the business that he was a good judge of the risks involved in ramping up production."[180]

He added: "If we were complacent in any way, maybe, maybe not, I don't know…We supported a C.E.O. who was willing and whose history would suggest that he might be really good at taking a few more risks."[181] On the board's responsibility, Calhoun said: "Boards are invested in their C.E.O.s until they're not."

A few days later, Calhoun walked back on some of his criticisms, expressing regret.[182]

Will things be different under the new CEO? Or is it a case of rearranging the seat configuration in a flawed plane?

The major proxy advisory firms certainly believe that more changes are needed. Although they offered qualified support for Calhoun, they have recommended that some board members be voted out at the April 2020 AGM. ISS recommended shareholders vote against four long-time board members: Edmund Giambastiani Jr.; Arthur Collins Jr.; Susan Schwab; and Ronald Williams. Glass Lewis once again recommended voting against Chairman Kellner, who previously oversaw the board's Audit Committee. It said: "We believe the audit committee failed to mitigate the risk posed by management's decisions and should be held accountable for its oversight."[183]

At the 2020 AGM, Top Boeing shareholder Vanguard Group voted against Chairman Kellner, citing "control failures" under its Audit Committee. Separately, large Boeing shareholder BlackRock Inc. said it voted against four other Boeing directors, citing safety concerns.[184]

With the COVID-19 pandemic causing havoc to the aviation industry, Boeing has its own twin disasters to navigate. Only time will tell if it will make a safe landing.

Discussion questions

1. Evaluate Boeing's corporate culture and comment on how it might have contributed to the problems. How can Boeing improve its corporate culture moving forward?
2. Critically evaluate the composition of the Boeing board at the time of the crashes. Was composition a factor in the failure of the board to provide adequate oversight? What other board-related factors may have affected its effectiveness?
3. What is the role of the Boeing board with regards to risk management? What actions should the board take in order to prevent such incidents from happening again?
4. Critically evaluate the remuneration policies for independent directors in Boeing. To what extent do you think that this may have contributed to the crisis?
5. Analyse the independence of the regulators. Evaluate the effectiveness of the FAA's approval procedures as well as its oversight role in the certification process. What are the potential issues that might arise from the lack of independence? What could the regulators have done to avoid such issues?
6. Was Boeing's response to the crashes adequate? What could Boeing have done better to handle the aftermath of the crashes?
7. Did the competitive nature of the aircraft manufacturing industry lead to inappropriate proper decision making of aircraft manufacturers? What should aircraft manufacturers and regulators do in the future to ensure the safety of aircrafts?
8. Consider the recent changes in the Chairman and CEO. Do you think appointing the former Chairman as CEO and an existing director as Chairman would improve Boeing's corporate governance? What do you think of Calhoun's comments about the former CEO and the role of the board? Explain.

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PATISSERIE VALERIE: THE MISSING LAYER CAKE

Case overview

On 18 June 2019, five people were arrested and questioned over the alleged accounting fraud at the café chain Patisserie Valerie in the United Kingdom. This came eight months after the company's former finance director, Chris Marsh, was arrested on suspicion of fraud by false representation – six months after Patisserie Valerie collapsed into administration and four months after being bought out by Causeway Capital Partners, an Irish private equity firm, for a total of £5 million. The alleged fraudulent accounting irregularities and material misstatements created a £94 million black hole, leading many to question the effectiveness of Patisserie Valerie's corporate governance and internal controls, as well as the competence of its external auditors. Patisserie Valerie had to close more than half of its 200 stores and fire 900 employees.

The objective of this case is to facilitate a discussion of issues such as board composition and effectiveness; internal controls; accounting misstatements; the role of external auditors; and regulatory oversight.

Start of the butter magic

"A woman who ran her business on her own from 1947 to 1965 – I never remember her complaining. She did it well, people liked it and that was her life,"

– Helene Vermeirsch, niece of Madame Valerie[1]

Patisserie Valerie was founded in 1926 when a couple – Belgian-born Esther van Gyseghem (Madame Valerie) and her husband, Theophile Vermeirsch – opened a café on the corner of Dean Street and Old Compton Street in London's Soho district. Vermeirsch had visited London before their marriage and loved the city so much that the couple decided to start a cake and pastry business to introduce high-quality pastries to the English.[2] It was an instant success.

Unfortunately, the Second World War resulted in the couple's original café being destroyed. However, it did not deter them from reopening their shop on Old Compton Street soon after. Madame Valerie was very passionate about her pastry business which remained popular throughout London, even attracting top celebrities to patronise her humble shop.[3]

This case was prepared by Edmund Pun, Francesca Yeoh, Jia Song Shan and Lee Hui Kay, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees.

From 1 to 200 real quick

Madam Valerie was left solely in charge of running Patisserie Valerie after the passing of her husband in 1947.[4] She eventually retired 18 years later and sold the business in 1965, moving to South London where she spent her last decade with her sister and brother-in-law.[5] It was then bought over by the Scalzo brothers in 1987.[6] The Scalzo brothers took Patisserie Valerie to greater heights by expanding the single store to eight outlets in London.[7]

In 2006, Luke Johnson's Risk Capital Partners bought a controlling stake in Patisserie Valerie.[8] Patisserie Valerie then saw phenomenal growth from eight stores in 2006 to over 200 stores in 2018, stretching across the United Kingdom.[9] Patisserie Holdings plc (Patisserie Holdings), the parent company of Patisserie Valerie, was then listed on the AIM Exchange, London Stock Exchange's junior market. In 2014, its shares were floated at 170 pence a share, and they were trading at 429 pence before trading was suspended in 2018.[10]

The melting butter

"We are determined to understand the full details of what has happened and will communicate these to investors and stakeholders as soon as possible."

– Luke Johnson, Executive Chairman of Patisserie Valerie, 2018[11]

One morning in early October 2018, Executive Chairman Luke Johnson came into his office and was briefed by Patisserie Valerie's Chief Executive Officer (CEO) Paul May that the U.K. tax authorities had filed for a motion to wind up the company after multiple failed attempts to pursue its overdue amount of £1 million in corporate taxes.[12] Internal investigations subsequently revealed potentially fraudulent accounting irregularities amounting to an estimated £40 million. This led to Patisserie Holdings' decision to suspend trading of its shares on 10 October 2018 to allow for a full investigation.[13,14] There was a possibility that past misstatements of accounts were extensive, with thousands of bogus entries being added into its ledgers,[15] as well as the involvement of key finance staff and suppliers in the scandal.[16]

Wrong ingredients

Further investigations uncovered significant irregularities and discrepancies in Patisserie Valerie's financial statements. The company's profitability was estimated to be much lower than reported[17] and the accounting scandal much worse than initial findings suggested. Without the immediate injection of capital, Patisserie Valerie was not expected to be able to sustain its normal business operations. The survival of Patisserie Valerie's 206 stores and 2,000 jobs was in serious doubt.[18]

Bad apple

To further aggravate matters, on 12 October 2018, Chris Marsh – Patisserie Valerie's finance director – was arrested by the police for suspicion of fraud by false representation.[19] Marsh had joined the company as finance director in 2006 and had worked with CEO May since 1998. He has a background in finance and consulting, having over 15 years of experience advising a number of companies before Patisserie Valerie appointed him as finance director and board member of the company.[20]

The criminal investigation into Marsh, led by the Serious Fraud Office (SFO),[21] shone the spotlight on the inadequacies in the finance function in Patisserie Valerie, as well as increased public scrutiny of its corporate governance. Although Marsh was subsequently released on bail, criminal investigations continued.[22] There were also questions about possible failure of the directors in discharging their duties.[23]

Fresh ingredients

"The most harrowing week of my life. I felt a moral obligation to rescue the business…There were 2,800 jobs at stake, there were 12 years of effort that I and colleagues had put into the business, and the board were determined not to allow the business to go into administration."

– Luke Johnson, Executive Chairman of Patisserie Valerie[24]

Due to the massive accounting black hole, Patisserie Valerie was faced with the imminent danger of bankruptcy. The Group was nearly £10 million in debt instead of having £28 million in cash as reported in its books.[25]

Johnson was the Executive Chairman of Patisserie Holdings, which owns Patisserie Valerie, Druckers, Philpotts, Baker & Spice and Flour Power City.[26] He owned 37% of Patisserie Holdings[27] and his wealth in 2018 was estimated to be around £260 million.[28]

On the day of Marsh's arrest, Johnson personally funded a £20 million emergency loan to pay for overheads and staff costs for over 200 stores and 2,800 staff.[29,30] This comprised a £10 million three-year interest-free loan and a £10 million bridging facility.[31] The latter was eventually paid off from the proceeds of approximately £15.7 million raised through a new share placement at 50 pence a share to other shareholders in November 2018.[32] Johnson's £10 million loan was not secured against Patisserie Valerie's assets and hence fell in line with other unsecured creditors such as suppliers and main financial lenders, HSBC and Barclays.[33]

Although the rescue plan had allowed Patisserie Valerie to escape bankruptcy for the time being, it was also criticised for being against the interests of smaller shareholders. This was because new investors were getting shares at a massive discount. It significantly diluted the shareholdings of the original smaller investors but they did not have any other option – the rejection of the rescue plan would result in the immediate collapse of the company.[34]

New chefs

Two unauthorised and unreported overdrafts amounting to £9.7 million set up with HSBC and Barclays were discovered on 14 October 2018, two days after emergency loans were made by Johnson. This escaped the attention of the board, external auditors and Johnson himself.[35] Despite regular statements being submitted to the board and clearance by the company's external auditors,[36] Grant Thornton U.K. LLP (Grant Thornton), the major discrepancy between the declared cash position and the actual cash position, as well as the significant understatement of the company's debt, was left undetected.[37]

As part of Patisserie Valerie's attempt to manage the crisis, the board was replaced and several changes in appointments were made the following month. Marsh was replaced by Nick Perrin as Chief Financial Officer;[38] Jeremy Jenson was appointed to the board and would replace director Lee Ginsberg as Chairman of the Audit Committee;[39] while May stepped down and was succeeded by 'turnaround specialist' Stephen Francis as CEO.[40] Non-executive director James Horler also resigned.[41]

The company also replaced its external auditor, Grant Thornton, with RSM.[42]

Despite the efforts to save Patisserie Valerie, it fell into administration on 22 January 2019 when it failed to secure extensions for its lending facilities and approvals for new bank finances. In a statement to the stock market, Patisserie Holdings said that this was a "direct result of the significant fraud", and thus, "the business does not have sufficient funding to meet its liabilities". Seventy of the nearly 200 stores closed immediately, and about 900 jobs were lost as a result.[43,44] Johnson's and all other shareholders' investments in Patisserie Holdings were wiped out.[45]

Cleaning team

Following the uncovering of the accounting fraud, Blair Nimmo and David Costley-Wood from KPMG LLP (KPMG) were appointed as joint administrators.[46] Manipulation of accounts and fraud was soon discovered with overstatements of almost £94 million, more than double the initial estimates of £40 million.[47] Based on the KPMG report, the misstatements were as follows:[48]

- Intangible assets overstated by £18 million;
- Tangible assets overstated by £5 million;
- Cash position overstated by £54 million;
- Prepayments and debtors overstated by £7 million; and
- Creditors understated by £10 million.

Over-baked cakes

PricewaterhouseCoopers (PwC) was also appointed to conduct a forensic investigation by the company's board.[49] In its report, it was discovered that the suspected fraud involved the collusion of certain finance staff members as well as a supplier.[50] The supplier allegedly abetted the fraud through the submission of fake invoices for refurbishment work while the four finance staff involved discussed adjustments of fake ledgers via email.[51] The report also alleged the double-counting of voucher sales to artificially inflate revenues, cost manipulation, tax avoidance and as many as 15 secret bank accounts to hide the cash-flow deficits.[52]

Messy kitchen

KPMG stated that it might have sufficient grounds to pursue legal claims against different parties, including Patisserie Valerie's external auditor Grant Thornton.[53] However, it was faced with a conflict of interest as Grant Thornton was also coincidentally the external auditor of KPMG's books. Consequently, KPMG had to step down as administrator and another restructuring firm, FRP Advisory, was engaged by Patisserie Valerie's creditors.[54] Two of FRP's senior partners, Geoff Rowley and Paul Allen, replaced KPMG's original administrators and resumed the task of looking into the potential legal claims against the parties involved, including former directors and advisors, as well as Grant Thornton.[55]

First layer of the cake – Board of directors

"If I was arrogant at times before, my ego has taken quite a battering since. A very public disaster such as this shatters your self-belief."

– Luke Johnson, Executive Chairman of Patisserie Valerie[56]

The board of directors comprised of Executive Chairman Johnson, CEO May, finance director Marsh, Ginsberg and Horler before the changes following the accounting scandal.[57]

Johnson was also the Chairman of the Remuneration Committee and a majority shareholder of Patisserie Holdings. He insisted he was not dishonest in the discharge of his duties and was completely unaware of the fraud despite being the Executive Chairman. He had received "solid weekly numbers, [and] comprehensive monthly management accounts" that reflected the good financial health of Patisserie Valerie, which led him to believe that it was doing well.[58]

Johnson felt that, as a "part-time Chairman", it was not necessary to be involved excessively in the day to day management of the business except for major issues such as agreeing new sites, capital expenditure, raising capital and acquisitions.[59] However, some critics argued that for a Chairman to have an "executive" function would imply having full participation in the management of the business.[60] In fact, Johnson was involved in many such "executive" positions among the 30 companies such as Brighton-based Small Batch Coffee Holdings, Elegant Hotels, and Brighton Pier Group where he was on the board.[61]

Johnson also pointed fingers at Patisserie Valerie's external auditors for having "the wool pulled very comprehensively over its eyes". Grant Thornton had not raised any material issues about the financial accounts and gave a "clean bill of health" without qualifications year on year.[62]

Apart from his position as finance director, Marsh took on the roles of director in Patisserie Holdings and company secretary of Stonebeach Limited, the main trading subsidiary of Patisserie Holdings. He was also involved with FishWorks and Healthy Living Centres, two other AIM-quoted companies which Johnson had invested in. However, FishWorks had gone into administration in 2009,[63] while Healthy Living Centres was delisted in 2006.[64] The former finance director is also a chartered accountant and was previously a tax accountant in a Big Four accounting firm.[65]

May, the former CEO, was with Patisserie Valerie for 12 years, and was Johnson's long-time business partner. Along with Marsh, he was issued share options worth several million pounds as part of a bonus scheme between 2014 and 2016,[66] allowing them to earn a combined amount of £4.6 million.[67] In October 2018, Patisserie Valerie admitted that it had awarded significant amounts of share bonuses to both May and Marsh without notifying shareholders in 2015 and 2016. Patisserie Valerie defended itself, saying that it did not know why the share options of those years had not been "appropriately disclosed and accounted for in its financial statements".[68]

Ginsberg, the non-executive director, Deputy Chairman and Chairman of the Audit Committee, was the only independent director of Patisserie Valerie. Prior to joining Patisserie Valerie, he was CFO at Domino's Pizza between 2004 and 2014. Ginsberg holds board positions at a number of other companies, including Mothercare plc, a British retailer listed on the London Stock Exchange.[69]

Horler is known to be a frequent business partner of Johnson. In addition to his directorship in Patisserie Valerie before his resignation, he is also Chairman of restaurant group Ping Pong and coffee chain Notes.[70]

Second layer of the cake – Audit and Remuneration Committees

Within the board, there were two committees, the Audit Committee (AC) and the Remuneration Committee (RC).[71]

The AC's primary responsibility is to supervise internal controls and ensure accurate reporting of the company's financial performance. The committee reviews reports from management and auditors relating to annual accounts as well as the accounting and internal control procedures used. It has unrestricted access to the internal audit function and would meet at least three times annually to conduct reviews. Before the accounting scandal broke, the AC was made up of Ginsberg as Chairman and Horler and Johnson as members.[72]

The RC's primary function is to review the performance of the executive directors and make remuneration recommendations to the board.[73] This includes the granting of share options and other equity incentives. The RC was made up of the same three directors as the AC, with Johnson as Chairman.

Internal audit

Some analysts have commented on the lack of an internal audit function in Patisserie Valerie, and speculated whether the fraud could have been uncovered earlier or even be prevented should there be stronger internal controls and an internal audit function in place.[74,75] In the U.K., under the Corporate Governance Code for publicly listed companies and based on the comply-or-explain approach, the reasons for the absence of an internal audit function should be explained in the annual report.[76]

Third layer of the cake – External auditors

"We are not doing what the market thinks. We are not looking for fraud and we are not looking at the future and we are not giving a statement that the accounts are correct. We are saying they are reasonable, we are looking at the past, and we are not set up to look for fraud."

– David Dunckley, Chief Executive of Grant Thornton[77]

Following the discovery of the fraud, external auditor Grant Thornton came under fire for allowing the fraud to occur undiscovered despite having audited the Group for 12 years.[78] In response, its Chief Executive, David Dunckley, said that there was an "expectation gap" that "needed to be fixed", arguing that it was not the role of the auditor to uncover fraud.[79] In a heated exchange with Member of Parliament and Chairman of a business, energy and industrial strategy (BEIS) committee, Rachel Reeves, Reeves noted that the Financial Reporting Council's (FRC) international standards of auditing rules require auditors to detect material misstatements where they are due to fraud or error.[80] The BEIS committee had organised a meeting with the U.K.'s seven largest accounting firms on 30 January 2019.[81]

Dunckley's response to the committee was not supported by representatives from BDO and Mazars, two other mid-tier audit firms. They argued that auditors are expected to be able to uncover fraud material to the financial statements and of relevance to the shareholders.[82]

In July 2019, the FRC placed the work of Grant Thornton under increased scrutiny, calling the quality of its work "unacceptable". Grant Thornton announced an independent review and a revamp of its operations to improve its standards. The company also said that it would create an 'audit quality board' with the authority to hold top officers to account if audit quality was not receiving appropriate investment.[83,84]

The fourth layer of the cake – Administrators

The administrators KPMG also came under heavy criticism and scrutiny as there were obvious conflicts of interests when Patisserie Valerie fell into administration.

When the appointment of KPMG was first announced, concerns were raised because Grant Thornton was the auditor of both Patisserie Valerie and KPMG, giving rise to a clear conflict of interest. Following its report on its investigations of Patisserie Valerie, KPMG announced that it would not be able to pursue any legal action against Grant Thornton. It became clear that KPMG was aware of the conflict of interest but still took on the role as administrator, earning roughly £1.5 million in fees. However, KPMG rebutted the criticisms, stating that prior to its appointment, the directors were made aware of the conflict of interest and that an additional administrator would be required to pursue any legal claims against Grant Thornton. Despite this, the board still agreed to KPMG's appointment.[85]

KPMG was also the auditor of Bread Holdings, the parent company to two bakery chains where Johnson was a director. KPMG was also engaged by Johnson in 2018 to provide advice on a sale of Bread Holdings. However, the company denied claims of a conflict, insisting that the two companies, Bread Holdings and Patisserie Valerie, are separate with no relationship connecting the two.[86]

Icing on the cake – Financial Reporting Council

"This level of audit quality is unacceptable. The quality of the audits inspected in the year, and indeed the overall lack of improvement in quality over the past five years, is a matter of deep concern."

– Financial Reporting Council, on Grant Thornton's audit quality[87]

The FRC in the U.K. is an independent regulator responsible for regulating auditors, accountants and actuaries. The FRC also sets the U.K.'s corporate governance and stewardship codes. It aims to promote transparency and integrity in businesses.[88]

Following the saga, the FRC's audit quality team conducted an investigation of Grant Thornton's audits of Patisserie Valerie for the years 2015 to 2017,[89] and reported the company's audit quality as "unacceptable".[90] However, earlier in April 2018, Grant Thornton's 2017 audits were given a "clean bill of health" when reviewed by the FRC.[91] Further, a spokesperson for the FRC said that the regulator's routine monitoring of audits is only devised to verify that a company's audit is conducted in a satisfactory way.[92]

Following an independent review of the FRC led by Sir John Kingman in December 2018, it was announced that the FRC would be replaced by the Audit, Reporting and Governance Authority (ARGA).[93] This new independent body will be granted a "new mandate, new leadership and stronger powers set down in law,"[94] in the hope of changing the current culture of the accounting sector in the U.K.,[95] and ensuring that the U.K. remains as the place with the highest standards in audit.[96]

The cherry on top - Causeway Capital Partner

In early February 2019, Sports Direct issued a surprise bid of £15 million[97] to acquire the business comprising the trade and assets of Patisserie Holdings and its group of companies.[98] However, it was not the only contender to acquire the beleaguered café chain. The auction had attracted a combination of private equity and trade buyers.[99] However, two days later, Sports Direct withdrew its bid, explaining that it was rejected by the KPMG administrators due to its low offer. KPMG allegedly informed Sports Direct that it would need to increase that offer by as much as £2 million.[100] Sports Direct further added that it was not given any opportunity to gather crucial financial information which would allow for a revision of its bid.[101]

Meanwhile, it was unclear whether other potential bidders such as coffee chain Costa Coffee were still keen on buying out Patisserie Valerie as a going concern.[102] On 14 February 2019, Causeway Capital Partners (Causeway Capital), an Irish private equity firm, bought over the Group for £13 million, a fraction of the £450 million it was once worth. Causeway Capital said that it wanted to "refresh and renew" the Patisserie Valerie brand, and it was announced that Johnson would no longer be involved in the business.[103]

KPMG also sold the 21 stores of Philpotts sandwich eateries owned by Patisserie Valerie to A.F. Blakemore & Son, a food retailer. Together, the two transactions successfully saved 117 shops and preserved 2,000 jobs.[104]

Present-day Patisserie Valerie

"We are delighted with the progress we have made. We found a lot of problems but we also inherited some great staff who really care about what they do. There's been a lot of hard work but it's very much back on track,"

– Matt Scaife, partner at Causeway Capital Partners[105]

With only 96 shops left after the buyout,[106] Patisserie Valerie was still struggling to keep its head above water. Investigations by the SFO continued after the successful buyout by Causeway Capital. On 18 June 2019, five unnamed people in connection with Patisserie Valerie's accounting scandal were arrested by the SFO in a joint operation with Hertfordshire Leicestershire and Metropolitan Police Services.[107]

Ten months after the buyout, the newly revamped Patisserie Valerie is on the road to recovery, with plans to upgrade the cafés and to introduce more premium tea and coffee offerings, as well as a potential online cake ordering system.[108] On the born again café chain, Causeway Capital said, "We are committed to restoring the business to long-term sustainable growth… by focusing on three simple values: quality, creativity and – crucially – integrity".[109]

Discussion questions

1. Comment on the composition of the board and board committees in Patisserie Valerie. Critically evaluate whether board and board committee composition may have played a role in the scandal.
2. Luke Johnson, the Executive Chairman of Patisserie Valerie, was holding many directorships on different boards at the time when the scandal happened. What are the pros and cons of an Executive Chairman versus Non-Executive Chairman? Do you think his Executive Chairman role and multiple directorships could have affected the discharge of his duties?
3. What were the failures in internal controls that resulted in Patisserie Valerie's accounting misstatements? How could the board of directors have ensured that internal controls were adequate and effective?
4. To what extent is the external auditor responsible for the detection of accounting fraud? What are the considerations when appointing an external auditor? What is the role of the Audit Committee in overseeing the external auditor?
5. What is the role of an administrator such as KPMG in the case? What are the duties of an administrator and its powers? Why is the conflict of interest an issue?
6. What do you think could have been done to avoid this scandal? Who in your view is or are ultimately responsible?

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PG&E: FIRE IN PARADISE

Case overview

On the morning of 8 November 2018, California saw its deadliest and most destructive wildfire in history consume the entire town of Paradise. Originating from Camp Creek Road, the 'Camp Fire' quickly spread across 153,336 acres over the course of 17 days, destroying more than 19,000 buildings and claiming 85 lives. The incident sparked an investigation by Californian regulators, which revealed that the ignition was caused by electrical transmission lines owned and operated by Pacific Gas and Electricity Company (PG&E).

PG&E faced heavy financial penalties and criminal charges of involuntary manslaughter relating to one of the most devastating wildfire incidents in California. Initially, its liability was estimated to exceed US$30 billion, more than three times the company's market value of just over US$9 billion. This led to the resignation of Chief Executive Officer Geisha Williams. Almost three months after the outbreak of Camp Fire, PG&E filed for Chapter 11 with the United States Bankruptcy Court in the Northern District of California.

The objective of this case is to facilitate a discussion of issues such as board composition; board responsibilities; corporate culture; remuneration; risk management; and external environmental, social and governance (ESG) ratings.

Keeping the lights on

"Safety drives everything we do at PG&E… Our customers count on us to provide safe, reliable and affordable gas service every day."

– *Nick Stavropoulos, former President and Chief Operating Officer of PG&E* [1]

Founded in 1905 from a merger between San Francisco Gas and Electric Company and the California Gas and Electric Corporation,[2] PG&E is an American public utility company regulated by the California Public Utilities Commission (CPUC).[3] It is the major subsidiary of PG&E Corporation (PG&E Corp), headquartered in San Francisco, California and listed on the New York Stock Exchange.[4] PG&E is responsible for providing natural gas and electric services to more than 16 million households and businesses in northern and central California.[5] In 2018, it boasted total revenue of US$16.76 billion,[6] positioning itself as the largest utility in the state of California.[7]

Despite being a utilities company, PG&E has been recognised as a leader in environmental, social or governance (ESG) by Sustainalytics, Newsweek and Dow Jones Sustainability

This case was prepared by Aaron Teo Yang Han, Khoo Wei Jie, Tan Wee Ning, Woo Yu Xuen Qiqi and Zhang Jinlin, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been substantially re-written, with information added, by Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees.

North America Index.[8] In reality, the actual practices within the company were rather different, eventually leading to the company's downfall.

A victim of its own fire

Between 2013 and 2019, historic droughts swept across California, killing millions of trees and leaving behind dry, forest floor debris. This made the state extremely prone to forest fires.[9] Between 1972 and 2018, the total area burnt by summer wildfires per year has increased fivefold. Since 2003, the state has seen nine out of 10 biggest fires in California history.[10]

The forest fires were not solely due to unfavourable meteorological conditions. For many years, PG&E was aware of its worn-out power lines and transmission towers. The average life expectancy of the steel transmission towers was around 65 years. However, the average age of PG&E's equipment was 68 years, with the oldest being in operation for more than a century. The company took no action to undertake the necessary maintenance and replacement, despite knowing the huge fire risk.[11] Many critics have accused PG&E of neglecting safety and cutting back on maintenance expenditures to improve its bottom line in order to increase dividends to investors.[12]

Cracks within the company began to surface as early as 1996 when PG&E settled a US$333 million class action lawsuit for dumping gallons of chromium-tainted wastewater around Hinkley, California.[13] This was followed by rolling blackouts for households and businesses during the California electricity crisis in 2001, which eventually drove PG&E into bankruptcy. Three years later, the battered company emerged from bankruptcy after repaying more than US$10 billion to its creditors.[14]

In 2010, investigations into the San Bruno pipeline explosion revealed that in the decade before the deadly explosion, PG&E's revenues exceeded authorised revenue requirements by US$224 million. Yet, the company reduced its spending on maintenance.[15] Internal audits found that teams were severely falling behind their maintenance and repair work schedules. Under immense pressure to comply with regulation and achieve unrealistic performance targets of zero late tickets, it was common knowledge at PG&E that employees were falsifying records. The company responded by dismissing mid-level managers but rewarding the programme directors who were behind the unrealistic targets with promotions and higher remuneration.[16]

In 2018, state investigations into the October 2017 wildfire which killed 44 people attributed the fire to faulty electric power distribution lines, conductors and the failure of power poles. These equipment all belonged to PG&E.[17] An internal memo revealed the need to replace transmission towers and better manage its equipment to prevent it from spreading fires. However, resources meant for maintenance were instead directed towards other 'high priority' projects, including the upgrading of substations. [18]

Paradise in flames

The Caribou-Palermo transmission line was known to be one of PG&E's worst-performing circuits, running through areas with elevated and extreme fire risks. Since 2013, PG&E has pledged US$30 million towards replacing equipment along the line. However, the project had been repeatedly delayed, citing reasons such as the work "not [being] maintenance-related".[19]

As dawn broke on 8 November 2018, strong winds resulted in a 'c-hook' getting dislodged from one of the oldest transmission towers of the Caribou-Palermo transmission line near the town of Pulga, causing electric lines to strike and fall to the ground. Numerous employees spotted the fire near the tower and reported it promptly, but the wildfire spread quickly.[20] The critical first few hours brought to light multiple failures within the emergency response system, which impeded the rescue and evacuation efforts by the city officials. Within 12 hours, the wildfire engulfed the whole of Paradise. Firefighters, engines and helicopters were deployed from all over western United States.[21]

The adjacent towns were not spared either, with Concow and Magalia also badly affected, losing a significant amount of their infrastructures.[22] The fire took a total of 17 days to reach 100 percent containment,[23] but its impact on the community continued to linger.

The destruction caused by the Camp Fire threatened PG&E's ability to carry on as a going concern.[24] It received thousands of claims relating to deaths, injuries, property damages, amongst others, estimated to add up to more than US$30 billion.[25]

In the week following the start of the Camp Fire, PG&E's market capitalisation slid to US$10 billion from US$16.9 billion.[26] It subsequently lost its investment-grade rating and looked towards California lawmakers and regulators for its survival.[27] The huge financial liabilities eventually led PG&E to file for Chapter 11 bankruptcy protection.[28]

As PG&E plunged into financial distress, Geisha Williams, the Chief Executive Officer (CEO) of PG&E Corp since March 2017, announced her resignation on 13 January 2019. John Simon, PG&E Corp's executive vice president and general counsel, was named interim CEO.[29]

The public attributed the wildfire to mismanagement of the company, and its activist shareholders lobbied for changes to the PG&E Corp's board of directors.[30] In February 2019, PG&E Corp announced plans for a major shakeup to its board, in an attempt to restore shareholder's confidence.[31]

Men vs nature

Following the San Bruno incident in 2010, the company introduced new corporate governance practices. This included enhancing board committees responsible for safety, improving commitment to shareholder involvement through regular dialogue, encouraging a speak-up culture, and increasing safety training for employees and board members.[32]

A fireproof board?

At the time of the latest disaster, PG&E Corp had seven board committees, with some of these committees also existing at the subsidiary, PG&E, with the same members and charters. The board committees included a Compliance and Public Policy Committee and a Safety and Nuclear Oversight Committee. The Compliance and Public Policy Committee assisted the board primarily in oversight of corporate sustainability issues, such as environmental compliance and leadership and climate change, including an annual review of PG&E's sustainability practices and performance. The Safety and Nuclear Oversight Committee helped in maintaining oversight relating to enterprise-wide safety matters and promoting a strong safety culture.[33]

PG&E Corp appeared to fare well in board independence. The entire board of directors was independent, with the exception of Williams, the then president and CEO of PG&E Corp.[34]

The entire board of the subsidiary, PG&E, except for Nick Stavropoulos, who was its President and Chief Operating Officer (COO), was a director on the board of PG&E Corp. The Chairman of the board of PG&E Corp has been an independent director since the positions of CEO and Chairman were separated in 2017. Furthermore, only independent directors are permitted to serve on PG&E Corp's board committees.[35]

PG&E Corp also tried to ensure that board members have diverse backgrounds, skills and experiences. Prior to the Camp Fire, half of the 12 directors were minorities or women.[36] This was similar for the directors at the subsidiary level.

Figure 1 shows how PG&E Corp and PG&E fared on diversity as disclosed in the 2018 joint proxy statement.

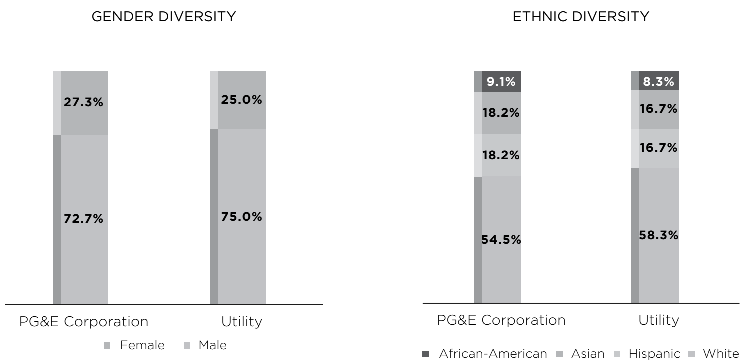

Figure 1: Gender and ethnic diversity for PG&E Corp and PG&E[37]

However, PG&E Corp only scored five out of 10 under the board structure component in the Institutional Shareholder Services Inc. Governance Quality Score in 2017, with one indicating a low governance risk.[38]

The average tenure of the directors was seven years. Out of the 12 directors in PG&E Corp, five directors had tenures exceeding nine years. Barbara L. Rambo was the longest serving director, with a 13-year tenure, and chaired the Finance Committee. Richard A. Meserve had served for 12 years, followed by Roger H. Kimmel, Rosendo G. Parra and Lewis Chew at nine years.[39]

Out of the seven board committees, four were chaired by long-serving directors with more than nine years of tenure. Four of the five members of the Nominating and Governance Committee – Rambo, Meserve, Kimmel and Parra – were long-serving directors.[40]

Fit for the job?

According to the 2018 joint proxy statement, the Audit Committee's (AC) responsibilities include reviewing the guidelines and policies that govern the processes for assessing and managing major risks, as well as the allocation of responsibilities to the other committees (such as to the Safety and Nuclear Oversight Committees). The AC Chairman was Lewis Chew, who joined the board in 2009 and was Chief Financial Officer (CFO) at Dolby Laboratories. According to his LinkedIn profile, Chew previously held positions as CFO of National Semiconductor Corporation and as a Partner at KPMG LLP, where he mainly served clients within technology and financial institutions.[41,42]

In the lethal 2010 San Bruno natural gas pipeline explosion, PG&E was found to be criminally liable. Furthermore, subsequent investigations revealed gross mismanagement in inspection, maintenance and pipeline replacement, and exposed the company as one which was more concerned with profits than safety.[43] However, six of PG&E's 2018 board members had retained their positions following the San Bruno explosion. CPUC's president, Michael Picker, criticised that this was "not a strong message of accountability to the rest of the organisation".[44]

Following the 2017 fires, State Senator Bill Dodd said PG&E and PG&E Corp needed "systematic change", including on their boards and "in the executive suite" in light of the findings that the utility had falsified gas pipeline records.[45]

After the 2018 Camp Fire, State Senator Jerry Hill called for "a shareholder revolt that forces a change in leadership on the board".[46] Blue Mountain Capital Management LLC, an asset management firm, also wrote to the shareholders of PG&E Corp on 24 January 2019, alleging that the company had failed its shareholders and stakeholders. In the letter, it said: "The company has lost the public's trust, and it has severely damaged its relationship with regulators and elected officials".[47]

Playing with fire – A risky affair

As a utility company, PG&E faces significant risks in its daily operations. The key risks can be classified into three broad categories – enterprise and operational risks, which include risks associated with public and employee safety, reliability and the operating environment; compliance risks, which involve compliance with applicable legal and regulatory requirements; and market and credit risks, which are associated with PG&E's energy portfolio, including trading in commodities and derivatives.[48]

The 'firefighters'

According to PG&E Corp's 2018 joint proxy statement, the company adopts an Enterprise and Operational Risk Management (EORM) programme which combines a 'top-down' and 'bottom-up' approach in its risk management framework.[49] This allows PG&E to assess and manage risks at both an enterprise and operational level.

The programme includes board-directed review processes and allows operational experts to identify emerging issues for the company. While the board oversees risk management policies and conducts annual reviews of enterprise risk, the day-to-day responsibilities for managing exposure to risks and implementing measures primarily fall on the management. The Vice President, Internal Audit and Chief Risk Officer (CRO) of PG&E Corp and the Utility are responsible for helping oversee the risk management process and reports to the AC of the respective boards.

In 2017, a new Vice President-level Risk Management Committee was established to provide strategic guidance and make recommendations to senior management on key aspects of risk management.[50] This is in addition to each line of business having its own risk and compliance committee to review their specific risks.

Despite the risk management policies in place, the investigations by CPUC revealed failure to comply with internal procedures. As noted in CPUC's 2019 investigation report on the Camp Fire, there was a failure to conduct detailed climbing inspections on the incident tower as set out in the company's policies.[51] Moreover, an outdated inspection form was used during its detailed climbing inspections conducted between 19 September 2018 and 5 November 2018.[52] The failure to comply at the operational level resulted in a complete unravelling of PG&E's overall risk management framework, culminating in the dislodgement of the 'c-hook' that ultimately led to the deadly Camp Fire.

The 'smoke' detectors

PG&E Corp's code of conduct sought to cultivate a 'speak-up culture', where employees are confident in voicing any opinions or concerns.[53] It pledges a strict non-retaliation policy against anyone who raises concerns in good faith.[54] Employees are provided with various avenues to make reports, including their direct supervisor, human resource representatives, or other appropriate departments, and are encouraged to utilise these platforms should they encounter any misconduct or questionable activities at work. A multilingual, 24/7 compliance and ethics helpline was established to help employees raise any issues relating to compliance and ethics.[55]

However, the strong stance towards protecting its employees and handling reports of misconduct and unsafe work practices apparently did not materialise in reality. PG&E was faulted for failing to handle complaints appropriately on multiple occasions.[56] Former PG&E employees who spoke out against the safety issues had also filed lawsuits against the company for "wrongful termination, employment discrimination and retaliation".[57] Some claimed that they were placed on leave and eventually, had their employment terminated without any justification.[58]

One example was in 2011, when Matthew Niswonger had a near-death experience in the Santa Cruz County. He was tasked by his supervisor to repair a broken electrical pole with his colleagues without cutting off power. Although no one was hurt in the process, the incident could have brought about disastrous consequences. Subsequently, Niswonger filed a safety complaint against his supervisor, only to have his employment terminated through a voicemail message one month later. Furious with how the company handled the case, Niswonger then initiated a lawsuit against PG&E and successfully obtained US$1 million compensation for wrongful termination.[59,60]

Safety first, they said

"Since the tragic San Bruno explosion, we've benchmarked against some of the safest companies in the world. We've learned from them and taken significant actions to improve our safety culture and performance."

– PG&E, in an email statement[61]

In 2017, a report by NorthStar Consulting Group (NorthStar) found that PG&E's efforts in promoting a culture of safety "do not yet add up to a consistent, robust, and accountable corporate-wide safety program". The report also mentioned that reconsolidating the company under a single president might help PG&E develop a "more consistent and inclusive approach to safety".[62]

Notwithstanding the numerous management-level committees working to engrain safety, an update from NorthStar on 29 March 2019 revealed differences in the safety culture and practices within the various lines of business.[63] The report highlighted how PG&E continued to take a reactive approach to potential issues and lacked a "single, comprehensive safety strategy addressing all aspects of safety". PG&E was also said to prioritise its productivity and performance targets, with minimal progress made on additional supervisory time in the field.[64]

This lack of a safety culture could be traced back to as early as 2009, when regulators found that PG&E employees repeatedly filed false records about the company's response to excavators, who were trying to avoid striking underground pipelines (the 811 programme). Due to pressure from their bosses to meet a goal of 'zero late tickets',[65] PG&E was alleged to have falsified more than 50,000 '811 tickets' in order to conceal the company's inability to meet the 48-hour deadline.[66] PG&E enacted the zero late ticket policy to avoid legal and civil penalties should an excavator strike one of their lines.[67]

Moreover, instead of ensuring its 'locate-and-mark' department - which responds to 811 situations - was adequately staffed, PG&E exploited a loophole in the law. US Code Section 4216.2(b) authorises a utility company and excavator to "mutually agree to a different notice and start date". PG&E instructed workers to contact the excavator to negotiate a start time after the 48-hour period. By doing so, PG&E was prima facie compliant with Section 4216.2(b)'s mutually agreeable start date requirement. However, the CPUC's safety and enforcement division report claimed that many excavators were never notified, and PG&E basically falsified its records.[68]

A whistle-blower, who was dismissed by PG&E after suggesting that the 811 programme was unsafe, testified that there was a culture of intimidation in the company and that “everyone knew it”.[69] Another PG&E lineman, Todd Hearn, who raised wildfire safety concerns was also dismissed after he blew the whistle on the vulnerability of power lines to dangerous fires.[70]

PG&E = Paying gratuitously (to) executives?

“We’re not at the point where they should be rewarded for not killing people. There’s no point to rewarding a company for fulfilling its basic function.”

– Mark Toney, executive director of The Utility Reform Network (A Non-Profit Consumer Protection Rights Organisation)[71]

PG&E had faced heavy criticism for paying top executives hefty bonuses for meeting safety benchmarks, even as the embattled utility company was facing numerous lawsuits for safety oversight that led to deadly explosions and fires. SEC filings revealed that from 2012 to 2017, the top five executives of PG&E were paid a total of US$17 million in bonuses, including special payments for exceeding public and employee safety benchmarks.[72] The filings added that “the safety component was structured to provide a strong focus on the safety of employees, customers and communities”, while the board claimed to have historically reviewed the company’s safety performance every year, overseeing goals and policies “with respect to promoting a strong safety culture”.[73] A PG&E spokesman added that “PG&E’s compensation programmes factor in the company’s safety performance across its operations — including power generation, gas and electric, as well as workforce safety throughout the company”.[74] Figure 2 shows the short-term incentive plan results disclosed in the company’s 2018 joint proxy statement.

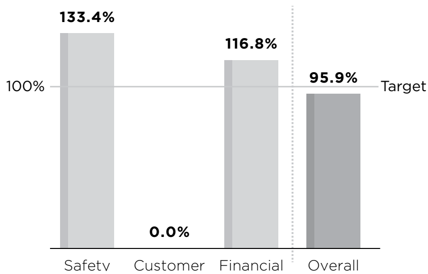

Figure 2: FY2017 short-term incentive plan results[75]

A review of PG&E’s FY2017 short-term incentive plan (STIP) - the annual cash incentive plan for executives - revealed that safety performance had exceeded targets.[76] The safety component of the STIP includes targets for Nuclear Operations Safety, Electric Operations Safety, Gas Operations Safety, and Employee Safety. Part of its Electric Operations Safety measure is an Electric Overhead Conductor Index, which gauges inspections, upgrades, and vegetation management.[77] The company had exceeded targets for this index, despite the wildfires which occurred during the year. However, while eligible for the incentives, the CEO and CFO did not accept the bonuses in the end.[78]

Additionally, PG&E also had the practice of excluding certain costs that "do not reflect the normal course of operations" from its earnings calculations, including the US$1 billion fine for the San Bruno explosion, and US$578 million in fines paid in 2015.[79] As such, since the executives' bonuses were partially derived from the company's financial performance, on top of not docking the executives' pay to cover the cost of the fines, exempting the costs meant higher earnings calculations which translated to higher bonuses.[80]

Safety first…for pay

Aside from bonuses paid to top executives, PG&E also came under fire for its controversial employee bonus packages. In April 2019, two months after scrapping US$130 million in employee bonuses in the wake of the 2018 California fires, PG&E gained approval from a federal judge for a US$235 million employee bonus programme.[81] PG&E said the payments, meant for 10,000 rank-and-file employees, and would not be allocated to senior management. The incentive formula, originally based 50% on safety and 40% on financial performance, was modified after criticism, to 65% based on safety and 25% on financial performance, with the remaining 10% based on customer service performance.[82]

The bonus programme included a performance metric based on PG&E clearing all trees and branches within four feet of its power lines in high-risk areas. However, the metric fell short of the original commitment made under PG&E's enhanced vegetation management programme, under which the utility company pledged to remove all trees and branches within 12 feet of power lines, as per the recommendation of CPUC.[83] PG&E cited California's "competitive labour market" as a reason to offer "appropriate employee compensation and incentives".[84]

In March 2020, days after informing a federal judge it would be "financially unsustainable" to keep a workforce of 5,500 tree trimmers for the year, PG&E filed a motion with the bankruptcy court seeking approval for over US$450 million in bonuses for employees and senior executives. It insisted that the rewards were not to be viewed as bonuses, but "short-term and long-term incentive programs".[85]

PG&E argued that it was "rapidly evolving and intends to emerge from Chapter 11 as a different organisation with an enhanced focus on safety, customer welfare and operational excellence".[86] It justified its actions by stating that "incentive-based compensation plans are designed to incentivise eligible PG&E employees to perform in line with key goals of the enterprise, and to enable those employees to realise a level of compensation competitive in the debtors' industry".[87]

Paying for failure

On 13 January 2019, Williams resigned from PG&E Corp, less than two years after she took on the role of CEO. She received a severance package of US$2.5 million even as PG&E geared up to file for Chapter 11 bankruptcy protection. Her payout came at a time where PG&E customers were facing the prospect of higher monthly bills and uncertainty relating to the company's bankruptcy filing.[88]

In 2018, Williams earned a base salary of US$1.085 million, in addition to up to US$8 million in long-term incentives over three years.[89] The severance package was in line with SEC filings, which states that Williams was eligible to receive a payout of US$7.4 million if she resigned, or US$3.1 million if she was terminated with cause.[90] The end of Williams' tenure was labelled as a "departure" by PG&E.[91]

PG&E has a history of executives who left with generous payouts. Nick Stavropoulos, former president and COO, who retired in September 2018, was eligible for a US$6.9 million cash payout for his retirement.[92] This came even after Stavropoulos was the executive-in-charge of gas operations from 2012 to 2017, during which PG&E allegedly falsified records in respect of its gas pipeline system.[93] Anthony Earley, Williams' predecessor, received a US$10.4 million severance when he retired as CEO in early 2017. Prior to Earley, former CEO Peter Darbee received a US$34.8 million severance package even though he helmed the company at the time of the deadly San Bruno pipeline explosion.[94]

Williams' successor, William D. "Bill" Johnson, has a three-year contract with an annual base salary of US$2.5 million – more than twice of his predecessor's.[95] Johnson also received a one-time transition payment of US$3 million on his first day on the job, as well as an annual equity award of about US$3.5 million. He would also receive a payout if his employment was terminated.[96]

PG&E said they believed "pay should be strongly tied to performance – particularly safety performance – and [its] compensation programmes are designed to reflect this".[97] It stated that over half of Johnson's incentive compensation was directly tied to safety performance and metrics, which PG&E believed significantly exceeded industry standards. It added that the company "sets executive compensation to be comparable with similar companies in the industry".[98]

Shareholders vs stakeholders

PG&E, being California's largest utility, has to engage with a great diversity of stakeholders and ensure that their interests are protected. However, the calamities and blackouts brought to the fore the different interests of shareholders, including the public who relies on PG&E for electricity, as well as the regulators which seek to hold PG&E accountable for their actions.

Within a short span of six years, PG&E power lines had caused more than 1,500 California wildfires, including the Camp Fire – the deadliest and most destructive fire in California's history.[99] The severity of these wildfires may vary, but one thing was clear – PG&E failed in its duty to have in place an effective inspection and maintenance programme such that the transmission lines were always in the best condition.

The root cause of the failure to ensure proper maintenance and equipment upgrade is arguably PG&E's placing its bottom-line as its main priority.[100] PG&E's employees have consistently spoken out against how management has consistently disregarded their concerns about the use of "faulty analysis and outdated equipment".[101] The CPUC also supported the public's opinion that PG&E prioritised profits over safety. In 2012, CPUC's investigations of the 2010 San Bruno pipeline explosion revealed that PG&E was cutting back on operations and maintenance, instead of ensuring safety and providing assurance to the public.[102]

In May 2017, PG&E approved a second dividend increase within just over a year to win investors' support, instead of channelling these funds to tackle the root cause of the wildfires. Such a move came off the back of over US$4.5 billion in dividends in the years prior to the wildfires of 2017 and 2018.[103] This was before PG&E finally suspended its quarterly cash dividends in October 2017, citing uncertainties about liabilities from the wildfires.[104]

In response to the recent fires, PG&E decided to implement public safety power shutoffs.[105] While this move aimed to help reduce the probability of future wildfires, it severely punished its 16 million customers living across California.[106] Not surprisingly, PG&E's plan for pre-emptive outages was heavily criticised by various stakeholders, including businesses, regulators and emergency services providers, who viewed such shutoffs as a huge threat and unsustainable. The shutdowns shifted the responsibility away from PG&E onto the public, as the company was more concerned about the hefty fines that it would potentially incur should another wildfire be caused by the company, rather than the interests of its stakeholders.[107]

PG&E's regulators

PG&E has a long record of run-ins with California state regulators, with more than US$2.6 billion paid in penalties and lawsuit settlements for the past 23 years.[108] CPUC had tried rectifying PG&E's behaviour through conventional tools of regulations, including imposing higher fines and removing responsible parties. However, the continued poor track record of PG&E in preventing wildfires points towards the fact that these traditional punishments were ineffective.[109]

According to PG&E's federal court filing in 2019, a total of US$5.3 million was contributed to political candidates and parties in 2017 and 2018.[110] This may have helped create a close relationship between PG&E and the politicians capable of influencing regulations.[111] U.S. District Judge, William Alsup, who oversaw PG&E's criminal probation, also questioned PG&E's decision to prioritise the campaign contributions over the replacement or repair of the aging transmission lines and trimming of hazardous trees located near power lines.[112] Alsup later expressed strong dissatisfaction with PG&E's response and efforts in meeting the tree-trimming requirements, stating that PG&E is "not even close to perfect".[113]

Furthermore, CPUC was criticised for being "excessively cosy with PG&E and the other companies it is supposed to regulate".[114] PG&E's friendly relationship with CPUC and U.S. politicians allegedly allowed it to influence the state laws designed to regulate it. The Camp Fire exposed CPUC's inability to hold PG&E accountable for the safety of the Californian citizens.[115]

CPUC's failure in ensuring PG&E's compliance with safety regulations has also been heavily attributed to ineffective political mandates from the state's leadership, the lack of resources for maintaining safety in the utilities it regulated, and its tendency to allow utilities to conduct their own safety oversight.[116] Furthermore, most of the utility commissioners appointed by California's governors placed greater focus on reducing the state's carbon footprint, rather than prioritising the operational safety of these utilities. As such, they were slow to react to the wildfire risk brought about by California's arid weather.[117]

PG&E took advantage of the inefficiencies with the regulators and further hindered their ability to carry out their duties. For over 25 years, it repeatedly “misled regulatory authorities, withheld required information, did not follow through on promised improvements, engaged in improper back-channel communications with regulators or obstructed an investigation”.[118] Mark Ferron, a former commissioner of CPUC, acknowledged that while CPUC was lacking in the uncovering of PG&E’s wrongdoings, PG&E was also guilty of testing the limits of the commission’s safety regulations.[119]

Catas-trophies

PG&E received many ESG-related accolades prior to the 2018 Camp Fire.[120] These include being named on the Dow Jones Sustainability North America Index (DJSNAI), being awarded the Emergency Recovery Award by Edison Electric Institute (EEI), and being ranked within the top 10% of its peers by Sustainalytics.[121]

Before the devastating Camp Fire, PG&E was named to the DJSNAI for the eighth time in 2017.[122] It was amongst one of the eight gas and electric companies to make the index during its 2017 annual review. The DJSNAI is based on the ‘total sustainability scores’ of North American companies resulting from the annual SAM Corporate Sustainability Assessment (CSA). Only the top 40 companies based on their sustainability scores are included.[123] The sustainability scores of companies within the utilities industry are evaluated based on a variety of ESG factors, including corporate governance, electricity generation and operational efficiency, amongst others.[124] PG&E was ranked ahead of its competitors in both the electric and gas industries.[125]

According to its 2018 corporate responsibility and sustainability report, PG&E invested US$5.6 billion in enhancing its infrastructure to improve safety and reliability, as well as allowed customers to enjoy savings of about US$300 million on their energy bills through its energy efficiency programs.[126] Furthermore, in 2018, PG&E achieved its climate goal of greenhouse gas reduction, with more than 80% of its electricity provided to customers being derived from greenhouse gas-free resources.[127] These initiatives allowed PG&E to achieve high scores in the CSA, especially in the environment component, which contributed heavily to its place in the DJSNAI.

Similarly, the EEI Emergency Recovery Award in 2017 highlighted PG&E’s readiness in restoring services to the public post-natural disasters, and its preparedness in the face of crisis.[128] The utility was able to lead its crew to successfully restore power to more than two million Californian customers in less than 24 hours, amidst the harsh storms and weather conditions brought about by one of the worst winters in California in early 2017.[129] That was the fifth recovery or assistance award PG&E had received from EEI in the past 10 years.[130] In January 2018, PG&E also received the EEI Emergency Assistance Award for its Hurricane Irma response, when the company aided Florida in restoring its power in the aftermath of the disaster in September 2017.[131]

Sustainalytics, a leading independent ESG-rating firm, also rated PG&E as among the top 10% of its peers in the environmental category in November 2018, shortly before the Camp Fire disaster. PG&E was also named by Sustainalytics as one of the top 10 companies in the world best positioned to leverage on the emerging ESG trends.[132]

An 'extinguished' sustainability leader

Following the 2018 Camp Fire, PG&E was immediately left out of most of the ESG accolades, especially those with an emphasis on environmental and social factors. Sustainalytics also quickly issued a statement to revise its rating on PG&E, claiming that its previous assessment was performed under an old methodology and hence, no longer valid.[133] Soon after Sustainalytics adopted its new risk rating framework, PG&E was ranked last out of 2,952 companies in respect of product governance – a category that encompasses quality and safety events.[134]

Powering forward

Regardless of the root causes, causing 1,500 fires over six years is a sign that something within PG&E had to change.[135] The leadership was a clear place to start. The devastating 2018 Camp Fire and the resulting fallout in terms of legal liabilities and public scrutiny finally provided PG&E the impetus it needed to make these changes, starting with sweeping changes to its boards.

In PG&E's 2019 joint proxy statement for both PG&E Corp and PG&E, it was disclosed that eight of the original 10 directors stepped down during a reshuffle of the board in April 2019, including most of the long-standing independent directors. All directors who held positions during the San Bruno gas pipeline explosion in 2010 – Kimmel, Meserve, Miller, Parra, and Barbara Mambo – left.[136] The departure of the directors was seen by some as a sign that PG&E was finally prioritising safety and beginning to enforce accountability for safety violations, starting with the leadership.[137]

Replacing the departed directors were 11 newly elected independent directors.[138] Shareholders of PG&E Corp subsequently voted to amend the Corporation Charter at the 2019 Annual General Meeting to increase the maximum number of directors from 13 to 15. This was to add "more diverse perspectives and to enhance the collective effectiveness of the PG&E Corporation Board".[139] Subsequently, Johnson – who replaced Williams as the president and CEO of PG&E Corp in May 2019 – was appointed as executive director of the PG&E Corp board.

Following the board refreshment, the boards of PG&E Corp and PG&E are identical. In terms of independence, 13 of the 14 directors of PG&E Corp are independent, with Johnson being the only executive director. Furthermore, 13 of the directors have held their position on the board for less than five years, with the remaining director, Fred J. Fowler, holding his position for seven years. The board remains diverse with regards to gender, race and age.[140]

Nora Brownell replaced Richard Kelly as the non-executive Chairman of the board of PG&E Corp. Prior to her appointment, she was the Commissioner of the Federal Energy Regulatory Commission, a member of the Pennsylvania Public Utility Commission and a President of the National Association of Regulatory Utility Commissioners, bringing with her a wealth of experience with regards to the energy sector, its challenges and its regulatory environment.[141]

PG&E Corp stated that the appointment of Brownell and Jeffrey Bleich, replacing Miller as the non-executive Chairman of the board of PG&E, "underscores their commitment to engage with their stakeholders to address the state's evolving energy challenges" and is part of "additional actions to bring about real and dynamic change that reinforces their commitment to safety and continuous improvement".[142]

Following her appointment, Brownell publicly stated that "PG&E's primary focus is taking action to create an operational environment where safety and integrity always comes first".[143] PG&E's 2017 corporate responsibility and sustainability report stated its culture as to "put safety first", to be "accountable", and to "act with integrity, transparency and humility", amongst others.[144] Yet, less than a year later in November 2018, PG&E caused the deadliest and most destructive wildfire in California history. It remains to be seen if Brownell can align PG&E's actions with its words, and whether the sweeping changes at the highest level of leadership within PG&E can inspire a fundamental change in culture and processes to reflect a sufficient focus on safety.

Amongst the newly appointed independent directors is Frederick W. Buckman, nominated by activist investor BlueMountain Capital Management LLC (BlueMountain) to serve in the Audit and Safety and Nuclear Oversight committees.[145] Brownell stated that she believed Buckman shares PG&E's core belief of safety and operational excellence being vital to its success and will help to make sure that this will continue to be the board's utmost priority.[146] However, Buckman soon stepped down in November 2019, with PG&E highlighting that his resignation "does not involve any disagreement on any matter relating to the corporation's or the utility's operations, policies or practices".[147]

As part of the same agreement with BlueMountain, PG&E Corp also hired the former Chairman of the National Transportation Safety Board, Christopher Hart, to serve as its special independent safety advisor, who reports directly to CEO Johnson. This was in line with PG&E's claims of prioritising safety, and its hope that this appointment can have the effect of "strengthening the company's safety culture".[148]

Rising from the ashes?

Moving forward, PG&E was tasked with devising a restructuring plan that allows the company to pay off its liabilities arising from the wildfires and emerge from Chapter 11 bankruptcy. To do so, it needed to satisfy creditors, wildfire victims and state officials, before the deadline of 30 June 2020, if PG&E wished to qualify for the US$20 billion state wildfire fund, which would cover future fire losses.[149] The restructuring plan was to outline how PG&E intended to raise sufficient cash to pay off "US$25.5 billion in claims as part of the settlements reached with wildfire victims, insurers and government agencies".[150]

However, PG&E faced a huge roadblock in the process – the proposed plans by PG&E had been rejected multiple times since December 2019 by the California governor, Gavin Newsom. He felt that the initial restructuring plan, which proposed to finance the wildfire damages through the issuance of debt and equity, would leave PG&E "too leveraged to make safety investments in the electric grid and failed to ensure operational change within its leadership".[151] This would make existing targets to spend at least US$37 billion on equipment upgrades and other improvements between 2020 and 2024 difficult to realise.[152] PG&E would require Newsom's approval to be covered under the state wildfire fund, which is critical to their successful Chapter 11 exit.[153]

Newsom is also demanding that the entire board of directors of PG&E be replaced in order to overhaul "a corporate culture that has repeated lapses in safety and played a role in a series of catastrophic wildfires".[154] The governor threatened to launch a state takeover of PG&E if his demands were not fulfilled. However, he faced opposition from both the public – due to the exposure of the state with a takeover – as well as labour unions, due to the possible loss of employee benefits.[155] Some questioned the state's ability to "run a more effective and efficient electricity system when it has struggled with its water services and transit system".[156]

In March 2020, PG&E managed to strike a deal with Newsom and the courts subsequently approved PG&E's US$23 billion bankruptcy financing package. While the governor's approval of PG&E's restructuring plan represented a major step towards emerging from Chapter 11 bankruptcy, it came with several concessions on PG&E's part, including:[157]

- PG&E agreeing to put itself up for sale if it is unable to exit Chapter 11 by 30 June 2020
- Continuing the freeze on dividend payments to shareholders for another three years, saving about US$4 billion
- The reduction of debt issuance from US$7 billion to US$4.75 billion and relying more on equity financing
- Safety compliance to be monitored by a state-selected "operational observer"
- Half of the board of directors to be filled with California residents

PG&E intended to undergo another "refreshment" of its board of directors, in response to Newsom's demands to replace the entire PG&E board.[158]

However, it was presented with yet another challenge regarding the claims by the wildfire victims. While the claims to the Californian government and insurance companies are to be paid in cash, the restructuring plan proposed to compensate half of the victims' US$13.5 billion claims through PG&E shares. Unfortunately, the stock market has plummeted in recent months due to the COVID-19 pandemic. This has left the wildfire victims unhappy, with some saying that they were unlikely to vote in favour of PG&E's restructuring plan.[159]

PG&E needed to obtain the approval of the wildfire victims who, alongside other creditors, would have until 15 May 2020 to vote on its restructuring plan to exit Chapter 11 bankruptcy. The lawyers, who initially negotiated the settlement, had advised the wildfire victims to hold off on voting for the plan until 1 May 2020 as they attempt to revise the settlement terms with the utility.[160]

The settlement faced another hurdle after a lawyer who helped broker the settlement was accused of conflict of interest due to his relationship with some of PG&E investors.[161] On 1 July 2020, PG&E announced its exit from Chapter 11 bankruptcy, and that it has paid US$5.4 billion in initial funds and more than 22% of its stock into a trust for victims of wildfires caused by its outdated equipment. “This is an important milestone, but our work is far from over,” said Bill Smith, its interim CEO.[162]

Discussion questions

1. Assess the board composition of PG&E Corp and PG&E before and after the Camp Fire. How effective do you think were the changes? Do you think the parent and subsidiary boards should be identical or nearly identical in this case? Explain.
2. Discuss how the corporate culture at PG&E could have contributed to the Camp Fire tragedy. Evaluate the impact of corporate culture on its whistleblowing policies.
3. Evaluate the remuneration of PG&E’s executives. Do you consider the remuneration plans to be excessive? Discuss any potential problems relating to Geisha Williams’ severance package.
4. To what extent do you think weaknesses in risk governance and risk management were contributing factors to the problems at PG&E? In answering this, evaluate the risk governance and management practices against a “four lines of defence” model.
5. Discuss the unique challenges in governing companies such as utility companies where there are significant public interests at stake. How can these challenges be resolved? Should such companies be listed? Explain.
6. Should the regulators be held accountable for the wildfire incidents? Discuss the role of regulators in this incident and evaluate whether the actions taken by CPUC are sufficient in preventing future wildfire incidents.
7. PG&E has been lauded for its exceptional ESG standards by many external rating agencies. Why do you think these rating agencies got it so badly wrong? What can be done to improve the rating methodologies?

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SAMHERJI: THE FISHING TITAN-IC

Case overview

When one thinks of Iceland, one imagines clear lakes, mountains of ice and the famous Northern Lights. When one then thinks of Namibia, one imagines arid deserts and a plethora of wild animals grazing in national parks. Iceland and Namibia – two words that were never heard of in the same sentence. That is, until now.

On 14 November 2019, Thorsteinn Már Baldvinsson, the former Chief Executive Officer of Samherji hf. (Samherji), stepped down after news of the Icelandic fishing company's involvement in Namibia's biggest corruption scandal came to light. This concerned bribes totaling US$10 million from Samherji, in exchange for quotas hitting tens of thousands of tonnes of horse mackerel a year, since 2012. Not only did Samherji's reputation hit rock bottom, it also came as a shock to Iceland due to her transparent reputation, with the nation ranked the 11th least corrupt country in 2019. Given the outsized role that the seafood and fisheries sector plays in the Icelandic economy, such an issue could also adversely affect the position of its fishing industry in the international market.

The objective of this case is to facilitate a discussion of issues such as whistleblowing; board oversight; risk management; cross border bribery risks; ethics; regulation and enforcement; and the corporate governance system in Iceland.

An Icelandic fishing giant

"It is hard to overstate the importance of fish to the Icelandic people. Through the centuries, it has been the lifeline of the nation, both as its main food supply, and its chief export product."

– Promote Iceland[1]

Established in 1983, Samherji hf. (Samherji) is one of the most prominent players in the Icelandic fishing industry. It is a vertically integrated seafood company with operations spanning from fishing vessels to fish factories and fish farming. Samherji's products are branded under the "Ice Fresh Seafood" brand.[2]

However, the true extent of Samherji's size lies in its overseas operations. By 2014, its operations had extended beyond Iceland to Norway, Faroe Islands, U.K., Germany, Poland, Latvia, France, Spain, Morocco, Mauritania, Namibia, Canada, and the Pacific Ocean. The Group also had over 40 vessels, fishing for shrimps, ground fish and pelagic species.[3]

This case was prepared by Brandon Loi, Ang Jia Wei Nicole, Lee Jia Yi Rachel, Ler Siang Hwee Stacia, Yeo Yih Peng and Lee Zhi Xin, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees.

Samherji is also highly profitable. It made a total of ISK112 billion profits from 2011 to 2019 and the Group's equity amounted to ISK111 billion, higher than the cost of all hospital services in Iceland's 2020 Budget.[4]

Thorsteinn Már Baldvínsson, Helga Steinunn Guðmundsdóttir, Kristján Vilhelmsson, and Kolbrún Ingólfsdóttir had a combined ownership of 86.5% of the shares in Samherji as at 14 May 2020, prior to the transfer of shares to their children.[5] Samherji was initially listed on the Icelandic stock exchange, ICEX, under the ticker SAMH. However, it was delisted on 28 July 2005 due to failure to fulfil listing requirements.[6] As such, there are no publicly available annual reports.

The company structure of Samherji (as at 4 April 2016), with respect to Namibian-incorporated companies, and the list of subsidiaries of the Samherji Group as of 2014 are shown in Figures 1 and 2.

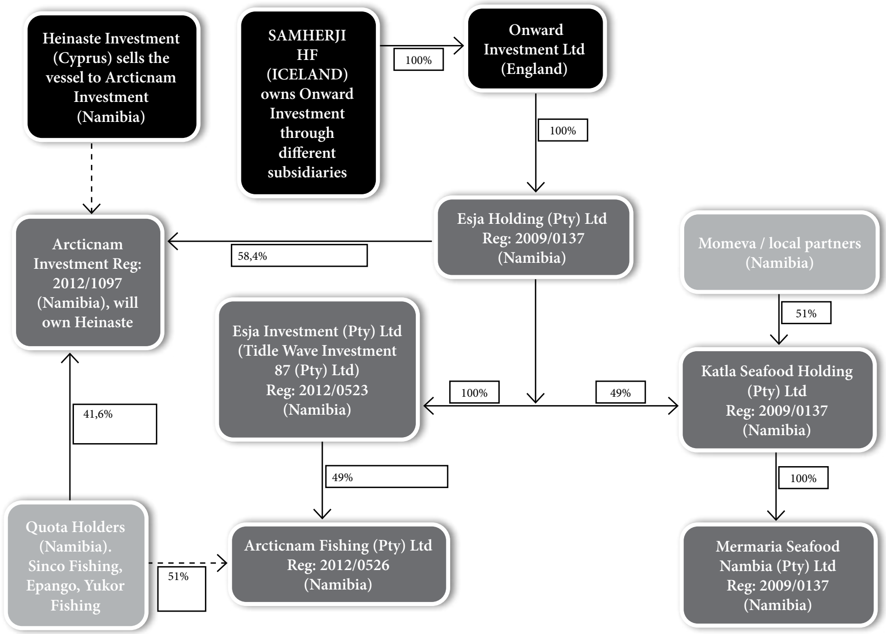

Figure 1: Company structure of Samherji (as at 4 April 2016)[7]

Figure 2: List of Samherji subsidiaries (as of 2014)[8]

Fishing for quotas: How money is made in the fishing industry

"The ocean is like a checking account where everybody withdraws but nobody makes a deposit. This is what's happening because of overfishing. Many fisheries have collapsed, and 90 percent of the large fish, sharks and tuna and cod are gone."

– *Enric Sala, marine ecologist and National Geographic explorer-in-residence*[9]

The business model of fisheries is uncomplicated. The fisheries fish for any species that they desire, process them, and export or sell them locally through distribution channels. The final product ends up in supermarkets, wholesalers and restaurants around the world.[10] Figures 3 and 4 show the value chain for Icelandic cod as an illustration.

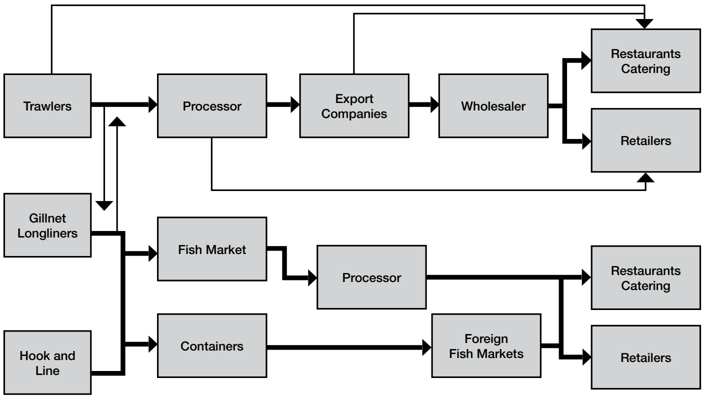

Figure 3: Value chain for the Icelandic cod fishery industry[11]

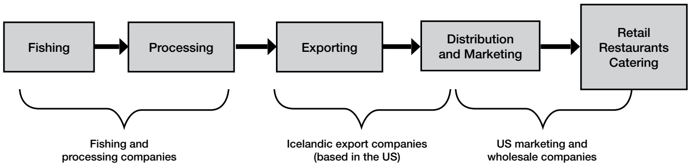

Figure 4: Value chain for Icelandic cod exported to the U.S.[12]

Before the 1990s, despite efforts to limit fishing, marine resources in Iceland were starting to drain at an alarming rate which could threaten the livelihood of the industry.[13] In response, the Icelandic government introduced a comprehensive system of individual transferable quotas (ITQs) via the Fisheries Act introduced in 1990. The ITQ system provides fishers permanent quota shares which they can opt to lease or sell. This gives them an incentive to take a longer-term view on the harvesting and management of the resources as fishers can reduce their fishing activities now to harvest more later, and less efficient vessels would leave the industry and instead receive compensation through the sale of their quotas. This policy serves to regulate, streamline and consolidate the fishing industry in Iceland.[14]

Similarly, Namibia uses fishing quotas to control fishing activities in its Namibian Marine waters. According to the Ministry of Fisheries and Marine Resources, there are several criteria for the granting of rights to harvest marine resources, one of which is whether or not the applicant is a Namibian citizen.[15] Many of its fishing policies also give priority to the locals. For example, longer durations for the fishing rights are reserved mainly for Namibians. This is because its fisheries policies focus on securing benefits for Namibia, using a term which they have coined as 'Namibianization'. Foreign investments are also welcome, as long as Namibia's national interests are not disregarded. Namibia's fishing policy was last amended in 2013, with the aim of enhancing areas such as stability, security, and investment potential. Since her independence in 1990, Namibia's fishing industry is one of the key pillars of the Namibian economy and policies have been put in place to protect national fishery interests.[16]

Regardless of location, fisheries cannot fish legally in the country's waters without fishing quotas, affecting the whole value chain that comes after. Fishing quotas are therefore extremely valuable and obtaining them is essential to the survival of fisheries worldwide.

Africa or nothing: Samherji's dependence on Africa

Africa's fishing industry is vibrant in both inland and coastal areas. Its fisheries and aquaculture sectors contribute US$24 billion to the African economy, representing 1.3% of the total African gross domestic product in 2011.[17]

Samherji's economic viability as a fishery hinged greatly on its African-based operations. Africa-based fishing quotas accounted for nearly one-third of Samherji's total turnover and profits, with six trawlers acting like floating factories, catching thousands of tonnes of fish every year off the coasts of Morocco and Mauritania. This all changed in 2010 when the quotas for fishing in Morocco and Mauritania were no longer available.[18]

Given the importance of securing fishing rights to Samheriji, Iceland's president was even personally involved in the negotiations with the Moroccans, leveraging on his connections with a powerful banker within Morocco itself. However, the negotiations were unsuccessful. Thus began Samherji's trek down south from Morocco towards Namibia, where the quotas for horse mackerel were abundant. The search for fishing quotas also extended to neighbouring Angola.[19]

A leaking hull: Corporate governance in Iceland

Iceland has in place Guidelines on Corporate Governance (Icelandic Code), published by the Iceland Chamber of Commerce. Although the guidelines mainly apply to public-interest entities, which include companies with securities listed on a regulated market, pension funds, financial institutions and insurance companies, companies of all sizes and activities are strongly encouraged to comply with the guidelines.[20]

Additionally, Iceland follows a two-tiered board structure system – the supervisory board consisting of only non-executive directors, and the management board comprising of only executive directors. Iceland does not impose a maximum tenure that can be served by the directors and only requires an explanation for companies' board independence.[21]

It is also required by the Icelandic national law for listed companies to establish an Audit Committee, while the Icelandic Code recommends having a Nomination Committee and Remuneration Committee. The minimum ratio of independent members recommended by the Icelandic Code in all three committees is at least 50%.[22]

Iceland also emphasises the need to effectively achieve gender balance and diversity on the boards of companies, with at least a 40% representation of each gender, effective from September 2013.[23]

Chinks in the armour: Iceland's stance on bribery

According to Transparency International, the Nordic countries have "traditionally enjoyed a low corruption perception".[24] Iceland is no exception to this as well and is considered to be one of the least corrupt countries in the world, ranking 11th on the 2019 Corruption Perception Index (CPI), with a score of 78/100.[25]

Iceland's General Penal Code (GPC) criminalises the acts of giving and receiving a bribe, abuse of office, trading in influence and fraud. It forbids bribery between businesses and Icelandic foreign public officials and imposes criminal liability on individuals and companies.[26]

Iceland is also a party to the OECD Anti-Bribery Convention.[27] The OECD Anti-Bribery Convention establishes legally binding standards to criminalise bribery of foreign public officials in international business transactions and provides for a host of related measures that make this effective. It is the first and only international anti-corruption instrument focused on the 'supply side' of bribery transactions.[28]

However, in recent years, chinks are beginning to show in Iceland's corporate governance armour and Transparency International noted that "the Nordics' reputation for good governance and business integrity is repeatedly being challenged" and "they are now seen as exporters of corruption".[29] Furthermore, Iceland had seen an increase in corruption cases over the past few years.[30] The Group of States against Corruption (GRECO) also highlighted that conflicts of interest and lack of transparency in the Icelandic government are pertinent issues that need to be addressed. GRECO also criticised Iceland for its lack of efforts in fighting corruption in politics.[31]

Africa's best and worst in class: Namibia's vs Angola's stance on bribery

Namibia borders four different African nations: Zambia to the northeast, Botswana in the east, Angola to the north and South Africa to the south.[32] The longest border shared would be with Angola, with the border spanning 1,376 kilometers.[33] However, despite being neighbours, Namibia's stance on bribery is vastly different from that of Angola.

Namibia is considered less corrupt compared to other African nations, ranking fourth least corrupt in Africa in 2017.[34] It is also ranked 56th of 180 countries in the 2019 CPI, with a score of 52 out of 100.[35] Furthermore, gifts and facilitation payments given or received as an inducement for an act are illegal according to the Namibian Anti-Corruption Act.[36] In contrast, Angola is ranked at 146th in the 2019 CPI, with a score of 26.[37] GAN Integrity Inc., a software company which compiled anti-corruption compliance and risk management resources under its risk and compliance portal, painted a bleak picture for the corporate governance scene in Angola, stating that "corruption remains widespread in Angola due to a lack of checks and balances, insufficient institutional capacity and a culture of impunity. Practices of nepotism, cronyism, and patronage pervade procurement rendering the procurement process opaque and corrupt."[38]

Despite the relatively positive outlook in terms of corruption in Namibia, companies which work closely with the country's public service sector still face significant risks of corruption.[39] This is largely attributed to an inefficient governing and enforcement body, where politically-motivated decisions are often made. In particular, Namibia's public procurement sector is susceptible to corruption because of the monopoly of state-owned companies. Bribes are often made so that companies are able to attain public contracts or licenses to conduct business. A study conducted revealed that 10% of firms expect themselves to give gifts to officials to secure government contracts.[40]

Guardians of the Namibian waters: The "sharks"

Namibia's waters are full of marine life such as sharks. There are a total of 131 species of different sharks in Namibia.[41] However, there is one type of shark not listed in these 131 species that Samherji is concerned with. This particular species regulates and governs the allocation of fishing quotas in Namibia and consists of Bernhadt Esau (ex-Minister of Fisheries), Sacky Shanghala (ex-Minister of Justice), James Hatuikulipi (ex-Chairman of state-owned Fishcor) and Tamson Hatuikulipi, who has familial connections with Bernhadt Esau and James Hatuikulipi.[42]

In the oceans, the sharks are at the top of the food chain. Similarly, in the Namibian fishing industry, the 'sharks' hold the ultimate decision as to who gets the fishing quotas and who does not. Consequently, they have the power to significantly influence Samherji's profits, especially since a large portion of these profits comes from its operations in Africa. Hence, Samherji cozied up to these 'sharks' in order to attain preferential access to the country's rich fishing grounds. Samherji "paid the sharks lots of money and strengthened this relationship" through all-expenses paid trips to Iceland and London.[43]

The Fishrot Files: Samherji Feeding the "Sharks"

"Politics and economics are bedfellows and difficult to separate."

– Sacky Shanghala, former Justice Minister of Namibia[44]

On 12 November 2019, a widespread leak unveiled Samherji's extensive corrupt acts. This leak sank no ships, but led to the sinking of the fishing company, as well as the reputation of the Icelandic fishing industry. A total of more than 30,000 documents detailing incidents between 2010 and 2016 were released by WikiLeaks – collectively known as the Fishrot Files.[45]

One of the most prominent practices that Samherji engaged in was bribing Namibian officials to get ahead in fishing quotas. These officials included Sacky Shanghala and James Hatuikulipi. This ill-fated relationship between Samherji and the 'sharks' began in November 2011, with Tamson 'Fitty' Hatuikulipi introducing himself as the minister's son-in-law to Aðalsteinn Helgason, who was both a director and manager of Samherji's African activities, and Johannes Stefansson, Samherji's managing director in the capital of Namibia. It then led up to Bernhadt Esau and CEO Thorsteinn Már Baldvinsson's first meeting in May 2012, along with Aðalsteinn Helgason, Johannes Stefansson, and two other 'sharks' - Tamson Hatuikulipi and James

Hatuikulipi. It was during that meeting that the minister promised Samherji the ability to obtain quotas at lower prices.[46]

The minister's promise was fulfilled through Fishcor, a Namibia state-owned company responsible for allocating fishing quotas.[47] Due to the changes in law made by the 'sharks', Fishcor had authority over a third of Namibia's horse mackerel quota – the largest in Namibia. Prior to this allocation of quota, Bernhadt Esau appointed James Hatuikulipi as Chairman of Fishcor. This was against the country's Company's Act which states that the Chairman should be appointed by other directors.[48]

When Namibia's Supreme Court deemed the minister's quota allocation to Fishcor illegal a year later, the minister was required to change the law. This allowed for changes to be made to the legislation which benefitted Samherji. With Samherji's intervention, the amendment resulted in Fishcor obtaining up to 80 thousand tons worth of quota yearly, which was then sold to Samherji at a low price.[49]

The Fishrot Files also revealed that approximately US$10 million of bribes were made and covered up and reported as "consultation fees" or "facilitation fees". To further complicate the transactions and covering of its tracks, these payments were made from Esja Seafood Limited in Cyprus – a Samherji holding company – to Tundavala Investment Limited in Dubai, owned by James Hatuikulipi.[50]

Samherji also hid its proceeds in Marshall Islands, a tax haven. This was done through a Den Norske Bank (DNB) NOR bank account of a shell company called Cape Cod FS (Cape Cod). Samherji had always been a major client of DNB NOR – Norway's largest bank – and continued to use the account for several years before the bank closed this account in May 2018 as it thought that the risks associated with Cape Cod were too high.[51]

The Fishrot Files revealed that Samherji used questionable business practices and did not actually outbid other companies to get hold of the fishing quotas in Namibia. This in turn eroded many business opportunities and profits for local African companies. Furthermore, Samherji previously promised senior officials that it would build infrastructure in Namibia and create jobs for its people, but all of these promises were never fulfilled.[52]

One more country to conquer: The Angola-Namibia quota exchange deal

Sharks are known to be able to survive three months without food after a large meal.[53] However, the Namibian 'sharks' were not so easily satiated. The 'sharks' were not satisfied with only selling Namibian quotas to Samherji; they devised means to sell Angolan quotas to Samherji as well. This idea was conceived by Sacky Shanghala in November 2013, through "getting the ministers of fisheries for neighbouring Angola and Namibia to make an international quota exchange deal".[54]

The mechanics of the arrangement are as follows. There would be a "pro forma" joint venture between Namibia and Angola that would receive the fishing quotas from the Namibian Ministry of Fisheries and Marine Resources, which would then flow to Samherji via a fishing agreement,[55] "guaranteeing a quota of 10 thousand tons a year for many years to come".[56]

Samherji did not waste any time in attempting to finalise the deal. In November 2013, Samherji invited James Hatuikulipi, Sacky Shanghala and the advisor to the Angolan Minister of Fisheries to Iceland, together with the Angolan minister's son and the Nambian minister's son-in-law.[57] Sacky Shanghala and the Angolan minister's advisor then sent a letter of recommendation to the countries' ministers which granted Samherji their unanimous vote of confidence, allowing the international quota exchange deal to proceed.[58]

Ringing the alarm bells: Who is Johannes Stefansson?

"Bribes are of course never termed "bribes"; they are "facilitation payments", often made by the resource extraction companies to local companies for unspecified services and whose beneficial owner is opaque."

– Johannes Stefansson, whistleblower[59]

When news of Samherji's practices first surfaced, one wondered, "Who is the daring soul willing to stand against the Icelandic shipping giant Samherji, and the Namibian political elite?" This turned out to be Johannes Stefansson – the former managing director of Samherji's operations in Namibia, who was directly involved in the scandal himself.[60]

Johannes Stefansson worked for Samherji from 2007 to 2016, and from 2011 to 2016, he led Samherji's operations in Namibia.[61] In 2016, he was apparently fired for "mismanagement and unacceptable behavior".[62]

Johannes Stefansson knew what he did was wrong and despite the prospect of a prison sentence, he "could not live with the knowledge" of what he did.[63] Hence, he reached out to the Namibian and Iceland authorities. Since August 2018, Johannes Stefansson had been working with the Namibian eco-crime unit to investigate the path taken by the dirty money out of Namibia, as well as assisting the prosecutor's office in Iceland.[64]

The actions of Johannes Stefansson led to severe consequences for himself. Since 2016, he has faced threats from the 'sharks' involved in Namibia's cash-for-quotas scandal. He also revealed in an interview that he had fallen ill from "something that could be similar to poisoning".[65]

In response to Johannes Stefansson's allegations, Samherji's CEO Thorsteinn Már Baldvinsson said, "We are deeply shocked that Johannes Stefansson not only admits being involved in illegal activities, he is now also making allegations against colleagues. This is not how we do business. This is not Samherji."[66]

Money laundering 101: Samherji's monies goes around the world

To avoid the high corporate tax rate of 32% in Namibia,[67] Samherji had a complex way of transferring funds, orchestrated by its chief accountant, Ingvar Júlíusson.[68] Monies from Namibia earned from the illegally obtained fishing quotas was first transferred to Mauritius to leverage on the double taxation treaty between Namibia and Mauritius, allowing Samherji to pay little taxes on the outgoing payments. Money was then transferred from Mauritius to Cyprus. Cyprus was chosen because of its relatively low corporate tax rate of 12.5%. In addition, different forms of payment – such as dividends – can be tax-exempt, subject to anti-avoidance provisions.[69] This allowed Samherji to pay significantly less taxes for its transfer of funds from Namibia to Cyprus. Transfers were then made from Cyprus to the 'sharks' through companies owned by them.[70]

Involvement of DNB

Between 2011 and 2018, a total of US$70 million was transferred via accounts in DNB NOR[71] (now DNB ASA) from Samherji through Cape Cod. This amount included revenue from Samherji's operations in Namibia and salaries to the crew members of Samherji's factory trawlers that fished for horse mackerel.[72]

Bribes to the 'sharks' and other Namibian officials that took part in the scandal were made through another intermediary in Cyprus. An example would be a transfer of US$3.5 million to a company named Tundavala Investments Limited owned by James Hatuikulipi, through DNB accounts owned by Esja Seafood Limited, Samherji's intermediary in Cyprus. Payments were also made to a company owned by Tamson Hatukulipi through the same intermediary.[73]

DNB is Norway's leading financial services group and the second largest primary listed company on the Oslo Stock Exchange.[74] Being a Norwegian bank, where the country itself has scored 84 on the CPI[75] and ranked seventh out of 180 countries, DNB boasts a clean and strong reputation. Furthermore, the largest shareholder of DNB is the Norwegian government, which owns a 34.2% stake in the bank as at 31 December 2019.[76] As a result, people were less likely to question the transactions that DNB allowed. The movement of money through its DNB accounts thus enabled Samherji to avoid suspicion.

In May 2018, an attempt to transfer money from Cape Cod's parent company, JPC Ship Management, was stopped by the Bank of New York Mellon (BNY Mellon), a U.S. bank. It was then that DNB decided to off-board the accounts under Cape Cod.[77] The decision to do so was made clear during a risk assessment done by DNB after the attempt was flagged by BNY Mellon for risks related to anti-money laundering (AML). It was stated in the report that "the client is not in need of Norwegian account or within LCI (Large Corporates and International) strategy" and "our recommendation is off-boarding the client".[78]

DNB's primary reason for its decision was the lack of information about the beneficial owner of Cape Cod,[79] which was clearly against the 'Know Your Customers' rules prescribed under the Financial Industry Regulatory Authority (FINRA) Rule 2090. The rule states that a bank should "know and retain the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer".[80] However, the off-boarding took place only when BNY Mellon flagged out the potential AML transaction, after nearly eight years of bank account activities.

The failure of the bank's controls in detecting money laundering drew criticism in the aftermath. The Financial Supervisory Authority (FSA) of Norway denounced the failure, saying that "[DNB] did not take sufficient care to monitor its client transactions through the bank",[81] allowing it to be used as an intermediary for money laundering.

A sinking vessel makes the most noise: Media scrutiny

"Just like before, we will not put up with the false and misleading accusations of a former employee, which are, once again, being served up by the same parties within the media and the Central Bank."

– Thorsteinn Már Baldvinsson, CEO of Samherji[82]

Soon after the Fishrot Files went public, numerous media outlets and newspapers partnered with WikiLeaks to bring the issue to light. Some of these media partners include the Icelandic National Broadcasting Service (RUV) investigative program Kveikur, Icelandic bi-weekly newspaper Stundin, Namibian newspaper The Namibian, and Qatari stated-owned broadcaster Al-Jazeera.[83] Samherji's public relations team worked to limit the damage to the company's reputation through both disavowing any knowledge of wrongdoing,[84] and accusing the media of cherry picking emails.[85] However, the involvement of these media partners made Samherji's defence more difficult.

When Samherji defended its behaviour by "[blaming] whistleblower Jóhannes and [launching] an internal investigation," Stundin pointed out that "the bribes had continued long after Jóhannes left the company". Samherji then "changed tactics and shrouded itself in silence". However, a month later, Samherji "turned defence into offence, attacking details in the media coverage".[86]

Stundin also accused Samherji of wrongdoing, postulating that "JPC Ship Management [seemed] to have simply been the stated owner of Cape Cod from 2010 to 2018 whereas Samherji was indeed the company that financed and used Cape Cod", engaging in money laundering through the entity.[87] Samherji had since denied ownership of Cape Cod, and claimed that the media reports on Cape Cod are incorrect.[88]

Popping smoke: Employing Wikborg Rein

Samherji engaged law firm Wikborg Rein to investigate the matter[89] and to "protect Samherji's financial interest in Namibia".[90] Wikborg Rein is one of the Norway's leading law firms[91] and had been working "for Samherji's interests" even before the scandal unfolded.[92]

Some Icelandic media reports suggested that Wikborg Rein was simply a "smokescreen" for Samherji "that will ultimately clear the company of any wrongdoing".[93] The engagement of Wikborg Rein was widely criticised, with many believing that Wikborg Rein would "do none other than turn in a report that showed Samherji in the best possible light".[94] To substantiate their assertions, the media also brought up a past case where "[Wikborg Rein] has previously defended Samherji's interests in a case involving the detention of their ship Heinaste in Namibia, accused of illegal fishing."[95]

In response, Wikborg Rein said it was only involved in "assisting the company in investigating the matter and providing relevant authorities with the results of such fact-finding. The conclusion on whether any wrongdoing was made, and the consequences thereof, will eventually need to be made by relevant authorities."[96] It also added that it "[did] not expect authorities or prosecutors to base their decisions in the Samherji case solely on the firm's findings".[97]

Colonial masters: Icelandic government's slow response

"Corruption in these countries, that's perhaps the root of the problem in this particular case. A weak government, a corrupt government in this country. That seems to be the underlying problem that we're seeing crop up now."

– Bjarni Benediktsson, Iceland's Minister of Finance[98]

As public anger mounted, the Icelandic government remained largely indifferent in its responses and even adopted blame shifting at the beginning. Some Icelandic officials had likened Samherji to an "honest European businessman", who had "no choice but to pay bribes to the corrupt Namibian officials".[99]

Similar to many Icelandic companies, Samherji had donated substantially to political parties in Iceland. Samherji also enjoys close and warm ties with the Minister of Fisheries in Iceland, Kristján Þór Júlíusson, who used to be on the board of Samherji.[100]

Off with their heads: Namibian government sets an example

"It was actually corrupt before we came in. You had a lot of people who understood that once I have the fishing right, I can get rich quick."

– Sacky Shanghala, former Justice Minister of Namibia[101]

Across the Mediterranean Sea, the chopping block had seen much more action. Following public uproar over the Fishrot affair, Bernhadt Esau and Sacky Shanghala resigned from their ministerial positions[102] as the government launched investigations into the state of Namibia's fisheries management system. James Hatuikulipi also resigned from his role as Fishcor's Chairman,[103] as well as his position as managing director of Investec Asset Management.[104] The Namibian government was determined to "prevent and eliminate, if any, instances of maladministration, nepotism and/or corruption".[105] Within days, the six identified people involved were arrested and held under police custody, where they awaited court trial. As at 5 May 2020, it was reported that the accused were set to remain in custody for a longer period of time, after failing to obtain a court order for their release.[106]

Finding a middle ground: Angola opens an investigation

"If there are signs of criminal acts, in due course we will provide information about the judicial process,"

– Alvaro da Silva Joao, Angolan state duty prosecutor[107]

On 11 December 2019, Angola launched a criminal case against a former minister of fisheries in connection with the scandal. The Angolan authorities stopped short of arresting the minister but took steps to freeze her assets to prevent her from moving them to foreign countries.[108]

However, some observers said that the actions taken by the Angolan government were insufficient. Friends of Angola, an "advocacy organisation based in Washington DC" that "raises the consciousness of the world community on the challenges facing Angola and to support Angolan civil society",[109] was one such organisation. It took issue with the fact that the Angolan government "[had] not charged anyone" in connection with the scandal.[110]

Samherji's management: Misalignment to true north

Samherji's management played a crucial role in the bribery scandal. Key personnel involved included CEO Thorsteinn Már Baldvinsson and former managing director in Namibia, Johannes Stefansson.

"Every obstacle was to be surmounted, to obtain the highest possible quota. Bribes were not an issue for Samherji," stated Johannes Stefansson.[111] They were disguised as "facilitation fees" and "consultation fees" to be paid to the 'sharks' to secure the fishing quotas, and these bribes were also alleged to be implemented only with the express consent of Thorsteinn Már Baldvinsson.[112] As such, when Johannes Stefansson was met with requests for a payment, he would communicate these requests to Thorsteinn Már Baldvinsson through Skype or video conference. When the payment was authorised by Samherji's CEO, Johannes Stefansson would then make these payments.[113] Johannes Stefansson also commented that the CEO had "largely organised the bribe payments", as he was "at the center of the company" and would meet with the bribe recipients in both Iceland and Namibia.[114]

Thorsteinn Már Baldvinsson had accumulated much wealth from the fishing activities in Namibia. From the estimated ISK10 billion profits made by Samherji from the Namibian fishery between 2012 and 2018, he personally made a profit of ISK1.77 billion as the company's shareholder. Additionally, in 2018, he received a monthly salary of ISK3.9 million as well as capital income of over ISK4 million on a monthly basis.[115]

When questioned, both Thorsteinn Már Baldvinsson and Kristján Vilhelmsson – Samherji's second largest shareholder and the de facto general manager in Iceland – refused to provide any information. The former published a statement, expressing his disappointment and pinning the blame solely on Johannes Stefansson, claiming that the bribes were "a work practice alien to us".[116]

Samherji's board of directors: The errant captains

"I will not answer any questions from you, not about this matter or any other. […] I do not owe you answers about anything."

– Kristján Vilhelmsson, in an interview about the Fishrot Files[117]

The company's attitudes towards governance practices during the scandal was visible from the actions of the directors.

Aðalsteinn Helgason, an ex-director and Johannes Stefansson' superior in Africa, was directly involved in the scandal, having instructed Johannes Stefansson to pay Bernhadt Esau bribes in return for the fishing quotas.[118] Eiríkur S. Jóhannsson, the Chairman of Samherji's board, claimed that the company is "committed to fair and honest business" and "will always strive to act in accordance with applicable laws and regulations".[119]

Two other directors, Kristján Vilhelmsson and Óskar Magnússon, showed indifference and were quoted saying that Thorsteinn Már Baldvinsson could stop the interview if he was offended by the reporters' questions, and stating that the reporter's questions were "monotonous".[120]

Hull inspection: Strengthening Samherji's corporate governance

In the bygone era, strong swimmers were sent below the hull of ships to patch up holes caused by underwater collisions. Similarly, there was a need for the appointed interim CEO, Björgólfur Jóhannsson, to patch the holes made by his predecessor.

In the wake of the Namibian cash-for-quota scandal, Björgólfur Jóhannsson pledged to take steps in implementing a corporate governance and compliance system. As part of a new internal program, the focus would be on the development of a compliance system that would involve all Samherji employees in reassessing the company's values, cultures and routines. A framework for risk assessment, code of conduct, and policies would also be implemented within this new compliance system. This was expected to be completed by the end of 2020 and would be part of Samherji Group's future management structure.[121]

In full retreat: Scrambling for safe harbour

Under intense media pressure, Samherji began divesting its Namibian business.[122] As of 6 February 2020, it had largely limited its operations in Namibia, with only one of the three vessels still operating in Namibian waters.[123]

The last vessel, Heinaste, had proven difficult to divest. In November 2019, Heinaste and her captain, Arngrímur Brynjólfsson, were detained by Namibian authorities for "illegal fishing".[124] The case was finally resolved on 5 February 2020 and the trawler's captain pleaded guilty to having fished in waters shallower than 200 meters deep and was subsequently fined.[125] Two days later, the police in Namibia seized Heinaste in the wake of the Fishrot scandal, despite the previous court order that the vessel should not be forfeited. In response, Samherji blasted the Namibian authorities' actions and threatened legal action.[126]

The company's divestments led to a loss of jobs. As Samherji's Namibian subsidiary, Saga Seafood, shut down, it had to let go of 210 employees, despite the fact that these employees are "the best in these waters".[127] Saga Seafood stated that there was nothing it could do to let the fishermen keep their jobs as the company received no quotas for the vessels which previously operated in Namibian waters.[128]

All is forgiven: The prodigal captain returns

"[Thorsteinn's] return to the position of Samherji CEO is contingent upon the Wikborg Rein report absolving him of blame,"

– Björgólfur Jóhannsson, interim CEO of Samherji[129]

On 31 December 2019, the World Health Organisation's China office heard the first reports of a new virus behind a number of pneumonia cases in Wuhan. Since then, COVID-19 has spread rapidly worldwide.[130] Amidst the global pandemic, Thorsteinn Már Baldvinsson stands to be one of the rare beneficiaries.

Although he temporarily stepped aside in November 2019 as investigations into the troubled fishing company were ongoing, he returned as the co-CEO of Samherji on 27 March 2020, alongside interim CEO Björgólfur Jóhannsson.[131] This came four and a half months after the Fishrot Files were revealed. Samherji's board justified its decision by highlighting that his strong leadership and detailed knowledge of the company's operations were required to tide the company through difficult times amidst the COVID-19 pandemic.[132]

Discussion questions

1. Discuss how Samherji can improve its corporate governance practices.
2. Although Iceland is ranked higher on the Corruption Perceptions Index in 2019 compared to Namibia and Angola, the Icelandic authorities were slower to crack down on Samherji than Namibia and Angola on their ministers. Why do you think this is so? Do you think that the high rankings the Nordic countries have received in terms of transparency and corruption are more form than substance?
3. What do you think are the additional risks that the boards of Samherji and DNB (as an intermediary) have to consider when trying to stop cross-border bribery? What recommendations would you provide to the boards to mitigate such risks? Who do you think is more responsible for the bribery scandal?
4. Being personally involved in the scandal and possibly facing adverse consequences, why do you think Johannes Stefansson still decided to whistleblow? What should companies and governments do in order to support individuals to speak up against wrongdoings? Provide an example of a company comparable to Samherji, with strong whistleblowing policies that Samherji can emulate, and explain these whistleblowing policies.

5. With Samherji's CEO claiming that measures would be put in place to strengthen its corporate governance moving forward, do you think they will be effective? How can the board of a large group of subsidiaries, internal/ external auditors and management provide sufficient oversight and assurance to prevent such scandals from happening?
6. Why do you think bribes of such large amounts remain undetected for so long? What internal control measures do you think should be in place to prevent such corrupt practices?

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SNC-LAVALIN: A MURKY PAST

Case overview

On 26 March 2012, Pierre Duhaime stepped down as President and Chief Executive Officer of Canadian construction giant, SNC-Lavalin Group Inc. (SNC-Lavalin), after internal investigations revealed that he authorised US$56 million in mysterious payments. The company has since been in the spotlight for countless investigations, exposing bribery in projects such as the Padma Bridge, McGill University Hospital and many others, where large amounts of “agency costs” were paid out to bid for these projects.

Under Canada’s Integrity Regime legislation, SNC-Lavalin could be banned from bidding on federal government contracts for up to ten years. The impending verdict caused a huge loss in investor’s confidence. Furthermore, being a major employer in Canada, SNC-Lavalin’s scandal had many employees worried about retrenchment were there to be no more federal contracts.

The objective of this case is to facilitate a discussion of issues such as the role of the board in management oversight and supporting management; fraud and bribery; ethics; corporate culture; internal controls and risk management; and the impact of politics on corporate governance.

Background of SNC-Lavalin

Based in Montreal, Canada and listed on the Toronto Stock Exchange (TSX), SNC-Lavalin Group Inc. (SNC-Lavalin) is one of the largest construction companies in the world and the largest construction company by revenue in Canada as of 2018.[1] It was formed in 1991 as a result of the merger of Surveyer, Nenniger and Chenevert Consulting Engineers and Canadian engineering giant Lavalin.

SNC-Lavalin has established its presence globally with around 50,000 employees across offices in over 50 countries.[2] According to the company’s 2017 annual report, it operates in four key sectors: infrastructure, mining and metallurgy, oil and gas, and power.[3] SNC-Lavalin has also been recognised for having a good corporate governance structure; its governance scores, based on Canadian newspaper The Globe and Mail, were 1st in 2005 and 2009, 2nd in 2006, and 3rd in 2008 respectively.[4]

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Carrying on a legacy

Before Pierre Duhaime took on the role as Chief Executive Officer (CEO) of SNC-Lavalin in 2009, his predecessor, Jacques Lamarre, had led the company to achieve unprecedented growth and revenue performance by landing many large-scale projects. He was particularly keen on expanding the business globally. The company's profits increased by tenfold under Lamarre's leadership and revenues surpassed US$7 billion. Before Lammare's retirement, he was asked by analysts whether he was concerned about SNC-Lavalin's prospects, as the financial crisis was taking its toll, resulting in a credit crunch and tanking commodities. However, the then-CEO replied that he was not worried as large government infrastructure projects were about to come.[5]

When Lamarre stepped down from SNC-Lavalin, Duhaime was then the executive vice president in charge of SNC-Lavalin's worldwide mining and metallurgy activities.[6] Lamarre had expressed utmost confidence in his successor, and said he had no doubt that Duhaime would "take this great company to new levels."[7] Duhaime did not disappoint and managed to secure large contracts internationally during his tenure as CEO.[8]

Fast forward three years, the outlook for the company had changed drastically. It found itself in the midst of a number of major bribery scandals, most notably the Padma Bridge controversy, as well as its dealings in Libya and with the McGill University Hospital.

Padma Bridge – Guilty or innocent?

Spanning 6.15km long and stretching across Bangladesh's Padma River – the world's third largest river – the Padma Bridge project aimed to reduce poverty in the southwest region and accelerate growth and development in Bangladesh. It relieves the challenge of crossing the infamous river and improves connectivity in the southwest region by reducing distances to major urban centres like Dhaka by approximately 100km.[9]

Approved in August 2007, the construction of the Padma Bridge was by far the most important and ambitious infrastructure project undertaken in Bangladesh then, with an area of influence spanning 44,000 km^2, or 29% of the total area of Bangladesh. Considering the impact that the Padma Bridge project was estimated to have on the lives of millions of people, the World Bank approved US$1.2 billion of credit to help fund the US$3 billion project in February 2011.[10,11] However, beneath the facade of what seemed to be an ambitious project, a scandal was brewing.

World Bank's withdrawal and revelations

"In an effort to go the extra mile, we sent a high-level team to Dhaka to fully explain the Bank's position and receive the Government's response. The response has been unsatisfactory."

– World Bank's statement on Padma Bridge[12]

In June 2012, just one year and four months after announcing its credit pledge for the Padma Bridge, the World Bank issued a statement to withdraw, revealing that it had uncovered a potential corruption conspiracy among Bangladeshi government officials, executives from SNC-Lavalin International Inc (SLII) – a now-defunct division of SNC-Lavalin – and other private individuals in connection with the Padma Bridge project.[13] In the statement, the World Bank declared that it had provided evidence from two investigations to the then Prime Minister of Bangladesh, as well as the Minister of Finance and the Chairman of the Anti-Corruption Commission of Bangladesh in September 2011 and April 2012, but was met with inadequate response from the relevant authorities in Bangladesh.[14]

Back in Canada, after multiple search warrants and a year-long investigation based on a referral from the World Bank, the Royal Canadian Mounted Police (RCMP) laid corruption and bribery charges in September 2013 against three former SLII executives and two influential businessmen and lobbyists – former SNC-Lavalin vice-president of energy and infrastructure Kevin Wallace; former SNC-Lavalin vice-president of international development Ramesh Shah; former SNC-Lavalin international engineer[15] Mohammad Ismail; Bangladeshi-Canadian businessman Zulfiquar Ali Bhuiyan; and prominent Bangladesh lobbyist Abul Hasan Chowdhury.[16]

The Padma affair

SNC-Lavalin was one of the five companies shortlisted for the construction supervision contract for the Padma Bridge project.[17] A letter from a World Bank panel of experts, which was subsequently leaked to the media in Dhaka and later obtained by The Globe and Mail newspaper, gave a detailed glimpse into the mechanics of the Padma Bridge bribery allegation against SNC-Lavalin. According to the letter, Syed Abdul Hossain, a former Bangladeshi communications minister, demanded to meet a “sada”, or white-skinned, executive from SNC-Lavalin before approving the winner of the bid for the project.[18]

On 29 May 2011, Wallace, accompanied by Shah, travelled to Dhaka to meet the communications minister. It was alleged that prior to the meeting, Bangladeshi public servants were feeding SNC-Lavalin confidential information regarding the status of its bid – the evaluation committee for the project had initially placed SNC-Lavalin behind Halcrow Group Ltd. (Halcrow), a British engineering consulting firm. The World Bank letter revealed that during the meeting, Shah noted down percentages next to the names of Hossain and Mohammed Mosharraf Hossain Buiyan, who was the executive secretary of the Bangladeshi Bridge Authority. An acronym “PCC” was used to indicate the cost of bribes to be paid to the officials. About two weeks later, the Bangladeshi Bridge Authority submitted a report to the World Bank which recommended SNC-Lavalin, citing “issues” over competitor Halcrow’s proposal.[19]

Investigative journalism reveals more instances of bribery

What started out as a stand-alone case soon began to unravel as an extensive bribery practice employed by SLII in several other countries following a joint investigation conducted by CBC News and The Globe and Mail in 2013.[20]

In March 2013, following his arrest together with his superior Shah for their role in the Padma Bridge bribery and after a raid by the RCMP on the SNC-Lavalin office in Oakville, Ontario, at the request of World Bank in September 2012, former SLII engineer Ismail filed a lawsuit against his former company on the grounds of wrongful dismissal back in 2011.[21] In the civil lawsuit, Ismail asserted that SNC-Lavalin had turned a blind eye to the harassment, intimidation and "callous" treatment he received from his then supervisor Shah, from as early as 2007.[22] More importantly, Ismail also revealed details that SLII had been using an internal accounting code, "PCC", to record bribery amounts for projects across Africa and Asia, hinting that Padma Bridge project was not the only instance.[23]

The code words "PCC" or "CC" were used in the company's documents to describe hidden "project consultancy costs". Internal documents obtained by CBC News and The Globe and Mail indicated that between 2008 and 2011, SLII had included these "costs" in 13 projects in countries including Nigeria, Zambia, Uganda, Ghana, India, and Kazakhstan. Based on various company emails, cheques and accounting records, the money recorded under "PCC" was consistently calculated as a percentage – usually around 10% – of the total value of contracts. These payments were concealed from funding agencies and clients in internal documents or calculated in the margins of budgets, and were recovered through artificially inflated salary tables. Following the RCMP raids on SLII's offices, internal auditors had gone through its accounting records and concluded that PCC was improperly factored into several projects.[24]

Ismail further commented that the use and meaning of "PCC" was well recognised within the SLII division, from the "office secretary to senior positions".[25] His claim was corroborated by another ex-employee, who confirmed that he understood that "PCC" was an acronym used to describe bribes.[26]

Aftermath of the Padma Bridge case

In April 2013, the World Bank announced the debarment of SNC-Lavalin and more than a hundred of its affiliates for a period of 10 years as part of a Negotiated Resolution Agreement between World Bank and SNC-Lavalin Group for its misconduct in relation to the Padma Bridge project as well as another project in Cambodia.[27]

In 2014, an investigation by Bangladesh's Anti-Corruption Commission found the suspected Bangladeshi officials and politicians who were alleged to have been involved in the corruption plot not guilty.[28] Subsequently, a Dhaka court acquitted all seven Bangladeshi government officials who were indicted in the Padma Bridge bribery case, including Hossain and Chowdhury.[29,30]

In January 2017, a Toronto court acquitted Wallace, Shah, and Bhuiyan of bribery charges in relation to the Padma Bridge project.[31] Justice Ian Nordheimer of the Ontario Superior Court threw out all wiretap evidence and rebuked the RCMP on grounds that the information provided in the wiretap evidence was "nothing more than speculation, gossip and rumour".[32] Ismail had also been relieved in 2016 following his decision to testify against his former superiors, while the charge against Chowdhury was also dropped.[33]

Eventually, the Bangladesh government went ahead to build the Padma Bridge with domestic funding.[34]

While it seemed that the Padma Bridge bribery case was in the end dismissed and SNC-Lavalin was deemed not guilty, the spotlight was already brought onto SNC-Lavalin's murky affairs, and subsequent revelations of other alleged wrongful dealings placed more pressure on the already scandal-laden firm.

Libya

Between 2001 and 2011, SNC-Lavalin won contracts worth at least US$1.85 billion[35] in Libya, from buildings to pipelines construction. These contracts include:[36]

- Benghazi pipeline project (2011) - US$58 million
- Sarir water pipe project phase I (2002) - US$475 million
- Sarir water pipe project phase II (2006) - Unknown
- Benina International Airport (2008) - US$500 million
- Benghazi Lake Rehabilitation (2009) - Unknown
- Guryan Prison (2009) - US$367 million
- Great Man-Made River (2010) - US$450 million

These were made possible by Riadh Ben Aissa, who was SNC-Lavalin's main liaison with the Libyan government. He was well-connected in Libya and had close ties with Saadi Gaddafi (Saadi), son of the then-dictator of Libya Muammar Gaddafi.[37] They were introduced to each other by Slim Chiboub, a prominent local businessman with powerful presidential ties. Chiboub told Aissa that "You can't work alone in Libya…you absolutely need to have a protector".[38] Aissa's work was one of the main contributors to the profitability of the company's construction division. Most notably, he turned around SNC-Lavalin's loss-making construction division. Former CEO Lamarre promoted Aissa to executive vice president in 2007 in view of his exceptional performance.[39]

After multiple investigations into SNC-Lavalin by the RCMP, it was confirmed that large sums of money had been paid to the Gaddafi regime in bribes to win lucrative contracts in Libya.

Fun times with Saadi Gaddafi

"My dear friend, make sure that this project will be ours," wrote Aissa to Saadi in respect of a construction contract in Libya, based on a June 2009 email obtained from Swiss authorities by the Financial Post.[40]

In early 2009, SNC-Lavalin's board of directors became aware of the financial irregularities arising from its operations in Libya. External auditors raised concerns with regard to the bill for entertaining Saadi during his three-month trip to Canada in 2008, which was arranged by Aissa.[41] Saadi, who was in charge of special forces in his father's army, was considered an important partner to SNC-Lavalin. The bills totalled US$1.9 million, which consisted of US$30,000 for escorts, US$180,000 for a stay at the Hyatt Regency hotel in Toronto, US$193,501.81 for limousine rides and cash advances of up to US$15,000.[42]

Lamarre admitted the board was aware of the hefty bill for Saadi's visit to Canada and claimed that despite ultimately paying for the bill, they did not approve of such an expenditure.[43]

Earn back the money at any cost

Such lavish spending was justified by Aissa for one specific reason: recoup the losses on the project in Libya. The company was undertaking a project known as The Great Man-Made River Authority, a state institution tasked by Muammar Gaddafi to build infrastructure that could bring water from aquifers beneath the Sahara desert to coastal cities in the region.[44] According to its website, it is the world's largest engineering venture, with Muammar Gaddafi calling it the "eighth wonder of the world".[45] It consists of the construction of over 1,300 wells, supplying 6,500,000m^3 of fresh water per day to the cities of Tripoli, Benghazi, Sirte and many others.[46]

However, the project turned out to be much more costly than anticipated and the company was losing money as a result. It filed a claim against the Libyan river authorities to attempt to recover an additional US$100 million for the additional costs incurred, but the negotiations stagnated and did not bear fruit.[47] Aissa, who had been leading the project for SNC-Lavalin, claimed that the newly appointed executive vice president, Sami Bebawi, told him to do whatever it takes, and pay whoever was necessary, to ensure that the company stopped losing money. The message from his new boss was clear: settle the claim and recoup the company's money, by any means necessary, or his job was at risk. Any subsequent dealings Aissa had with Saadi were always approved by Bebawi. This paved the way for subsequent lucrative construction contracts in Libya landing in the hands of SNC-Lavalin.[48,49]

Another red flag was raised in May 2009, when the board discovered that large amounts of cash were stored in the company's Libyan headquarters. Cash amounting to US$10 million was stored in a safe in the Libyan headquarters when the SNC-Lavalin board ordered that no more than US$1 million should be held there at any point in time.[50]

In September 2009, executives from SNC-Lavalin hosted Saadi again when he attended the Toronto Film Festival.[51] Although the company had a relatively smaller bill of around US$431,000, the RCMP alleged that the bill constituted bribery as well.[52]

Former Chairman of the board, Gwyn Morgan, claimed that the board was not aware of the way Aissa was spending company money and whether or not he was paying the Gaddafi family unlawfully. He also claimed to have had no reason to believe that other board members at that point in time were aware of Aissa's misdeeds.

The SNC-Lavalin board had comprised of prominent leaders in the corporate world, as well as experienced personnel from the banking, energy and railway sectors. He added that bribes paid to Gaddafi were intentionally and cleverly disguised as part of the normal project costs and as a result, were unidentifiable by the board.[53]

Costs for Libya… worth it?

According to the documents filed by the RCMP in court proceedings, SNC-Lavalin paid a total of US$160 million in bribes to win major contracts under the Gaddafi regime.[54] These kickbacks paid to the Gaddafi family included a 45-metre luxury yacht, as well as renovation costs for the penthouse that the Gaddafis owned in Toronto which amounted to US$200,000.[55] It was reported that bribe money was wired from SNC-Lavalin's Royal Bank of Canada accounts in Montreal and London to Swiss bank accounts controlled by Aissa, before being funnelled to others, including Saadi.[56] The Canadian construction giant insisted that it believed the funds represented legitimate agent fees, to be paid out to third parties who assisted it to land overseas contracts.[57]

Additionally, it was alleged that at the beginning of the collapse of the Gaddafi regime, Aissa and his associate, Stéphane Roy, used company resources to arrange for Saadi and his family to flee to Mexico. However, the plan did not materialise.[58]

In 2014, Aissa eventually pleaded guilty in a Swiss court and faced a jail term of three years. Meanwhile, SNC-Lavain was recognised as an "injured party", and Aissa was asked to compensate SNC-Lavalin approximately US$13.5 million for the damage he had cost the company during his tenure as vice president of construction.[59] He had since been helping authorities to prosecute former executives and directors whom he believed clearly knew about the bribes paid and the fraud committed in the Libyan projects.[60]

The RCMP charged SNC-Lavalin with fraud and corruption linked to its Libyan projects on 19 February 2015, alleging that the Canadian engineering giant offered US$38.2 million in bribes to Libyan officials from 2001 to 2011, and defrauded Libya of US$103.9 million.[61] SNC-Lavalin said the charges were without merit and caused by "alleged reprehensible deeds by former employees who left the company long ago".[62]

McGill University Hospital

On 27 June 2007, McGill University Health Centre (MUHC) made a call for bids for a contract, worth over US$1.3 billion, for the design, construction, financing and maintenance of its future campus.[63] It planned to consolidate its services from the Royal Victoria Hospital, the Montreal Children's Hospital and the Montreal Chest Institute in a single facility.[64] It would provide inpatient and ambulatory care and most of its funding would come from Quebec taxpayers through the Ministry of Health and Social Services.[65]

SNC-Lavalin assembled a team of 150 individuals which spent 10 months developing a proposal. Aissa led the charge in the construction component and the efforts paid off when SNC won the contract in April 2010.[66]

Too close for comfort

During the submission process, Arthur Porter, CEO and Director of MUHC, set up a shell company in the Bahamas called Sierra Asset Management.[67] Yanai Elbaz, Porter's right-hand man and director of redevelopment, planning and real estate management for the hospital, had also set up his own company, named Pan Global Holding.[68] Not long after, US$22.5 million was pumped into Sierra Asset Management by the Tunisian arm of SNC-Lavalin, of which US$10 million was subsequently transferred to Pan Global Holding.[69]

In exchange for the money, Elbaz supplied SNC-Lavalin with confidential information about the bidding process. The SNC-Lavalin executive in charge of preparing the proposal, Charles Chebl, told a public anti-corruption inquiry in 2014 that his superiors gave him details about a rival bid and he was then instructed to alter SNC's own proposal with that information.[70] When questioned about whether this reflects a problem with the organisation's culture, he replied "Here, we know that everyone is cheating...It's the entire management."[71]

Furthermore, Elbaz had unauthorised communications with Duhaime and Aissa before the proposal deadline. Duhaime himself made a brief call to Elbaz on 1 November 2009 despite not being allowed to do as SNC-Lavalin was involved in the MUHC bidding process.[72] Duhaime had also been informed early on that an SNC-Lavalin employee was in contact with Elbaz around the time SNC-Lavalin was trying to secure the hospital contract. However, Duhaime took no action, and his lawyers acknowledged that "he acted with wilful blindness, with the goal of helping SNC-Lavalin obtain the MUHC contract".[73]

Duhaime pleaded guilty to breach of trust in early 2019,[74] while Elbaz pleaded guilty to breach of trust and conspiracy charges earlier on in November 2018.[75] Meanwhile, Porter passed away due to illness in 2015 and charges against him were later dropped.[76]

Duhaime at fault?

"Instead of acting upon that knowledge, and stopping this from happening, which he could have done, he chose to look the other way,"

– Robert Rouleau, spokesperson for the Crown prosecutor's office[77]

The Crown prosecutor's office believed that by failing to look into that employee's actions, Duhaime committed a crime. Assistant chief prosecutor Robert Rouleau said that Duhaime "was in a position where he had reason to believe that privileged information was being transmitted illegally to put SNC-Lavalin in a preferred position. … He chose to look the other way. This is what he was sentenced for".[78]

Although Duhaime "was not considered to be one of the key actors in the bribery scandal", he was sentenced to 20 months of house arrest, 240 hours of community service, and was required to make a C$200,000 donation to a crime victim compensation fund.[79]

On 5 March 2019, SNC-Lavalin announced its intention to sue former CEO Duhaime for financial losses and damage to the company's reputation. It held that Duhaime hurt the company when he helped Elbaz commit a breach of trust tied to bribes which rigged the MUHC project in SNC-Lavalin's favour. The company demanded that Duhaime repay the US$22.5 million in bribes, as well as US$17.5 million in punitive damages and compensation for reputational harm. [80,81]

Board of directors – Closed both eyes?

Following the unravelling of these bribery scandals, there was a huge media outcry over the lack of oversight by the SNC-Lavalin's board of directors. The board was accused of allowing illegal operations to continue under its nose, regardless whether it had knowledge of the actions by SNC-Lavalin's management.[82]

Stephen Jarislowsky, the Montreal billionaire whose money management firm is SNC-Lavalin's single largest shareholder believed that SNC-Lavalin's current slate of directors provided inadequate oversight before the internal probe began. "We have a board that didn't keep its eye on things," Jarislowsky said. "The discipline was pretty loose".[83]

There were clear risks of bribery in certain countries SNC-Lavalin was operating in. In Transparency International's Corruption Perceptions Index 2011, Libya had a score of 2.0, placing it in 168th place out of 182 countries. It was placed in the lowest bracket of the most corrupt nations worldwide. Other countries involved in scandals associated with SNC-Lavalin included Tunisia with a placing of 73, and Algeria at 112.[84] Furthermore, companies had to rely on local agents to help secure work either by endorsing their services to potential clients or assisting with bid preparations.[85]

In SNC-Lavalin's annual "management information circular" for 2010, the company reported that seven of its 12 board members had claimed, on a grid of competencies, that "they know well the geographical regions where the company operates" and nine members had checked that "they have an international business experience". In the management information circular for 2011, it was stated that board members had participated in training sessions where 50 presentations were made on a number of projects worldwide. These sessions shared the global issues and acquisition strategies in specific countries such as India, Brazil, and Libya.[86]

It appears that there were ample opportunities for the board to raise its doubts. Unfortunately, despite the competencies of board members, continuous training and numerous red flags, the board failed to investigate the methods employed by the company to win large contracts in these markets, and did not follow up by implementing policies for restriction and supervision for bidding of contracts in said markets.[87]

In fact, former employees cited an environment at SNC-Lavalin which was extremely competitive, fractious, and was one that allowed top managers – such as Aissa – a lot of autonomy.[88] Former CEO Lamarre commented that Aissa "was a good achiever. You should see those projects over there. Real good achievements. These projects were all well-executed. He was a high achiever, and that is why he was able to abuse".[89]

Morgan, the former Chairman of the SNC-Lavalin board, wrote a commentary piece on how the Chairman and the board worked with extreme commitment and diligence only after the corrupt practices were brought to light to them by some members of the management.[90] Morgan had been a director of SNC-Lavalin since March 2005 and was previously the CEO of natural oil and gas producer Encana Corp.[91]

Morgan provided two main reasons as to why the wrongdoings could not be detected and prevented by the board in a timely manner. Firstly, the non-executive directors at SNC-Lavalin were not engaged in the day-to-day operations of the company and “must rely on information received from people within the company”. He further added that “When a small number of people deliberately set out to falsify documents, commit bribery and cover up theft, it can be exceedingly difficult to detect.”[92] Secondly, Morgan mentioned that separation of the board members and management duties was an extremely important corporate governance principle and thus “boards must trust management to be…trust-worthy and let management manage”.[93]

For a publicly traded corporation, there is a great likelihood that corporate governance is a mirage. From a distance, the board appeared to be the “decision-making and controlling body”, the “ultimate authority” over the company and its management.[94] However, in reality, it turned out that experienced independent directors, regardless of how stellar their biographies, were dependent on management for the required information, given the latter’s expertise and time devoted to the company’s business operations.[95]

Whistle-blower shrugged away

In December 2011, the board of SNC-Lavalin received an anonymous employee letter. It contained a string of significant but unsubstantiated allegations, including that the company had funnelled money through shell companies to the Gaddafi family.[96] However, Morgan downplayed the letter at the press conference after the company’s Annual General Meeting in May 2012. “I’ve run pretty major companies, and I’ve received anonymous letters before that have no credibility,” he said. “We did take note of it, certainly”.[97]

Bribery pays

Duhaime, the president and CEO of SNC-Lavalin from May 2009 to March 2012, was in the spotlight throughout internal investigations on US$56 million of company funds which had gone missing, paid to unknown agents on projects which did not exist. He received about C$5 million in various payments when he stepped down from his positions on 26 March 2012, including C$1.9 million in salary, two years’ worth of pension credit and approximately C$55,000 for professional development.[98]

Some shareholders such as the Caisse de dépôt et placement du Québec, had raised questions on why the company was paying senior management such significant amounts when police investigations and legal actions were still ongoing.[99]

In December 2012, these payments were suspended by the company on the grounds that Duhaime’s arrest on fraud charges on 28 November 2012 suggested that the board might not have been aware of all the facts when he resigned earlier that year.[100]

Ethics since Lamarre

The culture of corruption may have been bred in the company way before the unravelling of events in 2012. In the early 1980s, Lavalin had a difficult time winning contracts in Algeria. It was not until the company built a monument designed to commemorate the nation’s 20th anniversary of independence that projects started coming in. Lavalin's client contact then was a military commandant who one day asked Lamarre to name the strongest animal. After he suggested the white bear, the contact expressed his desire for one, to which Lamarre agreed to fulfil. Lavalin then jumped through regulatory hoops to secure two polar bears for his Algerian client.[101]

Gerard Seijts, executive director of the Ian O. Ihnatowycz Institute for Leadership at the Richard Ivey School of Business, highlighted that CEOs set the tone in their companies. He emphasised that "what they say, do, tolerate or sanction affects how others around them feel and behave".[102]

Furthermore, if things were thriving at SNC-Lavalin, executives understood Lamarre did not want to hear about how things got done. The former CEO was said to have "put his trust" in his people and was rewarded with "a more profitable and integrated company".[103]

Brief road to recovery…before the next fall

In the wake of its 2012 crisis, SNC-Lavalin revamped its executive suite, and recruited Robert Card to replace outgoing Duhaime as CEO. During his tenure from 2012 to 2015, his main role was to engineer a new approach to global ethics as a priority in the company, leaving behind its dark past where looser business development practices were tolerated, and even encouraged by previous management personnel.[104] His program included providing amnesty for employees to report offences and tying employee bonuses to ethical performance.[105] In addition, he introduced new business practices that barred the company from doing business in countries that occupy the bottom ranks of Transparency International's corruption rankings and banned the use of agents apart from in countries where agents are legally required.[106] Under Card, SNC-Lavalin also said that it had been improving efforts to impose strict ethical standards as well as monitoring and enforcement procedures following the corruption crisis. It also published full-page newspaper advertisements to explain the course of action undertaken to ensure there would be no more financial impropriety.[107]

Neil Bruce, who took over as president and CEO in 2015, continued to build on the legacy of ethical compliance and transparency that Card left behind during the company's post-scandal clean-up. In October 2016, SNC-Lavalin collaborated with global anti-bribery business association, TRACE International, to launch an anti-bribery and ethics awareness-raising campaign in South Africa. The campaign was targeted at small and medium-sized firms and multinationals in the region, and aimed to standardise anti-bribery compliance and business ethics.[108,109]

SNC-Lavalin, under the direction of CEO Bruce, also acquired Kentz Corporation Limited and WS Atkins in 2014 and 2017 respectively, which aimed to improve the company's revenue mix and margins.[110] Following the departure of Duhaime, the company had been revitalised and wholly transformed into a new entity, with a complete change of its top management and board of directors and reshaping of its business. The share price of the company increased from about C$40.00 in 2015 to C$55.00 in mid-2017, and then to a high of C$60.82 in mid-June 2018.[111]

However, this turnaround was short-lived. Following revelations by CBC Media, SNC-Lavalin soon became embroiled in another scandal that sent its share price plummeting.[112] What began as a plea for a deferred prosecution agreement (DPA) soon evolved into a full-blown political scandal involving the then ruling party of Canada – The Liberal Party led by Justin Trudeau.

Aid gone wrong

In February 2019, The Globe and Mail published an article, reporting that Prime Minister Trudeau's office had attempted to pressure Attorney-General Jody Wilson-Raybould to intervene in SNC-Lavalin's prosecution case.[113] Mario Dion, Canada's Ethics Commissioner further backed the claims against Trudeau, saying that the Canadian Prime Minister had misused the power of his office "to circumvent, undermine and ultimately attempt to discredit the decision" of both prosecutors and Wilson-Raybould.[114] In March 2019, the Organization for Economic Co-Operation and Development announced that it was "concerned" about the allegations of political interference and that it would monitor the ongoing situation to determine whether there was violation of an international anti-bribery convention by Canada.[115]

Initially, SNC-Lavalin lobbied for a DPA to avoid the 10-year ban on bidding for federal government contracts. The company received indirect support from Trudeau and his allies who supported a DPA for SNC-Lavalin.[116] However, the federal director of public prosecutors did not agree to that arrangement.[117] As Attorney-General, Wilson-Raybould had the final say on whether to negotiate a DPA. She could overrule the prosecution service and direct it to negotiate an agreement with SNC-Lavalin.[118]

In January 2019, during a cabinet reshuffle and after months of refusing to bend on the SNC-Lavalin case, Wilson-Raybould was moved into Veterans Affairs, which was widely seen as a demotion.[119] The Globe and Mail article reported that her lack of co-operation was one reason behind her change in portfolio.[120] In response, the Prime Minister's office emailed The Globe and Mail to assert that it had not directed Wilson-Raybould to draw any conclusions on the matter.[121]

Embroiled in allegations of violating ethics rules, Trudeau asserted that he had not tried to "improperly pressurise" the Attorney-General; the motive behind his action was simply to prevent retrenchment of the workers in SNC-Lavalin which would likely occur if the ban went through.[122] SNC-Lavalin – seen as Quebec's "crown jewel" – had a number of huge infrastructure projects in Canada and employed 9,000 people.[123] "My job as prime minister is to stand up for Canadians and defend their interests," said Trudeau in his defence.[124] However, he did apologise for the way things happened and took responsibility for his actions.[125]

Trudeau's victory

On receiving the news of Trudeau's election victory in the 2019 Canada elections,[126] SNC-Lavalin's shares jumped by 14%.[127] However, Ian Leslie Edwards, the most recently appointed president and CEO of SNC-Lavalin,[128] maintained that the company was not expecting any plea deal after the political win for Trudeau and the Liberal Party.[129] He stressed that SNC-Lavalin would be focused on defending itself through a court process.[130]

The new Attorney-General, David Lametti, refused to shut down the possibility of a DPA, which would lead to the charges against SNC-Lavalin being dropped in exchange for the company accepting responsibility for violations and accepting terms such as a monetary penalty and third-party monitoring.[131]

Putting the past behind

In December 2019, SNC-Lavalin agreed to plead guilty to fraud related to its work in Libya between 2001 and 2011 and pay a US$213 million fine.[132] SNC-Lavalin would also be subjected to a three-year probation whereby an independent monitor would ensure that the company is in compliance with ethics programmes. Under the deal, SNC-Lavalin Construction, one of SNC-Lavalin's subsidiaries, pled guilty to one fraud charge. In exchange, all other fraud and corruption charges against the parent company and its international marketing arm were withdrawn.[133]

Meanwhile, shareholders and employees of SNC-Lavalin had been spared from any more fallout. SNC-Lavalin's stock soared by 30% after the settlement was announced.[134,135]

CEO Edwards issued an apology for SNC Lavalin's "past misconduct" and called the settlement a "game-changer" as it would allow the company to move on from the fraud and corruption allegations.[136] SNC-Lavalin appeared to have dodged a bullet this time.

Discussion questions

1. SNC-Lavalin has been consistently recognised for having a good corporate governance structure. Discuss whether a good corporate governance structure may just be a facade.
2. What do you think were the major contributory factors to the series of scandals in SNC-Lavalin? To what extent did corporate culture play a role? Were weaknesses in the four lines of defence to blame? Explain.
3. The board of directors generally has a supervisory role and provides support for management. Are these roles conflicting? How can a board balance these roles? What do you think the SNC-Lavalin board should have done differently to prevent these scandals?
4. In SNC-Lavalin's case, the board was said to have strong competencies and also received extensive training, including about its projects, global business and acquisition strategies. Why did the board still fail to act?
5. Early warning signs and red flags, in the form of unusual activities or transactions, often point to the possible existence of corruption, unethical practices or fraud. To what extent do you think SNC-Lavalin's board should have been able to detect and prevent such irregularities?
6. In 2013, SNC-Lavalin launched an "amnesty program" to encourage employees to help root out corruption. Evaluate the usefulness of such a program in SNC-Lavalin. If introduced earlier, could it have helped the company to avoid its bribery scandals? Discuss.

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THOMAS OVERCOOKED IT

Case overview

On 23 September 2019, Thomas Cook Group plc (TCG) went into compulsory liquidation with immediate effect, leaving 21,000 jobs at risk and 150,000 U.K. holidaymakers stranded abroad. The abrupt end to the British travel group's 178-year history came after rescue talks between banks, shareholders and the U.K. government fell through dramatically. Faced with disruptions from online travel-related services and low-cost airlines, TCG failed to keep up with the changing modern business and leisure international travel market. Compounded by a series of poor merger and acquisition (M&A) and financing decisions from 2007 to 2019, TCG's fate was all but sealed when the debts eventually piled up and proved unsustainable.

The objective of this case is to facilitate a discussion of issues such as business model; role of the board directors in dealing with disruption; responsibilities of directors in M&A decisions; board competencies, financial management; risk management; remuneration; and the role of auditors.

Not enough runway

"We have worked exhaustively in the past few days to resolve the outstanding issues on an agreement to secure Thomas Cook's future for its employees, customers and suppliers. Although a deal had been largely agreed, an additional facility requested in the last few days of negotiations presented a challenge that ultimately proved insurmountable."

– Peter Fankhauser, Chief Executive Officer of Thomas Cook[1]

As Peter Fankhauser made the official statement announcing the liquidation of Thomas Cook Group plc (TCG) on that fateful Monday morning, he apologised to all of TCG's employees, customers, and suppliers. Months in the making, TCG's rescue had appeared likely with its top investor Fosun Tourism Group (Fosun), the Chinese owner of the Club Med resort chain, leading a £900 million rescue deal for the troubled Group. Unfortunately, when other lenders sought additional capital injections amounting to £200 million, TCG made a final plea for help from the U.K. government only to see it turned down.[2] The news reverberated swiftly across the global community and left 21,000 employees with their jobs at risk as well as 600,000 U.K. and non-U.K. customers stranded around the world.[3]

As the Civil Aviation Authority (CAA) scrambled to begin Operation Matterhorn, the sheer scale of the repatriation plan dawned upon all involved. TCG's collapse was the largest corporate

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failure of a British holiday package company and proved more challenging than that of Monarch Airlines' rescue operation back in October 2017. Monarch Airlines, which was the U.K.'s fifth-biggest airline then, required CAA to charter 34 aircraft to bring about 110,000 Monarch Airlines customers back home.[4,5]

Pioneer of modern tourism

Founded in 1841 by Thomas Cook, TCG was one of the oldest travel agencies in the world. Cook first conceived the idea of industrialised railway tourism from outings for members of the local temperance movement.[6] By 1855, the company offered a holiday "package" for the first time, which included travel, accommodation and food all within the fare. The brand became well-known over the years, along with its tagline: "Don't just book it – Thomas Cook it!"[7]

The business thrived in the early years. Although Cook was not the first to invent travel packages and guidebooks, he was a pioneer in tourism. These ideas were propagated and made ubiquitous in the region due to his efforts,[8] using his talents as a printer to print travel advertisements, guidebooks, and train timetables.[9] The Thomas Cook European Rail Timetables, published since 1873, were regarded as the sacred bible for European train travelers for many decades before its final copy was issued in August 2013.[10] Furthermore, Cook empathised with the drudgery experienced by the working and lower middle class people, motivating him to provide affordable leisure travel to help them explore a world beyond books and readings.[11] By 1888, Thomas Cook & Son Ltd had established offices in various countries.[12] Since the 1920s, however, the company ceased to be a family-run business when Thomas Cook's grandsons sold the company to investors.[13]

The growing up years

In 1997, German airlines Deutsche Lufthansa AG (Lufthansa) and German retailer KarstadtQuelle AG (KarstadtQuelle) merged their subsidiaries – Condor Airlines and Neckermann-Urlaubs-Reisen GmbH – to form Condor & Neckermann Touristic AG (C&N). Four years later, in 2001, C&N acquired Thomas Cook and adopted the Thomas Cook brand name. The newly formed company was called Thomas Cook AG. As a result of this acquisition, Thomas Cook AG became jointly owned by both Lufthansa and KarstadtQuelle.[14,15]

In the following years, Lufthansa planned to shed its non-core businesses, which led to the deal with KarstadtQuelle in December 2006 to sell its 50% stake in Thomas Cook AG for €800 million.[16] Thereafter, Thomas Cook AG was wholly owned by KarstadtQuelle.[17]

As mentioned in KarstadtQuelle's financial report in 2006, Thomas Cook AG was successful because of its ability to "increasingly operate a highly flexible business model with the lowest capital tie-up (asset-light model)". It stated that it intended to pursue the same asset-light approach and focus on Thomas Cook AG's participation in the consolidation of the markets in Europe. It added that the drivers of organic growth were the opening up of new markets, the accelerated expansion of new sales channels such as online platforms, as well as innovations such as financial services.[18]

Going against its "asset-light" strategy that was proposed by the board of the holding company, Thomas Cook AG went ahead with an asset-intensive strategy by merging with MyTravel Group plc (MyTravel) to form Thomas Cook Group plc (TCG) in 2007.[19]

The Group defended its strategy during its announcement of the potential merger with three reasons. Firstly, Thomas Cook would be listed on the London Stock Exchange and its value will be "adjusted upwards" by applying higher multiples typical of the market. Secondly, to gain synergies worth a "three-digit" million amount due to the merger, and lastly, to utilise MyTravel's losses carry-forward amounting to €1.2 billion.[20]

The stock market viewed the merger as a positive one as the price of MyTravel rose by more than 30% in the London Stock Exchange following the merger announcement, while that of KarstadtQuelle increased by 4.2% on the Frankfurt Stock Exchange.[21] In its merger procedure note, the European Commission which reviewed the deal also mentioned positive outcomes from the deal.[22] Upon the completion of the merger, Fontenla-Novoa, then Chief Executive of the Thomas Cook division, was to head the newly merged company, TCG.[23]

In the early 2000s, Thomas Cook AG began its venture into the airline business. By 2003, it began operating its own airline, Thomas Cook Airlines. Even though the travel company was successful in its operations back then, the lessons learnt from managing a travel agency did not necessarily apply to the operations of the aviation industry. In fact, many experts pointed out that the decision to go into the airline business was the primary source of the company's problems, resulting in its eventual collapse.[24]

Rise of the internet

The turn of the new millennium posed new challenges for the age-old business. A travel agency's business model largely depends on segregating the individual aspects of tourism before packaging them into one comprehensive travel package. However, with the rise of the internet, increased ease of online booking and emergence of a "sharing economy" fueled the 'do-it-yourself' travel model. The need to rely on travel agencies subsequently decreased.[25,26]

Yet, TCG remained committed to its business model of significant retail presence and was shackled to expensive operating costs from its 560 high street outlets. It was unable to compete in terms of price with budget airlines such as Ryanair and EasyJet, as well as low-cost "sharing-economy" accommodation options like Airbnb, which operate solely through online booking.[27]

Furthermore, with the expansion of online travel communities, individual travellers began sharing extensive travel-related information with one another, further reducing the relevance of travel agencies, which had traditionally been the primary source of such travel-related expertise.[28]

By 2019, only one in seven travelers would purchase a holiday through a brick-and-mortar travel agency, according to U.K. travel trade association ABTA. Those who do tend to be above 65 years old and from lower socio-economic groups. TCG faced a continually shrinking market segment comprising older age groups, without capturing new segments as younger individuals shied away from travel agencies.[29]

Expensive mergers that failed

To combat falling revenues, Thomas Cook underwent two major mergers.

In 2007, Thomas Cook AG merged with MyTravel to form TCG. With the merger, MyTravel Airways merged with Thomas Cook Airlines under the latter's brand. TCG would hence be able to further expand its operations as a travel company, further marketing itself as a one-stop-shop travel agency which could book flights, hotels and tours for travellers.[30]

Thomas Cook AG had expected the merger to create a European travel giant, producing £75 million in cost savings annually.[31] However, MyTravel only reported its first annual profit in the year ended 31 October 2006 with a pre-tax profit of £43.8 million, after a streak of losses from 2001.[32] This followed a £17.4 million loss in 2005.[33] The profit was not expected to persist as MyTravel warned that future conditions remained challenging for the industry, and cost-cutting was the main reason behind 2006's profit.[34] The nail in the coffin came in May 2019 when TCG wrote off over £1 billion of goodwill from the MyTravel merger.[35]

In October 2010, TCG, led by then-Chief Executive Officer (CEO) Fontenla-Novoa, decided to merge with The Co-operative Group (Co-op) to create the U.K.'s largest high street travel agency, with TCG owning 70% of the shares.[36] The rationale behind the merger was cost savings and consolidation.[37] TCG and Co-op each brought with them 803 and 401 shops respectively,[38] creating a 1,200-strong retail chain at a time when more travel bookings were made online.[39] The merger meant that TCG had multiple shops in some towns, sometimes two or more on the same street.[40] With a long history of co-operation and overlap between TCG and Co-op, the merger would have made commercial sense, if not for the fact that the traditional travel industry was in decline.[41]

CEO Fontenla-Novoa acknowledged in 2010 that online distribution was fast-growing and claimed that TCG was developing an online travel agent system to participate in the trend. However, he believed that offline distribution would remain an important channel, citing industry data that predicted that offline distribution could continue to account for up to 70% of total sales in 2014.[42]

In 2016, despite its growing level of debt, TCG bought out Co-op for £55.8 million and took full control of the business, owning 764 high street stores.[43] Ironically, since creating the largest high-street chain in the U.K., TCG had been trying to shed stores and jobs.[44] It also developed its online booking platform. By 2018, online booking accounted for 48% of TCG's bookings, versus 22% in retail, and 30% through third parties.[45]

More troubles

Besides structural disruptions in the travel industry, other external events worsened TCG's problems. In 2016, Turkey experienced political unrest which eventually led to an attempted presidential coup, and therefore a pronounced downturn in tourist numbers.[46] In 2019, the company also said that, in view of the uncertainty around Brexit, British customers were postponing travel plans for the summer due to the drop in sterling's purchasing power abroad.[47] The climate crisis also weighed down on TCG. In May 2018, a Europe-wide heat wave reduced holiday demand sharply, as more European holidaymakers opted to stay at home.[48]

Piling up of debts

TCG's financial troubles had begun as early as 2007, when the merger with MyTravel raised the Group's debts to £249 million.[49] In 2009, it issued the first of a series of profit warnings.[50] By 2010, TCG's net debt had risen to £804 million.[51] By the autumn of 2011 – shortly after the merger with the Co-op, TCG sought a £100 million extension from lenders to see it through winter that year.[52] TCG's debt had risen to £1.1 billion then.[53]

Fontenla-Novoa left TCG in August 2011 with a £1 million pay-off, following three profit warnings in a year.[54] In July the following year, Harriet Green was brought in to salvage the company. Green's turnaround strategy included reducing the number of shops and staff, and getting rid of non-core businesses.[55] During her tenure, profits rose, debt started to come down, and the share price rose from 14 pence to over 130 pence.[56]

However, two years into Green's initial six-year plan, she resigned, saying her work at the travel firm "is complete". There were allegations that TCG's board had dismissed her,[57] having felt that Peter Fankhauser – Green's successor – was better suited to run the business. Prior to taking on the role of CEO, Fankhauser was the company's Chief Operating Officer. The news of Green's departure triggered a 17% drop in TCG's share price.[58]

Under CEO Fankhauser, TCG focused on high quality rather than cost-cutting, and bought several hotels in an attempt to improve margins.[59]

Due to pressure from debt, TCG stopped paying dividends to shareholders in 2011, but resumed in 2017 and 2018, despite a lack of improvement in its financial position.[60] TCG explained that the dividends declared in 2016 and paid out in 2017 reflected a confidence in the strategy and a second consecutive year of profits, despite the impact of terrorism and Brexit.[61] Fankhauser said, "It is modest but it is the first we've paid in five years and it is a milestone for the business. In what's been a difficult year for tourism, it feels like Thomas Cook has come a long way in the last 12 months."[62] Pre-tax profit that year decreased to £42 million, from £50 million a year earlier, while revenue remained mostly constant at £7.8 billion.[63]

In February 2019, TCG was in talks to sell its airline business to reduce debts. The airline business had a 3.7% operating margin, compared to TCG's own-brand hotels with a 14% margin. The airline business was valued at between £1 billion to £3.2 billion, which was sufficient to repay the debts that mounted to £1.6 billion in end-2018.[64]

However, the downside of selling the airline business was that TCG would have to enter into a contract with the new airline owner to continue providing flights for TCG's holidaymakers, which would have a negative impact on profits. Moreover, TCG would become a pure tour operator in a price-war zone, as rival TUI Group indicated its intention to lower prices to protect its market share in early 2019.[65]

After putting its airline business up for sale, TCG would look to improve the performance of its tour operator division by shutting down stores, improving its digital offering, and expanding its own-brand hotels to improve margins. In July 2019, analysts at Jefferies thought the execution risk to implement these strategies was high because of TCG's vulnerable financial position that was heavily influenced by underlying demand.[66]

The collapse

In August 2019, TCG appeared to have staved off liquidation as its main shareholder, Fosun, the parent conglomerate owning family holiday business Club Med, led a £900 million funding package in a rescue deal. The deal would have seen Fosun take control of 75% of the tour operator business and 25% of its airline business, in return for a capital injection of £450 million. The remaining amount of £450 million would be provided by TCG's creditor banks and bondholders in exchange for 75% of its airline business and 25% of the tour operator business, converting its existing debt into equity. [67,68]

However, creditor banks put in a last-ditch request for an additional underwritten funding of £200 million in return for their support.[69] Despite scrambling to negotiate with creditors, the rescue deal collapsed, along with TCG, on 23 September 2019.[70] TCG then took its first steps into compulsory liquidation with immediate effect.[71]

Should Downing Street have intervened?

The British government was approached by TCG for a bailout days before its eventual collapse. A subvention of approximately £250 million had been requested, and the government was under tremendous pressure to continue talks due to the potential fallout from TCG collapse. Thousands of U.K. holiday-goers would suddenly be abandoned all over the world.[72,73]

U.K. Prime Minister, Boris Johnson, said that the amount requested was substantial taxpayers' money and utilising public funds for commercial purposes would have constituted a serious moral hazard. On the other hand, he promised full support for all stranded travelers if the situation arose. U.K. Transport Secretary also downplayed the practicability of providing the funds, which would have only prevented TCG from going under temporarily, as chances of a commercial turnaround was unlikely.[74]

Downing Street had previously refused assistance to other companies such as Carillion, then the second largest construction company in the U.K., on similar grounds.[75]

The trio of CEOs

TCG's former CEOs oversaw the transformation of the private company to a pan-European FTSE 100 Group. While the collapse of TCG was partly attributable to external factors, the former CEOs inevitably contributed to the company's downfall.[76]

Too "Manny" deals: Manny Fontenla-Novoa (July 2007 – August 2011)

"I just believe [in] the major decisions I got them right and I'm sorry the way it turned out."

– Manny Fontenla-Novoa, former TCG CEO[77]

Fontenla-Novoa was the CEO of TCG from July 2007 to August 2011. During his time as CEO, he led the £1 billion merger with MyTravel that led the company to its public listing. TCG hence transformed from a private company into a public group with the scale to compete with online rivals and low-cost airlines.[78] However, the joy was short-lived. Within weeks there were news of the merger of two of the best-known names in the U.K. travel industry. TUI Group, a German travel group, merged its tourism operations with First Choice Holidays Limited, and the newly formed company would be listed on the London Stock Exchange. The new company aimed to invest heavily in online operations as the dynamics of the industry evolved with the rise of the internet.[79]

In 2010, Fontenla-Novoa led TCG to acquire Co-op in a deal that was said to be overpriced. Despite the issues that these acquisitions brought to TCG, analysts noted that TCG would have been subscale and would potentially lose market share without them. Fontenla-Novoa left TCG in 2011 after three profit warnings, with the company saddled with a net debt of £891 million at the end of 2011 and annual interest charges amounting to £122 million. This was the beginning of the mounting debt that was said to have ultimately crippled TCG.[80]

"Greener" pastures: Harriet Green (July 2012 – November 2014)

"I believe that all of those actions, if allowed to continue would have positioned Thomas Cook very viably for the future."

– Harriet Green, on being ousted two years into her six-year turnaround plan[81]

The next in line was Green, who led TCG from July 2012 to November 2014. Green was the only female CEO the Group had and was the only CEO who did not have a background in the travel sector. She was said to have inherited "three profit warnings, a huge wall of debt, and a business model that was entirely out of sync with the industry" when she took over the reins.[82]

Green's reputation as a turnaround specialist was soon evident. She aggressively cut £500 million in costs – partly through removing 2,500 jobs – and bolstered TCG's balance sheet. She managed to bring shareholders onside but was heavily reliant on advisers despite the tight margins TCG faced. This was evident from the £180 million consultancy fees in the 2013 and 2014 accounts, which fell to £35 million in 2015 after her tenure as CEO ended.[83] Her tenure at TCG brought the company's value from an estimated £150 million to £2 billion.[84]

Despite turning around TCG from a loss of £398 million in 2011, the board felt that Green should step down with immediate effect and be replaced by Fankhauser in November 2014.[85] This was to allow the Group to "return to a more traditional travel leadership" after Green had focused on digitisation so as to cater to the younger market segment and to reduce the company's debt.[86]

"But don't forget, there is a team here, it's Thomas Cook that makes the strategy. Not just one individual can do that. Of course, she's the face, but maybe everything behind that face is unchanged."

– Chairman Frank Meysman on Green's departure[87]

Apologetic CEO: Peter Fankhauser (November 2014 – September 2019)

"I worked tirelessly for the success of the company and I am deeply sorry that I was not able to secure the deal. It was not one-sided that I failed. There were multiple parties who had to contribute to the deal which finally then did not succeed."

– Peter Fankhauser, on the collapse of TCG[88]

Fankhauser was next, serving as CEO from November 2014 till the company's collapse in September 2019. He was said to have inherited "the most complicated simple business", according to someone close to the liquidation process. TCG's profit of £23 million in 2015 turned into a loss of £163 million in 2018. With £150 million annually set aside for servicing the company's debts, Fankhauser had little capital for turning the business around.[89]

Fankhauser managed to reduce the number of shops from over 1,200 to 580. However, the remaining shops required refurbishment which TCG could not afford. Additionally, the shops on high street contributed to 40% of the seats on their airline, hence closing them was not straightforward. Despite having a strategy, Fankhauser admitted that it was not carried out fast enough. If given another chance, Fankhauser said he would have been more brutal.[90]

Fankhauser's attempt to revive TCG brought £200 million into the business through a £150 million hotel joint venture with investment company LMEY. This deal also enabled TCG to enter the China market through a partnership with shareholder Fosun. Yet, this was still insufficient to bring in profit primarily due to external factors beyond the company's control. In February 2019, TCG began looking for bidders to buy over its airline business. As the bids were not high enough to reduce the £1.2 billion debt, TCG began working on a final rescue plan.[91]

What about the board?

"The Group currently faces a number of significant challenges, but in the medium to longer-term we will be well positioned to build shareholder value on the back of premium brands and a fine heritage in the U.K. as well as internationally."

– Frank Meysman, Chairman of TCG[92]

An overrated Chairman?

Frank Meysman took on the role of TCG's Chairman in 2011. Given Meysman's international experience working in major companies such as Procter & Gamble, Douwe Egberts, and Sara Lee, his position was welcomed by those who felt the need for new blood in the board of TCG given the company's poor performance.[93]

Meysman's appointment was also supported by existing directors of TCG. The outgoing Chairman Michael Beckett said that "his experience and knowledge of international markets will be valuable to the Group in the future". Roger Burnell, an independent director said: "Frank's successful international executive career, coupled with his experience as a non-executive director and Chairman makes him an excellent choice for Thomas Cook."[94]

Following his appointment, Meysman began his search for TCG's next CEO after Fontenla-Novoa stepped down and Sam Weihagen was appointed as interim Chief Executive. Meysman overhauled the board, oversaw three refinancing deals in a year and rejected a £400 million rights issue proposal by shareholders and travel industry veterans in 2012. Green, who was without experience in the travel industry, was subsequently appointed as CEO in 2012.[95] Green apparently secured the position by cold-calling Meysman and telling him that "[he] needed her".[96]

After he took on the role as Chairman, Meysman had said that he did not care that former CEO Fontenla-Novoa had earned millions before leaving TCG despite profit warnings during his tenure. He told a BBC radio programme in 2012, "I don't know and I don't care because I wasn't there."[97]

A former TCG managing director John McEwan felt that Meysman should be responsible for the collapse of TCG given that TCG was "on [his] watch and therefore [he has] to take some responsibility for what has happened" regardless of whether the circumstances that caused the collapse were attributable to Meysman.[98]

Meysman was also accused of showing "very little remorse" and "contemptible arrogance". Meysman defended himself saying he was devastated by the collapse given his commitment to TCG which lasted almost a decade, and that it was "a gross mischaracterisation" to suggest that he was not sorry that the efforts were unsuccessful in preventing TCG's collapse.[99]

Members of the board

As at FY2018, the TCG board consisted of 11 members, including Non-Executive Chairman Meysman, two executive directors, and eight non-executive directors.[100]

The two executive directors were CEO Fankhauser and Chief Financial Officer (CFO) Bill Scott. Scott was only appointed to the board in January 2018, having replaced his predecessor, Michael Healy as CFO from 1 January 2018. He has extensive experience in financial planning and reporting, having previously undertaken senior finance positions in other companies. However, Scott stepped down from the board on 30 November 2018, less than a year from his appointment as CFO.[101]

The non-executive directors included Martine Verluyten, Chairman of the Audit Committee; Warren Tucker, Chairman of the Remuneration Committee; and Emre Berkin, Chairman of the Health Safety & Environmental Committee. Meysman was the Chairman of the Nominations Committee. Meanwhile, Dawn Airey was the Senior Independent Director.[102]

Verluyten was appointed to the board in May 2011, and was previously CFO of Umicore and Monistar and has significant experience in audit. Apart from chairing the Audit Committee, she also was part of the Nominations Committee. Tucker, a chartered accountant, has prior experience in the travel industry, including senior finance positions in British Airways plc. He was also part of the Audit Committee. Berkin, a Turkish national, was valued for his in-depth knowledge on low-cost airline business operations, as well as his expertise in key destination markets such as Turkey. He was part of the Nominations Committee as well.[103]

Apart from non-executive director Lesley Knox, who was a member of the Audit Committee, Remuneration Committee and Nominations Committee, all other board members were only part of a maximum of two of the four board committees. Knox is said to have a strong financial services and international background, as well as significant non-executive director experience in U.K. listed companies.[104]

A "rubber stamp" board?

Aggressive acquisitions

From 2007 to 2011, the board approved acquisitions that resulted in the Group incurring long-term debt of approximately £1.1 billion.[105] These included unprofitable deals such as the merger with MyTravel. In 2010, TCG's deal with Co-op further increased the number of physical stores owned by TCG, despite a sizeable portion of its clientele moving online.[106] This deal saw TCG acquiring more shops than required and eventually cost TCG another £82 million to shut down.[107] TCG hence moved from having net cash of £394 million to a net debt of £900 million from September 2007 to September 2011.[108] The company was unable to settle its debt burden of £1.1 billion that almost led to its collapse in 2011. The non-executive directors did not challenge the decision to take on the debt during the early years of the company.[109]

Failure to reduce debt

Should the board have paid more attention to balance sheet prudence in the face of management bluster? In light of situations such as the ash clouds from an Icelandic volcano in 2010 and the Arab Spring in 2011, should the board have pushed harder to reduce the company's debts?[110]

TCG managed to achieve a tenfold increase in share price in 2013. However, the Group did not actively reduce its debt levels. Two years later, when things were looking up, and in 2018 when the company achieved a £2 billion valuation, there was no fundraising to reduce borrowings which would have helped improve the financials.[111]

The implemented debt reduction plan of £100 million a year in late 2017 and early 2018 hinged on the continued progress in operations. Other debt-reduction measures the board oversaw such as a £425 million placement and rights issue in 2013 and the sale of £350 million worth of businesses were also insufficient to reduce the debt to manageable levels.[112]

The board had to decide on the long-term funding risk it was willing to accept. However, in 2018, with TCG's borrowings amounting to over £1 billion, its refinancing options closed.[113] Its final attempt to save TCG failed as lenders demanded an additional £200 million as a contingency before they committed, and the rescue plan fell through.[114]

Lack of clear strategy in dealing with industry disruption

TCG announced on 1 March 2013 the formation of a new digital advisory board. This was to aid management with the identification of "the leading-edge trends for online businesses".

The advisory board consisted of then-CEO Green, together with other senior leaders of TCG and external digital experts to help TCG adapt to the changes brought about by digitisation. However, due to cash shortfalls and internal disputes, this attempt eventually failed.[115]

John Straw, Chairman of the digital advisory board, highlighted that TCG's retail and e-commerce segments were in direct competition as they were treated as separate entities with separate profit and loss statements. TCG also faced problems such as the lack of a customer relationship management software and an outdated IT system running on a programming language developed in the 1950s. This meant that TCG required money and time to be able to compete with its industry rivals. However, short-term considerations took precedence and the plans were eventually shelved.[116]

Earlier in 2010, there were also plans by TCG's e-commerce advisor, Simon Breakwell, to transform TCG into a top-three player in the online travel agency market, earning a revenue of between £400 million and £450 million. These plans were derailed by then CEO Fontenla-Novoa's acquisition spree which badly affected the financials.[117]

The collapse of TCG was arguably not inevitable even though the industry was facing massive disruption, given the success of its business rival, TUI Group.[118]

Risk mis-management?

TCG's risk management was driven by its six strategic priorities – care, contact, holidays, services, partnership, and efficiencies. Each principal risk identified was linked to one or more strategic priorities. As at 2018, there were 12 principal risks identified. The direct cause of TCG's downfall – its inability to meet the debt obligations – was listed as the eighth principal risk called "cash and working capital", and linked to only one strategic priority, "efficiencies". TCG recognised that its "cash and working capital" risk was rising compared to 2017. Mitigation measures for this risk included refinancing a £400 million bond at lower cost, extending the debt maturity profile, issuance of a new bank facility, and operational savings from consolidating technology systems and harmonising processes.[119]

The fundamental external contributor to TCG's downfall – industry disruptions – was listed as the fourth principal risk called "digital strategy". TCG recognised that the inability to develop digital channels to meet changes in consumer behaviour would adversely affect its market share, profitability and future growth. Mitigation measures included developing its web and mobile channels, and regularly undertaking customer research to understand consumer behaviours.[120]

Similarly, as early as 2010, TCG identified "fall in demand for traditional package tours and competition from internet distributors and low-cost airlines" as a risk.[121] TCG's mitigation measures at that time included establishing TCG as a leading provider of independent travel and financial services, and improving online capabilities.[122] Independent travel refers to the traveling style where consumers build up the individual components of their own trip.[123] TCG also recognised that the dynamic nature of independent travel made the online environment ideal for travel research and purchases.[124] Its independent travel business entailed selling flights, hotel rooms, car hire and train tickets separately to customers.[125]

Anger from the public

After the demise of TCG, there was considerable criticism from the public and government officials about what they viewed as excessive remuneration, and the British government ordered a probe into the role of TCG's management in its collapse.[126] U.K. Prime Minister Boris Johnson even criticised the directors for paying themselves large sums of money while the company went "down the tubes" and there were calls for TCG's directors to return their bonuses.[127] Between 2014 and 2018, the company's shareholders approved over £20 million of director remuneration. During that same period, TCG had two CFOs who received £7 million in total while its non-executive directors collectively received £4 million.[128]

Creative remuneration policies?

Over the course of the 12 years preceding TCG's collapse, the three Chief Executives received more than £35 million in remuneration. Fontenla-Novoa had received over £17 million during his eight years at the helm. Green earned £4.7 million, excluding a £5.6 million share bonus, in less than three years. In the final four years of the company, Fankhauser was paid £8.3 million, out of which £4.3 million was in the form of bonuses.[129]

In 2017, the bonuses received by Fankhauser were 117% of his base salary, which amounted to £836,596. His total remuneration was over £1.5 million, compared to the company's 2017 accounting profit of £12 million.[130]

TCG's Remuneration Committee had a policy which ensured that "performance measures in the incentives plans reflect the key performance indicators (KPIs) of the business". There were three components in executives' remuneration – fixed pay, annual bonus and a performance share plan (PSP). The annual bonus paid out at 60% for on-target performance, based on maximum eligibility of 150% of base annual salary while the PSP was a conditional award of shares in TCG and would vest to the satisfaction of stretching performance conditions measured over three years.[131]

Under TCG's remuneration policy, the KPIs on which management's bonuses would be determined included Group Underlying Earnings Before Interest and Tax (EBIT) (35%), Group Free Cash Flow (35%), Net Promoter Score (15%), Employee Satisfaction (5%) and Strategic Progress on the New Operating Model (10%).[132]

The truth behind TCG's "performance-related remuneration"

What was not clearly disclosed in the annual report was how non-standard accounting figures used to assess the KPIs were arrived at. TCG's usage of controversial accounting methods cast doubts on its financial performance as well as brought to light issues with the way management was being compensated for achieving certain KPIs. Finance costs and 'exceptional items', such as write-downs and one-off costs, were omitted from the calculation of 'underlying EBIT'. This had been the company's practice for over eight years, flattering the company's financial results.[133] For example, in 2017, given the size of the finance costs from prior mergers and acquisitions, the bonus was awarded on the basis of ‘underlying EBIT’ (constant currency) of £312 million, while the accounting net profit after tax was only £12 million.[134]

Were the auditors to blame?

Days after the downfall of TCG, the Financial Report Council (FRC), the U.K.’s audit watchdog, disclosed that the Business, Energy and Industrial Strategy Committee (BEISC) of the U.K. Parliament will look into the role of TCG’s external auditor, Ernst & Young (EY). PricewaterhouseCoopers (PwC) was also embroiled in the controversy as it was TCG’s external auditor for nine years before EY took over in 2017. Both EY and PwC were criticised for repeatedly signing off the company’s financial statements with clean opinions despite raising concerns about certain accounting policies and material risks that were threatening the financial viability of TCG. Some members of parliament had accused the two firms of contributing to TCG’s failure.[135,136]

Questionable goodwill

“Deterioration in the U.K. business in the first half of 2019 was so strong that the arguments used to keep goodwill in the books for 2018 could not be kept – and that’s why we had to revisit the goodwill calculation.”

– Sten Daugaard, former CFO of TCG[137]

TCG’s intangible assets amounted to 70% of TCG’s total non-current assets, and goodwill made up 85% of the intangible assets. From 2007 to 2018, the ratio of goodwill to market value of the company was almost consistently greater than two times. During this period, the cumulative net losses amounting to just below £2.8 billion, with net income being negative for seven out of 13 periods.[138]

There had been little impairment for goodwill since 2012 because the auditors, PwC and EY, were satisfied that TCG’s cash flows and business plans were able to justify the amount of goodwill. In 2018, this position was based on assumptions contained in TCG’s plan of constant growth in EBIT of 28.3% from year one to year four. By the end of September 2018, goodwill of £2.6 billion accounted for 39.4% of TCG’s assets on the balance sheet.[139]

In May 2019, goodwill was finally impaired to the tune of £1.1 billion, resulting in negative equity of £1.35 billion.[140] The question is: why was goodwill not impaired earlier?

In defending the accounting treatment for goodwill, Martine Verluyten, then Chairman of the Audit Committee, said: “When we took a look at all the forecasts [in 2018] and all the information we had at that point in time, we felt that it was OK to leave the goodwill as it was.” The former CFO, Sten Daugaard, also said that the write-down of the goodwill just a few months later, in mid-2019, was a “reflection of how fast the business in the U.K. deteriorated”.[141]

Conflict of interest

The BEISC raised questions about conflict of interest for EY and PwC. PwC was challenged about its dual role as external auditor and adviser to the company's Remuneration Committee. As the auditor, PwC had to audit the allocation of exceptional items. However, at the same time, it was advising on remuneration schemes that would protect the management from exceptional loss items.[142] In response, PwC said: "The non-audit work as advisers to the remuneration committee, which ceased in 2009, was approved in advance by the audit committee, complied with all relevant regulatory standards and was disclosed in the company's annual reports."[143] The head of audit at a rival firm to PwC said: "Regardless of the rules, I'd have felt really uncomfortable offering remuneration advice to an audit client. I've never done it and I wouldn't ever do it."[144]

Rachel Reeves, the Chairman of the BEISC said that PwC should have stood its ground on the allocation of large exceptional items even though the management took a different position. Overall, PwC earned a total of £21 million for the non-audit services provided while simultaneously being engaged as TCG's auditor.[145] Meanwhile, EY was paid a total of £7 million for its role as auditors and consultants over two years.[146] EY provided an "independent review" of the benefits policy that led to a supplementary bonus paid to then-CEO Fontenla-Novoa in 2008.[147]

Going concern

According to Hemione Hudson, the head of audit at PwC, there was "considerable debate and challenge of the board" of TCG during PwC's appointment as auditor between 2007 and 2016. Hudson also mentioned that PwC had a "significant issue" with TCG as a going concern, which resulted in a delay in signing off its accounts. However, as TCG was able to obtain a £200 million financing from banks after 2011 – when PwC challenged the going concern basis of the company – the auditors agreed to sign it off as a going concern.[148]

EY was also questioned for signing off TCG as a going concern in March 2019 when the company had accumulated £1.6 billion worth of debt. In response, EY audit partner, Richard Wilson explained that the considerations for going concern was made after determining that TCG's lenders were still providing support to the company. The decision to sign off as a going concern was reached after the banks had committed in writing to a further £300 million loan.[149]

Exceptional items

TCG's accounts were also scrutinised over the use of exceptional items. When used correctly, the use of exceptional items is a way in which a company can separately disclose one-off charges to more accurately reflect its underlying performance. Both PwC and EY further disclosed that they challenged TCG's management about the practice of classifying certain expenses as 'exceptional items' and recommended that the process of identification and approval of separately disclosed items should be improved.[150]

For example, in the presentation of the income statement per the FY2016 annual report, ‘exceptional items’ amounting to £126 million are disclosed separately in a separate column from ‘underlying results’, which gives investors an impression that the company is doing well in view of the ‘underlying results’ figure of £168 million.[151] PwC’s 2016 year-end report to the Audit Committee clearly stated the items which were “separately disclosed” in the FY2016 annual report, which included £70 million of reorganisation and restructuring costs, as well as £16 million worth of onerous leases / contracts and legal disputes.[152]

Because of the separate disclosure of such ‘exceptional items’, TCG’s adjusted profits had been “flattered” and did not reflect the true nature of its financial performance. Such adjusted profits were then used to calculate management’s bonuses as they were contingent on – amongst other KPIs – the “Group underlying EBIT”, which was defined as “Earnings before interest and tax excluding exceptional items measured on a constant currency basis” in TCG’s annual report.[153,154]

Over eight years, a total of £1.8 billion worth of ‘exceptional items’ were excluded from reported accounting income. The inflated numbers were not only used to calculate executives’ bonuses but also for determining compliance with banks covenants.[155,156]

After EY took over as TCG’s auditor in 2017, it “warned that Thomas Cook could not go on disclosing costs as separate exceptionals” and insisted on the reclassification of £28 million of ‘exceptional items’ related to the transformation of the business and airline disruption as ‘non-exceptional’,[157] which subsequently resulted in a profit warning.[158] EY said it also voiced its concerns over the practice of signing off the ‘exceptional items’ when it first took over as TCG’s auditor in 2017.[159]

Epilogue

With its collapse, TCG joined the growing list of large U.K. corporate failures in recent years, which include Carillion, Patisserie Valerie and BHS. These failures have set off alarm bells and raises questions about audit quality in the U.K. Some major reforms relating to audit have been introduced in the U.K., including the most recent operational separation of the audit units in the major accounting firms to improve audit quality[160] and the creation of a new, more powerful regulator to replace the FRC.[161] There have also been proposals for mandatory joint audits at large companies.

Is the collapse of TCG a simple case of business failure caused by disruption? Or is it a case of mismanagement and poor corporate governance? Did poor quality audits contribute to the failure and were the auditors negligent in failing to sound the alarm bells early? Was it preventable?

Discussion questions

1. What were the key contributory factors to the collapse of TCG?
2. What were the key risks that affected the Group and what should the board and management have done differently to mitigate these risks?
3. Comment on TCG's remuneration policies. Did it contribute to the unravelling of the Group, considering the key performance indicators used and adjustments made to the calculation of the bonuses?
4. Should all three former CEOs be responsible for the collapse of TCG? What about the board? Were there other parties responsible?
5. Discuss the responsibility of the board, Audit Committee, management, and auditor responsibility for ensuring that the financial statements provide a true and fair view, particularly with reference to the accounting for goodwill and whether the Group can continue as a going concern.
6. Critically evaluate the independence of the external auditors and whether they have adequately discharged their responsibilities. What is the responsibility of the Audit Committee in ensuring the effectiveness of the external auditors, and how can the Audit Committee go about doing this?
7. Government intervention to bail out certain struggling corporations have been a topic of public debate in recent years. Should the U.K. government have stepped in to prevent the collapse of TCG?

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U.S. COLLEGE ADMISSIONS SCANDAL: DESPERATE HOUSEWIVES (& HUSBANDS)

"There can be no separate college admission system for the wealthy, and I'll add that there will not be a separate criminal-justice system, either."

– Andrew Lelling, U.S. Attorney for the District of Massachusetts[1]

Case overview

In March 2019, American federal prosecutors charged 50 people in a scandal that left American citizens in shock and hotly debating the meritocratic values that their nation has always strongly espoused. The crime? Bribery and fraud by wealthy parents, hoping to secure spots in top colleges such as Yale and Stanford for their children. Amongst those charged, many were prominent – including top business leaders and celebrities. Neither fame nor money however, could save "Desperate Housewives" star Felicity Huffman, and "Full House" star Lori Loughlin from the hand of justice.

As the scandal continued to unfold, with more parents charged and court cases in the midst of being settled, the spotlight turned on the colleges, raising issues such as the competitive landscape of college admissions, the acceptance of donations by colleges, and the failure of colleges to ensure fairness for all applicants. The objective of this case is to facilitate a discussion of issues such as the problems with the college admission process; ethics; bribery; and governance issues with colleges and their relationships with other organisations.

College or competition?

"That is not a race we are interested in being a part of, and it is not something that empowers students in finding a college that is the best match for their interests, which is what the focus of the entire process should be."

– Persis Drell, Stanford University Provost[2]

In 80% of U.S. colleges, over half of all applicants are eventually accepted. However, this is not the case for elite universities.[3] Amongst the elite U.S. universities, admission is highly competitive, with already low acceptance rates declining in recent years. Figure 1 shows the acceptance rates at Ivy League schools between 2015 and 2019.

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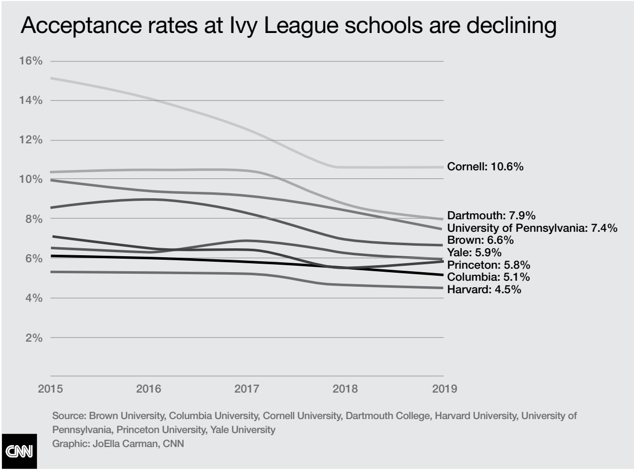

Figure 1: Acceptance rates at Ivy League schools[4]

While acceptance rates have been falling, applications have shown a reverse trend. More students are now applying for elite universities, increasing the competition for an already limited number of slots. Harvard University and Yale University, two of the most prestigious universities in the U.S., received more applications in 2019 compared to anytime in the previous four years.[5]

Improved quality of college applicants

"You can't go to a college fair anymore and say you have these grades and you're in,"

– Eric J. Furda, Dean of Admissions at the University of Pennsylvania[6]

To further complicate matters, students applying to such elite universities are not simply trying their luck; the quality of these students has been steadily increasing, with half of U.S. high school students now graduating with an "A" average.[7] This presents elite universities with an added challenge of determining a means to differentiate the cream of the crop. To do this, some universities have turned to looking at other factors, such as extracurricular commitments and "demonstrated interest" in the college that students are applying to. Such interest can be measured through an applicant's visits to the college, the timeliness of an application, and other application materials.[8]

Some critics have pointed out that such practices continue to perpetuate inequity in college admissions. Visiting a college might entail flying from one state to another, a luxury some students might not be able to afford. Some low-income students might not even own personal computers or have readily available Wi-Fi access, which are required for online college applications. Overall, lower income students continue to struggle with college admissions compared to students with higher income, who have access to much more resources to aid them in their application.[9]

The more the merrier: "Recruit to deny" practices

The perceived increasing difficulty of being accepted into a college may also be a result of greater marketing efforts. Certain colleges have turned to a practice which has been coined as "recruit to deny", where they encourage as many applicants to apply as possible – only to turn them down.[10] This results in a lower admissions rate, and the perception that these colleges are more selective. In doing so, such colleges hope that prospective students will view them as being better due to exclusivity. To perform targeted marketing, colleges purchase lists that combine various student variables together to create lists of targetable students from vendors such as the College Board, which conducts the SATs – the standardised test widely used for U.S. college admissions.[11,12] According to a Wall Street Journal article, 1,900 schools and scholarship programs license millions of names under the College Board's Student Search Service every year.[13,14]

Connections and cash: The two C's to unlock college

In spite of difficult odds, some students have seemingly breezed into their colleges, simply by being connected to the right people. Many top colleges show preferences to "legacies", who are students with a family connection to the university. Such students are usually viewed as potential donors, who would more likely contribute to the college monetarily.[15] Admission rates for "legacies" was about 27% higher in Harvard, while across the U.S., "legacies" had a 31% higher admission rate than the official admission rates for all applicants.[16]

Some other students have also found another way to beat the system. While not publicised, it is widely known that colleges accept donations, which might greatly help the case of applicants. Though a definitive link is unconfirmed, it was reported that Jared Kushner, son-in-law of Donald Trump, was admitted into Harvard shortly after his father donated US$2.5 million to the college.[17] In a lawsuit against Harvard pertaining to unfair admissions, lawyers revealed internal emails from a former dean of the Harvard Kennedy School, expressing his delight in the acceptance of applicants linked to potential donors, one of which had already committed to donating a building.[18]

An accidental discovery

Ironically, when authorities first discovered the scandal, they were working on a completely unrelated case. In April 2018, federal authorities had been investigating a separate securities fraud case, involving financial executive Morrie Tobin. Tobin was facing charges for a pump-and-dump scheme, where he had artificially inflated the stocks of two companies he secretly owned, manipulating investors into paying inflated prices and earning millions of dollars. Desperate for leniency, Tobin provided prosecutors with a tip he hoped would put him in a better position. He informed prosecutors that the head women's soccer coach at Yale University, Rudolph "Rudy" Meredith, had taken a bribe from him in exchange for guaranteeing his daughter a spot at Yale University. Tobin's daughter would be designated as a soccer player Meredith wanted for his team.[19,20]

It was this tip that triggered an investigation into what would become the college admissions bribery scandal. As part of Tobin's plea agreement, he met with Meredith to finalise the bribe while being monitored by FBI agents. As the two men settled their exchange, FBI agents listened in through hidden video cameras when Meredith revealed the identity of his co-conspirator, William "Rick" Singer – the man at the very centre of the scandal.[21]

The ringleader: William Singer

"What we do is help the wealthiest families in the U.S. get their kids into school,"

– William Singer[22]

William "Rick" Singer first entered the college admissions counselling industry in 1992, when he founded Future Stars College & Career Counselling. The company was later sold when Singer moved on to a senior executive role in recruitment and training at The Money Store, as well as subsequently taking on leadership positions in other corporations.[23,24]

In 2004, Singer reportedly started The CollegeSource, a counselling service provider.[25] Three years later, in 2007, he founded The Key (also known as The Edge College & Career Network LLC) and became its CEO. On paper, The Key provided counselling services relating to college admissions, with a focus on wealthy families. This was openly stated on its website, which claimed "The Key's clientele is all referral based; consequently, the quality of the service provided to many of the world's most renown [sic] families and individuals has proved an incredible foundation for The Key to grow its offerings worldwide".[26] In 2012, Singer set up The Key Worldwide Foundation (KWF), a tax-exempt non-profit entity with an aim "to provide guidance, encouragement and opportunity to disadvantaged students around the world".[27]

Aside from running The Key organisations, Singer self-published two books centered on tips and tricks for college applications.[28]

Singer was reported to have said that he wanted to "help" the most privileged.[29] Beneath the facade of a seemingly good-hearted college admissions consultant however, was the making of a US$25 million scheme. KWF was but a front to receive payments from wealthy parents who engaged Singer's services to bribe test administrators and elite university coaches in order to secure a spot in prestigious universities for their children.[30]

After receiving the tip-off from Tobin, federal authorities began tapping Singer's phones, listening in on his conversations with clients who sought to have their children admitted into elite universities through Singer's bribery schemes. By late September 2018, enough evidence had been gathered, and FBI agents swooped in on Singer. With nowhere to run, Singer agreed to cooperate with the FBI's investigations, sparking a chain of events that would soon embroil over 50 others, including several high-profile personalities.[31]

A side door for the wealthy

"I can make [test] scores happen, and nobody on the planet can get scores to happen."

– William Singer [32]

Singer claimed that he created a "side door" for the wealthiest families in the U.S. to get their children into the schools of their choice. This was done in one of two ways; either by falsifying a student's test scores, or by fabricating their athletic accomplishments.[33] Through this "side door" scheme, U.S. authorities said that clients paid Singer a total of US$25 million to bribe coaches and university administrators from 2011 until early 2019.[34],[35]

Typical college admissions in the U.S.

Typically, students apply for colleges via online portals, where their general information and application can be accessed by college counsellors for assessment. Computer software is normally used to assist the college counsellors in filtering through applications, due to the large volume of applications received. The computer software scores each student based on an academic scale, which factors in variables such as the high school attended by the student, the rigour of courses, and the student's admission test scores.[36]

Applications that pass this first review will then be assessed by an admissions committee, where admissions officers discuss and review the candidates. The committee will only view important scale ratings and other key information captured by their admissions system. They will consider applicants based on their merits, and each applicant's fit with the college, before deciding to accept, hold the applicant for review, or deny the application.[37]

How Singer cheated the system

As seen in the typical college admission process, having a good admission test score is the first hurdle that most students have to clear before making it through for further consideration.[38]

Given its importance, some wealthy parents were willing to take precautionary measures to boost the strength of their children's applications; and Singer capitalised on the said demand. It was reported that parents paid between US$15,000 and US$75,000 per test to be a part of the cheating scheme hatched by Singer.[39] The scheme was carried out in various ways, but first, parents were instructed by Singer to get a learning disability waiver for their children, which would give them more time to take the tests, or without the usual degree of supervision.[40] To do so, Singer worked with psychologists to obtain falsified disability reports which certified his clients' children as having learning disabilities.[41] He said that he could obtain a falsified disability report from a psychologist for US$4,000 to US$5,000.[42]

Singer would also get his clients to arrange or falsely disclose travel plans to either West Hollywood or Houston to allow his clients' children to take their tests at test centres in those areas which were reportedly under his control. Alternatively, clients could also contrive a family event that would require the children to take their tests at a private location where Singer could have complete control over the testing process.[43]

In these controlled testing locations, the children could be helped in one of three ways.[44] Firstly, administrators of the SAT and ACT college exams were bribed to allow someone else to pretend to be the student and take the exams in place of the student. Alternatively, a non-neutral person would serve as the proctor at the test location and direct the students to provide the right answers to the exam questions. This non-neutral person would be working with Singer and was a part of the scheme. Lastly, individuals working for Singer would review the test papers completed by the students and correct their answers. Under this method, students often did not know that their answers would be changed as they were not aware of the involvement of their parents.[45]

Athletic or aesthetics?

Most major universities with athletics programs allow athletic staff and coaches to submit a limited number of names as sports recruits to the admissions office, fast-tracking these students through the college admissions process.[46] This allows colleges to enroll the sports talents they want before other colleges reach out to them, and is also an alternate means for students with lower test scores to enter the college, provided they have the necessary athletic achievements. The number of openings available for such talents varies from year to year, and coaches have to negotiate for the number of athletes they can recruit with the admissions committee.[47]

Typically, the admissions process for a sports recruit begins with a coach recommending the applicant to the admissions office staff for review. While it is the responsibility of admissions office staff to verify the sports credentials provided by the applicant, it has been found that staff members spend less than eight minutes on each college application, possibly due to the volume of applications received. Despite the availability of information that can be used to verify a sports recruit's credentials, admissions staff often rely on the coaches – who are seen as the experts – and ultimately take their word for it. There is seldom any follow up on the sports recruits who are eventually accepted. It was this lack of follow up, and the over-reliance on the coaches to verify athletic accomplishments, that was exploited by Singer in his scheme.[48]

How Singer cheated the system

Some of the athletic staff and coaches were bribed by Singer to recommend his clients' children as sports recruits even though they were aware that the students had no prior experience in playing those sports.[49] One such incident occurred in Stanford University where the then coach of the sailing team, John Vandemoer, reportedly received a US$110,000 payment made to the Stanford University sailing programme in return for a designating a child of one of Singer's clients as a sailing recruit.[50]

Singer also falsified students' profiles which highlighted their athletic skills and awards, when the truth was that they had none.[51] In some instances, he photoshopped students' faces onto athletes' bodies or onto photographs of other people participating in the sport as evidence of the students' athletic abilities.[52] In one such instance, actress Lori Loughlin and her husband – fashion designer Mossimo Giannulli of Mossimo fashion - reportedly paid US$500,000 to have their two daughters accepted into the University of Southern California (USC) as recruits for the rowing team, even though neither of them took part in the sport.[53] In other cases, he added fake achievements into students' college applications. In one case, a girl who did not play soccer was identified as a star player, with her college applications citing her as the co-captain of a prominent club soccer team in Southern California. This led to her successful admission into Yale University as a recruit for the soccer team.[54]

Bribes disguised as donations

After a student had been accepted into his or her chosen university, parents would make large payments to Singer's company, which often amounted to hundreds of thousands of dollars. These payments were concealed as donations, which would then be funneled through the charity organisation KWF, controlled by Singer, to the university. These 'donations' were actually bribe payments to test monitors, school officials and coaches who were involved in the scheme.[55] To make matters worse, disguising the bribe payments as donations even allowed parents to get tax deductions.[56]

For example, Desperate Housewives actress Felicity Huffman and her husband, William H. Macy, allegedly concealed a US$15,000 bribe as a charitable donation to KWF for disadvantaged youth.[57] Huffman received a letter from KWF stating "no goods or services were exchanged" for the US$15,000, and that the funds would "allow [them] to move forward with [their] plans to provide educational and self-enrichment programs to disadvantaged youth". Despite what was claimed in the letter, prosecutors alleged that the money was instead used to pay for someone to take the SAT exam for the couple's eldest daughter.[58]

Key Worldwide Foundation: Unnoticed yellow flags

"Many things were off, odd. These are all yellow flags."

– Lloyd Mayer, a professor at Notre Dame Law School[59]

KWF's mission statement was "to provide education that would normally be unattainable to underprivileged students, not only attainable but realistic. … Our contributions to major athletic university programs, may help to provide placement to students that may not have access under normal channels".[60]

Founded in 2012, KWF painted a rosy picture of its mandate to potential donors, stating that it aims to provide educational opportunities to underprivileged kids. Its website claims that KWF "has touched the lives of hundreds of students that would never have been exposed to what higher education could do for them".[61] However, there were many yellow flags which suggest that the non-profit organisation was just an empty shell for Singer to conduct his grand bribery scheme.

Lack of employees, officers and independent directors

One key yellow flag was the obvious lack of employees and officers of KWF. Despite receiving over US$7 million in funds over four years and claiming to run an intern development program, KWF did not disclose having any employees, according to four years of disclosures filed with the U.S. Internal Revenue Service (IRS). Furthermore, KWF had just three officers – two of which worked zero hours – which was deemed very low for a charity with its assets. It was reported in KWF's tax filings that Singer worked eight hours a week for the non-profit organisation and did not report any compensation. The foundation also did not have any independent directors, which meant that its own officers, led by Singer, took on those roles. This is considered by the IRS to potentially raise conflicts of interest issues, due to personal or financial ties to the non-profit organisation.[62]

Dubious remuneration and expenses

Paul Streckfus, editor of EO Tax Journal, shared that a foundation's compensation policies can show obvious warning signs as to whether a charity is a fraud. In KWF's case, its income tax forms stated one independent contractor,[63] namely Gordon Ernst – former head tennis coach at Georgetown University who was charged with conspiracy to commit racketeering – received about US$1.5 million from KWF between 2013 and 2016 as a 'consultant'.[64]

Other unusual numbers included KWF reporting US$2,024,828 in "total functional expenses", of which only US$908 was for "management and general expenses". This raises the question of how KWF was using its funds.[65]

Donating to itself?

Between 2014 and 2016, KWF also distributed US$33,329 to "Community Donations", an entity located at the same residential address as KWF. While some charities occasionally raise funds through affiliated organisations which share the same address, experts encourage such charities to be extremely careful in keeping records as such coincidences would draw scrutiny as to whether the funds were raised for legitimate purposes. Lo and behold, records for the business entity with the name "Community Donations" could not be found.[66]

Fake partnerships with real charitable organisations?

KWF had also fudged information on partnerships with other non-profit organisations on its website. Representatives for three of the six organisations KWF mentioned as partners on its website said that they had never heard of KWF, much less had a partnership with it. Thais Rezende, CEO of Bizworld.org – one of the three said non-profit organisations – had also demanded that KWF immediately remove all references to it from the KWF website.[67]

The IRS: Apathetic or ignorant?

With so many signs pointing towards the possibility of KWF being a fraud, one would wonder why it never attracted the attention of the IRS. Experts say that the IRS does not scrutinise foundations like KWF unless someone alerts the IRS that there is possible misdeed. Marcus Owens, a former IRS official in charge of its tax-exempt division, explained that KWF's filings did not include details which "would automatically trigger an audit" as KWF avoided reporting the true nature of what they actually did and faked certain grants they made.[68]

"The whole conspiracy could be right there on the tax forms, and Singer submitted it all."

– Adam Looney, a regulatory expert at the Brookings Institution[69]

However, some believed that the most important information needed in order to root out the fraud was accessible via the income tax forms filed by KWF all along. The college admissions bribery scandal was hiding in plain sight for years and could have continued for a longer period of time because the IRS, which had access to sufficient information to call for an investigation, was too lax.[70]

Lloyd Mayer, an expert in tax law at Notre Dame law school said, "I'm fairly confident in saying that no human being at the IRS looked at the returns, given their low staffing level."[71]

Clearly, this raises questions about whether the IRS was properly carrying out its duties to root out and prosecute tax fraud. Many believe that the steep budget cuts and lack of manpower in the IRS in recent years have resulted in the failure of IRS to prevent such fraud. This is represented by the dwindling numbers of tax audits and reduced efforts to pore over tax forms to detect tax fraud.[72] Based on IRS data, a tax-exempt organisation had less than a one percent chance of being selected for an audit in 2017. The IRS had approximately 840 fewer tax examiners in 2017 than it did in 2013. Furthermore, the IRS is said to place more emphasis on individual taxpayers claiming deductions rather than on how charities utilise their funds.[73,74]

Aftermath of the scheme

In March 2019, more than 50 people were charged with participating in the college admissions bribery scandal, including more than 30 wealthy and powerful parents accused of paying millions of dollars in bribes, 10 athletic coaches accepting bribes to help students gain admission into colleges, and seven other people working in the administration and college admissions industry.[75]

Singer, the ringleader in the college admissions bribery scandal, pleaded guilty to four charges in federal court in Boston – involving racketeering conspiracy, money laundering conspiracy, conspiracy to deceive the U.S., and obstruction of justice.[76] He faces a maximum sentence of 65 years in prison and a fine amounting to US$1.25 million.[77]

Two other employees of The Key and Key Worldwide Foundation were also charged – Steven Masera who was an accountant and financial officer, and Mikaela Sanford, an employee who was accused of taking classes on behalf of students.[78]

Amongst the wealthy and high-profile parents, celebrities such as "Fuller House" television star Lori Loughlin and "Desperate Housewives" actress Felicity Huffman were charged with conspiracy to commit mail fraud and honest services mail fraud. Despite issuing a long and hand-wringing apology, Felicity Huffman lost her acting job immediately and was sentenced to 14 days in prison, fined US$30,000, and ordered to do 250 hours of community service.[79,80] Meanwhile, Lori Loughlin, who had dragged her case before eventually pleading guilty in May 2020, had been previously warned by Andrew E. Lelling, the U.S. attorney for the District of Massachusetts, that his office would issue a longer sentence if she went to trial and were convicted than if she pleaded guilty.[81] She was also not expected to return to her actress role on the Netflix show "Fuller House", and was edited out from her Hallmark Channel Show "When Calls the Heart".[82]

Other wealthy parents included CEOs of public and private companies, such as William E. McGlashan Jr., a former partner at TPG – one of the world's biggest private equity firms; Gordon Caplan, a lawyer and a co-chairman of the international law firm Willkie Farr & Gallagher; as well as Douglas Hodge, a former Chief Executive of one of the world's biggest bond fund managers PIMCO. Most of these high-profile and successful businessmen pleaded guilty and were immediately suspended from their companies. Some of their partner roles have also been stripped.[83]

Ten college-athletic coaches were also found guilty of accepting millions of dollars to open a backdoor to elite colleges for undeserving students who may have never played the sport. They include Gordon Ernst, a former head tennis coach at Georgetown University, who was accused of accepting US$2.7 million in bribes to help students get into the elite university. Four athletic officials from USC – Donna Heinel, Laura Janke, Ali Khosroshahin, Jovan Vavic – were also charged with taking bribes in the college admissions scheme, more than any other institution.[84]

Teachers, test administrators and private instructors were also named by the prosecution as co-conspirators. Mark Riddell, a counselor at a private school in Florida, pleaded guilty in April after admitting to have taken the SAT or ACT exams on behalf of the students and correcting their answers after they had taken the exams.[85] As a test administrator of a small West Hollywood school which was part of Singer's brazen scheme, Igor Dvorskiy was also accused of accepting bribes to aid in the cheating scheme.[86]

How did other students react?

The college admissions bribery scandal resulted in a federal class-action suit by a group of students and their parents. It was filed against elite universities linked to the scandal and the ringleader behind the scheme, Singer.[87]

Two students from Stanford University, Erica Olsen and Kalea Woods, sued eight universities, on behalf of "qualified, rejected"[88] students, accusing them for being "negligent in failing to maintain adequate protocols and security measures" regarding the admissions process. They argued that it was unjust for them to pay for their admissions process given that the systems in universities involved in the scandal were corrupted and rigged by fraud. Hence, they did not receive what they paid for as they were deprived of a fair process. In addition, they also argued that their Stanford University degrees would be "insignificant and worthless" as their future employers might perceive them as relying on "rich parents that were willing to bribe school officials", instead of entering based on their own achievements and merits.[89]

However, legal experts believed that the lawsuit is unlikely to be successful as it was near impossible for students to prove that they were affected directly by the college admissions scheme, such that they would have been accepted if not for the scandal. Alternatively, the best outcome for the lawsuit would be for the students to potentially get back the money paid for their application fees.[90]

The college admissions bribery scandal has dominated conversations on campuses. Some students felt outraged and appalled by the fraudulent scheme, rallying against greed and privilege, whereas some were afraid of their diplomas or degrees being tarnished.[91] In Georgetown University for instance, disputes blew up in class as some students displayed their loan applications as proof that their parents did not take part in the bribery.[92]

Additionally, the scandal has also sparked debate over what consequences people involved in the scheme should face. A poll conducted by Insider showed that the majority of Americans agreed that parents and school officials should face criminal charges and civil liabilities. Interestingly, 44% of Americans felt that students involved should be forced to re-apply to their colleges, 19.5% believed the students should be expelled and 13% thought that they should be suspended. The remaining 25% decided that nothing should happen to them.[93]

What about the children?

Federal prosecutors did not charge any students or universities, arguing that many students were unaware of their parents' wrongdoings.[94] However, some students of parents who had been charged received target letters, alerting them that they could be targets of a criminal investigation.[95] Several universities implicated said that they might penalise students who were involved in the scandal.[96]

USC – one of the colleges involved in the scandal – stated in March 2019 that students involved had been blocked from withdrawing or registering for classes as they waited for a review of their status by the college. They would have received written notification from the Office of Student Judicial Affairs and Community Standards (SJACS) that their admissions status would be under review and would be required to have an interview with an SJACS officer.[97] After the investigation is completed, the college will determine the appropriate sanction to take for each student involved, if any. Affected students could have their admission revoked or face expulsion.[98,99] On the other hand, some students reportedly left their schools willingly over fears of bullying.[100]

In Georgetown University, the officials released a statement that they would be dismissing two students who were involved in the college admissions bribery scandal.[101] Similarly, Yale University and Stanford University had also revoked the admissions for identified students involved in the scandal.[102]

Universities' reactions and changes

The universities took actions such terminating employees associated with the allegations, placing them on leave, or having a thorough review and strengthening of students' admissions process.[103,104]

USC conducted a full review and worked closely with U.S. Justice Department's Investigation to identify donations that were likely to be linked to the alleged scheme.[105] Additionally, employees associated with bribery were terminated immediately by the college.[106] It conducted a thorough review of the student-athlete admissions process, emphasising that "student-athlete applicants will now be reviewed by three levels of USC faculty, including the head coach, the senior sports administrator overseeing the team, and the USC Office of Athletics Compliance – before being sent to the admissions staff ".[107] The athletic rosters would also be audited and cross-checked with admissions lists at the start and end of every academic year.[108]

Similarly, universities like Georgetown also claimed to have strengthened the recruitment and admissions process, engaging an independent third party to audit its athletic recruitment.[109] Yale University engaged external advisors to propose recommendations or reforms that would help the university detect and inhibit efforts to defraud the admission process. It also emphasised that there would not be any exceptions for any delay in admissions decisions.[110]

What next?

After many months of investigations, the effects of the college admissions bribery scandal continue to unfold, with more plea hearings to be heard from parents and coaches in the months to come.

Beyond just the scandal, this case has challenged the American belief in a meritocratic and fair college admissions system and brought attention to the difficulties that minorities face in applying for college amidst a challenging environment.

As justice continues to be administered, the colleges involved have promised to improve their admissions processes to prevent such a scandal from ever happening again. Whether or not they succeed will depend on their commitment to due diligence and a strong culture of ethics.

Discussion questions

1. Discuss the ethicality of aggressive marketing practices such as “recruit to deny”, and the acceptance of applicants based on connections and donations. Were there any controls that could have been put in place to guard universities from succumbing to the issues in the case?
2. What were the loopholes in the admission process in U.S. colleges which allowed the scandal to occur? Are the proposed measures sufficient to address these loopholes? What more can be done by college management to ensure proper functioning of the college admission process?
3. Most of the college athletic coaches involved in the scandal were coaches with longstanding reputation in their respective colleges. Despite this, they agreed to be a part of Singer’s scheme. Discuss the factors that could have played a role in their choice.
4. Based on how the U.S. college admissions bribery scandal unfolded, evaluate what are the lessons learnt and what can be improved for the various stakeholders.
5. Ultimately, who should be held responsible for the U.S. college admissions bribery scandal? Should the universities be punished for the lapses in their admission system?
6. Are universities in your country subject to corporate governance and disclosure requirements? Do you think that they should be, and if so, what areas do you think are most important in terms of corporate governance and disclosures?

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WHY DIDN'T WEWORK?

Case overview

WeWork was co-founded in 2010 by Adam Neumann. It provided co-working spaces to entrepreneurs, startup companies, freelancers and larger enterprises. From 2010 to 2019, it experienced tremendous growth in revenue and scale, with a compounded annual growth rate for revenue of 61% from 2016 to 2018. WeWork was once hyped as one of the world's leading unicorns, commanding an impressive valuation of US$47 billion as at January 2019. However, its S-1 filing on 14 August 2019 for its planned initial public offering (IPO) revealed deep losses, highlighted inherent risks in its business model, and raised multiple corporate governance concerns. Investor confidence in WeWork rapidly plummeted, causing WeWork's value to plunge by almost 90%, and WeWork's IPO was formally withdrawn on 30 September 2019. Shareholder concerns about Neumann's power in WeWork also resulted in his ultimate resignation as Chief Executive Officer and relinquishment of majority voting control.

The objective of this case is to facilitate a discussion of issues such as sustainability of business models; valuation of tech companies; role of IPO bankers; influence of charismatic founder-leaders in startups; issues with multi-class share structures and concentration of power; excessive share-based compensation; severance packages; board composition; corporate culture; and the influence of venture capitalists on the tech industry.

Rise of WeWork

WeWork was co-founded in 2010 by Adam Neumann (Neumann) who became Chief Executive Officer (CEO) of the company, Rebekah Neumann (Rebekah), and Miguel McKelvey.[1] Neumann, who turned 41 in 2020, is known as a charismatic serial entrepreneur.[2] Prior to 2010, he already had a few business ventures.

In 2006, Neumann partnered with children's clothing designer Suzan Lazar to create the brand Egg Baby, a clothing brand with padded knees to protect infants.[3] Two years later, together with his friends Miguel McKelvey and Gil Haklay, he started a company called Green Desk, which provided co-working spaces using recycled furniture and sustainable energy.[4] It was seen as an early incarnation of WeWork.[5] Green Desk proved to be highly successful, with its spaces fully occupied shortly after construction.[6] Neumann and Miguel McKelvey subsequently sold Green Desk in 2009.[7]

WeWork began in 2010 when the funds from selling Green Desk were used to pay the deposit for a new location in SoHo, a neighborhood in New York City.[8] At the time of its founding,

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WeWork described itself as a co-working company that would revolutionise the traditional definition of workplaces and provide a collaborative and creative environment for innovative businesses and individuals.[9] Neumann purportedly intended WeWork to become a "community that helped people live life with purpose".[10]

In early 2010, WeWork opened its doors to its first member community (WeWork refers to its customers as "members") at 154 Grand Street in New York City.[11] At the start, most of its members were freelancers, small businesses and start-ups during their early founding years.[12] The company's early value offering was the provision of shared workspaces to start-ups at a lower cost than they would spend on their own.[13] By June 2010, WeWork had amassed 350 members.[14]

WeWork then expanded to other U.S. cities such as Los Angeles, San Francisco, Boston, and Seattle.[15] In 2014, it made its first international move by expanding to London and soon after to Tel Aviv. Two years later, WeWork had extended its presence to Shanghai and Mexico City,[16] and by 2019, WeWork had rapidly scaled to over 739 locations in 111 cities across 29 countries.[17]

How WeWork

At the core of WeWork's business model is an office rental company. The company leases shared office space to its over 527,000 members globally, which includes independent freelancers, remote workers and small businesses.[18] The key difference between WeWork and traditional commercial real estate companies is that WeWork does not own any of its offices. WeWork first takes out long term leases on commercial real estate, spruces up the spaces with fashionable amenities and furniture, and provides built-in services such as Wi-Fi and cleaning.[19] The company subsequently rents the space out to individuals and companies at a higher price, albeit on flexible leases. The benefit of such a model is that WeWork can make the differential between the rental it pays on its long-term leases and the rental it collects from customers, especially since rents tend to appreciate over the years.[20]

WeWork pioneered the "space-as-a-service" membership model, which is the centerpiece of the company's business. The model purportedly offers members the benefits of an inclusive and cooperative culture, the flexibility to upsize or downsize one's workplace accordingly and the power of a worldwide community.[21] Aligned with its concept of flexibility, WeWork offers members several plans with varying prices to choose from, depending on the location and workspace required (hot desk, dedicated desk, or standard private office).[22] However, it tends to charge prices 10-15% higher than International Workplace Group (IWG), its main competitor, for a similar locality and the same type of workspace.[23]

WeWork justifies its higher prices by providing greater value. According to its website, the amenities provided include super-fast internet, spacious and unique common areas, business-class printers, free refreshments, on-site staff and private phone booths.[24] WeWork ensures that everything is taken care of, from replenishing the ink and paper for printers to the electricity bill.[25] Spaces are also equipped with numerous leisure activities, such as arcade games and foosball, and the company facilitates networking sessions where members can meet and socialise.[26] Additionally, WeWork's spaces have been described as relatively casual, relaxed and community-driven environments, in comparison to the more formal and privacy-focused atmosphere in IWG's spaces. [27]

WeWork has also positioned itself as a technology (tech) company with better innovation and flexibility than a regular real estate company.[28] For instance, it used the term 'tech' 123 times in its S-1 filing, which was more frequent than the S-1 filing of the video calling software company Zoom.[29] Its filing also stated: "Technology is at the foundation of our global platform. Our purpose-built technology and operational expertise has allowed us to scale our core WeWork space-as-a-service offering quickly, while improving the quality of our solutions and decreasing the cost to find, build, fill and run our spaces." [30]

Indeed, WeWork has built a complex technology and logistics system to churn data out on construction, deliveries and maintenance.[31] 3D scanners are also installed in buildings to measure space, and heat mapping technology is employed to decide on the right mix of desks, common space and meeting rooms.[32] WeWork's improved technology efficiency and massive buying power allowed it to decrease the cost of adding a new desk by 45% to US$8,550 in 2017.[33]

How WeGrow

WeWork has been acclaimed as the world's most popular co-working space.[34] Members have commented that working at WeWork helps them stay motivated, and they get much less distraction than working from home or at coffee shops.[35] They have also expressed appreciation towards the community access WeWork provides to other founders and professionals,[36] and small businesses value the flexibility that WeWork offers, allowing them to downsize and upsize without hassle.[37]

The high demand for WeWork's co-working spaces allowed it to rapidly expand its real estate portfolio. From 2010 to 2020, WeWork consistently added spaces to its portfolio, and at its peak in 2019, it added 7.7 million square feet of spaces in its U.S. market (refer to Figure 1).[38] It has been hailed for transforming the face of office rental.

WeWork was the only non-finance company to make the top five office tenants in Manhattan in 2018, disrupting the monopoly that banks previously had over office real estate.[39] In 2019, it became the largest office tenant, surpassing JP Morgan by nearly 3 million square feet.[40] However, WeWork only expected to add slightly above 2 million square feet of space in 2020, an indication that the company's growth was decelerating.[41]

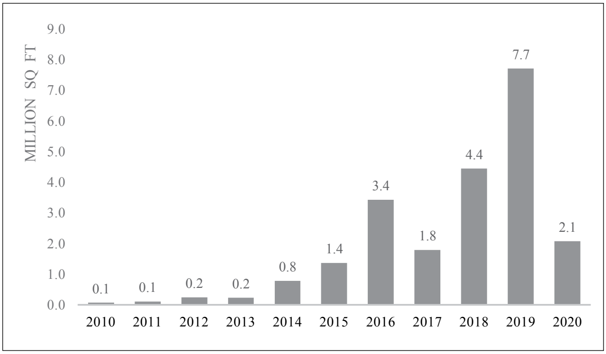

Figure 1: Amount of space added to WeWork's U.S. portfolio[42]

The combination of high demand and the rapid growth in WeWork's available spaces translated to impressive revenue growth for WeWork. Between 2016 and 2018, the company's revenue grew at a compounded annual growth rate of 61.05% (see Figure 2).

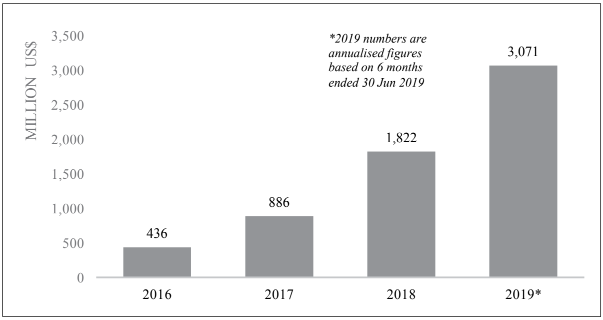

Figure 2: WeWork's revenue growth trend[43]

The tremendous growth that WeWork experienced helped it attract its initial investors. In its Series G funding round in 2017, it was valued at US$20 billion,[44] which put it on par with hotel operator Hilton Worldwide, and ahead of commercial real estate giants like Boston Properties and Vornado Realty.[45] A large part of this US$20 billion valuation came from SoftBank Group Corp. (SoftBank), WeWork's largest investor, which invested US$4.4 billion directly into WeWork.[46] Neumann's charm, charisma and persuasion chops played a huge role in clinching the said SoftBank investment deal – Neumann apparently managed to convince SoftBank' CEO Masayoshi Son in just 12 minutes.[47] It was reported that Masayoshi Son, believed that his investment in WeWork would provide the company with enough capital so that they can expand at an even faster pace.[48]

We burst

In January 2019, SoftBank invested another US$10.65 billion into WeWork on the basis that WeWork would go public at a valuation greater than US$47 billion.[49] On 14 August 2019, WeWork filed its S-1 prospectus for its Initial Public Offering (IPO) with the U.S. Securities and Exchange Commission (SEC), with plans to go public in September 2019.[50] However, the S-1 filing exposed deep losses in WeWork and revealed risks in its business model based on short-term revenue agreements and long-term liabilities, creating significant investor skepticism over the company's long-run sustainability and profitability.[51] The filing also raised a series of corporate governance concerns after it disclosed details of Neumann's sale of WeWork shares prior to its filing, his plans to retain control of WeWork even after the IPO, numerous related party transactions, and WeWork's male-dominated board.[52]

On 5 September 2019, WeWork announced that it was slashing its valuation to US$25 billion amidst low investor demand.[53] On 13 September 2019, it submitted an amended S-1 filing that included sweeping changes to address investor concerns, such as reducing the voting power of WeWork's Class B and Class C shares to curtail Neumann's voting power.[54] One day later, WeWork owner The We Company announced that it may seek a further reduced valuation of between US$10 billion and US$12 billion for WeWork.[55] On 16 September 2019, WeWork announced that its IPO would be postponed and it planned to have a roadshow to market the IPO, saying that it aimed to complete the offering by year-end.[56] On 24 September 2019, Neumann agreed to resign as CEO of WeWork and give up majority voting control.[57] However, Neumann was to retain his seat as Non-Executive Chairman.[58]

One week later, SoftBank revalued WeWork to just US$4.9 billion.[59] Over the course of nine months from January 2019 to September 2019, WeWork's value had plunged by almost 90%.[60] On the same day, WeWork formally withdrew the prospectus for its IPO.[61]

On 4 November 2019, a class action and derivative complaint was filed in the Superior Court of the State of California by a minority shareholder, Natalie Sojka, on behalf of WeWork against Neumann, WeWork directors and SoftBank. The complaint alleged breach of fiduciary duty, abetting breach of fiduciary duty, unjust enrichment, corporate waste, and abuse of control, and seeking declaratory and injunctive relief.[62]

We hype

WeWork's S-1 prospectus filed on 14 August 2019 provided the first in-depth look at WeWork's financial results.[63] The prospectus revealed that while revenue had been growing rapidly from 2016 to 2019, earnings before interest, tax, depreciation and amortisation (EBITDA) and net losses had become increasingly negative (see Figure 3 below).[64] Business Insider U.S. calculated that WeWork was losing US$219,000 every hour.[65]

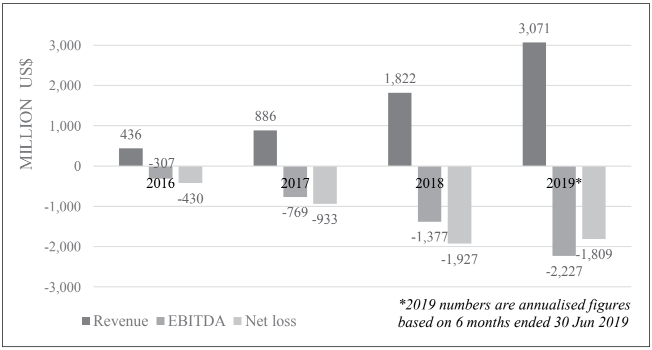

Figure 3: WeWork's key income statement figures[66]

"We have a history of losses and, especially if we continue to grow at an accelerated rate, we may be unable to achieve profitability at a company level (as determined in accordance with GAAP) for the foreseeable future."

– WeWork's S-1 filing submitted on 14 August 2019[67]

Indeed, WeWork's trend of net losses did not show signs of recovery in Q3 2019. Even though WeWork's revenue in Q3 2019 almost doubled to US$934 million compared to the year prior, it reported a net loss of US$1.25 billion in Q3 2019, up by more than 150% from a net loss of US$497 million in Q3 2018.[68]

WeWork's losses were attributed to the razor thin margins that it had been earning from its customers, since it spent almost as much money running its office spaces as it generated from tenants.[69] WeWork also incurred high costs to turn buildings leased from landlords into attractive spaces for tenants.[70]

Media articles also brought attention to WeWork's operating efficiency, which is represented by the trend in WeWork's losses as a percentage of revenue, as shown in Figure 4 below.[71]

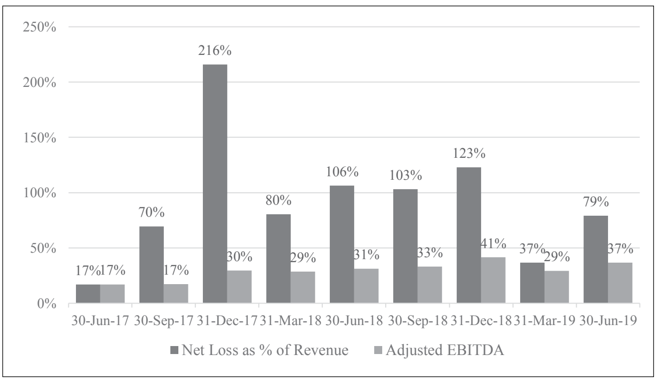

Figure 4: WeWork's losses as a percentage of revenue (quarterly)[72]

A media article observed that WeWork's losses as a percentage of revenue showed no clear trend of decreasing, regardless of whether net loss or adjusted EBITDA was used.[73] The prospectus also states: "Although we do not currently believe our net loss will increase as a percentage of revenue in the long term, we believe that our net loss may increase as a percentage of revenue in the near term and will continue to grow on an absolute basis."[74]

The media also compared WeWork's trend of losses against other recent IPOs.[75] WeWork lost US$1.4 billion from operations during the first six months of 2019,[76] while ride-sharing giant Uber Technologies, Inc. (Uber), another recent IPO, lost US$6.5 billion from operations over the same time period.[77] However, based on its IPO documents, WeWork reportedly lost about US$5,197 per member per year, which is about 24 times what Uber lost per active rider, 129 times what struggling meal delivery service Blue Apron lost per subscriber, and 753 times what pet e-tailer Chewy.com lost per regular customer.[78]

"No part of this company [WeWork] makes money, and it is difficult to see a path to profitability."

– Jim Edwards from Business Insider U.S., on WeWork's S-1 filing[79]

An analyst on Smartkarma, an investment research network, also wrote: "We cannot even fathom the contortions that would be necessary to articulate a path to profitability here."[80] However, even though analysts expressed doubts over WeWork's ability to become profitable, SoftBank, the largest investor in WeWork, remained optimistic. SoftBank CEO Masayoshi Son brushed off critics in an earnings conference call in August 2019, claiming that: "I think its high growth rate will continue for the next five to 10 years".[81]

Risky business

Investors questioned the sustainability of WeWork's business model, given its significant asset-liability duration mismatch.[82] WeWork leases buildings from landlords for about 15 years on average, and then rents out these spaces to members on much shorter terms of two-year commitments on average.[83] Real estate experts have advised that in the event of an economic recession, co-working spaces such as WeWork may lose customers when the number of new startups decreases,[84] more businesses fail, and individuals and startups opt for cheaper overhead.[85] Hence, an economic downturn could cause short-term rents to decline until WeWork would no longer be able to afford its long-term fixed lease expenses.[86] To exacerbate matters, many of WeWork's properties are in major cities where the economies were strong and real estate values were high.[87] This means that WeWork might have locked in many leases at close to top-of-the-market prices, further increasing the risk of not being able to pay its lease commitments.[88]

WeWork acknowledged the inherent risks of its business model in its S-1 filing, where it states: "An economic downturn or subsequent declines in market rents may result in increased member terminations and could adversely affect our results of operations."[89] Accordingly, it took some steps to address these risks.

WeWork turned its focus to corporate clients as they usually were willing and able to commit to longer-term rentals and subscribe to additional solutions.[90] It increased its enterprise membership from 20% on 1 March 2017 to 40% on 1 June 2019, which allowed enterprise members to account for 38% of membership and service revenue for the six months ended 30 June 2019.[91] In addition, WeWork had contracts with 38% of Fortune 500 companies, such as General Motors Company, Salesforce, and Bank of America as at the time of its S-1 filing.[92]

However, the above measures have not been without criticism. A media article observed that despite the significant growth in member-base of larger companies, WeWork was still incurring huge losses, suggesting that WeWork's profit margins were still too low.[93]

There were also questions about whether WeWork had sufficient diversification and risk mitigation. WeWork operates in just 111 cities, with a majority of revenue from a few expensive cities, such as San Francisco, Los Angeles, New York City, and London. In contrast, IWG operates in over 1,000 cities.[94] Additionally, there were concerns that due to COVID-19 cases spread and governmental responses to slow down transmissions, WeWork spaces could be forced to close, further threatening its revenue streams.[95]

Investors also raised concerns over WeWork's leverage and risk. Even though it has 20% less office space than IWG as at the end of 2018, WeWork has taken on significantly more operating lease commitments with longer terms and more geographic concentration.[96] In 2019, WeWork reported US$34 billion of debt in the form of future payments owed on the long-term leases that they entered into.[97] Furthermore, WeWork uses an extremely high discount rate of 8.2% to calculate the present value of its operating leases, as compared to the more conservative 3.7% used by IWG.[98] This exemplifies WeWork's aggressiveness in taking on extra risk to fuel its growth, and increases WeWork's risk of default in a recession.[99] WeWork's filing also said: "The long-term and fixed-cost nature of our leases may limit our operating flexibility and could adversely affect our liquidity and results of operations."[100]

The media has even drawn parallels between the business model of WeWork and that of serviced-office giants of the dot-com era. During that period, IWG (previously known as Regus) and HQ Global Workplaces Inc. (HQ Global Workplaces) had the same fundamental business model as WeWork – leasing spaces on a long-term basis and renting them out on a short-term basis – and similarly enjoyed high valuations. However, when the dot-com bubble burst, both companies suffered declining demand and revenues, while being crippled by their long-term lease commitments and debt obligations, causing them to eventually file for Chapter 11 bankruptcy protection. Subsequently, IWG bought HQ Global Workplaces, and took 12 years to recover to its IPO stock price, despite having grown its office space by six times during that period.[101]

We are tech

It has been observed that WeWork was a real estate company valued like a tech company.[102] Indeed, WeWork had attempted to defend its high initial valuation of US$47 billion on the basis that is a tech company with better innovation and flexibility than a regular real estate company.[103] Tech companies are often ascribed large EBITDA-based valuation multiples,[104] which provides a possible explanation of how WeWork's initial valuation of US$47 billion was more than 10 times the market capitalisation of its main competitor IWG, even though IWG had substantially more spaces and customers, and had actually made a profit during that time.[105]

However, investors were uncertain about whether WeWork should truly be considered a tech company. Modern tech companies like Airbnb and Uber have scalable virtual models that can be exponentially grown with little additional costs. However, this does not apply to WeWork since it is an office rental company which offers amongst other things, free internet, snacks, coffee, and working space to its customers. Tech companies are usually asset light due to low requirements for land, buildings, factories, and warehouses, yet WeWork has much higher capital requirements since it leases real estate which is considered capital assets. Most tech companies like Facebook also benefit from network effects, while WeWork is unlikely to experience significant network effects. As a result, many observers have argued that WeWork does not deserve its large EBITDA-based valuation multiple commonly ascribed to tech companies.[106]

Additionally, there had been inconsistencies between WeWork's service offerings and its claim of being an innovative tech company. It was reported that WeWork had cut costs in tech budgets by installing second-class routers and hiring less experienced staff to install IT networks, which created major IT infrastructure gaps in the buildings that it rents out to tenants.[107] Some of WeWork's customers had also complained about security vulnerabilities in WeWork's network.[108]

We value

Financial Times reported that prior to WeWork's S-1 filing, IPO bankers had dangled potential valuations even higher than SoftBank's initial valuation of US$47 billion in January 2019. JP Morgan informed WeWork executives that the company could be worth between US$46 billion and US$63 billion. Goldman Sachs estimated WeWork's valuation at between US$61 billion and US$96 billion. Morgan Stanley pegged WeWork's equity at between US$43 billion and US$104 billion in a presentation, but subsequently revised it to a more modest US$18 billion to US$52 billion in a pitch for WeWork's IPO.[109]

David Spreng, founder of Silicon Valley lender Runway Growth Capital, raised questions on why WeWork's underwriters had not identified investor concerns sooner in the process. He said, "That is their job … If JP Morgan's institutional investors were throwing up all over this, they should have known."[110]

A Bloomberg article reasoned that since WeWork was interviewing bankers to lead its IPO, bankers such as Goldman Sachs might have talked up WeWork's valuation to convince WeWork to hire them.[111] According to Financial Times, WeWork's listing was a potentially lucrative source of revenue for many bankers, with more than US$100 million in fees riding on the IPO.[112] JP Morgan was poised to earn US$50 million by restructuring a US$6 billion loan lent by it and a group of banks including Goldman Sachs, Bank of America, Citigroup, UBS, and Wells Fargo.[113]

During a panel talk in January 2020, David Solomon, the CEO of Goldman Sachs, defended Goldman Sachs' pitch to WeWork. He explained that Goldman Sachs had to rely on the inputs and models that WeWork provided, since there was previously no public information available about WeWork.[114]

Have we heard this story before?

Critics have been quick to point out the similarities in the story of WeWork and the fall from grace of other high-flying startups. Media articles have drawn parallels between WeWork and its founder Neumann, and the failed Theranos and its founder Elizabeth Holmes.[115]

Both Neumann and Holmes had the ability to associate themselves with exciting ideas, and then become the spokesperson for these ideas. Their ability to personify the goals and dreams of their respective organisations helped to inspire "cult-like" followings from investors who would buy into their dreams and push their companies to greater heights.[116]

The media had been especially critical of WeWork as, just like Theranos, it had enriched its founder greatly despite never turning a profit, and before the viability of the company's business model had been proven.[117]

However, it was also pointed out by various critics that Holmes was involved in fraud, since Theranos had lied about its technology and blood test results, whilst WeWork has been open about its financial position and the massive losses it has been incurring.[118]

Influence of Neumann on WeWork's culture

"If there is a culture, it is that of a revolving door."

– Former WeWork executive[119]

Neumann, however, was no less of a "controversial figure" than Holmes was. Many employees, both past and present, said that he was a fiery and inspirational leader who always had a high level of energy.[120]

A former employee recounted that Neumann's "superpower" was his ability to motivate his employees and sell his company to investors. However, with his high level of energy, he could also grow "furious" if he did not have access to his shots of tequila readily.[121]

His charismatic leadership and eccentric quirks also moulded the culture of WeWork. The media, as well as former employees have gone as far as to say that Neumann embodies the WeWork ethos, combining "a workaholic drive with a sense of purpose and a larger than life persona".[122]

WeWork has also been known to have a party-like atmosphere, as a company where employees get to enjoy free flow beer during working hours.[123] A signature event of WeWork is their annual Summer Camp, where a multitude of activities are offered – trapeze, archery, cocktail making, whiskey tasting and so on.[124] The company had also invited many well-known performers and splurged on these performances. The Chainsmokers were given WeWork stock as part of their payment and the Weeknd was flown in from Canada in a helicopter to perform.[125] Employees compared the Summer Camp to events such as music festivals like Coachella and Burning Man.[126]

"We're talking people having sex in the bushes, people openly popping pills, railing lines [of drugs] in the middle of crowds while watching Bastille perform. You could hear people audibly having sex in their tents all day and night. People peeing all over the place, and pulling down their pants and defecating in between the tents because they are so drunk they can't even make it to the bathroom."

– An employee on WeWork's Annual Summer Camp[127]

In the summer of 2019, Neumann's hard-partying behaviour was under the media spotlight again. This time he had reportedly smoked marijuana with his friends on a private jet to Israel after the flight crew found a "sizable chunk" of marijuana "stuffed in a cereal box" onboard.[128]

WeWork also promoted the hustle culture. There were signs telling employees to "hustle harder" and the statement "don't stop when you are tired, stop when you are done" were reportedly carved into the flesh of cucumbers in WeWork's water coolers.[129] Neumann was said to be excellent at motivating employees,[130] and his charisma allowed him to inspire new recruits into believing that they were part of something that was "world-changing".[131] These employees ended up working 60 or 70 hours a week, eventually leaving when they got burned out. They were subsequently quickly replaced by new recruits who were lured in by the company's mission, and the cycle continues.[132]

We control

"WeWork is the latest wakeup call for those who believe that multivote shares are the answer to innovation and entrepreneurship. We are seeing the problems of such shares at Facebook and at CBS/Viacom. Imagine entrenching someone like Adam Neumann – with multivote shares, there is no escape valve."

– National University of Singapore Associate Professor Mak Yuen Teen[133]

Among the series of corporate governance issues that WeWork's S-1 filing revealed, one glaring cause for concern for investors was the multi-class share structure WeWork had put in place which "made it extremely difficult for the company's board to forcibly remove him [Neumann]".[134] This was in addition to the fact that Neumann was both the CEO and Chairman of the board.[135]

In the initial S-1 filing in August 2019, WeWork disclosed three classes of shares. Class A shares, which are to be traded publicly after its IPO, will have one vote per share. Class B and C shares which are almost exclusively held by Neumann, have 20 votes each.[136] Although dual-class shares (DCS) structures are not uncommon among U.S. tech companies, 20 votes per share was "extreme" even by Silicon Valley's standards, with the norm being 10 or less as seen in Facebook and Snap Inc.[137]

A calculation of Neumann's voting power in WeWork showed that he held de facto control of the company despite his economic interest being disproportionately much smaller than what his voting power indicates. Neumann held 115 million shares in WeWork as compared to the 165 million shares held by WeWork's major external investors, thus it was approximately a 40/60 split in terms of economic interest. However, Neumann's Class B and C shareholdings, constituting 2.2 billion votes in aggregate, tipped the voting power to 93/7 in his favour.[138]

In a speech by Neumann to employees in January 2019, he was quoted saying that WeWork "[isn't] just controlled – we're generationally controlled", further explaining that he would see that his future grandchildren control the company 300 years in the future.[139] According to SEC Commissioner Robert Jackson, Neumann's outlandish proclamations seemed to be possible as perpetual dual class ownership can give founders so much power that control "will be forever held by a small, elite group of corporate insiders – who will pass that power down to their heirs."[140] Ken Bertsch, executive director of the Council of Institutional Investors, commented that WeWork's arrangement was "particularly egregious" as Neumann could selectively transfer his super-voting shares to people after his death, thus perpetuating "indefinite insider control".[141]

Some argue that the advantage of a multiclass share structure is that it gives founders disproportionate power so that they can focus on long-term strategic goals free from any external pressure to meet short-term earnings targets.[142] David Berger, a partner at law firm Wilson Sonsini Goodrich & Rosati posits that empirical evidence does not back up claims of multi-class stock opponents and that the choice of share structure does not correlate with better governance or corporate performance.[143]

Critics of multi-class share structures counter that such a share structure allows founders to act in their own self-interest rather than for the benefit of the company and its shareholders. The lack of accountability for founder-led corporations makes investing in them a risky proposition for investors.[144] The myriad of corporate governance issues at WeWork suggests that the structure is problematic.

Self-succession

WeWork's CEO succession plan also raised eyebrows when it was revealed in its August 2019 S-1 filing. Neumann's wife, Rebekah, was to lead a committee with two other board members in choosing a new CEO in the event Neumann becomes permanently disabled or passes away in the ten-year period after the completion of the IPO. If the other two board members are no longer serving, Rebekah has full control on selecting two alternate board members.[145]

One corporate governance attorney called the plan as "illustrative of a trend among companies going public with individuals closely entwined in their ownership who wish to retain a high degree of control, such as with dual-class share structures."[146] Charles M. Elson, a professor of corporate governance at the University of Delaware, commented that WeWork's succession planning was of concern as he believed that spouses are not objective and it should be done by independent directors instead.[147]

We hear you...

Amid growing investor concerns, WeWork amended its S-1 filing in September 2019 to curtail some of Neumann's power by reducing his 20 votes per Class B or C stock to 10 votes per share.[148] The company also removed the provision that allowed Neumann's wife to head the search for WeWork's successor in the event of Neumann's death or incapacitation.[149] Instead, WeWork's board was assigned the role of succession planning. The filing also stated that "no member of Adam's family will sit on [WeWork's] board."[150] These corporate governance changes were made in an attempt to appease investors in the hope of regaining public interest in the IPO.[151]

The me company

The revelation of Neumann's control over WeWork also uncovered a whole other set of problems – potential conflicts of interest between Neumann and WeWork.[152] WeWork disclosed far more related party transactions than other well-known startups in recent large IPOs. The terms "related parties" or "related party" appeared over 100 times in WeWork's S-1 filing, compared with 28 times for Lyft Inc. and seven times for Uber.[153] While investors were previously enthralled by Neumann's eccentricity, the disclosure of these related party transactions drew much criticism from investors and the media alike.[154]

It was reported that Neumann controlled WeWork by practising nepotism and cronyism, allowing his family and friends to dominate the higher management of WeWork.[155] Indeed, WeWork has been said to be a "boys' club",[156] with multiple executive positions being taken up by Neumann's Israeli friends and extended family members.[157] These positions included the Vice Chairman, Chief Impact and Brand Officer, Chief Product Officer, Head of Canadian and Israeli Operations, Head of Security, and the previous Chief Financial Officer (CFO).

For instance, Rebekah is the founder and Chief Brand and Impact Officer of WeWork, as well as founder and CEO of WeGrow, a project by WeWork to build and run private elementary primary schools.[158] WeGrow is cited as a project focusing on "conscious entrepreneurship", and its pilot programme of seven students included one of the Neumann family's five young children. The company was set up using cash from WeWork, but Rebekah had high hopes about WeGrow's prospects, and she believed WeGrow could eventually sustain itself financially.[159]

WeGrow had set up a page on its website dedicated to glorifying Rebekah's credentials, stating that she has studied Buddhism at Cornell University and is a certified Jivamukti yoga teacher.[160] Critics were however quick to point out that these certifications do not make her a qualified person in running an educational institution.[161]

Selling from me to we

The concentration of power in Neumann led to various other issues. His absolute control of the board enabled him to carry out several nonstandard financial practices that should have been flagged as conflicts of interest.[162]

In January 2019, WeWork collected US$2 billion worth of capital from SoftBank, in addition to the US$4 billion previously invested, and began rebranding itself into The We Company.[163] Later that year, in July 2019, The We Company acquired the "We" trademark from an investment vehicle co-owned by Neumann and WeWork co-founder Miguel McKelvey, We Holdings LLC. This transaction allowed Neumann to receive US$5.9 million worth of stock from The We Company.[164] During WeWork's IPO filing, this transaction received heavy disapproval from the public. As a result, WeWork recovered the US$5.9 million it paid to Neumann, while retaining the use of the trademark "We".[165] In the SEC filing, it was reported that these measures were done under Neumann's direction.[166]

In January 2019, Neumann was reported to be the landlord of four of the buildings leased by WeWork. For three of these buildings, WeWork entered into a lease on the day that Neumann acquired his ownership stake. For the last building, WeWork only signed the agreement later that year, after Neumann became the owner of the building. In the first half of 2019, WeWork made cash payments of up to US$4.2 million to buildings affiliated to Neumann. These lease commitments had a future lease obligation of US$237 million, adding up to 0.5% of WeWork's total commitments.[167] However, despite the large value of the lease commitments, neither the terms of the lease between Neumann and WeWork nor the price of at which the buildings were subsequently sublet by WeWork were disclosed.[168]

Then, in May 2019, WeWork launched an investment fund named ARK, which allowed the company to buy stakes in buildings which it plans to lease spaces from.[169] In view of the controversy surrounding Neumann leasing office properties to the loss-making WeWork business, Neumann sold part of his real estate holdings to ARK in May 2019, at the cost he spent in acquiring them.[170] Despite this move, many critics still highlighted the strong possibility of conflict of interest which still existed, as ARK – though ran independently from WeWork's main business – would remain under the executive team's control as part of The We Company.[171]

WeWork also had many dealings with other vendors or contractors who turned out to be family members of WeWork's executives and employees. One of Neumann's immediate family members was hired at a fee of up to US$200,000 for WeWork's 2018 "Creator Awards".[172] In another instance, WeWork paid the parents of then Vice Chairman Michael Gross to serve as real estate brokers for building leases in Miami, even though the couple were licensed small, independent brokers at the time.[173] In another example involving more junior employees, WeWork leased a building partly owned by the brother of Arash Gohari, WeWork's co-head of real estate.[174] It was also reported that the construction company which built many of WeWork's New York offices was owned by the brothers of Granit Gjonbalaj, WeWork's Chief Real Estate Development Officer.[175] According to Dow Jones International News, these related party transactions involving family members of lower-level employees could be an indicator of deep-rooted corporate governance issues at WeWork.[176]

Our WEalth

Neumann has also been involved in various other irregular transactions that had been highlighted by the media. In 2016, Neumann took a loan of US$7 million from WeWork at a generous rate of 0.64%, though he repaid the principal early in November 2017, together with US$100,000 worth of interest.[177]

In March 2019, WeWork provided a large stock option grant to Neumann for 42.5 million shares of common stock representing about 12% of the fully diluted economic ownership in WeWork at the time of the grant.[178] A per-share exercise price of US$38.36 derived from information disclosed in the S-1 filing indicates that the total fair market value of the shares underlying the option on the date of grant was US$1.629 billion.[179] In April 2019, Neumann took an additional loan of US$362 million from WeWork[180] which equated to the amount of the aggregate exercise price for the time-vesting portion of the stock options granted for 9.4

million shares of common stock.[181] No explanation was provided as to why WeWork granted Neumann the sizeable personal loan.

However, Neumann subsequently exchanged both the remaining unexercised portion of the March 2019 stock option grant and the 9.4 million shares previously acquired, for two lots of profit interest in WeWork. In July 2019, Neumann received 33 million units of profit interest in The We Company, in exchange for cancelling the unexercised portion of the March 2019 stock option grant of 33 million shares.[182] In August 2019, Neumann again received 9.4 million units of profit interest following his surrender of the 9.4 million shares that he had previously acquired upon exercise of the time-vesting portion of the March 2019 stock option grant.[183] According to Business Insider, Neumann benefits from these exchanges, since profit interest are seen to involve lower risks than options, which would have required Neumann to purchase the stocks and be subject to risks if WeWork's share price did not increase.[184] A compensation expert even described the transaction as "unsettling".[185] No explanation was given as to why WeWork entered into this transaction that placed Neumann in a financially favourable position. In fact, the lack of clear disclosure caused some media articles to be confused about the nature of the transaction and the underlying motivations.[186]

In July 2019, just before WeWork's IPO, Neumann also cashed out some of his stake in WeWork, whilst borrowing money against his holdings, with the value of these transactions amounting up to US$700 million.[187] This raised many questions from critics, who wondered if Neumann's cashing out was due to him being sceptical of WeWork's long-term profitability.[188]

Other board members and executives have also taken loans from the company. Board member Lewis Frankfort, Chief Operating Officer Jennifer Berrent and CFO Artie Minson received millions of dollars in loans issued in connection with restricted stock purchases and early exercises of stock options in January 2016. Since January 2016, WeWork wrote off approximately US$600,000 of the principal amount of the loan to Artie Minson. No explanation was provided by WeWork as to why a portion of the principal amount was written off.[189]

Although WeWork disclosed most of the related party transactions in its SEC filing, these transactions have raised red flags about WeWork's corporate governance.[190]

We and me

It was also revealed that Neumann had used company money to fund his personal hobbies. WeWork invested in many projects that seemed unrelated to the company's activities, as they ranged from pet projects to Neumann's personal love for surfing.[191]

In 2016, WeWork acquired a 42% stake in Wavegarden SL (Wavegarden), a company that makes surfing-wave pools, for US$14 million under the direction of Neumann.[192] It was reported that Neumann invested in it as "surfing creates community, the value central to WeWork". At the time of investment, WeWork referred to the Wavegarden investment as one of its "meaningful investments to significantly enhance our product offering."[193] Neumann also defended this investment choice by claiming that WeWork was still "discovering what is the best type of company" it wants to be.[194]

In fact, Neumann's love for surfing was evident not only through his investments. In April 2019, Neumann went on a surfing trip to celebrate his 40th birthday while WeWork was involved in its IPO process.[195] In order not to cut his surfing trip short, he decided to fly a WeWork employee out, using WeWork's money, to brief him on the company's IPO progress.[196]

In addition, WeWork paid for Neumann's US$60 million private jet, which he used for his personal endeavours.[197] Employees who worked on the renovation of his private jet claimed that the plane was renovated to include two bedrooms and a central computer through which staff members downloaded thousands of television shows and movies for Neumann's kids to watch.[198]

We pay

WeWork's S-1 filing disclosed that Neumann did not take a salary from WeWork in 2018 and was paid US$1 in 2017.[199] In 2018, WeWork's CFO Artie Minson earned US$51,000 in salary and US$625,000 in equity compensation, while Chief Legal Officer Jennifer Berrent earned US$871,154 in salary and US$7,731 in equity compensation.[200] WeWork's S-1 filing reported that "Adam, Artie and Jen are predominantly compensated through equity awards to align their interests with those of our stockholders and reward the creation of long-term value".[201]

To incentivise Neumann to push for the IPO, WeWork made a huge stock option grant to Neumann with sizable grants given to Artie and Jen as well. In March 2019, WeWork granted stock options to them to purchase a total of 49.4 million Class B shares, with Neumann receiving 42.5 million of these shares.[202] 16.4 million options would vest over a five to seven-year timeframe while the remaining 33 million options included time-based and performance-based vesting conditions tied to completion of the IPO and market capitalisation. According to Wharton finance professor Todd A. Gormley, awarding excessive stock options leads to more risk-taking by companies.[203]

Company insiders reported that Neumann's desire to show that WeWork's growth could be sustained led to the company's decision to aggressively open new properties in Q3 2019, with the expectation that the IPO would bring in US$3 to US$4 billion in new equity and US$6 billion in bank loans.[204] This was risky as new properties were generally less profitable than old ones as they required time to be occupied, compounding the huge losses WeWork already had.[205]

As WeWork's IPO fiasco unfolded, several WeWork's executives attracted attention over their remuneration as well. Artie Minson and Sebastian Gunninghan took over as Co-Chief Executives after Neumann was forced to step down in September 2019.[206] Their agreed salaries were US$1.5 million in the period when WeWork was desperately struggling to salvage its failing IPO.[207]

Golden parachutes off the crumbling building

In an extremely unpopular move, SoftBank's rescue package to WeWork included an unprecedented US$1.7 billion exit package to Neumann in exchange for reducing his voting power and Neumann leaving the board.[208]

As WeWork had banked on its IPO to give it the much-needed cash infusion to sustain its operations, the scrapping of its IPO placed the company in dire financial straits as it was expected to run out of cash by mid-November 2019. [209] WeWork accepted SoftBank's bailout deal in October 2019, which included a tender offer of up to US$3 billion for WeWork equity and an acceleration of an existing equity commitment of US$1.5 billion to WeWork. Softbank would also provide an additional US$5 billion debt package to WeWork, which consisted of US$1.1 billion in senior secured notes, US$2.2 billion in unsecured notes, and a US$1.75 billion letter of credit facility.[210] Consequently, SoftBank would own an estimated 80% stake in WeWork.[211] Sources have reported that WeWork's board chose SoftBank's rescue plan over an alternative rescue proposal by JP Morgan.[212] JP Morgan had reportedly refused to include a tender offer for shares which would give Neumann an avenue to offload his shares.[213]

Under the arrangement, Neumann sold an estimated one-third of his WeWork shares to SoftBank for US$970 million. SoftBank further extended a credit line of US$500 million to allow Neumann to repay his outstanding loans made to him by other banks. Furthermore, Neumann promised to work exclusively with WeWork for four years for a "consulting fee" of US$185 million.[214]

According to analyst firm Decision Data, Neumann's full US$1.7 billion payout deal could have paid the salaries of 4,000 WeWork workers – who were expected to be retrenched in the company's restructuring – for 4.7 years, assuming each employee earned an average annual salary of US$90,000.[215]

In a survey, 85% of WeWork employees said that Neumann's US$1.7 billion exit package was unfair in view that many employees were expected to be retrenched in WeWork's impending layoffs.[216] In response to employees' queries over Neumann's payout, Marcelo Claure, the new Executive Chairman of WeWork, commented that it was "going to be a great investment to basically put the company back into our hands for us to be able to run it without having somebody with a gun always basically voting shares 10 to 1."[217] As Neumann's Class B and C shares gave him disproportionate voting power, SoftBank had to buy him out to wrestle control of WeWork in order to implement any reform.

Meanwhile, the Co-Chief Executives of WeWork, Artie Minson and Sebastian Gunningham, were reportedly each given US$8.3 million exit packages, which were negotiated after Neumann stepped down as CEO.[218] A media article made a pertinent observation that: "No matter how badly someone at the top screws up, they walk away with a nine-figure check, while the costs of the mess they made slide down the corporate ladder."[219]

WeWork's leadership and culture

While Neumann had been blamed for WeWork's IPO failure, Business Insider's Editor-in-Chief, Alyson Shontell argued that WeWork's board has also "failed miserably at their job".[220] She stated that boards of startups like WeWork often consist of many venture capital insiders who consider a visionary founder to be integral to the success of a startup. [221] The venture capital insiders on WeWork's board knew that WeWork would never have achieved its US$47 billion valuation without Neumann.[222] Thus, WeWork's board likely gave Neumann "free rein to do almost anything [he] wants", ignored business metrics and failed to act as a check and balance for the company.[223] Another media article also argued that WeWork could have delivered on its valuation and avoided many of the problems it faced if the board had taken a step back and considered WeWork's execution readiness at each stage of expansion.[224]

Meet the board

WeWork had seven directors when it filed for IPO. Apart from Neumann, who was then the Executive Chairman of the board, the six other board members were non-executive directors.[225] Three of these directors – Bruce Dunlevie, John Zhao, and Ronald Fisher – were nominated by three major investors, Benchmark Capital, Hony Capital and SoftBank Vision Fund L.P., respectively.[226] They are the founders of these major venture capital firms.[227] From the SEC filings, there was no indication that any of the non-executive directors have had experience in the real estate industry.

The other three directors were Steven Langman, the co-founder of global private equity firm Rhône; Mark Schwartz, former Vice Chairman of Goldman Sachs Group Inc. and Chairman of Goldman Sachs Asia Pacific; and Lewis Frankfort, former Chairman of American luxury brand Coach.[228] With the exception of Lewis Frankfort, all of WeWork's non-executive directors mainly only had relevant expertise in finance and investments.[229]

"Diversity" in an all-male board

WeWork also faced criticism with its all-male board disclosed in its S-1 filing. Critics found this to be ironic for a company that boasted of its "culture of inclusivity".[230] In recent years, major investors such as Blackrock and State Street have been pushing back against companies with all-male boards.[231]

In response, WeWork announced in its amended S-1 filing on 3 September 2019 that it planned to welcome Frances Frei – a female professor of technology and operations managements at Harvard Business School – to its board upon completion of its IPO.[232] Frances Frei was the Senior Vice President of Leadership and Strategy at Uber and was hired to fix the toxic culture at the ridesharing company,[233] which was under scrutiny for issues of sexual harassment and sexism.[234] However, WeWork eventually withdrew its IPO application and Frances Frei was not appointed as a director.

"Inclusive" if you are one of us

"[Women] played a secondary role … They were told to not get involved – not get involved in a substantial way – to not talk too much about what they were contributing in big meetings and sometimes were brought artificially into meetings to sit there while their male counterparts would speak on their behalf."

– Male WeWork employee who worked closely with C-suite executives[235]

The issues of inclusivity and diversity did not only lie within the board, but extended to the entire company, with many instances of former employees filing lawsuits against the company for discrimination.

In 2018, a woman in WeWork's real estate department sent a 50-page document regarding alleged drug use, sexual harassment and pay discrimination in WeWork.[236] WeWork allegedly paid her US$2 million in cash as a private settlement.[237]

Ruby Anaya, who was WeWork's director of culture before her ousting, had also sued WeWork, claiming sexual assault at WeWork company events. She alleged that misconduct was enabled by WeWork's "entitled, frat-boy culture".[238] She claimed to have been fired after voicing discontent over the lack of action taken against her assailants and for bringing up the issue of WeWork's gender pay gap.[239] WeWork responded that the claims were "meritless".[240]

Lisa Bridge, a former executive at WeWork, sued the company for gender discrimination and unequal pay. She claimed that WeWork approved a number of equity grants worth above US$1 million "almost exclusively to men".[241] She raised this issue to the company, but the Chief Human Resource Officer justified such pay gaps on basis of stereotypes such as "men take risks and women don't".[242]

Richard Markel, a former vice president of construction in his sixties, also sued WeWork for age discrimination. According to the lawsuit, WeWork hired Lincoln Wood, who was 20 years younger than Richard Markel under the same job title without any explanation.[243] He alleged that he was fired shortly after he raised concerns about age discrimination.[244]

The new we

Major changes have been made to WeWork's board since its failed IPO.[245,246,247,248,249] Neumann was removed from WeWork's board as part of SoftBank's bailout.[250] In addition, Ronald Fisher, Steven Langman, and Mark Schwartz left the board prior to February 2020, and Lewis Frankfort was expected to resign in April 2020.[251]

SoftBank had the ability to appoint five out of 10 directors.[252] Following the departure of Neumann, SoftBank appointed its "corporate fixer" Marcelo Claure as WeWork's Chairman.[253] Other SoftBank appointments include Sandeep Mathrani, who became WeWork's new CEO;[254] Kirthiga Reddy, SoftBank executive;[255] and Jeff Sine, partner of Raine Group.[256] Kirthiga Reddy would be the first and only female on WeWork's board to-date.[257] Sandeep Mathrani is said to be a no-nonsense leader who "has a history of women reporting to him". [258] While WeWork is taking steps to clean up the mess, it still has a long way to go.[259] Four more directors are expected to be elected to fill up the empty board seats.[260] WeWork has also revamped its upper management team. In addition to the appointment of Sandeep Manthrani as CEO, four other executives were also added to the C-suite between February 2020 and March 2020, including two female executives.[261,262,263]

Despite these developments and Neumann's departure from WeWork, Neumann may still have some lingering influence. According to a media article, Neumann's exit deal would give him the right to nominate a director and appoint a non-voting observer while WeWork remains private, contingent on the repayment of his debt to SoftBank and compliance with a four-year non-compete agreement.[264] Neumann could regain two board seats contingent on the above conditions if WeWork goes public, provided the underwriters of IPO do not raise objections.[265]

Turnaround plan

After WeWork's disastrous IPO, the company announced plans that aimed to stem its losses by focusing on its core business, slowing down on expansion, and laying off workers.[266] WeWork aims to have a positive adjusted EBITDA by 2021 and positive free cash flow by 2023.[267]

Additionally, it plans to divest from non-core businesses[268] and has since sold the content marketing company Conductor it previously acquired back to its founders and executives.[269] It also announced on 22 January 2020 that it sold its minority ownership in co-working startup The Wing and business management software company Teem.[270] In March 2020, WeWork sold the office management company, Managed by Q, to workplace management platform Eden at a mere 11% of the price WeWork paid to acquire it in 2019.[271] On 31 March 2020, it was also reported that WeWork sold off the social networking platform Meeting to Alley Corp and other private investors for an undisclosed sum that was far less than the US$156 million acquisition price WeWork paid to acquire it in 2017.[272]

WeWork is also "slamming the brakes on expansion". [273] Only 64,000 and 49,000 square feet of new leases were signed in Manhattan and London respectively in Q4 2019.[274] This was the slowest growth in new leases in Manhattan since five years ago and in London since Brexit in 2016.[275] This is significant as New York and London are WeWork's top markets.[276] The growth of new leases in other markets has also been slow.[277] In addition, WeWork has been looking to unravel lease deals for up to 100 buildings, which represent 10% to 15% of WeWork's office footprint.[278] WeWork was also said to have plans to leave several U.S. markets and a number of planned locations in China and Southeast Asia.[279]

In WeWork's attempts to cut cost, 2,400 workers – 20% of WeWork's global workforce were laid off.[280] In addition, 1,000 maintenance and service staff were transferred to Jones Lang Lasalle, Unity Building Associates and ABM Industries.[281] WeWork is also expected to have a fresh round of layoffs in 2020 that could impact over 1,000 employees.[282]

Even unicorn magic may not be enough

As Silicon Valley continues to point fingers in respect of WeWork's high profile IPO flameout, WeWork's predicament remains unresolved. Investors have been quick to call out Neumann's unrealistic ambition with a personality bordering on megalomania as the root cause for downfall of WeWork.[283] Part of the blame has been placed on SoftBank and other investment banks like JP Morgan, Goldman Sachs and Morgan Stanley for "stroking Neumann's ego with forecasts of a $100 billion IPO valuation".[284] With multiple corporate governance issues resulting from over concentration of power in Neumann, coupled with a highly questionable business model, WeWork's IPO failure is emblematic of a recent trend of issues with unicorn tech companies in Silicon Valley. One article succinctly defines them as "a rarefied subset of multibillion-dollar tech companies that share the attributes of enormous valuation and unapologetically outlaw founders."[285]

The tech industry appears to be going through a phase of introspection.[286] Investors have become more wary of the valuations of unicorns, as observed from the decline in Uber's huge post-IPO valuation.[287] Neumann's rise and fall uncannily mirrors that of Travis Kalanick, the visionary co-founder of Uber who was kicked out for mismanagement and misconduct.[288] However, the underlying systemic problem of overvalued unicorns remains largely unaddressed.

The artificially low near-zero interest rates western governments had maintained for almost a decade to recover from the global financial crisis of 2008 has led to an excess of funds in the private equity market.[289] As investors continue to search for returns in a low-yield world, they have turned to riskier investments in the private capital market, leading to a compound annual growth of 8% from 2013 to 2018.[290] However, this huge inflow of cheap cash contributed to irrational exuberance. Venture capitalist funding is likened to a "house of cards." [291] Venture capitalists like SoftBank inject huge amounts of money into unicorns with possibly shaky fundamentals to artificially drive up valuations to insane levels. Their aim is to cash out "before that house of cards crumbles."[292] They have the mindset that most investments will fail but at least one might be the "next Facebook or Google and will offset all other losses".[293]

A 2018 study by University of California researchers argues that the proliferation of unicorns and the unprofitability of the bulk of unicorns after IPO is a repercussion of them "each trying to ignite the winner-take-all dynamics through rapid expansion characterized by breakneck and almost invariably money losing growth, often with no discernible path to profitability".[294] The power dynamics have inverted between startups and investors as venture capitalists compete to fund startups like WeWork.[295] This may potentially lead to the funding of companies with huge losses, ignoring governance practices and the blind adulation of startup founders.

In October 2019, SoftBank did not change its approach and doubled down to bail out WeWork with a financial rescue plan which saw the departure of Neumann from the company.[296] Thereafter, extensive management reshuffling and cost-cutting measures have been implemented to stem the bleeding of cash. Despite the drastic cuts, WeWork was reported to have burned US$1.4 billion in cash over Q1 2019.[297]

The global coronavirus pandemic came at an inopportune time for WeWork as lockdown and social-distancing measures could kill off the embattled firm. Chase Feiger, a senior entrepreneur and a tenant of WeWork commented "I think WeWork is potentially the worst place you can be during this pandemic".[298] Other reports corroborate the thin attendance at WeWork offices. A tech consulting tenant in Brooklyn Heights reported that there was "just eight people on a floor designed to hold 100 workers of small startups."[299] The post-coronavirus landscape could further disrupt the shared office business model as it could permanently reduce the appetite of people for working in offices.[300] This might be the last fatal blow to WeWork's main value proposition of working in close proximity to others.

In March 2020, SoftBank announced its withdrawal of the US$3 billion share buyout of WeWork, citing WeWork's failure to meet certain conditions.[301] Some of the reasons cited were the investigations into WeWork by the U.S. Justice Department and also the failure to agree on terms for consolidation of a WeWork joint venture in China.[302] The US$3 billion share buyout of existing WeWork shareholders included the nearly US$1 billion buyout of Neumann's shares in his exit package. Consequently, SoftBank is not obliged to provide US$1.1 billion in debt financing, compounding WeWork's cash crunch amidst the coronavirus crisis.[303] In response, a special committee of WeWork's board, on behalf of The We Company, has sued SoftBank to force it to continue with the abandoned US$3 billion share buyout.[304] WeWork alleged that

SoftBank had breached its fiduciary duties to WeWork's minority shareholders by abandoning the share tender offer.[305] More legal actions are expected to be launched against SoftBank.[306]

WeWork cannot seem to catch a break. Its magical rise to unicorn status fuelled by a seemingly endless amount of venture capital funding has been matched with an equally spectacular free-fall. Its charismatic and supposed visionary founder has been ousted. WeWork's endless well of cash seems to be running dry. What WeWork is left with is probably just an unsustainable business model.

A writer at The Atlantic pointed out, "[unicorns] have to change their stories, and their businesses. Magic made them. Only math will save them".[307] Amidst the global market uncertainty during the coronavirus outbreak, WeWork is on borrowed time to make the math work out.

Discussion questions

1. What are the inherent risks in WeWork's business model? Aside from corporate governance concerns, what other factors contributed to the failure of WeWork's initial public offering?
2. WeWork and Adam Neumann have been compared to other failed startups with prominent founders, such as Theranos and Elizabeth Holmes. To what extent were media articles justified in make these comparisons? What are the potential risks of a charismatic founder-CEO?
3. Discuss whether Adam Neumann had too much power in WeWork. What are the potential benefits and risks of Adam Neumann holding on to a lot of power, making particular reference to the multi-class share structure of WeWork?
4. Critically evaluate whether WeWork's related party transactions are a cause for concern. How are WeWork's related party transactions harmful for its minority shareholders and the company as a whole? What safeguards could have been put in place to restrict such abuses?
5. Based on the events that have transpired, were the remuneration packages awarded to Adam Neumann reasonable? Why do you think the board gave him a billion dollar exit package despite the huge losses reported during his tenure and revelation of corporate governance issues?
6. WeWork's culture has been described as being party-like, lacking in inclusivity and akin to a "revolving door". What were the factors that contributed to the culture in WeWork? What are the problems with such a culture?
7. Discuss the problems with the composition of the board of directors of WeWork prior to the S-1 filing on 14 August 2019, making reference to relevant rules or guidelines in corporate governance. Critically evaluate whether the directors of WeWork had breached their duties. Do you think the changes to the board are appropriate? Explain.
8. Discuss the influence of venture capitalists like SoftBank on the tech industry. Is the trend of venture capital funding responsible for the failure of recent unicorn IPOs?

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WIRECARD GONE HAYWIRE

Case overview

On 30 January 2019, the Financial Times made allegations – not for the first time – of accounting irregularities involving Wirecard AG's Singapore subsidiary. This resulted in a raid by the Commercial Affairs Department of Singapore. Wirecard AG categorically rejected the allegations of impropriety but this was just the latest allegation levied against the German company. Since then, there have been lawsuits and new allegations. An astounding €1.9 billion of cash on its balance sheet was reportedly missing. Its long-standing Chief Executive Officer resigned, while its 40 year-old former Chief Operating Officer became an international fugitive and is said to be a Russian agent.

The objective of this case is to facilitate a discussion of issues such as the German two-tier board system; how the board should respond to public allegations; accounting fraud; the four lines of defence model; whistleblowing policy; role of external auditors and audit failures; role of the media and regulators; governance of tech companies; and governance of overseas subsidiaries.

First sparks

Wirecard AG (Wirecard) became embroiled in a protracted public and legal battle with the British financial newspaper, the Financial Times (FT), after the FT accused it of round-tripping and accounting fraud at its Singapore subsidiary on 30 January 2019.[1] The allegations triggered a 40% fall in the company's share price to €99.[2] In a follow-up report on 1 February 2019, the FT substantiated its claims using details provided by an anonymous whistleblower, as well as a leaked preliminary report compiled by Singapore law firm, Rajah & Tann Singapore LLP (Rajah & Tann), which Wirecard had engaged to carry out further investigations on the matter.[3]

The man behind the accusations is FT journalist Dan McCrum, based in London, who first published an investigative report on Wirecard in April 2015 questioning Wirecard's accounting practices.[4] Since the release of the first article, McCrum and his team have continued following Wirecard closely, releasing a series of investigative reports on the company named the "House of Wirecard" series.[5]

Wirecard denied the allegations made by the FT, declaring them as "inaccurate, misleading and defamatory".[6] Wirecard's Chief Executive Officer (CEO), Markus Braun, also dismissed the accusations as a "non-story",[7] deeming it a local issue with insignificant financial impact on the company.[8] Wirecard instead made its own allegations against the FT, claiming it was "relying

This case was prepared by Koh Tzi Yene, Toh Jia Hui Tricia, Lim Jing Yuan Justin, Yeo Zhi Hui, Benjamin and Edison Tan Peng Keat, and edited by Isabella Ow under the supervision of Professor Mak Yuen Teen. It has been substantially re-written, with information added, by Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organizations named in the case, or any of their directors or employees.

on fake material and that its own journalism is corrupt and suspect" and that the reporters conspired with short sellers to manipulate the market.[9]

The colour of the wire

"Why so much drama? For one, Wirecard has a business model that is pure catnip to critics of every stripe."

– Roddy Boyd, The Foundation for Financial Journalism[10]

From red (light) to blue (chip)

Founded in 1999, Wirecard is a global financial technology (FinTech) giant of online payments and risk management services, headquartered in Munich, Germany.[11] In 2002, CEO Braun was hired to turn around what was then a three-year-old start-up that had been laid low by the dot-com crash.[12] His roles, besides chairing the management board of Wirecard, included being the Chief Technology Officer as well.[13] He held a seven percent stake in the company, making him the largest shareholder and a billionaire.[14]

Wirecard successfully transformed its clientele from online gambling markets and the adult entertainment industry,[15] to a global customer base of millions of internet merchants after the purchase of XCOM Bank AG at the start of 2006 (now trading as Wirecard Bank AG) for €13 million.[16] Wirecard then expanded its customer base for its payment services.[17] CEO Braun masterminded a series of quick fire acquisitions which helped the firm to double its revenue.[18] The acquisition of Citi Prepaid Card Services, a payment processing arm of the American bank, in 2016 is a prime example – Citi Prepaid Card Services already had more than 2,500 card programmes for large international companies situated primarily in the North American market.[19]

The purchase of the payment businesses of Great India (GI) Retail Group marked Wirecard's intent to secure a strong position in one of the world's most rapidly growing electronic payment markets.[20] In 2018, Wirecard partnered with Mizuho Bank, to provide issuing and acquiring services to Mizuho Bank's corporate clients.[21] Wirecard is also amongst the first movers in the current industry-wide effort to penetrate the Chinese market, by aiming to acquire all shares in Beijing-based AllScore Payment Services.[22]

Riding on the wave of global e-commerce, rapid expansion in its online payments business helped Wirecard to grow quickly. This drove Wirecard up the ranks of leading German companies. Wirecard secured partnerships with Chinese mobile payment companies Alipay and WeChat Pay, hoping to cash in on the increased prevalence of using mobile apps to pay for goods in stores worldwide.[23]

Figure 1 shows the partial group structure of Wirecard.

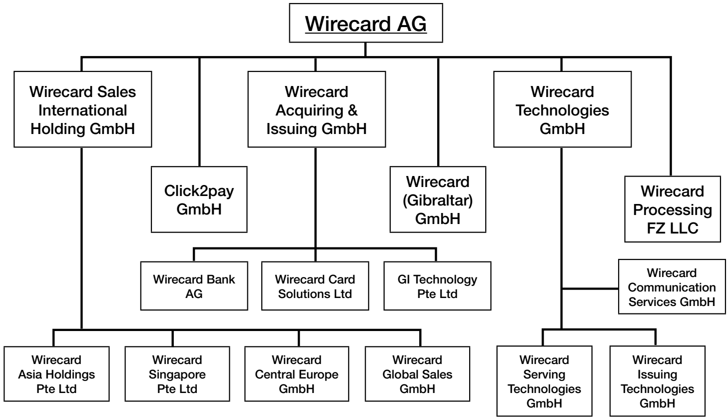

Figure 1: Main group structure of Wirecard AG (partial)[24]

In September 2018, the German stock exchange operator Deutsche Börse announced that Commerzbank AG (Commerzbank) would make way for Wirecard in the blue-chip DAX index.[25] This was just weeks after Wirecard surpassed Germany's biggest bank, Deutsche Bank, in market capitalisation.[26] As Germany's banks continue to battle with a legacy of bad debts, bloated headcounts and fines a decade after the global financial crisis, Wirecard was powering ahead.[27]

In FY2018, Wirecard's reported annual profits more than tripled from €94.5 million a decade ago to €347.4 million,[28,29] while total market capitalisation increased from €420 million to €16.41 billion in the same period. While Wirecard's stock price has been volatile since its listing at €5.22 in 2006,[30] it rose to an all-time high of €195.75 on 3 September 2018 and stood at €132.80 on 31 December 2018.[31]

Dealing the cards

Wirecard's business model revolves around transaction-based fees for the use of its services, as well as the provision of tailor-made and comprehensive digital solutions for corporates. It actively pursues strategic partnerships with fintech companies and banks to promote and operate its technologies throughout the entire payment value chain. A key revenue driver for Wirecard is the electronic payment service provided to e-retailers and brick and mortar businesses.[32]

As a member of the Visa and Mastercard payment networks, Wirecard deals with paperless money transactions in the range of hundreds of millions of euros a day.[33] It acts as an acquirer in the payment processing value chain.[34] Its role involves processing payment transactions through cards on behalf of merchants. As an acquirer, Wirecard receives the card transaction details from the merchant's payment terminal, usually provided by the acquirer, and passes these details to the card issuers, usually banks or financial institutions, via the card schemes, including Visa and Mastercard, for authorisation.[35]

In Singapore, Wirecard has embarked on projects that have provided comprehensive digital solutions for different organisations. It was involved in setting up an Electronic Road Pricing (ERP) payment service for the Singapore's Land Transport Authority (LTA) and DBS Bank project, which allows motorists who subscribe to the service to bill their ERP fees to their credit card.[36] Additionally, Wirecard Singapore Pte Ltd (Wirecard Singapore) provided a new payment processing solution to support Singapore's ComfortDelgro in its efforts to automate its payment processes and to carry out card payment transactions for all its Comfort and CityCab taxi services.[37]

Globally, Wirecard has more than 5,800 employees located in 26 countries.[38] 48% of its employees are stationed in the Asia Pacific region while 28% are in Germany.[39]

Located in Singapore, Wirecard Singapore and Wirecard Asia Holding Pte Ltd (WAH) are subsidiaries of Wirecard Sales International Holding GmbH, which is directly controlled by Wirecard.[40] While there are a number of subsidiaries in the region, these two entities give the Group access to the Asia Pacific markets and act as the channels of management from the Group to the other entities in the region. The Group's Asia Pacific headquarters is located in Singapore.[41]

Exposed wire

Wirecard's policy provides for employees to report violations of compliance or misconduct in the Group either by submitting in their own name or anonymously. Wirecard's senior legal counsel, Pavandeep Gill, and Head of Global Regulatory Compliance, Royston Ng, first received tip-offs from a whistleblower in April 2018 regarding concerns about the actions of a fellow finance team member based in Singapore.[42,43] Daniel Steinhoff, Wirecard's Head of Compliance in Munich, flew to Singapore for a briefing and on 13 April 2018, ordered the email archives of the suspected individuals to be seized.[44]

Following further investigations by the compliance staff, during which substantial evidence supporting the credibility of the whistleblower's claims was uncovered,[45] it was decided that the whistleblower's complaint warranted an independent investigation.[46] Wirecard AG engaged Singapore law firm Rajah & Tann and the investigation was codenamed "Project Tiger".[47]

According to the FT, it was approached by the whistleblower after he perceived inadequate follow-up measures undertaken by Wirecard to address the concerns, when it could potentially involve criminal liability.[48] On 30 January 2019, the FT proceeded to publish the first of a series of reports alleging financial wrongdoings by Wirecard.[49]

"Project Tiger" rears its ugly teeth

Rajah & Tann submitted a preliminary report on 4 May 2018 regarding Wirecard's corporate governance which described the key players and listed its key findings to date.[50]

The preliminary report shed light on the six finance team members based in Singapore whose names and roles were highlighted.[51]

Edo K.'s not O.K.

Central to these allegations is Edo Kurniawan (Edo K.) – vice president and director of WAH – one of the six suspects named who allegedly devised a round-tripping scheme to falsely bolster the revenue of the company.[52] The scheme involved the company making a series of transactions across various units which would eventually make its way back to the company again, falsely misleading the local auditors into thinking that these transactions gave rise to legitimate business revenue. Edo K. later left the company on 1 April 2019.[53]

Checking the wires

The preliminary report contained three key findings which were corroborated by the whistleblower's accounts and the documents which were reviewed in Project Tiger.

Firstly, there was evidence to suggest that Edo K., James Wardhana – international finance process manager of WAH – and Widhayati Darmanwan, the director of PT Aprisma Indonesia (PT Aprisma), had collaborated to sign backdated agreements in order to support invoices that were billed by PT Aprisma to third parties such as MILE & Associates, Right Momentum Consulting Sdn Bhd, Flexi Flex Abrasives, and Matrimonial Global.[54]

Secondly, Edo K., Wardhana and N R Venkatesan, a director of Hermes I-Tickets Private Ltd. (Hermes) – an affiliate of Wirecard – had collaborated to create and backdate an agreement related to Hermes and a third party named Orbit Corporate Leisure Travels I Private Limited.[55] Hermes would later reappear in a separate legal suit against Wirecard.

Lastly, evidence suggested that a share capital injection of €2 million by Wirecard into Wirecard Hong Kong Limited was based on a misrepresentation by Edo K. that the subsidiary had generated revenue of €3 million. These financials were submitted to the Hong Kong Monetary Authority to obtain a license which would enable the Hong Kong subsidiary to carry out its merchant acquisition business in Hong Kong.[56]

Under Section 477A of Singapore's Penal Code, these findings pointed to offences of "forgery and/or of falsification of accounts/documents".[57] There were suspicions that those involved might have concealed other offences such as cheating, criminal breach of trust, and money laundering. The preliminary report strongly recommended a full-scale investigation.[58]

Apart from Edo K. and Wardhana, the other four Wirecard employees suspected of "arrestable offences" were senior finance executive Irene Chai; managing directors Fook Sun Ng and Jeffry Ho Kok Hoong; as well as Grigory Kuznetsov, who was responsible for Wirecard's payment services licensing in Asia.[59]

When parallel wires conspire

"The charge of abetment by conspiracy is frequently used by the prosecution, especially in cases such as corruption."

– Rajah & Tann LLP, preliminary report[60]

In Singapore, a parent entity (in this case, Wirecard AG) may be liable for the acts of its subsidiary (Wirecard Singapore) if the parent entity was acting in conspiracy with its subsidiary. In particular, Wirecard AG may face an offence of abetment in Singapore under Section 108A of the Penal Code.[61] Compared to an offence of criminal conspiracy, the charge of abetment by criminal conspiracy is frequently used by the prosecution for cases of corruption where it is difficult to detect cases of conspiracy.[62] Under such a charge, the parent company need not be equally informed of the details but must be minimally aware of an unlawful plot's general purpose.[63] On top of this, the conspirator must play some role in the conspiracy as such knowledge or consent does not constitute a criminal conspiracy.[64]

Alternatively, Wirecard AG may also be held responsible for the acts of Wirecard Singapore if the corporate veil is pierced or the subsidiary was acting as an agent of the parent.[65] If Wirecard AG is found to be responsible for the acts of Wirecard Singapore, it may translate to criminal liability back in Germany on top of criminal liability in Singapore.

Live wire reported: CAD raids the Singapore office

Following the FT's allegations, the Commercial Affairs Department (CAD) of the Singapore Police Force raided the premises of Wirecard Singapore, with the first raid taking place on 8 February 2019.[66] Relevant materials and documents from the accountancy and compliance department were obtained,[67] although Wirecard did not grant the CAD full access to complete email archives of some of its employees.[68] Subsequently, an order for full access of documents was issued. When the company claimed to not have the archives, the CAD proceeded to seize 229 boxes of Wirecard documents from an external document management company.[69]

On 18 February 2019, Wirecard filed a criminal motion to limit the scope of CAD's investigations.[70] Despite the appeal, CAD raided Wirecard Singapore's office again on 20 February 2019 and 5 March 2019 to seize more documents.[71] The filing for limit of scope was eventually dismissed by the High Court on 11 March 2019[72] for having "no legal basis", regarding it as an "abuse of process…because they seek to unlawfully limit the investigations of CAD".[73] It affirmed that Wirecard was not bound by law to produce "all documents" but questioned its co-operation in the investigations.[74]

Wirecard's shares fell by 15.8% to €93.24 after the first CAD raid, and slumped by 44% since the first FT article was published on 30 January 2019.[75] The beleaguered company's share price recovered thereafter, but following the dismissal of limit of scope by High Court, the share price fell again, closing at €104.86 on 15 March 2019.[76]

Short (-sellers') circuit

Despite being one of the rare success stories of Europe's limited financial technology scene, Wirecard's stock has perennially been on the receiving end of speculative short-selling due to doubts over its rapid international expansion and accounting practices.[77] Over the years, Wirecard's stock price has been highly volatile, facing sharp drops in 2008 and 2016 following claims of accounting irregularities and fraud.[78]

In 2008, the then head of an investor advocacy group, Schutzgemeinschaft der Kapitalanleger, who was said to be a journalist holding a short position in Wirecard's stock, published accusations of accounting irregularities at Wirecard.[79] This prompted a raid of the investor group's premises by the Munich prosecutors, and in 2012, he was convicted for market manipulation.[80]

Subsequently, in 2016, fraud allegations were made against Wirecard in a 101-page report released on the website of a U.K.-based entity, Zatarra Research. This led to a probe of the report and subsequently, an individual responsible was fined.[81]

Germany's two-tier board system – Cross wire or earth wire?

A dual board system is prescribed by German law, with one board of executive officers and another separate board of supervisors.[82] The management or "executive" board is commonly comprised of the company's senior-level employees, appointed by the supervisory board to jointly run the business.[83] The supervisory board comprises experts working outside of the company who are appointed by shareholders, and employee representatives.[84] A high degree of neutrality and a clear division of the respective duties of the two organs are seen to be advantages of the two-tier board system.[85]

Wirecard follows a dual board system, with a separate management and supervisory board.[86] At least half of the members of the supervisory board should be independent and no more than two members of the supervisory board can be former members of the management board. There are also requirements relating to competencies, international experience and gender diversity.[87]

Wulf Matthias was the Independent Chairman of the supervisory board until January 2020, when he resigned and was replaced by former Deutsche Börse Chief Financial Officer (CFO) Thomas Eichelmann.[88] Austrian Stefan Klestil is the Independent Deputy Chairman.[89] The supervisory board consisted of five members until the end of June 2018 but was to be enlarged to six members following a resolution at the company's 2018 Annual General Meeting – although as of July 2020, there were only five members.[90]

Up to the end of FY2018, there were no committees in the supervisory board. In the first quarter of FY2019, three committees were formed – the Audit Committee; the Remuneration, Personnel and Nomination Committee; and the Risk and Compliance Committee.[91]

During FY2018, the supervisory board met eight times. According to the annual report: "Participation in the meetings by the members was also at a high level in 2018. All members of the supervisory board participated in significantly more than half of the meetings of the supervisory board in the 2018 fiscal year".[92]

The management board was led by four key personnel – its Chairman and CEO Braun (before he resigned in June 2020),[93] CFO Alexander von Knoop, Chief Operating Officer (COO) Jan Marsalek and Chief Product Officer Susanne Steidl.[94]

When allegations of suspicious accounting irregularities arose, supervisory board Chairman, Matthias, dismissed fraudulent accounting practices allegations as “annoyances” and that “they have better things to do”.[95]

Circuit breaker: The great BaFin ban

A two-month short-selling ban was imposed on Wirecard’s shares by The Federal Financial Supervisory Authority (BaFin) under the General Administrative Act starting from 18 February 2019.[96]

Unlike regulatory sandboxes extended to fintech companies in many countries including Singapore,[97] fintech companies in Germany are treated no differently from other companies in the finance sector and are regulated by regulatory authorities of the financial sector such as BaFin.[98] They are also subject to all relevant rules and regulations applicable to companies in Germany, such as the Securities Trading Act and EU regulations.[99]

BaFin aims to maintain financial stability in Germany.[100] It attributed the fluctuations in the market during the first half of February to Wirecard’s share performance, having observed sharp increases in the amount of short positions during this period and especially since the day prior to the release of allegations by the FT.[101] Other trends identified include large positions by foreign investors and “at levels below the notification threshold”, which culminated in an unprecedented short sell ban to stabilise the market.[102]

BaFin also noted a drop in the share price from €167.00 to €99.00 from 30 January 2019 to 15 February 2019. Coupled with the fact that Wirecard has been a short-seller’s favourite, BaFin believed that the ban will bring about benefits that outweigh any negative effect on the efficiency of the financial markets of Germany.[103]

Is BaFin the Muffin Man in disguise?

Following the initial allegations by the FT, the German prosecutors announced on 31 January 2019 that those allegations were not sufficient to start any investigations against Wirecard.[104] Instead, their priority was to commence investigations into potential market manipulation.[105] This led Roddy Boyd of The Foundation for Financial Journalism to question BaFin’s role as regulators.[106]

As a supervisory regulator, BaFin does not have the authority to make arrests. Instead, crucial evidence and findings are given to authorities such as the public prosecutor’s office.[107] BaFin submitted documents indicating the possibility of short selling attacks against the shares of Wirecard to the Munich Prosecutor’s Office on 16 April 2019.[108] This was in addition to ongoing investigations on market manipulation against short-sellers suspected to have been aware of the allegations prior to them being made public by the FT.[109]

The short-sell ban managed to achieve its desired effect of stabilising the price of Wirecard’s shares. However, the stabilisation only came into effect after a loss of €10.6 billion in Wirecard’s market capitalisation.[110]

Hermes issues tickets to the bashing party

To compound Wirecard's woes, between February and March 2019, the German company became entangled in multiple lawsuits surrounding its Chennai-based affiliate, Hermes.[111] Four years earlier, in October 2015, Wirecard purchased the Hermes payment business as well as a 60% stake in a related subsidiary, Great India Technology Pte Ltd (GIT),[112] in a €340 million deal from its parent Great India (GI) Retail Group.[113] This figure comprised a €230 million cash payment and €110 million in prospective earnout payments over three years.[114] The nature and amount of this transaction was the subject of the dispute leading to the subsequent lawsuits.

Wirecard's latest predicament arose after Hermes became the subject of investigations by the Singapore police, in light of the FT's allegations.[115] Hermes was implicated in the preliminary findings by law firm Rajah & Tann,[116] and was being investigated along with other entities related to Wirecard.[117]

In February 2019, two former minority shareholders of Hermes, Prashant Manek and Sanjay Chandi, filed a separate lawsuit in London against Wirecard for its alleged role in fraudulently concealing the true position of the acquisition deal transacted in 2015.[118] The separate lawsuit followed their original lawsuit in 2017 against Ramu and Palaniyapan Ramasamy, the founders and former majority owners of Hermes and GIT,[119] and present owners of GI Retail Group,[120] who signed off on the 2015 sales. In the initial lawsuit, Manek and Chandi insisted they have been duped by the majority owners and that their compensation was based on a purchase price of US$40 million when it should have been based on the higher price announced by Wirecard.[121] Wirecard was not formally accused of any wrongdoing in the initial lawsuit.[122]

Wires catching fire

In March 2019, GI Retail filed its own lawsuit in Chennai, India against Hermes, Wirecard and its COO Jan Marsalek, with the Ramasamy brothers accusing Wirecard of making wrongful assertions about the figure paid to them in the 2015 acquisition.[123] GI Retail sought clarification over details of the transaction from Wirecard, as it claimed to have been paid only "a fraction of that [€340 million] deal", through a Mauritius-based fund called Emerging Markets Investment Fund 1A (EMIF).[124,125] Both the fund and its supposed owner or agent, James Henry O'Sullivan, were also named amongst the defendants.[126]

The involvement of O'Sullivan and EMIF in the Wirecard acquisition opened up a new can of worms for a company already faced with numerous probes and lawsuits. O'Sullivan and Marsalek were alleged to have been behind a scheme to cajole GI Retail into selling Hermes and GI Technology under false pretences.[127] This involved O'Sullivan repeatedly pressing the Ramasamy brothers into agreeing a sale of the business payment companies to EMIF, at a figure closer to the valuation of €52.4 million based on corporate and government filings,[128] before selling it off to Wirecard for the subsequently announced price of €340 million just three weeks after.[129] Since Wirecard reported a purchase cost in the region of the higher figure in its 2015 to 2017 annual reports, if the claim is true, questions would naturally be raised on the remaining €287.6 million.[130]

The resale was alleged to have occurred just three weeks after the first transaction with GI Retail.[131] Further, O'Sullivan and EMIF might have been the intermediary for Wirecard in a series of other similar India-related transactions, although none of Wirecard's filings mentioned EMIF's role in its India strategy.[132]

In response, Wirecard's attorney stated that "Wirecard wholly rejects the allegations made against it by [GI Retail]".[133] A Wirecard spokesperson dismissed this as a "dispute between previous shareholders [at GI Retail]", while the company issued a statement reiterating "the case has no merit and has been filed in order to substantiate the plaintiff's case in their defense against their former partners".[134]

If O'Sullivan is proven to be the owner of EMIF and the fund is in turn connected to Wirecard, which has denied involvement with the two parties,[135] then there will only be more intense scrutiny of Wirecard's business and accounting practices.[136]

Something here, nothing there

Rajah & Tann was re-appointed by Wirecard to conduct further investigations with regard to the initial findings in the preliminary report. The law firm engaged others such as relevant forensic experts to aid in investigations. Past years' transactions and figures were also examined to determine the presence of accounting irregularities. The external law firm was also tasked to propose changes to improve Wirecard's current system.[137] Wirecard released a summary of findings from the investigations on 26 March 2019, with the approval of Rajah & Tann.[138]

The summary report disclosed findings of accounting irregularities which led to certain restatements in Wirecard's 2018 financial statements. One irregularity reported is that revenue was written down by €2.5 million, and the investigations discovered a transaction worth €2.3 million being recorded, only to be removed a month later.[139] However, Wirecard concluded that these findings did not have any material consequences.[140]

The report also highlighted the possibility that some of the employees in Wirecard Asia and Wirecard Singapore have breached the law in Singapore.[141] If the employees are proven to have falsified the accounts, they will be liable for breaching Section 477A of the Penal Code.[142]

The report stated that investigations conducted did not implicate the German headquarters.[143] If it is true that wrongdoings did not include round-tripping to the headquarters in Munich, then this may limit the criminal liability in accordance with Singapore law to the individuals in the subsidiaries only.

The share price of Wirecard jumped by 30% on the day of the release of the summary of findings from Rajah & Tann.[144]

Wirecard goes on the offensive

On 28 March 2019, Wirecard filed a lawsuit against the FT and McCrum at the Munich regional court, for misrepresentation of its trade secrets. The lawsuit was to "seek a halt to the incorrect use of business secrets for the purposes of reporting, as well as damages".[145]

Wirecard delayed the release of its 2018 annual report by three weeks, to 25 April 2019.[146] This was to give it time to take into consideration the findings in Rajah & Tann final report.[147] In late March 2019, Wirecard issued a profit guidance that its 2019 earnings before interest, tax, depreciation and amortisation (EBITDA) were projected to be between €740 million and €800 million.[148] These projections came a month before it announced that Japan's SoftBank Group Corp would be entering into a deal to purchase convertible bonds worth €900 million in exchange for a 5.6% stake in the company.[149]

The injection of capital by Softbank served as a vote of confidence for Wirecard.[150] However, it was later reported that Softbank then sold the debt to a group of institutional investors to book early profits, and was structured in such a way that Softbank took on no financial risk.[151]

On 25 April 2019, Wirecard issued its 2018 annual report.[152] Wirecard reported a rise in its EBITDA of approximately 37% to €560.5 million in 2018 from the year prior. Wirecard's consolidated revenues also jumped by 35% to €2.02 billion in 2018.[153]

Financial Times calls for reinforcements

"As a trusted news source, the FT's reputation rests on its gold standard journalism, its integrity and a scrupulous approach to accuracy."

– Lionel Barber, Editor at the Financial Times[154]

The FT sought to clear its reputation by engaging Reynolds Porter Chamberlain (RPC), a London-based law firm, in July 2019 to carry out a review of the accuracy of its reporting. The decision was triggered by Wirecard's accusations that FT reporters were working with short-sellers looking to cash in on the company's stock decline which, if true, had serious implications on the integrity of the FT's journalism. In a statement, the FT said that it considered the allegations by Wirecard "a diversionary tactic aimed at stifling further reporting on Wirecard".[155,156]

The FT has in place an editorial code, which states: "FT titles…[should] be (and be seen to be) free from proprietorial interference in editorial content." More critically, the Editorial Code specifies how "no one at the FT should undertake any activity that could possibly leave them or the FT open to allegations of having used their position for personal profit or any kind of undue market manipulation." Compliance with the code is an obligation for all FT editorial employees and contributors, and failure to abide will result in disciplinary action or dismissal.[157]

RPC concluded its two-month review and found no evidence of collusion between FT reporters and market participants.[158]

Down to the wire

"Al Alam was purportedly the spider at the heart of an international web, processing vast sums for 34 of Wirecard's most important and lucrative clients in the U.S., Europe, Middle East, Russia and Japan."

– Dan McCrum, reporter at the Financial Times[159]

On 15 October 2019, the FT published another investigative report[160] that knocked more than 20% off Wirecard's share price.[161] This time, the newspaper alleged that one of Wirecard's partner processing companies, a Dubai-based intermediary called Al Alam Solutions (Al Alam), was a threadbare operation with six or seven staff, which somehow managed to account for half of Wirecard's worldwide profits in 2016.[162]

As a partner processing company, Al Alam enables Wirecard's acquisition of payment processing businesses in more than 10 Asia-Pacific countries through the provision of local expertise and authorisation to process payments where Wirecard is lacking.[163] The FT pointed to records that show about €350 million of payments from 34 clients passing through Al Alam each month and alleged that "much of the payment processing attributed to these 34 clients could not have taken place."[164] Of these 34 clients, 15 have never heard of Al Alam and eight have been out of business by 2017, while the other 11 were unidentified or offered no response.[165] This suggested that fictitious transactions were being passed in order to inflate revenue and profit figures in Wirecard's financial statements.

Besides Al Alam, the report alleged that, based on spreadsheets and correspondence, Wirecard's senior finance team sought to inflate reported sales and profits of its Ireland and Dubai businesses.[166] Further, the report made certain damning assessments of the inconsistency in Wirecard's statements since the saga unfolded, and again raised questions over what could be an overly-sympathetic German regulator.[167] Wirecard refuted those allegations.[168]

Figure 2 shows the impact of key events on the share price of Wirecard.

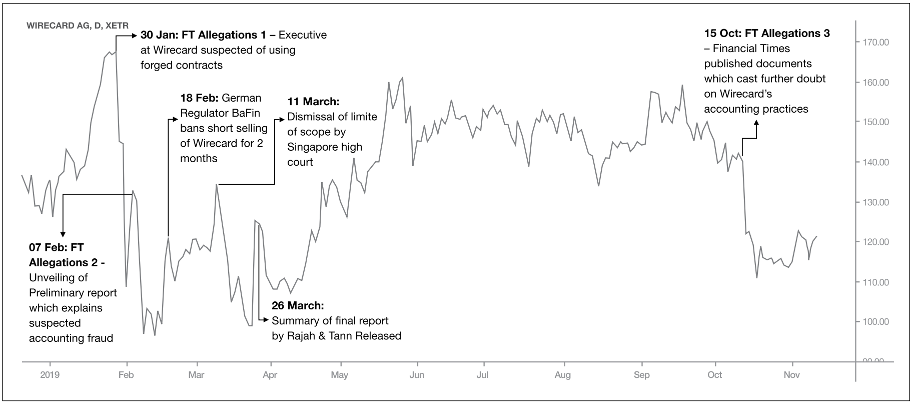

Figure 2: Wirecard's stock price movement from 1 January 2019 to 13 November 2019[169]

Wirecard's white knight

The series of allegations levied against Wirecard finally led investors and corporate governance advocates to call on the German company to engage an external independent auditor to allay concerns over its accounting issues. Wirecard's hiring of KPMG, a 'Big Four' accounting firm, for this purpose caused its share price to rise by 3.5% in pre-market trading.[170]

Wirecard's supervisory board was to oversee the independent audit and KPMG was to report directly to it. KPMG would also be granted unrestricted access to information across all levels of the Group.[171]

The Chairman of the supervisory board, Matthias, gave a vote of confidence to audit procedures performed to-date and their results, believing that engaging KPMG to perform an independent audit would lead to "a final end to all further speculation".[172] Similarly, CEO Braun said this was an "active strategic step" to "lay to rest any remaining speculation and give fresh confidence to the market".[173]

On 6 November 2019, Wirecard announced it was widening the scope of the KPMG audit to cover separate claims that it had overstated cash advances to merchants, as well as its accounting for third-party acquiring transactions.[174]

On 12 March 2020, Wirecard said that the largely completed special investigation by KPMG did not produce any substantial findings that would require any correction to its financial statements for FY2016 to FY2018.[175]

No vindication

If Wirecard was looking for the KPMG investigation to vindicate it, that did not happen. On 28 April 2020, the release of the KPMG report sent its share price falling by 26%, followed by another eight percent fall the next day.[176]

KPMG's 74-page report highlighted weaknesses in record-keeping and raised new issues about the Group's accounting. One example was Wirecard's senior managers not recording minutes when holding executive board meetings, and not signing a so-called declaration of completeness, stating that anything relevant to KPMG's inquiry was fully disclosed. Some essential documents for the review arrived at the last minute, while many never arrived. Original bank records detailing €1 billion of payments needed for the review could not be produced.[177]

KPMG had difficulty comprehending some of the accounting methods. The FT previously reported that three third-party payment processors were at times responsible for half of the Group's sales and most of its profits, which Wirecard dismissed. This was not refuted as KPMG said three partners had in fact "comprised the major part" of Wirecard's operating profit between 2016 and 2018. However, KPMG was not able to offer an opinion on whether the business was genuine because verification attempts "proved to be impossible, as we were not given access to the relevant data for the investigation period."[178]

Wirecard treated the third parties as an extension of its own business, with their sales counted as its sales and their costs as its costs. KPMG questioned the approach, saying: "We were unable to fully comprehend Wirecard's 'gross accounting' of revenue generated with [third-party acquiring partners]," and pointing out that it did not receive the necessary documents to do so. Wirecard could not produce minutes of quarterly meetings between the German company and its third-party business partners, saying such minutes were not taken in 2016 and 2017. However, this was contradicted by Wirecard's auditor Ernst & Young (EY), which on 23 April 2020, handed over the minutes that Wirecard had said did not exist.[179]

Wirecard did not track or monitor know-your-customer compliance checks carried out by its partners, which raised questions about its controls over money laundering.[180]

KPMG said: "There are arguments against Wirecard's accounting of escrow accounts as cash or cash equivalents during the investigation period of 2016 to 2018" and it might not have met international financial reporting standards. KPMG noted that Wirecard had obtained an opinion from a separate advisory firm stating that the approach to cash was appropriate.[181]

EY, which had issued clean opinions for Wirecard's accounts for a decade, was expected to do so again. Publication of Wirecard's full-year results was due on 30 April, but CEO Braun said it would be delayed because of the COVID-19 situation. Confident as ever, he reportedly told a conference call for investors that "we can fully reject all the allegations", that no need for corrections had been found, but that some "weaknesses in processes need to be addressed". This seemed at odds with the findings of the KPMG report.[182]

Meanwhile, in April 2020, billionaire activist investor Christopher Hohn of the US$24 billion Children's Investment Fund called on Wirecard's supervisory board to fire Braun.[183]

A series of shocking twists

On 19 June 2020, CEO Braun resigned after Wirecard announced the shocking news that €1.9 billion of cash on its balance sheet that was supposed to be held in two Philippine banks probably did not exist. It withdrew its results for FY2019 and the first quarter of FY2020.[184] James Freis, who was supposed to start in July running a new department called "Integrity, Legal and Compliance" was immediately appointed as interim CEO.[185]

A week later, on 25 June 2020, Wirecard filed for bankruptcy.[186] Although the troubled company said that it would continue operating, customers all over the world are now looking for alternative payment providers. Visa and Mastercard are considering cutting ties with Wirecard.[187]

External auditors EY came under heavy criticism. Wirecard had claimed that it had up to €1 billion held at a Singapore bank, OCBC, and that this was moved to the two Philippines banks, BDO Unibank Inc. and the Bank of the Philippine Islands at the end of 2019. However, it was reported that Wirecard has no banking relationship with OCBC.[188]

OCBC was said to have received no query from EY in relation to Wirecard between 2016 and 2018 and the auditor had reportedly failed to check directly with the bank to confirm that it held large amounts of cash on behalf of Wirecard. The two Philippine banks said that they have no banking relationship with Wirecard. Documents showing that Wirecard has banking relationships with the two banks were said to be forged.[189] EY had ostensibly relied on "documents and screenshots provided by a third-party trustee and Wirecard itself".[190]

EY defended itself by saying that there were "clear indications that this was an elaborate and sophisticated fraud, involving multiple parties around the world in different institutions, with a deliberate aim of deception". It argued that "even the most robust audit procedures may not uncover this kind of fraud".[191]

It was also reported that EY had warned Wirecard that KPMG's special audit risked misinterpretation.[192] Shockingly, EY was said to have prepared an unqualified audit opinion on Wirecard's accounts in early June 2020, subject to the company taking a few actions.[193] The draft opinion reportedly rejected allegations made by whistleblowers and the serious concerns raised by the KPMG special audit.

The German financial regulator, BaFin, also received scathing criticism. While it apologised for its failure, it also defended itself that Wirecard was not fully under BaFin's oversight because it was classified as a tech company rather than a financial services company.[194]

Meanwhile, Wirecard's former COO, 40 year-old Marsalek, who was fired shortly before Braun resigned,[195] has become an international fugitive and added a spy novel twist to the Wirecard story.[196]

He was reported to have flown from Germany to Philippines and then to China according to immigration records. However, it appears that those records were forged based on CCTV footage, airline manifests and other records, and he never entered the Philippines.[197] In a further twist, there were reports that he may have been a Russian agent living "multiple lives, with complicated and overlapping commercial and political interests".[198] He was said to have been involved in trying to recruit 15,000 Libyan militiamen and had touted Russian nerve gas documents. On 13 August 2020, he was added to Interpol's Most Wanted List.[199]

Christopher Bauer, a 44 year-old German businessman who was said to be responsible for one of Wirecard's biggest sources of reported profits, was declared to have died after Philippines authorities announced that he was under investigation.[200]

In early July 2020, Singapore police brought criminal charges against R. Shanmugaratnam, a director and owner of Singapore-based Citadelle Corporate Services Pte Ltd, for falsifying papers that showed more than €100 million in three separate escrow accounts held on behalf of Wirecard.[201]

One can only wonder what further twists there are to come in this incredible story.

Discussion questions

1. Consider Wirecard's business model. What are some of the risks of its business model? Did the business model contribute to the accounting irregularities? How can a company with a complex business model overcome investors' scepticism about its accounting practices?

2. Explain how the accounting fraud occurred and expound on the contributing factors. What are the four lines of defence and to what extent did failures in different lines of defence contribute to the Wirecard scandal?

3. To what extent did the fact that Wirecard is a tech company contribute to the scandal? Are the principles of good governance for tech companies similar to that of traditional companies? What are the special challenges in the governance of tech companies from the perspectives of directors and investors?

4. Wirecard has a large group structure with many subsidiaries and affiliates. What are the duties of the parent entity's directors in such a group structure? To what extent are they liable for the actions of their subsidiaries and affiliates? Is there any difference between German law and law in countries such as the U.K. in this respect? What are the advantages and disadvantages of overlapping directorships in such groups?

5. Wirecard adopts a dual board system. What are the main differences between the single and dual board systems, and their respective pros and cons? In a dual board system, what are the roles of the respective boards? Could a single board system have prevented the Financial Times allegations in 2019?

6. In the event of allegations such as those faced by Wirecard, what should the supervisory board, or in the case of a unitary board system, the board of directors, do?

7. Evaluate Wirecard's whistleblowing policy and whether its follow-up action was sufficient. Discuss and evaluate its decision to engage Rajah & Tann. What additional measures should Wirecard have taken?

8. In the case of Wirecard, who were the regulators involved and what were their roles in this event? Critically evaluate their actions.

9. What is the role of the media in reporting corporate governance issues in companies? With reference to the FT's Editorial Code and similar codes from other major publications, discuss the implications for all stakeholders involved, if journalists and newspapers were to breach them, with specific reference to the sections governing against market manipulation. Are there controls that may enhance or limit the effectiveness of the media's role?

10. Critically evaluate the role of the external auditors, Ernst & Young, in the scandal. What do you think is contributing to what appears to be an increasing number of audit failures involving major accounting firms?

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