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Edited by Prof Mak Yuen Teen

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Corporate Governance Case Studies

Volume eight

Mak Yuen Teen, PhD, FCPA (Aust.)

Editor

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Foreword

Achieving a high level of corporate governance is especially important as the fast-changing business landscape brings many new and ongoing complexities for boards and senior management.

Corporate governance is not a destination. It's an ongoing journey where all stakeholders have a part to play. This includes regulators, directors, management, investors, industry groups and professional bodies.

Following the revisions to the Singapore Code of Corporate Governance in 2018, the Monetary Authority of Singapore established a Corporate Governance Advisory Committee (CGAC), a permanent, industry-led body responsible for levelling up corporate governance standards and practices in Singapore. This aims to strengthen investor confidence in Singapore's capital markets and is an encouraging development locally to raise the bar on corporate governance.

CPA Australia is proud to be part of the journey towards a better corporate governance culture. In this regard, we are privileged to have partnered Associate Professor Mak Yuen Teen FCPA (Aust.) of the NUS Business School since 2012 to publish this annual collection of teaching case studies.

We thank Prof Mak for his meticulous efforts in editing the case studies and the students of the NUS Business School for their work in researching and producing the cases. We hope the 8th volume of case studies will continue to facilitate robust discussions on governance and contribute to advancing corporate governance standards in Singapore and in international markets.

Chng Lay Chew FCPA (Aust.)
Divisional President – Singapore
CPA Australia

October 2019

Preface

Each year, I look forward to editing this annual collection of corporate governance case studies. The publication is something that I am very proud of and it is pleasing to know that many others share my enthusiasm. The fact that the publication is available electronically on both CPA Australia website and my website (governanceforstakeholders.com) has helped it to reach a wide audience.

I use many of these cases myself, including at NUS and in director education and other programmes that I am teach in Singapore and the region.

This latest volume contains 25 cases – 13 Singapore cases, 5 Asia-Pacific cases, and 7 Europe and US cases. The Singapore cases include Hyflux, a saga which has yet to fully run its course. This is the longest case in this collection because of the myriad issues involved. Even then, the version that is published here is still an abridged version and does not cover the protracted restructuring process. There is also a sequel to the Noble case published in volume 5, covering the restructuring and developments leading up to it, including the company's battle with its substantial shareholder, Goldilocks. This shows how long the saga has dragged on – and we have not reached the stage of regulatory enforcement yet, if indeed any is forthcoming. Perhaps there will be a second sequel.

Another major Singapore case involves Midas Holdings – the S-chip which had a secondary listing in Hong Kong and won the "Most Transparent Company Award" for five consecutive years – only to suddenly collapse amidst a flurry of fraud allegations. The Hyflux, Midas and Noble cases have raised serious questions about the role of external auditors in Singapore companies – just as their role has also been questioned in other countries like the U.K.

The Singapore cases also include Ayondo, touted as the first financial technology (fintech) company to be listed on SGX, which was suspended from trading less than a year after its listing. The major data breach at SingHealth is the subject of another Singapore case, as is the controversial delisting of Vard Holdings that has led to changes in the delisting rules in Singapore.

For the Asia-Pacific cases, Commonwealth Bank of Australia, whose financial planning scandal was the subject of a case in volume 4, makes another appearance, this time for a money-laundering scandal. It is certainly not the only company that has been beset by just one scandal – a sign that some companies may have deeper issues probably related to corporate culture.

Perhaps the biggest of the Asia-Pacific cases – arguably one of the biggest cases in the world over the past year – is the one involving Nissan and Carlos Ghosn. This saga started very much as a scandal in Japan but has become a cross-continent case given Ghosn's role at Renault in France, and the alliance involving Nissan, Mitsubishi and Renault. The alleged abuses in this case – egregious behaviour and excessive remuneration – are something that one would often associate with U.S. corporations. This case is also about societal and corporate culture, and the dangers of an excessive concentration of powers and a charismatic CEO. As this case was written, new allegations have appeared.

The two cases involving companies in the People's Republic of China (PRC), Dalian Wanda Group and HNA Group, have certain similarities relating to the influence exercised by the PRC government on non-state owned companies and corporate governance of private companies.

For the global cases, Carillion is a landmark U.K. case which may have an impact on the accounting profession similar to the Enron case in the U.S., which led to the collapse of Arthur Andersen and significant reforms. Sadly, some of the lessons from Enron for the accounting profession appear to have been forgotten, and the profession may well pay a bigger price. Carillion has raised questions about the dominance of the Big 4 firms, leading to calls for fundamental reforms of the audit market.

The Facebook-Cambridge Analytica case is about user privacy and data mismanagement but has much to do with corporate culture, ethics and entrenchment in a dual class share company. Dual class shares also feature in the CBS scandal involving its Chairman and CEO Leslie Moonves, one of a growing number of powerful corporate executives whose sexual misconduct have been exposed in the #MeToo movement.

The case involving Danske Bank, Denmark's largest bank, shows how a small branch in a foreign country ended up laundering €200 billion, severely damaging the hard-earned reputation of its parent.

I would like to thank the students who wrote the original cases, the student assistants who helped with the editing, and Isabella Ow, who has once again being wonderful as the editorial assistant. Thank you also to CPA Australia and the Singapore team, led by Melvin Yong, for the strong support of this publication over the last 8 years. Most of all, I am thankful to my wife and family who have supported my twenty-year plus adventure in corporate governance so far.

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AYONDO: A FINTECH NIGHTMARE

Case overview

Ayondo Ltd. (Ayondo) is a financial technology (fintech) company which went public on Singapore Exchange's (SGX) Catalist Board on 23 March 2018. Since its listing, Ayondo has been plagued with problems, with its share price on a downward spiral. While Ayondo's initial listing created a flurry of excitement among investors as the first fintech firm to list on the SGX, the company was suspended from trading less than a year after its listing. The objective of this case is to facilitate a discussion of issues such as corporate governance challenges associated with fintech companies; the role of the major investors, the board of directors, sponsor and other intermediaries; conflicts of interest for stock exchanges with dual roles; and the role of regulators.

A star is born

Ayondo is a fintech group which provides social trading services in both the business-to-consumer (B2C) and business-to-business (B2B) markets. It was founded in 2008 by Thomas Winkler and Robert Lempka. Winkler served as Ayondo's Executive Chairman while Lempka was the company's executive director and Chief Executive Officer (CEO). [1,2]

According to Ayondo, it has found a way to disrupt the asset management industry by combining trading, investment and social media, thus offering a new way to trade and invest through social trading - where investors can "share and follow other traders' trading and investment strategies automatically, proportionally and on a real-time basis".[3] In other words, Ayondo's brokerage platform allows its users to copy the moves and strategies used by top traders on the platform in order to optimise their returns on investment.[4]

In March 2018, Ayondo became the first fintech company listed on SGX.[5] However, its stay on the Singapore bourse did not last long.

This is the abridged version of a case prepared by Elaine Eu, Lai Yinmin, Lee Wen Lie, Mirabel Clarissa Reynaldo and Tang Roderick @ Chua Roderick under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Clarisse Tan under the supervision of Professor Mak Yuen Teen.

Ayondo's business model

Ayondo provides two main platforms for its users to conduct trading activities. The trades can be done either socially via the WeTrade platform or independently via the TradeHub platform. Traded products available on Ayondo platforms include stock indices, foreign currency, commodities, equities, fixed income and cryptocurrencies.[6]

Users looking to trade on the TradeHub platform are categorised as 'self-directed traders' who prefer independent trading. These users view Ayondo as a platform to engage in trading of Contracts for Difference (CFDs). Users who prefer social trading use the WeTrade platform, where traders are categorised into two groups: 'social traders' and 'social trading leaders'. The social traders follow and copy the trading strategies of the social trading leaders on the platform, therefore allowing them to reap the benefits of the combined portfolio.[7]

Ayondo derives one source of its revenue from CFD spreads. When a customer makes a transaction on the platforms, it would be routed to Ayondo, which then adopts the opposite position. Ayondo can then earn a profit based on the users' trade based on the three methods below:[8]

1. Ayondo can choose to hedge against the position and direct the trade to other liquidity providers like financial institutions, and earn a smaller spread while minimising the financial risk it takes.
2. Ayondo can choose to keep and accept the position, recording it into its internal trading book. Through this method, Ayondo will bear the financial risks accompanying the position.
3. Ayondo can offset or balance off the position with a trade on the opposing side.

In all three scenarios, Ayondo will also earn financing income on the CFD products by charging interest for overnight positions.[9]

Time to up the game

On 20 June 2016, Catalist-listed Starland Holdings Limited (Starland) announced its plans to acquire a 100% equity interest in Ayondo for S$157.5 million using proceeds raised from the placement of new shares.[10] Starland is a Singapore residential and commercial property developer firm which develops properties in China. It has been listed on the Catalist Board since 2012.[11] The property developer firm saw the acquisition of the fintech company as part of its diversification strategy.[12]

The acquisition would effectively result in a reverse takeover (RTO) of Starland by Ayondo, allowing the fintech firm to be able to list on the SGX without going through an Initial Public Offering (IPO).[13] The RTO with Starland would also lead to a new group with consolidated market capitalisation of S$210 million.[14] With a larger market capitalisation, Ayondo hoped to increase the number of investors by attracting the attention of a larger pool of analysts and generating greater interest in social trading.[15]

Why RTO?

As Ayondo continued to grow, it wanted to gain access to public funding to bring it closer to its growth targets. By selecting to get publicly listed via an RTO, Ayondo would be able to do so in a shorter period of time with lower costs as compared to a conventional IPO.[16]

Ayondo chose to list on SGX as its significant shareholder was Luminor Capital Private Limited (Luminor Capital), a private equity fund based in Singapore.[17] Luminor Capital saw SGX as a favourable platform to establish its brand in Asia and worldwide.[18] Ayondo also acquired TradeHero, a Singapore social trading platform, in November 2016.[19]

Moreover, Singapore's economic setting was seen to be ideal for Ayondo in the eyes of its executives.[20] In its aim to establish itself as a fintech hub, Singapore provides great support to fintech firms and has organised the Singapore FinTech Festival which is held annually in the nation-state.[21] Furthermore, CEO Lempka has commented that SGX was a "reputable platform", with the compliance requirements for listed firms in Singapore also helping the company become "very solid and well-functioning".[22]

Ayondo's decision to list via RTO instead of IPO was attributed to the volatile market conditions in the financial markets. The RTO gave greater certainty to Ayondo as key terms could be negotiated between Ayondo and Starland. This would greatly reduce Ayondo's exposure to the market volatility.[23] Ayondo intended to use the funds raised from the RTO to invest in enhanced mobile technology to expand its business.[24] The RTO also gave the Ayondo an opportunity to expand its core operations to Asia and gain a strong footing in the growing financial markets in Asia.[25]

However, on 25 September 2017, the RTO deal took a surprising turn and lapsed due to the non-fulfilment of conditions precedent for the deal on the long-stop date of 23 September 2017.[26] Starland was given the option to convert its S$1.027 million loan to Ayondo into Ayondo's shares at a 33% discount as part of the settlement deal after the RTO fell through. However, Starland decided against the conversion of the loan. The loan was thus expected to be repaid in cash. The failed RTO added to Ayondo's financial woes as the two parties cumulatively incurred expenses amounting to approximately S$2.48 million with respect to the RTO.[27]

Breathe and move on

The failed RTO did not deter loss-making Ayondo's plans to become a public listed company. Subsequently, it sought to list via an IPO on the SGX Catalist Board, sponsored by UOB Kay Hian.[28] On this matter, Lempka raised "trust and credibility" as benefits of Ayondo gunning for an IPO, commenting that "being a listed company will make it easier" to find partners.[29]

The fintech company's IPO was fully subscribed at about 1.3 times, with Kwan Chee Seng – an executive director of Luminor Capital – taking up 3.75 million placement shares during the IPO exercise.[30]

Ayondo eventually listed on SGX on 26 March 2018 and the shares opened at S$0.24 apiece, below its IPO price of S$0.26.[31] The company expected proceeds of close to S$18.5 million, of which S$7.35 million was to be used for marketing and platform enhancement, S$2.6 million for general working capital, and S$8.5 million for repayment of indebtedness, including loans from Kwan, Ayondo's non-independent non-executive director Foo Fatt Kah, Starland and GRP Limited.[32,33]

Group structure

Figure 1 shows the group structure of Ayondo atthe time of its IPO.[34]

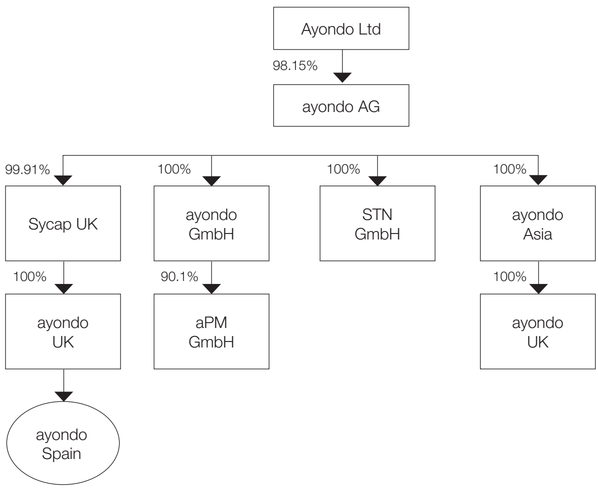

Figure 1: Group structure of Ayondo Ltd

Board of directors

At the time of its listing in March 2018, Ayondo's board comprised six directors. Winkler was the Executive Chairman while Lempka was executive director and CEO. The other four directors were Foo Fatt Kah, a non-independent non-executive director, and three independent directors – Foong Daw Ching, Chan Heng Toong and Lam Shiao Ning.[35,36]

Foo has over 25 years of experience in investment banking, venture capital and private equity. He is the managing director and co-founder of Luminor Capital.[37]

Foong, the lead independent director and Chairman of the Audit and Risk Committee, has more than 30 years of audit experience. He was a senior partner of Baker Tilly TFW LLP and its former manager partner, as well as regional Chairman of the Asia-Pacific region for Baker Tilly International Limited until October 2016. Foong is also an independent director of Starland, Travelite Holdings and Suntar Eco-City Limited.[38]

The Remuneration Committee (RC) Chairman, Chan, has over 17 years of experience in investment banking. Prior to his appointment, Chan was the head of investment banking in HL Bank and managing director of the investment banking division (corporate finance) in United Overseas Bank. He has an honours degree in Engineering from the University of Singapore and an MBA degree specialising in Finance from University of British Columbia.[39]

Lam, the Nominating Committee (NC) Chairman, is a corporate lawyer with more than 20 years of experience. She is a partner of Oon & Bazul LLP.[40]

Ownership

Immediately prior to its listing, several directors were substantial shareholders of Ayondo. Winkler had direct and deemed interests in Ayondo amounting to 7.1%; Lempka 5.8%; and Foo 25.7%. Other major shareholders include Kwan and his daughter Kwan Yu Wen, who collectively had direct and deemed interests of 29%. These include deemed interests in shares held by two Luminor funds, GRP and Starland.[41]

The man of the hour – Kwan Chee Seng

A key person in the RTO deal is the elder Kwan, a non-executive director of Starland. He is also a shareholder and convertible bond holder of Ayondo, and the co-founder and executive director of Luminor Capital.[42,43]

Kwan is thus deemed to have an interest in the shares of the company held by Luminor Pacific Funds 1 and 2 by virtue of Section 4 of the Securities and Futures Act (SFA). GRP Chongqing Land Private Limited owns 83.2% of Starland. GRP Chongqing Land Private Limited is a wholly-owned subsidiary of GRP Land Private Limited, which is in turn wholly-owned by SGX-listed GRP Limited (GRP).[44] Kwan had a 32.5% shareholding in GRP.[45] By virtue of Section 7 of the Companies Act, Kwan Chee Seng is deemed to have an interest in all the shares held by GRP and Starland.

In 2013, Kwan's role in the appointment of Peter Moe as an independent director of GRP emerged following queries raised by SGX and in the media.[46] Moe had previously been disqualified from acting as a director and also had complaints against him to the Law Society for professional misconduct and faced civil proceedings for his conduct as a lawyer, which were eventually resolved through mediation.[47]

SGX queried GRP regarding Moe's appointment, and about his suitability as a director. However, the company said that it was aware of Moe's prior disqualification and proceedings against him. Nevertheless, the board and NC concluded that Moe's conviction and proceedings against him would not affect his suitability as a director. The NC was of the view that Moe's conviction would make Moe a more experienced director and that Moe had already resolved to be more responsible and vigilant in his duties.[48]

The person behind the decision to appoint Moe as independent director turned out to be none other than Kwan. Moe was introduced to the NC by Kwan, who is a controlling shareholder of GRP and had become an executive director several months earlier. It was further disclosed that Kwan had past dealings with Moe back in 2005.[49]

Trouble is brewing

Following its listing, Ayondo saw its share price collapse from its first-day closing price of S$0.24 to S$0.048, before its shares were suspended from trading on 1 February 2019.[50]

The announcement of its first audited full-year results for FY2017 following its listing showed a net loss of 9.760 million Swiss francs (CHF), compared to CHF10.434 million the year prior.[51] However, its unaudited first quarter FY2018 results showed its losses had ballooned from CHF6.306 million, from CHF2.795 million for first quarter FY2017.[52] Subsequent quarterly results continued to show losses.

On 23 January 2019, the CEO of the company, Lempka, suddenly resigned.[53] A month later, further details about the circumstances surrounding his resignation were revealed. The company disclosed that there was discontent and disagreement between controlling shareholders and Lempka over issues such as the progress of the business, funding requirements, performance and future direction.[54]

On 17 April 2019, the company announced that it had received from Lempka a letter of demand for S$165,800 relating to his resignation.[55]

Accounting issues surface

On 14 February 2019, Ayondo announced that one of the Group's employees raised an issue regarding the calculation of Common Equity Tier 1 (CET1) ratio, a key financial metric that Ayondo Markets Limited (AML) has to comply with.[56] AML is 99.91% owned by Sycap Group (UK) Limited (Sycap), a subsidiary of Ayondo Holding AG, which is itself a subsidiary of Ayondo. AML is regulated by the Financial Conduct Authority (FCA) in the United Kingdom (U.K.).[57]

CET1 is a measure of a financial institution's solvency – a gauge of its capital strength.[58] According to Basel III, intangibles should be deducted from the common equity component of the tier 1 ratio because of the high degree of uncertainty related to intangible assets.[59] There were concerns over the accounting treatment of several items, including inter-loan company balances and treatment of software costs relating to the determination of the CET1 ratio.[60]

The concern over the determination of the CET1 ratio led to the engagement of KPMG LLP (KPMG) in the U.K. to assess the accounting and regulatory treatments done by AML, which would include the treatment used for software costs and inter-company loan balances. In a company announcement, AML stated that its statutory auditors had opined that AML had been complying with U.K. Generally Accepted Accounting Principles (GAAP) and Financial Reporting Standards (FRS) 102, the financial reporting standard that is applicable in the U.K. and Republic of Ireland.[61]

However, KPMG had expressed a different view regarding the accounting treatment that had been adopted by AML. If AML were to follow KPMG's view regarding software costs, this would negatively affect AML's CET1 ratio and thus its compliance with the requirement to maintain a certain level of CET1 ratio.[62]

Ernst & Young LLP (EY) had issued an unqualified opinion based on the Group's consolidated financial statements, which include AML's financial records.[63]

In response to the dispute, the board insisted that the accounting treatment adopted by AML was a matter of judgement of AML directors as FRS 102 does not specify the treatment that should be used for software and hardware costs. Furthermore, FCA had never raised concerns about AML's CET1 ratio compliance during the quarterly filings from 2014 to 2018.[64]

Extension after extension

On 1 March 2019, Ayondo announced that it was applying to SGX for a month-long extension to release Ayondo's unaudited financial statements for the financial year ended 31 December 2018, hold the annual general meeting (AGM) for financial year 2018, and release Ayondo's unaudited financial statements for the first quarter of 2019. Various reasons were given by the board, including additional resources and staff needed for the compliance with FCA's regulations and to prepare Ayondo's financial statements for the year ended 31 December 2018.[65]

However, on 29 March 2019, Ayondo applied for a further extension for its FY2018 financial statements, AGM and financial statements for the first quarter of 2019. This time, the reason given was that EY needed more time to audit its 2018 financial statements due to "the complexity and accounting considerations relating to the key outstanding matters for the audit review", which also included the "capitalisation of development costs in AML".[66] Earlier, on 6 March 2019, Ayondo had submitted an application for a two-month extension to hold its AGM to the Accounting and Corporate Regulatory Authority (ACRA).[67] ACRA's approval for the extension was announced on 3 April 2019.[68]

On 18 April 2019, SGX approved Ayondo's request for two-month extension for its annual and quarterly financial results, together with its AGM. This meant that Ayondo would be able to release its FY2018 annual financial statements by 1 May 2019 and its financial statements for the first quarter of 2019 by 15 July 2019. Ayondo planned to hold the AGM by 29 June 2019.[69]

Following KPMG's disagreement regarding the classification of software costs and the potential negative impact on AML's CET1 ratio, Sycap communicated with BUX Holdings B.V. (BUX), AML's largest customer, to convey its intent to sell AML to BUX.[70] BUX is a fintech company based in the Netherlands. As at September 2017, more than 60% of Ayondo's active clients came from BUX.[71] According to Ayondo, the sale of AML would allow the injection of fresh capital from BUX to address the capital insufficiency suffered by AML, due to the change in the classification of software expenses, a problem which would arise if KPMG's view is followed. Subsequently, Ayondo signed a non-binding Heads of Terms with BUX and a definitive agreement to sell AML to BUX. Before the proposed sale of AML can go through, regulatory bodies' and shareholders' approvals had to be obtained.[72]

SGX steps in

On 15 March 2019, Singapore Exchange Regulation (SGX RegCo) informed Ayondo's board to put the selling of AML to BUX on hold until FCA had clarified its position regarding the CET1 ratio requirements imposed on AML. On 16 April 2019, SGX RegCo issued a Notice of Compliance (NOC) to Ayondo, which was also sent to its sponsor, UOB Kay Hian. SGX RegCo noted the accounting issues plaguing AML and the possible sale of AML to BUX.[73]

SGX also issued a set of requirements that Ayondo must fulfil before it could proceed with the plan to sell AML to BUX. The requirements included the need for Ayondo's board of directors to obtain clarification regarding AML's CET1 ratio compliance with FCA; the completion of the audit of AML and Ayondo; the clearance from SGX RegCo for the circular relating to the proposed sale of AML to BUX; and approval from both shareholders and all other regulatory bodies such as FCA and SGX before selling AML to BUX. Ayondo should also disclose the reason for selling AML and Ayondo's detailed development plans.[74] In May 2019, Ayondo confirmed that the computation of the CET1 ratio was in line with market practices.[75]

More executives bid Ayondo goodbye

Ayondo faced continuing turnover among its key executives. Sean Downey, who was appointed as Ayondo's Chief Financial Officer (CFO) on 20 July 2018, tendered his resignation on 15 February 2019. He cited the "discontent with treatment and (the) working relationship" at Ayondo as the reason for his resignation. Unresolved differences in opinion between Downey and the board included changing the CET1 calculation as recommended by KPMG.[76]

Mita Natarajan, Ayondo's Chief Business Development Officer, who had joined Ayondo from SGX in June 2018, and Raza Perez, Ayondo's Chief Product Officer, tendered their resignations in June 2019. Natarajan's resignation came after Ayondo's sale of AML[77] following the approval from its shareholders. [78]

Following Lempka's resignation, Richard Mark Street was appointed as interim CEO of Ayondo, but he too quit after less than six months. UOB Kay Hian indicated that there were no specific reasons for Street's resignation.[79]

Other key executives who resigned include the Chief Operating Officer, Chief Marketing Officer, and Chief Talent Officer and general counsel.

In June 2019, Chan Heng Toong retired as an independent director, citing "personal time commitment".[80]

How did it happen?

The future for Ayondo looks grim. Its short and troubled history raises issues regarding the role of the sponsor and other intermediaries involved in its listing, and whether SGX is too hungry for listings, especially of technology firms. The role of the founders, original investors and the board of directors may also warrant scrutiny. Will lessons be learnt from this fintech nightmare?

Discussion questions

1. What are some of the unique challenges that technology firms, such as fintech firms, may bring from a corporate governance and transparency standpoint?
2. Critically evaluate Ayondo's group structure, business model and ownership structure. What are some of the key corporate governance risks relating to them?
3. Critically evaluate the composition of Ayondo's board of directors at the time of its listing. Are there conflicts of interest that may have affected its objectivity and effectiveness?
4. Why would companies such as Ayondo want to list through Reverse Takeover (RTO)? What is the risk from an investor's point of view associated through the listing via an RTO?
5. How can companies mitigate risks associated with inappropriate accounting treatment or misconduct? Explain the different lines of defence that can help mitigate these risks.
6. Evaluate how Ayondo communicated with its shareholders following issues with AML.
7. Evaluate the role played by different players in the disastrous listing of Ayondo. Who should be held accountable and how? To what extent might the dual commercial and regulatory roles of the SGX have contributed to the debacle?

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STORM OVER DECLOUT

Case overview

On 14 April 2018, three days after DeClout Limited (DeClout) announced its intention to enter into a S$10 million loan arrangement, minority shareholders objected vehemently to the imposition of the change of control provisions. The root of this dispute started a few months prior, when the same shareholders challenged the status quo and called for DeClout to let go of its listed subsidiary Procurri Corporation Limited (Procurri), citing numerous "governance overhang" issues plaguing the firm. The objective of this case is to facilitate a discussion of issues such as the risks related to business models of venture capital firms; the independence of directors and board committees; loan agreement covenants; and the role of shareholder activism.

Minority shareholders' outcry

Vesmond Wong fidgeted with his pen as he scrolled through the slide deck which was due to be presented in DeClout's Annual General Meeting (AGM) in a few days' time, on 30 April 2018. Although a few minority shareholders have raised several concerns regarding a loan the company had taken up recently, the company seemed to have largely allayed those concerns, and everything seemed to have been settled. He suddenly felt his handphone vibrating insistently in his pocket and wondered who might be sending him so many messages. Upon seeing "Lloyd Moffatt" on the screen, Wong let out a sigh, and wondered what the issue was this time round. As he read the minority shareholders' demand for him to resign from his role as DeClout's Chairman, he began to recall the company's turbulent past.[1]

DeClout's beginnings

DeClout was incorporated in Singapore on 21 August 2010 and was listed on Singapore Exchange (SGX) Catalist Board in October 2012. DeClout's business model revolves around two key business segments: IT infrastructure services and vertical domain clouds (VDCs).[2]

This is the abridged version of a case prepared by Bay Jo-Lene, Edmund Lau Jia Hao, Hu Ya Chu, Tan Zhen Ying and Yang Chunyu under the supervision of Professor Mak Yuen Teen The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees This abridged version was edited by Lum Shun Yi Richelle under the supervision of Professor Mak Yuen Teen.

Since 2016, DeClout has focused on being a global builder of next generation companies. It seeks to identify disruptive trends to create new growth platforms, incubate businesses that are either aggregators, enablers or eco-system builders, and scale these companies to become global or regional champions before harvesting these businesses in three to five years.[3]

The companies which fell under their business model are as follows:[4]

- Incubating: DeClout Investments' startup, Vi Dimensions Pte. Ltd. (Vi Dimensions), as well as its two VDC companies, namely Corous360 Pte. Ltd. (Corous360) and vCargo Cloud Pte. Ltd. (vCargo Cloud)
- Scaling: DeClout's ICT platform, Beaqon Pte. Ltd. (Beaqon)
- Harvested: Procurri Corporation Limited (Procurri) and Acclivis Technologies and Solutions Pte. Ltd. (Acclivis)

The golden Procurri goose

The saga started when three minority shareholders called for DeClout to realise Procurri's value through an in-specie distribution. While the three shareholders only had a combined total of S$100 worth of shares in DeClout, they collectively owned about six percent of Procurri, DeClout's golden egg-laying goose.[5]

Procurri has been in the spotlight since 2013. At the beginning, DeClout had set aside S$1.5 million – a quarter of its Initial Public Offering (IPO) proceeds – for the expansion of its IT infrastructure services in the initial phase of their operations.[6] With these funds, it expanded the service offerings of its wholly-owned subsidiary, ASVIDA Asia Pte. Ltd. (ASVIDA Asia), later known as Procurri. ASVIDA Asia provided IT asset recovery, independent maintenance services for data centre IT equipment and solutions for cloud service providers.[7]

DeClout also made many acquisitions and underwent restructuring exercises to grow ASVIDA Asia geographically, which included the following:

- In April 2013, ASVIDA Asia acquired Procurri LLC, an IT maintenance service provider, as part of its global expansion strategy into the North American market.[8]
- In January 2014, ASVIDA Asia was renamed Procurri Corporation Pte. Ltd., and underwent restructuring such that DeClout held a 50.1% interest post-restructuring.[9]
- In March 2014, Tinglobal Holdings Ltd, a company operating in the European market for refurbished mid-range computer equipment, was acquired.[10]
- Just two months later, in May 2014, Verity Solutions Sdn Bhd, a maintenance and system service provider, was also acquired under the Procurri Group.[11]

After numerous investments in Procurri, DeClout announced its intention to monetise Procurri in April 2015, and stated the company's intention to prepare Procurri for a spinoff by 2016 as a global IT asset player. The purpose of such a move was to reward DeClout's shareholders.[12] In October 2015, DeClout proposed to spin off Procurri and list it on the SGX Mainboard.[13] In July 2016, the SGX Mainboard listing was completed. DeClout's shareholding in Procurri was diluted to 46.53%.[14] With this listing, Procurri was able to finance its operations and expansion plans.

Procurri's listing was unlike DeClout's previous spinoff efforts. DeClout's shareholders had previously been rewarded almost immediately when the company harvested its other IT infrastructure subsidiary, Acclivis. Acclivis was monetised and sold off in October 2016 for a gain of S$27.9 million.[15] With the gain from the sale, DeClout's shareholders benefited from a share buyback scheme, as DeClout is a non-dividend paying company.[16] In the case of Procurri, although DeClout had announced its intention to monetise Procurri in 2015, DeClout decided to hold onto Procurri's shares to reap long-term growth benefits, while injecting its capital and resources into the rest of the business groups.[17]

Rule 406(7) of the SGX Catalist Board states that "A subsidiary or parent company of an existing listed issuer will not normally be suitable for listing if the assets and operations of the listing applicant are substantially the same as those of the existing issuer."[18] DeClout claimed that this spinoff did not constitute as a chain listing and Procurri should be allowed to list on SGX Mainboard.[19] SGX agreed with DeClout and allowed for Procurri's listing.

With Procurri's listing on the SGX Mainboard, its financial results for the prior years were made public, and observers noted that Procurri contributed a large portion of the Group's net profit after tax for the few years before it listed.[20,21,22,23]

Anger bubbles over Procurri

Three angry shareholders, Lloyd Moffatt, Nicolas Van Broekhoven, and Alex Turnbull, had lobbied for an in specie distribution of Procurri shares to all of DeClout's shareholders, as an in-specie distribution was one of the solutions considered in DeClout's forward strategy.[24]

Moffatt highlighted the fact that a few of the minority shareholders had previously demanded DeClout's management to realise value in Procurri through "an in specie distribution of Procurri to shareholders", and that they will "take steps to remove" the management if that did not happen.[25]

The push by these minority shareholders to realise the value of Procurri and the company's refusal to do so is one of the contributing factors that eventually led to these shareholders challenging Wong days before the AGM.

Questions over corporate governance

In addition to being unhappy about the situation surrounding Procurri, Broekhoven, a former manager of a boutique asset management firm, also raised other corporate governance matters, such as the issue of having the same lead independent director, Raymond Ho Chew Thim, for both DeClout and Procurri.[26]

Ho was appointed as lead independent director in DeClout on 26 September 2012 and has been holding the same role in Procurri since 27 June 2016. Procurri's corporate governance report in 2017 disclosed Ho's conflict of interest and explained that "(i) [Procurri] is independently and separately managed from the DeClout Group, with no sharing or overlapping of any key staff; (ii) [Ho] will not participate in any discussions in relation to any interested person transactions between [Procurri] and the DeClout Group, and will abstain from voting on any such proposals at any of either [Procurri]'s or DeClout's board of directors meetings and refer such matter to the Audit Committee Chairman; and (iii) [Ho] will abstain from participating in any proceedings involving transactions with the DeClout Group or where there would be conflicts of interest with the DeClout Group". As such, Ho was deemed to be able to serve on both boards as the Lead Independent Director. [27] Such statements were not found in DeClout's annual report.

It was also noted that Lim Swee Yong became DeClout's Head of Corporate Office for the corporate venture team on August 2015,[28] and was additionally appointed as a non-executive director of Procurri on 27 June 2016.[29] He subsequently left Procurri on 30 April 2018.[30]

Wong's performance in the spotlight

Attacks were also directed towards Wong, claiming that he had underperformed in his capacity as the Chairman and Group Chief Executive Officer (CEO) of DeClout, in view of many unsuccessful investments[31] such as Corous360. DeClout's board has been chaired by Wong since 2011. He was a Non-Executive Chairman of Procurri from 1 April 2013 till 27 April 2017. Following his retirement from Procurri's board of directors, he was appointed as an advisor.[32]As of 24 April 2018, Wong was still DeClout's largest shareholder, with a stake of 12.24% stake.[33]

DeClout's board of directors

DeClout's board consisted of six directors from 2012 to 2014 and 2016 to 2017, of which three were independent directors.[34,35,36,37,38,39] In 2015, the board size decreased to five members, of which three were independent directors. In 2018, the board size remained at six, of which two were independent directors, as independent director, Ch'ng Li-ling, retired[40] and Melvin Poh was appointed as a non-executive, non-independent director on 30 April 2018.[41]

In accordance with the Singapore Code of Corporate Governance, DeClout's board has three board committees: the Remuneration Committee (RC), the Audit Committee (AC), and the Nominating Committee (NC). Each of these board committees is chaired by an independent director and consists mainly of independent directors. The annual reports of DeClout since its listing in 2012 till 2017 stated that the independent directors will "meet at least once annually without the presence of the Executive Directors and the Management, and the Lead Independent Director will provide feedback to the Chairman after such meetings, if necessary".[42] NC meetings are held to evaluate each board member's performance and contribution and to report its findings to the board, while RC meetings are held to recommend the remuneration framework for the directors and executive officers, and to determine the specific remuneration packages for each executive director.

The annual reports show that the executive directors usually attend the meetings held by the three board committees as invitees. In particular, Wong has attended every single board committee meeting as an invitee since 2012.[43,44,45,46,47,48]

DeClout's failed investment in Corous360

Turnbull, an investment manager at Keshik Capital, a Singapore-based hedge fund, was the last of the three minority shareholders who raised concerns about Wong's performance as the Chairman and Group CEO. Turnbull opined that Procurri was undervalued due to its association with DeClout, given DeClout's poor investment track record.[49] He also asserted that as a result of its many unsuccessful investments, DeClout's role as a controlling shareholder for Procurri had raised eyebrows among the minority shareholders.[50] An example of such an unsuccessful investment is Corous360, which quietly disappeared a while after its debut.

In the initial phase of DeClout's development, the company invested S$3.6 million – 60.5% of its IPO proceeds – on its games cloud business through Corous360, DeClout's first VDC entity.[51] Corous360 had planned to create an online game ecosystem in Southeast Asia, capitalising on technological infrastructure to allow for unified payments and community portals. Through Corous360, DeClout acquired companies such as Netipay Pte. Ltd for mobile payments infrastructure,[52] and Play-E Pte. Ltd. for game distributions.[53] DeClout also entered into joint ventures with local game veterans.[54]

After unforeseen delays in the deployment of mobile games,[55] Corous360 shifted its original focus from the online games sector to e-commerce, with the aim to become the "Alibaba of Southeast Asia".[56] At DeClout's 2015 AGM, it announced plans to separate its games and e-commerce businesses and develop a separate VDC for e-commerce.[57]

In early 2016, DeClout completely shifted its focus away from Corous360. DeClout branched out into a new VDC domain in e-logistics via vCargo Cloud, a newly acquired associate, which became a subsidiary in June 2016.[58] DeClout portrayed vCargo Cloud and Corous360 as two separate VDC entities.

From 2016 to 2017, several of Corous360's subsidiaries were liquidated, including Netipay Pte. Ltd,[59] Corous360 (Thailand) Co. Ltd,[60] and PT Corous Three Sixty.[61] Corous360 Information Technology (Shenzhen) Company Ltd was disposed of as well.[62] Corous360's intangible asset – e-money platform ZiPAY – was fully impaired by S$5,782,000 in 2017, contributing to the poor financial results of the DeClout in FY2017.[63] In its six years of operation, Corous360 had only been profitable in FY2014 and FY2015.

Corous360's expansion into these industries was met with many "unforeseen circumstances". These included high-margin blockbuster game launches which affected its games distribution business in 2016,[64] as well as the inability to secure licenses for its e-money platform ZiPAY in 2017.[65]

Despite undergoing restructuring in 2017[66] and exiting from direct participation in the e-commerce sector,[67] Corous360 was excluded from DeClout's ecosystem, as seen in the 2018 AGM.[68] There were also no new updates on the future of Corous360, except that its withdrawal from direct participation would not incur further losses.[69] This left vCargo Cloud as the sole standing VDC entity under this business segment.[70]

A questionable loan agreement

Several months after the three shareholders threatened to remove management if they did not receive an in specie distribution from Procurri, DeClout announced that it had entered into a two-year loan agreement with six private investors for an aggregate amount of S$10 million at an interest rate of eight percent per annum on 11 April 2018.[71] The company said that it had decided to obtain the loan to finance the business expansion of Beaqon and vCargo Cloud. The six lenders were said to be introduced to DeClout by Xandar Capital Pte Ltd (Xandar Capital), with one percent of the aggregate loan amount paid to it for its service.[72]

The loan was pledged against DeClout's full stake of 132,319,978 shares in Procurri, which were valued at S$23.4 million as at 31 December 2017.[73] In addition, the loan was secured against corporate guarantees by Beaqon and vCargo Cloud, where the S$10 million loan would be directed to. The loan agreement also included clauses of 'relevant events', which when triggered, would oblige DeClout to repay each lender's portion of the loan along with accrued interest within 25 business days.[74] The 'relevant events' included situations whereby:-

i. DeClout or Procurri's shares are suspended or ceased to be listed on the Catalist Board or the Mainboard of SGX respectively for more than or equal to a period of 20 market days; or

ii. DeClout's shareholding interest in Procurri falls below 44.0% of the total issued and paid-up share capital of Procurri; or

iii. DeClout's pledged value of Procurri's shares falls below S$19 million; or

iv. DeClout's net tangible assets attributable to the owners of the Company falls below S$50 million; or

v. Wong ceases to be either the Executive Director on DeClout's board, the Group CEO, or if his stake in DeClout falls below 11% (from its current 12.24%); or

vi. Kow Ya ceases to be an Executive Director on DeClout's board.[75]

This loan agreement infuriated the three shareholders further, prompting them to interrogate the company's directors at the AGM.

Outrage against loan agreement

Upset with the management's decision to enter into the loan agreement, Turnbull voiced his disapproval on 14 April 2018, arguing that the "management cannot be removed" with the imposition of the change in control provisions, while Moffatt released a statement asserting that the loan was "not in the best interest of shareholders" as it stripped "minorities of the right to elect their board representatives".[76] Broekhoven then raised several red flags to The Business Times on 20 April 2018.[77] He questioned the benefits and consequences of the loan, and whether the company had considered alternative funding to meet its financial needs.

Moffatt then took a step further and contacted Wong on 24 April 2018, calling for him to resign as Chairman ahead of the company's AGM on 30 April 2018.[78] Moffatt also suggested that the company appoint a replacement that would be agreed to by himself and other parties, and to appoint two new independent directors at the AGM.[79] Furthermore, he called for Broekhoven to replace the current lead independent director, Ho. He also demanded the appointment of an "independent agent" with regards to the loan.[80] Moffatt also threatened to "continue lobbying regulators, pursuing directors and associates, and publishing further materials ahead of the AGM", should these requests not be met.[81]

Initially, DeClout defended itself by arguing that "it is not unusual" for companies to secure loans with such terms.[82] Wong also refused to divulge the identities of his lenders "due to reasons of confidentiality".[83]

SGX steps in

Subsequently, SGX wrote to DeClout's board to clarify the terms and circumstances of the loan agreement.[84] In addition to seeking clarifications on the current pledge value of the Procurri shares, the net tangible assets attributable to the owners of the company, and the company's gearing ratio, SGX questioned whether the loan was in the best interests of the company and the minority shareholders, given that some of the terms of the loan agreement might not be within DeClout's control, or might allow the lenders to have influence over the operations of the Group in the event of default.[85]

SGX also questioned if DeClout's board had tried to obtain funds via the secondary capital markets and requested for the company to elaborate on its confidentiality obligations for not being able to disclose information on the lenders.[86]

Wong stands his ground

On 24 April 2018, DeClout's issued an official response to SGX. Wong replied that "it is not unusual" for loan transactions to "(i) impose financial covenants; (ii) require security to be provided by the borrower; (iii) impose change in control provisions; or (iv) require lenders' consent for material transactions", and that the decision to undertake the loan agreement was approved by the entire board.[87]

Wong also defended the board's decision by stating that the decision to explore capital market options to finance the expansion of Beacon and vCargo Cloud was undertaken in March 2018 and in their corporate and business update announcement.[88] He also stated that the company had already explored various fundraising options via the secondary capital market, including convertible securities, share placements, and rights issues.[89] The company further justified its decision to take the loan by arguing that a direct loan was the "best available financing option" as it would help to minimise shareholding dilution, a concern brought up by investors previously at the FY2016 AGM.[90]

In respect of the issue of not being able to divulge information about the lenders of the loan, Wong explained that DeClout "owes confidentiality obligations to Xandar Capital unless consent is obtained from [it]".[91] He also pointed out that such confidentiality clauses are not uncommon in commercial agreements.[92]

Apart from the loan issues, Wong also responded to the governance issues that the shareholders had previously raised. DeClout justified its decision to consolidate Procurri's results into DeClout's FY2017 financial results by arguing that the company's auditor, Ernst & Young, had stated that the consolidation was in accordance with the relevant financial reporting standards, and clarified that Procurri made up 36% of the DeClout's net tangible assets instead of the 70% which Moffatt had previously claimed. [93]

Wong's statement further stated that Ho was the lead independent director for both DeClout and Procurri due to his extensive experience serving as an Independent Director for other listed companies, and that Procurri's board had assessed Ho's independence and deemed him to be independent "notwithstanding that he is also the lead independent director of [DeClout]".[94]

In a separate announcement made by DeClout on 28 April 2018, the company further explained that there was no independent agent appointed for the loan transaction as the lenders had not requested for it, and it would have caused DeClout to incur additional costs.[95] The company also clarified that it was still in the midst of reviewing its board composition so as to separate the Chairman and CEO roles.[96] As of 30 October 2018, Wong was still the Chairman and Group CEO of DeClout.[97]

DeClout disposes of Procurri's shares

While an in-specie distribution never happened, DeClout did eventually capitulate to the wishes of the minority shareholders, and sold the majority of the Procurri shares it held in three separate transactions. On 4 January 2019, DeClout sold 48 million shares in Procurri to two independent third parties for S$15.2 million, without disclosing who the buyers were.[98] After these sales, DeClout held approximately 84.3 million Procurri shares, which meant that its ownership of Procurri had been reduced to 26.92%.[99] The decrease in DeClout's stake in Procurri also meant that DeClout would no longer include Procurri's performance in its consolidated financial statements.[100]

DeClout then proceeded to sell another 36.3 million shares in Procurri to Novo Tellus Capital for S$12 million on 15 February 2019, leaving DeClout with 48 million shares.[101] Novo Tellus is a private equity firm that invests in technology and industrial companies based in Southeast Asia.[102] With the proceeds raised from this sale, DeClout's aim was to use S$4.2 million to pay its creditors and S$7.8 million to fund its merger and acquisition activities.[103]

A surprising turn of events

The significant sale of Procurri shares was just one of the major changes in DeClout's business structure. On 17 December 2018, DeClout disposed of its full stake in Corous360, in exchange for a 12.5% shareholding in Grand Centrex, an investment holding company.[104] The move was apparently motivated by a desire to increase the company's focus on its IT Infrastructure and VDC segments, which were under the purview of DeClout's subsidiaries, Beaqon and vCargo Cloud.[105]

More recently, DeClout accepted a buyout offer of S$86.6 million from Tokyo-listed Kyowa Exeo Corporation (Kyowa), a Japanese engineering conglomerate.[106] In line with Kyowa's wishes, DeClout delisted from the SGX on 22 April 2019.[107] The rationale behind DeClout's delisting was greater flexibility for management to carry out any operational changes, and optimising the use of the company's management and capital resources.[108] Following its privatisation, it seems that DeClout would no longer need to worry about highly publicised opposition from minority shareholders regarding its business actions.

Discussion questions

1. Refer to Ho Chew Thim and Lim Swee Yong in the case and assess the potential impact of holding multiple roles in a Group. In particular, evaluate Ho's independence as the lead independent director of both DeClout and Procurri.
2. Evaluate the composition of DeClout's board, paying particular attention to the following:
    a. the board's independence and competence
    b. the independence of the committees in reviewing/recommending decisions to the board.
3. To what extent can Wong be effective in carrying out his duties as the Executive Chairman, Group CEO, as well as the largest shareholder of DeClout?
4. Do you think the loan agreement undertaken for the business expansion of Beaqon and vCargo Cloud was in the best interests of the shareholders of DeClout? Do you believe that the imposition of change in control provisions is fair in such loans? Explain.
5. Discuss the role that activist investors like Moffatt, Broekhoven, and Turnbull play in the corporate governance of a company. Evaluate the likely effectiveness of shareholder activism in founder-type companies. What could be the motivation of the activist shareholders in this case? What are the pros and cons of shareholder activism for the company and its various stakeholders?

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DELONG'S STEELY RESOLVE

Case overview

Since its listing on the Singapore Exchange (SGX) in 2005, Delong Holdings Limited (Delong)'s share price has been on a rollercoaster ride. With an overwhelming majority of its shares held by Ding Liguo, the Executive Chairman and Chief Executive Officer (CEO), together with his wife, the company has not suffered the fate of many other Chinese companies listed on SGX, with a successful business in the steel industry. However, it has had its share of controversies, including lapses in disclosure of related party transactions, a contentious diversification strategy, questionable investments and write-offs, and a bungled privatisation offer. These and other issues have led to conflicts between the controlling and minority shareholders. The objective of the case is to allow a discussion of issues such as corporate governance of founder-controlled companies; role and powers of legal representatives in Chinese companies and the governance issues they pose; identification and disclosure of related party transactions; diversification; due diligence in investments; privatisation; director independence; shareholder activism; and the role of regulators.

The world of steel

Delong, a Chinese company listed on the SGX – or S-chip – is part the Delong Group in China, with its headquarters in Beijing. It specialises in steel manufacturing, particularly steel billets, mill rolls and hot-rolled steel coils, among many other steel products. Its products are used in the infrastructure, pipe-making, machinery fabrication and automotive industries. Delong's business also involves the procurement and sale of iron ore, cast steel articles and coal gas recycling. It reported a 29.9% increase in revenue from RMB9.9 billion in FY2016 to RMB12.8 billion in FY2017.[1]

Delong listed on SGX in 2005 through a reverse takeover of Teamsphere Limited.[2] Its share price peaked at S$19.50 on 8 July 2007, and hit its lowest point on 20 November 2016 at S$0.27, before subsequently recovering to S$5.94 as of 19 May 2019.[3]

This is the abridged version of a case prepared by Chang Xiao Yu Seishea, Wu Jie Ying, Wong Yen Sheng, Stephanie Quek and Tan Sin Nee under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Emma Lee Mei Jie under the supervision of Professor Mak Yuen Teen.

The people behind Delong

As of 15 March 2019, Ding Liguo, the Executive Chairman and CEO of Delong, and his wife, Zhao Jing, held 76.82% of Delong's shares through their control of Best Decade Holdings Limited (Best Decade), which is owned by Ding and his wife through two other companies which they wholly own. In addition, Ding directly owns 4.66% of Delong's shares.[4]

Delong has a number of subsidiaries and associates. It owns 100% of Asia Paragon International Limited (British Virgin Islands), Delong Asset Management (Hong Kong) Limited and Dexin Steel Pte Ltd (Singapore).[5] Delong's key subsidiaries in China include Delong Steel Limited, Dezhong International Finance Leasing Co., Ltd, Xingtai Xinlong Coal Gas Co.,Ltd, Xingtai Delong Machinery and Mill Roll Co., Ltd, Delong International Trading (Tianjin) Co., Ltd. Ding, Lan Jihong (Chief Financial Officer) and Wu Yujie (executive director) act as legal representatives for various companies within the Group.[6]

Under the General Principles of Civil Law of the People's Republic of China (PRC), a legal representative "performs the duties and powers on behalf of a legal person in accordance with the law or the constituent documents of the legal person". A legal representative's powers and responsibilities generally include running the general administration of a company according to its aims and objectives, giving one full control over the company's cash and capital.[7]

As the Executive Chairman, CEO and legal representative of various companies within Delong, Ding therefore wields considerable power.

About Ding Liguo

Ding is well-known and highly successful in the Chinese steel industry. In 1992, Ding established Tangshan Great Wall Steel Rolling Company and held the position of general manager.[8]

He founded Liguo Group in 1995 and served as its Chairman. In 2000, the Group acquired Xingtai Iron and Steel Company, which had debt of RMB240 million, and renamed it as Delong Steel Limited.[9] Ding invested RMB1.3 billion in Delong Steel Limited, and succeeded in increasing annual production from 150,000 tons to 1.2 million tons.[10] Delong established the Youth League Committee and set up a mutual fund to improve the living conditions of less fortunate employees.[11] It also contributed to the Chinese society at large by offering scholarships and donations. Between 2012 and 2016, the company invested more than RMB800 million in efforts to minimise pollution from its steel production.[12]

Ding was awarded "National Model Worker" and "Top 10 Outstanding Youth in China" by the Chinese government, becoming one of the most prominent entrepreneurs in China's steel industry. Ding was also a representative of the National People's Congress.[13]

Board of directors

Delong's current all-male board of directors comprises five members,[14] chaired by 49 year-old Ding as Executive Chairman. The other executive director is 56 year-old Wu Yujie, who is responsible for overseeing the operations of the Group. Wu Yujie was appointed to the board in July 2017,[15] following the resignation of Zuo Shuowen.[16]

The other directors are independent directors, including 63 year-old Lai Hock Meng (also known as Peter Lai), 47 year-old Wu Geng, and 72 year-old Wang Tianyi. Wu Geng had replaced Hee Theng Fong, a well-known Singapore lawyer, who retired from the board as an independent director in April 2017 after serving on it for just under 11 years.[17] In September 2018, another non-executive director, Yuan Weimin, had resigned "due to personal reason" after serving just over 10 years on the board.[18]

Wu Geng, who was appointed to the board in May 2017, chairs the Nominating Committee (NC) and serves as a member of the Audit Committee (AC) and Remuneration Committee (RC). He is also an independent director of a Chinese oil and gas company listed in Hong Kong and of an asset management company managing a real estate investment trust listed on SGX. A director of the well-known Singapore law firm, Drew & Napier LLC, he graduated with a law degree from Peking University, and has a masters degree in Law from the National University of Singapore and another postgraduate degree from University of Delaware in the United States.[19]

Wang Tianyi was appointed as an independent director in August 2013 and is the Chairman of the RC and a member of the AC and NC. He is the Executive Vice-President of The Chinese Society For Metals, and has more than 40 years of experience in the steel industry.[20]

Peter Lai Hock Meng, has been an independent director of Delong since 2007 and has been its lead independent director since 2013.[21] He is also the Chairman of the AC and a member of the NC and RC. Lai has held directorship positions in many companies listed on SGX and other countries at various times over the past 15 years, including a number of S-chips.[22] Some of the listed companies that he has been a director of include China Essence Group, China Oilfield Technology Services Group Limited, Dragon Group International Limited and Xpress Holdings.[23,24,25,26]

Lai was an independent director of China Essence Group from 2008 to 2015. According to its letter to its shareholders in 2018 when it delisted, the reason was the "company's unclear state of affairs after unauthorised transactions entered into by the previous management" came to light.[27] Five days after Lai left the company, the company reported a loss of RMB25.37 million for the quarter ended 30 June 2015.[28] Thereafter, the Group's shares were suspended from trading on 7 September 2015.[29]

Lai was appointed as an independent director of China Oilfield Technology Services Group in 2010. The company had listed on SGX in 2007.[30] It was delisted in 2015 after it failed to meet the SGX requirements under Listing Rule 1314, relating to exits from the watchlist based on financial criteria or minimum trading price.[31]

In 2015, Dragon Group International was to be placed on the SGX watch-list, under the financial entry criteria pursuant to Rule 1311(1).[32,33] Lai stepped in to assist the troubled company in 2017. Six months later, the company received an extension from SGX to remove itself from the watch-list by 3 March 2018.[34] However, by 31 December 2017, the Group faced a decline in revenue and its shareholders' equity was negative US$2.1 million.[35] It was notified by SGX on 12 April 2018 that it was to be delisted.[36]

On 12 December 2018, Lai resigned as independent director and Non-Executive Chairman of SGX-listed Transcorp Holdings, having joined the board just over four months earlier. The announcement said that the resignation was "due to medical reasons". The cessation announcement also listed his 14 other current directorships in listed and private companies, including Delong. However, Lai did not resign from Delong, nor it appears from other listed boards.[37]

According to Delong's 2016 annual report, during FY2016, Delong bought 2.35 million units in EC World REIT. At that time, Lai was the CEO of EC World REIT.[38]

Lapses in disclosure of related party transactions

Delong's external auditors are Deloitte & Touche LLP. In its independent auditor's report for FY2016,[39] the identification and disclosure of related party transactions was highlighted as the first key audit matter. The report stated that "certain related party transactions were omitted for disclosure in the past due to a lack of understanding and lack of familiarity with the definition of a related party". One such transaction was a "donation to a charity trust whose founder is a spouse of a director of the company" while another transaction was "sales to a company who has a common director with the company", amounting to RMB440,000 and RMB859,000 respectively.[40]

The Group had also provided a guarantee of RMB50 million for the bank borrowings of Hebei Delong Modern Special Tube Manufacturing Co., Ltd (Hebei Delong), which was eventually rescinded in March 2017.[41] No disclosures were made in the FY2015 annual report when the guarantee had already been provided, and it was only disclosed in the FY2016 annual report. Hebei Delong is not a subsidiary of Delong but is owned by Ding and his spouse.[42]

Too much steel

In January 2017, Delong announced reforms introduced by the Hebei Province's National Party Congress in relation to plans to reduce steelmaking capacity in Hebei Province by 31.86 million tonnes, and to accelerate the reduction of steelmaking capacity in several cities in the province. As a result, one of its subsidiaries, Laiyuan County Aoyu Steel Co., Ltd. (Aoyu Steel) may be required to reduce its capacity.[43]

Less than three months later, Delong announced that it had entered into a conditional agreement to sell 1.08 million tonnes of pig iron production capacity and 1.21 million tonnes of steel production capacity of Aoyu Steel for RMB400 million (or approximately S$81.1 million). The purchaser is a company incorporated in PRC and its shareholders are said to be independent third parties who are not related to the Delong Group or any director or substantial shareholder of the Delong. The unaudited net book value of the property, plant and equipment (excluding prepaid leases) of Aoyu Steel as at 31 December 2016 was RMB94.9 million. This was after taking into account an impairment charge of RMB600 million for Aoyu Steel for FY2016. An independent external valuer based in Hebei Province appointed by the Group had valued Aoyu Steel at RMB100 million.[44]

The transaction was completed in July 2017 following the receipt of the final consideration from the purchaser.[45] This followed a waiver received from SGX allowing the company to sell its production capacity without shareholders' approval.[46]

The diversification storm

In 2016, Delong decided to diversify its business. It embarked on two key types of diversification – a new business of investment and asset management, and international expansion of its core business. The rationale given was to provide shareholders with diversified returns, enjoy long-term growth, and reduce reliance on its existing steel business in China.[47]

In August 2016, Delong invested RMB60 million to buy a two percent stake in Qingdao Kutesmart (Kutesmart), a clothing garment company. Kutesmart focuses on the design and customisation of suits using automated production, enabling cost reduction through mass production.[48] Delong paid 5.5 times the net asset value per share as at 30 June 2016.[49] This amount was deemed to be reasonable by the board but some shareholders felt it was a puzzling investment.[50] The company said that the strong growth in Kutesmart was underpinned by its highly efficient business process, established distribution channels, wide customer base, and its string of capital injections by reputable investors.[51]

However, Delong recorded an impairment loss of RMB50 million in its fourth quarter results for December 2017, which represented 83% of its investment in Kutesmart. According to Delong, the unaudited financial statements of Kutesmart for the year ended 31 December 2017 did not show an actual drop in Kutesmart's performance. It asserted that Kutesmart's performance was improving according to the price-earnings ratio and price-to-book ratio, which were higher than at the time of purchase. Despite that, Delong carried out its own assessment using the discounted cash flow model and determined that an impairment should be made.[52]

Delong's shareholders were quick to question Delong's decision to impair Kutesmart within such a short period. Delong was selling off its steel production capacity at a time when steel prices were rising[53] while investing in and then divesting companies repeatedly.

A lost sheep in a foreign land

Delong Thailand was incorporated by Delong Steel Singapore Projects Pte Ltd, Permsin Steel Works Public Co Ltd, Asia Metal Public Co Ltd and Thai Yuan Metal Public Co Limited in 2014. Delong held a 55% stake as the main shareholder.[54] However, Delong Thailand soon ceased operations and minority shareholders of Delong Thailand strongly disagreed with the prices and sales strategies implemented by the company.[55,56,57]

In 2016, Delong Steel Singapore Projects Pte Ltd eventually entered into a binding memorandum of understanding with the non-controlling interests of Delong Thailand for the disposal of the Group's entire equity interest in Delong Thailand. The sale consideration of THB385 million was determined internally by Delong without any external third-party valuer.[58] Hence, shareholders questioned if the price was set correctly, or if it was intentionally under-priced for quick disposal.[59]

In 2017, Delong entered into an agreement to invest in a joint-venture company called Dexin Steel Indonesia, with Shanghai Decent Investment (Group) Co Ltd and PT Indonesia Morowali Industrial Park as joint venture partners. Delong held a 45% stake in Dexin Steel Indonesia as the largest shareholder.[60] This would reportedly cost the company up to 10 times its investment in Delong Thailand. Delong did not mention if banks were willing to finance the joint venture, which caused shareholders to be highly concerned with this joint venture.[61]

According to the feasibility report presented by WISDRI Engineering & Research Incorporation Limited, the project was deemed to be feasible in producing 3.5 million tons of steel annually to meet Indonesia's demand for steel. It also suggested that the project would have an internal rate of return of 17.21%, higher than the interest cost of 10%. In order to go forward with this joint venture, Delong would have to contribute US$67.5 million of capital and provide shareholder loans amounting to US$60.75 million.[62]

The voice of the powerless

Ding never saw the need for dividends even with Delong's large cash balance. This sparked unhappiness among minority shareholders who repeatedly brought up the issue during shareholder meetings. Some felt that it was a case of minority oppression and it became a significant issue as more shareholders pressed the board on this issue, only for their concerns to be dismissed. A group of shareholders, led by Martin Wong who owned about 400,000 shares, demanded that the company pay attention to minority shareholders' calls for dividends and less business diversification.[63]

The lack of a dividend payout policy was brought up by minority shareholders during AGMs and extraordinary general meetings (EGMs), but this was repeatedly vetoed by the controlling shareholder. This led several minority shareholders to write to the board raising several queries and proposing possible actions to be considered by the board.[64] The queries and comments were related to the company's strong financial results versus its dismal share price performance; its unsuccessful geographical diversification; weak capital management and diversification at the expense of shareholders; and weak corporate actions that diminish shareholder value. Some of the actions proposed by the shareholders included improving its investor relations to raise its profile and engage with existing and institutional investors; distributing dividends and introducing a formal dividend policy; explaining and providing more details about the investment in Delong Thailand; aborting the Indonesian diversification and focus growing the steel business in China; liquidating non-core investments; and implementing a 1-for-10 share split.[65]

Ding responded on behalf of the company on 12 December 2017, reproducing excerpts from the letter from shareholders. With regards to shareholders comments about the lack of a dividend payout policy, the company's response is shown in Figure 1.

Company's response:

The board takes into account various factors in deciding whether or not to declare dividends to the Company's shareholders. While the aforementioned decision also depends largely on the circumstances faced by the Company and the Group from time to time, the Board generally considers the following factors (which are neither exhaustive nor definitive):

(a) Cost of capital;

(b) Merger & Acquisitions;

(c) Capital expenditure (i.e. To be in line with the industry's rising environmental standards, the Group has continually invested in technological upgrades and enhancement);

(d) Working capital purposes;

(e) Uncertainty as to the Group's future profitability, especially given the introduction of governmental policies aimed at reducing steelmaking capacity in the People's Republic of China ("PRC"); and

(f) Uncertainty as to the availability of financing from external sources, especially since certain banks have scaled back their lending to steel enterprises in the PRC.

In view of the above factors, the Company does not intend to introduce a formal dividend policy at the juncture.

Figure 1: Board's response to minority shareholders regarding a lack of dividend payout policy[66]

The cash flow statements over the years show an increasing trend in the cash used in investing activities.[67] Non-current assets also increased over the years. One of the key items contributing to the growth in cash and non-current assets was the investment in Delong Thailand in 2015, which was disposed of in 2016.[68]

Dividends at last

10 September 2018 marked the first declaration of dividends for Delong, with a dividend of S$0.55 per ordinary share declared and payable on 26 September 2018.[69]

Earlier, on 7 June 2018, the company announced that Best Decade, the controlling shareholder of Delong which is owned by Ding and his wife, had bought a 17.33% stake from Evraz Group S.A. (Evraz Group) and Vollin Holdings Ltd. The acquisition cost was US$100,865,354 or US$5.28 per share which translates to about S$7.09.[70] However, another announcement on 11 June 2018 said that Evraz Group sold its 16,569,599 shares or 15.04% stake for US$91,714,048. This translates to about US$5.54 or S$7.42 per share.[71]

The S$7.42 represents a 65% premium to the then stock price.[72] There was speculation that the sudden declaration of dividends was to allow Ding to fund the acquisition of the 17.33% stake.[73]

The perfect privatisation: Trade wars in China

"Shareholders will have an opportunity to realise their investment in the offeree for a cash consideration at a premium above the historical market share prices."

– Delong announcement[74]

The steel industry had benefited from the improved global economic outlook in recent years. However, the trade war brewing between China and the United States resulted in a significant slowing down of growth in the world's second largest economy.[75] This is especially so in Delong's case with tariffs imposed on the steel industry. With the tide turning against them, Delong decided to go private to ensure better management and less discord in the board when making decisions.[76] Delong offered to privatise through a voluntary delisting which requires approval from at least 75% of shareholders with no more than 10% of shareholders voting against. Ding and his wife had deemed interest of 75.56% in Delong when the offer was announced.[77]

Eventually, a S$7 price was offered for the voluntary delisting.[78] With Delong's earnings increasing seven-fold in 2017, many minority shareholders felt that the S$7 offer was too low.[79]

Rule 17 of Singapore's Takeover Code requires Ding to raise the offer price to the highest price which he had paid in cash for shares carrying 10% or more of the voting rights in the six months leading up to the offer – which was S$7.42 per share, the amount he had paid in June 2018.[80]

To much surprise, on 11 October 2018, the company shocked the market when it announced that Ding had pulled out of the privatisation bid due to the requirement to revise the offer price. The shock announcement was made by PrimePartners Corporate Finance Pte Ltd (PrimePartners), which was acting for the offer vehicle Best Grace Holdings (Best Grace). The announcement said that the bid was to be funded by drawing down on loan facilities from Deutsche Bank. However, hiking the offer price to S$7.42 a share would "precipitate very substantial contingent liabilities that materially exceed the financial resources arranged for the offer".[81]

Delong's shares, which had been suspended from trading since 5 October 2018, resumed trading on 12 October 2018.[82]

A Business Times report reported that the Securities Industry Council (SIC), which enforces the Takeover Code, said that it was "investigating all the relevant circumstances leading to the withdrawal of the offer", especially with regard to whether there has been any breach of Rule 17.[83] The SIC appointed a five-member hearing committee, chaired by Professor Hans Tjio, to look into the matter.[84]

The SIC responds

"In advising their clients, advisers have to be vigilant and exercise due care at all times. Advisers must be conversant not only with the requirements of the code, but also how these requirements are applied in practice. This is fundamental, and cannot be over-emphasised."

– Securities Industry Council[85]

On 29 July 2019,[86] the SIC issued a public statement on Delong's case and rapped Ding and Delong's legal and financial advisers – Shook Lin & Bok and PrimePartners – in light of its privatisation plan being withdrawn merely two weeks after the offer was announced. Following a probe, the SIC ruled that there had been a breach of the Takeover Code. However, it determined that there was no need to compensate Delong's shareholders, given "the limited impact of the breach", as the non-compliance was noted shortly after the offer announcement and the offer was withdrawn prior to the distribution of the offer document.[87] Additionally, a trading halt in Delong shares was called within three business days of the offer announcement. It was lifted after the offer was pulled out.[88]

SIC's hearing committee found that Shook Lin & Bok fell short of the standards expected of a legal adviser under the Takeover Code. The law firm had previously advised that the offer should be made at the highest price paid for shares in the three months prior to the offer. However, it was only when a third party informed the legal adviser did it recognise that the offeror's cash purchase of Delong shares at S$7.42 per share in June 2018 triggered a longer six-month reference period. The SIC noted this as "a serious lapse". On the other hand, the hearing committee found PrimePartners "relatively less culpable" than the law firm in the breach of the Takeover Code.[89]

That being said, SIC stressed that both professional advisers "had collective responsibility to ensure that the offeror complied with the code".[90]

Try and try again?

On the same day that SIC's public statement was issued, Ding again revived his bid to privatise Delong and tabled a new buyout offer at the original price of S$7 a share. Best Grace re-launched the voluntary conditional cash offer on 29 July 2019, with Stirling Coleman Capital as its new financial adviser. This occurred after it successfully obtained a waiver by the SIC from the rule that bars an offer from being re-introduced within 12 months of a withdrawal.[91]

Best Grace said that its revived cash offer of S$7, which was at a 16.5% premium over the last transacted share price, would give Delong's shareholders the opportunity to cash out of their investments in the company, "which may otherwise be difficult due to the low trading liquidity of the shares". Best Grace further added that privatising Delong would result in the company not having to incur listing-related compliance costs, and provide the company more management flexibility.[92]

Delong's share price surged by around 15.8% on 30 July 2019, in light of the revived S$7 per share cash offer to take the steel manufacturing company private.[93]

Would Ding succeed this time round in taking Delong private? Observers are awaiting the final result with bated breath.

Discussion questions

1. What are the benefits and risks when major shareholders hold major roles on the board and in senior management, as in the case of Ding? In Ding's case, he was also the legal representative of several companies within the Group. What are the roles and powers of a legal representative in a PRC company and what governance risks do they pose? How can these risks be mitigated?
2. Critically evaluate the composition of the board of directors. Are there potential conflicts of interest and other concerns with the independent directors that may have impacted their objectivity and effectiveness?
3. What were the potential lapses in disclosure Delong may have committed, especially with regards to the company's related party transactions? To what extent should the board be held accountable for such lapses?
4. The company sold off part of its iron and steel production capacity in China and engaged in both geographical diversification and unrelated diversification. Critically evaluate each of these decisions and discuss whether those decisions are in the interests of the company and its shareholders.
5. Comment on the role of the board of directors in a company's decision-making process. What should the Delong board have considered in deciding whether the cash should be used for investments or for dividends to the company's shareholders?
6. Critically evaluate the concerns and issues raised by the minority shareholders? Do you believe that they are valid. Do you think the response of the board was adequate? Explain.
7. What are the different ways for a company to privatise and delist from SGX? Do you think that Delong's offer of S$7 for the voluntary delisting is reasonable?
8. Comment on the bungled privatisation offer. Who do you think should be held responsible? What actions do you think regulators should take? Do you think the regulators acted appropriately with regards to the privatisation, and more generally, in protecting the interests of shareholders of Delong Holdings? Explain.

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EMERGING TOWNS AND CITIES: FALLING THROUGH THE CRACKS

Case overview

Emerging Towns & Cities Singapore Ltd (ETC) followed a slew of S-chips in grappling with corporate governance issues. After a 'rebirth' in 2015, during which the entire board was replaced following a shareholders' revolt, 2017 ushered in a whole new set of problems. Its controlling shareholder, Luo Shandong, was alleged to have made unauthorised withdrawals from a subsidiary in China. The events which followed included legal action taken against the parties who were alleged to be involved, as well as shareholder requisition notices to remove the Chairman of ETC. The objective of this case is to facilitate a discussion of issues such as corporate governance in S-chips; maintaining control over offshore subsidiaries in S-chips; risk management; and the role of controlling shareholders and the board of directors.

Building a new future

Incorporated in Singapore on 17 October 1980, Catalist-listed ETC was formerly known as China Titanium Limited. Through a reverse takeover in 2012, it was renamed as Cedar Strategic Holdings Limited (Cedar), and ventured into real estate development.[1] However, Cedar soon found itself in disarray. In April 2015, Cedar was found to have accounting and internal control irregularities –including overpayment to former executive directors and management – which resulted in a suspension in trading of its shares and a shareholder revolt. These led to the ousting of its board of directors by a group of investors.[2]

S-chip governance

The woes of ETC, among other S-chips, is appropriately captured in the Chinese proverb, “山高皇帝远”. The Chinese proverb alludes to local officials' tendency to disregard the wishes of central authorities in distant Beijing during the imperial days. In ETC's case, its management and board were unable to oversee the Group's operations in China.

This is the abridged version of a case prepared by Celeste Tan Jiao Hua, Chia Zixue Benjamin, Lim Chern Miao Samuel and Ong Jing Wen under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Clarisse Tan under the supervision of Professor Mak Yuen Teen.

S-chips have been in the news for all the wrong reasons. The overall corporate governance is generally weak in most S-chips since small and medium enterprises in China constitute most of the S-chips. This has resulted in accounting woes, trading irregularities and scandals.[3]

Legal representative

Every business established in China, be it domestic or foreign, is required to appoint a legal representative. The legal representative is the main principal of the company and the employee with the legal power to represent – and enter into binding obligations on behalf of – the company in accordance with the law or articles of association of the company. A legal representative's acts are binding even if he is acting beyond the authorised scope of duties. A legal representative can be the Chairman of the board of directors, executive director (if there is no board of directors), or the general manager. He does not have to reside in China or be a Chinese citizen.[4]

Company chop

Similarly, every Chinese company is required to have a "chop" which will be in the custody of the legal representative. Control of the chop is important to minimise risks of unauthorised dealings. The legal representative's chop is required for numerous company documents and is regarded as a signature.[5]

Board of directors

On 24 June 2015, following a shareholder's revolt against the previous board, Christopher Chong and two other professionals, Tan Thiam Hee and Peter Tan, were appointed to the board as independent directors, with Chong acting as Non-Executive Chairman.

Chong was also nominated as a member of the Audit Committee, Nominating and Corporate Governance Committee, as well as the Remuneration Committee. At the date of his appointment, Chong was the partner and co-founder of ACH Investments Pte Ltd, a Singapore-based corporate advisory firm and sat on the board of four other Singapore-listed companies. He is said to have extensive experience in capital markets, securities law, corporate affairs and corporate governance.[6]

Tan Thiam Hee is a professional accountant by training with over 20 years of experience as Chief Financial Officer (CFO) or Chief Executive Officer (CEO) across diverse industries, while Peter Tan brings with him more than 30 years of experience in corporate accounting and management.[7]

Tan Thiam Hee eventually took on the role of CEO in ETC on 15 December 2015.[8] Chong and Peter Tan remained as independent directors on Cedar's board. Collectively, both of them chair the three board committees. As at 2015, four of the five directors on Cedar's board were former or current CEOs or CFOs from listed companies in Singapore or Australia.[9]

Back to the wall

Despite Cedar's balance sheet showing funds were available, the new board found only debts. The board subsequently sourced for additional funds and secured short term loans of about S$2 million.[10] Cedar then appointed Baker Tilly Consultancy as a "Special Auditor" to investigate issues pertaining to the lapses in corporate governance, internal controls and possible non-compliance with Catalist rules.[11]

In 2015, Cedar's independent auditor, Foo Kon Tan LLP, issued its Independent Auditor's Report, which contained a qualified opinion. Qualifications included failure to perform complete and correct declarations of related party transactions, inappropriate payments, and failure to fully comply with all accounting standards.[12]

Planting a new seed

The new board's top priority was to implement a new strategic plan and lift the share trading suspension. The plan sought to capitalise on niche areas and opportunities in emerging cities and regions. As part of its corporate turnaround strategy, Cedar sought to acquire Huizhou Daya Bay Mei Tai Cheng Property Development Co. (Daya Bay). Daya Bay was the sole developer of a real estate project in China and enabled the Group to focus on property investment and development.

Luo was the beneficial owner of all the shares of Shenzhen Tong Ze, which owned Daya Bay. Luo had lent money to Daya Bay's previous owners. However, when they had difficulty paying him, he took over the Daya Bay project. Taking advantage of the fact that Daya Bay's previous owners were unable to pay Luo back, Cedar stepped in to acquire Luo's 60% interest in Daya Bay at below market value on 4 November 2015.[13] In addition, it was agreed that Cedar would repay the RMB112.0 million owed by Daya Bay's previous owners to Luo at the end of 2017.[14]

As part of the oral agreement concluded with Cedar, Luo would comply with all rules and regulations set by the board of Cedar. The board of directors set two rules for the governance of Daya Bay:

a. The Non-Operational Payments Rule, whereby all non-operational payments by Daya Bay exceeding RMB500,000 must be approved by the board of directors of Cedar; and

b. The Related Party Payments Rule, whereby all fund transfers by Daya Bay to its related parties had to be approved by its board of directors.[15]

On 22 February 2016, Cedar entered a share subscription agreement with Luo. Luo became the major shareholder of Cedar, holding 17.91% of the voting shares.[16]

Out of the frying pan...

With Chong leading the new board, Cedar resumed trading of its shares on 31 March 2016, nearly one year after its suspension in April 2015.[17]

In line with the Group's growth strategy to focus on development and investment properties in emerging countries, Cedar acquired all the issued and paid-up shares of DAS Pte. Ltd. (DAS) for US$24.9 million. DAS held a 70% interest in Uni Global Power Pte Ltd, which in turn owned a 70% stake in Golden Land Real Estate Development Company Limited (Golden Land), which is the developer of Golden City, a luxury development in Yangon.[18] As a result of the acquisition of DAS, which effectively owned 49.0% of Golden Land, Cedar indirectly owned a 49.0% stake in Golden Land through two acquisition phases completed by 27 February 2017.[19] This acquisition marked Cedar's gateway into Yangon's luxury real estate market.

However, there was a need for further financing to fund the acquisition of DAS. Cedar entered into an agreement with Luo on 17 October 2016, who had agreed to grant a loan of up to US$29.3 million to supplement Cedar's cash resources to facilitate the acquisition.[20]

In order to consolidate all existing debts owed by the Group to Luo and to settle the Group's obligations due to him, Cedar entered into a convertible loan agreement with Luo on 25 January 2017. This agreement replaced the 2016 loans owed by the Group to Luo. Under the agreement, Luo had the right at any time within 15 months to convert up to the full sum of US$29.3 million and any interest accrued thereon into ordinary shares of Cedar, amounting to an aggregate of up to approximately 468.1 million fully paid new ordinary shares.[21] This arrangement improved Cedar's balance sheet position and reduced borrowings of the Group.[22]

On 28 February 2017, Cedar was rebranded as ETC Singapore to "mark its metamorphosis from a company laden with legacy issues to one which is ready to embark on its next phase of growth".[23]

...And into the fire

"We decided branding is important and that we would rather be known for what we now do rather than remind people we are a phoenix that arose from the ashes."

– ETC Chairman, Christopher Chong[24]

ETC's attempts to distance itself from its previous controversy did not last long. Instead of providing a new lease of life to ETC as the board had hoped, its business relationship with Luo subsequently soured.

Clash of the titans

A series of hostile exchanges between ETC and Luo were made public on 14 November 2017, when ETC announced that it would be filing a lawsuit against Luo and his companies, Dong Gang Industrial Co Ltd (Dong Gang) and Hunan Toener Investment Group Co Ltd (Hunan Toener).[25]

The lawsuit was in relation to unauthorised withdrawals of funds that amounted to RMB118 million (S$24 million). This was a result of Daya Bay employees refusing to comply with internal controls that were implemented.[26] ETC revealed that the withdrawals took place between 3 July 2017 and 25 October 2017, transferring funds from Daya Bay to the two companies owned by Luo.[27] The lawsuit was filed in the Singapore High Court.[28] Concurrently, ETC had commenced a shareholder's derivative suit in People's Republic of China (PRC) courts against the employees of Daya Bay, in relation to the unauthorised withdrawals and for refusing to surrender the Daya Bay company seal and financial books.[29]

Damage control

Earlier in 2017, ETC had initially approved small withdrawals by Luo to resolve the early repayment of the loan owed to him, until his demands became more significant and untenable.[30] When Luo started making larger withdrawals, Chong, in his capacity as the legal representative of Daya Bay, tried to block the unauthorised withdrawals. He travelled to China to obtain new bank tokens for the bank accounts of Daya Bay. However, his attempts were futile. Thereafter, ETC's CFO and Executive Director travelled to China to request that the Daya Bay employees involved surrender the existing bank tokens, but to no avail. Again, as the legal representative of Daya Bay, Chong sent warning letters to the employees at Daya Bay to cease the making of further unauthorised withdrawals. A subsequent reminder was sent.[31] These warnings went unheeded.

On the advice of lawyers in China, letters of demand were issued to the Daya Bay employees complicit in the unauthorised withdrawals. The letter demanded that they stop using the company seal and financial books of Daya Bay and return them to Chong. On 14 November 2017, ETC instructed its Singapore lawyers to issue a letter of demand to Luo and his companies. The letter demanded that Luo comply with all rules and regulations set by the board, that he and his companies immediately stop making unauthorised withdrawals from Daya Bay, and that he repay the outstanding RMB106 million to Daya Bay.[32]

Round #1 in the ring

Shortly after the first announcement made by ETC, the board announced that Luo had issued a requisition to ETC to convene an Extraordinary General Meeting (EGM) to vote for the removal of Chong and Peter Tan as directors of the company, and the appointment two proposed directors to replace them. [33]

The requisition was rejected by the board.[34] Chong and Peter Tan were the only independent directors of ETC then. As such, their removal would result in the company being non-compliant with Rule 210(5)(c) in the Singapore Exchange (SGX) rulebook, which requires at least two independent directors. Additionally, the curricula vitae of the proposed directors were not updated to disclose their complete backgrounds. As such, suitability issues were also raised. Additionally, the board had not received any notice that SGX had approved the appointment of the proposed directors. ETC asserted that the likely purpose of the requisition was to hamper the company's efforts in its legal action against Luo and his companies.[35]

Round #2 in the ring

Luo was undeterred. Just a week after the first requisition to convene an EGM was rejected, four other shareholders – Zhang Xiang, Tao Xucheng, Sun Yanli, and Tan Xueqin – who collectively held more than 10% of the total paid-up shares of ETC – filed a second requisition notice. Again, it was for the purpose of voting on the removal of Chong and Peter Tan as directors of ETC, along with the appointment of three other individuals as directors.[36]

The second requisition notice was likewise rejected. Similar reasons were given for the board's decision. ETC's sponsor, RHT Capital Pte. Ltd, was also unable to advise on the suitability of the proposed directors without additional information, which was not forthcoming.[37]

Furthermore, the company claimed to have grounds to believe that the second requisition notice was raised on the instruction of Luo and that the purpose of the second requisition notice was to hamper the company's efforts to proceed with legal action in the PRC and in Singapore with respect to the unauthorised withdrawals.[38]

Zhang was found to have acquired all his ETC shares in an off-market transaction from Luo.[39] Tao was also believed to be a close associate of Luo, having held the position of Executive Vice President of the financial business of Hunan Toener Group, where Luo is the Chairman and controlling shareholder.[40]

On the same day when the second requisition notice was raised, ETC received a letter from Shook Lin & Bok LLP, the solicitors of Luo, constituting a notice under Section 216A of the Companies Act for a representative action. The notice demanded that ETC request SGX to direct the company to appoint special auditors from one of the “Big Four” accounting firms to report on the matters concerning the unauthorised withdrawals and legal proceedings against Luo and the employees of Daya Bay. The notice also sought for the company to initiate action against Chong for alleged breach of his director’s duties in respect of his actions over the unauthorised withdrawals.[41]

Retreat and resolution

On 18 January 2018, ETC announced through a press release that it had arrived at a settlement deed with Luo. ETC had entered into a sale and purchase agreement to sell to Luo 100% of the issued and paid up capital in Cedar Properties Pte. Ltd. (CPPL), which represents the holding entity for ETC’s Daya Bay project, whereby the proceeds would be offset from the outstanding debt due under the convertible loan agreement with him. He would also transfer his 15.5% stake in ETC to Zhu Xiaolin and facilitate the handover of all bank tokens of Daya Bay to ETC within seven days. ETC would then file a withdrawal or discontinue the Singapore and PRC lawsuits against the respective defendants. Luo would also rescind the two requisition notices seeking the removal of Chong and Peter Tan as directors. Luo also agreed to withdraw demands for ETC to commence legal proceedings against Chong.[42]

The aftermath

Although the unauthorised withdrawals of funds amounted to RMB118 million, the board had highlighted that the financial impact of the unauthorised withdrawals was not expected to be material.[43] When the claim was made on 25 October 2017, the total amount of the unrepaid unauthorised withdrawals was RMB106 million, while Daya Bay owed a total of RMB112 million to the companies controlled by Luo under various loans agreements that were to be repaid at the end of the year. Additionally, ETC still owed Luo approximately RMB159 million under the convertible loan agreement.[44] This resulted in a net amount of about RMB164 million owed by ETC and Daya Bay to Luo and his controlled companies, greater than the amount that had been withdrawn.

Despite ETC’s reassurance that there was minimal financial impact following the unauthorised withdrawals and that it had arrived at a settlement with Luo, its stock price fell by 11.4%, closing at S$0.070 upon resumption of trading on 29 June 2018. The stock price closed at an all-time low of S$0.031 on 15 November 2018.[45]

Wearer of many hats, owner of none

In ETC's 2017 annual report, Chong addressed the shareholders in his eighth and last letter for the company. He would be resigning as independent director, after less than three years since his appointment. When Chong was appointed as a director of ETC in 2015, he held 10 directorships. Four of these directorships were in SGX-listed companies.[46]

Chong was not someone who was new to controversy prior to the ETC sage. In 2010, Chong had a heated public exchange with National University of Singapore's (NUS) Professor Mak Yuen Teen. Professor Mak had asserted that the appointment of alternate directors to assist busy independent directors in coping with their responsibilities was unacceptable as it reflected poor corporate governance, citing Xpress Holdings as an example.[47] Chong was an independent director of Xpress Holdings at that point in time and had appointed an alternate director. Koda Limited and ASL Marine Holdings, where Chong was also a director at the time, had disclosed similar plans for appointment of alternate directors.[48]

A more recent controversy arose at Singapore O&G Limited (SOG), where Chong was the lead independent director. He relinquished his appointment on 27 December 2017,[49] following SOG's claim for S$1.5 million from him in relation to a company transaction in which he was involved. It was unclear how the dispute originated. On 6 March 2018, SOG announced that, following mediation, Chong had agreed to a full and final settlement of S$1.25 million, without any admission of liability.[50]

The uncertain future

ETC faces new challenges ahead. With the settlement with Luo buying back Daya Bay, ETC had lost one of its two main revenue streams and has become a single asset company focused on developments in Myanmar.[51] Furthermore, external factors such as the ongoing Rohingya crisis in the country have raised more uncertainties in ETC's business plans.

It remains to be seen if ETC will be able to build a better future for itself.

Discussion questions

1. What are the key issues relating to legal representatives of Chinese companies from a risk management and corporate governance perspective? To what extent was Christopher Chong suited for such a role?
2. S-chips are often plagued with corporate governance issues. Apart from problems relating to legal representative and company chop as stated in the case, what are the other issues that embroil S-chips? Suggest improvements for both regulators and companies.
3. What are the roles and responsibilities of the Chairman of the board? What are the core competencies required of a Chairman? Evaluate the skills, competencies and the independence of Christopher Chong as Chairman of the ETC.
4. Comment on the adequacy of ETC's response to the withdrawals made by Luo Shandong. Did the board of directors do enough to mitigate the risk of unauthorised withdrawals? Suggest what should be in place to prevent unauthorised withdrawals.
5. Explore the role that controlling shareholders like Luo Shandong and the other subscribers play in the corporate governance of companies like ETC. How can it benefit or harm the company and its minority shareholders?

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THE FALL OF HYFLUX

Case overview

On 22 May 2018, Hyflux Ltd (Hyflux) shocked the market when it announced that the company and five of its subsidiaries had applied to the High Court of Singapore to commence a court-supervised restructuring process. This followed a request for a trading halt the day earlier. On 23 May 2018, it requested for a suspension in trading of its shares, and its shares have remained suspended since then as it embarked on a tortuous and drawn-out restructuring process. At its peak, Hyflux had a market capitalisation of nearly S$2.1 billion, but it was now suddenly effectively insolvent. The news was even more shocking because two months earlier, the company's external auditors had issued a clean audit opinion. The objective of the case is to facilitate a discussion of issues such as corporate governance of founder-controlled and managed companies; board competencies and independence; entrepreneurial versus managerial skills; remuneration; internal and external audit; ethics; investor protection; and the role of regulators.

An emotional appeal

"I can't promise...because we have so many lenders that are putting a lot of pressure on us. But what I can assure you is that I am still young and able to work, and I want to work for you."

– Olivia Lum, Executive Chairman and CEO[1]

Olivia Lum made an emotional appeal to lenders at the first round of townhall meetings with the bondholders of Hyflux Ltd (Hyflux) on 19 and 20 July 2018.[2] As Hyflux's founder, Executive Chairman and Chief Executive Officer (CEO), she had overseen its growth from strength to strength. Unfortunately, Hyflux entered a downward spiral culminating in an application for court protection against creditors' claims on 22 May 2018.[3]

What was once one of Singapore's most promising companies, which had counted Temasek Holdings as an investor, was now struggling to stay afloat. Hyflux, deep in debt, had five weeks left of cash before it could no longer sustain its operations.[4] Investors at the meetings pointed their fingers at Hyflux's Tuaspring Integrated Water and Power Plant (IWPP) project as the cause for Hyflux's downfall. Tuaspring has been loss-making since it began its operations due to the prolonged weakness in the Singapore power market.[5]

This is the abridged version of a case originally prepared by Denise Lee Shu Ting, Soon Wei Shi Favian, Tan Qun Wei Calvin, Tay Kai Lin and Teo Zhan Ning under the supervision of Professor Mak Yuen Teen, who added significant content to it. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Professor Mak Yuen Teen.

In her letter to stakeholders, Lum provided further details about the current status of Hyflux. She wrote that while Hyflux had "voluntarily suspended trading of [its] shares and related securities, in the interest of all stakeholder groups",[6] she knew that the suspension came as a disappointment to the 16,000 ordinary shareholders and 34,000 holders of perpetual securities and preference shares.[7,8]

At its peak in 2010, Hyflux had a market capitalisation of nearly S$2.1 billion,[9] having traded as high as S$3.62 per share on 21 December 2009.[10] By 18 May 2018, it had fallen to S$0.21 before its shares were suspended from trading,[11] with a market capitalisation of just S$165 million.

Olivia Lum – A sequel to Slumdog Millionaire

"There are no difficulties you can't overcome when you have faced the challenges of hunger and poverty."

– Olivia Lum, Executive Chairman and CEO[12]

The success story of Lum, the first woman to win the Ernst & Young World Entrepreneur Award in 2011, is one of tremendous hardship and extreme poverty. Abandoned at birth, Lum was adopted by an old lady and lived alongside four other adopted siblings under an illegally built tin roof hut in Kampar, a small town in Malaysia.[13] With a leaking roof and no running water and electricity, one might expect a bleak future for Lum. But remarkably, she was unafraid of dreaming big and was determined that she would make it one day.

At the tender age of 12, Lum was told to start working in order to supplement the family's finances and support the family of six. From rubber tapping to selling homemade ice lollies, Lum's aptitude for entrepreneurship was displayed at an early age.[14,15] It was undoubtedly an arduous task but she resolved to pay for her own education. Determined to further her studies, Lum packed her bags and bought a one-way ticket to Singapore.[16] With the thought of setting up a business at the back of her mind, she juggled multiple jobs and eventually, her tenacity and hard work paid off when she attained an honours degree in Chemistry from the National University of Singapore.[17]

While working at GlaxoSmithKline, Lum observed the treatment of wastewater from its processes and her intuition told her that the rise in urbanisation and industrialisation would mean an increased demand in clean water. In 1989, 28 year-old Lum finally took a leap of faith by quitting her job and selling both her car and apartment for S$20,000 to start her own company, Hydrochem (S) Pte Ltd (Hydrochem), the precursor to Hyflux.[18,19]

In 1992, she built a membrane-based pilot project when membranes were still an unproven technology to clean up water. These membranes contributed to much of Hyflux's success.[20]

Ownership

At the time of listing, Lum was the majority shareholder of Hyflux. As at April 2002, she held 51.58% of the ordinary shares.[21] 2G Capital Pte Ltd (2G Capital) became a substantial shareholder following a five percent placement by Hyfux to 2G Capital in June 2001,[22] increasing its stake to 9.58% by April 2002.[23] Gay Chee Cheong, 2G's Deputy Chairman and CEO, joined the board as a non-independent non-executive director (NINED) in August 2001.[24] Two other Hyflux's senior executives, Dr Deirdre Murugasu and Foo Hee Kiang held 3.13% and 1.23% respectively as of April 2002.[25]

As of April 2003, Seletar Investments Pte Ltd, an investment company owned by Temasek Holdings Pte Ltd, held 4.78% of the ordinary shares.[26] Following that investment, S. Iswaran, then a managing director of Temasek, joined the Hyflux board as an NINED in June 2003.[27] By March 2005, Seletar had pared its stake down to 0.89%,[28] before completely divesting its stake.[29] Iswaran resigned from the board on 30 June 2006.[30]

As 2G Capital was also reducing its stake, eventually exiting in 2006, other substantial shareholders invested in the company. By the time Hyflux issued the perpetual capital securities (perps) in May 2016, Lum was the only substantial shareholder, holding 34.05%[31] of the shares until the shares were suspended from trading in May 2018.

Rising above the waters

"The best decision I have ever made was to set up Hydrochem, believing firmly that the water business holds much promise and had the potential to grow into a big business. I am glad that I took the step to pursue my dreams."

– Olivia Lum, Executive Chairman and CEO[32]

Hyflux's beginning traces back to 20 June 1989, when it was founded by Lum under the name Hydrochem. Back then, Lum saw the water treatment business as a "sunrise" industry.[33] At the beginning, Hyflux acted as an agent for large companies, selling its water systems in the domestic markets of Singapore and neighbouring Johor Bahru, Malaysia.[34]

After many years of operating the business, Lum felt that she had gathered enough experience, and decided to break into the Chinese market in 1993. China was a huge emerging market then, and she saw the potential it could offer.[35] She faced difficulties in China, mostly due to the cultural differences and China's bureaucracy, to the point where Hydrochem almost went bankrupt. However, her instincts eventually turned out to be right. Hydrochem managed to gain some foothold in its third year, when several multinational companies investing in China became Hydrochem's customers. Subsequently, Hydrochem bloomed in the China markets, while its competitors in Singapore suffered badly due to the East-Asian financial crisis in 1997.[36] "Because of the circumstances, the financial crisis that set my competitors back a bit, I took the opportunity to run ahead," Lum said.[37] Once an insignificant caterpillar, the fully-fledged company was now ready to break out of its cocoon in China and spread its wings back in Singapore and around the world.

In 2001, Hyflux, with Hydrochem as its wholly owned subsidiary, listed on the Singapore Exchange (SGX).[38] In the following two years, Hyflux went on to win three tenders for water treatment projects by the Singapore Government. In 2001, it was awarded the contract to manufacture and install the water treatment technology for Singapore's first NEWater Plant in Bedok.[39] The success of the Bedok NEWater Plant led to Hyflux clinching a second project in 2002 to design, build and operate the country's third NEWater plant in Seletar. That same year, Hyflux won its third government project for the construction of "Chestnut Avenue Waterworks" – Singapore's first membrane-based filtration desalination plant.[40]

The company's success in China and Singapore fuelled its appetite and ambition to expand internationally, and it set its sights on the Middle East, North Africa, and South America. The expansion was evidently successful, and Hyflux grew to become one of the global leaders in the water treatment industry.[41] In 2005, Hyflux expanded into India and said that it hoped that the country would eventually account for 20% of its sales.[42] With this in mind, in 2006, it appointed Rajnish Gopinath as CEO, India, and Senior Advisor to Group CEO & President. He later joined the board as an executive director (ED) in August 2006.[43,44] However, that turned out to be short-lived as he retired as a director in April 2007.[45]

Hyflux owned and operated numerous desalination and water recycling plants all around the world.[46] A few notable examples are the world's largest seawater reverse osmosis (SWRO) desalination plant in Magtaa, Algeria with a capacity of 500m^3/day,[47] and the Tuaspring IWPP in Singapore with a capacity of 318,500 m^3/day.[48] Hyflux provides 30% of Singapore's daily water needs through recycling and desalination, reducing Singapore's reliance on Malaysia.[49]

In 2006, Hyflux was named as one of Forbes Asia's 200 Best Under a Billion.[50] It clinched many other awards and accolades including the Frost & Sullivan Asia Pacific Water Technology Company of the Year Award in 2010, 2011, 2013 and 2014.[51] It was also ranked fifth among the world's top desalination Engineering, Procurement and Construction (EPC) suppliers by capacity, and ranked the first by build-own-operate (BOO) / build-own-transfer (BOT) desalination capacity.[52] While these accolades recognised the growth in revenues and capacity of Hyflux, this growth came at a considerable cost.

Achilles' heel: Hyflux's business model

Hyflux's core business revolves around providing water treatment solutions for municipalities and industries. However, it also expanded into power generation and waste-to-energy solutions.[53,54]

While Hyflux has been enjoying apparent success, there were questions raised about its business model. Hyflux tried its best to employ an asset-light strategy[55] by continually divesting completed projects and recycling the capital into new investments to finance further growth.[56] Its capital-intensive business model relied more on borrowings rather than operating cash flows to fund growth.

Hyflux by the numbers

Hyflux's business model generated more revenue from EPC work than Operations and Maintenance. EPC projects involved Hyflux designing, building and transferring plants to customers.[57]

The rest of its revenue comes from operating and maintenance of plants, royalties from its membrane technology, and the sales of its ELO-branded products such as bottled water and skincare in its consumer business known as Hyflux Shop.[58]

Since 2009, construction revenues have accounted for at least nearly 70% of total revenues, and as high as 90% or more. These construction revenues are recognised in the financial statements using the percentage of completion method.[59]

Hyflux was producing stellar financial results, reporting high revenues and net profits. This helped drive its market capitalisation to a peak of S$2.1 billion in 2010 and its share price to a high of S$3.62 in December 2009.[60]

The year 2010 was its most profitable, with before-tax profit hitting more than S$100 million on the back of revenues of S$570 million. However, revenues and profits were highly volatile, with revenues of S$655 million in 2012 and S$831 million in 2016 with declines in other years, while the company remained profitable albeit generally trending downwards. In 2016, while revenues were at its peak of S$831 million, after-tax profit was a mere S$9.61 million. In 2017, revenues fell sharply from its high in 2016 and the company hit a record loss of S$115.6 million.[61]

Operating cash flows, however, told a more consistent and dire story, becoming negative from 2010 onwards.[62]

Hyflux continued to bleed cash and had negative operating cash flows since 2010.[63] In order to make up for this shortfall, Hyflux had to depend largely on debt financing, which increased the inherent risk in its business model.[64]

Problems arose when a large proportion of its S$1 billion EPC order book as at the end of 2017 was tied to lengthy concession periods under BOO, design-build-own-operate (DBOO), and BOT schemes.[65,66] For a DBOO project like TuasOne, EPC revenue does not correspond to actual cash flows. As UBS analysts had commented, "Revenue is recognised as construction progresses, but cash flow is usually received over the life of the concession period... The construction phase is funded by project financing and Hyflux only receives cash flows upon completion, and over the duration of the operation concession periods."[67]

Its debt situation was spiralling out of control. By 2017, Hyflux's net debt was 32 times its earnings before interest, taxes, depreciation and amortisation (EBITDA).[68] Total liabilities showed an almost continuous upward trend, while the interest coverage ratio declined from nearly 10 times in 2009 to just 1.6 times in 2016, before the company reported its first full year loss in 2017. By 2017, total liabilities had hit an all-time high of S$2.65 billion.[69] As its liabilities increased, Hyflux started using alternative sources of financing which were treated as equity in its balance sheet. In 2011, it issued preference shares (prefs) and in 2014, it issued its first tranche of perps.

By the time Hyflux announced its restructuring, bank debts amounted to about S$1.84 billion, with note holders owed S$265 million and perp holders and preference shareholders S$900 million.[70]

Nothing ventured, nothing gained: Tuaspring

"The opening of Tuaspring Desalination Plant marks another successful collaboration between the private and public sectors. We are honoured to play a role in contributing to the diversification and sustainability of Singapore's water supply."

– Olivia Lum, Executive Chairman and CEO[71]

With high hopes that the synergy between water desalination and power plants would increase Hyflux's competitiveness in its core water business by increasing energy efficiency and saving costs, Tuaspring IWPP, Asia's first integrated water and power project, marked Hyflux's venture into the power sector.[72] Fuelled by the success of larger integrated plants in the Middle East and North Africa (MENA) regions,[73] Hyflux's management felt that the company needed credentials in this area to help it secure other projects in this segment.[74] When the call for tenders for the Tuaspring project came along, Hyflux decided to respond to the tender, seeing it as a gateway into the power sector.[75]

Hyflux went on to win the tender in 2011.[76] At the grand opening of Tuaspring, the plant was praised by Singapore's Prime Minister Lee Hsien Loong for its capabilities in the power industry.[77] Although Lum had always been "very ambitious", she stated the decision to enter a IWPP project was not only hers to make, and that Hyflux "entered into this project purely because independent analysis of this project (said it would be) very viable".[78] Industry experts had also projected strong profitability from the sale of electricity in the Singapore power market, with electricity demand projected to grow significantly.[79]

Tuaspring was funded through a mix of project financing and corporate financing. Project financing through a S$720 million 18-year term loan facility was provided by Maybank Singapore, with Maybank Kim Eng Securities Pte Ltd acting as lead arranger, sole underwriter and bookrunner.[80] 6% Cumulative Perpetual Class A Preference Shares were also used for financing.[81]

A game of Russian roulette

"We have built plants worldwide, and we own many plants outside Singapore. Ironically, I failed because of the project I invest in Singapore"

– Olivia Lum, Executive Chairman and CEO [82]

When the Tuaspring project was undertaken, Hyflux had no experience in the power business.[83] Independent analysis which previously found the plant viable was subsequently proven to be wrong. Concerns about the economic viability of the electricity portion of the plant were raised from as early as 2013.[84] There was "too much risk", such as the high supply and deregulation of the local electricity market, and these "sources of risk will tend to multiply".[85]

In Tuaspring, the on-site gas turbine power plant produces electricity for the desalination plant and excess electricity is sold to the national grid.[86] The desalination plant was secured in a 25-year water concession with the Public Utilities Board (PUB) until 2038, after which ownership of the plant was to be transferred to PUB.[87] However, the electricity portion of the plant had no long-term supply contracts. As the water market and electricity market are structured differently in Singapore, power generation companies need to compete to supply in the market at market rates.[88]

The noose around the neck

Tuaspring grew its share in the electricity retail market from 3.6% in 2016 upon its inception to 3.9% in 2017.[89] However, it did so at a loss, and had in fact been registering losses since it began operations in March 2016.[90] The plant registered a net loss of S$114.5 million in FY2016 and S$81.9 million in FY2017.[91] Sitting at a book value of S$1.3 billion, it is Hyflux's single largest asset, and accounts for roughly a third of the Group's total assets.[92] Tuaspring became the "noose" around Hyflux's neck,[93] and Hyflux's snowballing losses were largely related to Tuaspring.[94]

In fact, due to take-or-pay contracts for natural gas, Hyflux had to pay a penalty for the gas it contracted for even though it would not be used.[95] The losses from Tuaspring resulted in Hyflux's first annual loss since its listing – a loss of S$116.4 million in FY2017, compared to a restated profit of S$3.8 million for FY2016.[96] For the first quarter of FY2018, Hyflux reported a loss of S$22.2 million.[97] As Lum commented in hindsight in July 2018, Tuaspring losses were the "the main trigger" for the six-month debt moratorium it applied for in May 2018.[98,99]

For the past few years, Singapore's power generation sector has been plagued by overcapacity. Even though the sector has a total capacity of 13,350 megawatts (MW), peak demand averaged only 7,000 MW in 2016 to March 2017, leaving a spare capacity of 48% in the system. The large overcapacity in recent years has pushed wholesale electricity prices to a historical low of S$63 per megawatt hour (MWh) in 2016, compared to a peak of S$215 in 2011.[100] With wholesale electricity prices clearing at levels below fuel costs in 2017,[101] Hyflux's plans for profits generated from electricity facilities to comprise the bulk of operating revenue of the plant fell apart.[102] The losses from the electricity portion of the plant contributed greatly to the overall losses of the plant as revenue from electricity generation made up 90% of the plant's revenue.[103] This resulted in prospective bidders downplaying the asset value of Tuaspring IWPP given the weak electricity market.[104] While electricity prices are subject to market forces, navigating the changes in electricity prices boils down to risk management.[105] As Professor Mak commented in relation to Hyflux, "When you're growing, you can't expect the best-case scenario…you cannot keep thinking (power prices) are only going to go up".[106]

The performance of Tuaspring was set to worsen in 2018, given the plan of the Energy Market Authority (EMA) to fully liberalise Singapore's electricity markets, providing all consumers the freedom to switch from buying electricity at the regulated tariff from Singapore Power Services to buying from electricity retailers that offer packages at different price plans. Such liberalisation is likely to increase competition in Singapore's electricity markets and put downward pressure on power spreads, thus further weakening the profitability of Tuaspring.[107]

Although Hyflux Ltd had been exploring a partial divestment of Tuaspring, the materialisation of such plans was uncertain. Given the saturated Singapore power generation industry, Hyflux's quest to partially divest the plant was being described as like "selling ice to Eskimos".[108,109] Tuaspring was put up for sale in end-2016 but there had been a lack of 'serious bids' for the plant.[110] The prolonged process of finding a buyer was compounded by the fact that Tuaspring is a strategic water asset in Singapore, necessitating approval from the national water agency PUB at "every step of the way".[111] Ultimately, only two Singaporean companies were granted approval to be suitors for Hyflux by PUB – Sembcorp and Keppel. Only Sembcorp submitted a final bid for Tuaspring before the deadline, but its offer was below Tuaspring's book value and would not have been enough to pay back loans to the project's main creditor, Malayan Banking Bhd.[112] The failure in the sale of Tuaspring was further exacerbated by the low wholesale electricity prices.[113]

As at 31 March 2018, the book value of Tuaspring was recorded at S$1.47 billion. In contrast, other projects had a much lower book value.[114]

Corporate governance – was it a contributing factor?[115]

"The current challenges facing the Group is driven by market conditions of the Singapore power sector, and not a result of corporate governance issues. All investments into any particular project recommended by management is reviewed and approved at Board level. None of the directors have any self interest in the Group's investment into any project, including the Tuaspring project."

– FAQs from SIAS and responses by Hyflux at town hall meetings[116]

Hyflux has claimed that its predicament is caused by market conditions and not because of poor corporate governance.

Management team

When Hyflux listed in 2001, it had 257 employees with business operations in Singapore and People's Republic of China (PRC). It had four direct subsidiaries – Hydrochem (S) Pte Ltd, Hyflux Engineering Pte Ltd, Hangzhou Zheda Hualu Membrane Engineering Co. Ltd and Hydrochem Engineering (S) Pte Ltd – and an indirect subsidiary, Hydrochem Engineering (Shanghai) Co. Ltd.[117] It then expanded into India, Middle East, North Africa and Southeast Asia by the mid-2000s. By 2007, its number of employees had grown by nearly four-fold to more than 1,200,[118] and then to more than 2,800 employees by 2016.[119]

Lum's entrepreneurial skills and strong personal belief of 'never say die' undoubtedly accounted for the transformation of Hydrochem into Hyflux. However, she did not have the experience of managing a large organisation, which Hyflux had become. As controlling shareholder, founder, Chairman and Group CEO, she clearly had a dominant role in the company.

Further, besides managing Hyflux, Lum had many other commitments during much of the period when Hyflux was growing and facing challenges, including being on the boards of International Enterprise Singapore, the National University of Singapore, and the Standards, Productivity and Innovation Board (SPRING),[120] as well as being a director of other companies such as Singapore Technologies Engineering Ltd,[121] Yeo Hiap Seng, Matex and Singapore Exchange. At one time, she was serving as a director on the boards of three other listed companies.[122]

At the time of Hyflux's listing, it had two executive vice-presidents who were EDs, Dr Deirdre Murugasu and Foo Hee Kiang.[123]

Dr Murugasu was appointed as an ED on 31 March 2000 and was primarily responsible for the development, application and marketing of new products and services of the Group to relevant market sectors. She has a Masters of Medicine (Family Medicine) from the National University of Singapore. Dr Murugasu joined Hyflux in 1996 and was Head of Business Development at Hydochem (S) Pte Ltd prior to her appointment as ED of Hyflux. Before joining Hyflux, she was a specialist in family medicine and also served as a registrar with the Ministry of Health.[124,125] In 2003, Dr Murugasu became Chief Operating Officer (COO) of Hyflux, and then Deputy Chief Executive (Operations) in 2004. In 2005, she became Senior Advisor to the Group CEO and President before leaving the company in 2007.

Foo was appointed as an ED on 8 September 2000 and Executive Vice-President (EVP) for Special Projects, and was also responsible for the marketing and sales of the company's products and services. According to the company, special projects "require intensive management expertise and structured planning" but it does not appear that Foo had such experience as his 15 years of experience before joining Hyflux was in marketing and sales. He holds a Bachelor of Engineering degree from the National University of Singapore.[126]

Board of directors

Prior to FY2011, Hyflux disclosed that it did not have a Board Chairman, with Olivia Lum having the title of Group President and CEO. In FY2011, Lum became Executive Chairman and Group CEO.

The Hyflux board had between seven and eight directors over the last decade. Over this period, two independent directors (INED) and one NINED ceased to be directors, and two new independent directors and one NINED joined. The NINED who left – Dubai-based Ahmed Butii Ahmed – did not stay on the board for long. He was appointed on 25 April 2008 and left on 1 March 2010.[127]

One of the two INEDs, Professor Tan Teck Meng, ceased to be a director following his death,[128] while the other, Rajsekar Kuppuswami Mitta, who joined in April 2007, left in December 2013 due to "family commitments".[129]

The two new INEDs who joined during this period were Simon Tay who joined in May 2011,[130] and Lau Wing Tat, who joined in July 2014.[131] Gary Kee, former CEO of the trustee manager and NINED of Hyflux Water Trust, joined as an NINED in May 2011.[132]

Over the last 10 years, the Hyflux board only had one ED – Lum herself. Of the remaining six to seven NEDs, at most one was an NINED, with the others being independent.

In 2004, Hyflux decided that the board should have only one ED and “as part of the corporate drive to improve corporate governance”, two of the then-EDs stepped down from the board.[133]

While there was some board renewal (forced or otherwise), four INEDs have remained on the board for more than 14 years, with one serving more than 17 years and two for more than 18 years (since Hyflux’s listing). These long-standing directors also had various types of relationships with the company.

Gay Chee Cheong, who was appointed as an NINED in August 2001, was a substantial shareholder following a five percent placement by Hyfux to 2G Capital in June 2001,[134] five months after Hyflux’s listing. Gay was at the time Deputy Chairman and CEO of 2G Capital and was therefore deemed interested in shares held by 2G.[135] As of April 2002, 2G held 9.58% of the shares of the company.[136] It reduced its interest over the following few years and ceased being a substantial shareholder in September 2005. 2G sold off its remaining stake in 2006. Gay continued to directly hold between 450,000 and 3 million shares, and at the time of suspension of trading in Hyflux’s shares held 3 million ordinary shares.[137]

In 2005, the same year that 2G ceased being a substantial shareholder, Gay was re-designated from NINED to INED and became Chairman of the Remuneration Committee, while remaining a member of the Audit Committee and Nominating Committee. In 2006, he became Chairman of both the Nominating Committee and Remuneration Committee, while remaining as a member of the Audit Committee.[138]

Christopher Murugasu – Dr Dierdre Murugasu’s brother – who was appointed to the board in February 2005, was formerly Senior Vice President of Corporate Services at Hyflux. He first joined the board as an NINED, but was re-designated as an INED in 2010. Dr Murugasu held 1.78% of the shares of Hyflux as of 15 March 2007 and was among the largest 20 shareholders, before disappearing from the list of top 20 shareholders in the 2011 annual report.

Two other INEDs – Lee Joo Hai and Teo Kiang Kok – have been on the board since December 2000. Teo is the lead independent director.[139]

Over the years, there were also other relationships between Hyflux and both Teo and Lee. Teo’s brother, Teo Yuan Cheng Casey, was Vice President of Business Development from May 2005 and was disclosed as an immediate family member of Teo Kiang Kok earning remuneration below S$250,000 until the 2008 annual report.[140]

Teo, who was classified as an INED and was Chairman of the Nominating Committee, was reclassified as an NINED in FY2006 and remained so until FY2008. He stepped down as Chairman of the Nominating Committee but remained as a member, while Gay took over as Chairman. The company did not announce the re-designation, mention the relationship between Teo and his brother in the discussion of the assessment of independence in the Corporate Governance Statement, or explain why he was re-designated to NINED – but since the period when Teo became NINED coincided with the time when his brother was apparently an executive, it seemed likely that the family relationship was the reason. In FY2009, Teo was re-designated back to an INED, again without any announcement or explanation. In FY2011, he took back over as Chairman of the Nominating Committee and was appointed lead independent director.[141]

Teo was a senior partner at the law firm, Shook Lin & Bok, and remains a senior consultant there. Between FY2005 and FY2010, Hyflux disclosed under interested person transactions that Shook Lin & Bok had provided legal services amounting to a total of S$364,000. In the case of Lee, who was a partner at BDO LLP from 1986 to 2013 – it was found that between FY2005 and FY2008, BDO Raffles provided internal audit services to the company amounting to S$186,000.

The disclosure of internal audit in Hyflux's 2005 annual report said "The Group has engaged the services of a professional accounting firm, independent of the external audit function to carry out regular internal audit review of the Group."[142]

In the 2006 to 2008 annual reports, but not in its 2005 annual report, it disclosed that BDO Raffles was doing the internal audit for Hyflux.[143,144,145,146] In 2009, Hyflux appeared to have moved to an in-house internal audit function as it disclosed that "it has put in place a dedicated team of internal auditors".[147]

Lee and Teo also serve together on at least two other boards. One was the formerly SGX-listed Adampak Limited and the other is the currently-listed IPC Corporation (IPC). At IPC, Lee retired from the board in April 2017 after joining the board in December 1996. He had agreed to stand for re-election with two other directors at the April 2017 AGM but subsequently all three directors withdrew from seeking re-election at the AGM. Teo then joined the board in July 2017 and was appointed lead independent director and Chairman of the Nominating Committee. In October 2018, Lee re-joined the board as INED.[148]

Most of the INEDs also have many other commitments, especially Lee, Teo, Gay and Tay. While the board collectively has diversity of skills and experience, none of the INEDs has deep knowledge of the water and electricity industries and the international markets where Hyflux operated.[149]

Board committees

Hyflux has five board committees – audit, nominating, remuneration, risk management and investment. The Audit Committee met four times every year since 2008. The nominating and remuneration committees each met once in 2008, and twice a year thereafter.[150]

In August 2005, Hyflux established a Risk Management Committee. The committee which initially met once a year,[151] became more active in FY2007 when it started meeting three times,[152] and met as much as nine times in FY2009.[153] The increased activity of the Risk Management Committee coincided with Rajsekar Kuppuswami Mitta joining the board and assuming chairmanship of the Risk Management Committee. However, in 2013, the Risk Management Committee became far less active, meeting only twice[154] – the same year that Mitta ceased being an INED. In FY2017, the committee met only once.[155,156]

The Investment Committee, formed in August 2014, is chaired by Lum herself. Lum is also a member of the Nominating Committee.[157]

In FY2008, Lum started attended all committee meetings by invitation (except on a few rare occasions when presumably she was unable to do so).[158]

Remuneration policies

When the Remuneration Committee was first established in September 2002, it was chaired by Teo, with other members being Lee, Gay and Lum.[159] In February 2005, Christopher Murugasu joined the board as an NED and became a member of the Remuneration Committee.[160] Lum left the committee in FY2006,[161] and Prof Tan Teck Meng joined the board and became a member in FY2007.[162] The latter took over as Chairman in FY2008.[163] In FY2009, Teo resigned from the committee.[164] In FY2011, following the demise of Prof Tan, Gay took over as Chair and Teo rejoined the committee.[165] Lee resigned from the committee in FY2014.[166] Since then, the committee has comprised of Gay as Chairman, with Teo and Murugasu as the other members. Therefore, at various times since the committee was formed in 2002, Gay, Lee, Murugasu and Teo were Chairman or members of the committee, with Lum attending all its meetings on an ex-officio basis since 2008.[167] Murugasu was Senior Vice President of Corporate Services just before his appointment as an NED, and joined the Remuneration Committee as soon as he became an NED.

For key management personnel who are not directors or CEO, Hyflux disclosed the remuneration for up to seven key management personnel in bands of S$250,000 in its annual reports, but the lowest band was shown as either below S$750,000 or below S$500,000. For Lum and the NEDs, it was disclosed in bands of S$250,000, rather than exact amounts.[168]

For Lum and the key management personnel, remuneration was made up of an annual salary, annual bonus, share options and allowances and other benefits. Lum's total remuneration fell over the years. In FY2010 and FY2011, her total remuneration was in the range of S$1.5 million to S$1.75 million with the bonus making up 55% and 53% respectively. Share options made up only 4% and 8% respectively. In FY2012 and FY2013, her remuneration dropped to the band of S$1 million to S$1.25 million but there was a shift towards a significantly higher proportion in the form of share options, with the percentages of 44% and 26% respectively. The cash bonus components had fallen to 4% and 26% respectively. Lum's remuneration fell further to the band of S$750,000 to S$1 million in FY2014 and FY2015, with bonus of 11% in both years, and share options of 22% and 15% respectively. In FY2016 and FY2017, while her total remuneration remained at the same band, the annual salary percentage now accounted for a significantly higher 85% and 87% respectively, with bonus of 7% in both years, and share options of 3% and 0% respectively.[169]

Hyflux did not provide much details when it comes to remuneration policy. For EDs and senior management, it merely said that it was based on service contracts, taking into account performance of the individual, the Group and market trends. It did not indicate what performance measures were used.[170]

The NEDs started participating in the share option scheme from FY2006. After an initial grant of 700,000 options in 2006 in total to Gay, Lee and Teo (later adjusted to 1,050,000 following a 1-for-2 bonus issue), further share options were granted each year from FY2010 to FY2017. Murugasu already had 862,500 options granted to him as a senior executive of Hyflux when he joined the board as an NINED.[171]

Unlike Lum and other employees for which the options have a 10-year life, the options for NEDs have a five-year life, exercisable after one year. Cumulatively, the directors other than Lum received 8,234,375 options since FY2006, exercised 2,134,375 of them, with 3.15 million options having expired. The estimated fair value of these options was S$1.973 million.[172]

The directors who were responsible for administering the share option scheme and determining the amounts to be granted over much of the period were also the ones who received the most share options, including Gay, Teo, Lee and Murugasu.[173]

The third line of defence

In the Corporate Governance Statement in Hyflux's 2017 annual report, the company stated that it has a dedicated team of internal auditors and that the internal audit team "meets the standards set by nationally and internationally recognised professional bodies including the Standards for the Professional Practice of Internal Auditing set by The Institute of Internal Auditors".[174]

Hyflux disclosed that during the relatively brief period from May 2013 to December 2015 when the NINED Gary Kee was re-designated to ED, he had responsibilities for Corporate Finance, Information Technology, Internal Audit and Corporate Marketing functions. This may raise doubts about the leadership, priority and independence of the function, given that he was overseeing various support functions that internal audit would be expected to review as part of its work. Even if he did not hold conflicting internal audit and other roles concurrently, these roles were held over a relatively short period of time.[175]

Further, as mentioned earlier, BDO Raffles was providing internal audit services to the company at least from FY2005 to FY2008, while its partner, Lee, was chairing the company's Audit Committee.

KPMG LLP (KPMG) have been the external auditors of Hyflux since FY2008, replacing Ernst & Young LLP. It is the auditor of all the significant subsidiaries in the Group. There were minimal non-audit fees paid to KPMG or its affiliates since its appointment.

KPMG issued an unmodified opinion for the company's FY2017 financial statements just two months before the company announced its restructuring plan in May 2018.[176]

The FY2017 financial statements of many of the subsidiaries, including Tuaspring, did not appear to be audited. Note 35 in Hyflux's FY2017 Annual Report disclosed nine key direct and indirect subsidiaries, six of which are incorporated in Singapore.[177] According to ACRA records, only one – Hydrochem (S) Pte Ltd – had filed audited financial statements for FY2017. The other five, including Tuaspring Pte Ltd, had only filed audited financial statements for up to FY2016.

"Far from perpetual" securities

Prior to 2011, Hyflux's capital structure consisted of debt in the form of loans and borrowings, other trade liabilities, and ordinary shareholders' equity. In FY2009, total liabilities were 65% of total assets, the interest coverage ratio was nearly 10 times, while net operating cash inflows was over S$60 million, and more than S$50 million after interest expense. While the total debt ratio remained fairly stable in 2010, the interest coverage ratio had fallen to seven times and the operating cash flow less interest was now negative S$66 million.[178]

2011 issue of preference shares

In April 2011, Hyflux used a new form of financing through a prefs issue of S$400 million, raising S$392.6 million, net of issue expenses. Olivia Lum said "We continually evaluate different options of financing for our growth strategy, and view the Class A CPS offering as one of the more suitable options for our needs, and more importantly, non-dilutive to existing Hyflux ordinary shareholders."[179] Initially, the company had wanted to raise S$200 million but this was increased to S$400 million due to demand for the shares.[180]

The prefs have a face value of S$100 each with a minimum subscription of S$10,000. Up to 35% of the CPF funds could be used to invest in these shares. There is a step-up margin of 2 percent after 7 years – that is, from 25 April 2018, the dividend rate was to go up to 8%. The sole lead manager and bookrunner for the issue was DBS Bank and subscription for the public tranche of S$200 million was through DBS/POSB, OCBC and UOB ATMs. The net proceeds were to be used for the Group's water and infrastructure projects and for general working capital.[181]

Following the issue of the prefs, Hyflux's liabilities continued to increase, with total liabilities increasing from S$845 million in FY2010,[182] to S$1.1 billion in FY2011,[183] S$1.3 billion in FY2012,[184] and S$1.5 billion in FY2013.[185] The debt ratio was relatively stable over that same period and in fact dipped in FY2011, buffered by the prefs. Meanwhile, operating cash flows continued to spiral downwards especially in FY2013 and FY2014 when they were negative S$234 million and negative S$422 million respectively, compared to negative S$49 million in FY2010.[186]

2014 issue of perpetual capital securities

In January 2014, Hyflux made its first issue of perps, raising S$300 million. The perps had an initial distribution rate of 5.75%, with the distribution rate reset every three years. The relevant reset distribution rate was the swap offer rate (SOR) plus the initial spread plus the step-up margin. The step-up margin was 2%. At the time of issue, the initial spread was 4.79%. Therefore, every three years, the distribution rate was to be reset to SOR plus 4.79% plus 2%.[187]

DBS Bank was again the sole lead manager and bookrunner and they were sold in denominations of S$250,000 to institutional investors under section 274 of the Securities and Futures Act (SFA) and accredited investors and other persons covered by sections 275(1) and 275(1A) of the SFA. The company said that the proceeds were for investments, repayment of existing borrowing, general working capital and general corporate purposes.[188]

Six months later, Hyflux made a second issue of perps to raise S$175 million, this time with Credit Suisse as sole lead manager and bookrunner. The initial distribution rate was 4.8% with a reset in the rate every 2 years. Like the January issue, they were sold in denominations of S$250,000 to institutional investors, accredited investors and other persons covered under sections 274 and 275 of the SFA. The proceeds were to be used for the same purposes as the January issue.[189]

The perps ranked ahead of ordinary shares, at parity with the 2011 prefs and other perps, and behind other creditors. Distributions were only payable if they were declared but were cumulative. The perps were classified as equity on the basis that they were perpetual with no final date of redemption and may only be redeemed at the option of the issuer, but not the holder. Hyflux could opt to redeem the perps at the first step-up date and any distribution payment date thereafter, or on the occurrence of certain redemption events. These redemption events were: if Hyflux became liable to pay additional amounts of tax; distributions were no longer tax-deductible; or accounting standards did not allow the perps to the classified as “equity”.[190]

The perps were classified as “equity” on the statement of financial position, therefore improving the debt ratios, while at the same time being allowed to be treated as debt for tax purposes. Following a break in the increase in total liabilities in FY2014 with the amount and the debt ratio actually falling, total liabilities resumed its upward trend with total liabilities increasing from S$1.4 billion in FY2014,[191] to S$1.7 billion[192] and S$2.3 billion[193] respectively in the following two years. The debt ratio also increased but the increase was again buffered by the issue of the perps and prefs. The interest coverage ratio continued to deteriorate and operating cash flows remained negative.[194]

The increasing reliance on debt, prefs and perps as sources of finance can be seen in the consistent increase in the ratio of these sources of finance relative to total assets. Between FY2010 and FY2017, total liabilities more than trebled even as it made those large “equity” issues in the form of the prefs and perps.[195]

2016 issue of perpetual capital securities

In May 2016, Hyflux made its largest security issuance yet, raising S$500 million through the issue of 500 million S$1 perp, with an initial distribution rate of 6% and a reset every four years, and a step-up margin of two percent. Initially, the company proposed to raise S$300 million but this was increased to S$500 million due to demand. Of this amount, S$329 million was allocated for public subscription with a minimum subscription of S$2,000; S$165 million was allocated for the placement tranche with a minimum subscription of S$100,000, and the remaining were reserved for directors, management and employees. Investors were not permitted to use CPF funds. DBS was the sole lead manager and bookrunner, and subscriptions to the public tranche can only be made at DBS/POSB and OCBC ATMs.[196]

Had S$300 million being raised, the company would have used about S$100 million to pay debt and S$175 million to redeem the 4.8% perps issued in July 2014 that was due for a reset in its distribution rate in July 2016. Under the scenario of S$500 million being raised, the company proposed to also apply the additional proceeds to repay or refinance existing borrowings, redeem outstanding perps, and to finance working capital and capital expenditure. Indeed, with the enlarged offering, it also redeemed the S$300 million of 5.75% perps issued in January 2014 that was due for a reset in its distribution rate in January 2017.[197]

Therefore, at least S$329 million of funds were raised from ordinary retail investors in the 2016 perp issue – possibly more as some may have also subscribed through the placement tranche through private bankers – while S$475 million raised from institutional investors and accredited investors were redeemed, mostly from the proceeds of the 2016 perp issue. Therefore, ordinary retail investors essentially bailed out the institutional investors and accredited investors who invested in the 2014 perps.[198]

The key features of the 2016 perps are as follows:-[199]

- The initial distribution rate is 6%, based on an initial swap offer rate (SOR) of 1.8% on 16 May 2016 and an initial spread of 4.2% per annum
- The distribution rate is reset every four years based on the following formula: the 4-year SOR on the second business day prior to the relevant reset date plus the initial spread of 4.2% plus the step-up margin of 2%
- Distributions can be deferred (deferred distributions will be added to the principal and earn interest at the distribution rate, and deferred distributions must be paid before distributions to junior claims, and junior claims cannot be repaid or redeemed without paying these deferred distributions)
- On winding up, the perps rank below senior creditors' claims, on par with other perps and prefs, and above ordinary shares
- The perps do not have a fixed redemption date, but are redeemable at the option of the issuer (but not the holder), including, inter alia, if the tax authorities rule that there are additional amounts payable by the issuer, distributions are ruled not to be tax-deductible, or changes in accounting standards require the perps to be classified as "debt" instead of "equity"

The 197-page offer information statement (OIS) provided illustrations of how the distribution rate would be recalculated at each reset date under various scenarios, including a scenario where SOR is negative and the reset distribution rate in future may be lower than the initial distribution rate of 6%.[200]

Clearly, the authorities recognised that the 2016 perp issue was risky as they did not allow CPF funds to be used. With the minimum investment amount of S$2,000 and subscription through the ATMs, even the most unsophisticated retail investor could subscribe.[201]

The 2016 perp issue came with a 12-page Product Highlights Sheet (PHS) that included on the second page a section on "Investment Suitability" which explains who the investment is suitable for, and by inference, who it is not suitable for. It also referred the reader to the "Risk Factors" in the OIS and the summary of risks in the PHS.[202]

Product highlights sheet

In the product highlights sheet, the company provided information on revenues, pre-tax profit and after-tax profit for first quarter of the latest two financial years and the latest three full years; summarised cash flow information for the first two quarters of the latest two financial years and latest two full years; and total assets, total loans and borrowings, total liabilities and total net assets as at the last two full years and the end of the latest quarter. The most significant factors contributing to the Group's FY2015 financial performance were also set out.[203]

However, for both the OIS and PHS, cash flow information was provided only for two financial years, compared to three financial years for income statement information. There was also no mention of cash flows in the discussion of the significant factors contributing to the Group's performance in the PHS. Only profitability was mentioned.[204]

The OIS also said: "In the event that the Group suffers a deterioration in its financial condition (such as a serious decline in net operating cash flows), there is no assurance that the Issuer will have sufficient cash flow to meet payments under the Securities." However, operating cash flows had been negative since FY2010, exceeding negative S$200 million since FY2012, except in the year preceding the issue of the 2016 perpetual securities when operating cash flows improved to negative S$44 million. The negative operating cash flows since FY2010 was not highlighted as a risk.[205]

Hyflux also presented two different operating cash flow numbers in its cash flow statements – in the annual reports, the OIS and the PHS. In addition to net cash used in operating activities, it also showed "net cash from operating activities before service concession arrangement projects". Since such projects are very much part of the business model of Hyflux, there is a question as to why Hyflux decided to show cash flows without such projects. The "pro forma" numbers looked better compared to net cash used in operating activities.[206]

A race against time: Debt moratorium

On 21 May 2018, Hyflux requested for a trading halt for its shares and securities. The share price last closed at S$0.21 on 18 May 2018.[207] On 23 May 2018, Hyflux requested for a suspension of trading of its shares. This affected a total of 34,000 perp holders and preference shareholders, and 16,000 shareholders.[208]

On 22 May 2018, Hyflux applied for a moratorium to give it time to sell its assets and meet its debt obligations. This application was assisted by legal advisors, WongPartnership LLP, and financial advisors, Ernst & Young Solutions LLP.[209,210] Hyflux was automatically given a 30-day moratorium under section 211B of the Companies Act.[211] However, Hyflux requested for a longer period of six months for protection against creditor claims. Under the terms of the moratorium, any amounts due to creditors after 22 May 2018 would not be paid. These amounts included the S$15 million coupon due to the S$500 million Perpetual Capital Securities (SGX:BTWZ) on 28 May 2018, as well as financing from banks and financial institutions not related to Qurayyat Independent Water Project (IWP) and TuasOne Waste-to-Energy Plant (WTE).[212,213] All suppliers would not be paid too, except the essential suppliers for Qurayyat IWP and TuasOne WTE.[214]

On 19 June 2018, the Singapore High Court granted Hyflux and four of its subsidiaries – Hydrochem, Hyflux Engineering, Hyflux Membrane Manufacturing and Hyflux Innovation Centre – an extended six-month moratorium.[215] This moratorium gave Hyflux's interested investors time to arrange for a combined loan, and it also provided time for Hyflux to develop two projects which were near completion. Hyflux was also ordered to give an update on the reorganisation of its liabilities and businesses in three months to the Court and creditors.[216] Without the moratorium, Hyflux would "run out of cash in the next four to five weeks".[217]

Bank debt for the Hyflux Group stands at S$1.84 billion. Hyflux has 29 bank lenders, of which six banks supported the moratorium, including Mizuho and DBS. Mizuho is Hyflux's largest unsecured bank lender at S$235.2 million while DBS stands at S$93.6 million. If Hyflux were to be liquidated, unsecured creditors were told that they were likely to incur a 72% to 85% loss on face value.[218]

On 6 July 2018, an agreement was made with Maybank, which is the only secured bank lender for the Tuaspring project. Maybank was to be "actively involved and engaged" in its divestment.[219] The Tuaspring IWPP was not to be part of the debt moratorium, and a deadline of 15 October 2018 was imposed to find a successful buyer and to obtain approvals from the PUB, Singapore High Court and shareholders on subsequent dates.[220]

Epilogue

The restructuring process for Hyflux has turned out to be a long and tortuous process. In October 2018, it was announced that a "white knight" in the form of an Indonesian consortium, SM Investments, has been found.[221] However, SM Investments has since become an adversary following the collapse of the agreement and litigation has commenced between the two parties.[222] In July 2019, it was announced that Utico FZC (Utico), an United Arab Emirates utilities group, was interested in buying an 88% stake in Hyflux.[223] However, with a deadline of 26 August 2019 imposed by Utico fast approaching and signs of frustration on Utico's part, the future for Hyflux and its stakeholders remain highly uncertain.

Discussion questions

1. What are the benefits and risks of having a founder-controlled company? In the case of Hyflux, do you believe that Olivia Lum's roles as controlling shareholder, founder, Chairman and CEO – together with her role in committees and her external commitments, contributed to the fall of Hyflux? Explain.

2. What are the key responsibilities of the board of directors? In the case of Hyflux, do you believe the board adequately discharged their responsibilities? Explain the areas where you think the board may have fallen short.

3. Critically evaluate Hyflux's board structure, board committees, remuneration policies, internal audit and external audit. Do you agree with the company that its problems are not related to corporate governance? If not, what aspects of its corporate governance were most directly related to its problems?

4. What were the major risks that Hyflux faced? How could Hyflux have better managed these risks? To what extent did weaknesses in its business model contribute to its fall?

5. Was Tuaspring a 'black swan' event or was it a result of a failed "asset-light" business model or weaknesses in corporate governance? Were there identifiable 'red flags'? Do you think that the failure of Tuaspring could have been avoided? Discuss some strategies that Hyflux could have adopted to mitigate the risks of the Tuaspring venture.

6. The failure of Hyflux affected many retail investors. Do you think these investors are solely responsible for their predicament, or are others such as the banks which helped with the sale of securities also to blame? Explain.

7. What actions, if any, do you think regulators should consider taking in the case of Hyflux?

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MIDAS: ALL THAT GLITTERS IS NOT GOLD

Case overview

Founded in 2000, Midas Holdings Limited (Midas) had risen quickly to become one of the leading manufacturers of aluminium alloy extrusion products for the booming passenger rail transportation sector in China. Patrick Chew Hwa Kwang, who was a founding member of the company, had been credited with playing an instrumental role in growing and leading Midas to a primary listing on Singapore Exchange's (SGX) Mainboard in 2004, and a secondary listing on the Hong Kong Stock Exchange in 2010. On top of having the world's top three train manufacturers – Alstom, Siemens and Changchun Bombardier – as clients, Midas had also been awarded the "Most Transparent Company Award" by the Securities Investors Association Singapore (SIAS) for five consecutive years from 2012 to 2016. On the surface, Midas appeared financially sound as it reported high net profit for the year to RMB100 million in 2016. Things seemed to be going well for Midas until cracks began to show. The objective of this case is to facilitate a discussion of issues such as corporate governance of Chinese companies listed overseas; roles, responsibilities and risks associated with legal representatives in Chinese companies; competencies of auditors; risk management; internal controls; governance awards and ratings; and the role of regulators.

Train wreck approaching

"SGX's public query to a company on unusual share trading already serves as a red flag to investors."

– Tan Boon Gin, Chief Regulatory Officer of SGX[1]

Since its listing on SGX in 2004, Midas had not been under heavy scrutiny by SGX's surveillance team. However, in 2017 alone, Midas received a total of six SGX queries.[2] In one instance, Midas was asked to explain why its trade receivables reported for three quarters in 2017 had increased to RMB2.44 billion when revenue remained at RMB1.36 billion.[3]

This is the abridged version of a case prepared by Amos Teo, Andrew Tan, Ling Wei Jie, Chang Jun Hua and Wang Mei Hui, under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Elizabeth Ong under the supervision of Professor Mak Yuen Teen.

On 23 November 2017, Midas issued an announcement which stated that under an extraordinary resolution, the maturity date of its Series 003 Notes, amounting to US$30 million, had been extended from the initial date of 23 November 2017 to 23 November 2018.[4]

The next day, 24 November 2017 when shareholders made their concerns known to the company – Midas' share price dropped from S$0.154 to S$0.148,[5] with 23.2 million shares traded on that very morning, making it one of the most actively traded stocks on SGX that day. This unusual trading activity triggered yet another query by SGX. Midas responded that save for its previous announcement, it was not aware of any other information, disclosed or otherwise, that could explain the significant increase in trading activity.[6]

In 2017, Midas' share price fell by over 60% from a high of S$0.255 on 27 February[7] to an all-time low of S$0.102 on 11 December.[8] The pressure on Midas' Chief Executive Officer (CEO) cum executive director Patrick Chew and the rest of Midas' board of directors had never been higher.

Nevertheless, the new year brought new hope. On 3 January 2018, Midas announced that its joint venture – CRRC Nanjing Puzhen Rail Transport Co., Ltd. (NPRT) – had secured three lucrative metro train contracts worth RMB2.68 billion, to be delivered between 2018 and 2020.[9] This piece of news was sufficient to offset the worries of investors who, just a month before, had been dumping Midas shares. That same day, Midas' share price spiked 43% from S$0.111 to the closing price of S$0.159[10], with an unusually high volume of 442 million shares being traded on that day. This time, SGX did not raise a query.

Gone off the rails

On 29 January 2018, Tong Din Eu, Midas' lead independent director, was alerted by Chief Financial Officer (CFO), Liaw Kok Feng, who had discovered previously undisclosed litigations, enforcement orders, and court documents involving Midas' subsidiaries in China.[11] An even greater concern was the discovery of undisclosed corporations that were related to several of Midas' Chinese subsidiaries.[12]

Over the following ten days, Tong Din Eu proposed to engage the legal services of Wong Partnership to assist with ongoing investigations.[13] Midas also consulted SGX on the appropriate next steps to take.[14] On 8 February 2018, Midas made a public announcement, providing investors with a breakdown of the subsidiaries involved in litigations and further information on enforcement orders. Notably, several freezing orders were outstanding. The orders froze shares owned by Midas in Luoyang Midas Aluminium Industries, Dalian Huicheng Aluminium Co., Ltd as well as CRRC Nanjing Puzhen Rail Transport Co., Ltd. Midas advised shareholders to "exercise caution when dealing in the securities of the company".[15]

Trading of Midas' shares was suspended the next day on 9 February 2018,[16] and was last traded at S$0.192.[17]

Patrick Chew resigned on 22 March 2018, citing health issues.[18]

A week later, on 29 March 2018, Midas' Audit Committee – made up of the three independent non-executive directors – lodged a police report with Singapore's Commercial Affairs Department over a possible breach of securities law and other offences.[19]

On 2 April 2018, SGX Regco issued a notice of compliance to Midas, stating that the developments raised "immediate and serious concerns" about the suitability of Chen Wei Ping, Midas' Executive Chairman, and Ma Ming Zhang, the legal representative of Midas' subsidiary, Luoyang Midas Aluminium Industries Co., Ltd (LYMA), to continue as director and executive officer of the Group respectively. SGX Regco also stated that it objects to the continuing appointment of the two individuals as director/executive officer and executive officer respectively for three years from the date of the letter.[20]

With the departure of the CEO and Executive Chairman, two independent non-executive directors – Tong Din Eu and Xu Wei Dong – were re-designated as executive directors. Additionally, Chan Soo Sen, a former Minister of State and an independent non-executive director of the company, was appointed as its new Non-Executive Chairman.[21]

The musketeers

As investigations unfurled, several systematic and recurring issues became clearer. This led shareholders and observers to take a closer look at how Midas' board of directors could have let this happen.

Up till February 2018, the Midas board comprised of five directors, of which two were executive directors and three were independent non-executive directors. There were three board committees present – Audit Committee, Remuneration Committee, and Nomination Committee.[22] Chen Wei Ping was the Executive Chairman and Patrick Chew was the CEO. The independent non-executive directors were Chan Soo Sen, Xu Wei Dong and Tong Din Eu. Tong Din Eu was also the company's lead independent director.[23]

Prior to taking up their roles in Midas, Chen Wei Ping and Patrick Chew were in the same corporation – Raffles LaSalle Limited. Chen Wei Ping had held the position of executive director from 1998 to 2003 in the said firm. Prior to his directorship, he held a position as a marketing manager in 1997. Raffles LaSalle Limited was helmed by Patrick Chew's elder brother, Chew Hua Seng, who also had a stake in Midas.[24] However, any questions that may have existed relating to Chen Wei Ping's capabilities and his connections to the Chew brothers were put to rest as Chen Wei Ping played a pivotal leadership role in Midas' foundational years.[25]

Rogue legal representative

The legal representative is the designated principal of the company and has the legal right to represent and enter into binding obligations on behalf of the company – even if they were beyond the legal representative's authorised scope – so long as laws and the company's Articles of Association were not violated.[26] As consequences which arise from the legal representative's actions are borne by the company, legal representatives essentially possess broad powers and potentially unlimited personal liability. As such, companies would need to have proper risk mitigation efforts in place.[27] Companies can control their power distribution levels by appointing legal representatives who hold titles of Chairman, executive director or general manager but are, in substance, not really involved in management.[28]

As at 31 December 2017, the legal representatives of the Chinese subsidiaries in Midas are as follows:

Legal representatives	Subsidiaries
Ma Mingzhang[29]	• Jilin Midas Aluminium Industries Co., Ltd • Shanxi Wanshida Engineering Plastics Co., Ltd • Luoyang Midas Aluminium Industries Co., Ltd
Sun Qixiang[30]	• Jilin Midas Light Alloy Co., Ltd
Yang Xiao Guang[31]	• Dalian Huicheng Aluminium Co., Ltd

Figure 1: Legal representatives of Midas' subsidiaries as at 31 December 2017

The Jilin Midas Light Alloy case

One of the irregularities uncovered dated back to an incident in 2016. On 2 November 2017, a lady named Ning Xiao Fei sued the following parties for a total of RMB30.5 million:

No.	Company/Party	Legal representative	Relationship
1	Jilin Midas Light Alloy Co., Ltd	Chen Wei Ping	Borrower
2	Jilin Midas Aluminium Industries Co., Ltd	Patrick Chew Hwa Kwang	Guarantor
3	Chen Wei Ping		Guarantor
4	Patrick Chew Hwa Kwang		Guarantor
5	Li Hui		Guarantor

Figure 2: Parties involved in Jilin Midas Light Alloy case[32]

Reportedly, Ning Xiao Fei had entered into various loan agreements with Jilin Midas Light Alloy Co., Ltd (JMLA) in 2016. These loans were for a period of one month and at an interest rate of 0.15% per day. The loan agreements allegedly had the legal representative stamps of Chen Wei Ping and Patrick Chew affixed onto them, as well as the signature of Li Hui, financial controller of JMLA.[33]

Therefore, in order to recover the long overdue principal and related interest amounts, Ning Xiao Fei took the guarantors to court. However, as the loans were obtained without the consent and knowledge of the board of Midas, the financial statements of the Group beginning from FY2016 Q3 omitted the loans from Ning Xiao Fei.[34] Furthermore, the parties involved did not report the litigation to the board.

The Jilin Midas Aluminium case

Another alleged irregularity uncovered involved unauthorised loans taken out by Jilin Midas Aluminium Industries Co., Ltd (JMAI). Independent inquiries conducted by Midas' Audit Committee found that on 14 March 2018, Midas' appointed legal counsel had received a litigation notice from the court on behalf of Midas,[35] filed against JMAI and the guarantors on 7 December 2017 by the lender Jilin Provincial Micro Refinancing Corporation (JPMRC) for defaulting on their loans. According to the documents obtained from the Jilin High People's Court, JMAI took out three loans amounting to RMB379 million. However, these litigations were not reported to the board of Midas by the legal representatives.

JPMRC did not exist in the Midas' accounts even though other members of the Group had provided corporate guarantees for the loans. According to the documents filed by JPMRC, the guarantee for the first loan was given by the following legal representatives: Chen Wei Ping, Ma Mingzhang, Sun Qixiang and Yang Xiao Guang and Zhou Yong Bo.[36] Furthermore, JPMRC had presented new evidence at the first hearing – an alleged board resolution dated 13 July 2017, which approved providing a guarantee for JMAI's loans for an amount of up to RMB400 million if Midas' subsidiaries failed to repay the loan amount to JPMRC. However, no approval was sought from Midas' board in respect of the loans. The resolution was only signed by Chen Wei Ping, Patrick Chew and Xu Wei Dong. Midas' CFO had no record of the loans made by JMAI and the board resolution approving the RMB400 million guarantee. As such, Midas' accounts did not record the existence of the loans taken from JPMRC and the guarantee given to JPMRC, and JPRMC was not recorded as a lender in Midas' books.[37]

The Chongqing Huicheng Aluminium case

Other than providing unauthorised guarantees to related companies, two of Midas' subsidiaries –Dalian Huicheng Aluminium Co., Ltd (DLHC) and Luoyang Midas Aluminium Industries Co., Ltd (LYMA) – allegedly acted as unauthorised guarantors for an unrelated company called Chongqing Huicheng Aluminium Co., Ltd (CQHC). The Audit Committee of Midas sighted the court order on 16 March 2018. The court order was dated on 7 August 2017 and was filed by a third party distributor, Sumec International Technology Co., Ltd (SITC), who supplied machineries to CQHC.[38,39] However, the new legal representative of LYMA, Ma Ming Zhang, who was appointed on 20 April 2017, did not inform the board of Midas of this litigation.[40]

According to the court documents, it was suggested that the guarantee may have started during June 2015, and thus disclosure of this guarantee was omitted for the accounting period starting from the second quarter of 2015. The guarantee agreement stated that LYMA had provided guarantee for all the debts owed by CQHC to SITC resulting from the transaction. The same agreement had the legal representative stamps of Patrick Chew (former legal representative of LYMA) and Yang Xiao Guang (legal representative of DLHC).[41] Similar to other cases, the guarantee was not reported to Midas' board of directors. Therefore, up until the independent review by the Audit Committee, Midas' board was kept in the dark.[42]

Curious case of Patrick Chew

Prior to 20 April 2017, Patrick Chew was the legal representative for JMAI, LYMA, and Shanxi Wanshida Engineering Plastics Co., Ltd (SWEP).[43]

In the three abovementioned cases, Patrick Chew's legal representative stamp was sighted on the documents. However, Patrick Chew claimed that he was unaware of the transactions that transpired and his stamp was not authorised for use.[44] In the case of JMLA, he further substantiated his innocence by insisting that he had neither been served any summons nor had any of his assets frozen by such litigations.[45]

Related party transactions

Involvement with Newport Metals

Having uncovered the actions of the legal representatives, the board set out to uncover other suspicious activities within the Group.

When Midas' board paid DLHC a visit on 29 May 2018, it discovered a series of related party transactions regarding DLHC which brought up more concerns regarding its governance and control over its subsidiaries.

One of the irregularities uncovered was regarding Midas' acquisition of Huicheng Capital Limited (HCL), holding company of DLHC. For the purpose of the acquisition, audit firm Mazars LLP was engaged to conduct financial due diligence on DLHC. Thereafter, the auditors prepared a report on 2 November 2015 stating that Newport Metals Inc was one of its top customers as DLHC's transactions with Newport Metals Inc made up 30.4%, 65.3%, and 52.7% of its revenues from FY2013 to FY2015.[46]

However during the visit, Midas' board discovered that Chen Chen, the nephew of Chen Wei Ping, was the sole director of Newport Metals Inc, and that both Yang Xiao Guang and Chen Chen were vendors of DLHC. Such material information was allegedly deliberately not disclosed to Midas' board during the proposed acquisition of HCL. Unfortunately, as the CFO of DLHC was uncooperative, the Midas' board hit a major roadblock in its investigation as to whether the significant prior years' sales to Newport Metals Inc had influenced the valuation in HLC's acquisition.[47]

Sale of Chongqing Huicheng Aluminium Co Ltd

The valuation of HCL was not the only pertinent issue that Midas' board uncovered during its trip to DLHC. The board subsequently discovered yet another suspicious transaction regarding the sale of CQHC to Lakeforest Capital Limited – owned by Chen Chen, the nephew of Chen Wei Ping –[48] which was part of the deal in the acquisition of HCL.

In the sale of DLHC's stake in CQHC to Lakeforest Capital – then known as Lesen Capital Limited – Midas only received RMB18.48 million of the total agreed cash consideration of RMB229.5 million. The remaining RMB211 million was transferred to another company's bank account, whose 99% shareholder and then legal representative was Ma Jin Sheng, while its former legal representative and largest shareholder was Ma Ming Zhang.[49] Subsequently, DLHC reassigned the consideration transferred out as a receivable on their financial statements.[50]

Riddle of the missing cash

Following an earlier announcement by Midas about its intention to redeem US$30 million of its Series 003 Notes, Midas instructed two of its subsidiaries in China – JMAI and JMLA – to remit funds to its Singapore office on 22 March 2018. However, Midas did not receive any of the funds and the local staff at JMLA were uncooperative towards Xu Wei Dong, the legal representative of JMLA.[51]

This aroused the suspicions of Midas' Audit Committee, and the board subsequently announced on 29 March 2018 that it planned to conduct a validation of the cash balances at the banks for JMAI, JMLA and Jilin Midas Investments Co. (JMI).[52]

On 16 April 2018, Midas' board announced that a police report had been filed in the People's Republic of China in view of the discrepancies in JMLA's accounts. From the statements obtained over the counter, JMLA only had RMB11,485 in its cash balance as at 31 December 2017, representing a shortfall of approximately RMB334 million. In addition, the discrepancies in JMLA's accounts uncovered by the board dated back to 31 December 2016.[53]

Little did Midas' board know that this discovery was just the tip of the iceberg. In May 2018, Midas' cash holdings were revealed to be a mere S$700,000 compared to RMB944 million (S$198 million) that was reported for the third quarter ended September 2017.[54]

Cash goes merry-go-round

On 7 June 2018, Midas' board obtained the bank statements of SWEP for the accounts with Industrial and Commercial Bank of China branch in Ruicheng County. Following a reconciliation between the bank statements and the audited ledger balance, the board found significant discrepancies.[55]

Date	Bank statements obtained (RMB)	Audited/Verified Ledger balance (RMB)	Difference (RMB)
30 June 2016	259,784.17	61,038,378.13	(60,778,593.96)
31 Dec 2016	552,468.00	62,863,409.95	(62,310,941.95)
30 June 2017	82,451.84	61,980,301.59	(61,897,849.75)
31 Dec 2017	1,973.27	1,973.27	-

Figure 3: Financial Information obtained on 7 June 2018 for SWEP[56]

In another shocking discovery, a series of round-tripping transactions were found to be made to create an impression of a RMB60.5 million loan by SWEP to LYMA.[57]

The legal representative of LYMA at the time of transfers was Ma Ming Zhang. He had advised that the money was transferred to Liaoyuan Jia Li Light Alloy Co., Ltd as advanced payments for supplies. However, Midas' board noted that LYMA was short of working capital and could not afford to advance money to suppliers at the time. The result of the round-tripping left LYMA with an unrecoverable receivable which covered up the missing money at SWEP. This event once again brought the legal representatives into the spotlight.[58]

Furthermore, the board believed that it had found evidence of more corporate malfeasance among its China-based subsidiaries when it discovered another set of round-tripping transactions between SWEP and JMAI. Unfortunately, the board did not manage to obtain access to the related bank statements as the relevant subsidiary was under judicial management.[59]

In light of these situations, the board decided to replace SWEP's board with representatives from Midas.[60] However, the damage had already been done.

Mazars pulls the brake

On 26 April 2018, Midas' board received a letter from Mazars LLP, which had been the company's auditors since 2012. The letter stated that in light of findings noted in the course of its audit work for FY2017, as well as recent developments of Midas, the auditor's reports for FY2012 to FY2016 may no longer be relied upon.[61]

In response to questions surrounding Mazars LLP's competency and its role in Midas' scandal, Mazars LLP issued a statement claiming that its audits were based on required audit procedures, but that it too had been deceived.[62]

Watchdogs follow suit

"What must be understood clearly by everyone is that there is no guarantee that a company or a person exhibiting good conduct today may continue to do so in the future. It is also not humanly possible for SIAS or anyone to predict the future perfectly."[63]

– David Gerald, President and Chief Executive of the SIAS

On 30 May 2018, slightly over a month after Mazars LLP issued its official statement, the Securities Investors Association (Singapore) (SIAS) withdrew its "Most Transparent Company Award" from Midas, which had been awarded to Midas every year from 2012 to 2016.[64]

David Gerald, President and Chief Executive of the SIAS, said in a statement that its decision to withdraw the awards stemmed from the basis of the awards, which includes the audited financial statements and relevant information from the annual reports, being undermined.

In his online article, "Comments on Straits Times article on withdrawal of SIAS awards for Midas", Professor Mak Yuen Teen shed light on how certain awards and ratings may be influenced by heavy lobbying by nominee companies or fundraising agendas by award issuers.[65]

Although Professor Mak believed that "mistakes can happen because good companies and people can turn bad", he was also of the opinion that organisations involved in governance awards or ratings should not use the excuse of others getting it wrong to excuse their own mistakes. Moreover, Professor Mak believed that a key role that governance awards play was to encourage "investors to look beyond just the financial numbers or the analysts' recommendations and to focus on governance and transparency factors that may be even more important for the long-term performance of companies".[66]

Will Midas get back on track?

Since the scandal unfolded, the remaining three directors on Midas' board – Tong Din Eu, Xu Wei Dong and Chan Soo Sen – have been hard at work trying to restore Midas' operations and business.[67] Laying out an eight-month action plan in July 2018, the board seemed clear on the direction Midas should take – Midas has to how that it has enough operations and assets, as well as publish its outstanding audit results.[68]

However, Midas continued to face more setbacks. It faced lawsuits from former Executive Chairman, Chen Wei Ping and former CEO, Patrick Chew. The former sued Midas for allegedly using "defamatory words" against him, while the latter claimed he was pressured to resign and sued Midas for S$3.3 million in unpaid loans, salaries and expenses not reimbursed.[69] To make matters worse, Midas was also left without a CFO after Liaw Kok Feng tendered his resignation in October 2018, citing health reasons.[70] On 7 November 2018, Midas' director, Tong Din Eu issued an announcement saying that there would be a further delay in the publication of the annual report for the financial year ended 31 December 2017.[71]

As minority shareholders, former executives and creditors all seek to claim their piece of Midas, chances of a happy ending seem less and less likely as the days pass. With its reputation in tatters, subsidiaries under judicial management, and regulators breathing down its neck – how did a company, once valued at over a billion dollars be brought to its knees and end up in such a sorry state?[72]

Discussion questions

1. What are some of the key challenges associated with the corporate governance of Chinesea companies listed overseas, from the point of view of the board of directors, external auditors, minority investors and regulators?
2. Given the roles and responsibilities of a legal representative, how should a Chinese company go about selecting an appropriate legal representative? What are the risks to the company associated with a legal representative? What are some safeguards against abuse of power by legal representatives?
3. Discuss the role of the board in ensuring that the internal control and risk management system of a company is adequate and effective. Using the Midas case as an example, how can the board manage the risks of the entire Group, both locally and abroad. To what extent should the Midas board be held responsible for the Midas debacle?
4. Discuss the responsibilities of the external auditor in relation to the issues that arose at Midas. To what extent should the external auditor, Mazars LLP, be held responsible? What factors could have contributed to audit quality issues at Midas?
5. In the Midas case, much attention has focused on the role of the external auditors, board of directors, regulators and even organisations giving out governance and transparency awards, but there has been little attention on the role of the internal auditors. What is the role of the internal auditor in relation to the issues that arose at Midas and how can the board and audit committee ensure that the internal audit function is effective?
6. What were some of the potential warning signs at Midas that could have alerted investors to its problems before the scandal erupted?

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NOBLE TAKES ON GOLDILOCKS AND THE BEARS

Case overview

Noble Group Limited (Noble) was once a highly successful commodity trading company, which, in its heyday, was featured on Fortune Global 500 list. However, following a series of allegations started by Iceberg Research in 2015, Noble found itself in deep financial trouble and its share price took a nosedive. Furthermore, its original debt restructuring plan was met with disgruntlement from its shareholders, and the struggling commodity trading company had to contend with a number of lawsuits and a flurry of questions raised – most notably from Goldilocks Investment Company (Goldilocks), a substantial shareholder of Noble. Goldilocks continued to lock horns with Noble with regards to its alleged lack of accountability and unjust treatment of shareholders. Eventually, a compromise was reached and an updated debt restructuring plan was given the green light by Noble's creditors and shareholders, including Goldilocks. The objective of this case is to facilitate a discussion of issues such as the role of shareholder activism; the roles and duties of board and management; crisis management; corporate governance; as well as remuneration policies and disclosures.

Noble Group

Once hailed as a "crown jewel" in the Asian commodities industry,[1] Noble Group Limited (Noble), a Bermuda-incorporated company, was founded by Richard Elman in 1987 and had grown into a billion-dollar company over the following decades.[2,3] While Noble's headquarters are located in Hong Kong, it had been listed on the Singapore Exchange (SGX) since 1997.[4] However, trouble struck in the mid-2010s, which brought the company to its knees.

Who is Goldilocks?

"We will fight any move that deprives shareholders of their legitimate rights."

– Goldilocks Investment Fund Manager, Ajit Vijay Joshi[5]

This is the abridged version of a case prepared by Cindy Victoria, Gan Xin Ying, Koh Sing Siong, Liu Siqi and Tanya Chee under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

Goldilocks Investment Company (Goldilocks) is an Abu Dhabi-based investment fund launched in 2015. According to the company, it typically invests and seeks to add value to undervalued companies through board representation and management engagement.[6] On 22 June 2017, Goldilocks purchased 50.5 million shares in Noble, resulting in a 5.03% ownership interest in the commodity giant. Two weeks later, Goldilocks further increased its stake in Noble to 8.19%, making it one of Noble's substantial shareholders.[7]

The Iceberg collision

In February 2015, Iceberg Research (Iceberg), a small short-seller research firm, released a series of reports accusing the commodity trader of accounting malpractice that allowed it to mask significant impairments and overstate the value of its assets.[8] The next day, Noble reported a loss in its 2014 financial results, its first loss since September 2011. The loss, which was attributed to a US$438 million impairment charge, raised eyebrows and Noble's share price fell eight percent the day after the release of its financial results.[9]

There was hardly any time for Noble to take a breather before Iceberg poured cold water on the commodity trader once again by releasing yet another report. In addition to allegations that Noble understated its debt, key corporate governance issues were raised as Iceberg flagged the long tenure of Noble's independent directors, as well as the generous remuneration accorded to key management despite Noble's lacklustre cash performance.[10]

Noble's board: Overseeing or overstaying?

In 2014, Noble's board consisted of 13 members, including eight non-executive directors who were considered to be independent.[11] Iceberg pointed out that the directors, having sat on the board for an average of a decade – with the two longest-serving directors being on the board for 19 years – could hardly be considered independent.[12]

In relation to Noble's board composition, Professor Mak Yuen Teen from NUS Business School wrote in a Business Times article that the board suffered from a lack of diversity and lacked the experience required to provide an oversight role for a large commodities trading company. There was an overwhelming number of independent directors having backgrounds in banking but none had any expertise in the commodity trading industry. Moreover, even though Noble is listed in Singapore, it was curious that Noble's board did not include a Singapore-based director.[13]

Furthermore, the role of Elman and his dominant influence on the company was also questioned. When he was the Chief Executive Officer (CEO) and Executive Chairman, Elman sat on the audit, remuneration and nominating committees. He stepped down from the audit and nominating committees following pressure from external parties such as proxy adviser Institutional Shareholder Services.[14] However, even as Elman progressively relinquished some of his leadership roles – first from his position as CEO at the end of 2009, followed by stepping down as the company's Chairman in May 2017 – Elman remained as Chairman Emeritus and the company's substantial shareholder.[15]

Remuneration for the "Nobles"

In the same 2015 Business Times article, Professor Mak also commented that Noble was opaque in relation to its remuneration of directors and senior executives, and has "extremely poor" remuneration policy disclosures. Noble merely disclosed that its three executive directors fell in the top remuneration band of S$1.5 million and above, as well as the percentage mix, while the top five key management executives were each paid S$1.5 million and above. The company also did not reveal the fee structure for its non-executive directors.[16]

Two years on, Noble's remuneration policies had not seen any improvement. When the global head of oil liquids and co-Chief Executive Jeffrey Frase departed from Noble in November 2017 following the sale of its oil business to Vitol Group,[17] he received a remuneration package of over US$20 million from the company.[18] This included US$500,000 salary in lieu of notice; fixed salary amounting to US$890,000; a US$3.8 million lump sum payment; US$3.82-million loan write-offs; and US$7.65 million prior year bonuses released from claw back (non cash).[19] This breakdown caught the attention of Professor Mak, who was of the opinion that the severance package, especially the loan write-off, was "extremely generous".[20]

On 7 March 2018, SGX issued a query to Noble as to why it did not comply with the Code of Corporate Governance 2012, which states that companies should name and disclose the remuneration of at least the top five key management personnel in bands of S$250,000.[21] In response, Noble said it presented the information in such a manner because of "highly competitive industry conditions", the fact that many of its competitors are private entities and as such do not disclose information on remuneration, as well as "the general sensitivity and confidentiality of remuneration matters".[22]

Going downhill, time to bite the bullet?

Following the run-in with Iceberg, Noble lost its blue-chip status and investment grade rating amid falling commodity prices and allegations about its accounting policies.[23] Hoping to turn things around, Noble appointed independent non-executive director Paul Brough as Chairman in May 2017 to oversee the review of strategic alternatives. Elman took on the role of Chairman Emeritus.[24]

Brough –the former head of KPMG's transactions and restructuring division in the Asia-Pacific region who retired in 2012 – was a restructuring specialist who worked on over 30 restructuring and insolvency assignments during his career.[25] After his appointment as Chairman, Noble informed investors that Brough's first job at the helm was to conduct a "strategic review of the business" and "explore strategic alternatives".[26]

As options were being explored to improve Noble's performance, the cash-strapped company had to seek credit extension for its debts, defer coupon payments, dispose equity interest in various subsidiaries and sell off a few key businesses, including its prized oil trading business.[27] DBS Group Holdings Ltd., one of Noble's key banks, pulled the plug on loans to Noble in November 2017.[28]

Timely information releases?

On 14 February 2017, Noble announced that it was engaging in talks with China's state-owned Sinochem Corporation about that latter potentially acquiring an equity stake in Noble. Noble later confirmed that it was indeed engaging in discussions but had not entered any binding agreements yet. The news drove Noble's share price up by as much as 16.8%.[29] However, the deal did not eventually materialise.[30]

A string of asset disposals at below market price

In September 2017, Noble sold its 50% equity interest in Coalridge Limited to Aspire Mining Limited for only US$1 million, even though the net tangible asset value attributable to the sale shares amounted to US$8.56 million.[31,32]

In December 2017, Noble said that it was in talks with Mercuria Investments to dispose of its ethanol producing unit – Noble Americas South Bend Ethanol (NASBE) – for a gross consideration of about US$20 million. With NASBE having a book value of around US$80.4 million as at 30 September 2017, the loss on disposal would amount to approximately US$60.3 million.[33] The sale was eventually completed on 2 January 2018, with a final consideration of US$18.1 million.[34]

Subsequently, in January 2018, Noble completed its sale of Noble Americas Gas and Power to Mercuria Energy Group for US$168 million –more than 30% below the US$250 million consideration Nobel originally hoped to receive.[35] In the same month, Noble completed the sale of its U.S.-focused oil business, Noble Americas Corporation, to Vitol Group. However, net proceeds of around US$400 million from the sale were lower than a previously announced estimate.[36]

Noble reported a loss of US$1.17 billion in the third quarter of 2017.[37] As the troubled commodities trading company continued sinking into the red, it was no surprise that in November 2017, Noble announced its plan to embark on a debt restructuring plan.[38]

Gunning for Plan A: Crumbs for shareholders

"This agreement marks the beginning of the final phase of our restructuring, and the creation of a new Noble as a focused and appropriately financed group set to capitalise on the high-growth Asian commodities sector,"

– Paul Brough, Noble Chairman[39]

With its debt amounting to US$3.4 billion, time was ticking for the distressed Noble. When the proposed debt restructuring plan was eventually announced on 29 January 2018, it was revealed that existing shareholders, including Elman, would end up with a mere 10% stake if the deal was approved. Through a debt-for-equity swap backed by 30% of Noble's creditors, the crisis-hit commodities trading company would be able to reduce its borrowings from US$3.4 billion to US$1.7 billion. In return, Noble's lenders would collectively own a 70% stake in the company, while 20% would be earmarked to "incentivise" its senior executives. This 20% stake would be shared by its senior management team, including Chief Executive Will Randall, and the company's finance director, Paul Jackaman. Additionally, the company planned to issue US$700 million of bonds that would be repaid from asset sales, as well as US$200 million of preference shares. Last but not least, the restructuring plan also included a three-year committed trade finance and hedging facility of up to a maximum amount of U$700 million on competitive market terms.[40,41]

The proposed debt restructuring plan left stakeholders questioning the special treatment of its senior management, especially since the company was in dire straits.[42] Following the announcement on the proposed debt restructuring plan, Noble's share price fell as much as 23.1% the very next day on 30 January 2018.[43]

Face-off between Noble and Goldilocks

In response to the proposed debt restructuring plan, Goldilocks issued a 17-page letter[44] to SGX on 29 January 2018, asserting that Noble's management had focused on its own interests over that of its shareholders and creditors. In its letter, Goldilocks questioned whether Noble's management had breached its fiduciary duty to the company and its shareholders, and requested for SGX to investigate into the company's matters. This included whether the company had strategically timed certain announcements to lift its share price ahead of capital raising exercises, and whether its asset disposals were appropriately conducted as the disposals were concluded at steep discounts to their respective book values.[45]

Goldilocks further said that despite flagging out these concerns to Noble's board, it did not receive any satisfactory explanation on the sale processes and no comments were provided by Noble on whether safeguards were in place to ensure that assets were disposed at fair value.[46] Minority investor advocacy group Securities Investors Association Singapore (SIAS) also followed suit, requesting Noble to offer existing shareholders a deal similar to the one offered to its senior management.[47]

Further exacerbating the situation, rating agencies Moody's and S&P further downgraded Noble's bond ratings, with the latter indicating that the rating was likely to reach the lowest junk-bond rating in near future.[48]

Two days later, on 31 January 2018, Noble issued an announcement denying the "unfounded" allegations that the management was benefiting itself at the expense of shareholders.[49] The company justified its restructuring plan by stating that its senior executives were essential to Noble's business as commodity trading – a fiercely competitive business with extremely thin margins[50] – was greatly dependent on its people. It went on to defend itself by saying that the creditors involved in the discussions around the company's debt restructuring had agreed to give management an initial 10% stake – with any further grants being subject to performance evaluations – in order to "retain them and align their interests with the future success of the company".[51]

In response to accusations of share price manipulation, Noble said that many of its announcements were required by SGX listing rules to address leaks, market rumours and articles in the media.[52] On the asset disposal matter, Noble's board represented that it had tried to maximise value from the company's asset disposals, but due to competitors capitalising on Noble's dire financial situation, the assets were usually disposed at discounted prices. The company went on to explain that working capital and operating losses also contributed to adjustments in consideration prices, all of which had been disclosed when seeking approval form shareholders.[53]

In response to Goldilocks' request for two board seats on 11 October 2017, Noble disclosed that it was Goldilocks' "precondition of any detailed talks over potential restructuring or investment options".[54] It went on further to explain that the board's Nomination Committee "was not comfortable acceding to this request, for corporate governance reasons".[55]

Goldilocks averred that Noble's response was meant to discredit it and trivialise the matters it was trying to raise. The investment fund also clarified that Noble's statement that the statement on the request of two board seats as precondition for negotiations was untrue and misleading, and that the real reason behind the request was to improve transparency of the company, to protect shareholders' rights and ensure the company's ultimate survival.[56]

Goldilocks had also written to Noble to request for a waiver of certain non-disclosure arrangements which prevented it from providing further details on the prior engagements with Noble.[57] However, Noble rejected its request. Noble insisted that its earlier announcement was “accurate and not misleading”,[58] and defended itself against claims of negligence in the disposal of assets by claiming that the sale processes were “competitive processes conducted over several months.”[59]

Other stakeholders have something to say

On 19 February 2018, Noble issued an announcement that warned it would report a significant loss for FY2017, quantified at approximately US$5 billion.[60] Despite that, Noble’s board was “satisfied that the group can continue as a going concern, until such time as the restructuring is completed”.[61] Despite the confidence of Noble’s board in relation to the company’s financial situation, its auditor Ernst & Young (EY) warned about its ability to continue as a going concern due to its substantial current liabilities and net deficiencies.[62]

Less than a month later, on 8 March 2018, SGX requested for Noble to appoint an independent financial adviser (IFA) to review its proposed debt-for-equity swap and provide an opinion on whether the proposed restructuring was fair and reasonable.[63] SIAS was pleased with this move, with SIAS chief David Gerald stating that the “independence of the IFA is paramount, for this review to be credible and fair to all stakeholders.”[64]

Yet another impasse

On 14 March 2018, Noble announced that it and a group of senior creditors representing 46% of existing senior claims have signed a revised restructuring and support agreement (RSA) on its proposed restructuring plan. The RSA included the provision of a new three-year committed US$600 million trade finance and a hedging facility worth US$100 million. The RSA also detailed that after the restructuring exercise, the ‘new’ Noble would continue to be listed on the SGX. Per the revised restructuring plan, a group of hedge funds and senior creditors would still take control of Noble, but shareholders would be given a slightly bigger equity stake of 15%. Perpetual bondholders would also be given improved terms under the RSA.[65,66]

Once again, Goldilocks was not satisfied with the revised restructuring plan, calling it “a wolf in sheep’s clothing”. It claimed that the plan would reward the company’s “errant and undeserving management”.[67]

The next day, on 15 March 2018, Noble delivered an ultimatum to its investors – it would file for administration if investors did not back the revised debt restructuring proposal. The threat came as Noble struggled to secure support for the revised plan before a US$380 million bond matures the following week.[68]

Professor Mak was appalled at Noble's second attempt at reaching an agreement through its revised restructuring plan. In a Business Times article, he brought up the fact that the proposed restructuring was driven by Noble's management and a group of senior creditors, completely blindsiding its public stakeholders who played no part in negotiating the RSA. Professor Mak was of the opinion that existing Noble shareholders and holders of perpetual securities "[had] every reason to feel oppressed". On this matter, Professor Mak further highlighted that compromise on the part of various stakeholders involved would be required for a successful restructuring plan. He commented that in Noble's case, as the RSA was developed between Noble's management and a group of senior creditors without consultation with others and oversight by an independent party with no vested interests, it was unsurprising that the terms of the agreement would be scrutinised, particularly if they appeared to overwhelmingly favour the parties who were involved in the development of the agreement. Furthermore, through the entire restructuring saga, stakeholders' trust in Noble had been lost, and it would be challenging for the embattled company to regain the lost trust unless there was an overhaul of the company's management and board of directors.[69]

After the announcement that the embattled commodity trading company would miss bond payments on its 2018 and 2022 notes, its shares fell to S$0.11 on 19 March 2018 – the lowest since 1999.[70]

Locked horns with no one backing off

On 7 April 2018, Noble announced that its Annual General Meeting (AGM) was scheduled to be held on 30 April 2018. One of the items on the agenda was the re-election of five directors – Christopher Dale Pratt, Wayne Robert Porritt, Andrew William Herd, Timothy Keith Isaacs and Fraser James Pearce.[71]

Goldilocks vehemently opposed the re-election of these directors in a letter lodged with Noble, on the basis that Pratt "did not take any action to prevent gross injustices" and "disregarded transparency standards and mismanagement", while the other four director nominees lacked the necessary qualifications.[72]

Advocating that shareholders oppose Noble's restructuring plan and vote against the company's director nominees, Goldilocks filed a notice to propose five alternative directors who would "bring a fresh perspective to the board and will strive to protect shareholder rights".[73]

Noble rebuffed Goldilocks' requisition on 23 April 2018. It argued that the investment fund held its shares in Noble through a depository agent – Central Depository Pte Ltd (CDP) – and thus, under the Bermuda law, it was this depository agent that was a registered member of Noble, not Goldilocks, which was merely the depositor. Noble took issue that the notice and requisition was not issued and signed under a registered member of Noble, but in Goldilocks' name, rendering the notice and requisition invalid as they were non-compliant with the company's by-law or Bermuda law.[74,75] Goldilocks was greatly angered by Noble's attempt to reject its requisition, calling its position "oppressive and coercive". In return, Goldilocks referred to Singapore's Securities and Futures Act which deems shareholders holding stock through a nominee account to be members of the company. Goldilocks also released a statement requesting Noble to provide complete details of when it had sought to engage an IFA and to explain why the announcement on the IFA's engagement by the company was not made.[76] It was later revealed on 10 May 2018 that Noble appointed Provenance Capital as its IFA. As the IFA, Provenance Capital would be required to provide an opinion on whether Noble's restructuring proposal would be fair to its shareholders.[77]

Goldilocks returns fire with a second lawsuit

In a last-ditch attempt to prevent the implementation of the restructuring plan, Goldilocks filed two separate lawsuits against Noble on 24 April 2018. Firstly, Goldilocks sought remedies including a declaration that it was entitled to recommend directors for election to the board, and to exercise its legitimate legal rights as a shareholder.[78] Secondly, Goldilocks sought an interim injunction to restrain Noble from holding any shareholder meetings, including the AGM scheduled on 30 April 2018, and from taking any further action on the restructuring plan.[79]

The Goldilocks lawsuits led Noble to lash out at its major shareholder, saying that the lawsuits were "without merit" and an "intentional attempt to obfuscate, delay, derail and/or prevent" the company from carrying out its restructuring plan. The embattled commodities trading company also reinforced its position on the proposed restructuring plan, stating that no other detailed proposals could be considered "even remotely credible in ensuring a financial return to shareholders".[80]

The verdict

On 27 April 2018, the Singapore High Court granted the injunction which would apply for Noble's upcoming AGM on 30 April 2018,[81] but would not extend to all shareholder meetings. The High Court also ruled in favour of Goldilocks with regard to the issue on whether CDP or Goldilocks was a member of Noble.[82]

End of the trench fight

After a protracted five-month battle against Noble, Goldilocks provided an irrevocable undertaking to support Noble's financial restructuring plan following its latest revision in June 2018. The two parties buried the hatchet and dropped all claims and legal proceedings against each other. The updated plan's new terms offered a 20% share of equity in New Noble to its existing shareholders instead of the previously proposed 15%. The remaining 70% of New Noble would be held by senior creditors, and 10% by its senior management.[83] As part of the sweetened deal, Goldilocks would also be getting its hard-fought seat on the board of directors of New Noble. Noble also agreed to reimburse Goldilocks up to US$5 million for legal costs and expenses incurred in respect of these legal claims. In return, Goldilocks' parent – Abu Dhabi Financial Group – would facilitate Noble's expansion into the Middle East.[84] At least 50% of the shareholders had to approve the plan during an upcoming Special General Meeting (SGM) for the restructuring plan to pass. With the backing of its dissident key shareholder, the path is finally paved for the embattled, crisis-stricken Noble to move forward towards restructuring its debt.

The market reacted favourably to the agreement, with Noble's share price rising as much as 57% after a two-day trading halt.[85]

Calling truce with the "New Noble-r" plan

"The outcome is totally expected. The alternatives facing them were liquidation where they will get nothing. Here, they see themselves getting 'hope'."

– Professor Mak Yuen Teen[86]

During the SGM on 27 August 2018, shareholders approved the proposed 'do-or-die' restructuring plan, with overwhelming 99.96% voting in favor of the proposal. Unfortunately, despite this outwardly positive result, many shareholders felt they had no choice but to go along with the restructuring plan in order to salvage what they could. As one shareholder regretfully expressed, "it's between the devil and the deep blue sea".[87,88]

Who will be on board the New Noble?

Brough, who would be stepping down after the restructuring was completed, announced on 18 September 2018 that the new board of directors would start off with a clean slate comprising of either eight or nine directors. Noble also assured stakeholders that the members of the New Noble board would be selected through a comprehensive and independent executive search.[89]

The new board is expected to consist of two of Noble's top management, one from Goldilocks, one nominated by senior creditors and up to five independent non-executive directors. One director from the old Noble would likely be part of the new board on an interim basis to assist the transition.[90] News also broke that Elman would not be taking up the appointment as an executive director of New Noble, citing personal reasons.[91]

Peering into the crystal ball: What lies ahead for New Noble?

The restructuring effective date occurred on 20 December 2018, when New Noble acquired substantially all of the assets of 'Old Noble' and shares in New Noble were allocated to the respective shareholders as per the restructuring plan.[92]

With a new board and its restructuring underway, Noble survives – at least for now. However, further obstacles may lie in the road ahead for New Noble. With stakeholder confidence already shattered by the entire saga, Professor Mak believes that "New Noble will continue to have a difficult relationship with the market".[93] In an interview with Bloomberg, Professor Mak also commented on the "sense of stubbornness" in Noble's management as the same people remained at the helm of the company and showed no signs of changing its old modus operandi.[94] Noble's "staunchest critic", Iceberg, also added that approval of the restructuring plan "will not stop securities holders from suing the individuals and organisations responsible".[95]

The million-dollar question remain: Could Noble be restored to its former glory? Or would the challenges prove to be too much to handle? The jury is out on whether Noble will prosper in the years to come.

Discussion questions

1. Discuss whether shareholder activism by Goldilocks proved to be beneficial to Noble and its stakeholders. Could other stakeholders have done more from the onset to prevent Noble's downfall in the first place?

2. Do you think that Noble's board and management should be held responsible for the decline of the company? Have they breached their fiduciary duties to shareholders? Discuss what they should have done to be more accountable and transparent to stakeholders.

3. Did Noble's remuneration policies reflect good corporate governance practices? Explain.

4. What were the difficulties encountered by Goldilocks in its bid to exercise its rights as shareholders and push through with its proposals? Did the fact that Noble was incorporated in Bermuda exacerbate the problems? If so, why?

5. Evaluate which stakeholder(s) (creditors, senior management or shareholders) had the short end of the stick and which stakeholder(s) emerged better off in the final restructuring plan.

6. What are some possible issues that may arise in New Noble, in view that senior creditors would now be substantial shareholders of the new restructured company?

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OCEANUS: IN THE DEEP END

Case overview

In 2013, the directors of Oceanus Group Limited (Oceanus) turned to Peter Koh, who was a successful entrepreneur on hiatus, hoping that he could set the ship on the right course once again. However, problems have shown no sign of abating over the years. Oceanus was soon hit with a flood of enquiries from the Singapore Exchange (SGX) and, eventually, entered the SGX watch-list, where it currently remains. The objective of this case is to facilitate a discussion of issues such as the responsibilities of the board of directors and management; director turnover; risk management; accounting and audit issues; SGX's watch-list criteria; and other regulatory issues.

Dire straits

"We are like a big ship sailing through the rough sea without our bearings and crippled with many punctured holes."

– Peter Koh, Oceanus' CEO[1]

Five years after withdrawing from the business world, Peter Koh joined Oceanus as an independent director (ID) and a member of the Nominating Committee (NC) on 11 October 2013.[2] He was then appointed Chief Executive Officer (CEO) and executive director in the following year.[3]

Together with Peter Koh at the helm were three non-executive directors – Kee Poir Mok and Edward Loy Chee Kim who were independent, and Stephen Lee who was non-independent.[4] This information was, however, not reflected on the company's website, with directors who have long left the board being included in this list.[5]

Stephen Lee and Kee Poir Mok are members of the Nominating and Remuneration Committees, while all three non-executive directors are on the Audit Committee.[6] Peter Koh's brother, Robert Koh, joined Oceanus in September 2014, and was promoted to Operations Director (China Operations) on 1 June 2017.[7] Peter Koh and Robert Koh have direct interests in the company of 10.23%[8] and 1.1% respectively, as of 31 March 2018.[9] Stephen Lee has a direct and deemed

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This is the abridged version of a case prepared by Lee Mei Jie Emma, Mohamad Robby Mifthahul Jannah Bin Jaffar, Poon Jey-Ren, Sattur Sanaya Milind and Yeo Min Qian Cassandra under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lum Shun Yi Richelle under the supervision of Professor Mak Yuen Teen.

interest of 19.79% in the company.[10,11] While he was deemed independent, Kee Poir Mok also has a direct interest of 0.8%.[12]

Peter Koh attributed Oceanus' dire state to inadequate planning and execution by management and periods of misfortune.[13] Issues he had to grapple with at the start ranged from "salaries for phantom workers and redundant expenses to threats by the local mafia and a riot caused by unpaid workers".[14] Oceanus saw its share price plunge from S$0.4070 in 2010[15] to S$0.004 in 2019.[16]

Stormy seas ahead

Formerly listed on the SGX SESDAQ (now known as Catalist Board) as TR Networks Limited in 2002, the company was later renamed Oceanus Group Limited after the reverse takeover of Oceanus Bio-Tech (Holdings) Ltd and its Chinese subsidiary on 29 April 2008.[17] On 25 May 2009, Oceanus was transferred from the Catalist Board to the Mainboard.[18] Between 2008 and 2010, Oceanus' business seemed to thrive, and its abalone assets grew from US$70 million to US$180 million over three years.[19] Its annual reports, however, showed that abalone sales were in fact declining over the years despite the reported profits.

An analysis of the annual reports between 2008 and 2010 showed that the bulk of its profits was attributable to fair value gains on the abalones rather than sales. This increase in value resulted mainly from a rise in the quantity of abalone, instead of the value per unit.[20] Some analysts viewed this as a red flag as they felt that existing abalones should have grown in size over the years, so a corresponding increase in value per unit should have been observed.[21] From 2008 to 2010, Oceanus reported approximately RMB2 billion in fair value gains against RMB1.2 billion of actual sales.[22]

Oceanus revealed that its auditors at the time, Deloitte & Touche LLP (Deloitte), needed over twenty people and three weeks to complete a five percent audit.[23] With an abalone population that was purportedly around 178 million at the end of 2010, this meant that a full audit would take years.[24] The incomplete audit raised questions regarding the remaining 95% of the tanks that were not audited. Some of the concerns included the reliability of the fair value gains on the abalones and the existence of the reportedly numerous remaining abalones.[25]

The first wave

On 9 November 2011, Oceanus reported that 42 million abalones had suffered mysterious deaths.[26,27] This number was approximately seven times the number reported in the same quarter the previous year.[28]

The loss of so many abalones resulted in a total loss of RMB1.2 billion in 2011, with RMB367 million written off for the "dead" abalones.[29] In Oceanus' response to SGX queries, the Group attributed the abnormally high mortality rate to the lack of food, summer heat, manpower limitations in the farms, and ultimately, the abalone producers' underestimation of the severity of the farm conditions.[30] The team said it then sent eight finance staff to its four farms in China to take stock of the remaining abalones.[31] Of these, 85.6 million were found to be laggards (too small for their age), and their fair value had to be written down by over 50%.[32] The company also announced that the "new mortality of abalones from now has to be matched by new empty shells".[33] This revelation left some to suggest that the shells of the 42 million dead abalones in this case were absent and that they may not have existed at all.

The board and the Audit Committee concluded that the system of internal controls and risk management maintained by Oceanus in the financial year ended 2011 was "inadequate in terms of financial, operational and compliance risks to safeguard shareholders' investments and the Group's assets".[34]

Oceanus' shares opened on 18 November 2011 at S$0.0662 and closed on 22 November 2011 at S$0.0795, following the public explanation from Oceanus regarding the abalone deaths.[35]

Man overboard

After the major setback in 2011, coupled with its declining performance, Oceanus' shareholders had enough. During the Annual General Meeting (AGM) later that year, shareholders representing more than 90% of Oceanus' shareholding voted against the re-election of the previous CEO, Yu De Hua, thereby removing him entirely from the board.[36] Earlier, in February 2012, Yu had been removed from his position as CEO of the company by the board of directors.[37] However, he had remained on the board as a non-executive director.[38]

In 2010, the remuneration of Dr Ng Cher Yew, the Executive Chairman, was disclosed within the band of "above $1,000,000" with no upper limit, and 44% of his total remuneration came from bonuses.[39] Yu's remuneration was under the next band of "$250,000 to below $1,000,000", with bonuses comprising 32% of his total remuneration.[40] That year, the Remuneration Committee consisted of three independent directors – Dr Ngiam Tong Tau, Lai Seng Kwoon, and Chua Hung Meng – and two non-executive directors – Dr Lim Lek Suan and Chu Chui Kuen.[41]

At the following AGM on 31 July 2013, Chua and executive director Wu Yong Shou faced strong opposition from shareholders, with 99% of votes against Chua and 95.5% against Wu for their re-election.[42] The latter remained as the General Manager in charge of Oceanus' China operations and production in the interim.[43] However, he was said to have become "increasingly un-cooperative towards the re-constituted board" after his removal from the board.[44]

Washed ashore

Just one day after the AGM on 31 July 2013, substantial and abnormal abalone deaths were reported to have occurred at Oceanus' China farms. Oceanus was notified of the deaths by the head of production on 2 August 2013 and again on 5 August 2013, but the board was unable to obtain verification through the finance team.[45] Oceanus suspended the trading of its shares.

On 30 August 2013, the company announced that the mortality was not "materially abnormal", and that it would not have any direct material adverse impact on the company's financials.[46] The affected abalones, said to be juveniles, had not been reflected in Oceanus' books and had no value attributed to them.[47] Oceanus' trading suspension was then lifted. This incident was not reflected in the 2013 annual report.[48]

In the third week of September 2013, more abalone deaths occurred when Typhoon Usagi hit the coastal areas in China.[49] The Singapore management visited the farms for on-site due diligence, to assess the extent of the damage. Preliminary estimation showed that losses in its biological assets amounted to RMB12.3 million.[50]

Despite the series of incidents, Oceanus still lacked a risk committee. The responsibility for risk fell on the board, Audit Committee, management and the Chief Risk Officer (CRO). The CRO, Matthew Tan, was only appointed on 16 September 2013,[51] and he then produced two risk management manuals. The measures introduced mainly aimed to improve farm safety, refine risk management plans by identifying potential farm hazards, and boost the breeding process of the abalones.[52] Tan subsequently stepped down on 1 November 2017 as he took on a new role as CEO of Oceanus Tech Pte Ltd (a wholly owned subsidiary), leaving Oceanus yet again without a CRO or a risk committee.[53]

Mayday!

Oceanus was issued a Disclaimer of Opinion for FY2011 by its external auditor Deloitte & Touche LLP (Deloitte) for several reasons, including unverifiable amounts such as the loss arising from the mortality of biological assets, as well as payables and other receivables.[54] Other reasons were insufficient evidence to determine the reasonableness of the value-in-use computation used to measure recoverable amounts for its investments in and advances to subsidiaries, and the failure to impair trade receivables. Deloitte also disclosed that the financial statements were prepared on a going concern basis.[55] In the same annual report, it was disclosed that Deloitte would not be seeking reappointment.[56]

In 2013, Oceanus appointed Foo Kon Tan LLP (FKT) as its new auditors.[57] FKT proceeded to express a Disclaimer of Opinion on the Group's financial statements from financial years ended 2012 to 2016.[58,59,60,61,62]

Meanwhile, SGX issued various queries with regards to the annual reports published by Oceanus. On 13 June 2014, SGX requested Oceanus to explain several key issues highlighted in its annual report. One of these included further disclosure of the breakdown of key management's remuneration, which was recommended by Guideline 9.3 of the 2012 Code of Corporate Governance. In response, Oceanus disclosed the remuneration of executive management in bands of S$250,000.[63] Another issue raised was the lack of documentary audit evidence, which led to the disclaimer of opinion involving biological assets, supporting accounting documents, and property, plant and equipment (PPE). Oceanus explained that due to the defiance and uncooperativeness of the ex-general manager and ex-Chief Financial Officer (CFO), the new management team faced great difficulties in securing supporting documents, including electricity billings, payroll, feed and sales.[64] Oceanus also claimed that records of abalones were previously kept by the farm workers in their personal note books.[65] SGX also queried whether Oceanus would be able to continue its operations by meeting its liabilities when they are due.

Fishing elsewhere

On 24 March 2015, Oceanus announced its intention to conduct a share consolidation exercise, to meet SGX's new minimum trading price criteria of S$0.20, by 30 September 2015.[66] However, on 3 September 2015, Oceanus announced its intention to transfer its listing from the SGX Mainboard to the Catalist Board, which it viewed as a "more suitable platform" which would improve its ability to attract investors. It entered into discussions with Stamford Corporate Services Pte. Ltd. to engage it as Oceanus' continuing sponsor.[67] Oceanus also explained that by transferring to the Catalist Board, it would not have to comply with SGX's new minimum trading price requirement. Thus, on 28 September 2015, Oceanus announced that the proposed share consolidation exercise would not take place.[68]

However, the next development delivered a significant blow to Oceanus, causing it to abandon its aspiration to attract more investors entirely.[69] The second wave had arrived.

Swept to the watch-list

On 14 December 2015, Oceanus entered the SGX watch-list under SGX Listing Rule 1311(1), as Oceanus had recorded pre-tax losses for three consecutive financial years and had an average daily market capitalisation of less than S$40 million over the previous six months.[70] To make matters worse, on 3 March 2016, Oceanus entered the watch-list once again, this time based on the minimum trading price criteria under SGX Listing Rule 1311(2) as its volume-weighted average price was below S$0.20 and average daily market capitalization was less than S$40 million over the previous six months.[71] Oceanus was required to exit the watch-list within three years from the effective date in relation to the applicable criterion to avoid being delisted.

Throw me a lifeline

On 8 December 2017, Oceanus applied to SGX for an extension of 12 months from 14 December 2017 to meet the Financial Exit Criteria.[72] SGX granted it an extension of up to six months to 2 June 2018.[73]

Between 2014 and 2018, Oceanus underwent debt restructuring twice. Having suffered losses for three consecutive financial years, it had cash flow problems and therefore, required an immediate injection of cash. On 31 October 2014, Oceanus entered a debt facility agreement with Ocean King Group Limited (OKGL) for a principal amount of S$30 million.[74] OKGL received share warrants as part of the agreement and by exercising them, the debt amount would be reduced proportionately. The restructuring also involved reducing the existing share warrants of debt holders, BW Investment Limited (BWIL), Ocean Wonder International Limited (OWIL) and Full Horizon Investment Limited (FHIL), as Oceanus' share price had dropped well below the existing exercise price.[75] The debt holders also received some shares in exchange for a portion of the debt owed. However, despite the first debt restructuring, Oceanus continued to suffer losses in the next two years. This eventually led to the second debt restructuring which occurred on 26 December 2017, as Oceanus was not able to pay its dues to its debt holders.[76]

The second debt restructuring by Oceanus involved converting a large portion of its outstanding debt to equity, with S$71.8 million or 85% of its outstanding debt converted into more than 19 million new shares.[77] The remaining S$12.8 million of debt was promised to be paid in cash on or before 31 December 2017, and was to be funded by the Group's internal resources[78] and the sale of its Gulei and Hulei Properties.[79] Hence, Oceanus managed to recognise a RMB273 million gain on the redemption of convertible loans and disposal of PPE, achieve zero debt, and receive an additional cash injection of S$6 million from 'new investors', which enabled the company to continue operating as a going concern.[80] It was stated in the debt-restructuring agreement that the amount of debts assigned to each of the new investors was determined on a pro-rata basis. Nonetheless, Peter Koh and Robert Koh, in their capacities as the key personnel managing the new funds, received 84.84% more shares in proportion to the money invested, as compared to the other 'new investors' involved in the debt restructuring. Consequently, Peter Koh's overall shareholdings increased significantly by 4.24%.[81] His overall shareholdings in Oceanus as a result of the debt-equity exercise increased from 0.24% to 10.23%.[82]

Another impact the second debt restructuring had was that it allowed Oceanus to fulfil the Financial Exit Criteria in order to be removed from the SGX watch-list. According to SGX Listing Rule 1314(1), an issuer may be removed from the watch-list if it is able to record a consolidated pre-tax profit for the most recently completed financial year and has an average market capitalisation of S$40 million or more over the previous six months.[83] Prior to the extension and debt-equity swap, the average market capitalisation of Oceanus for the period from 14 June 2017 to 14 December 2017 was S$39,508,150.86, below the minimum requirement. On 1 June 2018, Oceanus had an average six-month market capitalisation of S$201,750,091.78. Due to the one-time gain that resulted from the debt-restructuring, Oceanus recorded a supernormal profit of RMB189 million in 2017.[84] Hence, on 1 June 2018, one day before the new deadline, Oceanus requested to be removed from the SGX watch-list.[85]

More boats to stay afloat

In a bid to penetrate the Australian market, Oceanus entered into a collaboration agreement with Australian-based seafood processor and producer, BNY Abalone World Factory Outlet Pty Ltd (BNY), on 27 July 2017.[86] The agreement stated plans for Oceanus to gain an ownership of 60% in BNY in exchange for administrative, management and accounting support.[87] BNY was thus renamed Oceanus Australia Abalone World Pty Ltd (OAAW).[88] OAAW also planned to incorporate a joint-venture company and international sales office in Singapore, named Oceanus Australia Abalone World (S) Pte Ltd (SG JV Co), for international sales, procurement of farm abalones in China, trade facilities and finance purposes.[89]

On 1 March 2018, Oceanus announced that it had received letters from vendors of the BNY Shares alleging that the acquisition was void and calling for the shares to be transferred back to them.[90] As a result, BNY refused Oceanus access to its accounting and other records. Oceanus claimed that this would have no material impact on its financial results for 2017 and its core businesses.[91]

SG JV Co was eventually struck off.[92] For the financial year ended 2017, Oceanus recognised an impairment loss on the cost of investment of RMB17 million in OAAW.[93] Despite the impairment loss amounting to more than 80% of revenue, it was stated that it had no significant impact on the company.[94] Due to a lack of documentary support, FKT was unable to verify the impairment loss, and therefore, the carrying amount of the investment that year.[95]

In September 2018, Oceanus entered into a convertible loan agreement with Barramundi Asia Pte Ltd (BAPL), which marked its first venture into fish farming.[96] Between March 2019 and April 2019, Oceanus incorporated two new subsidiaries – Oceanus Opal (S) Pte. Ltd. (OOPL) and Oceanus Feed Pte Ltd (OFPL).[97,98] While OOPL was created to operate hatcheries and fish farms, no explanation of OFPL's principal activity was provided in the initial announcement, other than the fact that it was "in line with the Group's business plans".[99] In March 2019, it acquired 51% of the shares in an integrated marketing firm, AP Media Pte. Ltd.[100] Interestingly, prior to this acquisition, Oceanus had obtained shareholders' approval to eliminate the objects clause in its constitution.[101,102] It replaced the objects clause, which was no longer mandatory to state in the memorandum of association under the Companies Amendment Act of 2004, with a new Regulation 3 granting the board the "full rights, powers and privileges granted under Section 23(1) of the Companies Act".[103]

More big waves

On 2 March 2017, SGX requested for more information with regards to the cessation of two key personnel: Group Financial Controller, Tan Pern Yeen on 16 February 2017, and non-executive director and Chairman, Dr Ng, 12 days later. Oceanus responded that the cessations were due to health reasons for Tan and personal interests for Dr Ng.[104] The next day, Oceanus retracted the response and replaced it with another, citing personal interests for the cessation of both personnel.[105]

On 8 January 2018, Oceanus' non-executive and non-independent director Jason Aleksander Kardachi was disqualified from acting as a director for five years because he had been a director of at least three companies that were struck off the register within five years.[106] As it turned out, Oceanus was only informed of his disqualification on 26 December 2018 through a letter sent by Kardachi. He stated in his letter that his directorships in those companies that were struck off were "incidental to his job as an insolvency practitioner and do not suggest his lack of ability, integrity of competence to act as a director of a company"; that he did not fit into the profile of errant directors that the law targets; and that "his disqualification will not serve the purpose of protecting the public".[107]

For FY2017, FKT expressed a qualified opinion on the Group's financial statements.[108] Lingering issues relating to unverifiable amounts of payables, loans and biological assets contributed to this outcome.[109] Aside from a lack of documentation to support transactions, other questions arose in assessing payables when it was revealed that an amount of RMB1 million was paid to an executive director to settle a liability that had arisen in 2016.[110] The liability was said to have resulted from the director's payment of the sum to a third party on behalf of a subsidiary, "in the interest of time", to regain control of a farm seized by the subsidiary's contract security and protection services provider.[111] In Oceanus' treatment of convertible and other loans, FKT found that FRS32 and FRS39 had not been complied with respectively.[112]

As for biological assets, due to the management not conducting a physical count of them on 31 December 2016, it could not be determined whether retrospective adjustments would have consequential effects on the financial statements for 2017.[113] Finally, the impairment loss recognised on the cost of investment in Oceanus Australia Abalone World Pty Ltd (OAAW) due to its refusal to allow Oceanus access to its accounting records also lacked supporting documents for verification.[114]

The silver lining in this assessment was that the resultant adjustments led Oceanus to report a net profit that was eight percent higher than the unaudited value.[115] Despite the initial mutual agreement for FKT to be reappointed as auditors for the following year,[116] the Group ceased the engagement of FKT later that year.[117] This was considered to be “timely” and to potentially “enable the Company to benefit from fresh perspectives and views”.[118] Oceanus confirmed that there were no disagreements with FKT on accounting treatments within the last 12 months.[119]

The cessation of FKT was subject to both the Accounting and Corporate Regulatory Authority (ACRA)’s consent and shareholders’ approval at an Extraordinary General Meeting (EGM), both of which were received.[120] At the EGM, which was held on 29 January 2019, the resolution to appoint RSM Chio Lim LLP as the new auditors was approved by the shareholders; subsequently, a special resolution to adopt a new constitution was passed.[121]

Oceanus’ directors have been involved in various other companies that have been in the spotlight for questionable corporate governance or financial difficulties. Current independent director, Kee Poir Mok, was also the Audit Committee Chairman of YuuZoo Corporation (YuuZoo). He subsequently retired at the company’s first AGM on 29 May 2015, less than six months after his appointment.[122] YuuZoo was described as “a corporate governance nightmare”, as the company had at least 15 departures of directors and other key officers, all citing other commitments, personal interests or personal reasons.[123]

Former independent director, Lai Seng Kwoon, who left Oceanus in 2012,[124] was also a former independent director of Celestial Nutrifoods. In 2016, together with other members of that board, Lai was sued by liquidator Yit Chee Wah, for a breach of director’s duties.[125] Lai Seng Kwoon was also involved in another major controversy as Audit Committee Chairman of another troubled S-chip, China Sky Chemical.[126]

Former Audit Committee Chairman and independent director, Alvin Yeo Kan Yen, who left Oceanus on 30 April 2018,[127] is also currently the Vice-Chairman and executive director of Cacola Furniture International (Cacola).[128] Cacola was delisted on 3 April 2018, after its request for extra time to exit the watch-list was rejected.[129]

Former independent director, Nelson Goh Kok Liang, who left Oceanus on 30 June 2014,[130] was also an independent non-executive director of Pacific Healthcare Holdings Limited (Pacific).[131] Pacific was delisted 3 July 2015, after failing to meet the requirements for its removal from the SGX watch-list.[132]

Living on borrowed time

On 1 June 2018, Oceanus applied to SGX to exit the watch-list as they had met the necessary financial criteria in FY2017.[133] In addition, Oceanus applied to SGX for an extension of time to hold the AGM for the financial year ended 2018. This was due to changes in the financial statements for the previous financial year which would have consequential effects on financial statements for the financial year ended 31 December 2018.[134] Perhaps things may take a turn for the better in time, as CEO Peter Koh received the Outstanding CEO Award from Influential Brands in 2018.[135] However, as of 13 June 2019, Oceanus had yet to be removed from the watch-list although it had been granted a further extension until 31 July 2019 for its exit.[136]

Discussion questions

1. Comment on the board's responsibility with regard to the significant losses that arose from the abalone deaths. What could have been done to improve the risk management and internal controls in Oceanus? Discuss whether the series of abalone deaths were "black swan" or "grey rhino" events.

2. Examine the size and composition of the current board at Oceanus. To what extent has the company complied with the Code of Corporate Governance in Singapore? Discuss the potential warning signs investors could look out for in terms of director profiles.

3. Comment on the board's decisions with respect to diversification, acquiring more companies and forming more subsidiaries, with reference to SGX Chapter 10 Listing Rules. Discuss whether amending the constitution and removing the objects clause is in the best interests of the company. What are the risks to minority shareholders with respect to these decisions?

4. Kardachi had been acting as a director for almost a year before his disqualification was made known to Oceanus. During that time, he would have participated in making key decisions on the board. Do you think those decisions remain valid? Explain. He was automatically disqualified under the criteria specified in the Companies Act but claimed that he was not aware of this disqualification. Do you think this is a flaw of the automatic disqualification system or is Kardachi responsible? What changes would you recommend to the system, if any?.

5. Discuss the accounting and non-compliance issues relating to Oceanus that were raised by its auditors and whether the multiple disclaimers of opinion issued should be taken more seriously by the board and the regulators. In your discussion, compare SGX's watch-list entry criteria with Bursa Malaysia's PN17 or GN3 rules and evaluate whether SGX should adopt Bursa Malaysia's approach.

6. Oceanus was able to meet the Financial Exit Criteria of the watch-list in FY2017 through its debt restructuring process. Currently, the company remains in limbo in the watch-list. With reference to this case, evaluate the effectiveness of the watch-list's exit criteria and SGX's responses throughout.

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SHANGHAI TURBO: STALLED ENGINE

Case overview

On 15 April 2017, the results of the Annual General Meeting (AGM) of Shanghai Turbo Enterprises Ltd, an S-chip company, led to the cessation of executive director and Chief Executive Officer (CEO) Liu Ming after 56.86% of shares voted against the resolution to re-elect him. This led to a series of episodes related to his retaliation against the new management. This raises pertinent legal and corporate governance issues surrounding S-chip companies as well as investor protection issues. The objective of this case is to facilitate a discussion of issues such as removal of directors; the implications of changes in ownership structure; directors' responsibilities; rights of shareholders; and the corporate governance implications of different legal systems.

About the company

Shanghai Turbo Enterprises Ltd (Shanghai Turbo) was incorporated in the Cayman Islands on 14 July 2005 and listed on SGX on 16 January 2006.[1] As of 2017, Shanghai Turbo wholly owned a Hong Kong incorporated entity, Best Success (Hong Kong) Limited (Best Success). Best Success wholly owned a subsidiary called Changzhou 3D Technological Complete Set Equipment Co. Limited (CZ3D) which specialises in precision engineering, manufacturing of vane products and related subcontracting services. CZ3D is the only income generating entity of the Group. Both Best Success and CZ3D act as investment holding companies.[2]

Liu Ming, a Chinese citizen resident in Changzhou, Jiangsu Province, China, owned almost 30% of the shares in Shanghai Turbo as at 30 April 2019. After the passing of his father, Liu took over the business by inheriting his father's shares, becoming the largest substantial shareholder of Shanghai Turbo.[3]

This is the abridged version of a case prepared by Chua Yong Jun, Denise Goh Li Wen, Leow Li Feng, Neo Zhen Cheng and Ong Minyi 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. This abridged version was edited by Emma Lee Mei Jie under the supervision of Professor Mak Yuen Teen.

Removal of Liu Ming

Shanghai Turbo faced a steady decrease in profits from 2014 to 2016, and in 2017, the Group generated a net loss after tax of RMB156,070,000.[4] It was alleged that Liu had been transferring CZ3D's profitable business and customers to his own private company[5] and using CZ3D's resources for the benefit of this private company.[6]

At the AGM held on 15 April 2017, Liu's position as a director of the company came to an unexpected and abrupt end, as 56.86% of shares voted against his re-election.[7,8] The cessation of Liu as executive director and CEO of Shanghai Turbo called for a handover of management responsibilities.[9]

After Liu's removal from the board, Shanghai Turbo's board comprised of three directors, namely Daniel Liu, Raymond Lim and Jack Chia.[10] Daniel Liu was a non-executive, non-independent director while the other two were non-executive independent directors. Jack Chia was the lead independent director, before being appointed as non-executive independent Chairman on 1 August 2017.[11]

Delayed handover or illegal takeover?

With the unexpected cessation and abrupt handover of responsibilities to new management, production activity at the Group's factory in Chang Zhou faced temporary disruption.[12]

On 8 May 2017, Zhang Rong was appointed by the board as the CEO of CZ3D. Zhang Rong was previously a general manager of J&R Consulting (Beijing) Co., Ltd and Centrosolar Glass Trading Co., Ltd. The Shanghai Turbo board viewed him as an experienced and capable person, and believed that his appointment would be beneficial to CZ3D and the Group.[13]

Although Shanghai Turbo's normal business operations were initially expected to resume within a week, the operational halt was further extended and the expected resumption date of operations was postponed by a month. [14,15] The company further revealed that this would disrupt the revenue stream of the Group for that period.[16]

On 2 July 2017, the new management team of CZ3D convened a general meeting of all the employees of CZ3D. 205 of the 219 employees who attended signed an open letter to the local government authorities, requesting for assistance to end the illegal occupation of the factory premises by some of the former management personnel. Plans were also made to resume control of the factory premises peacefully by mid-July 2017.[17]

As of 20 July 2017, the former management personnel and their associates continued to occupy the CZ3D's factory premises illegally, and the factory's production was still halted due to the loss of operational control of CZ3D. A second general meeting was held by the new management team and two board members on 21 July 2017 in an attempt to regain control of CZ3D. An announcement was then released, stating that employees would receive compensation regardless of their decision to stay or leave the company. Most of the employees chose to stay in the company, but some demanded higher compensation.[18]

Chaos and violence

In addition to the production halt, CZ3D's new management team faced difficulties when it tried to enter CZ3D's premises – the team was blocked by security guards employed by the old management team.[19] The new management team had to explain to the workers the implications of illegally occupying the company premises, and threatened that it would have to resort to government assistance to evict the security guards.[20]

When Raymond Lim, Zhang Rong and their associates attempted enter the factory premises, they were physically assaulted with plastic batons by associates of Liu.[21] This assault led to physical injuries from "bruises on face and limbs, bleeding on the head to bone fractures of the limb(s)".[22] The incident was brought up to the local police and Singapore Consulate-General in Shanghai.[23] Following the assault, local authorities quickly intervened to remove the trespassers from the factory premises through the use of riot police, and some individuals were also arrested.[24]

Shanghai Turbo's operational losses

During this "five-month impasse" in the operational handover of CZ3D, the Group faced a steep financial decline. The 2017 full-year results revealed a drop in Group revenue from RMB136,977,000 in 2016 to RMB35,299,000, and net loss of RMB156,070,000 – a drastic drop from 2016's gross profit of RMB2,293,000.[25, 26]

Consequently, an Emphasis of Matter audit opinion was issued by the independent auditor for Shanghai Turbo's 2017 financial statements, which raised material uncertainties that cast doubt on the company's ability to continue as a going concern. These uncertainties mainly included the recoverability of receivables from two major customers of the Group, inventory write-down, and impairment of non-current assets.[27]

Legal episodes

On 27 June 2017, Shanghai Turbo issued a Writ of Summons against Liu to facilitate the handover of operations to the new management of CZ3D, on the grounds of Liu's failure to adhere to certain obligations in his service agreement with Shanghai Turbo.[28] The proceedings were mainly based on the following alleged breaches of the service agreement: Liu's failure to deliver up the CZ3D factory to the new management, diversion of business to another company, and disclosure of confidential information.[29]

As a pre-emptive defence, Shanghai Turbo secured a S$30 million injunction from the Singapore High Court against Liu on 15 September 2017. This effectively froze the disposal of his assets through a Mareva Injunction. He was also restrained him from requisitioning any Extraordinary General Meeting (EGM) to remove current directors or appoint new board members (Voting Injunction) and prevented from exercising his voting rights.[30]

Subsequently, an anonymous requisition letter was received by Shanghai Turbo on 20 October 2017, requisitioning for an EGM to replace the entire board with three former directors – Huang Wooi Teik, Kelvin Tan and Liu – as well as Pan Haiya, who was Liu's assistant.[31]

In November 2017, the requisition letter was deemed to be invalid.[32] On 4 January 2018, another requisition letter regarding the removal of the current board was sent, this time by two shareholders of Shanghai Turbo - Lin Chuanjun and Zhang Ping, collectively known as the "Requisitioning Shareholders".[33]

On 18 January 2018, Shanghai Turbo obtained another injunction against Liu, restraining him from exercising his voting rights. At the same time, Shanghai Turbo also sought to add Lim Chuanjun and Zhang Ping to these proceedings, to restrain them from holding an EGM to remove the new board.[34]

In response to the injunctions secured by Shanghai Turbo, the Requisitioning Shareholders appealed to the Singapore High Court on 9 March 2018 to vary the injunction. This resulted in the restraining of the company from issuing any shares, rights, or securities.[35]

On 20 March 2018, Liu challenged the jurisdiction of the Singapore courts on the injunctions placed on both himself and the Requisitioning Shareholders. Eventually, the Singapore High Court decided that this case laid in the hands of the Chinese Courts, and set the injunctions aside.[36]

Shanghai Turbo then filed an appeal on 18 May 2018 against the discharge of injunctions against Liu only. This allowed the injunctions against the Requisitioning Shareholders to be discharged, hence requiring the company to convene the EGM. The company persisted in its appeal for the stay on the orders discharging the injunctions against Liu.[37]

Plea to shareholders

Shareholders were notified of the convening of the EGM through a circular, and Shanghai Turbo urged them against voting for the removal of the current board due to various reasons. Firstly, there would be loss of continuity of oversight as Shanghai Turbo would lose a board of seasoned directors with significant commercial experience. According to the Appendix attached to the circular, none of the three proposed directors have directorship or senior management experience in a Singapore company, and do not have relevant formal training to equip them for such a role either. Secondly, the company will not be in compliance with Rule 221 of the Listing Manual of the SGX-ST if the proposed directors were to be elected as only one of the three proposed directors is a resident in Singapore. Rule 221 requires foreign issuers to have at least two independent directors who are Singapore residents. Additionally, the Requisitioning Shareholders and proposed directors were not interviewed by the current board and therefore little is known about their respective backgrounds and qualifications.[38]

View of the Securities Investors Association (Singapore)

"There appears to be no legitimate reason for two new shareholders to remove the current board,"

– SIAS President, David Gerald[39]

Securities Investors Association Singapore (SIAS) wrote an article, urging minority shareholders to stand firm and vote responsibly in the upcoming Shanghai Turbo EGM to keep the current board. This was based on two reasons, the first being the jurisdiction over the legal issues. It was noted that Liu's case was handed over to Chinese Courts. As a company listed in Singapore and having raised capital from Singaporeans, it was questionable for the jurisdiction of this lawsuit to be handed over to the Chinese Courts. Secondly, there was high possibility that Lin Chuanjun, Zhang Ping and Liu may be acting in concert, which would result in them exceeding the 30% threshold in shareholding. This would require them to make a general offer to shareholders. This was supported by Allport Ltd, a 27% stake shareholder of Shanghai Turbo since its Initial Public Offering in 2006 as "they too find it troubling that two new shareholders, whom they believe have recently acquired the new shares are joining forces to call for the removal of the current directors and the fact that this is the second attempt in doing so".[40]

The Court's decision

After the discharge of the injunction against the Requisitioning Shareholders, Shanghai Turbo was still left with legal disputes against Liu. The company initiated proceedings on the terms of the service agreement, which was written with a "floating" choice of law and jurisdiction sub-clauses. This resulted in the resolution by the Court that there was no basis to exercise jurisdiction over Liu, thereby setting aside the Mareva and Voting Injunctions.[41]

However, on 27 September 2018, the Court of Appeal ruled in favour of Shanghai Turbo with regards to the setting aside of the Mareva and Voting Injunctions in respect of Liu.

Uncertain future

The disruption in operations following the removal of Liu and actions of the Requisitioning Shareholders were highly detrimental to Shanghai Turbo and its shareholders. This was just the latest case of foreign-incorporated companies, particularly S-chip companies, having legal or corporate governance problems and often ultimately, delisting from SGX.[42] Could this be a call to action for SGX to tighten listing rules or implement additional preventive measures to enhance investor protection?

Future of Shanghai Turbo's board

Despite the Court of Appeal ruling in favour of Shanghai Turbo, three non-executive independent directors resigned from Shanghai Turbo on 1 October 2018. This was followed by the appointment of four new non-executive independent directors – Wee Liang Hiam, Leng Yew Chee Philip, Ong Sing Huat and Seet Chong Tong. The introduction of the new directors to Shanghai Turbo's board was intended "to produce a fresh perspective in light of the ongoing issue with Zhang Ping and Liu Ming". [43]

Not long after, announcements regarding the removal of these four new directors were made on 30 April 2019. [44,45,46,47] The four directors all failed to be re-elected by the same margin of votes, with a combined 52.6% of shareholders voting against them during the AGM on 30 April 2019.[48] Despite being rejected as proposed directors at the EGM in February 2019, Koh Wee Kiang and Loh Kai Keong were appointed as independent directors during the AGM, with the former becoming the new Remuneration Committee Chairman, and the latter heading the Audit Committee.[49,50] The other two independent directors appointed at the AGM were Lee Kiang Piaw, and Kuang Wooi Teik.[51,52]

The turbulence continues

On 12 April 2019, the independent auditor of Shanghai Turbo issued a disclaimer of opinion with respect to the company's consolidated financial statements for FY2018. Reasons for the disclaimer include the inability to verify the appropriateness of the company's going concern assumptions used for the preparation of the financial statements, together with issues of insufficient appropriate audit evidence.[53] At the 30 April 2019 AGM, shareholders refused to accept Shanghai Turbo's latest audited financial statements.[54]

Shareholders representing 55.66% also blocked the resolution to allot and issue new shares in the company.[55] With these turbulent meetings, lawsuits and board changes, what would it take for Shanghai Turbo to get back on track again?

Discussion questions

1. Despite the removal of Liu Ming from the board, he continued to have significant influence in the management of CZ3D. Discuss why this is so and the challenges this poses to board oversight and corporate governance generally.

2. Shareholders of foreign incorporated companies often have trouble taking action against directors and officers of such companies. Based on Shanghai Turbo's situation, how could minority shareholders be better protected?

3. Comment on the role and effectiveness of the Securities Investors Association (Singapore) in protecting minority shareholder interests in Singapore. What more can be done to protect the interests of minority shareholders?

4. What are the roles and duties of independent directors? In the case of Shanghai Turbo, do you think they adequately discharged their duties? In your opinion, should the three independent directors have resigned? Explain.

5. With reference to Rule 14.1(a) Singapore Code of Takeovers and Mergers, should the Requisitioning Shareholders be considered to be acting in concert with Liu Ming? The issue of concert parties often arises in a number of situations, such as change of control and interested/related party transactions. For example, there have been many instances of new shareholders acquiring just below the 30 percent threshold for a mandatory general offer (MGO) and taking control, without triggering a MGO. How can the concept of concert parties be better enforced?

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SINGHEALTH: POOR DATA HEALTH

Case overview

In June 2018, a series of security inadequacies and blunders led to the theft of data belonging to 1.5 million individuals, following a cyberattack on SingHealth. Singapore's Prime Minister Lee Hsien Loong had his medical data targeted "specifically and repeatedly". News of what was the largest cyberattack Singapore had faced to date sent shockwaves throughout Singapore and beyond, and raised issues about the ability of public institutions to protect and safeguard data. Following the incident, a Committee of Inquiry (COI) was set up in late July 2018 to investigate how the cyberattack occurred, its root causes and impact. The investigation had uncovered many lapses and software vulnerabilities that led to the cyberattack. The objective of this case is to facilitate a discussion of issues such as cybersecurity breach; risk management; crisis management; as well as to understand and apply the risk management process employed prior to their breach.

The key players

SingHealth's technology partner and software provider played key roles in the cyberattack.

SingHealth's technology partner: IHiS

Integrated Health Information System (IHiS). founded in 2008, serves as the information technology (IT) arm for Singapore's Ministry of Health (MOH).[1] Apart from being responsible for the upkeep of enterprise security measures in SingHealth,[2] IHiS has also implemented systems such as integrated queue and payment, medication automation and management, data analytics, medical device integration, video consultation, and TeleRehab in SingHealth.[3]

SingHealth's software provider: Allscripts Healthcare Solutions

Allscripts Healthcare Solutions (Allscripts), the vendor for the software which was hacked, had been SingHealth's software partner since 1999. The software, named "Sunrise Clinical Manager" (SCM), was the storage unit for all of SingHealth patients' Electronic Medical Records (EMR).[4]

This is the abridged version of a case prepared by Daryl Lee, Ganesh Muthupalani, Rachel Koh, Long Yingjie and Tyo Germaine under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to servce as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case or any of their directors or employees. This abridged version was edited by Elizabeth Ong under the supervision of Professor Mak Yuen Teen.

The calm before the storm

Zhao Hainan: Tempest in the teapot?

In 2014, weaknesses in SingHealth's EMR system were discovered by Zhao Hainan, an Allscripts employee. He was the first to discover that the loopholes in the system would allow unrestricted access to critical data stored in the system.[5]

Zhao disclosed the loophole to Allscripts' rival, Epic Systems.[6] According to Zhao, the loophole he discovered "could lead to a serious medical data leak, or even a national security threat".[7]

Allscripts intercepted the email and forwarded it to IHiS' Chief Executive Officer (CEO) Dr Chong Yoke Sin. The email stated that an employee had discovered an alleged security loophole in the EMR system. Allscripts Asia Pacific CEO David Chambers warned Dr Chong that the matter was "very serious" and must be taken as "genuine" as Zhao had worked in Allscripts' development laboratory.[8] Zhao was eventually dismissed by Allscripts.[9]

Lack of urgency

Dr Chong forwarded the email to Clarence Kua, Deputy Director of SingHealth's Chief Information Office, to investigate further. However, instead of looking into the alleged security flaw, Kua placed greater priority on verifying Zhao's private email address.[10]

Dr Chong also forwarded Allscripts' email to Foong Lai Chooi, IHiS Director of Programme Delivery for Clinical Care. Foong was in charge of operating and managing the EMR system. She was under the impression that the loophole "was not a big deal", as the alleged flaw would be "irrelevant" following recent upgrades to the system architecture. As such, she did not take further action to investigate the issue.[11] In the COI hearing, Foong testified: "I believe there was some communication between Mr Chambers from Allscripts and (Dr Chong Yoke Sin) but I was not included in the communications. I do not know what action, if any, was taken by Allscripts in relation to this matter."[12]

The case was closed after IHiS made a police report.[13]

Solicitor-General Kwek Mean Luck, a member of the four-member COI, commented during the COI hearings that the failure to address the alleged loophole in the security of the system could have been a contributing factor to the SingHealth attack.[14]

The eye of the storm

From as early as August 2017, SingHealth's cyber attacker had gained entry into the Group's network. This was done by planting a malware in a front end workstation. There, it stayed dormant for four months. The cyber attacker only started distributing malware to other workstations in December 2017, gradually moving horizontally in the network with the eventual objective of penetrating into the Group's EMR system. The hacker was careful and deliberate in erasing traces of his activities. Finally, in May 2018, the cyber attacker took advantage of an inactive administrator account to log into a server. After gaining a foothold in the system, the cyber attacker found a link to another system containing the EMR database.[15]

Counterstrike

On 4 July 2018, Chai Sze Chun, a database administrator for IHiS, noticed that the database activity did not make sense to him. It was a direct data query using Prime Minister Lee Hsien Loong's identity card number. Other queries raised were related to demographic data of patients and the medication that was dispensed. After a few instances, the queries stopped. Upon further probing, Chai Sze Chun identified the logins from a workstation and tried to find the user-ID of the person logging in. Despite his best efforts, his attempts were futile. The user-ID was untraceable. When Chai communicated his difficulties to Katherine Tan, another database administrator, he found that she had encountered similar query requests.[16]

However, as they were uncertain about the user who was running the queries, they decided to terminate the process of the queries and observe if any user would contact IHiS. However, no calls were received.[17]

Sensing that something was amiss, Chai tried to recall the procedure for reporting an IT security incident back from the time when he was still a trainee, to no avail. In the COI hearing, it was brought to light that other IHiS employees were also unaware of any formal security reporting framework at the organisation.[18]

Without knowing how to report the suspicious incident, Chai informed his supervisor, Steven Kuah, of his findings in July 2018.[19] Subsequently, the attack was made known to the Cyber Security Agency of Singapore (CSA), SingHealth, MOH on 10 July 2018. [20]

One up for the attackers

By the time the system was closed, patients' confidential data had already been stolen between 27 June 2018 and 4 July 2018.[21] Subsequently the public was informed that this "deliberate, targeted and well-planned cyberattack" accessed 1.5 million SingHealth patients' data, including their names, NRIC number, address, gender, race and date of birth. Of these, 160,000 patients had their medical records stolen. It was later revealed that patients who visited

SingHealth's specialist outpatient clinics and polyclinics between 1 May 2015 and 4 July 2018 had their records targeted.[22]

A joint statement from the MOH and Ministry of Communications and Information (MCI) said that the records were not tampered with (i.e. amended or deleted) and no other patient records – such as diagnosis, test results or doctors' notes – were breached.[23]

It was later revealed that the entire hack was executed mainly to get to the crown jewel of all data: Prime Minister Lee Hsien Loong's medical information.[24] With regards to the incident, Solicitor-General Kwek said that "inadequate situational awareness and response to red flags contributed to the data breach."[25]

Weathering the storm

In light of the events, SingHealth, IHiS and other government bodies scrambled to launch responses to control the cyberattack and appease the public.

Patching the cracks on the wall

Within SingHealth, immediate IT measures were implemented to contain the damage from the attack. As a precautionary measure, temporary internet surfing separation was implemented on all computers in SingHealth.[26] Furthermore, IT access controls on computers and servers were strengthened, all accounts were reset and users were required to change their passwords. A greater degree of user and monitoring controls were also implemented for computers and servers.[27]

Making things right with the public

SingHealth set up numerous channels to communicate details about the attack and assure its patients. A total of two million text messages were sent out to inform all affected patients after the first public announcement. Apart from that, 434,000 letters were later sent out to patients whom SingHealth could not reach via SMS or had no contact details in its system.[28]

Phone hotlines were manned by volunteer staff and a dedicated email address was also set up in anticipation of queries from patients and the public. SingHealth hotlines and call centres received a total of 13,400 calls in relation to the data breach. The public could also use the SingHealth website or the Health Buddy Mobile app to check if they were affected by the data breach. A total of 215,600 checks were made by patients on these digital platforms.[29]

Pause on Smart Nation projects

In light of the attack, all of Singapore's Smart Nation plans, including mandatory contribution to the National Electronic Health Record project – which enabled the sharing of patients' treatment and medical data among hospitals – were paused from 20 July 2018 to 3 August 2018.[30]

Reviewing cybersecurity
The CSA, together with the Smart Nation and Digital Government Group, reviewed the cybersecurity policies in the public sector. They issued a joint statement on 3 August 2018 proposing additional measures to protect IT systems in the public sector.[31]

The CSA also asked institutions in 11 critical sectors to review their IT systems to identify connections to untrusted external networks. The eleven sectors were government, infocommunications, energy, aviation, maritime, land transport, healthcare, banking and finance, water, security and emergency, and media.[32]

A period of self-reflection

As the dust settled on the "most serious breach of personal data" in Singapore's history, the COI was set up on 24 July 2018 to investigate the SingHealth data breach. The four-member COI was tasked to investigate the sequence of events, factors causing the attack and the impact of the attack. The COI would also assess the responses by SingHealth and IHiS and recommend measures to improve data-security and responses to data breaches in SingHealth and other public sector institutions.[33]

The COI hearings detailed multiple lapses and software vulnerabilities that led to the cyberattack.

Falling through the cracks: Lapses in server
Typically, servers are patched (updated) several times a month. However, the exploited servers in SingHealth's critical systems did not get any security updates for 14 months. As a result, this server became one of the many pathways the hackers exploited.[34]

There was also inadequate security to restrict access to the server. One of the weaknesses highlighted was that one administrator account for SingHealth's group server which was linked to the EMR had the password "P@ssw0rd". This was a weak password that could be decrypted easily, providing an opportunity for exploitation.[35]

Furthermore, the workstations in SingHealth were running a basic version of Microsoft Outlook, which had not been updated. As a result, it could not recognise the hacking tool, allowing the attacker to gain access.[36]

Lack of cybersecurity expertise in management
The COI also revealed that there was no official assignment of personnel to manage the server. Tan Aik Chin, a senior manager of the Cancer Service Registry and Development at the National Cancer Centre Singapore (NCCS), testified that he became the "convenient" custodian of the server in question. Though he was not supposed to manage the server, he had been doing so since 2014.[37]

The reason for this was not due to Tan's expertise for managing data servers but out of "convenience" because the server was located at the NCCS, where he worked. His main job was to plan business continuation programmes. As such, he was not trained in cybersecurity or server administration and had not been given any standard operating procedures for managing security incidents.[38]

Poor work culture in IHiS

In June 2018, IHiS database administrator Katherine Tan reported her discovery of unusual activity to her boss, Teresa Wu. However, instead of providing advice and next steps to take, Katherine Tan was told by Wu to approach other colleagues for their opinion. Katherine Tan proceeded to email her co-workers but received no responses.[39] She did not take further action for the next month until it was brought to her attention by Chai Sze Chun over lunch that he noticed similar unprecedented, unusual queries from the system.[40]

Even the security incident response manager did not appreciate the severity of the threat. IHiS Senior Manager for Infra Services-Security Management Ernest Tan told the COI that he was busy "clearing emails" after returning from his holiday. As such, it did not dawn on him to attend to the matter immediately. When he finally got to it, he decided that the matter was not a serious breach. Even if it was a "reportable security threat", it would have been the security officer's job to escalate action against the threat. When questioned further at his inaction despite sitting at a position higher than a security officer, Ernest Tan referenced standard operating protocol and said that the situation "did not ring alarm bells".[41]

Ernest Tan also delayed the reporting of the incident to higher management, fearing the need to "work non-stop" to answer managements' queries. He was told by a junior staff that the attacker had gotten into the system via IHiS' internal messaging application, who urged him to report the incident to higher management. To this, Ernest Tan was quoted to have replied: "If I report the matter, what do I get?" Despite being the designated response manager for all security incidents in SingHealth, Ernest Tan avoided reporting the matter. He did not want his team to be put under pressure to deliver answers. Upon further questioning by the COI, he also said that he was "too stressed to work that weekend" because his mother was hospitalised.[42]

Solicitor-General Kwek commented on the initial response to the security breach as "piecemeal" and "inadequate" and said that more could have been done to prevent the security incident.[43] Fingers were pointed directly at management. He added that "management's failure to ensure that systems were updated and well-maintained could have provided hackers access into SingHealth's network as early as August 2017".[44]

Head knowledge syndrome

Additionally, it was observed that staff and management did not report the incident in a timely manner as required under CSA's National Cyber Incident Response Framework (NCIRF). Given that the SCM system is a Critical Infrastructure Information system, a cybersecurity incident occurring in the SCM system would, in fact, be considered a Category 1 incident under the NCIRF and require verbal reporting to CSA by the sector lead within two hours. However, the staff "did not fully appreciate that multiple cybersecurity incidents culminating in a breach of the SCM database were occurring" as concluded by Solicitor-General Kwek. As such, prompt reporting was not done.[45]

Disorganised communication

SingHealth employees often used many different platforms to communicate important information. The platforms used were mainly WhatsApp, TigerConnect, email, phone calls or face-to-face communication. As a result, many important details were not officially recorded. Follow-up action on vital issues was also not prompted.[46]

During the COI hearing on 13 November 2018, experts suggested that SingHealth implement a centralised incident management and tracking system that logs all incidents pertaining to a breach. Vivek Chudgar, who was also involved in the investigations of the 2016 Bangladesh Central Bank cyber heist, highlighted that an organisation of SingHealth's scale should have a proper way to capture and organise information. That would have gone "a long way" in aiding the response to the cybersecurity breach. Implementation of such a centralised system would also ensure that all members of the security incident response team understand their own role and the necessary steps to be taken. Chudgar mentioned that the lack of understanding of the team's own role and actions led to a loss of "valuable opportunities" to stop the attack.[47]

Moving forward

SingHealth: Becoming more proactive and reactive

In the wake of the crisis, Professor Kenneth Kwek, SingHealth's Deputy Group Chief Executive issued a statement on his hope of deepening SingHealth employees' understanding of data protection, which he felt was a crucial component of patient clinical care.[48]

Although SingHealth had already provided cyber-security training as part of orientation programmes for new employees and conducted simulation exercises to raise their vigilance, more had to be done. To deepen awareness of cyber safety for all employees, more town halls would be organised to relay important information on evolving threats in cyber-security and ransomware. Professor Kwek also plans to adopt a more engaging storytelling approach to inform employees about cybersecurity issues, and illustrating the impact of such breaches. These measures would help employees relate better to the risks of cyberattacks. [49]

In addition, on 10 January 2019, the COI released its report containing its findings and recommendations. The recommendations are aimed at enhancing responses to similar incidents, to better protect SingHealth's database against similar attacks and reducing the risk of such cyberattacks on public sector IT systems with large databases of personal data. Of the 16 recommendations, there were seven priority recommendations. The recommendations were related to strategic and operational measures to enhance the state of cybersecurity of SingHealth and IHiS.[50]

IHiS: New systems, new people, fresh start

In response to the breach, IHiS released its own statement on subsequent measures, introducing a new standard operating procedure and technical measures with the aim to "reduce the risks and impact of human errors".[51]

Post-breach, two-factor authentication (2FA) was required for registration in any workstation. IHiS' security operation centre was also set to include new advanced features to counter malicious activities which manage to evade detection. Access control would also be enhanced via a virtual browser solution, which would reduce the risk of downloading malicious files residing on original websites. Further, only computers with the most updated anti-virus software and anti-malware security updates are to be used. A new database activity monitoring system would be set up to detect abnormal bulk queries, and security of the existing SingHealth SCM infrastructure strengthened. Finally, an advanced malware blocking software, the Client ATP, has been installed on all 6,000 servers, and 60,000 endpoint devices to identify threats.[52]

To directly target the root cause, IHiS is also enhancing access management capability, allowing weak passwords to administrator accounts to be automatically updated. By applying a combination of statistical modelling, machine learning and behavioural analytics, access management will be able to provide prompt detection of any suspicious activity.[53]

Besides enhancements to systems and software, IHiS has also improved its organisational processes and Standard Operating Procedures (SOPs) to reduce the impact of human errors. A framework has been established, whereby suspicious IT incidents have to be reported within 24 hours of the incident, even if investigations are unable to conclude that it is a security incident. Progressively, checklists will also be implemented to ensure that SOPs are adhered to. IHiS has also stepped up on its staff engagement to increase awareness of potential threats, via increased reminders, planned roadshows and cybersecurity briefings. The security team would also undergo training to better allow them to prevent, detect and respond to ever-evolving cyber threats.[54]

Enhancing cybersecurity measures for banks

The SingHealth cyberattack had reverberating effects with respect to raising awareness about cybersecurity. The banking and finance industry, in particular, was impacted the most in the wake of the incident. On 30 July 2018, officials from the Monetary Authority of Singapore (MAS) cautioned banks to not rely on personal particulars for the purposes of verification.[55] Instead, new technology such as biometrics and two-factor authentication must be used for identification.

On 7 September 2018, MAS tightened cybersecurity rules for financial institutions in Singapore by requiring binding cybersecurity measures to be adopted to protect their information technology systems.[56] Prior to this, MAS had also issued new guidelines for financial institutions on risk management practices in outsourcing, including a section on the usage of cloud services. MAS cautioned that outsourcing could increase the risk profile of an institution, and thus a risk-based approach should be taken.[57]

Wake-up call

This incident was truly a timely reminder of the vulnerabilities present in a digitally connected world. It is not only the protection of financial and employment data that is important. There is nothing more personal than an individual's history of diseases, diagnoses and medicines, which could possibly include psychological or even terminal medical conditions.

According to the government, the main takeaway from this incident should not be "who did it" but rather "what can we do about it". The Singapore government is expected to invest more in the cybersecurity industry, with a special focus on healthcare. The SingHealth data breach was truly a wake-up call for medical digitisation and highlighted the need for tighter cybersecurity controls in the healthcare sector.

Discussion questions

1. Would you consider the cyberattack at SingHealth a black swan event? Explain your reasons. What is the significance of the cyberattack on SingHealth and Singaporeans in general?
2. What are possible risks that SingHealth and IHiS could face with respect to digital processes in its daily operations? Assess the likelihood and impact of these risks.
3. To what extent do you agree that "people are always the weakest link in the internal control framework"? Explain with reference to SingHealth's data breach.
4. What courses of action could SingHealth's board and management have taken to review the adequacy of existing internal controls and systems?
5. Describe and evaluate the effectiveness of the risk treatment plan in SingHealth and IHiS for a cyberattack. How could the risk treatment plan be improved?
6. Who do you think should be held accountable for the cybersecurity breach at SingHealth?

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SPACKMAN ENTERTAINMENT: SEARCHING FOR THE MAGIC FORMULA

Case overview

Spackman Entertainment Group Limited (SEGL) is a South Korea-based film and television company which has been listed on the Singapore Exchange (SGX) since July 2014. The company made a slew of acquisitions – such as Korean film production company, Take Pictures Pte Ltd (Take Pictures), and Korean talent management agency, Constellation Agency Pte Ltd (Constellation Agency) – but has struggled to be profitable over the years. SEGL claimed that these acquisitions were carried out to strengthen the Group's content production and gain a stronger foothold in the Korean movie and drama sector. The objective of this case is to facilitate a discussion of issues such as corporate governance risks relating to acquisitions and investments; conflicts of interest; transactions with related parties; accountability of analysts; and the role of regulators.

The entertainer: Charles Spackman

Yoo Shin Choi, more widely known as Charles Spackman, is the son of James C. Spackman, former head of Prudential Financial Inc.'s Asian region.[1] He was adopted in 1955 after his biological parents passed away during the Korean War.[2] After graduating from Harvard University with an Economics degree, Spackman spent the first 17 years of his working life in a number of investment banks before establishing Spackman Group Limited in 1997.[3] He had also founded Littauer Technologies Co., Ltd. (Littauer), an international holding and management company, in 1988.[4] Currently a Hong Kong-based businessman, Spackman is known for his generous donations to his alma mater.[5]

This is the abridged version of a case prepared by Gan Hui Kang, Heng You Wei Jonathan, Noelle Cheah Li Ying and Yang Shuyu under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

Spackman has held various positions in the Spackman Group. He was the Chief Executive Officer (CEO) and Chairman of SEGL since 8 August 2014 and 20 June 2014 respectively, until he stepped down from his roles in 19 December 2017. He was also the Chairman, CEO and Corporate Secretary of Spackman Equities Group Inc. (SEGI) from 31 October 2011 to 8 November 2017. SEGI, an investment company listed on the TSX Venture Exchange, invests primarily in companies in Asia which have strong growth potential.[6]

SEGL: The rabbit in the hat

According to its 2018 annual report, SEGL's business is primarily "the independent development, production, presentation, and financing of theatrical motion pictures in Korea". However, the company has also diversified its business portfolio to include Korean television drama productions and investments in companies and funds involved in the entertainment industry.[7]

SEGL was listed on SGX's Catalist Board in July 2014. Unfortunately, for the first three years after its listing, the company had been in the red. SEGL recorded losses of US$8.1 million in 2014, and continued to be in a loss position in 2015 with a net loss of US$1.1 million.[8] In 2016, it reported a loss of US$2.43 million.

In 2017, things took a turn for the better when SEGL recognised a US$2.98 million profit.[9]

Controversies surrounding Charles Spackman

A hard-fought battle over Littauer

In 2000, the Financial Supervisory Service of the South Korean authorities (FSS) began its investigation into Littauer after finding evidence of potential stock price manipulation. Littauer's share price increased dramatically in the period between February and May 2000, reaching an all-time high of KRW 362,000 on 18 May 2000. It was previously trading around KRW 5,000 between November 1999 and February 2000.[10] In the following year, Littauer's then-CEO, Heo Rok, was arrested for violating the Securities and Exchange Act. Littauer's stock also collapsed in the same year.[11]

In 2003, Sang Cheol Woo, an aggrieved minority shareholder, filed a lawsuit against Spackman in relation to Littauer's collapse.[12] It was alleged that in 2000, Spackman caused Littauer to enter into a self-dealing merger with a Bermuda-based company that he and his business partners controlled,[13] valued at approximately US$1.3 billion.[14] Through this merger, Spackman was alleged to have pocketed over US$100 million, while minority investors like Woo suffered significant losses.[15]

Woo subsequently won a civil judgment against Spackman in Korea in 2011, which remained unpaid as Spackman had reportedly fled to Hong Kong amidst Littauer's collapse.[16] Over the following five years, Woo attempted to collect the US$4.5 million Seoul High Court judgment against Spackman, which had grown to US$12 million with interest as at March 2017.[17] In June 2016, Woo sued to enforce the judgment in Hong Kong.[18] Then in February 2017, Woo filed an action in a United States federal court to obtain financial records and testimony from Harvard University and Spackman's daughter, who was a student at the university, to support and enforce the unpaid judgment against Spackman.[19,20] A Boston federal judge later ruled that Harvard University must provide testimony and documents disclosing the bank accounts, routing numbers, wire transfers and other interbank messages utilised by Spackman to provide funds to his alma mater.[21]

SEGI's headache

In 2017, SEGI had to refile its interim financial statements. This was due to inadequate disclosures made by the company - specifically, failing to indicate that the interim financial statements had not been reviewed by an auditor as required under the Part 4.3(3) of the National Instrument 51-102. This was flagged during a continuous disclosure review by the Ontario Securities Commission. Further, all of the company's interim financial statements filed before 2017 were not reviewed by an auditor. During this period, Spackman was the Chairman and CEO of SEGI.[22]

Giving up on Opus Pictures

On 19 April 2016, SEGL announced its intention to restructure its loss-making businesses.[23] Opus Pictures Limited Liability Company (Opus Pictures), its motion picture subsidiary, had been incurring losses since FY2014. The company reported that film projects that Opus Pictures was involved in since June 2014 had performed below expectations, resulting in a US$9.3 million aggregate loss and a negative 50% rate of return to investors.[24,25] As part of this restructuring, Opus Pictures' founder and CEO, Lee Tae Hun, agreed to buy back the company through a sale and purchase agreement (SPA).[26] The Group expected to significantly reduce its fixed overheads and operating expenses in light of the disposal of Opus Pictures.[27]

More than meets the eye?

In 2015, SEGL acquired UAA Korea Co. (UAA Korea), which it called a leading talent management agency in Korea representing Korean stars such as Song Hye-kyo and Yoo Ah-in.[28] SEGL claimed that UAA Korea was positioned to become one of the leading talent agencies in Korea.[29] However, UAA Korea made losses shortly after the acquisition by SEGL and was disposed of in the following year.[30]

Seven months after the official disposal of UAA Korea, a new entity UAA & Co Inc. (UAA & Co), appeared in SEGL, alongside an announcement of the signing of Park Hyung-sik, Korea's top free agent actor to UAA & Co.[31] UAA & Co also signed contracts with Song Hye-kyo, Yoo Ah-in and Ellen Park.[32]

Controversial spin-offs

Incorporated in April 2015, Spackman Media Group Pte Ltd (SMGPL) was initially a subsidiary owned by SEGL. SEGL cited the Group's "internal reorganisation" plans to streamline the Group's structure to justify the incorporation of SMGPL.[33] However, SEGL began to slowly dilute its shares in SMGPL shortly after incorporation and eventually disposed of all of SMGPL's shares by May 2016.[34]

In May 2015, SMGPL started issuing new shares, and SEGL's shareholding in SMGPL was diluted following multiple share subscription agreements with various "independent investors". As a result of these share issuances, SEGL received gross proceeds of US$7.1 million from two share subscription transactions.[35,36]

At the end of 2015, SEGL announced a proposed spin-off of the company's remaining shares in SMGPL in exchange for 27.4% interest in Spackman Media Group Limited (SMGL), a new Hong Kong incorporated company which was then considering a listing on the Hong Kong Stock Exchange. SMGPL reported a US$0.86 million loss for the nine-month financial period ended 30 September 2015. In a company announcement, SEGL stated that the proposed share swap would generate value creation in the future, allowing both SMGPL and SMGL to "benefit from an enhanced market presence and expected synergistic advantages through the combination of complementary assets and businesses".[37] The share swap of SEGL's 45.8% interest in SMGPL for an approximate 27.4% stake in SMGL was completed in May 2016.[38]

A "flexible" acquisition approach

Spackman was active in acquisitions and investments in new companies in recent years through share "allotment and swap", claiming that it was to pursue its long-term goal of business diversification.[39]

On 1 March 2017, SEGL entered into a SPA to purchase 1,000,000 shares of SMGL at US$3 per share from what it said were independent vendors which it did not name, in exchange for newly-issued 26,161,491 SEGL ordinary shares at an issue price of S$0.161 – a total consideration of US$3 million or S$4.212 million. The previous day's closing price of SEGL shares was S$0.174.[40]

Several more SPAs were entered into by SEGL in 2017 and 2018 as it gradually increased its stake in SMGL. Most of these SPAs were said to be with unrelated third parties or certain existing shareholders whose identities were not disclosed.[41]

In total, five SPAs were entered into for SMGL between March 2017 and August 2018 as SEGL increased its stake in SMGL from 24.5% to more than 45%. The SMGL shares acquired through these transactions were said to be valued at nearly US$19.4 million or more than

S$26.2 million. In several of these transactions, the value of the SEGL shares issued were stated as being above the then current market price of SEGL shares. For example, on 22 May 2018, SEGL acquired 2.3 million SMGL shares at US$3 per share. The total purchase consideration amounted to US$6.9 million, and was satisfied through the issuance of 101,607,865 newly issued SEGL shares at an issue price of S$0.09 per share. This represented a premium of 26.8% over the volume weighted average price of S$0.071 for SEGL shares.

The unaudited profit before tax for SMGL for FY2016 was US$860,00, while the audited FY2017 profit before tax was US$269,560. Unaudited net tangible assets and net asset value at the end of FY2016 were US$7.13 million and US$11.61 million respectively, while audited amounts as at the end of FY2017 were US$7.9 million and US$12.7 million respectively.[42,43]

Similar share "allot and exchange" strategies was used to acquire three subsidiaries in 2017 and 2018 – Take Pictures,[44] Constellation Agency,[45] and Greenlight Content Co., Ltd (Greenlight Content).[46] In all of the SPAs, there were no publicly disclosed information with regards to the identities of the "independent investors" whom SEGL engaged with in those transactions. SEGL said that the vendors were all unrelated third parties.

On 11 October 2017, SEGL acquired the entire issued and paid-up share capital of Take Pictures in exchange for 25,686,816 newly-issued SEGL shares at an issue price of S$0.13 per share.[47] Soon after, on 22 December 2017, SEGL entered into a SPA with "independent third party investors" to acquire the entire issued and paid-up share capital of Constellation Agency. Through the acquisition, 144,770,861 new SEGL ordinary shares were issued at S$0.115 per share.[48]

Most recently, on 19 October 2018, SEGL acquired a 100% interest in Greenlight Content, which business activities include investing into dramas and movies, and consulting on Korean content production. The consideration of the acquisition consisted of 150,000,000 of newly-issued shares of SEGL at an issue price of S$0.046 per share.[49]

SGX's curiosity is piqued

SGX queried SEGL on 6 June 2018, seeking clarifications on SEGL's share swap with SMGL with the following questions:[50]

(A) Please explain how the purchase consideration of US$6.9 million was arrived at in light of the NTA and NAV of SMGL.

(B) What is the Board's views and bases on why this acquisition is in the interest of the Company?

SEGL's response to the first question was that the quantum of US$3 per SMGL share was arrived at simply based on prior transactions. However, there was no actual supporting information to substantiate how the consideration was determined.[51] It also cited a RHB report by an unnamed analyst who has estimated SMGL's value per share to be between US$4.70 to US$8.00. According to a blogpost, a RHB analyst had put a bullish valuation on SMGL in 2017 and this same analyst had set a target price for SEGL of 32 cents in 2017, then lowered it to 27 cents, then 23 cents, then 20 cents and finally 10 cents in May 2018, while consistently maintaining a "buy" recommendation for SEGL's shares.[52]

Clearly dissatisfied with the response, on 6 August 2018, SGX issued a further query with eight questions based on the company's response to the first SGX query. Amongst its questions, SGX queried SEGL on its future plans for SMGL, its rationale for acquiring stakes in SMGL at a significant premium, the individuals holding key leadership positions in SMGL, as well as the controlling shareholders of SMGL. SEGL provided its responses to the SGX query on 23 August 2018 and 29 August 2018.[53,54]

SGX subsequently issued yet another query, with a focus on the Group's strategic business direction for SMGL. In its response, SEGL repeatedly mentioned SMGL's "potential" to grow and be monetised despite its current net loss position.[55]

Are SGX's persistent queries a sign of problems in SEGL? SEGL, which listed on SGX's Catalist board in July 2014 through a private placement of 69.44 million shares at S$0.26 each,[56] has seen its share price fall from a high of more than S$0.52 post-listing to just S$0.018 on 18 July 2019.[57] Clearly, shareholders would not be amused.

Discussion questions

1. SEGL entered into a number of sales and purchase agreements with "independent" or "unrelated" third parties as it increased its stake in SMGL between 2017 and 2018. Critically evaluate these transactions and their possible impact on the value of SEGL's shares.
2. In a number of cases, SEGL issued shares through share swap transactions and the issue prices of those shares were stated to be above the prevailing market price. There are other companies which have done the same. Why might companies do this and is this beneficial to the shareholders of these companies?
3. What are the potential conflicts of interest in the disposal and sale of UAA Korea and Opus Pictures to SEGL's former CEO? Discuss the possible implications of UAA Korea losing its assets (i.e. well-known Korean artistes) to the new entity, UAA & Co.

4. SGX issued a number of queries to SEGL. Critically evaluate the usefulness of SGX's queries and whether you believe the company's responses were adequate? Do you think SGX should have done more to ensure that the transactions concerned are in the best interest of SEGL's shareholders? If so, what else do you think SGX could have done?

5. There are a number of issues relating to the founder of SEGL, Charles Spackman, which have been reported in the media. Do you think SEGL should have been allowed to list on SGX given these issues? Explain, citing relevant SGX rules which may be applicable.

6. SEGL cited the valuation placed on SMGL by an unnamed analyst in helping justify the consideration paid to acquire SMGL shares. This analyst also consistently set high target prices and maintained "buy" recommendations for SEGL shares. What is the role of analysts in the corporate governance ecosystem? What are conflicts of interests that analysts may face? How can analysts be made more accountable, given that investors may rely on their projections and recommendations in making investment decisions?

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TRANSCORP: TEEING OFF INTO TROUBLE

Case overview

The fall of Transcorp Holdings Limited (Transcorp) (formerly known as Transview Holdings) began after the company disposed of its primary business in the golf industry in 2014 and moved from the Mainboard to the Catalist Board of the Singapore Exchange. Ventures into a diverse array of different industries, such as automobile, fintech and property development, led to limited success. Transcorp also faced various problems with the retention of key personnel and an unprofitable business model. The objective of this case is to facilitate a discussion of issues such as board structure; high board turnover; interested party transactions; risks of diversification; due diligence in acquisitions; and the effectiveness of stock exchange rules in protecting investors' interests.

The tee-off

Established in 1984 and incorporated in Singapore in April 1995, Transview Holdings (Transview) found its niche in the premier golf segment. The company became a leading wholesaler and distributor of golf equipment in Southeast Asia by leveraging on its exclusive distributor deals with market-leading brands of golfing equipment and accessories.[1] In addition to shops selling golfing equipment and accessories, Transview also sought to improve consumers' shopping experience by operating several driving ranges whereby they could test out equipment before committing to a purchase.[2] It was listed on the Mainboard of the Singapore Exchange (SGX) in September 2000.[3]

This is the abridged version of a case prepared by Darius Seow Kiat Ming, Liow Yee Ting, Tan Jing Yen, Tan Yan Nicholas Samuel and Teo Ler Yi Jerlyn under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Mirabel Clarissa Reynaldo under the supervision of Professor Mak Yuen Teen.

The honor roll

Transview was founded by brothers Tan Ching Khoon and Tan Cheng Chuan, who were the executive directors in charge of running the daily operations of the company. In 2014, they had a combined shareholding of 53.89%.[4] As a result, they had effective control of the company. There were no other substantial shareholders in the company. Also on the board were lead independent director, Lee Soo Hoon, Phillip, together with independent director Sin Boon Ann and non-executive director Lim Teng Neng. The three non-executive directors have different backgrounds in accounting, law and the food and property development industry respectively.[5] Lee and Lim were both appointed in 2000, while Sin was appointed in 2002.[6]

Mining on a golf course

In 2009, Transview sought to diversify into the mining business by "investing in the exploration and commercialisation of iron, copper, gold and uranium deposits".[7] The diversification stemmed from the company's belief that the resource and mining business would be a growth engine for the company.[8] In 2012, Transview pursued further diversification and entered the property development business to create supplementary revenue streams. The company aimed to become a "boutique developer of residential properties" and establish its foothold in the property market.[9]

Bogey

Transview began its property development business through a joint venture with other investors under which it held a 10% stake in Santarli Realty Pte Ltd.[10] However, this venture resulted in the company facing significant impairment losses relating to investments in its subsidiaries in the financial year (FY) 2014. The subsidiaries were engaged in investment properties, investment holdings, property development and retail of golf equipment and accessories. The impairment losses for FY2014 stood at S$1,862,279, and totalled S$2,291,381 over two years.[11]

From fairways into the bunker

The Group suffered a hit in profitability in 2013 – Group profit before tax was S$1,300,076 in 2012, but swung to a loss of S$2,270,488 in the following year.[12] In December 2013, Transview announced its intention to dispose of its golf business due to the highly competitive nature of the industry. Management's rationale was that this would provide an immediate injection of cash into the company, thereby improving the company's working capital. This would improve the current operations of its property development business and allow for greater flexibility in future investments.[13]

To dispose of its golf business, Transview entered into a conditional business transfer agreement with Leonian Singapore Pte. Ltd. (Leonian) for a consideration of S$28 million on 17 December 2013.[14]

An extraordinary general meeting (EGM) was held and an ordinary resolution regarding the proposed disposal of the company's existing golf business to Leonian was passed on 18 March 2014, with 82.3% of the total shares voted and 100% shareholder approval.[15] Transview recognised a gain on disposal of S$11,029,757.[16]

On 13 June 2014, the company announced its half-year results and a tax-exempt one-tier interim dividend of S$0.15 cents per share. Based on the 179,280,000 issued shares (excluding treasury shares), the total interim dividends would have amounted to S$26,892,000, which was more than the amount of retained earnings (revenue reserve) of S$24,229,000.[17] On 16 June 2014, Transview issued a "corrigendum" and announced that the interim cash dividend would be S$0.12 per share instead.[18,19] The total dividends declared in FY2014 amounted to S$21,872,180, up from S$358,560 in FY2013, even though the company recorded an operating loss of S$1,798,551 excluding the gain on disposal of assets.[20]

On 1 April 2014, Transview changed its name to Transcorp Holdings Limited (Transcorp).[21]

New players

On 11 March 2015, Sin Boon Ann resigned as independent director, having joined the board in November 2002, with the reason given being "need to refresh the composition of the board".[22] This was followed by Tan Ching Khoon, who resigned as director and Executive Chairman on 30 March 2015.[23] He also ceased to be the substantial shareholder following the disposal of his entire shareholding[24] to SG Royal Group Pte. Ltd. (SG Royal Group),[25] which was 100% owned by Chu Wan Zhen. Chu then became a substantial shareholder of Transcorp with a deemed interest of 29.65% in the company,[26] and was appointed as a non-executive director and Non-Executive Chairman of Transcorp on 8 April 2015.[27] She became Executive Chairman on 23 November 2015.[28]

Lee Soo Hoon, Philip resigned as independent director on 16 April 2015,[29] and Lim Teng Neng as non-executive director on 21 April 2015.[30]

Playing on a new course

On 20 October 2015, Transcorp transferred from the Mainboard to Catalist.[31] According to the company's 2015 annual report, the board felt that the move was in the best interests of the company as a Catalist listing would "better position the company appropriately in anticipation of future business prospects and allow the Company to attract investors in the future, as well as better resemble the business, market capitalisation and risk profile of the Group". The board also believed that the Catalist was a more conducive platform for the Group for fundraising purposes and for potential acquisitions and disposals in the future.[32]

The move to Catalist subjected Transcorp to less stringent requirements compared to being on the Mainboard. Catalist's regulations for major transactions are less strict and it does not have a watch-list for companies based on either financial criteria or minimum trading price. Catalist also provides greater flexibility in the issuance of additional shares, with companies being allowed to issue more shares under an annual general mandate passed by the company's shareholders, compared to the Mainboard.[33]

Steering down the fairways with Regal Motors

On 21 December 2015, Transcorp announced that it had decided to venture into the automobile industry with the purchase of Regal Motors Pte. Ltd. (Regal Motors), an automobile importer. The proposed acquisition involved acquiring approximately 88.5% of the issued share capital of Regal Motors for a consideration of up to S$20 million. Shareholders' approval was required for the acquisition to proceed under Rule 1006(c) of the Catalist Rulebook.[34] Following shareholders' approval obtained at the EGM held on 12 January 2016, the acquisition of Regal Motors was completed on 25 January 2016.[35] The final consideration for the acquisition was S$14,363,814 and Transcorp recorded a goodwill of S$6,388,610.[36]

A private company limited by shares and incorporated in 2013, Regal Motors was owned by Cheng MingMing and Chua Heng Chuan Ronnie,[37] who subsequently became the second and third largest shareholder of Transcorp Holdings in 2017, ranking only after SG Royal Group.[38] Regal Motors is a parallel importer and authorised distributor of "Lorinser" brand automobiles.[39]

Transcorp had a vibrant outlook for the automobile industry in Singapore. Based on an analysis of historical vehicle registrations and the remaining lifespan of vehicles, it foresaw a growth in demand for cars between 2015 and 2019. This was a motivation behind the acquisition of Regal Motors. Furthermore, Regal Motor's business model of maintaining a stable inventory was seen to provide a competitive advantage. The company also had strong financials, having recorded a net profit after tax of S$2,361,111 in 2015 prior to its acquisition by Transcorp.[40]

Missed putt

However, Transcorp's investment backfired. In 2016, Regal Motors recorded a loss of S$1.5 million. The goodwill of S$6,388,610 recognised from the acquisition in 2016 was fully impaired based on cash flow projections that showed Regal Motors expecting to continue incurring losses in the following three years. Regal Motors subsequently recorded losses of S$3,133,351 and S$6,633,750 in 2017 and 2018 respectively, which were largely attributable to a reduction in car sales.[41,42]

With regards to the impairment, SGX issued several queries relating to its measurement and the views of the internal and external auditors, management and sponsor on the issue. In response, the company explained that it was due to the unexpectedly low popularity of the "Lorinser" brand, and that the relevant parties concurred with the impairment.[43]

The loss of a legend

In February 2016, shortly after Transcorp's move to the Catalist Board on 20 October 2015 and the acquisition of Regal Motors on 25 January 2016, then 53-year-old Tan Cheng Chuan –managing director of the company since 1995 – resigned as a director of Transcorp, citing "retirement" as the reason.[44] In March 2016, he disposed 4.18% of his interest in the company, reducing his stake to 13.97%.[45] He also resigned from his role as corporate representative in all subsidiaries within the Group. However, he continued to hold directorships in Leonian Singapore Pte Ltd, Nippon Golf Pte Ltd, Transview Lifestyle Pte Ltd, and T-View Interior Pte Ltd as of 29 April 2016.[46]

Soon after, several other directors submitted their resignations as well. These included independent director Seah Chee Wei, executive director Neo Yim Pui, executive director Swee Kay Seng, non-executive director Chu Yi Han and Chief Executive Officer (CEO) Jong Khee Beng Ainsley. Jong Khee Beng Ainsley took on the role as CEO on 19 August 2015 and stepped down in February 2016.[47] Of the five other directors who resigned, three of them were on the board for about two months and none of them served for more than a year. They cited personal reasons for stepping down, such as retirement, pursuit of their own interests and other work commitments. The mass exodus of directors left behind three other directors – executive director and Chairman Chu Wan Zhen, executive director Goh Chin Soon, and independent director Pok Mee Yau Karen.[48] Pok Mee Yau Karen subsequently resigned on 6 October 2016.[49]

The acting Chief Financial Officer (CFO), Yong Chor Ken, also resigned on 31 August 2016 "to pursue his own endeavours".[50]

From me, to me

On 9 May 2016, just 10 days after Transcorp announced its proposed disposal of several subsidiaries to Tan Cheng Chuan, who had indicated an intention to retire, Transcorp completed the disposal for S$9,182,748. Using the bases set out in Rule 1006 of the Catalist Rules, the net asset value of the sale shares to be disposed of, compared with the Group's net asset value of S$17,872,458, was 29.6%.[51] Having successfully moved its listing to the Catalist Board, Transcorp did not need to seek approval from shareholders for the disposal. This was because only disposals that exceed 50% of the Group's net asset value are considered major transactions under the Catalist Rule 1014.[52] Had the transaction taken place while Transcorp was still on the Mainboard, it would have been considered a major transaction under the Mainboard Rule

1014 and would have required the approval of shareholders, as it exceeded the 20% threshold applicable to companies listed on the Mainboard.[53]

Furthermore, since Tan Cheng Chuan had resigned from the board and all subsidiaries within the Group and was not a controlling shareholder, he was no longer an “interested person”, and thus the transaction was also not considered an interested person transaction.[54]

Transcorp rationalised the proposed disposal as a way for the company to enhance shareholder value by helping the company to shift away from its reliance on rental and loan income – which was the main source of the company’s revenue since its disposal of its main business of wholesale of golf equipment and related products in 2014. Through the proposed disposal, the company hoped to obtain more working capital, which would be beneficial for the operations of Regal Motors. Moreover, the company said that the additional working capital would be used for other business ventures and investments in the future to further enhance value for shareholders.[55]

Who rules the fairway?

Transcorp continued to struggle to retain its directors and key management personnel.

On 10 March 2017, the company announced that Kwan Hun Fah, who had only joined as CEO in November 2016, would resign with effect from 31 March 2017.[56] Chu Wan Zhen, who joined two years earlier, resigned on 28 April 2017, together with independent director Lim Yit Keong who resigned after less than six months.[57]

More resignations followed in February 2018, when Tan Chade Phang, Roger resigned as independent director after about ten months,[58] and Goh Chin Soon resigned as Executive Chairman.[59]

In August 2018, Tan Wee Heong resigned as non-executive director after less than three months.[60] Tan Wee Peng Kelvin, who joined the company on 27 June 2016, resigned as lead independent director and Audit Committee Chairman on 31 October 2018.[61]

Soon after, Lim Boon Ping resigned as CFO on 5 November 2018,[62] and his replacement Wang Yingyang left on 7 December 2018 after just four days.[63] Lai Hock Meng, who joined as Non-Executive Chairman and independent director resigned a few days later, after a little over four months.[64] Finally, 35 year-old You Zihui, who joined as executive director in November 2018, resigned in April 2019.[65]

Almost all of cessation announcements gave reasons such as “to pursue other interests” and “heavy work commitment”, although in Lai Hock Meng’s case, “medical reasons” was cited.

Before the resignation of You Zihui on 5 April 2019, the board of directors consisted of only three directors.[66] These three directors were all part of the Remuneration, Nominating and Audit Committees.[67]

Transcorp also changed its sponsor from Stamford Corporate Services to Asian Corporate Advisors with effect from 1 September 2017.[68] Neither Asian Corporate Advisors[69] nor the predecessor sponsor Stamford Corporate Services appeared to have questioned the reasons for the cessation of directors and key management personnel over the years.[70]

The company cited the lack of executive directors for its inability to prepare its 2018 annual report and hold its annual general meeting (AGM) on time.[71]

Alongside the high turnover of directors and key management personnel, the company continued to engage in a number of contentious corporate actions.

One for all

During the AGM held on 27 February 2018, 99.85% of the shareholders granted the company a new share issue mandate pursuant to Rule 808 of the Catalist Rulebook.[72] Under this new mandate, the board was authorised to issue new shares of up to 100% of total issued shares on a pro-rata basis and up to 50% of new shares on a non-pro-rata basis, such as through private placements.[73] This would allow Transcorp to issue up to 119,696,500 on a non-pro-rata basis without further shareholder approval.[74]

If Transcorp had remained on the Mainboard, the limits would have been 50% on a pro-rata basis, and 20% on a non-pro-rata basis.

Golfing legends driving Uber

Shortly after the passing of the mandate, Transcorp proposed the acquisition of a 10% interest in Motor MegaMall Pte Ltd (Motor MegaMall) on 23 March 2018 for S$1.5 million. Motor MegaMall was described as a fintech start-up firm that aims to provide an agency platform for owners and purchasers of motor vehicles to obtain financing. It was stated that former Executive Chairman Goh Chin Soon had been negotiating to invest in Motor MegaMall prior to his resignation on 28 February 2018, and Chua Heng Chuan Ronnie, as a key management of Transcorp, completed the negotiation after Goh's departure.

The S$1.5 million consideration was satisfied through an issue of 30 million shares priced at S$0.05 per share to Oh Chee Tat, the founder of Motor MegaMall. Based on the mandate passed less than a month before, no shareholder approval was necessary as the number of shares issued was only 30 million, well below the 119 million threshold.[75] The acquisition was completed on 7 June 2018.[76]

Dongshan Dibao disaster

On 31 October 2017, Transcorp announced that it had entered into a tripartite Memorandum of Understanding (MOU) with controlling shareholder Cheng MingMing, who owned a 27.03% stake in Transcorp as of 31 October 2017, and Dongshan Dibao Property Co. Ltd. (Dongshan Dibao), to undertake a property development project in Dongshan County. As Cheng MingMing is the sole owner of Dongshan Dibao, the MOU was an interested person transaction.

Under the MOU, Transcorp would be given the exclusive right to participate in the project and Transcorp proposed to take up a 51% stake in the project. According to the MOU, Transcorp would pay a good faith deposit of S$6.003 million to Dongshan Dibao, which would be fully refundable as long as no formal agreements were entered into. To secure the deposit, Transcorp was provided with a charge over Cheng MingMing's shares in both Dongshan Dibao and Transcorp.[77]

Transcorp entered into the MOU with the purported intention of capitalising on the lucrative property development industry in China in order to improve the profitability of the company as it was suffering losses from the automobile business. Furthermore, with Cheng MingMing being both the controlling shareholder of Transcorp and sole owner of Dongshan Dibao, the board felt that all three parties in the MOU would have their interests aligned to ensure the project's success.[78]

However, Transcorp recorded an impairment loss of S$3,275,811 for the refundable deposit in 2018.[79] On 28 February 2019, after careful review, the board decided not to enter any formal agreements related to the Dongshan project, to terminate the MOU and request the full refund of the S$6,003,000 deposit by 31 March 2019. The board's decision was based on two key considerations: the Group did not possess the "necessary expertise, financial and operational resources" to see the project through, and the vision to direct its financial resources towards its existing car rental business that involved lower risk to Transcorp.[80] However, as of 21 May 2019, Transcorp had not yet received the refund. Transcorp continued to defend its decision in terminating the MOU.[81,82]

Meanwhile, Transcorp's subsidiary, Regal Motors, had also been attempting to recover S$2.6 million in advanced deposits paid to one of its suppliers, Car Profile. Goh Chin Soon, Transcorp's former Executive Chairman, is a deemed shareholder of Car Profile.[83] Transcorp had issued letters of demand to the supplier, and subsequently continued discussions over the return of the advanced deposits.[84] However, as at 28 June 2019, there had not been "repayments of any amounts or any acceptable repayment proposal".[85]

Going, going...concern

Transcorp announced on 10 June 2019 that it would have a going concern issue if it did not manage to raise funds amounting to S$1 million[86] by the end of the month.[87] A month later, on 9 July 2019, the company updated its shareholders that it was in discussions with various groups of investors and had received a formal proposal from one group. The engagement with the particular group of investors was reportedly at "an advanced stage", although no agreement had been executed at that point of time.[88]

Teetering on the edge of a going concern issue, the survival of Transcorp looks very much in doubt.

Discussion questions

1. Discuss the key red flags in Transcorp's corporate governance and how they may contributed to the events that unfolded.
2. Critically evaluate the differences in rules between the Mainboard and Catalist Board. Analyse how the transfer from the Mainboard to Catalist Board may have contributed to the events that transpired. Do you think that Transcorp took advantage of the more lenient Catalist's rules? Explain.
3. Assess the possible issues behind the frequent turnover of the company's directors and key management personnel. Do you think the directors who joined and then resigned had discharged their fiduciary duties to the company? Should there be stricter rules regarding the resignation of directors? Explain.
4. Consider the disposal of subsidiaries to Tan Cheng Chuan and the Memorandum of Understanding with DongShan Dibao. Evaluate whether the rules for interested party transactions are adequate.
5. Critically evaluate all the major corporate transactions undertaken by the company following its exit from the golfing business. What are the duties of directors with regards to these transactions? Do you think the directors who were on the board at the relevant times when those transactions were executed had adequately discharged their duties? Explain.
6. Critically evaluate the effectiveness of regulators in protecting minority investors based on the Transcorp case. What actions could minority shareholders take, and what barriers are they likely to face?

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VARD: TURBULENT VOYAGE TO PRIVATISATION

Case overview

In November 2018, Vard Holdings Limited was delisted from the Singapore Exchange (SGX) Mainboard after three takeover attempts in 2013, 2016 and 2018 respectively. The saga was marred by cries of unreasonable offer prices by minority shareholders and the public at large. It culminated in 2018 with a series of events that led to the regulators in Singapore making unprecedented rulings and proposing regulatory changes in a bid to protect minority shareholders. The objective of this case is to facilitate a discussion of issues such as the role of independent financial advisers; shareholder activism; conflict of interest; the independence of directors and management; corporate governance in delisting companies; and regulatory intervention.

Vard's beginnings

Vard Holdings Limited (Vard) is an international shipbuilder, with expertise in constructing offshore and specialised vessels. The entity was first established under the name STX Europe, after the South Korean industrial group STX Group acquired Oslo Børs-listed Aker Yards ASA (Aker Yards) in 2008.[1] The Group then sold off most of Aker Yards' shipyards except those in Finland and France. Shipyards in Norway, Romania, Brazil and Vietnam were listed on the Mainboard of the SGX under the name STX OSV in 2010.[2] The entity rebranded itself as Vard in 2013, when the STX Group sold all its shares in the company to Italian shipyard Fincantieri - Cantieri Navali Italiani S.p.A.[3,4]

Fincantieri

Fincantieri - Cantieri Navali Italiani S.p.A is an Italian shipyard group founded in 1959 and owned by the Italian state. It is in the business of designing and constructing cruise ships, and a leader in all high-tech shipbuilding industry sectors such as naval vessels, mega yachts, high-value added vessels, ship repairs and ship conversions. Today, it is one of the world's largest shipbuilding groups.[5]

This is the abridged version of a case prepared by George Fong Jia Jiun, Gerald Teo Huan Han, Khairin Fadil Bin Sahudin, Lim Shi Wei and Prathaban S/O Subaramaniam under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

In 2013, through its wholly owned subsidiary Fincantieri Oil & Gas S.p.A (Fincantieri), it acquired 50.75% of STX OSV at S$1.22 per share. In compliance with Singapore Code of Take-overs and Mergers, Fincantieri had to announce a mandatory general offer for the remaining shares at a price of S$1.22 per share.[6] On 13 March 2013, the offer closed with Fincantieri receiving valid acceptances of only 4.88%, resulting in their total shareholdings increasing to 55.63%.[7] As such, Fincantieri's first attempt to buy out STX OSV was not successful. STX OSV, which adopted the new brand name Vard post-acquisition,[8] therefore remained listed on the SGX Mainboard.

Since the acquisition of its stake in Vard in 2013, Fincantieri's objective was to delist Vard with the aim of achieving synergies in engineering and production by integrating Vard into the Group.[9]

Crude awakening

Little did anyone know that Vard would never see its share price at such highs again. Amidst the world-wide recovery from the 2008 recession, oil prices soared above US$100 per barrel, with prices averaging around US$110 per barrel between January 2011 and June 2014. Stakeholders in the oil industry were mostly optimistic about the business. However, during the latter half of 2014, the oil crisis struck and oil prices crashed down to merely US$50 per barrel.[10]

Prices remained sluggish and there was a worldwide downturn in the marine, oil and gas sector, sending many companies into default or liquidation. Vard was not spared, with its share price pummeled as it faced increasing losses and failed to keep its orderbook filled – signaling problems of future cash flows for the business. By February 2016, as oil prices seemingly reached rock bottom at US$35 per barrel, Vard was trading at an all-time low of S$0.13 per share.[11]

Another privatisation attempt

On 13 November 2016, Fincantieri issued a voluntary conditional cash offer to take Vard private for S$0.24 per share. The offer was conditional upon Fincantieri acquiring over 90% of Vard's total shares. The offer represented an 11.63% premium over the company's one-month volume weighted average price (VWAP). At the time of the offer, Fincantieri owned 55.63% of Vard's outstanding shares.[12]

The privatisation offer was supported by Vard's independent directors and KPMG, its independent financial adviser (IFA). However, investor advocacy group Securities Investors Association Singapore (SIAS) requested for Fincantieri to raise its offer price due to concerns from minority shareholders that the price offered was too low. In particular, it noted that the offer was below Vard's net asset value (NAV) per share at the time.[13]

The offer received sufficient acceptances to turn unconditional, but eventually fell short of the amount required to trigger the delisting despite a further two-week extension for shareholders to decide whether to take up the offer.[14,15] At the close of the offer period, Fincantieri had increased its shareholdings in Vard from 55.63% to 74.45% and Vard remained listed on the SGX Mainboard.[16] Another 12 months would lapse before Fincantieri would be allowed to make another offer according to Paragraph 33.1(a) of Singapore's Take-over code.

Fincantieri continued to acquire Vard shares in the open market.[17]

Third time's the charm?

In November 2017, Fincantieri made another attempt at privatising Vard – this time via a voluntary delisting. Fincantieri had offered S$0.25 per share, one cent higher than its previous offer one year prior. The offer represented a 0.9% discount to Vard's one-month VWAP at the time.[18]

On 5 April 2018, SGX granted its approval for the proposed delisting. By this time, Fincantieri had amassed an approximate 83.06% stake in Vard after acquiring 736,000 shares at the offer price of S$0.25 per share. Fincantieri publicly announced its intention to vote in favour of the Vard delisting proposal at the upcoming Extraordinary General Meeting (EGM) on 30 April 2018.[19] The delisting resolution would be passed unless more than 10% of shares present and voting voted against it during the EGM.[20]

On 13 April 2018, Vard, through its financial adviser CIMB Bank Berhad, Singapore Branch (CIMB), released the joint announcement on its delisting, the delisting circular, and IFA letter.[21,22]

Building ships, destroying relationships

"If the controlling shareholder wishes to privatise, it should have to bid a price that investors accept voluntarily. What has happened in the Vard case should be labelled a forced and unfair delisting, not as a voluntary one!"

– *Apollo Investment Management*[23]

Vard's IFA, CIMB, had given the opinion that the offer was "not fair, but reasonable". It advised Vard's independent directors to recommend that Vard's shareholders accept the offer or sell their shares in the open market. Vard's independent directors accepted the recommendation. CIMB evaluated that the exit offer was not fair as the offer price was at a discount to NAV per share, and that the Group's financial performance had been improving. It went on to state the exit offer was "reasonable" as the market price of Vard's shares was likely to have been supported by market purchases by Fincantieri, Vard's majority shareholder.[24,25]

On the other hand, DBS Group Research maintained a mixed view.[26] The offer price was largely similar to its own target price for the stock at S$0.25 per share. It observed that Vard's share price had not moved significantly since the close of the last offer despite improvements in oil prices due to its earnings being in the red, coupled with its order book reflecting a negative outlook. It also pointed out the illiquidity of the stock. DBS Group Research also opined that this might incentivise shareholders to accept the offer this time round.[27]

On 15 April 2018, Claire Barnes from Apollo Investment Management wrote an opinion piece to call for Vard shareholders to vote against the proposed delisting. She pointed out several issues such as an "unusually tight" timetable and the improving company performance due to upturn of shipbuilding cycle. She further mentioned that Vard's share price was deflated by the takeover uncertainty despite improving fundamentals. At the end of the opinion piece, she declared that Fincantieri is "trying to take Vard private on the cheap at the bottom of the cycle" and that Fincantieri should "bid a fair price, and achieve their goals by persuasion, not force".[28]

Shareholder activism

On 26 April 2018, SIAS released a statement that it had received feedback from minority shareholders of Vard expressing their disappointment towards the latest offer. It mentioned that shareholders felt that the offer of S$0.25 per share did not reflect the real value of the company and is below the company's NAV. It also urged minority shareholders to turn up at the EGM, encouraging those who wanted to block the delisting resolution to vote against it.[29]

A day later, the Business Times reported that a group of minority shareholders was rallying others to vote against the board's delisting proposal. This was in the form of a Facebook group called "Vard Minority Shareholders Community Singapore",[30] which reached out to shareholders with a combined shareholding of 8.5 million shares.[31]

For the delisting resolution to be passed, two conditions must be satisfied. Firstly, the delisting resolution must be approved by at least 75% of outstanding shares held by shareholders present and voting, either in person or by proxy, at the meeting. Secondly, the resolution must not be voted against by 10% or more of the total outstanding shares held by shareholders present and voting, either in person or by proxy at the meeting.[32]

Roy Reite: Vard's loyal servant?

The delisting circular issued by Vard and its IFA on 13 April 2018 disclosed and confirmed the independence of Vard's Chief Executive Officer (CEO) and executive director, Roy Reite, for the purpose of making recommendations to shareholders pertaining to the exit offer.[33]

Following public feedback, SGX queried the contents of the circular on 20 April 2018, questioning the company's basis for assessing Reite's independence.[34]

The Code of Corporate Governance defines an independent director as "one who is independent in conduct, character and judgement, and has no relationship with the company, its related corporations, its substantial shareholders or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgement in the best interests of the company".[35]

Vard Holdings responded to the queries by SGX by claiming that in determining the independence of Reite, reference should be made from the Singapore Code of Takeovers and Mergers, rather than from the "entirely separate concept" of an independent director under the Code of Corporate Governance. In addressing SGX's question on whether the company had consulted SIC in determining whether Reite was considered independent for purposes of making recommendations in relation to the exit offer, Vard implied that there was no need to consult the SIC on the matter.[36]

The first EGM: Confuse and conquer

The EGM on 30 April 2018 was chaired by Vard's CEO, Reite. The main agenda of the EGM was for Vard to seek shareholders' approval to its delisting proposal. However, the EGM did not proceed smoothly. Minority shareholders present actively raised their concerns regarding Vard's delisting proposal. Amongst the concerns raised, perhaps the most serious was in relation to an error in the IFA report.[37]

In its defence, Vard stated that the error would not have changed the adviser's opinion. It said that CIMB's calculation mistake in the valuation multiples of the comparable companies table "[did] not have a material impact" on CIMB's overall assessment. Vard asserted that the price-to-net asset value (P/NAV) multiple implied in the offer price would still be within the range of P/NAV multiples of the comparable companies if the correct figures were used instead.[38]

Eventually, the EGM was concluded with shareholders voting in favour of the delisting offer. However, investors were left with a bad taste in their mouths due to errors in the delisting circular and the way the meeting was conducted.[39]

The tumultuous journey to a second EGM

On 1 May 2018, SGX launched an inquiry into the conduct of the first EGM which was convened on 30 April 2018, given the complaints of error in the circular dated 13 April 2018 and the allegations of improper poll voting conducted during the meeting. SGX Regco said that "SGX will review the conduct of the EGM proceedings and the issues raised regarding disclosures in the circular to see if shareholders' approval was properly obtained".[40]

SIAS also requested for Fincantieri to extend the offer period for Vard following a disorganised EGM. There was apparent confusion over whether the Chairman was going to adjourn the vote after the error was discovered in the IFA report. There were also complaints that Vard proceeded with the voting despite shareholders waiting for the company's responses to questions raised.[41]

On 10 May 2018, SGX RegCo issued a regulatory announcement to withhold its "no-objection" to the proposed delisting unless Vard fulfils certain conditions set out by SGX RegCo:-[42]

a. Submitting an updated draft Delisting Circular to the Exchange for its review pursuant to Listing Rule 1202. In this regard, the updated draft Delisting Circular must include, inter alia,:-
   i An updated IFA letter with the inaccuracies corrected and reflecting the current developments of the company; and
   ii An updated Independent Directors' recommendation to shareholders (taking into account the updated IFA Letter). The recommendation should state their assessment and the basis as to whether: (1) the shareholders should vote for the Delisting Resolution; and (2) the Exit Offer Price is reasonable;
b. Convening a general meeting based on the Delisting Circular in accordance with Listing Rule 704(15); and
c. Obtaining shareholder approval for the delisting in accordance with Listing Rule 1307.

On a separate but related note, SGX RegCo stated that due to the error, shareholders were given the impression that the exit offer was closer to the mean multiple than it actually is. It was noted that the exit offer was at a P/NAV multiple of 0.9 times, whereas the correct P/NAV of comparable companies should be 1.2 times – not the incorrect 1.1 times stated in the original IFA report.[43] SGX RegCo expressed the view that P/NAV figures are part of the information that shareholders would consider when making an informed decision on Vard's proposed voluntary delisting.[44]

According to an observer, "what SGX RegCo is doing is unprecedented." He stated that the move by the regulator reflected a more interventionist and direct approach to deal with inappropriate incidents.[45]

On 11 May 2018, Vard issued its responses regarding the inaccuracy in its comparables. It repeated its earlier assertion that "CIMB confirmed on multiple occasions during the EGM that the discrepancy in Sembcorp Marine's historical P/NAV multiple does not have a material impact on CIMB's overall assessment and CIMB maintained its opinion that the Exit Offer Price was not fair but reasonable. CIMB explained the reason why there was no change to the overall assessment is that even with a correction, the P/NAV multiple implied in the Exit Offer Price continued to be well within the range of P/NAV multiples of the Comparable Companies which is one of the bases upon which CIMB considered the Exit Offer Price to be reasonable."[46]

Voice of the minority shareholders

In June 2018, SIAS raised a number of questions to Vard with respect to its 2017 annual report as part of its initiative to improve the quality of annual general meetings.[47,48]

On 29 June 2018, Vard responded to the questions raised by SIAS. It was noted that only two of the six directors on Vard's board were independent despite the company having a non-independent Chairman. This was not in accordance with Guideline 2.2 of the Code of Corporate Governance, which states that the independent directors should make up at least half the board where the Chairman of the board is not an independent director.[49] Vard previously cited the ongoing privatisation attempt as a reason for the deviation from the guideline. In this regard, SIAS sought further clarification for any other reasons which might have led to the said deviation, but Vard's response was, without any elaboration, "No".[50]

SIAS also questioned if "a strong(er) independence element on the board [would] be more crucial in view of the proposal to privatise the company by the parent company". Vard responded by citing that the independence of directors defined under the Singapore Code on Takeovers and Mergers is different from that in the Code of Corporate Governance. Vard further mentioned that the Takeover Code does not stipulate a minimum number of directors who are independent for the purpose of making a recommendation on the exit offer.[51]

SIAS further questioned whether the board would reconsider the deviation from the Code of Corporate Governance and reconstitute the board in compliance with the guidelines since the company remained listed and thus should comply with the Code. Vard's response was non-committal, stating that such an issue was for the board to consider and was dependent on the outcome of the delisting process.[52]

The series of events surrounding Vard's delisting also prompted corporate governance advocate Professor Mak Yuen Teen to point out that there was not much that minority shareholders could do in such a situation in Singapore, where access to justice is poor as there is no contingency fee-based class action, resulting in legal action for minority oppression being very costly. Professor Mak also suggested that minority shareholders should be allowed to sue at little or no upfront cost – which is similar to the United States of America or the United Kingdom – or that regulators could sue on behalf of minority shareholders. While maintaining that Singapore "should have a system that fairly balances the rights of different shareholders, including minority and major shareholders", Professor Mak further urged Singapore's regulators to implement changes to better protect minority shareholder interest.[53]

The updated delisting circular

On 9 July 2018, Vard released an updated delisting circular that was approved by SGX and confirmed that the second EGM would be held on 24 July 2018.[54] In addition, the exit offer was extended from 20 July 2018 to 7 August 2018.[55]

Shareholders found it curious that the IFA letter in the updated delisting circular included some minor changes to Vard's valuation. In addition to the correction of the previously known error, CIMB excluded the takeover of CH Offshore from the list of comparable precedent transactions. In addition, the revised circular maintained that the independent directors concur with the IFA's opinion, and recommended shareholders to accept the exit offer despite it being "not fair but reasonable".[56]

SGX RegCo's query of IFA Letter

In response to the updated delisting circular dated 9 July 2018, SGX RegCo requested Vard and CIMB to respond to certain queries raised by Vard's shareholders in connection with the delisting. On 18 July 2018, Vard and CIMB responded to the queries in a company statement.[57]

As to why CH Offshore was taken out of the list of precedent transactions in the updated IFA letter, the response was that upon further consideration, CIMB felt that CH Offshore did not engage in shipbuilding operations and therefore was "less comparable" to Vard. CIMB also highlighted that the exclusion did not have any impact on its opinion that the exit offer was "not fair but reasonable".[58]

During the second EGM on 24 July 2018, the delisting resolution was passed with 96.43% voting in favour of the delisting resolution, and 3.57% against the resolution.[59]

A new chapter: Vard, a Fincantieri company

On 19 September 2018, Fincantieri extended the deadline for its buyout offer to 15 October 2018. It continued to offer S$0.25 per share to take Vard private and all terms under the exit offer remained unchanged. At that point of time, Fincantieri had effective control over a 94.73% stake in Vard.[60]

The buyout offer from Fincantieri closed on 16 October 2018 with Fincantieri controlling 95.99% of Vard's issued share capital.[61] Vard was finally delisted from the SGX Mainboard on 2 November 2018.[62]

Further outcomes

"What the Vard case illustrates is that if a company has inactive minority investors, then the safeguards work against minorities and work in favour of the offeror. We realise that this needed our attention and had to be rectified,"

– SGX RegCo's CEO, Tan Boon Gin[63]

On 9 November 2018, SGX RegCo proposed to raise safeguards on voluntary delisting rules by disallowing offerors and parties acting in concert from voting on voluntary delistings. SGX RegCo's CEO, Tan Boon Gin, admitted that the Vard case had highlighted the inadequacies in existing safeguards for minority interests.[64]

The changes included scrapping the provision that a delisting would not proceed if it was voted against by those who hold more than 10% shareholding. Additionally, exit offers with respect to voluntary delisting would have to be deemed both "fair and reasonable" by the IFA for the deal to proceed. Issuers are thus pushed to give shareholders a better exit value in a voluntary delisting. With these changes, SGX RegCo hoped to align the interests of all parties involved in a delisting, and to protect minority interests.[65] Professor Mak welcomed the new changes but expressed his concern that IFAs may not be truly independent.[66]

Following the conclusion of public consultations, SGX Regco announced that it will proceed with the proposed changes, with the approval threshold maintained at 75% of the total number of shares held by independent shareholders present and voting, and the removal of the 10% block.[67]

Discussion questions

1. Discuss the role of independent directors in a company's corporate governance. Do you think Roy Reite is truly 'independent' for the purpose of the delisting? Comment on Vard Holdings Limited's argument that reliance should be placed in the definition of 'independence' found in the Singapore Code of Takeovers and Mergers rather than the Code of Corporate Governance.

2. What is shareholder activism? Were there any alternatives for activist shareholders to block the resolution?

3. The role of independent financial advisers is to provide competent independent advice to protect the interests of shareholders. Are there any inherent conflicts of interest in such a role? And if so, what are some regulations and provisions in place to ensure the independence of independent financial advisers? What improvements, if any, would you propose?

4. Discuss regulations that help prevent abuse by majority stakeholders during takeovers. Identify the loopholes present in current rules which majority shareholders can potentially exploit.

5. Compare the regulatory environment with regards to delisting resolutions in Singapore and other developed countries, like Hong Kong and United States. What are the pros and cons with each country's stance on situations such as Vard's? How can Singapore improve on its rules to further protect the interests of minority shareholders?

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COMMONWEALTH BANK OF AUSTRALIA: THE UNWITTING MULE

Case overview

Australian banking giant Commonwealth Bank of Australia (CBA) received international scrutiny in 2017 when it emerged that international criminal syndicates had been using the bank's Intelligent Deposit Machines (IDMs) for years to launder money and finance terrorism. The bank was accused of having a poor regulatory compliance and governance environment, which was exploited by the money laundering syndicates. An Australian Transaction Reports and Analysis Centre's (AUSTRAC) investigation highlighted many instances where CBA was forewarned of illicit activity but took inadequate actions – public observers voiced their opinions that the bank's key management and directors were all asleep at the wheel. With CBA's large influence in the international financial market, news of the money laundering scandal not only shocked and impacted the domestic market, but also stakeholders worldwide. The objective of this case is to facilitate a discussion of issues such as money laundering; board leadership and oversight; risk assessment and management; and accountability to various stakeholders.

About CBA

CBA is a multinational financial group that provides integrated financial services such as retail banking, business and private banking, institutional banking and markets, and wealth management to its customers.[1] Founded in Australia in 1911,[2] the bank has established its longstanding position as one of the pillars of the Australian financial industry. In 2015, CBA was ranked at the top of the Australian Securities Exchange (ASX) market capitalisation report.[3] The group has grown its operations both locally and globally through a wide network of branches, subsidiaries and associates such as Bankwest, Colonial First State Investments, ASB Bank, and Commonwealth Securities.[4]

This is the abridged version of a case prepared by Khoo Dingyan, Le Quang Quan, Tng Shiqi and Wecom Huang under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Clarisse Tan under the supervision of Professor Mak Yuen Teen.

The landmark case

On 3 August 2017, AUSTRAC initiated civil proceedings against CBA in the Australian federal courts for severe breaches of the Australian Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (the AML/CTF Act) between November 2012 and September 2015.[5] This was a landmark case that caused a ripple of shock for observers as each instance of breach in the Act carried a maximum penalty of A$18 million. The maximum fine of nearly A$1 trillion dwarfed the entire bank's market value.[6] After news of the legal proceedings emerged, CBA's share value fell by 3.9% the following day.[7]

Four syndicates, of which three were linked to drug dealing and distribution, were discovered to have carried out money-laundering activities using the bank's fleet of IDMs – a smart ATM that could process cheques and cash deposits instantly – making the funds immediately available for transfer. The drug syndicates made deposits into several separate accounts under fake names, ensuring that each deposit was under A$10,000 – a limit that legally required CBA to report the transaction to AUSTRAC. The syndicates transferred the money out to overseas accounts thereafter.[8] CBA had allowed such transfers exceeding A$75 million to remain undetected for over two years.

Attacks from all sides

After the first civil proceeding was initiated by AUSTRAC, more parties started to hop on the bandwagon, adding to the bank's headache. Other regulators such as the Australian Securities and Investment Commission (ASIC) also began to announce that they were starting their own investigations into CBA.[9] Members of the Australian Senate also called for a royal commission in parliament to investigate the breaches.[10]

The Australian Prudential Regulation Authority (APRA) also announced that it would initiate an independent public inquiry against CBA, focusing on whether the bank deliberately overrode its controls and safeguards in pursuit of higher potential profits.[11] Such an action was unprecedented as APRA had normally operated 'behind the scenes', and the overt action was interpreted as a symbolic move that government regulators were adamant in making changes to the bank's leadership.[12]

The intelligent laundromats

Problems started back in 2012 when CBA introduced its IDMs into the market. The IDMs provided its customers with another integrated financial service. The introduction of IDMs saw an increase in transactions and savings.[13] Competition in both domestic and global markets remained stiff with other competitors launching new innovative products and services. Therefore, to place itself ahead of its competition and to prepare for potential stagnant economic growth, CBA offered consumers an option of using IDMs in the hope that this would it bring the bank to the forefront of financial technological advancement.[14]

What made the IDM seem like a superior service was that individuals, regardless of whether they were personally CBA customers, could deposit either cheques or cash into CBA accounts without a limit on the number of transactions.[15] This strategy helped attract more customers to CBA, especially small and medium enterprises, which were heavily reliant on cash.[16] These small and medium enterprises could also now bypass certain stringent restrictions in place when making large transactions. Furthermore, the technologically advanced and fast IDMs would ameliorate the large salary expenses that CBA incurred for bank tellers and front desk personnel, significantly reducing the bank's operating expenses.[17]

Without a limit on the number of transactions per day, large transactions could take place daily without any restrictions imposed by the IDMs. However, due to control oversight, the IDMs failed to capture unusually large transactions. This violated the compliance regulations imposed by the Australian authorities. The AML/CTF Act prescribed that any transactions exceeding the threshold value of A$10,000 had to be reported in Threshold Transaction Reports (TTRs) to AUSTRAC within 10 business days.[18] In addition, as the machine could be used by anyone – including non-CBA customers – anonymous deposits were permitted.[19]

In fact, the IDM platform was not a unique technological innovation exclusive to CBA. Westpac Banking Corporation (Westpac), another Australian bank, had also conducted a trial using IDMs. However, Westpac concluded in its trials that the risk of such machines being utilised by criminal gangs for money laundering purposes were too high, and ultimately chose to not proceed with the roll out of IDMs for public use.[20] However, CBA decided to install more than 805 IDMs country-wide by May 2017.[21]

Foong's gold

The launch of CBA's IDMs with weak controls came as pleasant news to two members of a methamphetamine manufacturing and trafficking ring based in Sydney, Australia – Yuen Hong Fung and Kha Weng Foong. Fung and Foong began laundering more than A$650,000 a day through CBA's IDMs from late 2014 to August 2015. An estimated total of A$20.6 million was deposited through IDMs into CBA accounts, and all of it was transferred offshore.[22]

This was not the first time that Foong had used his expertise in fabricating false identification cards. In 2009, he was involved in producing fake credit cards that enabled him to misappropriate almost A$7 million from retailers in Australia. Foong's expertise was just what Fung, who wanted to launder money made from methamphetamine sales to Hong Kong, needed. In 2014, Foong helped Fung to create false CBA accounts using fake driving licenses. Foong went by many names, such as Ronald Brown, Luke Shaw, and Richard Whippy. However, had CBA's staff looked closer, they would have noticed that all the fabricated licenses used the same picture of Foong.[23]

Fung used a number of IDMs throughout Sydney and ensured that the amounts deposited were under A$10,000 for each transaction. CBA had identified consistent, suspicious patterns of cash deposits in 16 of these accounts by April 2015. Despite this, the bank did not follow up on its findings, and allowed an estimated A$9.1 million to be transferred to Hong Kong between April and July 2015.[24]

The lone hero

On the morning of 28 May 2015, the manager at CBA's Leichhardt branch received an error message from one of the branch's IDMs, indicating that the machine was full. As this was an unusual occurrence, he was prompted to investigate further. He found that multiple deposits of about A$50,000 each were made to two accounts that morning. Upon further investigation, it was discovered that over the past month, both accounts had received deposits of at least A$1 million each which were then almost immediately transferred offshore. Fung had deposited A$457,980 that day as he went around using IDMs located in different locations. The problem at Leichhardt meant he had to go to Ashfield to deposit the remaining amount.[25]

A month later, on 30 June 2015, the Leichhardt branch manager approached Fung while he was doing his usual deposit run, which disrupted his actions. Fung simply moved to another location to carry on his business. That same night, CBA blocked 19 of Foong's accounts at the request of the Australian Federal Police (AFP). By this time, the bank had identified that the false accounts were opened by foreign nationals on holiday visas. The money laundering was therefore put to a stop for five days. However, it resumed later with 11 new accounts. These accounts utilised the same modus operandi previously identified by CBA. They fell through the cracks as there was a lack of subsequent follow-up monitoring for money laundering and terrorism financing risks.[26]

Foong and Fung were eventually arrested on the morning of 24 August 2015 at CBA's Eastgardens Branch for dealing with the proceeds of crime and structuring offences. Meanwhile, AUSTRAC alleged that CBA had failed to report 60 TTRs related to transactions by Fung and suspicious activities relating to Fung on 92 separate occasions.[27]

A lack of follow up

Foong and Fung were not the only criminals making use of CBA's IDMs to launder money. Between June 2014 and May 2016, three other money laundering syndicates making use of CBA accounts were identified. These three syndicates adopted similar practices of executing financial transactions in a specific pattern. Large amounts of cash were deposited into multiple CBA accounts through IDMs. Almost immediately after each deposit was made, the money would be transferred to either other domestic accounts or offshore bank accounts. These deposits were the proceeds made from drug manufacturing and trafficking carried out by the syndicates.[28]

In all three situations, CBA was aware of the unusual patterns of these transactions and identified the suspicious accounts, a few months after the money laundering activities started. For one of the syndicates, CBA had even identified evidence of structuring, and concluded that some of the accounts belonged to suspicious money remitters that were potentially part of a money laundering syndicate. However, CBA did not continue to monitor these customers and accounts and continued to allow these highly suspicious individuals to deposit cash and make transactions for their accounts. Despite the large and structured cash deposits made, several transactions for these accounts did not trigger transaction monitoring alerts for structuring. Although alerts were raised in the remainder of these instances, CBA failed to review them in a timely manner and did not submit timely Suspicious Matter Reports (SMRs), as required legally by the AML/CTF Act.[29]

In late 2015, the AFP advised CBA that several of the accounts related to one of these syndicates were involved in an investigation into serious criminal offences including drug importation and unlawful processing of money. However, even after the warnings were issued, CBA did not close several of these accounts and allowed more transactions to occur.[30]

Regulators given the run-around

It was clear as day that CBA had failed to manage its regulatory compliance obligations adequately. Within the three-year period from November 2012 to September 2015, CBA did not submit 53,506 TTRs on time, totalling A$624.7 million.[31] Even when the amounts transacted were less than A$10,000, CBA had a legal obligation to file SMRs to AUSTRAC when it identified suspicious patterns of activity. Such patterns might include customers who deposit amounts just under the threshold transaction limit to avoid detection. However, CBA adopted an internal policy where SMRs would not be submitted if suspicious matter of the same nature had already been reported in the previous three months. Between August 2012 and June 2017, there were 69 cases identified where CBA failed to submit SMRs related to possible money laundering crimes on a timely basis, even after receiving requests from law enforcement for account details to assist in their criminal investigations.[32]

In many other cases, SMRs were not submitted due to a lack of transaction monitoring alerts raised or reviewed. For the incidents where alerts were raised and reviewed, CBA's submissions were usually incomplete.[33]

Risk assessment falls short

Before the introduction of IDMs into the mass market, CBA did not perform risk assessments for anti-money laundering and counter-terrorism financing risks. Such risk assessments were required under the AML/CTF Act in Australia. As a result, there was a lack of adequate risk-based systems and controls to manage these risks.[34]

After the IDM launch, CBA did not carry out the necessary risk assessments from 2012 to mid-2015 even when there was an exponential increase in the amount of cash deposited during this period. An estimated A$8.9 billion in cash was deposited through CBA's IDMs before it performed the risk assessment required. CBA had also failed to comply with its transaction monitoring program for 778,370 accounts from the launch date to September 2016.[35]

Around July 2015, CBA's intelligence analysis had obtained evidence that criminal syndicates were laundering several millions of dollars through its IDMs. Following that, CBA contacted the serious organised crime units of the AFP, New South Wales (NSW) police, and Western Australian police regarding the said money laundering activity. However, once again, CBA failed to follow its own anti-money laundering procedures and no new risk controls were introduced to tackle the problems that surfaced.[36]

One year later in July 2016, CBA evaluated that the IDMs had a high inherent money laundering risk but once again, it concluded that the residual risk was low. Hence, no action was taken to address the high inherent risk.[37]

Mismanagement of operational risks

CBA had the legal obligation to continually monitor its customers so that the risk of money-laundering and terrorism financing could be managed and reduced. Once suspicious transactions have been identified, CBA must carry out enhanced customer due diligence (ECDD), as required by the AML/CTF Act. This may include ascertaining the source of the customer's wealth or terminating their accounts.

However, when dealing with suspicious customers, CBA was slow to decide on whether to cease doing business with these customers. They gave the criminal syndicates 30 days' notice before suspending their accounts and in 20 of these cases, AUSTRAC noted that the money laundering offences continued during the notice period given. CBA did not put in place any additional checks on these transactions and was unable to address the problem properly.[38]

Legal tussles

By December 2017, CBA had filed its response to the legal suit filed by AUSTRAC. The bank only admitted to 91 allegations, challenging the remaining hundred or so claims made by AUSTRAC.[39] The agency responded by increasing the scope of its claims and charged the bank with 100 additional new claims of breaches of the AML/CTF Act.[40]

CBA responded by denying a further 89 of these claims. A deadlock between CBA and AUSTRAC ensued, with both parties increasing their accusations and claims over the scandal. On 22 March 2018, the courts ordered mediation between the two parties.[41]

Missing from the equation: accountability

The bank identified 'accountability' as one of its five core values in its 2014 Shareholder Review.[42] However, accountability appears to be lacking in CBA's corporate culture.

APRA released the CBA prudential inquiry final report on 30 April 2018.[43] The report noted that CBA's culture had a lack of clear accountability, and hence it was difficult to identify who was accountable when problems arise. A lack of collective accountability by senior leadership was one of the main factors identified by the regulator that led to CBA's ineffective management of its regulatory compliance obligations, leading to the money laundering scandal.[44]

APRA had also assessed the internal practices of CBA through interviews and focus group discussions with employees from various levels. The company's culture was characterised as lax, complacent and reactive based on the findings. The report highlighted that CBA employees tended to adopt a sense of helplessness because of the large size of the company and the complexity of issues. The employees of the bank attributed the problems faced by the bank to external factors such as the highly volatile nature of the financial markets, rather than internal failures. Employees were found to have a "check-box" mentality whereby they would just carry out the processes assigned to them and nothing more due to their lack of understanding of the rationale behind decisions made.[45]

Who is to blame?

CBA's first response to the AUSTRAC accusations was to downplay the severity of its error. It claimed that due to technicalities of the law, the 53,700 breaches alleged by AUSTRAC may only be considered as just one breach as all the breaches were caused by a software update error. [46] The software update error had caused the IDMs to malfunction and stopped the generation of TTRs required for all transactions above A$10,000. CBA's Chief Executive Officer (CEO) Ian Narev claimed CBA only discovered the error three years later in 2015 and had taken steps to notify AUSTRAC and provided a fix for the machines within a month.[47]

Suspicions related to illegal activities had already been raised within the bank since 2014. These red flags should have prompted the company to file reports regarding their IDMs being used for illegal activities to AUSTRAC within three business days under the AML/CTF Act.[48] However, CBA did not do so for many transactions.

According to a report by AUSTRAC, "Had [CBA] introduced daily limits earlier it would have disrupted money laundering activity through IDMs by syndicates involved in the importation and distribution of drugs including methamphetamine."[49]

Signs of repentance

Under immense public pressure, the board of CBA announced in August 2017 that it would cut all short-term incentive bonuses for its top management, as well as reduce the director fees of its board members by 20% for the year.[50] In addition, CBA announced that its CEO would be leaving the bank by the end of the 2018 financial year.[51]

Following the additional pressure from legal actions being taken against the bank, as well as the fall in its share price, Catherine Livingstone, the Chairman of the board, announced a board restructuring plan, with three directors being replaced. She also announced that the bank intends to establish a director subcommittee to oversee the investigations and responses relating to the scandal.[52]

Analysts estimated that the increase in operating costs arising from legal fees to defend itself against lawsuits would amount to A$200 million over the following two years.[53] In addition, it was estimated that CBA would have to incur a A$2.5 billion fine as a result of its breaches.[54]

Subsequently, CBA announced that Narev would not be eligible to cash in his long-term bonus shares for the year. In an investor conference, Narev apologised for the scandal and took responsibility for it. Livingstone also apologised for the scandal during the shareholders meeting. In addition, it was announced that two more board directors would leave by the end of 2018.[55]

Directors asleep at the wheel?

CBA's board of directors also came under the spotlight when consumer advocates claimed that the "long-serving Commonwealth Bank board members had been asleep at the wheel", leading to the bank's long string of scandals since 2009 that included the bribery of CBA's executives in relation to the award of business contracts, provision of shoddy financial planning advice, and the "fees for no service" scandal.[56]

The board was originally made up of 10 directors, out of which eight were independent non-executive directors.[57] The Chairman of the Risk Committee, Shirish Apte, did not reside in Australia, where the CBA headquarters are located. Instead, he lived in Singapore, where he was employed.[58]

APRA's final report on CBA's prudential inquiry had found that there was a culture of complacency, dismissiveness toward government regulations, and a general lack of accountability and oversight of the risks by CBA's key management and senior executives. The regulator found that the board had placed high trust and confidence in the bank's management due to their continual financial success. The board also believed that CBA, being one of the four largest banks in Australia, was conservative and had a culture of prioritising their customers' interest. This led the board to let its guard down.[59]

APRA noted that these factors resulted in the board being complacent and less attentive to signals that may have alerted it to the risks introduced by the IDMs and the money laundering scandal. The report also said that the board and its committees were often slow in dealing with non-financial risks, which may have communicated a tone of inaction to the rest of organisation. The inquiry found that the board was not sufficiently rigorous in ensuring that management mitigated high risk areas.[60]

The beginning of the end

In early April 2018, Narev stepped down as CEO of CBA with A$12 million worth of shares as a parting gift. He was replaced by Matt Comyn, the head of CBA's retail bank since 2012.[61] Two months later, CBA and AUSTRAC reached a settlement agreement. As part of the settlement, CBA would pay a record A$700 million fine to settle the claims of money laundering and terror financing breaches. The bank admitted to failure in the late or non-filing of more than 53,700 reports to AUSTRAC for cash deposits over A$10,000 and 149 suspicious matter reports. CBA claimed that it had improved its internal controls and systems since then.[62]

Epilogue: Hayne's call for change

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was tasked with investigating if Australia's banks have engaged in misconduct, and whether adequate controls were put in place. The one thousand-page report by Commissioner Hayne, which was released in February 2019, contained 76 recommendations. Among the recommendations, financial regulators are to impose criminal charges against entities associated with the "fees for no service" scandal. The royal commission also recommended the retention of the "twin peaks model" for financial regulation, but with a clearer segregation of roles. APRA continued to retain its role in regulation, and ASIC would oversee conduct and disclosure. ASIC was also urged to commence legal proceedings when dealing with large corporations in the event of law breaches, instead of merely issuing infringement notices, which should only be used for administrative matters. In addition, APRA and ASIC should also be more stringently monitored by an independently chaired regulator-oversight body, to ensure the accountability of regulators by conducting regular reviews.[63]

Following the royal commission's calls for further investigations by the regulators into CBA's failings, CEO Comyn addressed past lapses and pledged to improve its compliance and risk functions.[64]

Commissioner Hayne highlighted that the Australia's financial institutions must change their culture and conduct.[65] The CBA scandal involving money laundering and terror financing breaches was arguably one of the largest scandals in recent years. However, other misconduct such as deceased customers being charged fees and unqualified customers being sold insurance, was also uncovered. The Hayne report is a wakeup call to the financial industry in Australia.

Discussion questions

1. Describe the deficiencies in oversight and accountability within CBA that contributed to the failure. Should the CEO, Ian Narev, be held responsible for a technical operational error? Suggest potential improvements.

2. Discuss how the culture at CBA contributed to the lapses in risk management. Suggest improvements to be made.

3. Comment on the actions taken by CBA following the discovery of the vulnerabilities. Was there more that the company could have done?

4. Evaluate if the penalty imposed by the courts was fair to CBA's stakeholders. Should the board of directors have been held responsible for the breaches?

5. In light of the recent wave of technological integration within the banking and finance industry, discuss its impact and how the risks can be managed.

6. What are the regulatory bodies and regulations in place for Singapore in relation to money laundering and terrorism financing? In your opinon, would the CBA case have been prevented if it were to happen in Singapore?

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DALIAN WANDA: BINGE AND PURGE

Case overview

Dalian Wanda Group first attracted global attention due to its global acquisition spree, aggressively buying stakes in well-known overseas assets. Wang Jianlin, one of China's richest individuals and owner of the Wanda Group, was the brains behind the Group's business strategy. In 2017, Wanda announced that it would sell off its theme parks and hotel assets and redirect its focus from foreign to local investments. This was the result of a government crackdown on Wanda for its numerous overseas acquisitions. The objective of this case is to facilitate a discussion of issues such as corporate governance in founder-led companies; corporate governance of private companies; role of the government in corporate governance; the impact of external market factors; and risk management regarding acquisitions.

The Dalian Wanda conglomerate

The Dalian Wanda Group was founded by Wang Jianlin in Dalian, China, in 1988. The Group is the epitome of the China's rags-to-riches story – what started as a small residential real estate developer in 1988[1] grew into one of China's biggest property developers and the largest cinema chain operator worldwide. Its main businesses include commercial property, department stores, luxury hotels, and tourism.[2] The Group is best known for its various tourist resorts and the large-scale Wanda Plazas – building concepts integrating retail, hotels and residential – which can be found across China.

This is the abridged version of a case prepared by Chen Zhen Yun, Lam Yi Fung, Wu Jinyu Nicholas, Yap Zhi Xin Regine and Zhao Mingsha under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

Wang's the one

Wang was born to a family closely related to Mao's People's Liberation Army in Mianyang, Sichuan Province. He served in the Army for 16 years, after which he worked as the office administrator for the Xigang District. In 1988, he entered the real estate industry where he worked as a general manager in Xigang Residential Development Company, a debt-laden state-owned property developer company.[3,4] Later in 1992, as its situation began to improve, the company was renamed Dalian Wanda, with Wang in full control.[5] Wang has been the Chairman of the Group since 1989,[6] and has served as its CEO since 1993.[7] Due to Wanda's growing success, Wang became the richest man in China and Asia in 2015.[8]

As founder, Wang had strong control over the Wanda Group, which allowed him to direct many of the company's future plans. In the beginning, he led Wanda with a highly authoritative style – Wang was the sole decision-maker in the firm, while other employees simply executed his plans as instructed. Failure to execute his instructions could result in penalties such as fines.[9] Over time, Wang placed a greater amount of trust in the senior management of various divisions under Wanda. Decision-making in subsidiaries was carried out by the individual divisions while Wang focused on corporate strategies at the Group level.[10]

The power of *'guanxi'*

On 28 April 2015, the New York Times published an article reporting that political ties with the Chinese government is the main driver behind the flourishing Group's success.[11] It was noted that related parties of some of China's influential politicians and their business associates own substantial stakes in Wanda Group, including the sister of China's President, Xi Jinping.[12]

The article reported that Wang claimed that "it's a fact that China's economy is government-led,"[13] as state-ownership plays a dominant role in the Chinese economic growth, with market forces reacting accordingly.[14] However, Wang had publicly stated that his company policy is to "stay close to the government but distant from politics" to ensure Wanda's long-term survival.[15]

In response to the New York Times article, Wang stated that "Wanda has no political affiliation" and attributed the Group's success instead to fortunate circumstances such as overwhelming reception in the market in response to the January 2000 private placement for its commercial properties subsidiary.[16] He further commented that "market forces" and "creative abilities" – as opposed to personal connections – were key to developing a successful business in China.[17]

Wanda's global strategy – the race to acquire

In 2012, Wanda Group got into the global spotlight when it started a series of worldwide investments and acquisitions to expand its influence and strengthen its competitiveness across the globe. Many of its overseas acquisitions and investments were centered on the cinema, sports and entertainment industry, which is a far cry from its original property developer roots.

This “aggressive level of diversification”[18] was in line with Wang’s plan to globalise Wanda. At a Harvard Business School forum in 2015, Wang commented that “If Chinese companies don’t go through the globalisation phase, it’s hard for us to make China powerful or realise the Chinese Dream”.[19]

Wanda made many foreign acquisitions that span across several industries. Most notably, the Group acquired AMC Theatres (AMC) in May 2012 for US$2.6 billion and Legendary Entertainment (Legendary) in January 2016 for US$3.5 billion.[20] Both companies are large U.S.-based film companies – AMC is the biggest movie theatre chain in the U.S., and Legendary is a highly-established media company.[21] One of the costliest investments made by Wanda in the properties market was EuropaCity, a shopping and leisure complex based in France. Wanda announced in May 2017 that it would invest a total of US$3.3 billion in the project, which is set to be completed by 2024.[22] These acquisitions were seen to be part of Wanda’s global strategy to spread China’s soft power to other countries around the world.[23]

As a private entity, the Group was not able to raise funds for these major acquisitions through the public market. Instead, the foreign acquisitions were funded by a group of state banks.[24] This represented a significant amount of debt undertaken by the Group.

The crackdown

In 2017, Wanda’s ambitious globalisation plan faced a huge setback as the Chinese government cracked down on its aggressive foreign acquisitions. The Chinese financial regulators ordered the country’s biggest banks to stop providing loans to Wanda to finance its foreign acquisitions.[25] This was aligned with Beijing’s measures to control potential systemic risk by preventing outflow of capital and foreign direct investment.[26]

The regulators and executives of China’s state-owned lenders had a meeting on 20 June 2017, which focused on six of Wanda’s foreign acquisitions. It was advised that those acquisitions, which included four completed projects and two pending projects, had violated capital restrictions enacted in the prior year.[27]

This crackdown on Wanda by the Chinese government was reported to have been personally signed off by Xi Jinping. Wanda was banned from obtaining additional financing from the Chinese banks for the four projects already purchased, and from using its Chinese funds to finance any of the deals, jeopardising the Group’s ability to raise funds for further investments.[28]

Wanda was not the only company that was targeted as other Chinese private companies that had been aggressively acquiring foreign companies were also subjected to the crackdown. After the 2015 stock market meltdown, many Chinese companies had turned to overseas investments to hedge their revenue against such market risk and to search for investments with better returns.[29]

The motivation behind the crackdown was to minimise irrational foreign investments and in doing so, better develop China's foreign investments. China had attempted to clean up the draining of capital from aggressive buying of overseas deals, which arose from a lagging economy as well as downward pressure on foreign exchange rates.[30]

The Chinese currency had been depreciating fast and Chinese officials were worried that money flowing out for overseas purchases would exacerbate the currency's depreciation and spur a selloff in the yuan.[31] In an effort to slow down the depreciation of the Chinese yuan, President Xi Jinping called for greater scrutiny of outbound investments on 26 June 2017.[32]

In view of this, Wang had to forgo many potential foreign acquisitions, including the partial financing of Arc of Justice,[33] the acquisition of Dick Clark Productions Inc.,[34] and plans to buy Nine Elms Square in London.[35]

The purge of assets

In addition to backing out on pending deals, Wang embarked on a series of restructuring efforts in July 2017 to reduce Wanda's debts. These restructuring efforts were also part of Wang's plans for Wanda Group to transition to an asset-light business model.[36,37]

On 12 July 2017, Chinese developer Sunac announced that it would be acquiring 76 of Wanda's hotels and numerous theme parks for US$9.3 billion.[38] A week later, it was announced that property developer R&F Properties would join in the deal as Sunac faced scrutiny on its own high debt levels. Eventually, it was agreed at R&F Properties would purchase 77 hotels while Sunac would purchase a significant portion of the tourism project portfolio from Wanda.[39] The deal would allow Wanda's property arm, Wanda Commercial, to halve its debts and increase its cash by 70%.[40]

Less than a month later, in August 2017, Wanda Hotel Development – Wanda Group's Hong Kong-listed real estate arm – announced that it would acquire Wanda Hotel Innovation Group and Wanda Hotel Management for a total of US$952 million.[41]

In 2018 and 2019, in its commitment to "an asset-light, low-debt developmental strategy",[42] Wanda conducted a fire sale of many of its assets, including its well-known department stores and theme parks. On 18 January 2018, the Chinese conglomerate sold a luxury development project in London for US$81 million. In the same month, it sold two Australian projects to AWH Investment Group Pty Ltd, a China-backed developer.[43] The announcement came a day after Wanda denied that it was considering selling the projects in Australia.[44] The string of disposals is consistent with the company's strategy to de-leverage and strengthen its financial position.[45]

Most notably, all 37 Wanda department stores were sold to electronics retailer Suning.com in February 2019. As a result of its sales, assets on its balance sheet decreased by over 20% between end-2016 to March 2019. It has been reported that Wanda is still in the midst of divesting and deleveraging. Unfortunately, in the process of doing so, Wanda's net worth has dropped by approximately 37% from a high in 2017 of US$31.9 billion to US$20.2 billion in April 2019.[46]

Turning the focus to local

After the crackdown by the Chinese government in 2017, Wang vowed to confine his major acquisitions within China's borders. He declared that the conglomerate would curb its finger-dipping into various industries overseas, and instead it would "actively respond to the state's call and had decided to put its main investments within China".[47] With Chinese regulators tightening their grip on Wanda's piggybank, whether the Chinese conglomerate would still be able to achieve as much growth as before remains to be seen.

Discussion questions

1. The founder of Wanda Group, Wang Jianlin, played a huge role in determining the direction of the Wanda Group. What are some pros and cons of such founder-led companies?
2. Wanda Group being a private entity owns several listed subsidiaries such as AMC and Wanda Hotel Development. What are some corporate governance issues associated with such a structure? What are the safeguards that should be in place with respect to listed companies with private holding companies?
3. In your opinion, should corporate governance requirements and standards applicable to listed companies be applicable to a large private company like Wanda Group? What are the arguments for and against?
4. How might the acquisition of overseas subsidiaries affect the overall risk level of the Wanda Group? What do you consider to be the key risks of such a strategy? What risk management and risk governance policies and practices do you think Wanda Group should have in place?
5. Wanda Group has been able to make a number of significant acquisitions in places like the U.S. and Europe. Do U.S. and European companies have a similar ability to acquire Chinese businesses and invest in China? How might restrictions in foreign ownership and investment affect the quality of corporate governance in a country.

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HNA GROUP: SHOP TILL YOU DROP

Case overview

HNA Group was one of China's most aggressive dealmakers, until it began facing liquidity challenges and pressure from the government. It faced further stress when investors raised questions about its opaque ownership structure and complex deals. While its acquisitions valued at more than US$40 billion over six continents from 2015 to 2017 had helped it ascend the rankings of the Fortune Global 500 list, the Chinese conglomerate was eventually forced to sell a significant amount of its assets in light of the Chinese government's crackdown and to keep afloat. The objective of this case is to facilitate a discussion of issues such as risk management; corporate governance in China; overlapping directorships on related companies' boards; non-segregation of shareholders, management and the Board; and corporate governance of large private entities and charitable foundations.

In the beginning

HNA Group Co., Ltd. (HNA Group) was co-founded by Chen Feng and Wang Jian in 1993. The two co-founders each held 14.98% shares in HNA Group and served as the Group's co-Chairmen.[1] HNA Group quickly grew during the Chinese economic reform, transforming from a local aviation operator to an international company with a diverse number of core businesses.[2] The Group comprised seven sub-groups – HNA Aviation, HNA Tourism, HNA Capital, HNA Holdings, HNA Modern Logistics, HNA Innovation Finance, and HNA Innovation Media & Entertainment.[3]

Familiar business partners

The younger brother of Chen Feng – Chen Guoqing – and Chen Feng's son – Daniel Chen – became involved as one of the frequent business partners of HNA Group's subsidiary, Hainan Airlines. Chen Guoqing incorporated New York-based Pacific American Corporation (PAC), an exclusive purchasing agent which sourced for aviation transportation equipment in the overseas market for Hainan Airlines. For its services, PAC was compensated with an agency fee of one and a half percent.[4]

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Despite documentation submitted during court cases which disclosed that PAC was at one point of time an affiliate of HNA Group, HNA Group claimed that it did not have any stake in the company. Furthermore, there had been a lack of disclosures in HNA Group's regulatory filings – the Chen family's significant involvement in PAC and the multiple deals between the two companies were never disclosed.[5]

HNA Group's dealings with related parties were not only limited to Chen Feng's family members. The Group had similarly awarded many business opportunities to Wang Wei, the younger brother of Wang Jian. According to corporate filings, Wang Wei had set up more than 30 companies to conduct business with HNA Group and its affiliates from 1994 to 2010.[6] Similar to its involvement with the Chen family's businesses, HNA Group did not fully disclose the extent of Wang Wei's connection to the Group. The New York Times reported that in its review of hundreds of company filings for the past 25 years, Wang Wei's name was only mentioned a few times and there was no indication of his relationship with Wang Jian.[7]

The sky's the limit

Over the span of three years from 2015 to 2017, HNA Group made over 123 overseas deals, accumulating US$45.7 billion in debt as a result.[8,9] In October 2016, it purchased a 25% stake in Hilton Worldwide Holdings for US$6.5 billion. The purchase for US$26.25 per share was at a 14.6% premium to Hilton's closing share price.[10] The Group's Chief Executive Officer (CEO), Tan Xiangdong, justified that the purchase was in line with HNA Group's business strategy to enhance its global tourism business.[11]

HNA Group's business sprawl extended to the real estate sector as well. In March 2017, it completed the purchase of 245 Park Avenue in Midtown Manhattan for US$2.21 billion and spent another HK$7.44 billion (US$960 million) for four plots of land in the Kai Tak area in Hong Kong. The price paid per square foot for the latter was nearly twice as much as the price paid in an earlier land sale in the same location.[12] HNA Group defended the exorbitant price paid, stating its plan to construct a world-class integrated residential complex in the area.[13] The deal increased HNA Group's investment in the Hong Kong property market to an aggregate amount of HK$27.2 billion (US$3.5 billion), which HNA Group claimed was "not a big number".[14]

Two months later, in May 2017, HNA Group increased its stake in Deutsche Bank to 9.92%, making it the largest single shareholder with a stake worth US$3.7 billion. This was despite heavy fines being imposed on the bank due to its involvement in a number of scandals, and a €1.4 billion loss recorded for the FY2016. The reason provided by the Chinese conglomerate for this investment was that Deutsche Bank's shares were "substantially undervalued".[15]

Other high profile purchases include the US$2.5 billion acquisition of Avolon Holdings Ltd, an Irish aircraft leasing company, in 2015,[16] the US$2.8 billion acquisition of air-ground handler Swissport International Ltd (Swissport),[17] as well as the US$1.5 billion acquisition of airline catering company, Gategroup Holdings in 2016.[18] The Chinese conglomerate also purchased Ingram Micro, a technology distributor in the United States, for US$6 billion in 2016.[19]

HNA Group's acquisition spree propelled it up the Fortune Global 500 rankings. It first appeared on the list in 2015 – ranked at 464 – and again the following year, when it was ranked 353. HNA Group was on the Global Fortune 500 list for the third time in 2017, where it catapulted to the 170th position with reported annual revenue of US$53 billion.[20]

Calm before the storm: financing its investments

The acquisition binge from 2015 to 2017 resulted in HNA Group amassing more than US$40 billion worth of stakes overseas.[21] The purchases were financed through leveraging its existing assets.[22] As a result of the rapid succession of acquisitions, its debt had accumulated to US$94 billion in 2017.[23] Furthermore, Bohai Capital Holding Co, a listed subsidiary under HNA Group responsible for the Group's leasing assets, loans and bonds, had outstanding debt of RMB232.62 billion at the end of March 2017, which was over 600% of its net assets.[24]

Seeking help from within: Intergroup loans

To cover the liquidity gap across its business units, the Group turned to its subsidiaries for intergroup loans.[25] In this regard, Swissport made numerous short term loans to affiliated companies of the Group.[26] Swissport's lending had sparked anxiety amongst investors, resulting in a fall of the aviation service company's own bond prices.[27] Following that, HNA Group extended the interest payments and maturity for a loan of US$470 million due to Swissport in November 2017.[28] The extension led to a drop in Swissport's credit rating by ratings agency Standard & Poor's to a B- a month later, which was considered to be deep in the "junk" category.[29]

Another related party, Bohai Life Insurance Corp., which was controlled by Bohai Capital, was reported to have provided billions of dollars to HNA Group for its acquisition spree through shadow-banking products.[30] The intergroup related party transactions between Bohai Life Insurance Corp. and HNA Group and its related parties were forcefully halted for six months by the China Insurance Regulatory Commission in October 2017. Additionally, Bohai Life Insurance Corp. was ordered to terminate or unwind its financial transactions with its ultimate parent company. The move was part of the Chinese government's crackdown on China's most aggressive overseas acquirers, due to concerns that leverage-fuelled acquisitions would accumulate risks – especially to China's domestic market.[31]

Sinking in debt

In 2015, China hit a record high of US$676 billion in capital outflow, which accounted for almost 92% of the country's total emerging markets outflow.[32]

Due to fear that such major capital outflows would drain the country's foreign currency reserves, the Chinese government stepped in to curb the overseas shopping sprees. In June 2017, China's bank regulators ordered domestic lenders to evaluate their exposures to conglomerates – including the HNA Group – which engaged in an overseas acquisitions or investments through over-leveraging.[33] Subsequently, in the second half of 2017, HNA Group started to display signs of financial distress, when its generated profits were insufficient to cover its interest expenses for the year.[34]

In the face of tightening controls, HNA Group turned to costly alternative financing methods, such as private funding and high-interest short-term dollar bonds. However, that did not save HNA Group from its massive debt and the Group started to face severe cash flow shortage in late 2017.[35,36]

Furthermore, seven of HNA Group's subsidiaries listed on the Shanghai and Shenzhen stock exchanges were halted from trading between November 2017 and January 2018.[37] Five of these suspensions were made days before the Group announced that it was facing liquidity issues.[38] In July 2018, Fortune magazine removed HNA Group from the Fortune Global 500 list.[39]

Introducing the crew: HNA Group's board of directors

Facing a liquidation crisis, HNA Group's board of directors was under immense stress. The situation was further complicated after co-Chairman Wang Jian's sudden death during a business trip in France.[40] After Wang Jian's death, Chen Feng reshuffled the board. HNA Group's board consisted of eight non-independent directors.

Name	Position	Independence	Other related roles
Chen Feng	Chairman	Non-independent	• Co-founder of HNA Group
Tan Xiangdong	Vice Chairman	Non-independent	• CEO of HNA Group
Li Xianhua	Vice Chairman	Non-independent	• Co-founder of HNA Group
Zhang Ling	Vice Chairman	Non-independent	• President of HNA Group • Chairman of HNA Aviation and Tourism Group
Chen (Daniel) Xiaofeng	Member	Non-independent	• Assistant to Chairman • Vice CEO of HNA Group • Chairman and CEO of HNA Group (North America)
Chen Wenli	Member	Non-independent	• Co-founder of HNA Group
Huang Qijun	Member	Non-independent	• Chairman of HNA Logistics
Bao Qifa	Member	Non-independent	• Vice Chairman of HNA Aviation and Tourism • Chairman of Hainan Airlines Holding Co., Ltd

Figure 1: HNA Group's board of directors[41]

Chen Feng's son, Chen Xiaofeng was promoted to be a member of the board and as the Vice CEO of the Group.[42] Although it is not uncommon for family members or relatives to sit on the board or take on key management positions in family-associated companies in China, investors were seeking better disclosures from HNA Group.[43]

Do as the locals do

Board of supervisors

In addition to having a board of directors, Chinese company law mandates that a limited liability company must establish a board of supervisors.[44] The board of supervisors should consist of at least three members, comprising of shareholders and employee representatives. In general, the board of supervisors is given the authority to monitor the financial and business activities conducted by the board of directors and key management personnel, on behalf of company shareholders.[45]

As at March 2019, HNA Group only had two members on its board of supervisors.[46]

Legal representative

The company law in China stipulates that every limited liability company has to appoint a legal representative. The legal representative has the legal power to represent and enter into binding obligations on behalf of the company. The company would bear the consequences of any actions of the legal representative, even if the actions are beyond the legal representative's authorised parameters.[47]

Chen Feng is the legal representative for HNA Group.[48] He holds the legal representative chop, which would be used to authorise company documents and agreements.[49]

Hiding behind the large private company status

Under the newly revised Code of Corporate Governance for Listed Companies in China, listed companies will have to disclose their shareholding structure and reveal who controls the company (Chapter 7).[50] However, as a large private company,[51] HNA Group is spared from this mandatory disclosure requirement. Hiding behind the large private company status with little disclosure, it is difficult to decipher the ownership and operations of HNA Group.

Foreign regulators and banks' concerns

"We simply don't know what we don't know, and are not prepared to take the risk."

– Matthew M. Koder, President of Bank of America[52]

In July 2017, Europe's banking regulator questioned HNA Group's stake in Deutsche Bank, which was reported to be at 9.9%, just 0.1% below the 10% threshold to initiate a supervisory investigation on the investor.[53]

This questioning came about because of the opaque ownership structure of HNA Group, which was a concern to many of the foreign regulators and investors. The scepticism towards HNA Group's ownership structure was intensified after Guo Wengui, an exiled business tycoon, made bold statements suspecting that HNA Group had secret ties with Wang Qishan, China's Vice President and anti-corruption tsar.[54] While Guo's allegations that HNA Group was secretly owned by a high-ranking Communist Party official and his nephew were refuted by HNA Group as "false and defamatory",[55] its obscure ownership structure did not help in dispelling Guo's allegations and led many investors to shun the HNA Group and its affiliates.[56]

Citigroup made the decision to close its doors to HNA Group, citing that the company had failed to meet its Know Your Customer checks.[57] Bank of America also stopped its dealings with HNA Group amid concerns about the Group's growing debt and the lack of transparency in its ownership structure.[58]

The big revelation

"Although we are a private company with no obligation to disclose our ownership, we respect and appreciate the desire for transparency in this regard,"

– HNA Group[59]

Amidst intense public scrutiny and criticism, HNA Group was cornered to publicly disclose its ownership structure.

Its disclosure revealed that the Hainan Cihang Charity Foundation – a New York-based non-profit organisation – held the largest shareholding of 29.5% in HNA Group, after receiving the shares from a little-known investor called Guan Jun.[60,61] Secondly, a charitable foundation based in Haikou, Hainan Province Cihang Foundation, was indirectly holding 22.75% of HNA Group's shares. The remaining shares were held by 10 other individuals who were either executives or directors of the Group, and Hainan Airlines Holding, which had the smallest 0.25% stake in the Chinese conglomerate.[62]

Following the disclosure, there was considerable speculation about the identity of Guan Jun and how he managed to hold such a substantial percentage of shares in HNA Group. The public had very little information about Guan, which led Guo to speculate that he was an illegitimate child of Wang Qishan.[63] However, Guan subsequently refuted the allegation,[64] and it was later revealed that he had purchased his stake from Hong Kong-based businessman Bharat Bhise.[65]

HNA Group's Bhise-ness

Bhise, the Chairman of a boutique investment firm Bravia Capital, had co-invested with HNA Group in a series of offshore investments. He was also a board member of five HNA Group-invested companies.

During an interview with Reuters, Bhise said that he never actually owned the shares in HNA Group, but had held them as "accommodation" to HNA Group without any compensation in return. HNA Group's senior executives made this request ahead of forming the charity now known as Hainan Cihang Charity Foundation. He further stated that the reason for doing so was because he was not a Chinese citizen, and thus would not require Beijing's approval to hold the shares outside of China. Subsequently, Bhise sold the stake to Guan.[66]

The controversy surrounding who truly owns HNA Group prompted HNA Group's CEO Tan Xiangdong to come forward to explain that the large shareholding under Guan's name was "[HNA Group's] own stake. For the whole time. They [Mr. Guan Jun and Mr. Bhise] had just held the stake for us. That's why I can move the shares."[67] This added further confusion to HNA Group's ownership structure.

Sudden change of key players

Subsequently, Guan's name disappeared from HNA Group's shareholding list in July 2017. He had donated his shares to Hainan Cihang Charity Foundation, a charitable foundation established by the HNA Group's founders in 2016. As a result of the transfer, the charitable foundation became the largest shareholder in HNA Group, holding 29.5% of the Chinese conglomerate's shares.[68]

After co-founder Wang Jian's sudden death in July 2018, his shares were transferred to Hainan Province Cihang Foundation. This was in accordance with an open letter issued to all HNA Group employees, which stated that all individual shareholders of HNA Group "have pledged to donate all their shares to the two charitable foundations upon their resignation or death" in 2017.[69,70] As such, Wang Jian's death increased the shareholding of Hainan Province Cihang Foundation to 38%. Collectively, close to two-thirds of HNA Group is currently held by the two charitable foundations.[71]

Behind the charity curtain

Although it is a common practice for charities to apply for tax exemption in order to maximise their resources for philanthropy, Hainan Cihang Charity Foundation decided not to apply for tax exemption.[72] HNA Group's exact motives for this were not disclosed.

In Deutsche Bank's filing of Schedule 13D with the U.S. Securities and Exchange Commission, it was revealed that both charity foundations in Hainan and New York were governed by individuals connected to HNA Group. Hainan Province Cihang Foundation – the charity foundation in Hainan – was headed by Sun Mingyu, the Chairman of the supervisory board of HNA Group. Tan Xiangdong, Chen Feng and Chen Xiaofeng also sit on the board. Meanwhile, the directors of New York-based Hainan Cihang Charity Foundation are Chen Guoqing, Chen Xiaofeng and Tan Xiangdong. Chen Xiaofeng is also the Secretary-General of the foundation.[73]

Weathering the storm – the great unwind of HNA Group

HNA Group's debt totalled just under US$100 billion as at the middle of 2018.[74] Experiencing immense cash flow strain and having exhausted all borrowing means, HNA Group resorted to offloading its non-core assets to reduce financial burden from its large debt and corresponding interest costs. Along with its aggressive disposal plans, HNA Group has expressed its willingness to cooperate with the Chinese government to exit specific investments that became banned by the government,[75] and to focus on its core airline businesses instead.[76]

Following Chen Feng's strategic plan to "slim down" and streamline operations around aviation,[77,78] debt-laden HNA Group began selling many of its valuable quality assets such as land and commercial properties.[79] For instance, HNA Group disposed four plots of development land at Kai Tak area in Hong Kong.[80] In its struggle to raise cash and slash debt, it also sold its significant stakes in Park Hotels and Resorts and Hilton Worldwide Holdings in March 2018 and April 2019 respectively.[81] HNA Group also announced plans to withdraw its investment in Deutsche Bank, and reduced its ownership in the bank to 6.3% as at February 2019.[82]

Moving forward

Despite disposing of over US$44.73 billion worth of assets in 2018,[83] HNA Group still had a debt repayment of US$2.8 billion in 2019 and an estimated US$30.7 billion by 2025.[84]

HNA Group resorted to further stretching out its divestment plans to its core aviation business to meet debt payment requirements. On 6 March 2019, HNA Group revealed its plan to sell one percent of its ownership in its flagship unit, Hainan Airlines, in order to repay some of its debts.[85] Further, on 28 March 2019, HNA Group agreed to sell Hong Kong Express, a Hong Kong-based low-cost airline at a price of HK$4.93 billion (US$628 million).[86]

Following a dampened outlook for valuation and growth both domestically and overseas, analysts are still uncertain about HNA Group's unwinding strategy.[87,88] Would HNA Group's selling spree be enough for it to emerge unscathed? Only time will tell if the Chinese conglomerate will be able to put its problems behind and rise up the Fortune Global 500 ranking once again.

Discussion questions

1. Comment on the risk appetite of HNA Group. Explain your answer by giving an overview of the considerations in determining the appropriate level of risk appetite.
2. What are the benefits and risks posed by the non-segregation of shareholders, board, and management in the case of HNA Group?
3. Discuss the advantages and disadvantages that could arise from directors having overlapping directorship on related companies' boards.
4. With regards to China's Code of Corporate Governance, evaluate the effectiveness of the board of supervisors in overseeing the management in HNA Group.
5. Large private companies are not required to comply with the China Corporate Governance Code. In light of the situation with HNA Group, should large private companies be subjected to the same corporate governance standards as listed firms?
6. Discuss the rationale of having charitable foundations as controlling shareholders and controversies in relation to HNA Group.

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NISSAN: THE TALE OF THE GAIJIN

Case overview

Nissan Motor Co Ltd (Nissan), is a Japanese automobile manufacturer that operates across the world, selling cars under the Nissan, Infiniti and Datsun brands. From its humble beginnings in 1914, it has risen to become a major player in the automobile industry. In November 2018, the company became embroiled in a financial scandal centred on Carlos Ghosn, the Chairman of Nissan. He was not only a key figure in the Japanese automotive company, but also an industry legend who stood at the peak of the Renault-Nissan-Mitsubishi alliance. Throughout his career, Ghosn wielded almost unbounded power over the three companies in the alliance. The objective of this case is to facilitate a discussion of issues such as the role of societal and corporate culture in influencing corporate governance; corporate governance issues surrounding complex ownership and corporate structures; conflicts of interest; board composition, the role of independent directors; remuneration; and whistleblowing.

The story of Nissan

Nissan was established in Yokohama City on 26 December 1933 and currently manufactures vehicles in a total of 20 countries and territories around the globe. The automobile manufacturer has come a long way from producing its first car, the DAT, in 1914 under the name of Kaishinsha Motor Car Works.[1] As of 2016, Nissan was the sixth largest automaker in the world and third in Japan by production volume.[2] The company is also the world's largest electric vehicle manufacturer. Driven by the popularity of the Nissan LEAF, Nissan's total global sales volume of all-electric vehicles was approximately 320,000 as at April 2018.[3]

This is the abridged version of a case prepared by Charles Low Yu-Jie, Lim Ping, Wang Shiqing, and Wang Ting Nan under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Clarisse Tan under the supervision of Professor Mak Yuen Teen.

However, the journey to success has not always been smooth for Nissan, and the company had faced severe financial difficulties back in the 1990s, to the point where its survival was threatened. Nissan panicked amidst falling profits in the 1990s and, in a hasty attempt to increase productivity and sales, flooded the market with a series of boxy, practical family sedans. This was a sharp deviation from the sleek and contemporary designs that brought Nissan its initial success. With manufacturing costs driven up, the company lost an estimated US$1,000 for every car sold in the United States for most of the 1990s. Sales figures plummeted as Nissan saw its customers turning away, and in 1993, the company reported its first loss in 50 years, amounting to US$1 billion. By 1999, Nissan was left reeling from a hefty US$20 billion debt.[4]

That same year, Nissan sought foreign buyers to rescue itself from insolvency. A Nissan executive, Alfonso Albaisa, recalled hearing other automakers expressing little interest in bailing the Japanese firm out, noting that "some companies were saying … they would be better off just putting millions of dollars in a trunk and sinking it in the Pacific."[5]

Fortunately for Nissan, its saviour came in the form of Carlos Ghosn, who became the Japanese carmaker's Chief Operating Officer (COO) in June 1999. Immediately after his appointment, Ghosn took quick and decisive steps to cut costs, directing cost savings into the development of 22 car and truck models within three years.[6] His drastic measures to boost competitiveness included trimming procurement costs, shutting down five factories and cutting 21,000 jobs.[7] Despite facing backlash from Nissan employees, such as in January 2000 when around 5,000 union members took to the streets in Tokyo to protest Nissan's restructuring plans,[8] the results of Ghosn's reforms were significant. Within two years, Nissan went from a state of near-bankruptcy to profit generating.[9] As the company experienced a revival, Ghosn also gained a massive following in Japan, acquiring the nickname "Le Cost Killer" for his business strategies.[10]

Ghosn served as the Nissan's Chairman before his dismissal following his arrest for alleged financial misconduct. Currently, Nissan's board consists of four executive directors and seven independent non-executive directors. Yasushi Kimura is the independent non-executive Chairman.[11] In addition, Nissan has four statutory auditors as part of its audit committee and there are plans to establish a remuneration committee.[12]

The alliance

In March 1999, an alliance was formed between French automaker Groupe Renault (Renault) and Nissan, under which the two companies each held a 50% interest. This was the first of its kind in the automotive industry, involving two automobile manufacturers based in different countries, each with its own distinct corporate culture and brand identity.[13] Renault held a 43% stake in Nissan, and Nissan a 15% stake in Renault. In 2016, Mitsubishi Motors (Mitsubishi) became part of the alliance after Nissan acquired a controlling stake of 34% in the struggling Japanese automaker.[14]

The acquisition came after Mitsubishi became embroiled in the mini-vehicle model mileage falsification scandal, where it admitted falsifying fuel economy data for over 600,000 vehicles sold in Japan.[15] Nissan, then headed by Ghosn, recognised the opportunity to increase its competitiveness and gain a stronger foothold in the ASEAN market, where Mitsubishi had better sales performances. The resulting three-member strategic partnership produced an impressive combined annual sales of 10 million vehicles, making it one of the top three automotive groups in the world by sales volume.[16]

Enter the protagonist

A key figure in the formation of the Renault-Nissan-Mitsubishi alliance, Ghosn spent close to two decades with the French tyre manufacturer, Michelin, in his early days before rising up the ranks to head its North American unit. Thereafter, the Brazilian-born French national spent another three years with the French automobile manufacturer, Renault, as Executive Vice President, before being assigned to Nissan, which was close to bankruptcy at the time when he took charge.[17]

In 2001, Ghosn became the Chief Executive Officer (CEO) of Nissan. Four years later, he took up the position of CEO in both Renault and the Nissan-Renault partnership, which had its own board. In 2008, he took on the role of Chairman of Nissan's board of directors. A year later, he also became Chairman on the board of Renault.[18]

Subsequent to Nissan's acquisition of a controlling stake in Mitsubishi in 2016, Ghosn became the Chairman of the latter automaker, effectively making him the Chairman of all the three companies in the alliance. A year later in 2017, the 64 year-old stepped down as CEO of Nissan. He attributed his resignation to his wish to focus on improving profitability at Renault and ensuring that the alliance would be "irreversible" after his imminent retirement.[19]

With over two decades spent at the pinnacle, Ghosn wielded extensive power in the top management and on the board. As the first person in history to serve concurrently as CEO of two Fortune Global 500 companies, his influence extended beyond the automotive empire. In the Japanese society where there is a general sentiment of distrust towards foreigners, Ghosn's hero status was nonetheless enshrined in a superhero manga comic book, "The True Story of Carlos Ghosn".[20] In 2004, then Emperor Akihito personally received Ghosn at a garden party in the Akasaka Palace and awarded him a Blue Ribbon Medal in recognition of his contributions, making him the first *gaijin* (as foreigners are called in Japan) business leader to be given the honour.[21]

However, it was this very centralisation of authority and overwhelming dominance which contributed to Ghosn's downfall.

The other face of the hero

On 19 November 2018, Ghosn was arrested by investigators from the Tokyo District Public Prosecutors Office for questioning in relation to his potential involvement in financial misconduct.[22] One of Ghosn's closest aides, Greg Kelly, a former Nissan representative director, was also arrested that same day upon his arrival from the United States.[23]

Both Ghosn and Kelly were indicted in December 2018 on charges of underreporting Ghosn's executive compensation by US$44 million over a five-year period from 2011 to 2015. Ghosn, with Kelly's assistance, allegedly misstated the deferred compensation that he was set to receive after his retirement by over US$80 million.[24]

In February 2019, Nissan announced that it will hold an extraordinary shareholders' meeting in April, where shareholders would vote on the dismissal of Ghosn and Kelly from the board of directors of Nissan.[25] Both men were voted out at the meeting.[26]

Money, money, and more money

In 2010, the law in Japan was amended in 2010 to mandate that companies disclose salaries of executives earning more than JPY100 million. A year prior to the change in the law, Ghosn earned approximately JPY1.75 billion. However, instead of facing potential public backlash for his generous remuneration package, Ghosn directed his staff to pay him only slightly more than half of the JPY1.75 billion and to defer the remaining amount. In FY 2018, Ghosn made about JPY735 million, but once again deferred most of it to after his retirement.[27]

While media reports initially cast the spotlight on the alleged underreporting of Ghosn's executive compensation, it soon become clear that the accusations directed at Ghosn were far more complicated than an isolated instance of financial misconduct.[28]

Your assets are my assets

Ghosn was reported to have used significant amounts of corporate resources for personal gains. He was alleged to have multiple homes which he used, all paid for by Nissan's shell companies. These luxury homes were located in various cities across the globe, including Beirut, Rio de Janeiro, Paris and Amsterdam – where Nissan did not have major operations in – and were all solely held for his personal use.[29]

A key issue related to the funding of his private housing involved Zi-A Capital BV – a Nissan unit in the Netherlands – and its subsidiaries. Payments for the multi-million dollar luxury homes were allegedly split up by Ghosn's aides into smaller units of one million and then processed, thus escaping the eyes of Nissan's finance staff, its auditors and staff in the alliance. As technology start-ups, Zi-A Capital BV and its subsidiaries did not draw much attention from Nissan's finance staff as investments in this sector were largely deemed confidential.[30]

Ghosn and a few close associates also had access to a fund dubbed the "CEO Reserve" by insiders to pay for Ghosn's family residences and other personal expenses. This reserve was set up with the intention of catering to unplanned business needs, but after Ghosn's arrest, questions were raised about whether expenses claimed from this fund received formal approvals in the first place. Apart from the purchase of overseas residences, there were also other expenses that included a yacht club membership, Ghosn's family vacations, home utilities, and donations to a college.[31]

Nissan's auditor, Ernst & Young ShinNihon LLC (EY Japan), had questioned the company's management multiple times in 2013 about the purchase of these luxury private homes for Ghosn's personal use and the stock-appreciation rights which he had obtained. However, Nissan dismissed the issue by maintaining that the transactions and reporting were appropriate.[32]

There was other alleged misuse of company resources.[33] In 2017, Nissan saw the unveiling of a 16-foot-tall sculpture, named "Wheels of Innovation", at the entrance of its Yokohama headquarters. The sculpture was created by Nadim Karam, a Lebanese artist based in Beirut, to honour Ghosn's 17 years of leadership at the company.[34] This artist was a personal friend of Ghosn, and received a commission of US$888,000 for his work on the sculpture.[35]

Back in October 2016, Ghosn held a lavish Marie Antoinette-themed wedding ceremony and birthday party for his wife in Château de Versailles in France. Two years later, in November 2018, a compliance audit conducted within Renault uncovered an amount of €50,000 allocated under Ghosn's "personal benefits". This contribution was part of a €2.3 million sponsorship agreement between Renault and the French palace, under which Renault was granted benefits including a pre-specified number of opportunities to host its events on the palace grounds. Renault then brought the findings of its investigations to the attention of the French judicial authorities.[36] Ghosn, who was already under detention at that point of time, denied knowledge of his party taking up Renault's allotted usage and, through his lawyer, offered to pay the fee.[37]

The supreme leader

At the time of his arrest on 19 November 2018, Ghosn served as the Chairman of the Renault–Nissan–Mitsubishi alliance, the Chairman of all three individual companies, as well as the CEO of Renault, effectively giving him an overarching leadership role without supervision and oversight. Ghosn had stepped down from his position as CEO of Nissan in April 2017, after 15 years at the helm of the company. He was succeeded by Hiroto Saikawa, who had over 40 years of experience at Nissan in his role as Chief Competitive Officer.[38]

On 28 November 2018, over a week after Ghosn's arrest, Saikawa apologised to Nissan employees in a company-wide address, condemning the ousted Chairman for amassing too much power. While he reaffirmed Nissan's commitment to the alliance with Renault and Mitsubishi, he placed blame on Ghosn for the concentration of authority on himself as the top man at all three automakers. He further lamented that Ghosn had muddled Nissan's brand image with his own persona, stating that some people "only associate the company with one face".[39]

The accomplices

At the time of his arrest, Kelly was a director on Nissan's board. Prosecutors had alleged that Kelly instructed another executive in charge of legal affairs and other officials within Nissan to make false statements regarding Ghosn's pay in securities reports.[40] Unlike Ghosn who remained in custody, Kelly was released on bail on Christmas after more than a month in detention. That same night, Kelly released a press statement through his attorney, refuting any suggestions that he falsified any reports relating to Ghosn's executive compensation.[41]

In his statement following the arrest of the two men, CEO Saikawa accused Kelly of being a co-conspirator in Ghosn's financial misconduct. He also said that Kelly would be ousted from the company along with Ghosn, at the shareholders meeting scheduled for April 2019.[42]

On 11 January 2019, another Nissan executive – Jose Munoz – resigned from the company. Munoz was widely considered as a close ally to Ghosn and was touted by industry analysts as his potential successor who would lead the alliance between Nissan and Renault once Ghosn retired from active participation in the companies. Munoz had been designated as a "person of interest" in Nissan's widening internal investigation as well as in investigations by the Japanese authorities. He served as the company's Chief Performance Officer, as well as the head of Nissan's sizable China operations. It was reported that Munoz, who had earlier been placed on a leave of absence, had not been cooperating with the internal investigation.[43]

Blowing the whistle

Ghosn's alleged misconduct – which involved the underreporting of income and misuse of company's assets – was brought to light by a whistleblower who was a staff from Nissan's legal department.[44] This event prompted Japan's financial regulators to highlight the importance of protecting whistleblowers who are doing their part for corporate governance.

To protect the interests of whistleblowers, there is a Whistleblower Protection Act[45] in place in Japan which sets out specific rights of whistleblowers and certain acts that companies are prohibited from carrying out with regards to the treatment of whistleblowers which would put them at a disadvantage. For example, under Article 3 of the Act, the dismissal of a whistleblower as a result of his or her whistleblowing act will be nullified if the case in question adheres to items that come under the list of 'Acts Subject to Whistleblowing' set forth in the article.[46]

Further, in June 2018, a new plea bargaining system was introduced in Japan. This system allows for a prosecutor to enter into a formal plea bargaining agreement with a suspect or defendant to drop or reduce criminal charges, or agree to a predetermined punishment, if the suspect or defendant provides evidence or testimonies in relation to certain types of crimes. One potential concern raised in the New Plea Bargaining System report is that one may give false evidence to authorities in an attempt to implicate otherwise innocent third parties in criminal matters in a bid to reduce or avoid their own criminal culpability. However, there are safeguards in place to minimise such risks, one of which is the compulsory participation of defence lawyers in the agreement negotiation process. That being said, it has been acknowledged that such safeguards are not foolproof and they can only serve to potentially minimise but not completely eliminate such concerns and risks.[47]

The Japanese corporate governance culture

The Stewardship Code for institutional investors and Japanese Corporate Governance Code were introduced in 2014 and 2015 respectively. These were part of the initiative by the Abe government to encourage better corporate governance which is aligned with Western standards.[48]

Key issues which have been raised for the potential revisions of the codes pertain to cross-shareholdings and independence of board structure. These issues arose over criticisms of the lack of robustness in Japanese corporate governance codes compared to its Western counterparts.

While Japanese firms claim that cross-shareholdings have aided customer and supplier relations as well as strengthened business relations with companies across industries, the new guidelines disqualify business relationships as a rationale for establishing cross-shareholdings. Cross-shareholdings have been argued by market participants as a major impediment to improved returns for shareholders, as it results in lower return on equity caused by inefficient capital allocation.[49]

Japan's 2015 Corporate Governance code stipulated that companies should have at least two independent directors, recommending a percentage composition of 33%.[50] Compared to other countries, this has been criticised for its inadequacy in terms of safeguards against entrenched management interests, hence allowing management to determine their own remuneration, which was the case observed in Nissan. In the long run, shareholder interests and capital efficiency are adversely affected as well.[51]

Although shareholders have powers such as vetoing board members' remuneration packages and voting for their removal, Japanese shareholders have very rarely used these powers to enhance accountability of the management. According to a 2017 report for the Corporate and Securities Law Association (CSLA), the majority of Japanese CEOs are supported by 95% of their shareholders.[52] While the increasing support for shareholder proposals demonstrate a shift in attitudes towards encouraging greater shareholder actions where necessary,[53] the Japanese corporate culture has been criticised for lacking shareholder empowerment mechanisms.

Nissan's corporate governance reforms

Following Ghosn's case, Nissan established the Special Committee for Improving Governance which comprises three of Nissan's independent directors and four independent third party members.[54] The aim of the committee was to determine the root causes of corporate governance issues and provide recommendations for the enhancement of Nissan's governance. In addition, Nissan's board also approved the establishment of an advisory committee on 22 November 2018 as well as recommended the establishment of the nomination, remuneration, and audit committees to ensure independence when it comes to decisions made in these areas.[55]

On 27 March 2019, a report by the Special Committee for Improving Governance was published, which highlighted deficiencies in Nissan's corporate governance framework. It included allegations that Ghosn oversaw a culture in which no one could raise objections to his conduct and decisions, where board meetings were unusually short, and where statutory auditors were not re-elected if they were too fastidious. It also suggested that Ghosn engineered a situation in which departments which should have provided checks and balances were made "opaque" such that they "did not necessarily function effectively with respect to Mr Ghosn's demands for his personal gain".[56]

The alliance then announced that it would remodel its corporate leadership structure to put the three parties of the strategic partnership on more equal footing, while creating a more sustainable structure. Going forward, Renault's Chairman, Jean-Dominique Senard would be Chairman of the alliance, while the respective member companies' CEOs would be part of the board.[57]

It still remains to be seen if Nissan's establishment of the new committees will improve the vehicle manufacturer's corporate governance.

Discussion questions

1. Consider the influence of cultural factors on the corporate governance of Nissan and discuss whether the company's corporate culture is related to the broader societal culture in Japan. To what extent did corporate culture contribute to Ghosn's misconduct and the lack of action over it?

2. To what extent do you think the corporate culture of Nissan and the Japanese societal culture affected the effectiveness of Nissan's whistleblowing policy?

3. How did Nissan's remuneration system function? Discuss the problems with the system and possible improvements, making reference to relevant guidelines on remuneration in codes of corporate governance.

4. Evaluate Nissan's board structure. What are the potential problems of having a person like Ghosn who wields significant power? What should the role of the independent and non-independent directors be in ensuring that there are proper checks and balances in a company?

5. The Nissan-Renault structure has been criticised in light of the scandal. In the Nissan Corporate Governance Report 2018, disclosures under Principle 1-4 Cross-Shareholdings stated that:

   > *"Alliances and cooperative relationships to realize various business advantages such as synergies are an important element of our business. We have limited cross-shareholdings to what is reasonably necessary to build and maintain such alliances and cooperative relationships."*

   Evaluate the challenges which such a cross-shareholding system would entail. What are the conflicts of interest and corporate governance issues with the multiple roles held by Ghosn within the alliance?

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SAMSONITE: TOO MUCH BAGGAGE?

Case overview

On 24 May 2018, Samsonite International S.A. (Samsonite) fell victim to Blue Orca Capital (Blue Orca), a short-seller, which slammed Samsonite for the company's poor corporate governance and the falsification of a doctorate degree by its Chief Executive Officer (CEO), Ramesh Tainwala. Blue Orca further questioned the accounting practices in Samsonite, related party transactions between Samsonite and several Indian entities controlled by Tainwala and his family, as well as a frequent change of auditors at the luggage maker's South Asia unit. Samsonite responded swiftly to defend the allegations with a clarification announcement. This was followed by the resignation of Tainwala as the company's CEO. The objective of this case is to facilitate a discussion of issues such as the role of short-sellers; internal controls; accounting and auditing practices; conflict of interests between related parties; and fraud.

Life's a journey

Ramesh Tainwala strolled across the office lobby for the last time as he looked up at the firm's tagline – "Life's a Journey". Indeed, it had been. Raised in a small farm in Northern India, Tainwala started his career as a commodities trader before getting into the luggage business as a manufacturer of the plastic sheets used in suitcases. His relationship with Samsonite as a supplier then led to a joint venture in the late 1990s to produce high quality luggage in India. Tainwala then joined Samsonite and rose through the ranks at Samsonite, taking on the role of Head of Asia-Pacific by 2011, and subsequently CEO in 2014.[1] Since taking over as CEO, Tainwala has helped Samsonite to achieve substantial growth. Samsonite's shares nearly doubled from 2014 to 2016, driven by a spate of deals including the US$1.8 billion purchase of Tumi Holdings Inc. (Tumi), a manufacturer of high-end suitcases and bags for travel.[2] However, given the turn of events in the recent month, perhaps it was time to let it all go.

This is the abridged version of a case prepared by Lim Jun Da, Ong Li Wei Janel, Tan Bo Jiang, Tyo Jerian and Zhong Keyi under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

Founded in 1910 by Jesse Shwayder in Denver, Colorado, Samsonite started out as a trunk manufacturing company. By the 1960s, the company was considered to be one of the top luggage manufacturers in the world. Today, it is the world's largest travel luggage company, with its products sold in over 100 countries world-wide.[3] Samsonite has been listed on the Hong Kong Stock Exchange since 2011.[4]

Baggage handlers

As at 31 December 2017, Samsonite's board of directors consisted of nine directors, including two executive directors, three non-executive directors, and four independent non-executive directors. The board also established an Audit Committee, a Nomination Committee and a Remuneration Committee which were chaired by Paul Kenneth Etchells, Timothy Charles Parker, and Keith Hamill respectively.[5]

Treading in deep waters

"Samsonite is a mid-level brand masquerading as a premium luxury player."

– Blue Orca, in its Short-Seller Report[6]

On 24 May 2018, Blue Orca released a report (Short-Seller Report) accusing Samsonite of accounting manipulations, poor corporate governance and an unjustified premium valuation.[7] It often releases damning reports that allege financial misrepresentation, questionable accounting practices or fraud, with the hope of profiting from a fall in the share prices of the companies it targets.[8]

Among the allegations, Blue Orca accused Samsonite of inflating profit margins and hiding sluggish growth by making overly aggressive acquisitions and adopting questionable accounting practices, engaging in unsupportable related party transactions, as well as its CEO's resume fraud.[9] Following the accusations, Samsonite's share price fell 12% the same day before being suspended following a trading halt request from the company.[10] The luggage maker's share price dropped by another 12% – to a nine-month low of HK$26.80 – when trading resumed the next day. A few days after, on 28 May 2018, Samsonite yet again sought another trading halt.[11]

On 31 May 2018, Samsonite released a response (Clarification Announcement) addressing the Short-Seller Report, calling it "one-sided and misleading" and that the conclusions drawn about Samsonite and its financial results are incorrect. The company's board of directors also stood by the company's track record of transparency and corporate governance. Samsonite also cautioned shareholders about Blue Orca's short-selling interest in Samsonite's stock and its financial gain from the decline in Samsonite's stock price. In addition, it affirmed that its consolidated financial statements, audited by KPMG LLP, were in accordance with the International Financial Reporting Standards (IFRS) and stated that KPMG LLP had neither withdrawn nor indicated any intention to withdraw its audit opinion.[12]

Overpriced luggage?

Since its Initial Public Offering (IPO) in 2011, Samsonite has experienced strong and continuous year-on-year growth.[13] The company's share price has also been on a steady upward trend from the issue price of HK$13.46, trading at over HK$33 in April and May 2018.[14]

Trading at an all-time high during this period prompted the Short-Seller Report to raise doubts about the valuation of the firm. Blue Orca claimed that Samsonite traded at a premium valuation close to luxury brands such as Louis Vuitton, Prada and Burberry. In addition, it claimed that "even this comparison would be charitable" against mid-tier brands such as Hugo Boss, Michael Kors and Ralph Lauren. Compared to the share price of HK$34.05 on 23 May 2018, Blue Orca valued Samsonite's shares at only HK$17.59. Its reasons for applying the valuation discount is Samsonite's allegedly mediocre branding status, accounting and financial irregularities, and corporate governance issues.[15]

Shopping spree

Over a span of five years, Samsonite acquired nine companies as shown below[16]:

Date	**Acquired company**	**Price**
17 July 2012	High Sierra Sports Company	US$110 million
2 August 2012	Hartmann	US$35 million
1 April 2014	Lipault	€20 million
29 May 2014	Speck Products	US$85 million
23 July 2014	Gregory Mountain Products LLC	US$84.14 million
17 February 2015	Rolling Luggage	£15.75 million
2 October 2015	Chic Accent	€8.5 million
1 August 2016	Tumi Holdings Inc.	US$1.8 billion
5 May 2017	eBags Inc	US$105 million

The spotlight fell on Samsonite's largest US$1.8 billion acquisition of Tumi, at a 33% premium. Samsonite believed that Tumi was a "perfect strategic fit" for its business, citing synergies and the opportunity to expand Tumi's presence in Asia and Europe.[17,18] However, Blue Orca was of the opinion that Samsonite turned to such debt-financed acquisitions to mask its declining operating margins and the decline of its main business.[19]

Lost-and-found payables

The Short-Seller Report claimed that Samsonite had materially overstated Tumi's payables to bolster its slim profit margin and to avoid recording at least US$61.6 million of expenses through its income statement. Although Tumi's reported pre-acquisition trade payables were only US$39 million on 26 June 2016, Samsonite reported US$139 million of post-acquisition trade payables in Tumi in its FY2016 annual report.[20]

While IFRS 3 provides an acquirer with the discretion to revalue the acquiree's assets and liabilities to fair value at time of acquisition,[21] Blue Orca alleged that a US$100 million increase in payables was improbable, given that accounts payable are simply the aggregate of outstanding bills due to suppliers that can be measured reliably and accurately. The short-seller also asserted that such a huge increase within a month was highly unlikely given that Tumi had never reported over US$48 million in payables in the previous 10 quarters.[22]

Samsonite's Clarification Announcement rebutted Blue Orca's allegations by stating that Blue Orca did not make a like-for-like comparison of 'trade payables' to 'trade and other payables'.[23] Samsonite justified Tumi's payables of US$139 million by stating that it included accrued expenses and other payables amounting to US$83.7 million, which were filed in Tumi's 10-Q filing in 26 June 2016. The remainder of the payables included an approximate US$22 million in acquisition fees, US$19 million for the settlement of Tumi's employee equity awards, and an increase in income tax payables of US$14 million due to US GAAP to IFRS accounting translations. Samsonite also denied any intention to inflate margins and claimed that the payables have been settled by cash.[24]

Worthless Tu-mi

The Short-Seller Report further alleged that Samsonite under-reported the value of Tumi's Asian distribution networks and inventory balance post-acquisition. In spite of paying US$64.9 million for Tumi's distribution networks, Samsonite only recorded the value of the acquired inventory through Tumi's distribution network at US$9.4 million in its books, instead of its actual cost of US$46.4 million. The difference was recorded under goodwill and customer relationships.[25] In this regard, Blue Orca argued that Samsonite had an incentive to reduce the cost of inventory in its books. When such inventory was sold off, Samsonite could record inflated margins over the reduced cost of goods sold.[26] As a result, this would give investors an impression that Samsonite's profitability was higher than it actually was.

Regarding the alleged under-reporting of inventory balance, Samsonite corrected the Short-Seller Report's assumptions about its estimated inventory value of US$46.4 million. Samsonite also affirmed its view that the reported inventory value was reflective of its fair value and adjustments were consistent with the company's policies on slow-moving products. Samsonite further justified that the profits earned from the sale of Tumi's inventory were due to costs savings from reductions in promotional activity and synergies realised through reduced freight costs.[27]

Further, the luggage company pointed out that the short-seller's assertions were based on incorrect information. Blue Orca alleged that the valuation of Tumi's five to six months' worth of inventory was "80% less than the amount of Tumi's sales to distributors in the previous six months", which implied that its current valuation was not indicative of the fair value of Tumi's inventory. However, Samsonite pointed out that the Short-Seller Report quoted Tumi's global sales as a basis of comparison instead of Tumi's Asian sales. Samsonite was of the view that it was inaccurate to make such a comparison.[28]

Profits from out-of-style luggage

In FY2017, Samsonite recorded a write-down of US$542 million of inventories to arrive at a net realisable value of US$229.6 million.[29] This write-down was done in accordance with IAS 2, under which an entity carries its inventories at the lower of cost or net realisable value. Despite the write-downs, Samsonite's margins seemed to be unaffected as the annual report showed that gross margins on sales were healthy at around 56.1% in FY2017. The short-seller alleged that such margins were made by hoarding zero-margin stale inventories while realising gains on the other inventories. It believed that this was not a sustainable measure as the zero-margin inventory will eventually be realised in the future, which would result in a severe contraction Samsonite's current margins then.[30]

In the same Clarification Announcement, Samsonite rebutted that the write-down was done in accordance with IFRS and company policy. The company conceded that there was an error in the disclosure of the inventories' net realisable value, but stated that the difference was deemed immaterial by Samsonite and its auditors, and that the figure would be corrected.[31] Samsonite claimed that this error would not impact the company's reported profitability, consolidated statement of financial position, consolidated income statement or consolidated statement of cash flows to any material extent. KPMG LLP concurred with Samsonite's assertion.[32]

A revolving door of auditors

More controversies emerged from the luggage maker's South Asia unit – Samsonite South Asia Private Limited (Samsonite South Asia) – the 60/40 joint venture between Samsonite Corporation Limited, U.S.A. and the Tainwala Group.[33]

Blue Orca revealed that Samsonite South Asia had changed auditors thrice in a short span of three years.[34] Although KPMG LLP remains as the Samsonite's Group auditors,[35] its Indian affiliate, BSR & Co. LLP (BSR), resigned as the statutory auditor of Samsonite South Asia in FY2016, citing an "unwillingness to be re-appointed".[36] Spark & Co. Chartered Accountants – a small five-partner firm based in Pune, India – then took over . However, it resigned after a year, citing the same reason as the previous auditor.[37] Another small audit firm, Kangude & Waghmode Chartered Accountants (Kangude & Waghmode), was then appointed in FY2017.[38]

Blue Orca highlighted the series of statutory auditor resignations as a significant “red flag”. It also questioned Samsonite’s selection of external auditors and expressed concerns about the competence of the two small and less experienced local audit firms to review the potentially complex transactions in Samsonite South Asia.[39]

In its Clarification Announcement, Samsonite indirectly admitted the changes of Samsonite South Asia’s statutory auditors in the past three years but confirmed the role of BSR – an affiliate of KPMG LLP – as the company’s group reporting auditors in India. The company said that BSR would report Samsonite South Asia’s audited results to KPMG in the United States as part of the Group’s consolidated audit. Samsonite argued that the implications of statutory auditor changes in Samsonite South Asia were overstated by Blue Orca and “there was no change of auditor”[40] related to the company’s audited results as BSR continues to perform its audit for Samsonite South Asia’s results as the group reporting auditor. Samsonite also attributed the series of resignations of Samsonite South Asia’s statutory auditors to mandatory auditor rotation provisions (under Indian Companies Act, 2013)[41] as well as the need to maintain continuity with the same engagement partner, who had joined the third audit firm engaged, Kangude & Waghmode. However, it did not address the issue of the appointment of small local audit firms as Samsonite South Asia’s statutory auditors, Blue Orca’s concerns over the competency of those firms, and the credibility of the audit results.

Mislabeled luggage

There was also evidence of a lack of proper internal controls at Samsonite South Asia. Blue Orca pointed out that the registered email address in the company’s India regulatory filings did not have Samsonite’s email domain – @samsonite. Instead, a Gmail account listed as ‘Samsonite.secretarial@gmail.com’ was indicated as the company’s registered email address, which was corroborated with online corporate databases. This raised further concerns about the effectiveness of Samsonite South Asia’s internal controls and data security as corporate communications were not carried out on a secured corporate email server. Samsonite conceded the use of the Gmail address for its Indian regulatory filings but declared that it was merely used for “administrative convenience to allow multiple users within the Company to access the account”.[42]

Baggage marked with red flags

Blue Orca also drew attention to a number of additional red flags and internal control issues in Samsonite’s audit profile.

Firstly, Blue Orca highlighted that KPMG LLP had identified revenue recognition policies across jurisdictions as a key audit matter in FY2016 and FY2017 due to “inherent risk” associated with the policies. Most notably, KPMG LLP disclosed the company’s review of “manual journal entries” of transactions recorded to revenue at year end. Blue Orca believed that such manual entries increased the risk of potential discrepancies in Samsonite and raised doubts over the effectiveness of Samsonite’s internal control systems.[43]

However, Samsonite rebutted this accusation by stating that it was common to have such manual journal entries in the consumer products industry and that it was “not uncommon for auditors to perform procedures related to manual journal entries”.[44] It also clarified that most entries in the year were properly recorded through an automated system and that manual entries were utilised only for special cases at the year end to account for sales cut-off and sales returns and allowances in accordance with IFRS accounting standards.[45]

Transit in India – Abhishri

The Tainwala Group, which is owned by the family of Samsonite’s CEO, also owns Abhishri Packaging Pvt Ltd (Abhishri), a luggage manufacturer for Samsonite. According to Samsonite’s FY2017 annual report’s related party transactions disclosure, “certain subsidiaries of the Group purchase raw materials and finished goods from, and Samsonite South Asia Private Limited sells certain raw materials and components to, Abhishri Packaging Pvt. Ltd”.[46]

Blue Orca alleged that there was a potential conflict of interest when the CEO of Samsonite was also the supplier for the company.[47] It questioned Abhishri’s role in Samsonite’s supply chain and said that Abhishri might be earning profits from Samsonite by playing the role of a middle man between Samsonite and its Chinese suppliers.[48]

Samsonite responded that “Abhishri does not function in any way as a middle man for the Group” and explained that the raw materials procured by Abhishri from Samsonite’s Chinese suppliers were only used to manufacture products and not resold to Samsonite. Nevertheless, there was still a potential for conflict of interest between Samsonite and its CEO when dealing with transactions related to the Tainwala Group. In its reply, Samsonite said that it ensured that sufficient safeguards were put in place in accordance with the Hong Kong Stock Exchange’s listing rules.[49] Under the Hong Kong Exchange listing rules on connected transactions, independent non-executive directors and the auditors are required to review the connected transactions annually and these transactions are required to be disclosed.[50]

First class privileges – Bagzone

Bagzone Lifestyles Private Limited (Bagzone), a company controlled by the Tainwala Group, was the preferred retailer of Samsonite products in India.[51] According to Samsonite’s FY2017 annual report, sales from Samsonite to Bagzone for the financial year amounted to US$11,211,000.

The total receivables due from Bagzone to Samsonite for the same period was reported to be US$13,429,000. Blue Orca said that the amount of receivables relative to sales amount indicated that Bagzone was given better credit terms than other distributors. The Group's reported sales and receivables figures were US$3,490,921,000 and US$411,457,000 respectively for the FY2017. This suggested a longer days sales outstanding and thus preferential credit terms for Bagzone.[52]

In addition, Blue Orca raised the possibility of channel stuffing, whereby Bagzone purchased stocks from Samsonite that it was unable to sell in order to bolster Samsonite's sales figures. According to the short seller, Bagzone suffered net losses for the FY2017 even though sales figures have increased compared to the preceding financial year.[53]

Samsonite defended itself by stating that "Bagzone's transactions with Samsonite India were conducted on normal commercial terms and the profit margin available to Bagzone was within a range reasonably consistent with that made by other third-party dealers in India to whom Samsonite India sells products." It also indicated that Bagzone was increasing its purchases from Samsonite for expansion purposes. Samsonite went on to further explain that the "historically consistent levels of Bagzone's receivables, across a large number of retail outlets, reflect appropriate sell through on the Bagzone distribution channel."[54]

Nothing to declare – Undisclosed related party

Apart from Abhishri, Bagzone, Samsonite South Asia and Samsonite Middle East FZCO, no other declaration of related party transactions between Samsonite International S.A. and the Tainwala Group were made. However, Blue Orca mentioned that corporate records of six companies found from the online database "informix.in" showed that these companies had directors from the Tainwala family and were registered using @samsonite email addresses. Two of the six companies were even involved in the business of luggage manufacturing. Additionally, the report suggested that there might be undisclosed dealings between Samsonite and the six related parties.[55]

Wrong luggage tag

Apart from its accusations regarding Samsonite's business and accounting practices, Blue Orca also claimed that Tainwala had falsely represented that he has a doctorate in business administration from the Union Institute and University in Cincinnati. The short-seller called on the company's board to remove Tainwala as Samsonite's CEO. After verifying with the university's registrar office and the United States National Student Clearinghouse, it was confirmed that Tainwala merely enrolled into the programme from February 1992 to September 1993 but had never obtained a degree from Union.[56]

In response, Samsonite then defended that since the company's IPO in 2011, it had always accurately described Tainwala's educational background and that "the board also takes seriously the allegation that has been made about his academic credentials".[57]

While the false doctorate title was omitted in Tainwala's company biography, Blue Orca said that the representation of Tainwala's doctorate had frequently been cited in online biographies and other documents, including in Wall Street Journal and Bloomberg databases up until 2018. The false credential was also evident in formal settings such as Samsonite's 2011 earnings call, where Samsonite referred to Tainwala as "Dr".[58]

CEO packs his bags

Following the release of the Blue Orca's report, Samsonite's shares plummeted 21%.[59] On 1 June 2018, a week after the release of the report, Samsonite announced the resignation of Tainwala as the Group's CEO, citing personal reasons.[60] Kyle Gendreau was appointed as CEO with immediate effect. Gendreau had held the role of CFO and executive director of the Group since January 2009.[61] When trading of Samsonite's shares resumed after a week-long halt on 1 June 2018, the company's shares recovered by over 15%.[62]

The future

Analysts praised Samsonite's swift actions in response to Blue Orca's attack,[63] but it remains to be seen if Samsonite had sufficiently resolved the issue. Samsonite has much baggage to deal with before it can fully reverse the negative effects of the allegations by Blue Orca. One thing is certain – a stronger corporate governance framework would be necessary to regain the trust of investors in the long-term.

Discussion questions

1. What is the role of short-seller activists such as Blue Orca? Evaluate how a short-seller activist can improve the corporate governance of companies.
2. Based on the case, discuss the role of the board of directors with regards to the company's internal controls and appointment of external auditors. Did Samsonite's board fulfil its role?
3. Comment on the short-seller's allegations and Samsonite's response with respect to the company's business and accounting practices.
4. Identify and explain the potential conflict of interests involving Tainwala and Samsonite. How can such conflicts of interests be mitigated?
5. Moving forward, how can Samsonite strengthen its corporate governance to regain investors' confidence in the company?

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CARILLION: WHEN A GIANT FALLS

Case overview

The collapse of once mighty British construction company Carillion in January 2018 led to accusations that the directors and management of Carillion were prioritising their self-interests over the financial health of the company and their responsibilities to stakeholders. While they could walk away with their bonuses, the liquidation of Carillion caused the thousands of job losses and unpaid suppliers. The objective of this case is to facilitate a discussion of issues such as duties of directors to shareholders and other stakeholders; remuneration of directors and management; the role of external auditors, internal auditors, regulators and other players in the corporate governance ecosystem; and dominance of the Big 4 firms and reforms of the accounting profession.

The fall of a giant

Before its collapse, Carillion was the second largest construction company in the United Kingdom (U.K.). The firm boasted approximately 43,000 employees, generated revenues of between £3 billion to £4 billion, and had a market capitalisation of around £2 billion.[1]

In early January 2018, Carillion ran into major difficulties and collapsed.[2] In addition to destroying shareholder value, the company's demise left unfunded pension liabilities of approximately £2.6 billion with respect to 27,000 employees. Thirty thousand unpaid suppliers were collectively owed £2 billion, and there was uncertainty regarding hundreds of service contracts with an estimated cost of around £150 million to ensure continuity of services.[3]

This is the abridged version of a case prepared by Joel Tan Xingyu, Lim Zhi Quan, Tham Kai En, Vincent Kharistia and Yeo York Hao under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Mirabel Clarissa Reynaldo under the supervision of Professor Mak Yuen Teen.

Birth of Carillion

Carillion demerged from Tarmac Group in 1999. Thereafter, Carillion grew rapidly and expanded beyond the construction sector into facilities management.[4] Most of its growth was attributed to acquisitions aimed at removing competition. Mowlem – one of the U.K.'s largest construction and civil engineering firms – and Alfred McAlpine – a sizeable construction firm – were acquired by Carillion in 2006 and 2008 respectively. In 2014, Carillion tried unsuccessfully to merge with one of the largest players in the market, Balfour Beatty. Balfour Beatty was skeptical about the potential benefits from cost savings.[5] In 2011, Carillion purchased Eaga plc (Eaga), a supplier of heating and renewable energy services. Before the acquisition, Eaga had accumulated profits of £31 million. However, five years after the merger, its losses totaled £260 million. At the same time, Carillion failed to fund its pension deficit of £605 million.[6]

Carillion did not appear have a clear strategy for its acquisitions and consistently paid more than the target's net identifiable assets.[7] As a result, large amounts of goodwill were accumulated.[8] Failing to generate synergies from its acquisitions, Richard Howson, the former Chief Executive Officer (CEO) of Carillion, stated that the company would shift its strategy to bid aggressively for contracts to generate cash, leading Carillion into an international expansion to gain exposure to new markets.[9]

Spread your wings and learn how to fly

In 2011, Carillion had a contract with Msheireb Properties, a construction company based in Qatar, to build residential and commercial buildings in Doha.[10] However, in 2018, there was a major dispute between Carillion and Msheireb Properties regarding a £200 million payment from the Qatari company to Carillion,[11] and this was identified as the cause of the liquidation of Carillion's Qatari arm in the same year.[12]

It was later discovered that even though a 2009 board strategy paper gave a poor outlook on the Middle East market, Carillion still pursued several construction partnerships in the region, including 13 construction contracts in Qatar between 2010 and 2014.[13]

The people behind the scene

According to the Corporate Governance section of Carillion's annual report, the majority of the board members were independent directors. Some of the directors, including the Chairman, had numerous external roles as well.[14] Carillion's board consisted of seven members as of 2016, comprising an independent Chairman, two executive directors who were the CEO and Chief Financial Officer (CFO), and four independent non-executive directors. In line with the U.K. Corporate Governance Code, all directors of Carillion offered themselves for annual re-election at each Annual General Meeting.[15]

Board committees

The Audit Committee (AC), led by Andrew Dougal, reviewed and reported to the board on the Group's financial reporting, made recommendations on the appointment of external auditors, and reviewed the external and internal audit functions. Risk management functions came under the purview of the AC as well. Carillion's internal audit was outsourced to Deloitte.[16]

The Remuneration Committee (RC) reviewed and advised the board on remuneration arrangements for the Chairman, executive directors and their direct reports.[17] This committee, chaired by Alison Horner, increased the remuneration of numerous senior staff in 2016 despite the company's declining share price. Howson, the CEO of Carillion at that time, also received bonuses of more than 30% of his salary even though he did not meet any of his financial performance targets.[18] Additionally, Carillion changed its pay policy in 2016, which made it more difficult for the company to recover or claw back executive bonuses.[19]

The Financial Reporting Council (FRC) Stewardship Code maintains that "investors monitor the performance of companies in which they invest, including by checking on the effectiveness of leadership and the quality of reporting".[20] BlackRock was one of the major shareholders in Carillion. In 2016 and 2017, BlackRock rejected a request from Carillion's RC to support the increase in remuneration and bonuses for the executives of Carillion. Amra Balic, managing director of BlackRock, said that focus of Carillion's board was on the executives' remuneration and not on what was happening to the company.[21]

Executive directors

Carillion had two senior executives on the board of directors. They were the CEO and CFO of the company.[22]

Chief Executive Officer

Howson was the CEO of Carillion from January 2012 and resigned in July 2017 following the company's profit warning.[23] He had joined the board in 2009 and was its longest-serving member.[24] He was the Chief Operating Officer (COO) of the company prior to his appointment as CEO.[25] The company's 2016 annual report said that Howson possessed "detailed knowledge of key business units" and operational leadership experience.[26]

After Howson resigned in July 2017, he was replaced by Keith Cochrane as interim CEO. Cochrane was an independent non-executive director.[27] He is a chartered accountant who had worked at Arthur Andersen.[28]

Chief Financial Officer

From 2007 to 2017, Carillion had three CFOs. Richard Adam held the role from 2007 to 2016.[29] His successor, Zafar Khan, was Carillion's CFO for a mere nine months, from 1 January 2017 to 11 September 2017,[30] before passing the baton to Emma Mercer.[31]

Adam started his career as an audit manager with KPMG.[32] During the U.K. inquiry into Carillion's collapse, he was severely criticised and named as the "architect of Carillion's aggressive accounting policies who resolutely refused to make adequate contributions to the company's pension schemes".[33] Adam also proceeded to sell £776,000 worth of his Carillion shares in March and May 2017.[34]

Khan was previously the CFO of Associated British Ports Holdings before joining Carillion in 2011.[35] In 2016, Khan was promoted to CFO from his prior position as the Group Financial Controller.[36] He was fired by Carillion's board in September 2017, having "spooked" the board with a financial update that showed the company's poor situation.[37] During the inquiry, many directors tried to put the blame on him for the company's collapse.[38]

Mercer was often referred to in the press as a "whistleblower".[39] During the inquiry, she was described as "the only Carillion director to emerge from the collapse with any credit".[40] When she was in charge of finances of the Group's construction department immediately prior to becoming CFO, she raised concerns about Carillion's accounting practices to the Group's human resources department – going through internal whistleblowing processes, and eventually bringing it up to the board in May 2017. It took Mercer just six weeks after taking over as CFO to "spot and pull the thread that unraveled the company".[41]

Corporate culture

The U.K. Corporate Governance Code states that the underlying principles of good governance are accountability, transparency and a focus on the long-term success of an entity. After the collapse of Carillion, Phillip Green, who was the Chairman of Carillion since May 2014, insisted that Carillion's board upheld those standards, describing a culture of "honesty, openness, and transparency".[42]

However, after the liquidation of the company, minutes from a board meeting in August 2017 showed that there was a culture of manipulation of numbers and "wilful blindness" among long-serving staff with regard to what was happening in the company. In view of this, the board emphasised that the culture of the organisation required urgent changes.[43]

When Carillion collapsed in January 2018, the Group's structure consisted of 326 companies across many geographical locations. A representative of The Insolvency Service in the U.K. stated that it was difficult to ascertain basic information, such as director listings, from these companies.[44]

Carillion also had a rather dispersed shareholding structure,[45] with major shareholders each holding around 10% or less.[46]

Lack of shareholder engagement

In Carillion's 2016 annual report, the firm stated that it strove to engage in "regular dialogue with shareholders to discuss and take feedback on its remuneration policy and governance matters".[47]

However, institutional investors became frustrated by the behaviour of Carillion's board as the responses given by them were incomplete and vague. As a result, some investors such as Standard Life and Kiltearn Partners started to divest their investments in the company. They were "left with little option other than to divest" due to the company's failure to provide trustworthy information and respond accordingly to investors' enquiries and discussions.[48]

How to earn money – the Carillion way

Carillion operated three primary businesses:

- Support services, which the company described as the provision of maintenance, facilities management and energy services for major property and infrastructure.
- Project finance, which included arranging the funding for Public-Private Partnership projects and delivering public sector properties and infrastructure.
- Construction services, which included the delivery of properties and infrastructure.[49]

To drive revenue growth, then-CEO Howson believed that Carllion had to bid aggressively to secure contracts and make money, which exerted a strain on margins.[50]

Carillion disclosed its 2016 financial performance partly through the use of Alternative Performance Metrics (APMs) "to present additional information that reflects how the directors measure the progress of the Group". The APMs were determined by adding back traditional accounting items such as (i) non-recurring charges, (ii) change in fair value of financial instruments and currency instruments, and (iii) amortisation of intangibles.[51]

Revenue

In Carillion's financial reports, revenue was recorded based on recognition of revenues and margins from the company's portfolio of construction contracts. Its revenue recognition policy was based on management's estimates that were reviewed by the AC. The AC had determined that management's estimates were reasonable.[52]

In July and August 2017, Deloitte examined peer reviews conducted between January 2015 and July 2017 related to the construction contracts.[53] It found that Carillion's management contract appraisals tended to report higher profit margins than its peers. Differences between the two assessments were substantial: in more than 50% of the cases where the peer review pointed to a lower margin, the differences exceeded £5 million.[54]

Further, board minutes revealed that the board was aware of the concerns related to the aggressive accounting methods. Board meeting minutes from June 2017 stated that "management need to be aware that high-level instructions such as that to 'hold the position' (i.e. maintain the traded margin) may, if crudely implemented, have unintended consequences".[55]

Additionally, the board members had personal incentives to present a rosy picture of the company. Board minutes from March 2015 showed that the Carillion board raised concerns about potential claw-backs of director bonuses, saying that the bonuses should not include "retrospective judgements on views taken on contracts in good faith".[56]

Margins

While the growth in its revenues was substantial at around 10%, the company continued to experience chronically weak margins. Gross margins were in single digits from 2009 to 2016.[57]

Despite the weak margins, Carillion's board had been increasing the dividend payouts yearly since the company's inception in 1999. This was despite its stated policy of only distributing dividends when the net profit was strong and sustainable.[58]

Although net profit decreased in 2012 and 2013, the company still increased its dividend payments. A dividend distribution of £55 million was made just one month prior to its profit warning on 10 July 2017. Despite proposals from then-CFO Khan to withhold dividends and pay off debt, Dougal, the AC Chairman, and Keith Cochrane, a senior independent non-executive director, supported the dividend distribution for fear of market ramifications.[59]

Pension schemes

The most significant pension schemes arose from the acquisition of Mowlem and Alfred McAlpine. By the end of 2011, the pension deficit arising from these companies amounted to £424 million. In the U.K., it is mandatory for pension schemes to be valued at least once every three years to assess if the statutory funding objective is met. Carillion had deficits of £327 million in 2008, £617 million in 2011, and £439 million in 2013.[60]

After the profit warning in July 2017, Carillion stated that it would cut costs. The pension scheme payments were one of the ways for the company to do so.[61] It was later discovered that Carillion's directors were not part of the pension scheme. Managing risk of pension deficit was excluded from the directors' performance indicators.[62]

Debt and other liabilities

Carillion had also been taking more debt to fund its operations. The build-up of liabilities and the company's inability to service its debt sparked concerns among Carillion's shareholders.[63]

However, Carillion's growing debt did not seem to be a major concern to the board. Keith Cochrane, a non-executive director in Carillion, described the debt and pension deficit as a lesser concern in 2015.[64] On hindsight, many of the directors agreed that the debt level was unsustainable.[65]

Additionally, Carillion relied on an extensive network of suppliers. At the point of the company's collapse, the trade association of construction in the U.K. estimated that Carillion's supply chain included almost 30,000 companies which were owed money by Carillion.[66]

Carillion signed the U.K. government's Prompt Payment Code in 2013, under which the company pledged that it would pay suppliers on time. However, Carillion paid its suppliers late.[67] Early payment schemes, in which the contractors could get additional discounts by paying the suppliers at an earlier time,[68] were made available in the U.K. in 2012 and Carillion was one of the first participants. However, after signing this scheme, Carillion changed its payment terms to 120 days. CFO Mercer claimed that this was a deliberate strategy employed by Carillion to improve its working capital.[69]

Accounting practices

Many institutional investors questioned the timing of the £845 million provision made in July 2017. They were uncertain if the management knew or ought to have known earlier about the £845 million impairment. Of the £845 million, £729 million were from revenues that should not have been recognised in the first place.[70]

Moody's, one of the world's leading credit agencies, claimed that Carillion had concealed its true level of borrowing from financial creditors. Carillion presented bank borrowings as liabilities to other creditors, instead of recording them as bank borrowings. As a result, as much as £498 million was claimed to have been misclassified.[71]

Mercer spotted an unusual way in which the company was classifying receivable balances for construction contracts. Subsequently, she flagged out the company's aggressive accounting policies.[72] The board of Carillion then engaged KPMG to review work that it had previously audited and approved. KPMG agreed that Carillion had misclassified its assets, but it stressed that the company had not misstated its revenue.[73]

Khan, who signed off the 2016 annual report, said that he did not adopt aggressive accounting. When KPMG sought clarification with management as to whether the company's financial statements were misstated due to fraud or error, the board answered that provisions were made due to a deterioration of construction contracts between March and June 2017.[74]

The review done by KPMG eventually led to the £845 million in impairment made in July 2017.[75]

The world finds out

A profit warning was issued on 10 July 2017 after the £845 million in impairment was made. This impairment erased seven years of Carillion's profits. The financial health of the company was then called into question, as net liabilities now amounted to £405 million and borrowings also increased to £961 million. Goodwill recognised on the balance sheet was reduced by £134 million and the working capital ratio fell to 0.74.[76]

Even before the disclosure was made, there was a sell-off of Carillion stock. Carillion's share price fell by approximately 70% over a short span of five days from 7 July 2017 to 12 July 2017, and it did not recover prior to the eventual liquidation of the company on 15 January 2018. Most institutional investors had sold their shares after the July 2017 profit warnings.[77]

Was the external auditor at fault?

KPMG had been Carillion's auditor since 1999.[78] In March 2017, KPMG signed off the company's 2016 annual report, stating that it gave a "true and fair view of the financial statements provided by the company".[79]

However, on 10 July 2017, four months after the 2016 annual report was published, Carillion issued a profit warning, reporting impairment charges amounting to £845 million.[80] A second profit warning was issued in September 2017, with an increase the amount of impairment to £1.045 billion.[81]

In mid-January 2018, Carillion officially became insolvent.[82] With only £29 million in cash, the company was unable to repay debt exceeding £1 billion to banks, £2 billion to suppliers and £2.3 billion to pension holders.[83]

On 29 January 2018, the FRC started an inquiry into the 2014, 2015 and 2016 audits of Carillion, focusing on accounting estimates and recognition of revenue for significant contracts, and accounting treatment for pensions.[84] In early 2019, FRC announced a second investigation regarding KPMG's audit of Carillion's accounts.[85]

KPMG was questioned by the FRC about its competence in performing adequate testing of revenue for certain audits and about its testing for impairment of goodwill. In particular, FRC questioned whether KPMG had sufficiently challenged management's assumptions on goodwill impairment.[86]

What about the internal auditor?

Deloitte had been Carillion's internal auditor since 2010. Annual fees of about £775,000 were charged.[87]

Throughout Deloitte's appointment as internal auditor, a number of recommendations were made. However, issues raised were normally not deemed to be of high priority by Deloitte. Out of 309 recommendations between 2012 and 2016, only 15 were deemed to be such. Moreover, out of 61 internal audit reports made in 2015 and 2016, only one cited a lack of internal controls. The FRC's enquiry found that Deloitte did not know about the ongoing dispute with Msheireb Properties with regards to the £200 million of debt owed. The FRC's view was that Deloitte had failed in performing its professional duty to identify insufficient risk management and financial controls.[88]

Apart from being Carillion's internal auditor, Deloitte also acted as advisors to the RC, providing advice on the company's pension scheme and undertaking due diligence for the acquisition of Eaga in 2011. After the acquisition, Deloitte received £730,000 in fees for attempting to restructure Eaga to improve profitability.[89]

Involvement of other Big Four accounting firms

Ernst & Young (EY) was another big four accounting firm engaged by Carillion to try to turn it around. After the profit warnings in July 2017, it was tasked with a cost reduction project to cut £123 million in expenses.[90]

PwC was later engaged to be the special manager in the liquidation of Carillion by the government. At the same time, PwC was engaged by the pension trustees of Carillion to advise on how to protect the members of the pension schemes while Carillion was facing worsening financial difficulties. It also advised the government, a major Carillion shareholder, on contingency plans in the event of the collapse of Carillion. [91]

FRC's handling of Carillion

The FRC is the regulator of accountants, auditors and actuaries in the U.K. and its primary responsibilities includes maintaining high standards of financial reporting and auditing and pursuing sanctions against those who fall below established professional standards.[92]

Generally, the FRC can take legal action with respect of misconduct and breaches of professional standards. However, the U.K. Corporate Governance Code operates on a "comply or explain" basis. Directors of companies are not subjected to legal action for non-compliance with the Code. It is principally a matter for shareholders to ensure that the board complies with the Code and that the company is managed effectively.[93]

As early as 2015, FRC identified some concerns relating to Carillion's poor disclosure of information. It reviewed the company's accounts and found that there were inadequate disclosures by the company. After Carillion made the necessary disclosures, FRC did not follow up the following year.[94] In addition, FRC had not evaluated the audit of Carillion accounts by KPMG since 2013 despite reports of aggressive accounting practices. FRC only took action after the first profit warning in July 2017.[95]

After the collapse of Carillion, FRC conducted a thorough audit review for Carillion, starting from the financial year 2014. On 19 March 2018, it started an investigation into the conduct of Adam and Khan with regards to their respective approvals of Carillion's financial statements.[96]

However, under its powers at that time, the FRC could only act against those with accounting qualifications. Thus, it could not launch an investigation into all the directors who had certain powers over the financial statements. Additionally, the CEO of FRC shared that the FRC's enforcement team had only been increased from 20 to 29 since January 2016, although it had forward plans for increasing manpower.[97]

Government's role

In 2011, the U.K. Cabinet Office introduced a new approach – the 'Crown Representative' network – for how the government engages with its key strategic suppliers. Its role was to "act as a focal point for particular groups of providers looking to supply to the public sector".[98]

The U.K. Cabinet Office has the responsibility to monitor financial information, especially regarding "trigger events", referring to information that "could potentially lead to the invocation of financial distress measures in government contracts". An example of a trigger event was the profit warning issued by Carillion. From July to November 2017, Carillion issued a total of three profit warnings.[99]

However, from August to November 2017, no Crown Representative was appointed to Carillion. The government said that this temporary vacancy did not affect its ability to identify Carillion's problems.[100]

Pension trustees and pension regulators

Trustees invest the assets of a pension scheme and are responsible for ensuring members' benefits are secured and that it is run smoothly. However, Carillion exercised budgetary control over the trustees. As a result, the pension trustees had very limited power. Thus, to recover pension payments, they had to write to the pension regulators to intervene.[101]

Unlike the trustees, pension regulators have powers under Section 231 of the U.K. Pensions Act 2004 to impose a schedule of pension contributions. However, the regulators did not enforce this on Carillion. Furthermore, the pension regulators failed to challenge Carillion about its dividend policy, instead merely acknowledging that the company dividend payment to pension contribution was better than other listed companies. It also stated that it would not prevent the company from paying out a dividend if it the company believed it was the right thing to do.[102]

Plea for government support

Carillion eventually sought financial aid from the government on 31 December 2017. Although the government and Carillion were in discussions at the time, the only aid that the government had given to Carillion was a deferral of tax liabilities under a HM Revenue and Customs "Time To Pay" arrangement valued at £22 million in October 2017.[103]

Subsequently, Carillion made another request to the government to defer tax liabilities totaling £91 million from January to April 2018. However, it did not succeed in its request. The government ignored further requests for guarantees or administration, aimed at propping up a failing business. Carillion's fate was thus sealed.[104]

The end

Carillion's 2016 annual report stated the company as "one of the U.K.'s leading integrated support services companies, with a substantial portfolio of Public Private Partnership projects, extensive construction capabilities and a sector-leading ability to deliver sustainable solutions".[105] However, Carillion and its five subsidiaries were wound up by the U.K. High Court on 15 January 2018. The court appointed David Chapman, the Official Receiver, as liquidator.[106]

The collapse of Carillion had great repercussions that affected many stakeholders.[107] By April 2018, there were more than 1,800 redundancies.[108] The Official Receiver estimated that total liabilities could be as high as nearly £7 billion.[109] Taxpayers also borne the brunt of the collapse as the Redundancy Payment Office made around £50 million in redundancy payments to workers, with the final bill likely to be around £65 million.[110]

In February 2019, it was announced that £413 million had been recovered from Carillion with more recoveries to come. However, it was "far too little and too late" for those badly affected by the collapse of Carillion, including its employees, suppliers and customers.[111]

Discussion questions

1. Directors are supposed to act in the interests of the company. To what extent are they required to take into account the interests of stakeholders, other than shareholders? What steps should directors take in ensuring that interests of different stakeholders are taken into account? In Carillion's case, do you think the directors have adequately discharged their duties?
2. In your view, who was most responsible for Carillion's collapse? Analyse the role of different players who contributed to the company's eventual downfall.
3. Examine Carillion's financial performance and position prior to the collapse. What were some of the primary issues with Carillion's financial position? Assess how the company dealt with its financial issues.
4. Critically evaluate the remuneration policies for directors and senior management of Carillion before its collapse and compare them with the financial performance of the company. To what extent did the remuneration policies contribute to its collapse?
5. Assess the handling of the Carillion scandal by the regulatory bodies in the U.K. What should the government and regulators have done to protect various stakeholders?
6. The external and internal auditors form the third line of defence for internal control and risk management of a company. Assess the effectiveness of the external and internal auditors in performing their roles. What factors may have impeded their effectiveness? Explain.
7. The Carillion collapse has led to intense scrutiny of the accounting industry, in particular, the dominance of the Big 4 firms and contributed to a breakdown in trust of the value of the external audit. What changes, if any, do you think are necessary to improve trust in the external audit?

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CBS: MOST WATCHED R-RATED CORPORATE DRAMA

Case overview

In September 2018, Chairman and Chief Executive Officer Leslie Moonves ended his 23-year tenure in CBS Corporation (CBS) after media articles made numerous accusations against him relating to sexual misconduct and retaliatory actions. At the same time, CBS was undergoing a separate legal battle with parent company, National Amusements Inc. (NAI). Coupled with the sexual misconduct scandal, CBS was rocked to its core, and its board of directors was left with a number of issues to tackle. The objective of this case is to facilitate a discussion of issues such as those relating to the role of the media in promoting corporate governance; corporate culture; whistleblowing policy; a leader's competence versus integrity; severance packages succession planning; directors' duties; and board composition.

The story of Jones and Moonves

"The revenge behaviour, the 'I'll get you for not kissing me, I'll get you for not doing what the hell I want you to do' – it never quite leaves you."

– Janet Jones, on Leslie Moonves' unwanted advances[1]

In the spring of 1985, Janet Jones, an aspiring writer, managed to secure a pitch meeting with Leslie Moonves, former CEO of CBS Corporation. At the meeting, Moonves interrupted Jones during her pitch and forced himself on her. She pushed him off and tried to leave but realised that the door to his office had been locked. To get him to unlock the door, she threatened to scream. After the encounter, Jones received a call from Moonves, who warned her that he had the power to ruin her career if she informed anyone about the incident.[2] This was not the only instance of Moonves allegedly committing sexual assault.

This is the abridged version of a case prepared by Cheng Chai Hao (Jayden), Jasmine Wong Jiamin, Shannon Tan Xin Yi and Vernice Tan Ching Wei under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

About CBS

CBS Corporation (CBS) is an American mass media company incorporated in 1986 which operates in four segments: Entertainment, Cable Networks, Publishing, and Local Media.[3] In 1999, CBS was acquired by Viacom Inc. (Viacom),[4] another large entertainment company that is home to Nickelodeon, MTV and Paramount Pictures.[5] However, in 2006, Viacom split into two publicly traded companies and re-established CBS.[6] National Amusements Inc. (NAI), which is controlled by Sumner Redstone and his daughter Shari Redstone, is the parent company of the two separated entities.[7]

TV programming wizard Moonves

Moonves started off in the entertainment industry as an actor before making the switch to the corporate world. In the early 1990s, he had a successful stint as President of Warner Bros, having developed two of television's greatest hits – Friends and ER. He joined CBS in 1995 as the President of CBS Entertainment before he was promoted to Chief Executive Officer (CEO) of CBS in 2006. Under Moonves' leadership, CBS transformed into the most-watched television network in the United States with many popular shows including CSI: Crime Scene Investigation, Two and a Half Men, and The Big Bang Theory.[8] Much of CBS' success had been attributed to Moonves, who became one of the most powerful figures in the media industry.[9]

Moonves sex-posed

On 27 July 2018, a report published by Ronan Farrow from The New Yorker sent shockwaves across the entertainment industry in the United States when it alleged that Moonves had sexually harassed six women with whom he was supposed to have professional dealings with.[10] Most of these alleged acts of sexual misconduct were committed about 20 years ago.

On 9 September 2018, The New Yorker delivered another exposé on the sexual harassment saga, revealing the stories of six more women who were allegedly harassed by Moonves.[11] Several hours later on the same day, CBS officially announced that Moonves had been dismissed from his position at CBS.[12]

The encounters had similar storylines – the women would be invited to meet Moonves alone in his office or to dinner meetings for supposedly work-related discussions. The rendezvous would then end off with Moonves trying to forcibly initiate sexual relations with them. The sexual harassment incidents included making inappropriate sexual comments, forced oral sex, kissing, and groping. It was also alleged that the women resisted, there was retailiation ranging from physical intimidation to threats of getting fired from their acting roles at CBS.[13]

The roof caved in and the truth came out

In 1995, budding actress Bobbie Phillips was introduced to Moonves by Marv Dauer, a Hollywood talent manager.[14] At her first meeting with Moonves, he was said to have exposed his private parts to her and coerced her to be his girlfriend in exchange for a job on any show she wanted. Moonves then allegedly forced her to give him oral sex.[15] Philips was saved by an incoming call for Moonves and quickly took the chance to leave the room once the call was over. Dauer did not know the exact details of what happened, but he knew that Philips had been uncomfortable at the meeting. Philips was greatly traumatised by the experience and it affected her future performances at auditions. She eventually retired from acting and relocated to Toronto.[16]

22 years later, in November 2017, a reporter from the New York Times picked up on rumours circulating about Moonves. The news agency then called Dauer and asked about Moonves' history of sexual misconduct, but Dauer did not expose Moonves then.[17] Over the following months, Dauer and Moonves were in frequent contact, exchanging text messages and phone calls primarily on whether Philips had spoken to the media about her sexual harassment encounter with Moonves.[18]

On 19 July 2018, Farrow contacted CBS for comment regarding the article he was about to publish in The New Yorker.[19] Moonves then called Dauer, persuading him to delete their text messages, but Dauer did not follow through. The spokesman for Moonves denied this ever happened.[20]

Later that year, in November 2018, The New York Times released an exposé of Moonves sexually harassing Bobbie Philips.[21] Moonves continued to insist that all sexual encounters were consensual.[22]

Impact on CBS' share price

On the day The New Yorker story was published, CBS' stock price fell six percent, losing approximately US$1.4 billion in market value.[23] In less than two weeks, the company's stock lost an estimated eight percent of its value.[24]

On 10 September 2018, the first trading day after it was announced that Moonves would be stepping down from his position at CBS, the stock closed at approximately two percent lower for the day at US$55.20 per share.[25]

Corporate culture

"[It] felt like a boys' club, where a number of talented women seemed to be marginalized and undervalued."

– Katie Couric, anchor at CBS Corporation[26]

During Moonves' reign at CBS, there was reportedly a culture of keeping things under wraps – even when there were accusations of sexual misconduct – as well as the company paying off the women involved in exchange for their silence.[27] Many of the company's employees, including high-ranking executives and even members of the board, were said to be aware of Moonves' sexual misconduct and subsequent efforts to conceal the misdeeds. However, no one had stopped him.[28]

The culture in CBS was ironic given how Moonves was a prominent voice in the #MeToo movement – a movement against sexual harassment and sexual assault. He had previously helped to establish the Commission on Eliminating Sexual Harassment and Advancing Equality in the Workplace[29] – a commission involving 25 of Hollywood's most significant institutions working together to "set best policies and practices aimed at eliminating sexual harassment and bias in the entertainment industry".[30]

Moonves' private actions completely contradicted his stance on what CBS' corporate culture stood for. According to current and former employees of CBS, this behaviour was not exclusively displayed by Moonves; it was also prevalent in other highly regarded segments of the corporation as well. Jeff Fager, the former Chairman of CBS News and the present executive producer of 60 Minutes, was accused of inappropriately touching employees at company parties.[31] The culture in CBS was what many current and former CBS executives would call a "boy's club".[32] "It's top down, this culture of older men who have all this power and you are nothing," a veteran producer commented on how Fager cultivated the culture of harassment in the department.[33]

A CBS News reporter, Jericka Duncan, spoke out on CBS Evening News about how Fager had sent her threatening text messages in the midst of the sexual misconduct allegations made against him. Fager told Duncan in a text, "Be careful. There are people who lost their jobs trying to harm me and if you pass on these damaging claims without your own reporting to back them up that will become a serious problem."[34] This was not an isolated incident and there were other alleged instances of improper behaviour at CBS which were silently covered up.

In a bid to reassess and improve its corporate culture, CBS created a new position of Chief People Officer on 11 October 2018 – a month after Moonves stepped down as CEO – and appointed Laurie Rosenfield for the role. The Chief People Officer would report directly to Joseph Ianniello, President and acting CEO of CBS.[35]

United they stood, divided he fell

In January 2018, months before the first exposé by The New Yorker was published, rumours were rife that Moonves would be the talk of a new article. Additionally, the board of CBS was apparently already aware that a sexual assault complaint was made against Moonves and the Los Angeles Police Department had begun its investigation on him.[36] In an attempt to reassure his company, Moonves met with Michael J. Aiello, a lawyer hired by board of directors of CBS, and insisted that the board should not be concerned as there were only a handful of sexual harassment incidents and those happened a long time ago.[37]

However, once Farrow's story was published by The New Yorker in July 2018 and Moonves was publicly accused of sexual harassment and assault, CBS could no longer downplay the situation. CBS hired two law firms to initiate an investigation on Moonves. However, the independence of the law firms selected was questioned, as they were also engaged by CBS for its mergers and acquisitions activities.[38]

CBS' board of directors subsequently convened a conference call to decide on the next course of action concerning Moonves. The board was clearly divided – a number of directors who were under Shari Redstone's heed felt that it would be in the company's best interest for Moonves to, at the very least, take a leave of absence.[39]

Prior to the conference call, Moonves held a private meeting with some of the independent directors on CBS' board, excluding Shari Redstone. Moonves persuaded these directors that the allegations made against him were "grossly overstated". Convinced, these directors decided to stand by him and pledged their full support. An independent director, Arnold Kopelson, was particularly defensive and allegedly said after the meeting, "I don't care if 30 more women come forward and allege this kind of stuff. Les is our leader and it wouldn't change my opinion of him."[40]

However, the board's faith in Moonves' leadership and integrity was completely shattered in a matter of weeks. Instead of informing the board that one of his accusers had threatened to go public with her claims, Moonves attempted to silence her by finding her a job at CBS.[41] Once the board got wind of Moonves' actions, even the directors who initially supported Moonves were shocked and outraged by his deceit.[42]

The new information shed some light on the situation and the board finally came to a decision. On 9 September 2018, mere hours after the publication of the second exposé by The New Yorker, the board announced the departure of Moonves. Three days later, CBS dismissed Fager for sending threatening texts to the CBS News reporter who was investigating the allegations made against him for perpetuating a culture of harassment at 60 Minutes.[43]

CBS needs sirens instead of whistles

According to CBS' business conduct statement, one of the company's goals was to create a harassment-free workplace environment. The company was said to have a "zero tolerance" policy for sexual and discriminatory harassment – such acts were strictly prohibited, and effective remedial action would be taken against the perpetrators.[44]

Under the section "Implementation of the CBS business conduct statement", the procedures for reporting any act of harassment were laid out. The section listed the compliance officers, who they reported to, and clearly set out their responsibilities, which included "investigating violations or suspected violations of the statement". Under employee reporting procedures, employees should report misconduct in this particular order: first to their supervisor, followed by their department head, human resources representative, the company's general counsel, a compliance officer, or directly to the Audit Committee, depending on who the employee felt most comfortable contacting and whether the employee felt that he or she had obtained a satisfactory response from the point of contact.[45]

The section also stated that employees would not be retaliated against if they had made a good faith report. Retaliation in this case would refer to discharging, demoting, suspending, harassing, or in any manner discriminating against any employee in the terms and conditions of employment, as a result of such employee's lawful reporting of a complaint.[46]

According to formal CBS employees, there were hardly any platforms for them to report personal and private complaints about discrimination and misconduct. Some felt that there was a lack of oversight, while others felt that there was no one to turn to if the tone at the top was one which tolerated such behaviour.[47] Meanwhile, those who attempted to speak out were faced with retaliation. Another former producer said that after reporting a misconduct against former news anchor Charlie Rose, the complaint yielded no tangible outcome. In anguish, the former CBS producer said, "If it's just behaviour from the top, tolerated at the top, and there's no one to talk to, what do you do?"[48]

Besides the unsatisfactory platforms for whistleblowing in the company, the attitude of top executives also contributed to the suppression of employee complaints. Moonves was well known for having a short temper, and this deterred employees from stepping on his toes. A few executives who fell out with Moonves said that they were blacklisted in the entertainment industry. One such individual was Andy Hill. After he left CBS and sought a job at another studio, Moonves threatened the head of that studio and said that if he hired Hill, Moonves would refuse to conduct any business with him.[49] The women whom Moonves sexually harassed also feared speaking out at CBS as they were afraid it would lead to retaliation from Moonves, who was reputed for his ability to make or break careers.[50]

The golden parachute: Less for Les?

Prior to the sexual harassment saga, Moonves was one of the highest-paid corporate executives, with compensation of almost US$70 million in 2017.[51] Collectively, Moonves received more than US$1 billion in salaries, bonuses, and other compensation during his long leadership tenure at CBS.[52]

Following Moonves' exit, CBS reportedly tried to reach an agreement on the terms of his exit and settlement package. Moonves' original contract stated that if he is terminated not for "cause" or "good reason", he would obtain 36 months of his annual base salary, cash compensation, three times of the average of the previous three completed calendar year bonuses, cost of providing health insurance benefits and value of accelerating the vesting of outstanding equity awards. This amounted to a hefty sum of approximately US$180 million.[53]

The board of directors' preliminary decision was to allow Moonves to receive about two-thirds of the US$180 million CBS owed him, if he were to be terminated without "cause". The remaining amount would be contingent on the conclusion of CBS' investigation. Moonves and CBS would also contribute US$20 million to the #MeToo movement. When news broke about this, the public was outraged that Moonves could still walk away with such a generous severance package.[54]

However, on 9 September 2018, when Farrow published a second article reporting that six more unnamed victims would come out and testify against Moonves, the directors decided that Moonves' severance pay would be unwarranted as he would be terminated with "cause" due to violation of company policies on sexual harassment.[55]

On 17 December 2018, the board of directors of CBS released a statement announcing that the investigations on Moonves were completed, and it was concluded that there was sufficient evidence to terminate Moonves with "cause" as reflected in his employment agreement.[56] As a result, the severance payment would be withheld from him. However, on 16 January 2019, Moonves notified the company that he would challenge the decision through arbitration.[57]

The other shake-up at CBS

For CBS, the sexual misconduct scandal centred around Moonves was just one of its many problems. The company also had to tackle controlling shareholder Shari Redstone's plans of merging the company and Viacom.

CBS has a dual class share structure that differentiates voting shares (Class A) and non-voting shares (Class B). The majority of the shares traded are Class B shares with no voting rights.[58] The Redstone family, through NAI, owns approximately 80% of CBS' Class A common stock, with only an effective equity stake of about 10% in economic interest.[59] The dual class share system allowed the concentration of power in CBS to be vested in the Redstone family.

Talks about a merger first arose in 2016, when the Redstone family indicated its plans for the reunification of both media companies and that it would not tolerate any form of third-party control.[60] In January 2018, Shari Redstone announced plans to merge Viacom and CBS. CBS subsequently set up a Special Committee made up of independent directors in February 2018 to evaluate the possible merger with Viacom.[61]

In April 2018, CBS reportedly offered to buy out Viacom for a price below its market value then, with the new company being led by CBS' management team going forward. The move would have allowed Moonves and his right-hand man Ianniello to be in control of the merged company.[62] However, this move was against Shari Redstone's wishes as she intended for Bob Bakish, CEO of Viacom, to be the second in command for the newly merged entity.[63]

In May 2018, the Special Committee eventually concluded that the merger would not be in the best interests of the company's shareholders.[64] However, if the merger did not occur, it was speculated that Shari Redstone would retaliate by exerting her power to replace members of the CBS board with directors who would not go against her views and decisions.[65]

When news broke that the potential merger had fallen through, CBS stock price took a significant hit, falling 14.7% from US$60.53 in December 2017 to US$51.61 in May 2018.[66]

CBS declares war against NAI

CBS fought back using a provision in the company's charter which allowed it to issue new Class A shares to all shareholders, including Class B shareholders, thus potentially diluting the voting rights of NAI – and correspondingly, the Redstone family – to 17%.[67]

CBS subsequently filed a lawsuit against NAI and Shari Redstone with alleged claims that Shari Redstone breached her fiduciary duties and did not act in the best interests of CBS' public shareholders when she tried to influence the merger between CBS and Viacom.[68] The lawsuit stated that "through her control of (National Amusements), Shari Redstone's recent actions have led the Special Committee to conclude that she presents a significant threat of irreparable and irreversible harm".[69]

CBS specifically requested for a temporary restraining order against NAI, preventing Shari Redstone and NAI from attempting to replace the CBS board and modifying CBS' corporate governance documents. This however, was rejected by the judge.[70]

In response, NAI unilaterally amended the company's bylaws to require a supermajority of 90% to approve the issuance of a special dividend that will dilute NAI's voting power.[71] This change in bylaws would invalidate the vote to dilute NAI's power in CBS.[72] In response, CBS formally rejected this claim and contested it.[73] Subsequently, NAI responded by filing a 66-page complaint to the court, seeking to block the dilution of voting power in CBS.[74]

The show must go on

On 9 September 2018, CBS announced the departure of Moonves as CEO, President and Chairman, as well as a settlement agreement with NAI. NAI agreed not to raise the possibility of a merger for a minimum of two years and to undo the amendment of CBS' bylaws previously made in response to the threat. Meanwhile, the CBS Special Committee rescinded the previously announced Class A share dividend, which ended the struggle for control between CBS and NAI.[75]

Following Moonves' resignation, Chief Operating Officer (COO) Ianniello took up the role of President and acting CEO while the board searched for a permanent replacement. Ianniello had joined CBS in 2005 and had been the COO of CBS since June 2013.[76]

In addition, five independent directors and one NAI-affiliated director stepped down from the board. Six new independent board members were appointed to replace them.[77] The new independent directors were interviewed by existing independent directors on CBS' board, Bruce Gordon and Martha Minow,[78] and were subsequently endorsed by remaining members in the Nominating and Governance Committee.[79] The new board was made up of 11 independent directors and two NAI-affiliated directors.[80]

On 25 September 2018, Richard Parsons, a candidate nominated by Shari Redstone,[81] was named interim Chairman of the board of directors. At the same time, the company announced the resignation of two directors – Gordon and William Cohen – who had served on the board since 2006.[82] Gordon was one of the directors who filed a lawsuit against NAI while Cohen had been a vocal supporter of Moonves, who was against a merger with Viacom.[83]

Although NAI and Shari Redstone agreed to refrain from pushing for a merger of CBS and Viacom for two years, CBS may initiate the deal if two-thirds of the independent directors vote for it.[84] With Gordon, Cohen and other long-serving board members no longer sitting on the CBS board of directors, analysts have expressed the view that the tide had turned in Shari Redstone's favour.[85] Michael Morris, a Guggenheim Securities analyst, commented that the changes in board composition "could increase the potential that independent board members revisit a possible recombination with Viacom".[86]

On 21 October 2018, Parsons resigned from the CBS board, citing health issues. Strauss Zelnick was appointed as the new interim Chairman. Zelnick is a media industry leader who has held management roles in various entertainment companies and founded his own media-focused private equity company, Zelnick Media Capital.[87]

Who's next in line?

Moonves had been a critical figure in driving CBS' success. He was well-known as the "best show picker in TV" and was highly involved in day-to-day programming decisions.[88] With Moonves ousted, CBS faced challenges in finding a permanent successor to fill his shoes.[89]

CBS hired executive search firm Korn Ferry to help recruit a new CEO. It was reported that CBS was searching for someone who has the capacity to lead a giant media corporation through the times of a changing industry, and who at the same time, has experience in merger and acquisition. However, it failed to find such an individual. The board had missed its internal end-of-March deadline to select a new CEO.[90] In April 2019, CBS announced the suspension of its search for a new CEO while extending Ianniello's term as acting CEO until the end of 2019.[91]

In a span of a few months, CBS had experienced its fair share of drama and yet, the curtain call has not occurred. Will CBS be able to find a new leader who could lead the company out of its flurry of issues and towards success? Its stakeholders are most certainly watching very intently at the sidelines, hoping that the media company would get back on its feet again.

Discussion questions

1. The media played a significant role in exposing Leslie Moonves' sexual misconduct. Discuss the role of the media in promoting good corporate governance in your country.
2. With reference to the case, discuss the importance of corporate culture and the tone at the top in a company. How does it influence the effectiveness of whistleblowing policies? Provide recommendations on how companies can enhance the effectiveness of whistleblowing policies.
3. Leslie Moonves was highly regarded as one of the most influential media figures and led CBS to greater heights during his tenure as CEO. Evaluate the conflicts that a company might face between a CEO's competency and his integrity.
4. Evaluate Moonves' remuneration. What does it tell you about the company? Discuss the rationale for golden parachutes and the problems associated with such pay-outs.
5. Shari Redstone is the controlling shareholder of CBS and Viacom. Furthermore, she is on the board of both companies. Discuss the possible impact of having a controlling shareholder on the board and having directors sitting on the boards of different companies with possible conflict of interests. How can companies exercise good corporate governance in such situations?
6. CBS has a dual class share structure. What are the pros and cons of such a structure? In CBS' case, how could the dual class share structure have harmed the interest of the company and shareholders as a whole?

7. Moonves' sudden departure from CBS highlights the importance of having a succession plan as part of a company's risk management framework. Evaluate the adverse effects of an unplanned succession. What are the features of a good succession plan?

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DANSKE BANK: HUNG OUT TO DRY

Case overview

In 2017, it was revealed that Danske Bank – Denmark's largest bank – was involved in one of the world's largest money laundering scandals. Between 2007 and 2015, 9.5 million suspicious payments from Russia and other ex-Soviet states, amounting to an aggregate of €200 billion, were made through the Estonian branch of Danske Bank. The scandal rocked the financial sector and significantly dampened the credibility of Denmark's financial markets and negatively impacted Danske Bank's reputation as a stable and efficient bank. The objective of this case is to facilitate a discussion of issues such as risk management in financial institutions; whistleblower policies; group structure and integration; anti-money laundering (AML) regulations and policies; and the role of financial supervisory authorities.

The source of it all

In November 2006, Danske Bank expanded into Finland through the acquisition of Sampo Bank, the third-largest bank in Finland. This acquisition also included Sampo Bank's Estonia subsidiary and its non-resident portfolio, which comprised of customers from the Russian Federation and the larger Commonwealth of Independent States, including Azerbaijan and Ukraine.[1]

From 2011 to 2013, there was a significant increase in the proportion of the Estonian branch's profits that were derived from foreign money. By the end of 2013, the non-resident portfolio held 44% of total deposits from non-resident customers in Estonian banks – an increase from 27% in 2007 – and 76% of the share of profits before tax of Danske Bank's Estonian branch was derived from customers in the non-resident portfolio.[2]

This is the abridged version of a case prepared by Chua Tuan Xin, Goh Kwee Yong, Katty Teo Kai Heng, Jerome Lim Zi En, Jessica Goh Kai Ling and Nicholas Lee Jian Wei under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Mirabel Clarissa Reynaldo and Isabella Ow under the supervision of Professor Mak Yuen Teen.

The beginning of a huge discovery

In 2007, months after acquiring Sampo Bank together with its Estonia branch, Danske Bank received a warning from the Russian Central Bank[3] that its Estonia branch was being used for tax evasion and money laundering[4] of billions of Russian roubles every month.[5] Additionally, the Estonian Financial Supervisory Authority (FSA) issued a critical inspection report, which highlighted possible "tax and custom payments evasion" and "criminal activity in its pure form, including money laundering", estimated at "billions of roubles monthly", at the Estonian branch.[6] In 2009, the Estonian FSA performed further follow-up investigations. The investigations concluded with a less critical report than the financial regulator's initial inquiry in 2007.[7]

In 2010, Danske Bank's executive board got wind of the high level of suspicious activities occurring in the Estonian branch. However, the issue was brushed off as the bank's managers felt that they were "comfortable" with "substantial Russian deposits".[8]

The laundromats

Laundromats are criminal financial vehicles which used shell companies to perform money laundering activities across the globe through fraud, manipulation of state contracts, and evasion of tax. It was found that the Russian and Azerbaijani Laundromats were central to the Danske Bank money laundering scandal.[9]

Between 2011 and 2014, 21 shell companies were created in the U.K., New Zealand, and Cyprus to launder US$20.8 billion from 19 Russian banks. These funds eventually ended up in 5,140 companies in 96 countries.[10] Several accounts in Danske Bank had been used by a member of Russian President Vladimir Putin's family and the Federal Security Service of the Russian Federation, to launder significant amounts of suspicious money.[11]

The Azerbaijan Laundromat – which existed between 2012 and 2014 – was a secret fund utilised by the Azerbaijan government to court favours amongst international peers. Similar to the Russian Laundromat, it utilised Danske Bank's Estonian branch to process 'dirty' funds, before the funds were channelled to four U.K.-registered shell companies and used to pay off politicians and purchase luxury goods.[12,13] The Estonian branch of Danske Bank managed the accounts of all four Azerbaijani Laundromat companies and it enabled billions to move without scrutinising their propriety.[14]

What's happening at the Estonian branch?

Danske Bank's branch in Estonia functioned as if it was a stand-alone entity which had its own systems and procedures relating to its anti-money laundering methods.[15] As such, any reporting to the Group was dependent on reporting from local management in Estonia.[16]

The Estonian branch had its own IT platform. As a result, the branch was not using the same customer, risk and transaction monitoring systems as the rest of the Group. The idea of integrating the Baltic banking activities onto the Group's IT platform were abandoned in 2008 due to the high costs involved. Hence, it did not subscribe to the Group's AML procedures.[17]

Further, as numerous documents were prepared in Estonian or Russian, Danske Bank had faced a language barrier and thus a lack of insight into the Estonian branch's activities. Danske Bank simply assumed that the branch was using appropriate AML procedures. However, the Group's faith in the branch was misplaced. The Estonian branch's AML procedures were found to be insufficient to monitor and mitigate the risk of fraudulent financial activities, leading to many breaches of legal obligations by the branch.[18] This also resulted in missed opportunities to detect and investigate any fraudulent activities at the Estonian branch, allowing fraudulent transactions to carry on undetected for a significant period of time.[19]

42 staff and eight ex-staff of the Estonian branch had also been deemed to be involved in colluding with criminals to carry out money laundering activities. Amongst other misdeeds, these staff actively evaded the bank's compliance procedures,[20] performed dubious transactions, deposited large amounts of cash, and were involved in suspicious transactions with other staff.[21] They were also found to have failed to carry out basic background checks on non-resident customers.[22] Moreover, the Estonian branch's employees actively conducted and covered up the violations to the bank's senior management in Denmark as well as to the Estonian FSA.[23]

Problems with internal controls

"All three lines of defence collapsing in this case: it's a matter of internal collusion; it's an underestimation from management of the impact of this case; it's basically looking at this case as risk minimising and not as crime. That might be the biggest mistake. We have a cultural thing we need to work on."

– Jesper Nielsen, Danske Bank's interim CEO[24]

The first line of defence, the business operations, paid insufficient attention on high risk clients in the branch's portfolio. Meanwhile, the Group's business banking team that the Estonian branch reported to relied on continual assurances that all regulations were followed by the branch.[25]

The second line of defence omitted the details of AML risk residing in the Baltic branches in reports to the top management.[26] The bank deferred the decision to terminate part of the high risk non-resident portfolio that related to clients with no personal or business-related links to the Baltic nations until January 2015, which was not completed until January 2016.[27]

The third line of defence in the form of the branch's internal audit function was not fully integrated into Danske's Group Internal Audit department.[28] At the beginning of 2014, Danske Bank failed to inform the Danish FSA of the problems related to the AML issues, even though it was evident to some executive board members that previous reports provided by the bank to the Danish FSA and the Estonian FSA were inaccurate.[29]

Corporate culture

The culture cultivated in the Danske Bank discouraged employees from speaking up. When faced with problems, employees were encouraged to work out the issues at a lower level instead of alerting top management. This "mean and lean" culture could have contributed to the sudden explosion of Danske Bank's Estonian money laundering scandal.[30]

Run-in with the financial regulators

In 2007, the Russian Central Bank alerted the Danish FSA regarding the money laundering risks. Subsequently, the Danish FSA requested a report from Danske Bank and discussed the matter with the head of its legal department and the bank's Chief Audit Executive. The response stated that no money laundering risks were found in the Estonian branch. The Estonian FSA discovered lack of care related to the management of money laundering risks by the Estonian branch. Thus, the Estonian FSA ordered the branch to enhance its background checks on non-resident clients and its internal controls to prevent money laundering.[31]

Between 2007 to 2014, the Estonian FSA conducted a total of four AML inspections.[32] In 2012, the Estonian FSA became concerned about the number of non-resident clients in Danske Bank's Estonian branch and communicated these concerns to the Danish FSA. The Danish FSA then ordered Danske Bank to resolve the issues raised by the Estonian FSA. Following the bank's submission of a comprehensive illustration of the Estonian branch's management of money laundering risks and a review of its business procedures, the Danish FSA decided that even though the concentration of clients from high risk countries could be "problematic", the bank's procedures and controls were adequate.[33]

The Estonian FSA contacted the Danish FSA in 2013 once again on the risks of money laundering in the Estonian branch following a warning given by the Russian Central Bank, which covered a record of dubious clients from Russia and its own analysis of the customer mix of the branch. The Danish FSA ordered Danske Bank to solve this issue. In response, the bank said that it had already established a special arrangement in the Estonian branch in light of the increased money laundering risk. The Estonian FSA subsequently requested documentation from the Estonian branch on the suspicious Russian customers but did not find any significant breaches of internal procedures or legal requirements, and therefore saw no basis for swift regulatory action.[34]

Thereafter, two AML inspections were carried out by the Estonian FSA in 2014. However, the Estonian FSA did not invite the Danish FSA to participate in these inspections. It was later revealed that there were serious deficiencies in Danske Bank's AML system, which prompted an overhaul of the branch's local management. Eventually, the Estonia FSA issued a critical report to Danske Bank,[35] putting pressure on the bank to exit the non-resident business.[36]

The Danish FSA was of the view that as the host country supervisor, the Estonian FSA was responsible for the AML supervision of Danske Bank's Estonian branch, which is in line with the AML directives and the division of responsibilities prescribed by European Union (EU) legislation.[37]

The Estonian FSA, on the other hand, was of the opposite view that supervision over branches operating in Estonia should be exercised by the supervision authority of the country of origin. It therefore relied on the Danish FSA as the lead for AML supervision of Danske Bank.[38]

As a result, a war of words erupted in late January 2019 between the two regulators when the Danish FSA released a report placing responsibility on the Estonian regulator.[39]

Did they know?

The Russian Central Bank's warning in 2007 was Danske Bank's first real opportunity to investigate the suspicious transactions at its Estonian branch. However, this opportunity was missed by the bank's management and board. Five years later, in 2013, J.P. Morgan, a correspondent bank of Danske Bank, brought the correspondent banking relationship with the Estonian branch to an end as it was concerned that it was being used as a conduit for illicit funds. Although this event prompted the Group to initiate a review of the non-resident portfolio, the review was not properly completed.[40,41]

Reporting from the Estonian branch to the Group's executive board and board of directors was almost completely reliant on reporting from local country management. This resulted in censored information that did not paint the full picture of the Estonian branch's activities and performance. For example, between 2011 and 2013, the board of directors was given incomplete reports regarding the Estonian branch, including a presentation on 5 May 2011 which provided no detailed analysis and no mention about the non-resident portfolio.[42]

For years, the Group believed that the high risk represented by non-residents in the Estonian branch was mitigated by appropriate AML procedures. However, in late 2013, a report from a whistleblower emerged. Together with audit letters from the Group Internal Audit in early 2014, the fog surrounding the circumstances at the Estonian branch dissipated and it became clear that the branch's AML procedures were vastly inadequate.[43]

The whistleblower

In 2013 and 2014, Howard Wilkinson, who led the trading unit of Danske Markets in the Baltics since 2007, alerted the executive board of Danske Bank about the occurrence of suspicious activities at the Estonian branch.[44] He made four reports to the executive board regarding suspicious clients in the Estonian branch's non-resident portfolio[45] in the hope that investigations would be promptly initiated.[46]

Wilkinson's suspicions were first aroused when he came across the documents of Lantana Trade LLP (Lantana). The U.K. company did not have any net assets and yet it moved US$480 million through the Estonian branch of Danske Bank in five months. This prompted Wilkinson to check if the business records filed by Lantana with the authorities were aligned with the deposits with Danske Bank. Based on its filings to the U.K. authorities, Lantana's bank accounts had US$20,500 as at 31 May 2012. However, bank records revealed that it had deposits amounting to nearly US$1 million with Danske Bank. Wilkinson then emailed the bank's headquarters about the matter in December 2013.[47]

After several more reports made by Wilkinson drawing management's attention to several suspect transactions and an investigation by the bank's internal audit team – which produced a damning draft report stating that the Estonian branch acted in violation of AML legislative requirements, there was still no action taken to address the matter. Wilkinson then realised that Danske Bank's top management did not seem to want to fix the problem. He observed that "there was a curious lack of interest at senior management level".[48]

In April 2014, Wilkinson resigned from his position.[49] On 8 April 2014, he informed Danske Bank's Chief Risk Officer that he would report the false accounts to the Estonian authorities if no action was taken by the bank.[50] Soon after, the Group presented Wilkinson with a non-disclosure agreement (NDA) to sign before he left the bank.[51]

In Europe, whistleblowers generally lack special legal status to protect them from retaliation by their employer.[52] As such, they may risk retaliatory action if they expose wrongdoing.[53]

What happened next?

Over the period from 2015 to 2016, Danske Bank closed its non-resident business in its Estonian branch. This withdrawal occurred following orders issued by the Estonian FSA in 2015 for Danske Bank to exit the non-resident business.[54,55]

On 19 September 2018, Danske Bank announced that its board of directors and executive board "[did] not wish to benefit financially" from the suspicious transactions in its Estonia branch. It decided to donate the gross income derived from the non-resident portfolio between 2007 and 2015 – estimated to be kr. 1.5 billion – to an independent foundation established to support initiatives directed at tackling international financial crime and money laundering.[56]

Wilkinson was invited to address both the Danish and European Parliaments in late November 2018. Prior to his testimony, on 24 October 2018, the European Union placed pressure on Danske Bank to drop its NDA with Wilkinson to ensure crucial whistleblower testimony from Wilkinson would not be blocked. On 29 October 2018, Danske Bank informed that it had "released the person in question of all contractual duties of confidentiality in relation to Danske Bank."[57,58]

Improvements

Following the eruption of the money laundering scandal, enhancements were made to Danske Bank's AML and compliance frameworks. Initiatives to address the specific issues relating to the Estonian branch were also implemented.

Firstly, Danske Bank made the decision to only enter into engagement arrangements with subsidiaries of Danske Bank's Nordic clients and global clients with a solid Nordic footprint. The bank's non-resident portfolio in Estonia was shut down in 2015. Danske Bank also strengthened its governance and oversight of its branches in the Baltics with the establishment of a new pan-Baltic management team, and boosted independence of control functions in the region to uphold the same degree of risk management and control as the rest of the Group. There was also an IT migration exercise to integrate the Baltics operations' IT systems with the rest of the Group, thus allowing greater transparency and oversight.[59]

Danske Bank also started a comprehensive AML programme, including better organisational structures, improved routines and procedures, and the implementation of new, upgraded IT systems. Additionally, Danske Bank promised to continously improve the organisation-wide compliance knowledge and culture through extensive compulsory training and a robust management focus. Furthermore, risk management and compliance in performance agreements were put in place for all members of the executive board and senior managers.[60]

This was further reinforced by the appointment of Philippe Vollot as the bank's new Chief Compliance Officer on 18 July 2018. He was formerly the Global Head of Anti-Financial Crime & Group Anti-Money Laundering Officer in Deutsche Bank, and has extensive experience in tackling financial crime and money laundering activities.[61]

Danske Bank's whistleblower setup had also been upgraded and a better governance setup was implemented to manage reports. The bank's employees were also actively informed about the whistleblower system through mandatory training sessions. On this matter, Danske Bank made a commitment to ensure that whistleblower reports and correspondences with supervisory authorities form part of reporting to the board of directors.[62]

As part of a new governance model for interactions with financial authorities, Danske Bank planned to establish a central unit at the Group level, which role is to "coordinate and register all significant interaction" with the financial authorities. The Group would hold this unit to the highest standards of "quality, transparency and completeness".[63]

Borgen out

On 19 September 2018, Borgen announced his plans to step down from his position as CEO after a long-term successor was found. However, he was officially dismissed by Danske Bank on 1 October 2018, after the board of directors selected Jesper Nielsen – who formerly headed Danske Bank's Danish banking activities – as interim CEO.[64,65] Observers were of the view that the appointment of Nielsen as interim CEO demonstrated the board's sense of "urgency" to remove Borgen. The decision came after the bank's shareholders, including the Danish Shareholders' Association – Denmark's largest investor group - demanded his immediate exit and expressed anger and frustration at the board's initial decision not to dismiss Borgen.[66]

In December 2018, Estonia arrested 10 former employees of the Estonian branch of Danske Bank on suspicion of knowingly enabling money laundering. This came as a part of an investigation into the bank's money laundering activities.[67]

Exiting the Baltics and Russia

In February 2019, Estonian FSA demanded that Danske Bank exit the country and quit all operations in Estonia. The head of Estonian FSA, Kilvar Kesser, said that scandal had greatly harmed the Estonian financial market reputation and called for Danske Bank's departure due to "serious and large-scale violations of the local rules". In response, Danske Bank said that it would not only cease its operations in Estonia, but in Russia, Latvia and Lithuania as well.[68]

Financial regulators not spared

European Banking Authority's investigation

During the money laundering saga, fingers were also pointed at the Estonian and Danish FSAs over their supervisory failings. On 19 February 2019, the European Banking Authority (EBA) launched a formal investigation into both financial regulators.[69,70]

However, two months later, on 16 April 2019, EBA decided to shelve the investigation after it voted to reject an internal draft report into the supervisory failings of the Danish and Estonian supervisory authorities. The draft report identified breaches of union law, such as "significant shortcomings" in cooperation between the two supervisory authorities, insufficient and ineffective monitoring of whether due-diligence procedures were carried out by Danske Bank, as well as inadequate reviews of Danske Bank's governance arrangements.[71]

This move drew severe criticism from senior EU policymakers who wanted tougher legislation for the financial services industry. One member of the European Parliament, Sven Giegold, commented that it was "scandalous" that the EBA had rejected the report. He further urged the EU commission to open "infringement procedures" against Denmark and Estonia for failure to apply EU law.[72]

Other inquiries

The U.S. Justice Department also started criminal investigations into Danske Bank in January 2019. The investigation was regarding whether as a correspondent bank, Deutsche Bank had sufficiently monitored billions of dollars in suspicious transactions from Danske Bank when it assisted its Estonian branch to convert foreign currency into US dollars for its customers.[73]

On 20 February 2019, Estonia's state prosecutors expanded their investigations to include Swedbank AB – a Nordic-Baltic banking group based in Sweden, in view of allegations of suspicious transactions in Estonia with Danske Bank. It was alleged that from 2007 to 2015, US$4.3 billion were transferred between Swedbank and Danske Bank.[74] Meanwhile, Denmark's authorities also expanded investigations to target accounting firms, including Ernst & Young, for its audit of Danske Bank's accounts in 2014.[75]

Epilogue

Danske Bank's money laundering scandal had stunned the world's banking sector, the general public, as well as Denmark's political establishment. As a result, Danske Bank's reputation has been severely tarnished and its shares had plunged about 50% during 2018, reducing its market value by over US$18 billion.[76]

All in all, one of history's largest money laundering scandals highlighted the importance of implementing robust internal control policies and proper enforcement of such policies. It also highlighted that countries' financial supervisory authorities have a part to play in ensuring that money laundering is not pervasive. As money laundering methods evolve to become more sophisticated and complex, countries and companies alike need to stay vigilant and constantly update national and organisational policies to be several steps ahead in the game.

Discussion questions

1. Evaluate Danske Bank's internal control framework using the Three Lines of Defence Model and/or other relevant concepts.
2. If you were Howard Wilkinson, would you have blown the whistle? Compare and contrast whistleblowing legislation in Europe and in the U.S.
3. Who were the key players in the money laundering scandal, and how did their roles and actions further contribute to Danske Bank's money laundering scandal becoming one of the largest money laundering scandals in history?
4. Discuss the effectiveness of the Danish and Estonian FSAs in carrying out their duties as regulators. What more could they do to prevent money laundering activities?
5. Comment on Danske Bank's improvements in response to the money laundering scandal and what other financial institutions could learn from the scandal.

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FACEBOOK AND CAMBRIDGE ANALYTICA: A TALE OF TWO DATA MINERS

Case overview

On 17 March 2018, The Guardian and The New York Times exposed a major data breach involving Facebook and Cambridge Analytica (CA). Facebook was publicly criticised for exploitation of user privacy and data mismanagement. Ignoring various warnings, the social media giant had allowed third party access to its user database, when only 300,000 out of 87 million users involved consented to the use of their profiles. This data was then allegedly utilised by CA to create psychographic voter profiles using statistical models, which aided in various political campaigns worldwide, including the Donald Trump presidential campaign in 2016. Mark Zuckerberg, Chief Executive Officer (CEO) and Chairman of Facebook, was forced to face congressional hearings to testify on the controversies involving Facebook users' data and privacy in April 2018. The objective of this case is to facilitate a discussion of issues such as corporate culture; ethics; risk management; data privacy; dual class shares; controlled companies; and corporate governance regulatory framework.

Corporate culture of Facebook

Facebook's mission is "to give people the power to build community and bring the world closer together".[1] The company describes its corporate culture as a hacker culture, focusing on innovation and describing their employees as "builders at heart".[2] This organisational culture serves as a tool for Facebook to maintain its competitiveness within the industry. To supplement its fast-paced workplace, Facebook has developed a matrix organisational structure, dividing its employees according to corporate function, geographic location, and product.[3] This corporate structure was implemented to facilitate flexibility across the company, such that it would be able to easily adapt to the changing market conditions.[4] In addition, such a structure would also allow Facebook to be able to retain control over its worldwide operations.[5]

This is the abridged version of a case prepared by Aw Kwan Hong, Keegan Sim, Xie Peiyi and Xie Shiying under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Richelle Lum under the supervision of Professor Mak Yuen Teen

Aimed at providing a ‘frictionless’ work space, Facebook has their employees working together on big, white, communal desks – even CEO Zuckerberg does not have an office.[6] However, despite Facebook priding itself in having an open culture, a Facebook employee group was reported to have criticised the company as having an “intolerant liberal monoculture”. A senior Facebook engineer wrote in a post that “We claim to welcome all perspectives, but are quick to attack – often in mobs – anyone who presents a view that appears to be in opposition to left-leaning ideology”.[7] His post initiated the formation of an online group named “FB’ers for Political Diversity”, which aim was to “create a space for ideological diversity within the company”.[8] However, the group consisted of only about over 100 people, which indicated that Facebook’s employees were seemingly less inclined than other employees in other technology firms to challenge leadership, with most employees in Facebook appearing to be loyalists to Zuckerberg.[9]

Furthermore, Facebook has had difficulty integrating conservatives into their leadership. One such example was when Palmer Luckey – co-founder of Oculus VR, a technology company selling virtual reality products which was acquired by Facebook in 2014 – was pressured to leave Facebook for donating to an organisation dedicated to spreading anti-Hillary Clinton memes. Peter Thiel, a member of the board and a vocal supporter of Trump, had also faced pressure to resign from Facebook’s board of directors.[10]

Mark Zuckerberg’s dominance

Zuckerberg has singular control of Facebook through the use of a dual class share structure. Facebook’s Class A shares grant one vote per share while its Class B shares allow for 10 votes per share.[11] According to Reuters, Zuckerberg owns “about 4 million Class A shares and about 419 million Class B shares, collectively representing about 53.8% of total outstanding voting power.”[12] Moreover, many of Facebook’s Class B shares are also controlled by Zuckerberg’s close inner circle, totaling about 18% of all shares. Together with Zuckerberg’s own shares, Zuckerberg and his inner circle control approximately 70% of voting power within the social media organisation.[13]

As over 50% of the voting power is held by Zuckerberg, Facebook listed itself as a “controlled company”, which allows for exceptions to the corporate governance rules for public companies. This status exempts Facebook from complying with the requirements of having the majority of the board of directors consisting of independent directors, and having independent directors on the governance/nominating and compensation committees.[14]

Investors have questioned Zuckerberg having so much power in Facebook. In Facebook's 2018 Annual General Meeting, an estimated 83% of outside voters supported a proposal for the removal of Class B shares. The proposal was subsequently overturned as Zuckerberg and his inner circle controlled the company through a share majority via Class B shares. However, as commented by Charles Elson, a professor at the University of Delaware, "People are upset, but there's nothing they can do about it."[15]

Zuckerberg: Chairman and CEO

Not only does Zuckerberg control Facebook through the use of dual class shares, he also holds both roles of Chairman and CEO of the social media giant. While the dual class share structure is not unheard of amongst large technology companies, separating the Chairman and CEO roles is becoming more common in this industry.[16] Other large well-known technology companies such as Microsoft, Twitter, Apple and Oracle separate these two positions.[17]

Wielding unquestioned power

In 2016, there was a proposal to introduce a new class of shares – Class C shares – which would result in every shareholder of Facebook being granted with two new Class C shares for every outstanding Class A and B share. The Class C shares will have the same economic rights as the Class A and B shares. However, the new class of shares are non-voting shares.[18]

The share split would allow Zuckerberg to sell his shares in order to fulfil his pledge to donate 99% of his Facebook shares to charity through the Chan Zuckerberg Initiative – a limited liability company established and owned by Zuckerberg and his wife – while maintaining his voting power. This led to observers such as Professor Davidoff Solomon commenting that such a move would give Zuckerberg "lifetime control over Facebook".[19]

A special independent committee made up of independent, non-executive directors from Facebook's board of directors – Marc Andreessen, Erskine Bowles and Susan Desmond-Hellmann – was set up to evaluate this proposed alteration of Facebook's capital structure. According to the Securities and Exchange Commission (SEC) filings, "the special committee unanimously recommended, and the board of directors unanimously approved (with Mark and the other management directors not participating) the Reclassification proposal."[20]

Facebook shareholders subsequently questioned the independence of this special independent committee. Andreessen, who was part of the committee and was supposed to represent Facebook shareholders, had ongoing communications with Zuckerberg as discussions were proceeding. Text messages between the two revealed that Andreessen had been instructing Zuckerberg on what he had to say to win over the special committee's approval for the stock change.[21] Andreessen's venture capital firm, Andreessen Horowitz, had stakes in Instagram and Oculus, both of which were acquired by Facebook. Furthermore, all the members of the special committee were also dependent on Zuckerberg to re-elect them to the Facebook board each year.[22]

Following the approval of the proposal, protests against it ensued. A group of Facebook investors and a consumer watchdog group, SumOfUS, proposed that Zuckerberg give up his role as Facebook's Chairman, as they argued that an individual taking on dual roles would weaken the company's corporate governance.[23] Furthermore, Lisa Lindsley, the capital markets advisor for SumOfUs, remarked that Facebook had "a symptom of a board that has capitulated to the CEO," and that "Clearly, in this case, you have the directors looking to Zuckerberg as the only authority figure on the board."[24] Michael W. Frerichs, the state treasurer of Illinois also believed that "In essence, Mr. Zuckerberg is not accountable to anyone. Not the board, nor the shareholders."[25]

In response, the Facebook board of directors quickly defended their proposal, arguing that they believed that in the long run, "forcing a division between our Chairman and our CEO could harm our performance and be detrimental to interests of our stockholders".[26] Defending Zuckerberg, they stated that "Mr. Zuckerberg, as our founder, has guided us from inception and is invested in our success. We do not believe that requiring the Chairman to be independent will provide appreciably better direction and performance, and instead could cause uncertainty, confusion and inefficiency in board and management function and relations."[27]

Eventually, after strong retaliation and a lawsuit from shareholders, Zuckerberg dropped the share proposal, five days before he was scheduled to take the witness stand and to stand trial.[28]

Despite this, the presence of the dual class shares and the continued combined role of Chairman and CEO allowed Zuckerberg to maintain dominance over minority shareholders. Zuckerberg asserted that his control over Facebook will eventually benefit the company in the long run. In an interview with Vox, he commented that "One of the things that I feel really lucky we have is this company structure where, at the end of the day, it's a controlled company. We are not at the whims of short-term shareholders. We can really design these products and decisions with what is going to be in the best interest of the community over time."[29]

Relationships with co-founder

Back in 2003, Zuckerberg approached Eduardo Saverin about TheFacebook.com. Saverin was requested to invest US$15,000 capital in return for a 30% share as a business partner. The following year, in 2004, Zuckerberg, along with Dustin Moskovitz, another co-founder of Facebook, decided to settle down in Silicon Valley. Meanwhile, Saverin had an internship with the Lehman Brothers in New York. According to business news website Business Insider,[30] Zuckerberg tasked Saverin with administrative duties and the sourcing of business capital. However, Saverin was ineffective and his role was taken over by entrepreneur, Sean Parker, who quickly secured a US$500,000 investment from PayPal's co-founder, Peter Thiel.[31]

Later, through the incorporation of a new company and issuance of new shares, Zuckerberg was able to reduce Saverin's stake in the company from 30% to less than 10%. Along with the dilution of his shares, Saverin had also signed an agreement to give all of Facebook's intellectual property rights and voting rights to Zuckerberg.[32] Previously, under Delaware law, Zuckerberg had required Saverin's signature for the reformation of the company, in order for Facebook to get the funding it needed.[33] However, Saverin, who was occupied with his internship in New York, paid little attention to the urgent situation, frustrating Zuckerberg immensely. Hence, Zuckerberg decided to covertly reduce Saverin's stake in Facebook, effectively ousting Saverin from having any effective say over the company. In leaked messages, Zuckerberg revealed his motivation behind blindsiding Saverin: "... because until I do this I need to run everything by Eduardo. After this I have control".[34]

Relationships with business partners

While Facebook's major acquisitions of well-known companies such as Instagram, Whatsapp and Oculus have proven to be financially sound, Facebook's relationships with the founders of those companies were not in good shape. In 2017, Oculus's co-founder, Luckey, left Facebook. This was followed by Jan Koum, the founder of WhatsApp, who departed in May 2018. Kevin Systrom and Mike Krieger, the co-founders of Instagram, then left in September 2018, leaving Zuckerberg with total control over the acquired companies.[35]

These departures were linked to disagreements with Facebook's executives. Koum left Facebook due to differences between WhatsApp and Facebook's approaches to data privacy and encryption.[36] There was disharmony between the Facebook and WhatsApp leadership due to the inherent nature of both companies. WhatsApp promised user privacy and encryption whereas Facebook based its business model on aggregation of user data.[37] This led to what marketing consultancy GBH Insights referred to as a "massive culture clash." Facebook's acquisition of WhatsApp in 2014 exacerbated this friction between the two leaderships, resulting in Koum's departure.[38,39]

In Instagram's case, there was tension between the two social media platforms' leadership with regards to Instagram's autonomy. Although it was initially promised that Instagram could function independently after the acquisition by Facebook, Zuckerberg started to push for cross-publishing of content across the two platforms after a short period of autonomy. Following WhatsApp and Instagram's rapid growth, Zuckerberg began to formulate plans to integrate both platforms with Facebook Messenger, by combining their technical infrastructure and using end-to-end encryption.[40] Zuckerberg's planned integration was contrary to what he had promised at the time of acquisition, which was autonomy from their parent company.[41] Shortly after Systrom and Krieger's departure, Adam Mosseri – former Vice President of Facebook News Feed and a member of Zuckerberg's close inner circle – took over as head of Instagram.[42]

Unheeded warnings and red flags

As Facebook's privacy policy changed over the years to allow for greater monetisation of users' data, concerns with the management and the governance of third party risk and privacy surfaced many times but remained largely unaddressed until the Facebook-CA scandal broke in 2018.

In 2010, many lawmakers raised concerns about Facebook's privacy issues. Washington Senators Charles Schumer, Michael F. Bennet, Al Franken and Mark Begich sent a letter to Facebook, urging the social networking giant to change the way it provides user data access to third-party advertisers. In the letter, the lawmakers outlined three major areas of concern:

1. User profile information, such hometown, education and interests, became more widely available through a program called "connections". Through the application, a user has to make that information available in order to participate.
2. A user's information can be stored with a third-party advertiser indefinitely. Previously, a third-party partner was required to delete such information within 24 hours.
3. New partnerships with companies like The Washington Post and CNN would allow Facebook users to connect with other users on those sites. However, lawmakers said that the "instant personalisation" feature allowed access to a user's friends lists and the publicly available information about those friends.[43]

Furthermore, the media started to question Facebook's measures to educate its users on the possible privacy issues that might crop up on the platform, as few users knew much about how their personal data was being shared by Facebook. As commented by Business Insider as early as 2010, Facebook was quiet on how it introduced new technology that allowed new ways of using its customers' personal data.[44]

Trouble brewing

The root of the CA data breach scandal was the application, "This is Your Digital Life", created by Aleksandr Kogan in 2015. The application took advantage of the features in Graph API and collected not only data from the users of the application but also the data of users' Facebook friends, violating the privacy of those who had never consented to the application's use of their data. Despite the Facebook developer policy having a clause which stated that a developer was not allowed to transfer or sell the data collected, Kogan claimed that he was not aware of the clause and that he never read the policy.[45]

The feature in Facebook's Graph API that allowed Kogan to conduct a mass data collection was called "friend permissions". It effectively allowed users to give a Facebook application the permission to access their friends' data. Kogan and many developers expressed that accessing the data of Facebook friends who did not opt-in for third parties to access their data was not a big deal. Kogan mentioned in an interview with CBS News that "this was a core feature of the Facebook platform for years. This was not a special permission you had to get. This was just something that was available to anybody who wanted it who was a developer." He went on to claim that "tens of thousands" of developers did the same: taking data from users who never consented to the use of their data.[46]

Sandy Parakilas, a former Facebook employee and the whistleblower for Facebook's internal security practices during the CA scandal, also said that he had raised concerns about giving access of users' data to third party application developers years before Kogan built his app. He further criticised Facebook for prioritising the growth of the number of its users rather than governing data privacy and claimed that there were no internal controls governing the policing of data once it has been accessed by a third party. He professed that once the data left the Facebook platform, the firm had no real way to find out or police what happened to it.[47]

The exposé

In March 2018, when Christopher Wylie, the former director of research at CA, decided to expose CA's unauthorised collection of data, he went directly to The Guardian and The New York Times. Facebook had known of his intention beforehand and contacted the media firms to argue its case for why it believed that the data leak did not constitute a "breach".[48] Nevertheless, on 17 March 2018, both news sources released reports, informing the public about the Facebook-CA scandal.

The scandal revealed a large-scale data breach. Despite being a third-party company, CA had widespread access to Facebook users' data. Such access was obtainable through dealings with Global Science Research (GSR), a company that developed the application "This is Your Digital Life".[49] This application tapped on Facebook's 'special permission' feature for selected applications, where data of all end users' friends could be harvested once the users gave their own consent to the application. This feature greatly expanded its network and increased the speed of data harvesting from Facebook. As a result, although only approximately 270,000 users had consented to Kogan's application accessing their data, it was revealed in 2018 that a total of 87 million Facebook users' data was breached by CA.[50]

The harvested data was subsequently used in a statistical model to develop psychographic profiles that include demographics, social influences and personalities. Kogan further mentioned that this model worked similarly to Netflix's movie recommendation model.[51] In this case, instead of recommending movies, fake news and specially created information were fed to users in an attempt to shape political perspectives. According to Wylie, it was done in a customised manner that was most effective in influencing the intended audience.[52]

Zuckerberg breaks his silence

On 21 March 2018, five days after the CA scandal broke, Mark Zuckerberg finally broke his silence via a Facebook post:

> *"We have a responsibility to protect your data, and if we can't then we don't deserve to serve you. I've been working to understand exactly what happened and how to make sure this doesn't happen again. The good news is that the most important actions to prevent this from happening again today we have already taken years ago. But we also made mistakes, there's more to do, and we need to step up and do it".*[53]

Zuckerberg also gave a public apology in an interview with CNN, stating that the scandal was "a major breach of trust" and that Facebook had "a basic responsibility to protect people's data".[54]

Upon recognising the impact of the data breach and the usage of Facebook users' data to manipulate politics, many regulators and policymakers immediately took action. In the United States, two Senate committees – the Judiciary, and Energy and Commerce – pressured Zuckerberg to testify on Facebook's business model, privacy concerns and the data breach scandal, amongst other issues. In addition, The Federal Trade Commission began an investigation into Facebook's data-handling practices.[55]

Zuckerberg agreed to testify at two U.S. congressional hearings after two weeks of public and congressional pressure. However, Zuckerberg had previously refused British lawmakers' repeated requests for him to appear before the members of the UK parliament. Instead, he sent many deputies to represent Facebook in his stead during the hearings.[56] Consequently, his agreement to stand before the U.S. Congress was surprising. As the magazine WIRED commented:

> *"The decision marks a shift for Zuckerberg, who just last month suggested that the company's engineers and lawyers were better-equipped to answer Congress's detailed questions. What Zuckerberg seemed to miss when he gave that excuse—and what he now has an opportunity to address—is that the problems plaguing Facebook have far less to do with the company's technical flaws than with its fundamental ethos."*[57]

During the Senate hearings, Zuckerberg admitted to Facebook's mistakes in the CA scandal and for not informing users about the data breach. Pledging to do better in the future, Zuckerberg said Facebook would be "investigating many apps, tens of thousands of apps, and if we find any suspicious activity, we're going to conduct a full audit of those apps to understand how they're using their data and if they're doing anything improper. If we find that they're doing anything improper, we'll ban them from Facebook and we will tell everyone affected."[58]

Recommendations from stakeholders

Following the hearings and public debates, investors stepped in to question Facebook about its corporate governance and risk management practices.

Scott Stringer, New York City's Comptroller, wrote a letter on 27 March 2018, pushing Facebook to add three new independent directors and replace Zuckerberg with an independent Chairman. Stringer was the custodian of the city's US$160 billion pension fund, which held 4.7 million Facebook shares.[59]

Additionally, Trillium Asset Management (Trillium), an active investor in Facebook, recommended that Facebook's board establish a risk-oversight board committee and urged investors to support its proposal. The justifications included the recent controversies, the current lacking risk oversight structures, and the need to learn from Microsoft's past of learning from government and public scrutiny.[60] Jonas Kron, Senior Vice President and director of shareholder advocacy from Trillium, commented:

> *"At a time when Facebook has such profound impacts on society, and Zuckerberg has demonstrated—through repeated cycles of apologies followed by fresh controversies—that he is unable or unwilling to address those impacts, the company needs some changes to its governance architecture. It is time to empower a board committee with the authority and resources necessary to oversee how management's actions are creating, confronting, and mitigating these social risks."*[61]

OpenMic, a stakeholder management firm who also worked on Trillium's proposal, indicated that Facebook strongly opposed the proposal. However, the proposal attracted support from over 45% of Facebook's independent shareholders.[62]

Trillium proceeded to file another proposal in 2019, calling for the splitting of the Chairman and CEO roles, as well as the establishment of an independent board leader.[63] The same proposal was last tabled in 2017, when 51% of independent investors voted to oust Zuckerberg as Chairman.[64] However, with his considerable voting power, Zuckerberg was able to ensure that the proposal would never come to fruition. While Trillium recognises that their latest proposal was unlikely to pass as well, it deemed the proposal an important avenue for the voicing of shareholder opinions.[65]

Advertiser backlash

Many advertisers who used Facebook responded to the scandal by reviewing their use of advertising on Facebook, fearing reputational consequences.

One such advertiser was the open-source browser and application developer Mozilla. The company said it was "pressing pause" on its Facebook advertising after the revelations prompted it to take a closer look at the site's default privacy settings. Mozilla stated that "when Facebook takes stronger action in how it shares customer data, specifically strengthening its default privacy settings for third party apps, we'll consider returning."[66]

Commerzbank, a banking and financial services company based in Germany, also said it would rethink its advertising on Facebook. The head of brand strategy, Uwe Hellmann, went on to explain that brand safety and data security were of utmost importance to the company.[67]

The price of the scandal – government action

On 25 May 2018, the European Union's General Data Protection Regulation (GDPR) was passed into law. Under this new legislation, companies operating within the region must report data breaches to regulators within 72 hours. The failure to protect personal information would result in fines of up to the higher of €20 million or four percent of annual global turnover.[68]

In the preliminary phase of the investigation, the UK Information Commissioner's Office (ICO) identified various regulatory actions. It issued 11 warning letters requiring action by the main political parties backed by assessment notices for audits in late 2018. An enforcement notice and criminal prosecution was also directed at SCL Elections Ltd, also known as Cambridge Analytica. Finally, audits of the main credit reference companies and Cambridge University Psychometric Centre were put into place.[69] The ICO also fined Facebook £500,000 for the harvesting of users' data.[70]

Following suit, the U.S. Federal Trade Commission (FTC) fined Facebook US$5 billion, after ruling that Facebook had violated a 2011 agreement under which Facebook had to clearly notify users and gain "express consent" to share their data.[71] While the fine still needs to be finalised by the Justice Department's civil division, it would be the largest fine ever levied by the FTC on a tech company.[72] Nevertheless, it seems that Facebook was unfazed, having expected the fine. In fact, Facebook has told investors that it had already set aside a sum of money for this very purpose and hence, will not face an unexpected financial strain.[73] While monetary punishments have been put in place, it is uncertain whether there will be further repercussions for the company, such as privacy oversight regulations, or for Zuckerberg.

Discussion questions

1. To what extent did Facebook's corporate culture contribute to the scandal? Discuss this in relation to Zuckerberg's personality and his dual role as both Chairman and CEO of Facebook.

2. Discuss the pros and cons of a dual class share structure and comment on the potential corporate governance issues associated with such a share structure in the context of this case. In this regard, comment on the lack of separation between ownership and control.

3. From a risk management point of view, what do you think is the main cause of the scandal involving Cambridge Analytica and what are some lessons that the company should learn from?

4. Discuss Facebook's management of users' data from an ethical standpoint. With regards to the ethics of data collection, at what point does the collection of data becomes an invasion to privacy?

5. Do you think the regulators have responded adequately in light of the Facebook-CA scandal? What are some implications of these measures?

6. Compare and contrast the corporate governance regulatory framework in the United States with Singapore with reference to Facebook, particularly with reference to the regulatory approach to corporate governance, the concept of controlled companies, fiduciary duties of controlling shareholders, dual class shares, and enforcement.

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OXFAM: NOT SO CHARITABLE AFTER ALL

Case overview

On 9 February 2018, The Times newspaper reported allegations of sexual misconduct during Oxfam's provision of emergency and humanitarian aid for the Haiti earthquake victims in 2010. The news article reported that Oxfam was aware of these sex scandals in 2011 but silently conducted investigations to cover them up. Following the release of the news article, Oxfam's public image was severely tarnished. In addition, many employees resigned, existing partnerships with corporate sponsors were dissolved, and government funding was cut from the organisation. The objective of this case is to facilitate a discussion of issues such as corporate governance in non-profit organisations; tone at the top; ethics; the role of regulators; crisis management; and whistleblowing.

Oxfam

The Oxford Committee for Famine Relief (Oxfam) is an independent non-profit organisation with a focus on the issue of global poverty. Founded in Britain in 1942, Oxfam campaigned for food to be delivered to women and children who were starving during World War II.[1] In 2017, the organisation raised £427.2 million from various sources – 49% (£207.0 million) of the total amount was funded by government and other public authorities, 23% (£99.3 million) was received as donations and legacies, 22% (£93.9 million) was raised from trading sales, 3% (£12.4 million) from Disasters Emergency Committee appeal income, and the remaining from gifts-in-kind and other sources.[2]

Board and management

A corporate leadership team supervises Oxfam's daily operations. This includes the Chief Executive Officer (CEO) as well as seven divisional directors who report to the CEO. These directors' roles cover a range of areas, from social and human rights to Oxfam's internal core functions such as finance and policy making.[3]

This is the abridged version of a case prepared by Chan Boon Yee Rachel, Koh Ching Wen Camilia, Han Xin Yan, Tan Pei Yi and Yoon Woo Jin under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

Oxfam has a two-tier governance structure, comprising the executive board and the board of supervisors. Additionally, it has a council of trustees. This council is legally responsible for Oxfam, and members are expected to have the relevant experience, knowledge and passion towards their work at the charity.

The disaster in Haiti

In 2010, a calamitous magnitude 7.0 earthquake hit Haiti, which resulted in widespread damage and claimed an estimated 220,000 lives. The earthquake left many people homeless or injured. Many countries and charity organisations responded to appeals for humanitarian aid. Oxfam promptly dispatched a team of a hundred people to aid in the provision of clean water, shelter and basic sanitation to survivors.[4]

The wake-up call

On 9 February 2018, The Times newspaper published an article exposing Oxfam's sex scandal during its provision of emergency and humanitarian aid for the Haiti earthquake victims in 2010. The article alleged that the charity organisation tried to hide claims that senior staff engaged prostitutes, some of whom might have been underage, while they were working in Haiti.[5]

In response, Oxfam admitted that some of its aid workers' behaviour was unacceptable, but denied that it had covered up any claims on the use of prostitutes by its staff. Oxfam further defended itself by stating that it had publicly announced an investigation into the accusations to get to the bottom of the matter and identify the miscreants when they first surfaced in 2011.[6]

After the investigation, three of Oxfam's staff who were dispatched to Haiti tendered their resignation, while four others were dismissed for gross misconduct. However, one of the dismissed staff was eventually re-hired as a short-term consultant for Oxfam in Ethiopia.[7]

One of the resignees, Roland Van Hauwermeiren, was then Oxfam's country director for Haiti. After discovering his use of prostitutes in Haiti, Oxfam did not impose any sanctions on him and simply allowed him to resign after the internal investigations ended in 2011. He faced no repercussions despite his admission of engaging sexual workers in Haiti.[8,9] Further, Oxfam had only disclosed in a public report that "serious misconduct" had taken place in Haiti, without giving full details on the identities of the associated staff.[10] This enabled Van Hauwermeiren to join another charity organisation, Action Against Hunger, as its Bangladesh country director. It was later reported that prior to joining Oxfam, Van Hauwermeiren left Merlin, a medical emergency relief charity in Liberia, in 2004, after being investigated for having sex parties with local women.[11]

The whistleblower

Following the publication of the Times article, former Safeguarding Head of Oxfam, Helen Evans, came forward to supplement those allegations with more details. She revealed that her worry had begun after obtaining the confidential survey results for a report back in 2014, which she was supposed to present to Oxfam's former CEO Mark Goldring's leadership team. The survey centered on 120 staff across three different countries and stated that 10% of the participating staff witnessed or experienced sexual assault with seven percent reporting rape or attempted rape.[12] However, the meeting with Goldring's leadership team was cancelled. When Evans subsequently questioned Goldring about the decision, she was informed that the leadership team was unable to address her concerns.[13]

A month later, Evans reported that Oxfam received further allegations. These allegations included young volunteers being abused by adult volunteers in shops, and ongoing sexual exploitation of beneficiaries where women were coerced into having sex in return for aid.[14] She said that Oxfam had failed to live up to its reputation as a charity organisation which had the public's trust and confidence. It failed to protect its young volunteers and beneficiaries due to lack of proper disclosure and the barring of checks on its staff and volunteers.[15] Although she tried her best to push for more resources to allow her to continue investigating these cases, she was met with repeated nonchalant responses from Oxfam's management. Frustrated that there was no immediate commitment by Oxfam to implement changes, Evans subsequently resigned in 2015.[16]

In June 2015, Evans approached the Charity Commission for assistance as she believed that the severity of the sexual abuse allegations was far worse than reported and needed serious intervention. However, the Charity Commission did not ask her for more information regarding the matter. Her final push for action was in August 2015 when she liaised with her local minister, who wrote to several government departments about her findings. Despite this, there was still no proper response to the matter.[17]

Evans reached out to The Times news agency to provide details as her last resort. In response, Goldring claimed that Evans should not have gone public with her concerns. He defended Oxfam and responded that her concerns were "unbalanced". Goldring went on to lament that the "scale and intensity of criticism [received by Oxfam] is disproportionate".[18]

Drawing the line with Oxfam

As the former programme director during the period in which the misconduct occurred, Oxfam's deputy CEO, Penny Lawrence, expressed that she felt "ashamed"[19] about the harm and distress caused to Oxfam's supporters and beneficiaries shortly after the publication of the Times article. Taking full responsibility for the entire incident, Lawrence resigned from her role on 12 February 2018.[20]

Subsequently, four out of 15 of Oxfam's celebrity ambassadors resigned,[21] including actress Minnie Driver and Archbishop Desmond Tutu. The four ambassadors publicly expressed their disappointment in the charity organisation and declared that their unwillingness to support Oxfam in light of the sex scandal.[22,23,24] The resignations came amid mounting backlash from Oxfam supporters, donors, corporate sponsors and celebrities.[25]

Oxfam's corporate sponsors such as Marks and Spencer, Visa, and Sainsbury's also voiced their concerns about the allegations, and sought to understand the steps that had been taken to address staff misconduct as well as how Oxfam would improve its safeguards in its international programmes going forward.[26,27]

Lost trust

Amidst concerns that Oxfam did not disclose all known details of the scandal, Penny Mordaunt – the international development secretary – threatened to cut government funding to Oxfam. This reduction in funding would occur unless Oxfam was willing to declare how it would handle forthcoming allegations around safeguarding, report staff members involved in the incidents to their respective national governments, and cooperate with the Haitian authorities by handing over all evidence held on the misconduct which had occurred.[28]

On 16 February 2018, Oxfam agreed on the withdrawal from all bids for new government funding until the government was satisfied that the charity organisation was able to meet the expected standards. On that note, Mordaunt commented that Oxfam has "a long way to go" before it could regain the public's trust.[29]

The Haiti allegations led to a loss of confidence in Oxfam by its regular contributors as well. On the Saturday, Sunday and Monday following the publication of the Times article, Oxfam confirmed that 1,270 direct debit payments to the charity were cancelled.[30] In June 2018, it was reported that Oxfam had to seek for up to £16 million of funding to ensure the majority of its work could continue.[31]

Ten steps to a calm exit

On 14 February 2018, Goldring formally apologised to the public with an open letter on Oxfam's website, detailing the significant improvements made in Oxfam since 2011.[32]

Two days later, on 16 February 2018, Oxfam announced its 10-point action plan to strengthen its safeguarding controls and to transform its organisational culture.[33] The action plan is based on three key principles – transparency, transformational change in Oxfam's culture, and women's rights.[34]

Oxfam's 10-step action plan is as follows:[35]

1. An Independent High-Level Commission on Sexual Misconduct, Accountability and Culture Change
2. Reiterated commitment to collaborate with all relevant authorities
3. Re-examine past cases and encourage other witnesses or survivors to come forward
4. Increase our investment in safeguarding
5. Strengthen internal processes
6. Re-enforce a culture of zero tolerance towards harassment, abuse or exploitation
7. Work with our peers across the sector to tackle physical, sexual and emotional abuse
8. Active engagement with partners and allies, especially women's rights organisations
9. Listen to the public
10. Recommit and strengthen our focus on gender justice externally

The actual revelations: Report 2011

On 19 February 2018, two senior members of the charity, Simon Ticehurst and Margalida Massot, met with Haiti's minister of planning and external cooperation to present a formal apology over the sex scandal. The apology was made as Oxfam released its investigation findings on the behaviour of relief workers who helped out in Haiti after the catastrophic earthquake.[36]

The 2011 internal investigation report released by Oxfam, in which the names of all guilty parties apart from Van Hauwermeiren had been redacted, disclosed that Van Hauwermeiren had admitted paying for sex and that three of its staff had physically threatened a witness. The report also included information on the discovery of the incidents, the investigation conducted, and subsequent actions taken in relation to staff who were found guilty of misconduct.[37] Oxfam stated that the names were redacted in the report "to comply with the need for due process and confidentiality required by both privacy law and recommended UN guidelines on the issue of sexual exploitation and abuse".[38]

According to the report, the sexual misconduct first came to light on 12 July 2011, when the Oxfam Great Britain (OGB) loss prevention team was notified of claims that various staff on the Haiti project had breached the Oxfam Code of Conduct. The alleged breaches included fraud, negligence, nepotism and sexual exploitation such as engaging in prostitution and sexual harassment of staff. After a discussion, an investigation team which included three members of the loss prevention team was set up.

However, another allegation that the country director of Haiti had breached the Oxfam Code of Conduct by engaging in prostitution at his Oxfam-funded residence was received before the investigation team left for Haiti. This shifted the focus of the investigation to the country director's alleged serious misconduct.[39]

The investigation proved that the claims of the country director's use of prostitutes in his Oxfam residence were true. A subsequent interview by the investigation team led to the country director's admission of the use of prostitutes in his residence. The country director was reported to have accepted full responsibility and offered to resign. It was then decided that the country director was allowed to resign if he cooperated with the rest of the investigations.[40]

The 2011 report also documented allegations of other staff using sex workers in Oxfam-rented accommodation, and bullying and intimidation of Oxfam staff.[41]

Lessons learnt

In the report, Oxfam also identified certain weaknesses within the organisation and detailed the corresponding actions proposed to tackle these issues. One key weakness highlighted was its organisational culture. Oxfam stated that the corrective action plan included placing greater emphasis on its Code of Conduct, organisational values and importance of women rights. The charity organisation also planned to increase awareness and refresh its training on preventing sexual exploitation and abuse, particularly in high risk countries, to deter and prevent future cases of sexual exploitation.[42]

It also proposed an improved mechanism for reporting of behavioural issues and for Oxfam's regional human resource function to carry out regular checks on countries. Additionally, it also highlighted the need to improve its whistleblowing policy to ensure that all staff can to gain access to it. The whistleblowing mechanisms would be improved to include various communication channels such as email and telephone line, and would be available in five languages.[43]

Last but not least, investigation and audit processes would be enhanced within the organisation. The report stated that Oxfam would aim to improve its internal audit processes to cover culture and human resources more effectively.[44]

Fair game, fair judge?

The Oxfam scandal rocked the charity sector in the U.K. and worldwide. Observers were appalled that the established charity organisation had such skeletons in the closet.

The Times article prompted the U.K.'s Charity Commission, the charities watchdog, to launch a statutory inquiry – the most serious action it can take[45] – into Oxfam on 12 February 2018, amid concerns that the scandal-hit charity might not have "fully and frankly disclosed" complete details about what had happened in Haiti.

Oxfam reported its ongoing investigation on the allegation of misconduct by its aid workers in Haiti to the Charity Commission in August 2011.[46] However, it decided not to pursue the issue and merely worked with Oxfam on their safety procedures as it was raised as an internal issue by Oxfam. Despite the allegations faced by Oxfam, the Charity Commission continued to give Oxfam a clean bill of health annually, up until 2017. It was only when the news of the scandal broke, that the Charity Commission demanded an urgent clarification from Oxfam about the events that occurred in Haiti six years prior. The Charity Commission further clarified that it would have taken a different approach had there been proper disclosure on the allegations of beneficiaries as well as the possibility that the serious sexual misconduct had involved minors.[47]

Other repercussions in Oxfam

On 16 May 2018, Oxfam CEO Goldring announced his departure from the charity organisation at the end of 2018. He stated that Oxfam's future "will best be led by someone bringing fresh vision and energy and making a long-term commitment to see it through."[48] Goldring's successor, Dhananjayan Sriskandarajah, took over the reins in January 2019 and vowed to rebuild trust in the charity.[49]

On 13 June 2018, due to Oxfam's "violation of its laws and serious breach of the principle of human dignity", Haiti's government banned Oxfam from operating in the country.[50]

The watchdog's findings

"Over a period of years, Oxfam's internal culture tolerated poor behaviour, and at times lost sight of the values it stands for."

– Helen Stephenson, Charity Commission chief executive[51]

Oxfam was severely criticised by the Charity Commission for the way it dealt with the sexual misconduct allegations. It described Oxfam as having a "culture of tolerating poor behaviour" and that it had "missed opportunities" to address its aid workers' "cultural and behavioral issues" in Haiti at the time. The charities regulator also issued an official warning to Oxfam in a damning report released on 11 June 2019.[52]

The Charity Commission's report was released after an 18-month investigation into Oxfam's misconduct in Haiti. It reported that Oxfam did not heed warnings that expected safeguarding standards were repeatedly not met, and that the charity failed to fulfil its promises. It faulted Oxfam for failing to investigate allegations that minors were involved in the sex scandal, and accused the charity of not being as full and frank as it should have been about Haiti. With regards to the former finding, the Charity Commission said that Oxfam should have put in more effort to investigate claims adequately before dismissing them as false so hastily.[53]

Following the issuance of its report, the Charity Commission instructed Oxfam to submit a plan on how it would address concerns about its misconduct, in an effort to regain the public's trust and confidence.[54]

In response, Oxfam's chair of trustees, Caroline Thomson, said the charity accepted the findings, and commented that "It was a terrible abuse of power and an affront to the values that Oxfam holds dear."[55]

Non-profit organisations: A league of their own?

The Oxfam scandal was a wake-up call for all non-profit organisations. In the aftermath of the release of the Charity Commission report, it was reported in July 2019 that the number of serious incidents and whistleblowing cases had risen sharply since the Oxfam sex scandal came to light. The charity regulator stated that the Oxfam scandal was a "catalyst" for highlighting the disastrous impact of safeguarding failures in the charity sector. Ultimately, as Helen Stephenson –the Charity Commission's chief executive – aptly puts it, "Public expectations of charity, and the role of charity in our society, are changing, and it is vital that charities change with it. As the regulator, we exist to serve the public interest, and are committed to ensuring everything we do helps charity thrive and inspire trust so that people can improve lives and strengthen society."[56]

Discussion questions

1. How should safeguarding and whistleblowing arrangements be implemented in non-profit organisations such as Oxfam?
2. Do you think Oxfam handled its crisis well? To what extent did management contribute to the scandal? How should Oxfam have handled the allegations at the time?
3. Do you think that the U.K. Charity Commission fulfilled its role as a regulator of charities and watchdog? Explain. Do you think the Charity Commission could have done something to prevent the incidents of sexual misconduct in Oxfam?
4. What are the similarities and differences between governance of for-profit organisations and non-profit organisations?

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STARWOOD'S CYBER-WARS

Case overview

On 30 November 2018, Marriott International, Inc. (Marriott) announced that there had been a data security incident which involved the hotel reservations database of its subsidiary, Starwood Hotels and Resorts Worldwide (Starwood), being compromised. An unauthorised third party had gained access to the database since 2014, before Marriott had acquired Starwood, and obtained data relating to 383 million guest records, making it one of the largest data security breaches in history. To make matters worse, Marriott's response to the breach angered those affected. Marriott's handling of the incident led to a collapse in consumer confidence and its stock price plunged following the announcement. The objective of this case is to facilitate a discussion of issues such as cybersecurity; risk management; and the board's role in overseeing risk.

Breach of data

In November 2015, days after Starwood Hotels and Resorts Worldwide (Starwood) announced the imminent acquisition by Marriott International, Inc. (Marriott), it warned of the possibility of a credit card data breach.[1] Cybercriminals had infected payment systems at 54 of Starwood's hotel properties with malware, exposing the credit card details of numerous clients. At the time of the announcement, Starwood said that the malware had been removed, and also that the data compromise was limited to the point-of-sales systems at restaurants, gift shops and other retail areas and that the hotels' front desks were unaffected by the breach.[2] This incident foreshadowed the subsequent massive data breach which occurred in 2018.

Uh-oh, we are in trouble

In September 2016, the hotel industry saw the acquisition of Starwood by Marriott for US$13.6 billion. The new company would become the world's largest hotel chain,[3] operating or franchising over 5,700 properties, and representing 30 leading brands in over 110 countries.[4,5]

This is the abridged version of a case prepared by Lim Li Jun Tracy, Chen Jiaxin, Choy Jie Min Jasmine, Lee Cheng Xi and Rebecca Ong Chien Lin under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

On 8 September 2018, Marriott received information from an internal security tool that an alert was raised in relation to an attempt to access the Starwood guest reservation database. Marriott then engaged leading security experts to investigate further. Shortly after, malware – more specifically, a remote access trojan which allowed hackers to covertly access and use a computer – was found on the Starwood IT system. In October 2018, a penetration tool called Mimikatz, used by hackers to search a device memory for usernames and passwords, was uncovered as well.[6] Later in November 2018, it was found through the investigation that there had been ongoing unauthorised access to Starwood's database dating back to 2014 – prior to Marriott's acquisition of Starwood. More specifically, the data breach occurred in relation to the Starwood guest reservation database.[7]

On 30 November 2018, Marriott disclosed on its website the extent of the data breach, and also issued an apology from its Chief Executive Officer (CEO), Arne Sorenson, as well as steps to be taken by Marriott to support the hotel guests affected.[8]

It was further announced that for approximately 327 million guests, compromised personal information included names, mailing addresses, phone numbers, email addresses, passport numbers, and Starwood preferred guest account information, and other private details. Other guests potentially had their credit card information leaked, but those numbers were encrypted.[9]

Marriott's stock price fell by 5.6% following the announcement of the massive data breach.[10]

Risk management

Risk identification and analysis prior to breach

In 2014, Starwood had already recognised its increasing reliance on technology and the administrative burdens associated with complying with applicable laws and regulations in the U.S. and all other countries in which they operate, as risks relating to their business. In particular, it recognised that cyber threats and the risk of data breaches or disruptions of its information technology systems could adversely affect its brand and business.[11]

Given the potential risk of cybersecurity breaches, Starwood claimed that it had taken steps to protect personal information by implementing network security and internal controls, but acknowledged that the possibility of system failure, unauthorised access or data breach occurring was still present.[12]

Risk management program prior to breach

Starwood had plans to enhance its risk management in 2013 by adopting software developed by MEGA International to enhance its Enterprise Risk Management (ERM) program.[13] MEGA International is a software company which helps organisations to manage enterprise complexity.[14] Its software develops the ERM tools to allow organisations to better understand their risk context and impact by connecting risks, business processes, IT assets, data and privacy management.[15] According to Starwood's senior director of ERM, Mark Reiss, the implementation of the MEGA software would assist Starwood with the identification, testing and controlling of existing and emerging risks.[16]

Lapses in managing cybersecurity risk

"The only way a company the size of Marriott can have a breach this big, for this long is that nobody's looking for it."

– Brian Krebs, cybersecurity expert[17]

Poor IT security assessments

Marriott came clean that the Starwood network had been compromised since 2014, indicating that the unauthorised intruder was able to steal data while evading detection for four years.[18] The sheer amount of time that the hackers had before being discovered would allow them to wear down IT system defences and to study the system to find out where the more valuable data was contained.[19] Given that vulnerabilities in the system were not uncovered, and indicators of intrusion went undetected for so long, suggested that either cybersecurity assessment tests carried out were not conducted effectively or such tests were not conducted at all.[20]

Lack of due diligence prior to merger

According to a Harvard Business Review article, the data breach occurred in Starwood's network.[21] As the breach occurred two years prior to the acquisition, many experts posited oversight on Marriott's part during the merger and acquisition process, where cybersecurity risks were not sufficiently addressed and cybersecurity assessments were not effectively carried out, thus leading to security gaps not being exposed earlier.[22] Further, the breach could potentially have been detected in 2015 if an investigation was conducted when the first data compromise was uncovered.[23]

Furthermore, it was highlighted by Marriott's CEO during the integration process that matters relating to technology were costly and time consuming – integrating the IT systems of Marriott and Starwood was undoubtedly a complex task.[24] It was also noted by analysts that during the merger, most of Starwood's employees – including those working in IT and cybersecurity – would have been dismissed as part of the combined company's cost savings plan.[25]

Any stars on board?

Starwood's board

Prior to its acquisition by Marriott, Starwood's board of directors consisted of 11 members – the CEO, as well as 10 other independent directors, including the Chairman of the board.[26]

The CEO sat on Starwood's board as the company believed that his understanding of the Starwood's operations and his knowledge of the hotel and leisure industry were crucial to board-level discussions. The company also felt that having a separate independent Chairman would provide clear and independent leadership and engagement within the board.[27]

The four board committees – Audit Committee, Compensation and Option Committee, Corporate Governance and Nominating Committee, and Capital Committee – also played supporting roles in the company's risk oversight function. The Audit Committee was in charge of the company's compliance activities, controls and management's processes in identifying and quantifying risks. Meanwhile, the Compensation and Option Committee oversaw risks associated with the company's compensation policies, practices and structures, as well as adequacy of measures that discourage excessive risk-taking. The Corporate Governance and Nominating Committee supervised board processes and corporate governance-related risks, as well as legal and regulatory risks with the company's general counsel. Last but not least, the Capital Committee's oversight role covered risks related to the hotel portfolio, capital improvement plans, capital budgets, investments, divestitures, significant asset sales, mergers and acquisitions and other extraordinary transactions.[28]

Marriott's board

Marriott's board of directors consists of 14 members, with 11 independent directors. In the company's 2019 proxy statement, it stated a summary of the board's skills, which included expertise in finance, global business, corporate, leadership, investment and legal, as well as business knowledge and strategy. The board is led by Executive Chairman J.W. Marriott Jr., the son of the company's founder, since 31 March 2012. CEO Sorenson has also been on Marriott's board since 2011.[29]

Marriott has five board committees – Audit Committee, Compensation Policy Committee, Nominating and Corporate Governance Committee, Committee for Excellence, and Executive Committee.[30]

Board expertise

Following the discovery of the data breach, Marriott's board came under heavy scrutiny, attracting criticisms on its lack in cybersecurity expertise. In a Harvard Business Review article, it was mentioned that there was a "noticeable absence" of cyber risk management expertise at the board level, with none of the directors possessing a cybersecurity background. The article also highlighted that Marriott did not have a board committee dedicated to managing cyber risk. As such, the company had to reply on third-party experts to measure the extent and impact of the cyber breach.[31]

Not so starry anymore

After the news of the massive data breach broke, stakeholders pursued legal action against Marriott. In November 2018, a national class action lawsuit was filed against Marriott on behalf of more than 500 million clients whose personal information were pilfered during the data breach.[32] In January 2019, over 150 of Marriott's hotel guests filed a class action lawsuit against Marriott as a result of the data breach, claiming that the hotel giant did not adequately protect its guests' personal information and that when the breach was uncovered, it "failed to provide timely, accurate, and adequate notice" to affected guests.[33] In a U.S. SEC filing, Marriott disclosed that as at December 2018, about 100 putative class action lawsuits had been filed by its clients and others against it. Its clients generally claimed to have been harmed by the company's actions due to the breach and sought monetary damages from the hotel giant, amongst other reliefs.[34]

On 26 February 2019, a shareholder derivative complaint was filed against the hotel giant and each of the directors on its board for various claims such as breaching their fiduciary duties, mismanagement and violating U.S. federal securities law.[35]

Marriott's response to the breach

On 30 November 2018, in the same public announcement Marriott had made to disclose the data breach, Marriott also launched a guest outreach effort and announced the measures it would take to support individuals affected by the data breach, such as emailing guests who were affected by the data breach and setting up of a dedicated call center and website to address hotel guests' concerns or questions. The website is also supplemented with any relevant follow-up notices made by Marriott on the data breach, and a section of frequently asked questions.[36,37]

Affected clients were notified via email on a rolling basis from 30 November 2018. As at 21 December 2018, Marriott had completed the sending of emails to affected guests.[38] These guests were also given the opportunity to sign up for WebWatcher free of charge for a year. This service provided by Kroll, a corporate investigations and risk consulting firm, allows users to monitor internet sites where personal information is shared and generates an alert to the user if evidence of the user's personal information is found.[39]

Marriott released a follow-up announcement on 4 March 2019 to inform various stakeholders of several updates to the investigation of the data breach. It revealed that the upper bound of the total number of guests affected by the data breach was approximately 383 million. The company further informed the public that it believed that about 9.1 million unique encrypted payment card numbers, 5.25 million unique unencrypted passport numbers, and approximately 18.5 million encrypted passport numbers were affected in the data breach. Furthermore, the stolen data might have included several thousand unencrypted payment card numbers, based on the company's preliminary assessment.[40]

A substandard response

Marriott's response towards the data breach drew harsh criticism from observers and cyber experts.

Firstly, observers attacked Marriott's untimely disclosures with regard to the data breach. Even though the data breach was first flagged out on 8 September 2018, the hotel giant only issued a public announcement revealing information about the cyberattack involving hundreds of millions of Marriott customer records three months later on 30 November 2018. Marriott also filed a Form 8-K with the U.S. Securities and Exchange Commission (SEC) disclosing the data breach only on the same day. Observers had highlighted that a Form 8-K should be filed within three days of a material corporate event.[41] Due to the scale of the data breach and the delay in reporting such a material event to the public, Marriott might also have caught the attention of European regulators. Under the General Data Protection Regulation (GDPR), data breaches must be reported within 72 hours,[42] and any organisation which possesses or uses data on people inside the European Union would be subject to the GDPR rules, regardless of where the organisation is based.[43] A breach under the GDPR might result in a fine of up to 4% of annual turnover.[44]

Additionally, certain IT security risks were identified by cyber experts in Marriott's modes of communication with affected clients. Firstly, Marriott sent out emails to affected individuals to inform them of the data breach via the domain "email-marriott.com". The domain did not appear to be legitimate at first glance, as it lacked an accompanying identifying Hypertext Transfer Protocol Secure (HTTPS) certificate. Besides a nondescript note on Marriott's data breach notification website, there were no other readily available way to verify that the domain was legitimate. This resulted in doubt and confusion amongst recipients of the emails over whether the message from Marriott was legitimate. Furthermore, hackers might use the data breach event to prey on individuals by using a spoofed domain to trick them into surrendering more private information.[45]

In addition, Marriott directed customers to a separate website – not on its own corporate website – for further information on the data breach. Cyber experts raised that this might expose users to cybersquatters who create web pages under a slightly modified address – which look legitimate on the surface – to carry out phishing attempts.[46,47]

Changes made after the breach

After the massive data breach, Marriott adopted several cybersecurity measures to prevent similar incidents from occurring in the future, and acknowledged that existing controls proved inadequate. It removed the unauthorised access to the Starwood reservation database and subsequently phased out the operation of the Starwood reservations database. Marriott also added technical measures to its existing network to limit the threats that arose from the data breach.[48] That being said, Marriott inserted a caveat in its Form 10-K filed with the U.S. SEC for the FY2018 that it still could not assure the public that "all potential causes of the incident have been identified and remediated and will not occur again".[49]

The mighty GDPR

"The GDPR makes it clear that organisations must be accountable for the personal data they hold. This can include carrying out proper due diligence when making a corporate acquisition, and putting in place proper accountability measures to assess not only what personal data has been acquired, but also how it is protected,"

– Elizabeth Denham, U.K. Information Commissioner[50]

The GDPR, replacing an earlier data protection directive, was agreed upon by the European Parliament and Council in April 2016, and was implemented in May 2018.[51] It acts as the primary law regulating how organisations protect European Union citizens' personal data. The most significant revision is the extended territorial scope of the GDPR – the rules apply to all organisations processing the personal data of data subjects in the European Union, notwithstanding the organisation's location.[52] This implied that Marriott would be exposed to the GDPR even though it is incorporated in the United States.

The GDPR places the onus on all organisations to report certain personal data breaches to the applicable supervisory authority. Organisations are required to do this within 72 hours of being alerted of the breach, where practicable. If the breach would likely result in a high risk of adversely affecting individuals' rights and freedoms, organisations must also inform those affected without undue delay. Additionally, under the GDPR, organisations should ensure that they possess robust breach detection, investigation and internal reporting procedures. Organisations are also required to keep a record of all personal data breaches which had occurred.[53]

A fine hotel

On 9 July 2019, Marriott announced that the U.K. Information Commissioner's Office (ICO) issued a fine under the GDPR to the tune of £99,200,396 against the company.[54] The heavy penalty was imposed due to the massive data breach that exposed 339 million guest records worldwide, including 30 million Europeans and seven million U.K. residents.[55,56] The ICO held that Marriott did not undertake adequate due diligence when it acquired Starwood in 2016 and expected that more should have been done to ensure that its IT systems were secure.[57] In response, the hotel giant said that it would contest the fine and vigorously defend its position.[58]

The large fine indicated that the ICO was prepared to exercise its powers to make organsisations think twice about handling personal data carelessly. The proposed fines are set based on "the seriousness of the incident, including the number of people affected, the types of data involved, the degree to which there were failings by the companies and the measures they took to co-operate with the ICO and mitigate the harm to impacted individuals. [It] also set fines as a deterrent to others."[59]

Left seeing stars?

The end of this saga is still not yet in sight. It is still unclear if shareholders and customers would be appeased by the remedial actions taken by Marriott, or if the culprit for the massive data breach would ever be found. Against the backdrop of an evolving technological landscape and an ever increasing reliance on technology in organisations' day-to-day business, the Starwood saga has exemplified the increasing need for organisations to beef up their cybersecurity measures and controls, and not to place such matters on the sidelines any longer.

Discussion questions

1. Evaluate the composition and expertise of Starwood's and Marriott's respective board of directors. What is the role of the board in mitigating cyber risk? To what extent should the board be responsible for the cybersecurity breach?
2. Evaluate the corrective actions and steps undertaken by Marriott after the breach and discuss whether they were sufficient. What are some measures that can be taken to mitigate such incidents from happening again?
3. Give some examples of other prominent cyberattacks in your country. What are some measures implemented or lessons that other companies can learn from these cyberattacks?
4. Who do you think is ultimately to blame for the occurrence of the massive data breach?
5. Do you think the General Data Protection Regulation (GDPR) is effective in deterring organisations from handling personal data carelessly? Compare the GDPR with similar data protection rules in your country.

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TELIT: CAT'S OUT OF THE BAG

Case overview

Oozi Cats, Chief Executive Officer (CEO) of Telit Communications PLC (Telit), had been at the helm of a major international Internet of Things (IoT) business since the early 2000s. Uzi Katz is a fugitive indicted for wire fraud in the United States (U.S.) back in the 1990s, who was still at large in mid-2017. Was it just a coincidence that these two individuals shared similar names? After allegations that Oozi Cats and Uzi Katz are one and the same, Cats tendered his resignation and Telit lost its long-time CEO. The objective of this case is to facilitate a discussion of issues such as ethics; Alternative Investment Market (AIM) rules; role of nominated advisers (Nomads); timing of directors' share transactions; role and responsibilities of the board of directors; shareholder activism; and keyman risk.

Telit as it is

Telit Communication PLC (Telit) has its roots back in 1986 in Telital and Telital Automotive, with its main business of providing research and development services to multinational telecommunication companies.[1] Oozi Cats came into the picture when he co-founded the Telit Group in 2000, serving as its Chief Executive Officer (CEO).[2] Telit was subsequently incorporated on 30 November 2004[3] and became listed on AIM, the sub-market of the London Stock Exchange on 4 April 2005.[4]

The Group evolved to become a global provider of machine-to-machine (M2M) wireless technology and an enabler of Internet of Things (IoT) technology, serving well-known clients such as Tesla, Cisco and AT&T.[5] Although Telit is listed in the United Kingdom (U.K.), it also operates in countries such as Italy, Israel, South Korea and Cyprus.[6] Over the years, it actively expanded its business through both organic growth and numerous strategic acquisitions in the automotive and IoT industries.[7]

As an AIM-listed, U.K.-incorporated group, Telit is subject to the U.K. Companies Act, and is also regulated by the London Stock Exchange (LSE) through the AIM Rules for Companies rulebook, as well as by the Financial Conduct Authority (FCA).[8]

This is the abridged version of a case prepared by Liau Zhengyu, Goh Su Wen Joey, Tay Jia Xian Amelia, Ng Seanne Daphne Ko and Soh Gek Cheng Jasmine under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

Cat with a history

In 1992, Uzi Katz, together with his wife, Ruth V. Katz, and another accomplice, were charged by a Boston district court over wire fraud with regards to a series of property deals in the state. However, the couple fled from the United States (U.S.). Uzi Katz was indicted and the indictment had not been dismissed. He was reported to have visited the U.S. several times after that, including the Boston, and even indicated in his non-immigrant U.S. visa application form that he also uses the name Uzi Katz.[9]

25 years later, on 8 August 2017, an Italian newspaper, Il Fatto Quotidiano, alleged that Telit's CEO – Oozi Cats – was actually a wanted fugitive of the U.S. Department of Justice. A day after the news came to light, Telit's share price fell by as much as 45%.[10]

Following the allegations, Cats took a leave of absence from the company,[11] while Telit promptly commissioned the law firm CMS Cameron McKenna Nabarro Olswang LLP to conduct a thorough investigation into Cats' past.[12] Telit also engaged the services of a crisis management firm, and removed Cats' profile from its corporate website.[13] Under pressure, Cats resigned from his position as CEO on 14 August 2017 following the internal review.[14] Telit's shares shot up by as much as 17% following his resignation.[15] The investigation eventually confirmed that the allegation was true – Oozi Cats the CEO was indeed Uzi Katz the U.S. fugitive.[16]

In a public statement, Telit claimed that the 1992 indictment against Oozi Cats was not previously disclosed to the current and prior members of its board of directors and that they were only made aware of the indictment through third parties.[17]

While Cats may have hidden his fugitive background and adopted a new identity, he was nonetheless an accomplished businessman with a proven track record of several successful companies which he founded.

The feline mastermind

Cats' journey with Telit began in 2000 as co-founder and director at the budding technology company. In 2005, he led the company's flotation on the AIM as CEO, raising about £20 million in the process.[18,19]

With Cats at the helm, Telit achieved impressive business milestones over the years. He identified the importance of M2M communication technology early, allowing Telit to establish a stronghold in the market[20] with the company's cloud-based platform, m2mAIR, seeing results in 2014.[21] The company expanded its outreach into the region while riding on the success of its M2M and IoT innovations across a wide range of applications.[22] Cats subsequently recognised opportunities in the automotive product business and IoT, making strategic acquisitions in the area of IoT connectivity and Application Enablement Platform.[23,24]

Another significant milestone reached under Cats' leadership was the launch of what Telit claimed to be the world's first hybrid module for the IoT that combines 3G Cellular, Wi-Fi, Bluetooth and GNSS.[25] Telit proceeded to cement its position as "global enabler" of IoT after its purchase of the Gainspan Wi-Fi business in 2017.[26] The company also attributed the recurring increase in revenues from the IoT Services business unit to its acquisitions over several years.[27] Morgan Stanley, a large multinational investment bank, had high hopes for Telit, calling it the "top European pick in the Internet of Things (IoT) sector".[28]

Under Cats' leadership, Telit's performance – and share price – was on an upward trajectory.[29]

AIM's regulatory model

AIM was launched in 1995 with the intention of allowing smaller companies with no track record in profits access to the market.[30] It is operated and regulated by the London Stock Exchange. AIM companies have to comply with the AIM Rules for Companies set by the Exchange. They also need to comply with any relevant national law and regulation as well as certain European Commission Directive standards and regulations where applicable, such as Market Abuse Regulation, the Disclosure and Transparency Rules and the Prospectus Rules.[31]

With regards to the admission criteria, AIM-listed companies need not comply with any market value or float size requirements, and they only need to submit an admission document that complies with the AIM's Rules for Companies. Supporters of the AIM's system argue that the flexibility facilitates innovation and reduces the compliance costs for these growth companies.[32] Detractors, on the other hand, argue that it is simply too lax, giving AIM an unfair advantage in attracting foreign listings.[33]

The role of Nomads in AIM

Central to AIM's "light-touch" regulatory system are the nominated advisers (Nomads) – investment banks, corporate finance firms, accountancy firms or other qualified firms approved by the LSE to be a Nomad.[34,35] According to the AIM Rules for Nominated Advisers, a Nomad is primarily responsible to the LSE for "assessing the appropriateness of an applicant for AIM, or an existing AIM company when appointed as its Nomad, and for advising and guiding an AIM company on its responsibilities under the AIM Rules for Companies".[36] A Nomad's role includes guiding the company throughout the AIM flotation process, and advising it on rules which need to be complied with and the responsibilities the company needs to fulfil once the company is admitted to AIM.[37] Regulatory and compliance costs are significantly lower for smaller companies which wish to list on AIM.[38]

A Nomad must act with due skill and care.[39] The responsibilities of Nomads are clearly set out in the AIM Rules for Nominated Advisers. These responsibilities are presented in the form of numbered principles, which must be satisfied in all cases. Each principle is accompanied by a list of actions that a Nomad would typically be expected to take up in order to satisfy that principle. The list of actions merely serves as examples of how the principles translate into practice and are not exhaustive.[40] Furthermore, should a Nomad decide that a particular action set out in the list is not appropriate, it may substitute it with other actions to satisfy the overriding principle.[41]

Although Nomads occasionally act as underwriters or brokers of the AIM companies, their principal responsibilities are owed solely to LSE and not to the company. The AIM Rules for Nominated Advisers also contain rules relating to the eligibility and disciplining of Nomads.[42]

Nomadic Nomads

Back in 2005 when Telit listed on AIM, it appointed Seymour Pierce Ltd (SPL) as its Nomad and broker.[43] As the Nomad of Telit, SPL's admission responsibilities included assessing Telit's appropriateness for AIM, as well as coordinating and overseeing the preparation of Telit's AIM admission document. More importantly, SPL was required to undertake due diligence and report to LSE on whether Telit's directors – including co-founder and CEO Cats – were suitable to serve on the board for a public company.[44]

In addition to the admission responsibilities, SPL was also required to carry out continuous oversight on Telit as part of its ongoing responsibilities. These responsibilities included maintaining regular contact with Telit, monitoring the trading activity of the Group's securities, and advising the Group on matters relating to any changes to the board of directors.[45]

SPL acted as Telit's Nomad for five years following Telit's listing on AIM in 2005. In 2009, Astaire Securities Ltd took over the role,[46] and it was in turn succeeded by Investec Bank Ltd.[47] Not long after, in 2011, Canaccord Genuity Limited took over as Telit's Nomad.[48] In August 2017, finnCap Ltd, together with joint broker Berenberg Bank, became the latest Nomad.[49]

All Nomads engaged after SPL – the Nomad which assisted in Telit's admission to AIM – were required to carry out both engagement responsibilities and ongoing responsibilities. Engagement responsibilities apply when a Nomad is being engaged to an existing AIM company. These responsibilities are similar to admission responsibilities, but the expected actions to be taken are largely dependent on the unique circumstances surrounding each AIM company. One of the engagement responsibilities requires Nomads to investigate and deliberate the suitability of each director and take into consideration the efficacy of the board as a whole to serve the company's needs.[50]

Due diligence failure: Are the Nomads to blame?

Given the various corporate collapses and scandals that took place over the years, AIM has earned its reputation as a 'wild west' exchange, where "cowboys are allowed to roam free".[51] Furthermore, critics have pointed out that the market's record shows that its system has failed to tackle cases of fraud or corruption.[52]

One major issue often highlighted by critics is the potential conflict of interest arising from the dual role that Nomads usually play.[53] While a Nomad's primary obligation is to act as the pillar of regulatory enforcement on AIM and undertake due diligence, it may also act as a broker for the same company that it regulates and oversees. Broker-Nomads are paid by the AIM company to advise on trading issues and investment opportunities, and they also earn a commission on the capital raised for the company.[54,55] Unfortunately, most brokers are small deal-dependent businesses, so they may not actively take steps to manage this conflict of interest.[56]

Telit's corporate governance

Prior to 28 September 2018, AIM companies are not required to comply or explain against any definitive code of corporate governance. Instead, they are encouraged to adhere to Quoted Companies Alliance code (QCA code), which are based on the U.K. Corporate Governance Code but specifically tailored to the needs of small and mid-sized companies at their stage of development.[57] The guidelines are designed to be 'outcome oriented' and to encourage directors and shareholders to tangibly and actively build trust with each other, rather than treat the guidelines as a mere checklist.[58]

Under AIM Rule 26, companies had the choice of either stating on their websites which corporate governance code they followed, or merely stating that they did not follow a code and had instead set up their own arrangements with regards to corporate governance.[59] In Telit's case, the Group indicated that it fully supported the principles set out in the UK Corporate Governance Code and attempted to comply wherever appropriate, depending on its size and resources available.[60]

Starting from 28 September 2018, AIM companies have to disclose on their websites the details of the corporate governance code that has been applied, how the company complies with that code and any instances where it departs from its selected corporate governance code.[61] In view of this, Telit had updated its company website to indicate that the Group applied the QCA code and provided disclosures on how it complies with the code.[62]

A less than purr-fect year?

In 2017, the same year when Cats' alleged criminal background came to light, Telit was scrutinised for potential non-compliance with market rules. During the first half of the year, Telit painted a rosy picture of its financial health and growth potential, reassuring investors that the IoT market was gaining traction around the world and that Telit was well-equipped to cope with market demand. On 25 April 2017, the Group issued a trading update which highlighted the positive progress in the Group's business, the collaborations it had entered into and how it was on track for "double-digit revenue growth in the current financial year".[63]

However, just as things were looking up for Telit, it encountered several hiccups in the second half of 2017, with paltry revenue growth, weaker gross margins and a balance sheet that was in a net debt position even after taking into account the £38 million capital raised earlier in the year.[64] However, Telit rejected concerns about its financial health, stating that "the board confirms that there is no substance to the speculative and accusatory articles that have been published and that it stands behind the group's audited accounts to 31 December 2016, and the most recently published interim statement".[65]

Against the backdrop of the Group's disappointing performance, numerous trading activities by directors relating to their shares in the Group were discovered. In May 2017, Cats sold £24 million worth of shares when Telit's share price was at a record high of 375p.[66] Following the sale, Cats agreed to refrain from selling any of his remaining 14.8 million shares, which represented about 12% of the company's capital, until after a 180-day period was completed.[67] In August 2017, he bought back 400,000 shares at a much lower price of 171.87p, following the release of the company's half-year interim report, which showed poor financial results.[68]

Separately, on 28 June 2017, CEO Cats,[69] Chairman Enrico Testa[70] and Yosi Fait – then president and finance director of Telit – exercised their share options on a cashless basis.[71,72] Post-exercise – when Telit's share price was trading at a relatively high price of above 300p – Fait immediately sold a portion of the shares he obtained from exercising his options.[73,74] The timing of these share trades led to an outcry from investors, one of whom called it a "prima facie example of potential market abuse".[75]

On 27 March 2018, the FCA launched an investigation into the matter.[76] The focus of the investigation was on the timeliness and accuracy of Telit's announcement relating to its interim results on 7 August 2017 and whether Telit had complied with market-cleanliness rules. Subsequently, on 18 December 2018, the FCA announced that it had widened the scope of its investigation to consider announcements made by the company in early 2017, including the trading update made in 25 April 2017 which highlighted Telit's supposedly excellent financial projections.[77,78]

Regaining investors' confidence

After Cats stepped down as Telit's CEO in August 2017, Fait took over as interim CEO in the same month.[79] One of Fait's first tasks was to "conduct a preliminary review of the Group's activities and cost base". Two months later, in November 2017, Fait was appointed as Telit's permanent CEO.[80]

In an effort to improve its corporate governance, Telit sought to increase the number of independent non-executive directors (NEDs) from two to five to make up the majority of the board. It engaged recruitment firm Korn Ferry to lead the search for three NEDs, including a new Non-Executive Chairman.[81,82]

On 23 November 2017, Richard Kilsby was appointed as Telit's new Non-Executive Chairman.[83] Kilsby has held a variety of roles in listed and unlisted companies in several industries, including financial services and technology. Prior to taking up the role as Telit's Chairman, he was the Non-Executive Chairman of 888 Holdings Plc, a public-listed gambling company. Former Executive Chairman Testa remained on the board as an executive director. Meanwhile, Yariv Dafna, who was previously Chief Operating Officer, joined the board as finance director.[84]

Telit also welcomed Shlomo Liran and Miriam Greenwood as new NEDs in March 2018. The revised board then comprised five independent NEDs and two executive directors.[85]

However, at an Annual General Meeting on 25 June 2018, Kilsby was voted out. Greenwood and Liran, who had only been on the board for approximately three months since their appointment, were also voted out by Telit's shareholders.[86]

Although Greenwood was voted out by shareholders, Telit's board passed a resolution to re-appoint her as NED with immediate effect on an interim basis. The reason provided by the board was so that the "the board and its committees [could] continue to be quorate with an appropriate number of independent, non-executive directors".[87] This justification drew criticisms from Rodger Lawson, an active stock market investor and campaigner for reforms to the market, who said that board committees typically do not convene frequently and new NEDs could generally be recruited relatively quickly.[88]

Lawson further added that Greenwood should not have been reappointed to Telit's board since it was the shareholders' intention to remove her based on their voting, and that "shareholder views and rights should not be abused". He did however, urged the FCA to issue guidelines on what would be permissible in the event that a board has the intention to re-appoint directors who have been voted out, given that the Companies Act is silent on it.[89]

Que Sera Sera – Whatever will be, will be

"Never have I witnessed a share option plan of this size being launched by a company undergoing fundamental operational and governance restructuring and within nine months from the award of another very generous share-based incentivising plan,"

– David Serra, in a letter to Telit's board[90]

In July 2018, Telit awarded a bumper share option payout totalling 4,785,000 options to a number of directors, senior management and employees in order to "incentivise and retain these key individuals over the longer term". Among the selected individuals were Fiat and Dafna who received 2,000,000 and 300,000 options respectively, as well as Chief Financial Officer Eran Edri and Chief Legal Officer Micheal Galai, who each received 250,000 options.[91]

David Serra, Telit's fourth-largest shareholder with a 6.1% stake,[92] took issue with the bumper share options awarded, saying that the plan would "destroy shareholder value". The hedge fund manager and activist investor then decided that he could no longer watch from the sidelines. With a group of like-minded shareholders behind him,[93] Serra issued a shareholder requisition for a general meeting to remove interim Chairman Simon Duffy and CEO Fait as directors of the company and to appoint four new directors: Suvi Linden, Jonny Bourne, Anders Torstensson and Adam Power.[94,95] Accompanying the notice was a furiously penned letter by Serra laying out the reasons for their dissatisfaction. Serra was effectively demanding a boardroom clear-out.[96] Telit had to act quickly as it is mandated by the U.K. Companies Act that a company has to issue a notice of a general meeting within 21 days from the date on which the requisition was received.[97]

Fortunately, the Telit board managed to reach an agreement with Serra and the other shareholders and the requisition was withdrawn 14 days later. On 21 September 2018, Telit's board announced that Fait had agreed to step down as CEO and director with immediate effect. Non-Executive Chairman Paolo Dal Pino – who joined the company in September 2018 – would become the interim Executive Chairman and the company would start the recruiting process for a new CEO.[98] Dal Pino would subsequently go on to become Telit's CEO in May 2019.[99] Together with two other directors, namely Gil Sharon and Harald Rösch, two of the four directors nominated by the shareholders – Suvi Linden and Adam Power – were appointed as NEDs.[100]

Good performance despite poor corporate governance?

In early 2017, prior to the scandal involving Cats, Telit's board consisted of Cats, Fait, Testa, David Gilo, Ram Zeevi and Lar Reger.[101] By the end of the following year, none of them remained. However, despite these changes, it appeared to be business as usual. Telit announced certifications with telecommunications company AT&T in late August 2017, a partnership with outdoor power products manufacturer Husqvarna Group in September 2017, and a partnership to expand into emerging markets with PST Electronics Partner in January 2018.[102] This happened alongside numerous launches of new product offerings and certification of products.[103] On 7 August 2017, just before allegations of Cats' chequered past appeared in the media, the company announced that it had received its first purchase order from Tesla for its new Model 3 cars, which would signify a significant source of revenue for the company.[104]

Aftermath

On 2 July 2019, the LSE announced that it had handed Telit a £350,000 fine and a public censure over a breach of rules – that a director's full name and any previous variations of names must be disclosed – while it was listed on the AIM. However, the London bourse also said that the fine would be waived as "the exchange recognises, in the particular circumstances of this case, the real difficulties faced by the company's board and its advisers in being able to reasonably uncover information relating to the historical indictment of its then CEO at the time of admission and thereafter."[105]

In an announcement responding to the censure, Telit said that it had "entirely reconstituted its board" since its ex-CEO's departure and had fully co-operated in the LSE's investigation.[106]

Later that month, Telit announced the sale of its automotive division – which supplied to Tesla – to Chinese company TUS International for a cash consideration of US$105 million. Fait said that the sale was "part of the business focus process" by the company, allowing it to reduce its debt levels and place greater focus on the integration of its hardware and IoT services product lines.[107]

Telit again

After the revelation regarding Cats and his past misdeeds, and the board reshuffles which ensured, the million-dollar question is this: if a company could perform well in spite of its poor corporate governance, has the importance of corporate governance been exaggerated? Without strong corporate governance practices, would Telit be able to tide through future troubles, with stakeholders breathing down its neck?

Discussion questions

1. Compare the eligibility criteria and responsibilities for nominated advisers for AIM on the London Stock Exchange and sponsors for Catalist on SGX. Which do you think is stricter? Explain.

2. With reference to the AIM Rules for nominated advisers, to what extent should the Nomads be held accountable for the issues relating to the former CEO Cats at Telit? How should the rules be improved to prevent such incidents from happening in the future?

3. Compare the selection criteria and necessary qualifications, if any, for an individual to be appointed as a director in the U.K. and in Singapore. Do you think an individual with a previous criminal record should be allowed to be a director? Explain.

4. Discuss the issues that may arise from directors trading in a company's shares just before the announcement of financial results and at other times. What safeguards should a company put in place with regards to directors' trading in a company's shares?

5. Was Oozi Cats a keyman of Telit? How can a company mitigate keyman risk?

6. Cats seem to be able to perform effectively as a CEO. Do you think the company should have retained him despite his chequered past? Explain.

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