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VOLUME SEVEN

Edited by **Mak Yuen Teen**

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Volume seven

Mak Yuen Teen, PhD, FCPA (Aust.)

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Contents

Global

Foreword

Corporate governance is an on-going journey for listed companies to build trust in society and achieve high standards of governance and performance in a disruptive, fast-paced and volatile operating environment. Listed companies are increasingly under pressure to be more transparent and accountable to their stakeholders. Therefore, the current corporate governance structures and processes need to evolve to remain relevant and effective in the future economy.

Extensive work has been done on this front in recent years in Singapore. In August 2018, the Monetary Authority of Singapore announced changes to the Singapore Code of Corporate Governance. The new code aims to support sustained corporate performance and innovation and strengthen investor confidence in Singapore's capital markets. These are encouraging developments to raise the bar on corporate governance.

In Singapore, CPA Australia is proud to be part of the national effort to improve the overall corporate governance culture. Among our key initiatives in the past decade is this ongoing series of Corporate Governance Case Studies.

CPA Australia is 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 this 7th volume of case studies will continue to encourage robust discussions on governance and contribute to advancing corporate governance standards in Singapore, the region and beyond.

Yeoh Oon Jin FCPA (Aust.)
Divisional President – Singapore
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October 2018

Preface

Since the first volume of this publication in 2012, it has always been my intention to make the case studies as timely as possible and to continue to expand the range of issues and countries that are covered – while remaining faithful to a significant Asia focus. In this latest volume, I have also been more directly involved in writing some of the cases, especially those where I have been involved in raising possible issues in the companies concerned. This volume also contains a few cases that are longer than usual because of the many issues involved. Even then, in some companies, a difficult decision has to be made to focus on just a subset of the issues. Some companies may require an entire book to cover all the issues and, given the drama, maybe a movie to go with it.

The objective of having the cases being as timely as possible means that for some of the cases, the story has not ended yet. Some may well see a sequel in the future. We have also tried to track further developments until as close as possible to the publication date.

This year's volume has 26 cases – the most in the series so far. Ten are Singapore cases, including several which Singapore readers may be familiar with, such as Datapulse Technology, Keppel Corporation, Trek 2000 International and YuuZoo Corporation. Two of the five cases from other Asia-Pacific countries are from Malaysia – which so far in the earlier volumes has only seen one case. One of the Malaysian cases about Felda Global Ventures case has political governance aspects to it, perhaps timely given the change in government there. The case about Razer's listing in Hong Kong could very well have been classified as a Singapore case, given that the founder is a Singaporean. Part of this case is about differences in corporate governance and listing standards in Hong Kong compared to Singapore.

The eleven global cases include, for the first time, two cases from South Africa involving Bell Pottinger and Steinhoff and a case with an Italian connection about the subsidiary of London-listed BT Group plc.

The cases in the previous volumes continue to be used by various universities, institutions and professional bodies around the world and we continue to receive very positive feedback. I personally use many of the cases in professional development courses for directors, regulators and industry professionals, and for my corporate governance and risk management course at the NUS Business School.

I am delighted that we have in September this year published the second volume of cases in Chinese - co-edited with my former colleague, Associate Professor Vincent Chen at National Chengchi University in Taiwan - which are based on a selection of cases from past volumes. This follows the success of the first volume in Chinese published in 2016.

I would like to thank CPA Australia for their continuing partnership on this publication, and especially Joanna Chek for her excellent work in supporting it. My gratitude also goes to to the students who wrote most of the original cases as part of their course requirements, and the student assistants who helped edit the cases. Isabella Ow once again proved to be an excellent editorial assistant, doing first-round editing for many cases and further editing for all the cases, and coordinating and reviewing the work of other student assistants.

Associate Professor Mak Yuen Teen, PhD, FCPA (Aust.)
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October 2018

IS DATAPULSE FLATLINING?

Case overview

In November 2017, Datapulse Technology (Datapulse), a digital storage company listed on the Singapore Exchange (SGX), made disclosures about the status of its existing manufacturing activities that led to media scrutiny. This was soon followed by further scrutiny and criticism relating to issues such as the appointment of new board members following a change in controlling shareholder, acquisition of a new hair care business, diversification strategy, and even possible insider trading. Past transactions and disclosures were also scrutinised and questioned. The second largest shareholder also requisitioned the company to convene an Extraordinary General Meeting (EGM) to consider the removal of all the directors and to appoint new directors, and to block the proposed diversification. There was also regulatory intervention by the SGX in the form of queries and notices of compliance directing the appointment of an independent reviewer. This case focuses on the circumstances surrounding the appointment of a new board of directors, acquisition of a new business and diversification by the company. It allows a discussion of issues such as the duties of directors; appointment and resignation of directors; board composition; due diligence for acquisitions; related party transactions; diversification into unrelated industries; and effectiveness of regulators in protecting minority shareholders.

This case was written by Professor Mak Yuen Teen, with assistance by Ho Zhan Kuan, Luo Qing, Ng Hui Hwee and Tran Thanh Tung. 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.

Finding the right pulse

Datapulse was founded in 1980 by Ng Cheow Chye (NCC) and Ng Khim Guan. It started out as a manufacturer of cassette-related products and grew to offer a host of digital storage products and services in the Asia-Pacific region today.[1] Unfortunately, starting from 2012, Datapulse struggled with decreasing revenues year-on-year and its bottom line took a big hit.

On 31 July 2017, Datapulse announced that it had granted an option to a purchaser to buy its existing property, which housed its disk drive manufacturing activities. It was mentioned that "The Company intends to deploy part of the proceeds from the Proposed Disposal to acquire a new premise to continue its existing business and operations."[2] On 7 August 2017, it said that it had been granted an option to purchase a smaller industrial property as a potential replacement, subject to regulatory approval for the proposed use.[3]

A notice of EGM and circular for the disposal of the existing property was then issued on 12 September 2017. The EGM circular mentioned that "the Company is trying to optimise the utilisation of its assets by relocating to a building which is more appropriate for its current level of manufacturing activities" and that it "has identified the Toa Payoh Property which is more appropriate for its current scale of operations".[4]

On 16 September 2017, Datapulse announced that it had exercised its option to purchase the replacement property.[5] The EGM to seek shareholders' approval to dispose of its existing property was held on 28 September 2017. The resolution for the sale of the existing property was duly passed.[6]

However, on 14 November 2017, the company announced that the option to purchase the replacement property was terminated.[7] The deal fell through because the authorities had rejected its application to use the property for digital storage media manufacturing. The company then disclosed for the first time that it had received two rejection letters from the authorities on 4 and 22 September 2017. It said it did not disclose the letters earlier because it had engaged a consultant to apply to the relevant authority for the change of use and to reconsider twice.

New shareholder steps into the picture

At Datapulse's Annual General Meeting (AGM) on 9 November 2017, NCC, the controlling shareholder, CEO and deputy Chairman, and Hilary Quah (an independent director) stood for re-election and were re-elected. However, the very next day, NCC entered into an agreement to sell his entire 22.3% stake for S$27 million, or S$0.55 per share, in an off-market transaction. This was at a 52.8% premium to Datapulse's closing price of S$0.36 one day before the sale agreement. Datapulse announced this transaction on 14 November 2017.[8] On 23 November 2017, the buyer's identity was revealed in a company filing[9] – Ng Siew Hong (NSH), an accountant. In total, she acquired a 29% interest in Datapulse for S$34.9 million, at S$0.55 per share, in a number of married deals. NSH thus became the new controlling shareholder.

An announcement on 25 November 2017 said that NCC had disclosed that NSH is not related to NCC or his family, and that he does not know her personally [10]. However, he understood that NSH would like to have board representation and expected that she would be communicating to the board directly on this matter.[11]

On 4 December 2017, the board invited NSH to attend a board meeting scheduled on 8 December 2017. Through an email via her lawyer, NSH said: "Given that the core business of the Company is no longer profitable and the Company will be ceasing its manufacturing business soon, it will be detrimental to shareholders if efforts are not made to diversify the core business of the Company. It would be in the interests of the Company and its shareholders to diversify the business of the Company to include multi-industry investments as part of the core business of the Company".[12]

However, she did not attend the board meeting and the board could not get more information from her.[13]

Board and management changes

Shortly after NSH became the new controlling shareholder, all three of Datapulse's independent directors resigned on 10 December 2017, with two of them having served the board since 1994 and 1999.[14,15,16] They cited the "change of the controlling shareholder" as their reason for leaving. The next day, two more long-standing executive directors resigned, one of whom was CEO Ng Cheow Leng, who is NCC's brother.[17,18] Reasons cited for cessation by the executive directors were "change of controlling shareholder and board renewal". That same day, four new directors – three independent and one executive – were appointed to replace the outgoing board members.[19,20,21,22] Low Beng Tin (LBT) was appointed as the new Chairman of the board, with the appointment template stating that he had prior experience as a director of several listed companies and was "well versed with listing compliance and corporate governance matters".[23] The other three new directors had no prior experience as directors of listed companies.

Due to the lack of disclosure surrounding the appointment of the new directors and the fact that the previous independent directors had resigned suddenly before the appointment of the new directors, a media article argued that the new independent directors were "effectively appointed by the new controlling shareholder" and that "the new independent directors have been deemed independent without any proper assessment."[24] Datapulse issued a clarification on 14 December 2017 that the new independent directors were screened by "the then board of directors".[25] It also said that LBT was introduced to NSH by "a third party" as a possible candidate for independent director and Chairman of the board.

The board's assertions were again challenged in another media article.[26] It was pointed out that the company had disclosed that the new independent directors, Ng Der Sian Thomas (NDS) and Rainer Teo Jia Kai (TJK), are business acquaintances of NSH, and neither had any past board experience in listed companies. Also, NDS, who was appointed as the new Chairman of the audit committee, was said to have accounting and audit experience, even though information in the appointment template indicated otherwise.

LBT, the new Chairman, held 979,066 shares of Datapulse as at 9 October 2017 or a 0.447% stake, and is one of the 20 largest shareholders of the company.[27] He had sold off 700,207 shares shortly before his appointment to the Datapulse board.[28]

Datapulse released another clarification on 23 December 2017 stating that the new independent directors, executive directors and CEO were screened by only the remaining members of the former board, which comprised of three executive directors, and that the "three previous independent directors were not involved in the appointment."[29] It said that LBT's shares were sold to NSH through the introduction of NCC on 22 November 2017, although the two Ng's were said to not know each other personally.[30] It also now said that LBT was actually introduced to NSH by NCC. The company also provided more information about the background of NDS and how NDS and TJK got to know NSH.

Datapulse defended the independence, competencies and experience of the new directors. It also said that "shareholders will have an opportunity to consider their independence, competencies and experience and vote accordingly when they are proposed for re-appointment at the next upcoming AGM".[31]

On 26 December 2017, NCC resigned as CEO and executive director, citing "change of controlling shareholder and board renewal".[32]

Appendix A shows the members of the Datapulse's board at different points in time, together with their profiles.

Buying Wayco: Quick as a haircut

On 12 December 2017, one day after the new board was formed, Datapulse announced the proposed acquisition of a Malaysian company, Wayco Manufacturing Sdn Bhd (Wayco), from Way Company Pte Ltd (Way Company).[33] Wayco is a manufacturer of personal care and household products, and the deal was stated to be for S$3.5 million in cash. The acquisition was completed on 15 December 2017.[34]

The speedy acquisition process led to questions as to whether proper due diligence was conducted for the deal. The company responded that the lack of extensive due diligence was driven by the poor financial results of Datapulse, the risk of facing the prospect of not having any operating activities left after its sale of existing property, as well as the risk of being deemed as a cash company under SGX Rule 1018 and being delisted.[35] However, it was pointed out by an observer[36] that under the listing rules, a company can avoid a suspension from SGX if it takes certain steps after ceasing its operating activities. Subject to compliance with these steps, SGX may allow continued trading of the company's securities on a case-by-case basis.

Datapulse said that it would not be seeking shareholders' approval for the acquisition since it was not required to do so under the listing rules, given the amount of the consideration involved.[37] However, it promised to seek shareholders' approval on the diversification of the company's core business to include the manufacturing of hair care, cosmetics, and other homecare chemical products.

What due diligence?

The unaudited net tangible assets of Wayco was stated to be about S$2.5 million, which included three properties in Malaysia valued at S$2.4 million.[38] The valuers for the three properties were appointed and paid by the vendor. When questioned by SGX on why Datapulse did not appoint its own valuer, it responded that under the terms of the sale and purchase agreement, the vendor agreed to bear the costs of valuation of the properties and the company was satisfied with the credentials of the two independent valuers chosen by the vendor. Hence, it did not consider it necessary to appoint its own valuers.[39]

The company also said that it "did not conduct extensive due diligence as the CEO was a former employee of the Vendor" and that the supplemental agreement gives the Company the right to "require the Vendor to buy back 100% of the Target Company during the Buyback Period of 1 year if there are material adverse events or matters affecting or relating to the assets, liabilities and/or business of the Target Company."[40] It said the new CEO, Kee Swee Ann (KSA), was a former general manager of the target company from 2008 to 2010 but did not hold shares in the company.

A media article challenged the response given by Datapulse.[41] It said that "the board has to exercise its own independent judgement about the acquisition" and "the fact that the CEO has a prior relationship with the target company and the vendor should make the board even more conscious about the need to undertake proper due diligence".[42] Also, the business environment today might be different from that of 2008 to 2010.

It was also disclosed that some of Wayco's plant and equipment were almost fully depreciated.[43] This meant that Datapulse may have to make additional investments to replace those assets after acquiring the company. Hence, the media article noted that the buyback agreement based on the original purchase price may not be advantageous to Datapulse.[44]

Further details were later provided by the company about the conditions which may trigger the exercise of the buyback undertaking, including:[45]

(a) The existence of defects in title relating to the real properties or fixed assets of Wayco.

(b) The existence of actual or contingent liabilities (other than those arising in the ordinary course of business) which were not reflected in Wayco's audited or management account reviewed by the Company.

(c) Possible issues relating to Wayco's ownership of, or otherwise its rights relating to the use of, the various product recipes or formulae of its products.

(d) Possible issues relating to Wayco's ownership of, or otherwise its rights relating to the use of the various trademarks and/or brand names of its products.

(e) Possible findings from the Strategic Review suggesting that the valuation of Wayco and/or its business may be less than the effective purchase consideration paid by the Company for Wayco.

In an announcement on 30 January 2018, Datapulse stated that although the sale and purchase agreement for the acquisition was signed one day after the board's appointment, the board members were furnished with information relating to Wayco by the vendor about two weeks prior to their appointments to the board, so they had sufficient opportunity to review and consider before deciding to undertake the transaction. The company also claimed that the new board did not form its decision to make the acquisition purely based on the direction of the controlling shareholder.[46] This led to a question as to why the proposed acquisition was not presented to the board that was in existence at that time, rather than to the proposed board members about two weeks before they were appointed.[47]

More relationships emerge

It turned out that both the new CEO and executive director, KSA, and the new controlling shareholder, NSH, have ties with Ang Kong Meng (AKM), the owner of Way Company (the parent company of Wayco). NSH was the one who had put the new board members in touch with the vendor before they were appointed to the board.[48]

According to a media article: “Mr Kee used to be the general manager of Wayco and therefore worked for Mr Ang. He is also director and/or shareholder of two private companies – Captaino Pte Ltd and Great Rich Pte Ltd – audited by Ang & Co, which was founded by Mr Ang. Mr Ang is a controlling shareholder and non-executive Chairman of a Cayman Islands-incorporated company called HKE Holdings which is proposing to list in Hong Kong, and Mr Kee has been named an independent director. Ms Ng and Mr Ang are joint shareholders of a private company called Anone Investment Pte Ltd, where Ms Ng is also a director.

Ms Ng and her siblings used to be substantial shareholders and/or key management at an SGX-listed company called HLN Technologies, which was later renamed Sinjia Land. Some time between 2014 and 2015, the Ngs disappeared from the list of top 20 shareholders at Sinjia Land and Mr Ang became a substantial shareholder, although it is not clear whether the Ngs were the ones who sold their shares to Mr Ang.”[49]

In a media interview with NSH, she confirmed that she had worked as an audit assistant in AKM’s firm, Ang & Co, between 1987 and 1992. The two had also jointly invested in two residential properties through investment vehicles Anone Investment and YCT Holding, which were sold back in 2007 and 2011.[50]

Although SGX has detailed rules on related party transactions (called interested person transactions or IPTs), the Wayco acquisition was not deemed to be an IPT. This is because AKM is not considered an “associate” of NSH or KSA, despite the business relationships. Had the Wayco acquisition been considered an IPT, NSH would not have been able to vote.[51]

Given that the final effective purchase consideration of S$3,433,760 would have been 6.88% of the latest audited net tangible assets of S$49,918,865[52] – above the five percent threshold under the SGX rules for shareholder approval of IPTs – the Wayco acquisition would have required the approval of independent shareholders if it was an IPT.

A media article argued that the Wayco acquisition should have been considered an IPT based on the spirit of the SGX rules,[53] which state: "The objective of this Chapter is to guard against the risk that interested persons could influence the issuer, its subsidiaries or associated companies, to enter into transactions with interested persons that may adversely affect the interests of the issuer or its shareholders."

"In applying these rules, regard must be given to:-

(1) the objective of this Chapter; and

(2) the economic and commercial substance of the interested person transaction, instead of legal form and technicality."[54]

More management changes

In the midst of the intense scrutiny over the Wayco acquisition, further management changes occurred. KSA, who joined on 11 December 2017, resigned as executive director and CEO with effect from 2 February 2018, citing "health reasons".[55] The company explained that he had a pre-existing medical condition which had taken a turn for the worse due to "recent events surrounding the Company".[56] He would remain as a consultant to advise the board on matters relating to Wayco and its business. Lee Kam Seng, the CFO and company secretary, was appointed as interim CEO.

On 22 February 2018, the company announced that it had appointed Wilson Teng Wai Leung as CEO and executive director with effect from 8 March 2018. Wilson Teng's principal place of residence was in Hong Kong, with prior experience in sales and business development roles in data centres and communication industries.[57]

SGX steps in

On 23 February 2018, SGX Regco issued a notice of compliance to Datapulse, directing the company to appoint independent professionals to undertake an independent review of its internal controls and corporate governance practices, especially relating to the Wayco acquisition and the appointment of directors.[58] RHTLaw Taylor Wessing LLP (RHTLaw) was appointed on 11 March 2018.[59] The independence of RHTLaw was questioned given the prior relationship between the Datapulse Chairman and RHT Capital, a member of the RHT group of companies.[60]

SGX Regco, in a strongly-worded letter to Datapulse on 4 April 2018, issued a second notice of compliance to the company, directing it to appoint a new firm to undertake the review.[61] On 11 April 2018, the company announced the appointment of another law firm, Lee & Lee, as the reviewer.[62]

EY sheds some light

Datapulse appointed EY to advise the company on strategic options for Wayco's business. The findings from EY's strategic review disclosed that Wayco's business was not a sustainable one, although it had "the potential to improve its business viability by transforming its business into a value chain play by developing its distribution capability and its suite of brand assets and products".[63]

It stated the following four conditions needed to be met for Wayco to be sustainable:

"(a) The Company puts in sufficient efforts to increase the utilization of manufacturing plants of Wayco;

(b) The Company invests sufficient capital expenditure to enhance the aged plant and equipment of Wayco;

(c) The Company puts in sufficient investment in developing the "Goodlook leaf" brand it owns; and

(d) There are fair commercial terms regarding the sharing of profit margins and payment and collection terms with its current key customer."[64]

Was the Wayco acquisition part of a bigger plan?

Wayco is part of a group of three companies (collectively referred to as Wayco Group). It is owned by another private company in Singapore, Way Company Pte Ltd, which is itself wholly owned by AKM. Way Company also owns Wayco Trading Sdn Bhd, another private company in Malaysia. Wayco is the manufacturing company within the Wayco group. Way Company and Wayco Trading are responsible for sales and distribution in Singapore and Malaysia respectively.[65] Over the past few years, between 80% and 87% of Wayco's revenues are from sales to Way Company. Appendix B shows the sales and purchases between Wayco and Way Company for the past few years.[66]

In its 28 December 2017 announcement, Datapulse said: "…the board does not preclude the possibility of the Group having a possible merger with or acquisition of the Vendor in future, assuming parties are able to come to an agreement on the terms of such merger or acquisition…".[67] One of the options that the board tasked EY to look into in its strategic review was an acquisition of Way Company and/or Wayco Trading and this possibility was mentioned several times in the circular for the EGM.[68]

This raises the question as to whether Datapulse bought Wayco separately in order to avoid having to seek prior shareholder approval which may have been required if the entire Way group of companies was acquired in a single transaction. Under the SGX rules, if the "relative figures" (such as consideration) exceed 20% of prescribed benchmarks, prior shareholder approval is generally required, although there are exceptions.[69]

A bad hair day: Questions over trademarks

According to Datapulse, the consideration was based on: (a) the market value of the properties; (b) the "future earnings potential of the Target Company, inter alia, in view of certain intangible assets which it holds or owns, including trademarks, product formulations and distribution networks"; and (c) the "potential residual value of certain plant, machinery and equipment…which are almost fully depreciated".[70]

It was queried by SGX about the announcement and one of the queries asked the company to "provide details of the intangible assets and how they are instrumental to the future earnings potential of the Target Company". Its response on 28 December 2017 said: "The intangible assets that the Target Company owns are mainly the product formulations or specifications for its products, which are unique or proprietary to the Target Company, and the trademarks set out in Annex B. All of the trademarks set out in Annex B are registered and relate to the Hair Care Products and Household Products manufactured by the Target Company, including trademarks to well-known brands such as "Good Look".[71]

Annex B then listed 19 trademarks with no further information.[72] In the circular for the EGM issued on 26 March 2018, the company provided further information on the 19 trademarks owned by Wayco.[73] It turned out that only four of the 19 trademarks were in use. 14 of the trademarks will expire by November or December 2018.[74]

A media article questioned the ownership of the trademarks.[75] It pointed out that one trademark listed as owned by Wayco was shown on product labels to be owned by a company called Wayco Research (UK) Ltd. A search of the U.K. Companies House found that Wayco Research (UK) is a private limited company incorporated in U.K. in 1988 and has been dormant since its incorporation. It has two shareholders, AKM and Ang Ai Chim (AAC). AAC is AKM's sister. The balance sheets available for every financial year since incorporation show that Wayco Research has paid-up capital of £100 and assets of £100.

The circular also mentioned that the "Glorin" trademark is owned by Way Trading, which the board was also considering acquiring. However, labels on Glorin products show that the license is owned by "The London Dispensary Co. Ltd. England.". This company was incorporated in 1997 in U.K., had also been dormant since its incorporation, again with the two Ang's as shareholders. Like Wayco Research (UK), it had £100 paid-up capital and £100 of debtors or cash throughout most of its history.[76]

Yet more questions about Wayco

Questions continued to be raised about Wayco, this time about the utilisation and value of its assets and true profitability.

On 28 December 2017, Datapulse had responded to queries from the SGX which asked, inter alia, questions about the fixed assets of Wayco, including its properties.[77] An article pointed out inconsistencies between the values of these fixed assets provided in the company's response and Wayco's audited accounts obtained from the Companies Commission of Malaysia (CCM). It also questioned the company's statements about the profitability of Wayco.[78]

In its response, Datapulse listed all of Wayco's fixed assets and their book values as at 30 June 2017 (see Appendix C).[79] For the three properties – labelled as Property 1, Property 2 and Property 3 – Datapulse also provided details about the property, address, date of valuation and amount of valuation (see Appendix D).[80] The EGM circular dated 26 March 2018 stated that "…the board and management has, inter alia, performed site visit and inspection of the Wayco Properties, carried out continuing review of the monthly performance of Wayco."[81]

The article pointed out that, based on a visit to the properties and photos taken, the building in Property 2 carried the name of a different company and the letterbox on the gate carried the names of other companies but not Wayco. It asked why this was so; whether the property was acquired by Wayco and, if so, when and at what price; and whether it was used by Wayco or this other company.

The article also pointed out that Wayco reported rental income of only RM36,000 for FY2016, which included rental income from the KL property. Given the small amount of rental income, it expressed doubt that Wayco was earning rental income from Property 2.[82]

The company responded by claiming that part of Property 2 was rented out to the other company to utilise excess capacity, and the tenant had put its name on the property.[83] This led to further questions as why the partial rental of Property 2 was not disclosed earlier; how long the property has been rented out for; what proportion of the building is rented out; and how much rental is being paid. Given the low total rental income reported by Wayco, the decision to allow the tenant to put its name prominently on the building (with no mention of Wayco's name) was also questioned.[84]

Values of Wayco's properties and other fixed assets

A comparison of the book values of the fixed assets as at 30 June 2017 disclosed by Datapulse in its response to SGX and the book values of these fixed assets in Wayco's audited accounts for the year ended 31 December 2016 identified a number of discrepancies.[85]

The book values that Datapulse disclosed to SGX were 89% higher than what the book values that should have been in Wayco's accounts at the same point in time. When the valuers appointed by the vendor valued these three properties in early December 2017, they valued them at 2.67% below the total book value these properties as at 30 June 2017 provided by the board. However, when compared to the total book value of these properties that should be in Wayco's accounts as at 30 June 2017, the total valuation was actually 84.4% above the total book value.[86]

The book values for the other fixed assets (such as plant, machinery and equipment) in the board's response were found to be at least 460% higher than the amounts that should be in Wayco's accounts.[87]

Wayco's accounting policies for property, plant and equipment and investment properties specifically stated that these assets are initially measured at cost and subsequently measured at cost less accumulated depreciation and any accumulated impairment losses. For investment properties, the accounting policy specifically stated the cost basis is used as "fair value cannot be measured reliably without undue cost or effort due to lack of reliable evidence about comparable market transactions".[88]

Further, Wayco directors had on 13 June 2017 signed off the Wayco accounts for FY2016 and stated: "At the date of this report, the directors are not aware of any circumstances which have arisen which render adherence to the existing methods of valuation of assets or liabilities of the company misleading or inappropriate." The article said that one would not have expected any changes in accounting policies between 13 June 2017 when the accounts and existing methods of valuation were signed off by the directors, and 30 June 2017 when the book values were submitted to SGX.[89]

In its response, the company claimed that the properties were revalued and that additional purchases accounted for the increase in book values of other fixed assets.[90] Again, this was challenged. It was pointed out that the applicable accounting standard requires a choice between the cost and revaluation model, and that Wayco had chosen the cost model. Further, the use of the revaluation model requires that revalued amounts can be reliably measured. The Wayco board had also confirmed the appropriateness of the cost method just 17 days before the higher book values supposedly based on revalued amounts or fair value were submitted to SGX. The purchase amount for other fixed assets mentioned in the company's response also did not explain the entire increase in the book value of these other fixed assets. It was also pointed out that any changes in accounting policies ought to be justified, documented and properly disclosed in Wayco's accounts and records.[91]

Wayco's profitability

In the EGM circular, the directors said that as part of its due diligence prior to deciding to acquire Wayco, the board had taken certain steps or actions to review and evaluate Wayco's business, including "Review and consideration of the financial performance of Wayco based on the audited accounts for the financial years ended 31 December 2014, 31 December 2015 and 31 December 2016 and the unaudited accounts of Wayco for the financial period ended 30 June 2017."[92]

The board also said it was "of the view that the Proposed Acquisition is opportune for the Company to acquire a profitable business and diversify its core business into the beauty/wellness products or industry, which should have reasonable prospects for growth."[93] The directors also made similar statements about Wayco being a profitable business in the EGM circular.[94]

The company's announcement of the Wayco acquisition on 12 December stated that Wayco unaudited after-tax profit was RM160,632 (or S$53,201) for the six months to 30 June 2017 (based on an exchange rate of RM1:S$0.3312) – or RM321,264 (S$106,402) for FY2017 on an annualised basis.

The board's view about the profitability of Wayco was challenged.[95] According to Wayco's audited accounts for FY2016, revenues for Wayco was RM4,113,196 (S$1,362,291) while after-tax profit was just RM125,801 (S$41,670). That is, Wayco's unaudited annualised profit for FY2017 was said to be more than 2.5 times its audited profits for FY2016. If the book value of the property, plant and equipment is now higher than the book value as at 31 December 2016, this would also mean higher depreciation, which would adversely affect the profitability of Wayco in FY2017 and going forward.[96]

Further, according to the audited accounts for FY2016, other operating income was RM155,201, and this amount included, inter alia, a net foreign exchange gain of RM51,537 and rental income of RM36,000. "Other operating income" was therefore larger than the total before-tax profit of RM136,629. The profitability of the core hair care business was questioned.[97]

According to the EGM circular, sales of Wayco in Singapore are mainly to Way Company, which in turn sells through different channels. The circular noted that Wayco's sales through Way Company constituted 85% of Wayco's total sales.[98] However, revenues for Way Company had declined by an estimated 9.3% between FY2016 and FY2017 (after annualising the revenues for 11 months in FY2017 disclosed in the circular). The decline in revenues was across all sales channels.[99] This raised doubts as to whether the core hair care business of Wayco was actually profitable for 2017.[100]

The dependence of Wayco's profits on the other Wayco companies and the market share of Wayco products were also questioned.[101]

It was pointed out that as there is significant under-utilisation of Wayco's manufacturing capacity and that most of the trademarks are near expiry and/ or not currently used, Wayco likely faces a demand problem for its products, not a supply problem. Further, the hair care business is a highly competitive one dominated by multinationals, and large expenditures are likely required to raise brand awareness and to replace the aging manufacturing facilities.

While the company disputed the questions about its profitability,[102] the results for the quarter ending 30 April 2018 (Q3 FY2018) released on 14 June 2018 appear to support the view that Wayco is not doing well. These results included those for Wayco for a full quarter for the first time, with all of Datapulse's revenue solely attributable to Wayco. They show that Wayco's revenue for the quarter was S$266,000, or S$1,064,000 on an annualised basis. This would be significantly lower than even the FY2016 revenue for Wayco. Datapulse did not disclose the profit contribution of Wayco.[103]

Diversification or value destruction?

Datapulse had in March 2013 obtained shareholders' approval to diversify into the property business.[104] However, its previous foray into property development did not last long as its 20% stake in a property development venture in Australia was sold off after just 16 months.[105]

At its EGM on 26 March 2018, Datapulse sought shareholders' approval to diversify into the consumer business and investment business[106] It had already started the diversification in the consumer business through the Wayco acquisition. The diversification into the investment business was to involve investing and trading in publicly-listed securities and instruments, including equities, funds and debentures. The board claimed that 37-year-old independent director TJK, with his experience in investment management and fund-raising, will be able to provide invaluable advice to the board for the investment business.[107]

The proposed diversification was criticised as it was argued that shareholders can easily diversify themselves and do not need the company to do so. Further, the board and management may not have the required expertise for the new businesses.[108]

The day before the EGM on 20 April 2018 – at which the attempt by the second largest shareholder to remove the existing directors, appoint new directors and block the diversification strategy failed – Datapulse shares were trading at 34 cents, about 15% below its net asset value and 13% below cash value per share. In the months following the EGM, Datapulse shares traded as low as 24 cents.

More controversy ahead?

On 16 July 2018, Datapulse announced that it has signed a non-binding letter of intent with Midscale Investments Pte Ltd (Midscale), a wholly-owned subsidiary of ICP Ltd (ICP), a Catalist-listed company, to acquire the entire issued and paid-up capital of MHI MY 1 Pte Ltd (MHI). MHI is a joint venture between Midscale, which owned 73.3% and four other individuals. MHI, through its wholly-owned subsidiary, owns Geo Hotel Kuala Lumpur.[109] The hotel was bought on 15 September 2017 by MHI's Malaysian subsidiary, MHI MY1 Sdn Bhd, for RM85.5 million.[110]

Two days after the announcement of the signing of the letter of intent, Datapulse disclosed that NSH had sold 21.9 million shares, or a 10% stake, to Aw Cheok Huat at 55 cents per share on 17 July.[111] The company's shares had closed at 28 cents that day. Aw is the non-independent non-executive Chairman, and controlling shareholder, of ICP. On 15 August 2018, he was appointed as a non-executive director of Datapulse[112] before becoming its Chairman on 27 August 2018.[113]

Meanwhile, the report of Lee & Lee, which was appointed to undertake the internal controls review back on 11 April 2018, has yet to be made public. Datapulse shareholders must wonder what further surprises lie in wait for them.

Discussion questions

1. What are the potential pitfalls for minority shareholders in companies with a controlling shareholder? In your country, what are the safeguards to avoid abuse of power against minority shareholders and how effective are they?

2. Evaluate the composition of the Datapulse board before and following the change in controlling shareholder. Do you believe that the previous and current independent directors are truly independent? Critically evaluate the actions of the independent directors, including their resignations.

3. Evaluate the process for appointing the new directors and the assessment of their independence and suitability. How can the appointment of independent directors be improved and their independence better ensured in situations where there is a controlling shareholder?

4. Should the acquisition of Wayco be considered a related party transaction (or interested person transaction)? Explain. Should the listing rules be enhanced to address situations such as the Wayco acquisition and if so, how?

5. What do you consider to constitute proper due diligence when a company makes an acquisition? Did the Datapulse board adequately discharge its duties in making the Wayco acquisition? Explain.

6. Discuss the issues relating to the assets, trademarks and profitability of Wayco. Do you believe that they raise serious concerns about the Wayco acquisition and the disclosures by the company?

Appendix A: Board of directors of Datapulse, 2017 – 2018

Board of directors before 11 December 2017
Hee Theng Fong – Non-Executive Chairman and Independent Director
Ng Cheow Chye – Executive Deputy Chairman and CEO
Si Yok Fong – Executive Director (Technical)
Ng Cheow Leng – Executive Director (Human Resource and Administration)
Hilary Quah Lam Seng – Independent Non-Executive Director
Guok Chin Huat Samuel – Independent Non-Executive Director

Board of directors between 11 December and 25 December 2017
Low Beng Tin – Chairman and Independent Director
Ng Cheow Chye – Executive Director
Kee Swee Ann – Executive Director & CEO
Ng Der Sian – Independent Director
Teo Jia Kai – Independent Director

Board of Directors between 26 December 2017 and 29 January 2018
Low Beng Tin – Chairman and Independent Director
Kee Swee Ann – Executive Director & CEO
Ng Der Sian – Independent Director
Teo Jia Kai – Independent Director

Board of Directors between 30 January and 7 March 2018
Low Beng Tin – Chairman and Independent Director
Ng Der Sian – Independent Director
Teo Jia Kai – Independent Director
Michael Lee Kam Seng – Interim CEO and CFO (non-director)

Board of Directors between 8 March 2018 and 14 August 2018
Low Beng Tin – Chairman and Independent Director
Teng Wai-Leung – Executive Director & CEO
Ng Der Sian – Independent Director
Teo Jia Kai – Independent Director

Board of director profiles

Name	**Hee Theng Fong**
Position	**Non-Executive Director** (January 1994 – December 2017) **Non-Executive Chairman** (4 June 2015 – 10 December 2017)
Description	Mr Hee Theng Fong was appointed as Chairman of the Board of Directors on 4 June 2015. He was appointed as a Director from January 1994 to December 2017. He was the Chairman of the Board of Directors and the Nominating Committee and a member of the Audit and Remuneration Committees. Mr Hee is also a director of several listed companies, including Straco Corporation Limited, First Resources Limited and China Jinjiang Environment Holding Company Limited. He is a senior lawyer with more than 30 years of experience in litigation practice and arbitration practice

Name	**Ng Cheow Chye**
Position	**Executive Deputy Chairman** (January 1981 – 26 December 2017) **Chief Executive Officer** (1 September 2014 – 26 December 2017) Co-founder
Description	Mr Ng Cheow Chye is the founder of the Company. After being with the Group for thirty-seven years, he resigned in December 2017. He has extensive trading and manufacturing experience in the media storage industry since the early 1970s. As the Executive Deputy Chairman/CEO, he was responsible for the overall management of the Group and was instrumental in setting and implementing the Group's strategic plans and key operational initiatives as well as exploring other investment and business opportunities. In striving to be a leading company in the media storage industry, he continues to ensure the Group employs the latest manufacturing technology to meet and exceed customers' expectations. Mr Ng was appointed as a Director in January 1981. He was a member of the Nominating and Remuneration Committees of the Company. Apart from the present directorship of the Company, Mr Ng did not hold directorship in any other listed companies.
Name	**Si Yok Fong**
Position	**Executive Director (Technical)** (January 1994 – 11 December 2017)
Description	Mr Si Yok Fong joined the Group in 1981. He was responsible for the procurement, production, quality assurance and engineering functions of the Company. He also worked closely with the Executive Deputy Chairman/CEO to continuously streamline the Company's production processes in order to maximise the efficiency and usage of the Company's assets. Mr Si was appointed as a Director from January 1994 to December 2017. Apart from the present directorship of the Company, Mr Si did not hold directorship in any other listed companies.

Name	**Ng Cheow Leng**
Position	**Executive Director (Human Resource and Administration)** (January 1994 – 11 December 2017)
Description	Mr Ng Cheow Leng, the younger brother of the former Executive Deputy Chairman/CEO, is the Human Resource and Administration Director of the Company. He had been with the Group for twenty-nine years and was responsible for the formulation and implementation of the Company's human resource, administration and information technology policies. Mr Ng was appointed as a Director from January 1994 to December 2017. Apart from the present directorship of the Company, Mr Ng did not hold directorship in any other listed companies.
Name	**Hilary Quah Lam Seng**
Position	**Independent Non-Executive Director** (October 1999 – 10 December 2017)
Description	Mr Hilary Quah Lam Seng was appointed as a Director from October 1999 to December 2017. He was the Chairman of the Remuneration Committee and a member of the Audit and Nominating Committees. Mr Quah comes with multiple industries experience; from high technologies to economic planning and development, from retail sales in transportation to retail banking services, operations and technologies, and banking services start-up to strategic consulting start-up. Mr Quah holds a Bachelor of Science, Electrical and Electronics from the University of Wisconsin-Madison and practiced semiconductor and circuit design in Japan and in the Silicon Valley for about five years. He left the high technology business to spend about five years at the Singapore Economic Development Board where he held various investment and development positions in Singapore and the United States.

Name	Guok Chin Huat Samuel
Position	**Independent Non-Executive Director** (13 August 2012 – 10 December 2017)
Description	Mr Guok Chin Huat Samuel was appointed as a Director from August 2012 to December 2017. He was the Chairman of the Audit Committee and a member of the Nominating and Remuneration Committees. Mr Guok is currently an independent non-executive director of Global Palm Resources Holdings Limited, Redwood Group Limited and Asiatravel.com Holdings Ltd. He is also an executive director of several private limited companies and has over thirty years of experience in investment banking, venture capital and private equity businesses. Mr Guok holds a Bachelor of Science degree in Business Administration from Boston University with Majors in Finance and International Economics, Minor in Chemistry.

Name	Low Beng Tin
Position	**Chairman and Independent Director** (11 December 2017 – Present)
Description	Mr. Low Beng Tin was appointed as Chairman and independent director of Datapulse in December 2017. He also founded OEL (Holdings) Limited in 1984 and served as its Managing Director from 20 July, 1992 to 1 March, 2016. He has more than 30 years of working experience in the field of engineering related to oil, gas, petrochemical, chemical and marine industries. He served as Chairman of OEL (Holdings) Limited from 20 July, 1992 to 1 March, 2016. He has been an Independent Director of China Yongsheng Limited since 22 June, 2007 and serves as its Lead Independent Director. He has been an Independent & Non-Executive Director at Lian Beng Group Ltd since 8 July, 2015. He has been a Non-Executive Director of Fuji Offset Plates Manufacturing Ltd since 3 May, 2017. He has been Independent Non-Executive Director of Cosmosteel Holdings Limited since 9 November, 2005. He served as an Executive Director of OEL (Holdings) Limited until 18 October, 2016. He served as a Director of OEL (Holdings) Limited since 15 September, 1984. He served as an Executive Director of Brothers (Holdings) Ltd. (G&W Group Holdings Ltd.) from 27 December, 2002 to 28 February, 2007. He served as an Independent Director of Global Ariel Ltd. (formerly known as Ho Wah Genting International Ltd.). In recognition for his contribution to the community, he was conferred the Pingat Bakti Masyarakat (Public Service Medal) by the President of Singapore in 2004.

Name	**Ng Der Sian**
Position	**Non-Executive Director** (11 December 2017 – Present)
Description	Mr Ng Der Sian was appointed as Independent Director of Datapulse on 11 December 2017. From December 2004 to December 2016:, he was co-founder and director of EV Capital Limited, an exempt private company in Singapore which has since been struck off. He has been the founder and director of BVI-incorporated One Investment & Consultancy Limited since March 2011. According to the company, he is an accountant by training with a Bachelor of Accountancy degree from the Nanyang Technological University, and gained his audit experience in the then Arthur Andersen where his last position held was as audit assistant manager, and his key audit clients included several SGX listed companies. His work experience includes roles undertaken at financial institutions including a local bank and he has extensive corporate work and capital markets experience, including acting as a consultant (either in his personal capacity or through a company co-founded by him) to the controlling shareholder or issuer in respect of several listings, both locally and overseas, such as Hengxin Technology Limited, Sound Global Limited, Sinotel Technology Limited and Ziwo Holdings Limited on SGX. Prior to his appointment, he did not have any experience as a director of a listed company.

Name	**Teo Jia Kai**
Position	**Non-Executive Independent Director** (11 December 2017 – Present)
Description	Mr Teo Jia Kai was appointed as Independent Director of Datapulse on 11 December 2017. He has experience in the fund management industry. He is a senior client adviser at Third Rock Capital with a background is in private banking and wealth management. Before joining Third Rock, he was Director of Wealth Management at One Asia Investment Partners. Mr Teo has also held private banking and wealth management positions at ABN AMRO, Credit Suisse and Citibank. He has a Masters of Applied Finance from Monash Business School and a Bachelor of Computing from Monash University. Prior to his appointment at Datapulse, he did not have any experience as a director of a listed company.

Name	**Kee Swee Ann**
Position	**Executive Director & CEO** (11 December 2017 – 8 February 2018)
Description	Mr. Kee Swee Ann has been Consultant at Datapulse Technology Ltd since 2 February, 2018. He served as Chief Executive Officer and Executive Director at Datapulse Technology Ltd from 11 December until 8 February, 2018. Prior to his appointment as a director of Datapusle Technology, he had no prior experience as a listed company director. Mr Kee has more than 35 years of business management, development and operational experience primarily in the consumer product sector, including products such as beauty and cosmetic products, garments and food and beverage. From 1980 to 1999, he worked at Crocodile Holdings Pte Ltd, a manufacturer, importer, exporter, retailer and wholesaler of garments and accessories, which has business and operations across Asia. His last position at Crocodile Holdings Pte Ltd was Managing Director. From 1999 to 2005, he assumed the position of General Manager at Chia Khim Lee Food Marketing Pte Ltd., which engaged in the manufacturing, importing, exporting and distribution of beverages, edible oils and other food products. He subsequently took on management positions at a couple of companies before assuming the position of General Manager at Way Company Pte Ltd from 2008 to 2010, where he was also involved in the management of Wayco Manufacturing (M) Sdn Bhd. Since 2013, he has been appointed as a director at Captaino Pte Ltd and Great Rich Pte Ltd (in which he holds a minority shareholding stake), which are currently mainly investment holding companies.

Name	**Teng Wai-Leung (Wilson)**
Position	**Executive Director & CEO** (8 March 2018 – Present)
Description	Mr. Teng Wai-Leung, also known as Wilson, has served as Executive Director and Chief Executive Officer of Datapulse Technology Ltd. since 8 March, 2018. Mr. Teng is a Non-Executive Independent Director at Sincap Group Ltd since 2 April, 2018. He served as Vice President of Sales and Business Development of iAdvantage Ltd from June 2016 to 22 February, 2018, Sales Director of Global a Digital Realty from February 2014 to January 2016, Regional Director of Asia Pacific at GTT Communications (formerly known as Tinet) Hong Kong from February 2007 to July 2013. He used to be a Director of Cassia Mining Resources Limited, Hong Kong.

Sources: Datapulse Annual Report 2017, SGX announcements, ACRA filings, Online employee profiles, Capital IQ

Appendix B: Sales and purchases between Way Company and Wayco

Wayco's Sales to Way Company			
Financial Year	Total Sales (RM)	Sales to Way Company (RM)	%
2014	3,387,940.24	3,033,818.35	89.55
2015	3,385,032.70	3,118,307.36	92.12
2016	4,113,195.62	3,403,912.44	82.76
Jan-Nov 2017	3,359,295.55	2,927,210.25	87.14

Purchases by Way Company from Wayco			
Financial Year	Total Purchases (S$)	Purchase by Way Company from Wayco (S$)	%
2014	1,358,225.00	1,189,732.69	87.59
2015	1,428,408.35	1,125,954.33	78.83
2016	1,204,495.42	1,151,967.37	95.64
Jan-Nov 2017	1,087,816.51	947,965.85	87.14

Appendix C: Breakdown of fixed assets of Wayco as at 30 June 2017

FIXED ASSETS	**BOOK VALUE** (MYR$)
Air-Conditioner (ADM)	7,796.25
Electrical Installation	15,135.62
Factory Equipment (FAC)	16,274.78
Furniture & Fittings	750.00
Laboratory Equipment	0.00
Motor Vehicle (ADM)	21,675.00
Office Equipment (ADM)	15,933.04
Computer System	2,304.80
Plant & Machinery (FAC)	396,329.72
Renovation	9,741.31
Signboard (ADM)	0.00
Warehouse (Lot 1511) Equipment	478.12
Freehold Land(FAC) - Dewani	2,431,201.96
Freehold Land(Warehouse) - Lot 1511	2,132,688.49
Freehold Land-Kl Shop Office	930,850.00
Factory Building(FAC) - Dewani	768,808.04
Building – Warehouse (Lot 1511)	1,067,311.51
Building - Kl Shop Office	169,150.00
	7,986,428.64

Appendix D: Wayco properties

Property 1		
Lot No./Title No.: 12893/GRN60048, in the Mukim of Tebrau, District of Johor Bahru, Johor Darul Takzim	**Address: No. 11, Jalan Dewani 3, Kawasan Perindustrian Dewani, 81100 Johor Bahru, Johor Darul Takzim**	
Full Description	**Date of Valuation**	**Valuation Amount (MYR$)**
Property 1 consists of a parcel of freehold industrial land, generally rectangular in shape with land area of 22,776.4 square feet. It has a frontage width of about 58.2 metres onto JalanDewani 3 and an average depth of 45.4 metres onto a water reserve line. Property 1 also has a double-storey detached factory. The factory has, amongst other things, packaging areas, offices and storage areas. It also has access to water, electricity supplies and telephone facilities. The factory was occupied at the time of the valuation.	4 December 2017	3,200,000.00

Property 2		
Lot No./Title No.: 1511/GRN 92310 in the Mukim of Tebrau, District of Johor Bahru, Johor Darul Takzim	**Address: No. 12, Jalan Dewani 3, Kawasan Perindustrian Dewani, 81100 Johor Bahru, Johor Darul Takzim**	
Full Description	**Date of Valuation**	**Valuation Amount (MYR$)**
Property 2 consists of a parcel of freehold industrial land, generally trapezoidal in shape with land area of 1,985.5 square metres. It has a frontage width of about 48.5 metres onto JalanDewani 3 and an average depth of 59.4 metres. Property 2 also has a double-storey detached factory with a mezzanine floor. The factory has production areas, offices, changing rooms and toilets. It also has access to water, electricity supplies and telephone facilities. The factory was occupied at the time of the valuation.	4 December 2017	3,100,000.00

Property 3		
Lot No./Title No.: 66628/GRN233725, Mukim and District of Petaling, Selangor Darul Ehsan	**Address: No. 10, JalanPuteri 7/11, Bandar Puteri, 47100 Puchong, Selangor Darul Ehsan**	
Full Description	**Date of Valuation**	**Valuation Amount (MYR$)**
Property 3 is freehold property. The site of Property 3 is rectangular in shape, and has a titular land area of 1,302 square feet. It has a frontage of about 6.095 metres onto Jalan Puteri 7/11 and a depth of about 19.812 metres. Property 3 is a 1.5 storey intermediate terraced shop-office. The shop-office has access to water, electrical supply and telecommunication facilities. The shop-office also has tenants at the date of valuation.	24 November 2017	1,000,000.00

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FAT LEONARD: THE ELEPHANT IN THE U.S. NAVY'S ROOM

Case overview

In January 2015, Leonard Glenn Francis, President and Chief Executive Officer (CEO) of Glenn Defense Marine Asia Pte. Ltd. pleaded guilty to charges of bribery, conspiracy to commit bribery, and conspiracy to defraud the United States, admitting that he had defrauded the U.S. Navy of US$35 million. It was reported that over 200 naval officers were under investigation in connection with the corruption scandal that involved some of the highest-ranking officers of the U.S. Navy. The objective of this case is to facilitate a discussion of issues such as the impact of organisational culture on corruption; bribery risks in certain sectors and countries; cross-border bribery risks; internal control measures to combat bribery and corruption; and the impact of legislation in different countries in addressing bribery, especially overseas bribery.

This is the abridged version of a case prepared by Sarita Kuan Ting Yi, Marcus Chua Tsing Aun, Chen Guan Ming, Tay Wei Lun and Lennard Tay Jia Ren under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Yeo Hui Yin Venetia under the supervision of Professor Mak Yuen Teen.

Glenn Defense Marine Asia

Glenn Defense Marine Asia Pte. Ltd. (GDMA) is a subsidiary and the flagship company of the Glenn Marine Group, a premier maritime service provider.[1] GDMA is a commercial and government contractor whose main business involved the husbanding of marine vessels.[2] Based in Singapore, GDMA was founded in 1946[3] with operations mainly in the Asia-Pacific, including Japan, Singapore, Thailand, Malaysia and the Philippines. GDMA was a reputable company with strong business ties with the U.S. Navy for 25 years.[4]

Between 2006 and 2013, GDMA was awarded multiple high-value contracts to provide husbanding services to U.S. Navy ships and submarines at ports throughout Singapore, Japan, Philippines, Malaysia, Pacific Islands, South Asia and Islands in the Indian Ocean.[5] In addition to the provision of husbanding services, GDMA also engaged in other services such as naval support, maritime security, and force protection.[6]

Fat Leonard

Leonard Glenn Francis (Francis) was a Singapore-based defence contractor who was President and CEO of GDMA.[7] Born in Penang, Malaysia, he was nicknamed Fat Leonard, Lion King, and Big Bro due to his large size.[8] Francis took over the family business – Glenn Marine Enterprise – from his father at the age of 24 and later renamed the company as Glenn Defence Marine Asia. As GDMA became a renowned name in the husbanding services industry, Francis amassed wealth which he unabashedly flaunted. Francis was known to be a remarkably sociable individual who had a way with people. His penchant for throwing lavish parties for his clients and business partners earned him a reputation as a high-flying businessman in the maritime and defence circles.[9]

However, on 16 September 2013, the party ended for Francis when he was arrested in a hotel room in San Diego on charges of bribing U.S. Navy officers to obtain contracts and defrauding the United States.[10]

The U.S. Navy

The hierarchical nature of the U.S. Navy

The U.S. Navy, and the military in general, has a very hierarchical structure "characterised by strong chains of command and obeying orders", which may enable high-ranking officers to get away with corrupt acts without being reported by their subordinates.[11] As the high-ranking officers provided Francis with classified information in exchange for bribes, subordinates would rarely question their actions.[12]

Nature of husbanding services in U.S. Navy

The Navy is always on the move, constantly negotiating access to foreign ports for resupply and replenishing, and is therefore particularly reliant on foreign contractors at these ports. These contractors are known in the maritime world as 'husbands', a position that GDMA served for the U.S. Navy. GDMA would arrange everything that the Navy ships in the Pacific Rim required, from tugboats for docking to people who emptied the bilges. At the end of the stay in port, the bill for various subcontractor services would be presented by the husbanding agent to the ship.[13]

However, the system was not particularly well run, as it was difficult for ship captains to keep up to date with changing costs, fees, and tariffs. "The Navy's ability to track and analyse port-visit cost changes remains rudimentary," says a 2009 Naval Postgraduate School paper.[14]

Throughout the process of contracting, there was little oversight and insufficient internal controls to deter abuse and fraud, thereby creating opportunities for bribery to occur.[15] Adding to this, there is a greater risk when dealing in foreign countries and ports where bribery and corruption are pervasive, such as Indonesia, Philippines and Thailand, which rank poorly in the Corruption Perceptions Index.[16] In such countries, giving and accepting bribes are commonplace.

Modus operandi

Lure of the high life

Between 2006 to 2013, in order to win exclusive high-value husbanding services contracts from the U.S. Navy, Francis offered bribes to Navy officers in the form of cash, gifts, prostitutes, airfare, luxury hotel stays, alcohol, and much more. He cultivated favour with high-level commanders through his lavish spending and hospitality, reeling the U.S. officials into his sphere of influence. During a court hearing in 2015, Robert Huie, an assistant U.S. attorney in San Diego, referring to Francis' acts of bribery, commented that "Mr. Francis' conduct has passed from being merely exceptional to being the stuff of history and legend."[17]

Steering ships his way

For Francis and GDMA, the bribes often had their intended effect. In exchange for the bribes, the Navy officers provided Francis with information about the scheduling and selection of U.S. Navy port visits, competitors' pricing and performance, competitors' bids and other information.[18]

Armed with this information, Francis was able to influence the 7th Fleet's port visits. In one instance, Francis requested Captain David Newland (Newland), the Chief of Staff to the 7th Fleet Commander, to convince Navy officials to ensure that the U.S.S. Abraham Lincoln's escort ships docked at Laem Chabang, Thailand. Newland, having been a recipient of Francis' gifts, duly complied and exerted pressure on Navy officials to ensure the docking of three escort ships at Laem Chabang. In April 2006, GDMA was awarded nearly US$2 million in contracts to service the escort ships of U.S.S. Abraham Lincoln. Similar incidence of diverting U.S. Navy ships to ports in Laem Chabang, Port Klang and Phuket occurred multiple times, earning GDMA millions of dollars in profits.[19]

Francis and other GDMA employees also undermined the bidding process for Navy contracts by getting his Navy co-conspirators to brush aside competition and put pressure on Navy officials who were contemplating awarding contracts to GDMA's competitors.[20]

Bogus companies and fraudulent quotes

The contracts that the Navy awarded GDMA were often of significant value. In 2011, the Navy Supply Systems Command awarded GDMA three contracts in three different regions. The contract in the Southeast Asia region had a first-year base value of US$25 million, comprising of fixed price items where prices of services were agreed upon beforehand, fuel and port tariff items which were billed at the actual cost without mark-up, as well as incidentals.

The process of sub-contracting for incidentals required GDMA to provide at least two competitive quotes, after which the Navy would decide which vendor to use. GDMA was allowed to submit its own quote among the two required, but it was required to disclose any profit or mark-up.[21] GDMA's management team created bogus companies and port authorities, representing them to be bona fide organisations to the U.S. Navy, and subsequently submitted fraudulent quotes for incidentals and inflated port tariff items under these bogus companies. Fraudulent bids that were fictitious or falsified were submitted to ensure that GDMA's quotes would be chosen. These quotes were inflated, allowing GDMA to illicitly overcharge the U.S. Navy for the provision of the aforementioned items over a span of eight years. It was reported that GDMA and Francis defrauded the U.S Navy of close to US$35 million through this scheme.[22]

Covering their tracks

As Francis and the corrupt Navy officials became wary that their lavish parties and extravagant dinners were gaining unwanted attention, they attempted to cover their tracks by fabricating receipts that represented only a small fraction of the actual value of things that Francis had provided, or reimbursing Francis to comply with ethics rules.[23,24]

The mole investigator

Francis was not afraid to continue his exploits and managed to evade the authorities as he had control over an agent within the Naval Criminal Investigative Service (NCIS), Supervisory Special Agent John Bertrand Beliveau, Jr. (Beliveau), who fed Francis sensitive information and gave advice on the agency's investigations against him and GDMA.[25] Beliveau proved extremely reliable and Francis' intelligence system became so successful that Francis began to feel absolutely untouchable by authorities.[26]

Establishing an elaborate network

Over the years, Francis formed a strategic network of informants throughout the ranks of the Navy, including its contracting office in Singapore, the hub for maritime operations in Asia, the wardroom of the flagship of the Navy's 7th Fleet and the U.S. Embassy in Manila. While allegations against GDMA came up frequently in law enforcement case files, informants and agents whom Francis had bribed were quick to shoot down accusations, hampering or dismissing investigations.[27]

All in all, NCIS opened a total of 27 investigations into GDMA but failed to gather sufficient evidence to take action against it. All 27 cases were eventually closed. With turncoat admirals within the Navy, investigative efforts were blocked for more than two years. It was only in 2013 that they were able to gather sufficient evidence to charge and arrest Francis.[28]

Breeding corruption

Lust and greed

Francis manipulated the naval officers by feeding their insatiable lust. One official on the receiving end of such bribes was Commander Jose L. Sanchez (Sanchez), a logistics officer at the headquarters of the 7th Fleet, who regularly sought out Francis to arrange for the services of prostitutes for him and his friends in Singapore, Kuala Lumpur, and Manila. This was in exchange for classified ship and submarine schedules, as well as tip-offs each time GDMA went under the radar for defrauding the Navy. In total, Sanchez was estimated to have accepted tens of thousands of dollars' worth of cash and prostitution services, in addition to other bribes.[29]

Francis was also adept at capitalising on the greed of several other Navy officers. One example was Dan Layug (Layug), a petty officer in the Japanese headquarters of the 7th Fleet. Francis and his team initially bribed Layug with a free mobile phone, but over the next three years, the bribery escalated to a monthly allowance of up to US$1,000 and free hotel stays.[30]

Once Navy officials got a taste of Francis' lavishness, their lust and greed always seemed to make them seek him out again. The Navy officials who most frequently participated in these revelries at Francis' expense and provided him with confidential information became known as the "cool kids" or the "wolf pack", making them more devoted accomplices in Francis' grand corruption scheme.[31]

Futility of whistleblowing

There were occasions when individuals lodged complaints about Francis, but the Navy's whistleblowing process proved futile against other forces. The culture of corruption had become deeply entrenched in the 7th fleet. Despite Francis' scheme becoming known to many, few took any action, preferring instead to fiercely protect the status quo. Lower-ranking officials who challenged GDMA and attempted to blow the whistle were intimidated by Francis and other Navy officials.[32]

The involvement of high-level officials proved to be a further impediment to junior officers who wanted to expose Francis' scheme. This was because promotions in the U.S. Navy were heavily dependent on a superior's endorsement, and the Navy had an "up or out" promotion policy; that is, junior officers either get promoted or are forced to leave the service. Junior officers seeking to stay in the Navy long enough to earn their pensions were thus incentivised to keep their bosses satisfied, even if it meant feigning ignorance about their corrupt activities.[33]

Failure of ethics rules and policies

There were several instances in the scandal when the ethics rules and policies put in place in the U.S. Navy clearly failed. On 16 February 2006, the 7th Fleet Judge Advocate General circulated an ethics message to all senior officers of the 7th Fleet advising them about ethics regulations on acceptance of gifts in foreign ports, which clearly prohibited receiving gifts, particularly from defence contractors such as GDMA. The Navy officers forwarded the ethics message to Francis, informing him that their corrupt relationships would have to be kept a secret. The very next day, Francis lavished Navy officers with a dinner at the Petrus Restaurant in Hong Kong that cost US$20,435.[34]

In January 2010, a senior civilian lawyer drafted an ethics message for Navy personnel, reminding them of federal ethics rules that restricted the value of gifts from defence contractors, as well as introducing a regulation that required the submission of receipts and a written justification for accepting gifts in kind. Although it did not specifically target Francis or GDMA, it applied solely to contractors that provided port services, an area that GDMA dominated in Asia. The proposal was rejected and revised multiple times due to admirals who were on good terms with Francis, such that the final approved message two and a half years later had significantly fewer restrictions than when it was first drafted.[35]

Caught up by the law

When the United States Federal Agents (Feds) eventually discovered that there was a mole within NCIS, they decided to set a trap for Francis, which eventually led to his arrest. They were able to gain access to Francis's emails, which revealed incriminating evidence that pointed to corruption and bribery between GDMA and U.S. Navy officials.

Francis was charged under three separate counts of the United States Code – Conspiracy to Defraud the United States, Bribery, and Conspiracy to Commit Bribery. Based on the plea agreement signed by the attorneys for the U.S. and Francis, Francis faces a total prison sentence of 25 years.[36] Presently, his sentence is still pending.[37]

In November 2015, a total of 440 active-duty Navy personnel and Navy veterans, including 60 current and former admirals, were under investigation for suspected violations of military law or federal ethics rules in connection with Francis and GDMA.[38] The number has since grown to a total of 480, excluding those who have already been charged. It has been reported that more than half of these individuals have been cleared of wrongdoing. However, the Navy has substantiated misconduct by approximately 50 of them thus far.[39] Five sailors have been subject to court-martial proceedings and have been charged under military law, four of whom have either contested the charges or declared that they are innocent of wrongdoing. Additionally, six admirals have been admonished and disciplined by the Navy, with punishments such as censure, reduction of rank, forced retirement, fines and administrative action.[40]

To date, the U.S. Department of Justice has indicted 28 people,[41] including two admirals.[42] The indicted include Francis and four other GDMA executives who have pleaded guilty; 14 Navy officials who have pleaded guilty, including Sanchez, Layug and Beliveau; nine named Navy officials, including Newland; and one unnamed GDMA employee awaiting trial. Those sentenced face prison terms ranging from 18 months to 12 years, with some facing fines and restitution.[43]

However, these cases represent but a small fraction of a longer list of present and retired Navy officials who remain under investigation but who have not yet been publicly named.[44]

Additionally, the former lead contract specialist of the U.S. Navy, Gursharan Kaur Sharon Rachael, was charged under the Prevention of Corruption Act (PCA) of Singapore for corruption and money-laundering offences punishable under the PCA and the Corruption, Drug Trafficking and Other Serious Crimes (Confiscation of Benefits) Act (CDSA), relating to accepting bribes from Francis.[45]

GDMA in tatters

Under the Plea Agreement between GDMA and the U.S. Navy, GDMA was charged with a maximum penalty of a 5-year probation and a minimum of a one-year probation.[46] In the forfeiture addendum, GDMA consented to forfeit to the United States US$35 million, which represented a portion of the gross proceeds of the conspiracy to commit bribery and defraud the United States.[47]

Besides Francis, four other executives of GDMA, Neil Peterson, Linda Raja, Edmond Aruffo and Alex Wisidagama, pleaded guilty for conspiring to defraud the U.S. Navy.[48] Wisidagama was sentenced on 18 March 2016 to 63 months,[49] while Peterson and Raja were sentenced on 11 August 2017, to 70 months and 46 months respectively.[50]

Sweeping reforms across the U.S. Navy

In an audit report dated 30 September 2014 concerning Navy husbanding and port services contracts, the Auditor General of the Navy outlined opportunities to improve internal controls in areas such as the acquisition of port services, awarding of task orders or contracts, surveillance responsibilities, and invoice review and payment process supporting the delivery of goods and services relating to husbanding and port services contracts.[51]

The recommendations include the designation of an organisation within the Navy to take primary responsibility for the oversight of assessments and improvements in internal controls; the detailing of specific responsibilities, in writing, of each command in the appointed office of primary responsibility and circulating it Navy-wide to ensure necessary oversight and accountability over husbanding and port service processes; improving the system controlling approvals and authorisation of the purchase of goods and services overseas; and conducting routine assessments of individual commanders to ensure compliance with Navy regulations.[52] Improvements were also made to the whistleblowing channels and ethics training programs based on best practices that were being employed around the world.[53]

With the implementation of new measures and revamps of processes still in progress,[54] one question is whether these changes can truly address deficiencies and change the organisational culture to prevent similar scandals in the future.

Discussion questions

1. To what extent might the hierarchical culture in the U.S. Navy have contributed to Fat Leonard's ability to carry out his corruption scheme? What other types of organisation have a similar culture and may face similar issues?

2. From the perspective of a Singapore company that has business dealings abroad, what are the key risks faced relating to corruption? What can such companies do to manage corruption risk when doing business abroad?

3. Francis's ability to manipulate the U.S. Navy's top leadership played a central role in the scandal. Do you think a whistleblowing policy in the Navy would have prevented the corruption?

4. In response to the corruption scandal, the U.S. Navy has put in place more rigorous internal controls on the management of its husbanding and port services contracts. Do you think the measures would be effective and sufficient in preventing future corruption cases from happening?

5. Evaluate the effectiveness of Singapore's Prevention of Corruption Act (PCA), as well as foreign anti-corruption legislation, in fighting corruption.

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A GOOD DEAL? PRIVATISATION OF GLOBAL LOGISTIC PROPERTIES

"The process is a farce and the most unprofessional I have ever seen...No fair play."

– Private equity executive on the GLP deal process, 23 June 2017[1]

Case overview

In December 2016, Global Logistic Properties' (GLP) major shareholder, the Government of Singapore Investment Corporation Pte Ltd (GIC), launched a strategic review to determine the course of action for GLP to enhance shareholder value. This was followed by a high-profile buyout. However, the involvement of GLP's Chief Executive Officer (CEO) Ming Z. Mei and director Fang Fenglei (through the consortium Nesta Investment Holdings) in the buyout raised many issues, including claims of unfairness. While actions were taken midway to address the complaints, the majority of the potential bidders had pulled out. Ultimately, GLP was sold to Nesta Investment Holdings – the consortium at the root of the controversy. The objective of this case is to allow a discussion of issues such as the board independence; remuneration policies for directors and key management; conflicts of interest arising from directorships in both the seller and buyer companies; rules governing privatisations; and corporate governance in a buyout situation.

This is the abridged version of a case prepared by Berlinda Lim Zhi Yan, Crystal Li Yao Yu, Lee Xin Yi Claris, Teo Kah Yong and Teo Yee Chen Belicia under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Yeo Hui Yin Venetia under the supervision of Professor Mak Yuen Teen.

Birth of the logistics unicorn

GLP was founded by Jeffrey Schwartz and Ming Z. Mei through a purchase of Prologis China and a stake in its Japanese property funds.[2] Being the financial backbone of GLP since inception, GIC assisted in GLP's listing on the Singapore Exchange (SGX) as a logistic "unicorn" (a start-up company worth more than US$1 billion),[3] becoming Asia's ninth biggest Initial Public Offering in 2010 and Singapore's second biggest offering.[4] GLP's shares surged 12% on its first day of trading and continued to do well even after its debut.[5] Over time, GLP grew to establish itself as one of the biggest modern logistics facilities providers in China, Japan and Brazil.[6] It is also one of the world's largest real estate fund managers.[7] Meanwhile, GIC remained as GLP's largest shareholder, with a 37% stake in the company.[8]

Board of directors

As at FY2017, GLP's board of directors comprised 10 members, of which nine, including the Chairman, were non-executive directors (NEDs). The lone executive director was the Group's CEO, Mei. Eight of those directors were independent directors (IDs), with Fang Fenglei being the only non-independent director.[9]

Board committees

As of FY2017, GLP had six board committees – the Audit Committee (AC), Human Resource and Compensation Committee, Investment Committee, Nominating and Governance Committee, Risk Management Committee, and Special Committee. All the committee members, except one in the Investment Committee, were IDs.[10]

Dr Seek Ngee Huat, the Group's Chairman, was concurrently chairing three committees. Steven Lim Kok Hoong was the Chairman of two committees, including the Audit Committee, as well as a member of two others.[11]

There was no Risk Management Committee prior to FY2017.[12,13] The company also did not have a Chief Risk Officer (CRO).[14]

Remuneration

Mei's total annual remuneration amounted to nearly US$9.2 million in 2017.[15] About US$5.1 million (56%) was in the form of equity awards.[16] This is a contrast to the average share-based remuneration of CEOs of large market capitalisation Singapore companies, which stands at 11%.[17] A Harvard Business Review article also suggested that the potential for risk-taking behaviour to maximise short-term profits would follow the granting of equity awards.[18]

Non-executive director remuneration

GLP paid its NEDs a total of US$2.7 million in director fees and equity awards in FY2017,[19] while the median total remuneration for NEDs of companies listed on the SGX with similar market capitalisation was S$632,000.[20] Dr Seek, the independent Chairman, received cash fees of US$306,167 and equity awards valued at US$333,333. Lim, who is the Audit Committee Chairman, received cash fees of US$218,742 and equity awards of US$120,000.[21] According to a report by consulting firm Hay Group Singapore (Hay), the median base fee for an AC Chairman in 2015 was S$89,650.[22] The other seven NEDs had cash fees ranging from US$78,000 (for Fang) to US$182,621,[23] with equity awards of US$120,000 for each of them. In contrast, the average NED remuneration was S$99,529 for SGX-listed companies in 2015 according to Hay.[24]

For GLP, an aggregate of 1,034,500 shares under the restricted share plans (RSP) were granted to the NEDs in 2017, which would vest fully over a period of one year.[25] In light of the management buyout in 2017, the winning price of S$3.38 per share represented a 81% premium over the twelve-month volume weighted average price per share, signifying an average 81% profit if shares were purchased or granted twelve months before the acquisition.[26]

Calm before the storm

An early indication of the GLP deal emerged in November 2016, when a Bloomberg report on GLP said that it was attracting interest from a group of investors, including China's sovereign fund China Investment Corporation (CIC).[27,28] GIC stepped in to prompt GLP management to undertake a strategic review of its available options to enhance shareholder value.[29] The decision was driven by GLP's poorly performing shares in 2016. It led to the formation of a special committee[30] headed by GLP's Chairman Dr Seek.[31]

The action by GIC alerted the market to the possibility of GLP's stock being under-priced.[32] On 5 January 2017, when GLP formally solicited for first-round offers by early February, GLP's shares jumped as much as 9.4% and continued to climb after GLP confirmed preliminary discussions had been held with various parties regarding a possible sale of the company.[33]

The news spread like wildfire, inundating GLP with numerous bidders. Most notably, two of the world's largest private equity firms – Blackstone Group LP and Warburg Pincus – expressed interest in GLP.[34,35,36] The potential for the acquirer to participate in the boom in demand for warehouse space following the rise of e-commerce companies like Alibaba Group Holding Ltd. and JD.com Inc drove the fight for the buyout.[37] Widespread interest for GLP was further sparked by its dominant market share in China, its modern warehouses and its logistics facilities.[38]

However, uncertainty brewed when it became known that the proposals received included companies connected to parties involved with the strategic review, namely GLP's directors. This potential bidder was the Chinese consortium – an insider group headed by GLP's CEO Mei which included big names in the China's corporate landscape such as Hopu Investment Management (Hopu), founded by Fang, who is a part of GLP's investment committee, and a company owned by Mei.[39] To reassure the public, GLP confirmed that Mei and Fang recused from all board matters related to the review since its commencement.[40]

GLP then proceeded with the shortlisting of interested parties, and invited them to conduct due diligence on the company by examining GLP's financials.[41] However, what followed next became a huge source of controversy.

A three-way handshake?

Dr Seek Ngee Huat

Dr Seek, the independent Chairman of GLP,[42] is also the director and Chairman of the Latin Business Group of GIC.[43] Dr Seek's link with GLP dates way back, as GLP was formed with his involvement when he was the head of GIC Real Estate.[44] Dr Seek was the one leading the special committee overseeing the entire review, whose prime purpose was to ensure fair play.[45]

Fang Fenglei

Fang, a non-executive director at GLP,[46] raised eyebrows with his role in the bidding process. He is the founding partner and Chairman of Hopu, a Chinese investment consultancy firm[47] that was part of Nesta Investment Holdings, the Chinese consortium bidding for GLP.[48] Further, Fang's close relationship with GLP started much earlier. Hopu was said to have previously granted significant personal benefits to GLP's co-founders.[49] Together with GIC's support, the co-founders had established GLP in 2008.[50] His dual role was controversial, inducing suspicions that the mainland consortium Nesta had access to inside information, giving it an unfair advantage in the bidding.[51]

CEO Ming Z. Mei

The individual who was the greatest source of controversy was Mei. With his own company involved in the Chinese consortium, his independence was similarly questioned.[52] Mei's participation in the buyout, given his inside knowledge in the running of the business and privileged access to information, raised concerns.[53] The possibility of him influencing the other board members given his position as the CEO surfaced.[54] For the other rival bidders, there was the problem of information asymmetry for them as potential acquirers, which put them at a disadvantage in terms of understanding the target company's actual information.[55] Concern with the fairness of the bidding process eventually led to potential bidders dropping out as it was suggested that an insider bid would render other submissions pointless.[56]

A poison pill – an ineffective management buyout

Further complaints were made by other bidders regarding their inability to secure financing from the banks due to the banks' prior commitment with Mei. Nesta Investment Holdings was said to have received exclusive commitments for financing from both Singaporean and Chinese banks as well as from some members of its bidding group.[57]

Apart from claims of a flawed process, the non-disclosure of terms of the sale of GLP's Chinese stake dogged GLP's sale. Concerns over the provisions governing the 2014 sale of about a third of GLP's China business to a group involving Mei, albeit with a different composition from the Nesta consortium, surfaced. In effect, the 2014 Hopu-led group were granted veto power over a huge portion of the China assets, including consent for asset sales and pledges with additional rights if Mei left the company.[58] This hindered the ability for a potential acquirer to realise the full value of the group, making the 2014 sale effectively a poison pill. Rival bidders began questioning their ability to control the China entity even with control of GLP.[59]

The sale of GLP's China Holding Company shares to Fang's Hopu was also at a disadvantage to GLP. Despite GLP itself valuing that unit at 1.3 times book value and its clarification to investors that the China assets should be valued at two times book value, Hopu managed to purchase the Chinese business at one times the book value.[60]

Additionally, that same year, Hopu provided financing to Mei for his personal purchase of 46.7 million shares in the China unit, worth approximately US$51 million then.[61]

A hidden friendship – an invisible helping hand

"It's impossible to sit at both sides of the table and say that you're impartial,"

- Senior executive of a U.S. real estate investment firm.[62]

The three individuals' involvement in the buyout did not stop there. Real estate intelligence company, Mingtiandi, exposed GLP's series of investments into companies related to Eastern Bell Venture Capital, a company that has GLP's CEO Mei as its Investment Committee Chairman. Mei took up stakes in four Chinese startups that GLP invested in.[63]

It was revealed that GLP has chosen to "take a stake in, or engage in business bringing potential benefit to mainland companies that already have received funding from Eastern Bell Venture Capital." However, a GLP spokesperson later defended Mei, stating that "He invests in these funds, but he is not involved in daily operations, or in investment decisions." Mei, as a director of GLP, is said to have recused himself from GLP's decisions relating to investments in Eastern Bell portfolio companies.[64]

While GLP insisted that the company's investments in the Mei-backed ventures and Eastern Bell and its related party business dealings did not represent a conflict of interest, other observers believed otherwise. An independent observer noted that, "Even if you can document that an investment is done at arm's length or that you've recused yourself, owning a stake in a company personally, and then investing in that company as the head of a listed firm looks like the definition of conflict of interest."[65]

A last-ditch effort

Additional accusations from bidders about important documents creeping in slowly and missing important details led to GIC stepping in and providing stricter vetting of GLP's operations. An extension of deadline was offered, with reassurance by GLP's Chairman about the independence of the strategic review being "in the interest of all shareholders".[66] However, it seemed to be all for nought, with many potential bidders dropping out. The potential bidders believed that the ties between GLP and the consortium led by GLP CEO Mei and Hopu would render their submissions pointless. They further questioned their ability to control GLP subsequent to taking control.[67] Hence, GLP suitors eventually dwindled to two – Nesta Investment Holdings and Warburg Pincus.[68]

The battle ends

Eventually, the stamp of approval was given for GLP to be acquired by Nesta Investment Holdings, sealing the whole buyout deal.[69] GIC reaped a large total gain, with the offer price of S$3.38 per share at about 25% above GLP's last traded closing price.[70]

With Ping An Insurance Group pulling out from the winning consortium, GLP's shareholders may feel that "if at least one buyer thinks the price tag is too stiff, then the offer must be at least halfway fair."[71]

Following the completion of Singapore's largest merger and acquisition deal, GLP was privatised and delisted from SGX on 22 January 2018.[72] The delisting offer was deemed to be fair and reasonable by GLP's independent adviser, Evercore Asia.[73] And that was the story of how GLP went private.

Discussion questions

1. Evaluate the independence of GLP's board of directors. Identify the issues that could have contributed to the controversy surrounding the buyout.

2. Comment on GIC's role in GLP's buyout and evaluate any potential conflicts of interest arising from Dr Seek's role in both GIC and GLP's board. In your view, should Dr Seek be considered an independent director? Explain. Do you think anything more could have been done with regards to GIC's controversial role in the management-led buyout?

3. Examine the inherent conflicts of interest in a management buyout using the GLP case as an example and suggest measures for addressing such conflicts. In GLP's case, were the conflicts adequately addressed? Explain.

4. In light of the complaints surrounding the buyout of GLP, what do you think are possible regulatory reforms that can make the management buyout process more transparent and fairer to all bidders and in the best interest of all shareholders?

5. Critically evaluate GLP's remuneration policies for its directors and key management. GLP pays relatively high fees to its non-executive directors, including its independent directors. Do you believe that this may affect the independence of the independent directors? Explain.

6. Should equity awards be used for non-executive directors, including independent directors, and if so, should there be vesting conditions? Explain.

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THE DIAGNOSIS OF HEALTHWAY

Case overview

Members of the public were perplexed and enraged when no doctors turned up for work at seven of Healthway Medical Corporation (HMC)'s family clinics on 13 March 2017. At that time, HMC was widely perceived to be doing well, owning close to 50 family clinics in Singapore and over 100 worldwide. It was revealed in a Straits Times article the next day that HMC owed its doctors and senior management combined salaries amounting to S$3.9 million. This article was the first in a series of articles chronicling a chain of events that would progressively debilitate one of Singapore's largest private clinic operators. A subsequent article described how HMC faced a liquidity crunch, having lost millions of dollars in questionable loans made to two entities over the past seven years. Additionally, HMC also undertook an onerous S$70 million convertible bond deal in January with a Cayman-based private equity fund, Gateway Holdings (Gateway). The objective of this case is to allow a discussion of issues such as turnover of board and management; risk management; communication and accountability to shareholders; and the role of private equity firms.

This is the abridged version of a case prepared by Cai Qingwen Brendan, Cheah Khai Yuen, Chee Ping Yi Samuel, Kendrick Goh Jielong, and Toh Chun Yang 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 Jacqueline Lor under the supervision of Professor Mak Yuen Teen.

In good health

Established as a family clinic by Wong Weng Hong in 1990, HMC expanded rapidly over the next two decades. In 2006, HMC tied up with Fan Kow Hin and other investors to expand its network to 38 clinics. By 2008, HMC comprised more than 80 family medicine and specialist clinics, boasting the largest clinic network in Singapore. It was also listed on the Singapore Exchange (SGX) Catalist Board that year.[1]

From its humble beginnings as a family clinic providing primary care to the public in 1990, HMC and its subsidiaries' clinics became providers of a comprehensive range of specialist services across the medical value chain.[2] HMC also provides healthcare benefits management services to a host of insurers and corporate clients. Additionally, the company caters to Japanese expatriates living in Singapore through its Japanese medical and dental centre. It has also expanded overseas to China through its China Healthway subsidiaries.[3] At its prime, HMC owned more than 100 medical clinics worldwide.[4]

Frequent check-ins and discharges

Wong Weng Hong served as HMC's medical director and Chief Executive Officer (CEO) from 1994 to 2007. He then took on the role of managing director (medical services) from 2008 to 2011[5] and held the position until his resignation in 2011 when he chose to leave HMC "to pursue his personal interests".[6]

Fan Kow Hin became HMC's Executive Chairman from 2007.[7] He eventually resigned in May 2015[8] but remained a significant shareholder until his bankruptcy on 15 June 2017.[9] His 12.62% deemed interest in HMC was subsequently transferred to his wife, Chee Yin Meh, making her HMC's second largest substantial shareholder as of 15 June 2017.[10]

Between 2015 and 2017, four individuals had taken on the role of Chairman in HMC. During these three years, half to two-thirds of the board were made up of independent directors.[11,12,13,14] HMC's board of directors consists of three committees: Audit Committee, Remuneration Committee, and Nominating Committee.[15] The President, a role similar to that of a CEO,[16] heads HMC's senior management. HMC had seen its President change thrice from 2016 to 2017.[17,18,19] Besides the multiple changes in President, HMC also had numerous changes in its Financial Controller during the two years. On this matter, the company's independent director, Sunny Yuen, commented it was "normal" in today's labour market.[20]

The emergency situation

News of HMC's financial difficulties first went public in March 2017, when no doctors turned up for work in seven of its family clinics.[21] This incident made headlines in the local news as HMC was then a well-known and established network of clinics in Singapore. In a statement by HMC, it disclosed that it had not paid the salaries of its doctors and senior management, amounting to S$3.9 million, for the previous month. An interview with one of its doctors revealed that the issue of unpaid salaries had started even earlier.[22]

Precursors of poor health

HMC's problems may have been forewarned months before prior to the release of its Q2 2016 financial statements. Four of its directors – making up half of HMC's board – successively resigned before the release of the results, citing various reasons.[23] These directors had spent at least four years with HMC and were said by one of its remaining independent directors to be leaving on their own accord as "part of succession planning".[24] Out of the four remaining directors, two were fairly new to HMC's board. Independent director Moses Lin Weiwen, a lawyer, joined the board a week prior to the release of the annual report. Independent director Ho Sun Yee, former CEO of Singapore Heart Foundation, had joined the month before.[25]

Malignant growth in loan impairments

HMC's liquidity crunch was not the first time that the company had found itself in an awkward situation. Controversies over certain financial statement disclosures had arisen in 2015.

HMC had consistently been making a series of loans to two anonymous entities, from as early as 2010.[26] While these loans grew over the years, HMC had to recognise millions of impairment losses due to portions which were deemed unrecoverable. The two entities were disclosed in HMC's financial statements simply as "Party A" and "Party B".[27] Their identities remained hidden until increased public scrutiny of HMC's financial situation led to speculation in 2016 that Party A was Healthway Medical Enterprises Pte Ltd (HME).[28]

In the company's 2016 annual report, HMC finally revealed the identities of the parties to the loans. "Party A" was named to be HME, a company owning medical clinics in Singapore, while "Party B" was identified as Wei Yi Shi Ye Co. Ltd (Wei Yi), a Shanghai-incorporated medical centre owner. In addition to the loans, HMC also provided management and administrative services to both HME and Wei Yi for a fee.[29]

Transfusion from HMC

From 2010, HME received a series of loans from HMC, which led to an accumulation of loans receivable within HMC's financials throughout the years. These loans were reported as providing "long term funding for the development, set-up and operations" of HME's medical facilities.[30]

By 2013, the loan receivable amount was reported to be S$33 million. The full amount was initially agreed by both parties to be repaid on 15 January 2015. An additional clause in the agreement also granted HMC first rights to acquire clinics from HME at a mutually agreed price.[31] By the end of 2014, the total loan receivable amount ballooned to S$55 million, following a S$22 million loan extension. HMC further disclosed that it was considering exercising the option to purchase HME's clinics by using its loan receivable as part of the purchase consideration.[32]

In 2015, HMC again extended the existing loan by S$2 million and the repayment date was pushed back to 30 June 2016. Additionally, HMC also recognised an impairment loss of S$3 million on the estimated recoverable amount.[33] Meanwhile, HME's sole director, Wong Ong Ming Eric, resigned from HME's board and joined HMC on 5 May 2015.[34]

In 2016, a further impairment loss of S$15 million was recognised. On top of the loans, HME also owed HMC management and administrative fees of amounts exceeding S$7 million.[35] On 21 April 2017, HMC exercised its option from the loan agreement and acquired 100% of HME, making it a wholly-owned subsidiary.[36]

Blood bank

In 2010, HMC granted loans with a 10-year tenure to Wei Yi which would be repayable by end-2020.[37] In 2013, the loan receivable amount was S$28.5 million, of which S$13 million was deemed to be impaired.[38] In 2014, HMC reported that it had also waived interest that was charged to the loans for years 2013 and 2014 whilst still continuing to provide the loans under the initial agreement.[39] During 2015, HMC further extended the loan by S$3.2 million despite making more impairments. This brought the total impaired amount to over S$14 million. In the same year, a letter of intent was also signed between Wei Yi and a third party for an acquisition of Wei Yi by the latter party.[40] The purchase consideration from the acquisition was to be used to repay the loans.[41] However, it was reported that negotiations for the acquisition had come to a standstill in 2016.[42] Following this, HMC made the decision to impair the full amount of the loan receivable, reducing its recoverable amount to zero.[43]

It was then later revealed that the sole executive director of Wei Yi, Jamie Fan Wei Zhi, was the was the daughter of Fan Kow Hin, who by then had already resigned but remained a significant shareholder.[44]

When probed about these arrangements, neither HMC's then-President, Veronica Chan Wee Ping nor Financial Controller, Goh Lay Lan, could furnish details of the management contracts or loan terms between HMC and the loan counterparties.[45] Given the uncertainty surrounding the situation, SGX called for an independent review of these loans. On 11 April 2017, HMC announced that accounting firm BDO LLP was appointed as the independent reviewer.[46]

A Gateway to recovery

HMC ended 2016 with a cash balance of S$0.53 million, a dismal figure against its current liabilities amount of S$27.7 million.[47] In January 2017, HMC declared that it was unable to procure new loans or refinance its maturing debt obligations.[48] Shortly after, HMC entered into a subscription agreement with private equity firm, Gateway Fund 1 of Gateway Partners (Gateway). This agreement was targeted to raise S$70 million through a mixture of convertible and non-convertible bonds issued by HMC to Gateway, which would immediately alleviate the debt crisis of HMC. However, if converted, the bonds would entitle Gateway to swap for up to 90.17% of HMC's existing share capital, or an amount translating to 47.4% of the enlarged share capital.[49] The note issuance would result in Gateway potentially gaining a controlling interest in HMC. If HMC were to default on payment, it would lose its entire core business to Gateway.

In view of the convertible notes deal, HMC's shareholders questioned the board's lack of transparency and its rationale for borrowing S$70 million, since less than 40% of the amount would be set aside for working capital and to repay the banks.[50] Shareholder Tan Kay Cheng, who wrote to SGX seeking intervention, likened the Gateway deal to a "poison pill", designed by the board to fend off any unwelcome takeover bids at the expense of its own financial survival.[51]

SGX stepped in on 8 March 2017, a day before the notes were issued, stating that it would not be able to proceed with the notes issue on the first closing date.[52] The issuance of notes would result in transfer of controlling interest and Rule 803[53] of the Listing Manual Section B: Catalist Rule requires HMC to seek shareholders' approval for the notes issuance.[54] Gateway was unable to disburse funds to HMC due to this directive. The lack of immediate funds escalated HMC's inability to continue as a going concern, even as the revision of deal terms with Gateway was ongoing.[55]

Eventually, the terms were amended, and it was agreed that the convertible bonds would be issued in two tranches. The first tranche, amounting to S$10 million, was issued on 24 March 2017 at a conversion price of S$0.034 per share. After subtracting upfront fees of S$1.4 million, HMC received S$8.6 million from Gateway. According to Rule 803 of the Catalist Rule, shareholder approval would be required for the second tranche before issuance, but not the first tranche. This would enable HMC to fulfil its immediate liquidity needs.[56]

Following the revised agreement, Anand Kumar was appointed as a non-executive non-independent director on HMC's board on 24 March 2017 as a representative for Gateway.[57] An Extraordinary General Meeting (EGM) was held on 21 April 2017 to gain shareholder approval for the second tranche of notes issuance. Minority shareholders were apprehensive about Gateway's motives and its commitment to stay with HMC as a long-term investor.[58] Kumar responded by saying that he is neither a "trader" nor "here to do eight months of work and do a quick flip".[59] In the end, shareholders voted 95.2% in favour of the issuance, seeing it as the only lifeline to keep HMC afloat.[60] HMC issued the second tranche of the convertible notes comprising the remaining S$60 million.[61] Gateway profited from the deal, selling off 25% of its convertible notes to "independent parties" and Gentle Care Pte Ltd (Gentle Care), an indirect subsidiary of various entities under the Lippo umbrella.[62,63,64]

Some gentle care

As of 2 February 2017, Indonesian conglomerate Lippo Group held a 13.29% stake in HMC.[65] One of the Lippo entities which owned a stake was Gentle Care. On 7 February 2017, Gentle Care made a cash offer of S$103 million for the remainder of HMC's issued and paid-up shares, equivalent to an offer of S$0.042 per share, in an attempt to raise its stakes in HMC.[66]

A representative from Lippo China Resources Limited (Lippo China Resources) – Gentle Care's parent company – had attributed the cash offer to HMC being a "well-established private healthcare provider in Singapore", which "matches Lippo's strategy to acquire quality healthcare management capability".[67] As of 19 March 2017, four days before the revised convertible bonds deal with Gateway was announced, Gentle Care had also placed on the table a lifeline of a S$10 million loan with the condition that the money would only be used to repay remuneration owed to HMC staff.[68] HMC would receive net proceeds of S$8.3 million after upfront fees were made. The bond was a zero-coupon bond, enabling it to be redeemed at maturity at 100% of the principal amount plus a redemption premium, giving Gentle Care an internal rate of return of six percent. This stood in stark contrast to HMC's high borrowing rates of as much as 65.7% a year. However, Lippo also asked for security in the form of a general pledge over the company's businesses and assets.[69]

At that point in time, Lippo's offer placed it head-to-head with Gateway. Lippo had even offered to buy the S$10 million convertible bond from Gateway, but the offer was eventually rejected. Instead, Gateway sold the bond to "unnamed independent parties".[70] On 23 April 2017, just two days after the S$60 million deal from Gateway was approved, Lippo and Gateway came to an agreement – Gateway would sell a quarter of the S$60 million notes to Lippo for S$18.6 million, with Gateway netting a profit of S$3.6 million. This represented 13.86% of the enlarged share capital of HMC.[71] As of 24 April 2017, Gentle Care held about 29.2% of HMC.

Gateway said in a statement that "both Gentle Care and Gateway Partners will be large shareholders in the company going forward. HMC's business currently is going through difficult times. We need to focus the management on the turnaround of the business and we want to make sure that all stakeholders are aligned towards this objective."[72] In line with Gateway's position, Gentle Care said in a statement: "As a significant shareholder of HMC, we understand that the welfare of the doctors, nurses and staff, in addition to operational stability, are of great importance. We are pleased that the company's immediate financial needs are being addressed and we remain committed to HMC."[73]

Lippo-suction: Reshaping Healthway

Following the closure of the voluntary cash offer on 12 May 2017, Lippo China Resources owns more than 50% of the issued and paid-up share capital of HMC.[74] Accordingly, HMC is now a subsidiary of Lippo China Resources. The ultimate holding company of HMC is Lippo Capital Limited, a Cayman-incorporated company.

Lippo replaced HMC's Chairman with John Luen Wai Lee and included an additional seat for its executive director Stephen Riady on HMC's board of directors.[75] Chan, who was previously HMC's President,[76] as well as three of the four directors from the previous board that remained, has since left following HMC's 2017 Annual General Meeting, citing various personal reasons.[77]

HMC has been incorporated into the Lippo umbrella of companies with a new set of directors and key management personnel. Despite continuing losses, HMC's share price has shown an upward trend since the takeover,[78] indicating that the market has been responding well to the acquisition. Despite falling ill over its handling of financial matters, HMC seemed to have recovered fairly well. However, its health will be closely monitored by shareholders and other stakeholders.

Discussion questions

1. Evaluate HMC's multiple changes in directorship and management, and the resultant impact on its board effectiveness.

2. HMC did not disclose the full identities of parties to the loan agreement – Healthway Medical Enterprises Pte Ltd and Wei Yi Shi Ye Co Ltd – in its financial statements, choosing to simply list them as "Party A" and Party B". Should companies be allowed to conceal identities of loan recipients in this manner? Discuss how this affects users of their financial statements and suggest what should have been done instead.

3. The volume and nature of HMC's loans contributed significantly to its cash flow issues. What measures could have been taken to avoid such issues?

4. Discuss whether the board of directors has adequately communicated the problems HMC was facing to its shareholders. What more can be done to improve the board's accountability to shareholders?

5. One shareholder highlighted the "poison pill" arrangement in the Gateway deal. Explain the implications of a private equity investment in HMC and evaluate the arrangement of the sale of convertible bonds by Gateway to HMC.

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INTERNATIONAL HEALTHWAY CORPORATION: RISING FROM THE DEAD

Case overview

Following a successful Initial Public Offering (IPO) in 2013, International Healthway Corporation Ltd (IHC) was listed on the Singapore Exchange (SGX) as a spin-off from Healthway Medical Corporation Limited (HMC). However, in 2016, IHC experienced a shareholder revolt, largely due to concerns about the board of directors' aggressive asset acquisition strategy, lack of strategic focus and execution problems. It was also criticised for its overvaluation of shares during the IPO. Eventually, an Extraordinary General Meeting (EGM) was held on 23 January 2017 to consider changes to the board. OUE Limited (OUE) then came into the picture after it launched a surprise takeover offer for IHC. The objective of this case is to allow a discussion of issues such as the roles of different parties in corporate governance; internal controls and risk management; chain listings; shareholder activism; and takeovers.

This is the abridged version of a case prepared by Lau Zheng Fong, Loh Wan Yun, Low Jie Ying, Ong Sin Ee, Tan Shi Ying and Tay Chin Kiong under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Yeo Hui Yin Venetia under the supervision of Professor Mak Yuen Teen.

HMC: The beginning

In February 2006, HMC Group was formed when Dr Wong Weng Hong, Fan Kow Hin, Dr Jong Hee Sen, Aathar Ah Kong Andrew and several investors, acquired Healthway Medical Group Pte Ltd, Healthway Medical Enterprises Pte Ltd and BUPA Healthcare Singapore Pte Ltd from BUPA Healthcare Asia, through its investment holding company, Universal Healthway Pte Ltd. On 16 May 2007, HMC was incorporated in Singapore as Healthway Medical Services Pte Ltd, later changing its name to Healthway Medical Corporation Private Limited in the following year. On 11 June 2008, HMC assumed its current name as it converted into a public limited company.[1]

Listed on SGX Catalist Board on 4 July 2008,[2] HMC Group prides itself as a leading private healthcare provider with a vast network of medical centres and clinics in Singapore, as well as a growing network in Shanghai, China. Operating and managing more than 100 medical centres and clinics that it owns, HMC provides a wide range of medical care services, including specialist services.[3]

IHC: A healthy breakaway?

Co-founders Fan Kow Hin, Dr Jong and Andrew Aathar, who also founded HMC, decided to form IHC.[4] IHC was incorporated in February 2013,[5] and listed on the SGX Catalist Board on 8 July 2013,[6] breaking away from its parent company HMC.[7] This allowed IHC to focus its expansion efforts into Japan, China, Malaysia, and Australia.[8] However, IHC faced numerous issues right from the get-go.

Board composition

In FY2016, IHC's board underwent multiple changes, with its board size varying between four and eight directors.[9,10] Initially, the board consisted of five directors with a lead independent director. All members of the board had experience in finance and accounting but most had little experience in the healthcare and medical fields.[11]

Three directors were then added to the board early in 2016 – Lim Beng Choo was added as an executive director, while Gerald Lim Thein Su and Leonard Chia Chee Hyong joined as non-independent non-executive director and independent director respectively.[12]

After the company's Annual General Meeting (AGM) in July 2016, three independent directors, including the lead independent director, retired from the board but were not replaced. This left the board with only two independent directors and three non-independent directors.[13]

Later that year, Ong Lay Khiam resigned from the board, citing family reasons and other commitments,[14] and was replaced by independent director Alviedo Rodolfo Jr San Miguel.[15] Subsequently, Dr Jong resigned from the board as he felt that he could not effectively act as a director given the shareholder tussle.[16] This left the board with four directors – Lim Beng Choo, Gerald Lim, Leonard Chia and Alviedo Rodolfo Jr San Miguel – all of whom were newly appointed during the financial year. One other key change was the appointment of Gerald Lim as Non-Executive Chairman, replacing Dr Jong.[17]

IHC's board had three committees, namely the Audit Committee (AC), Remuneration Committee (RC) and Nominating Committee (NC). At the end of FY2016, IHC's AC and RC were chaired by Leonard Chia, with Gerald Lim and Alviedo Rodolfo Jr San Miguel as members, while the NC was chaired by Alviedo Rodolfo Jr San Miguel, with Leonard Chia as a member.[18]

Indigestion from an excessive risk appetite

Despite the initial positivity, concerns were raised regarding the company's risk management and risk appetite, which resulted in various operational problems. Since its incorporation, IHC emphasised its growth strategies,[19] taking on a diversified approach geographically and delving into the area of real estate investment.[20] Comments in the media by investors highlighted the board's alleged failure to limit its risk appetite in pursuing the company's objectives, which resulted in IHC being constantly plagued by large debts and the inability to repay its loans.[21,22] However, the board and management made no attempt to alleviate the situation. Concerns were only brought up by the board after IHC experienced operational problems.

The path to the revolt

On 7 September 2016, two IHC shareholders, Oxley Holdings' Eric Low and his sister, Audrey Low, sent a notice to IHC demanding an EGM to be convened. They proposed that all four directors – Lim Beng Choo, Gerald Lim, Ong Lay Khiam and Leonard Chia – be removed from the board.[23] However, IHC said that the requisition was invalid and successfully stalled the EGM. Lim Beng Choo responded to media queries and explained that IHC had been advised that under Section 176 of the Companies Act, shares must not be in the nominee accounts for one's shareholding to be counted towards the 10% threshold required for requisitioning an EGM. While the rule necessitates those demanding an EGM to be the members listed in the company's share registry, nominees are not mentioned. However, it is possible for individual companies to state their own rules in their constitution with regard to counting shares held in nominee accounts.[24]

The situation became more disputed as other parties expressed their opinions on the issue. A lawyer mentioned that he had never observed such a basis for denying a requisition; another further commented that IHC could not avoid the inevitable.[25]

Following an overwhelming rejection of the annual general share issue mandate in the AGM in July,[26] an EGM was convened to seek approval for issuing new shares on 12 October 2016.[27] However, the resolution again failed to pass.[28] Shareholders were disgruntled following a fall in share price that did not recover. Additionally, IHC's poor track record in reporting and delayed payments to its creditors was a cause for concern.[29]

On 28 October 2016, the EGM to remove the four directors mentioned above was requisitioned again by Eric Low and Audrey Low.[30]

Spinning into trouble

Despite the concerns and unhappiness expressed by shareholders, IHC continued to pursue its aggressive asset acquisition strategy. On 13 January 2017, an open letter by Switzerland-based activist investor, Quarz Capital Management (Quarz), attributed IHC's underperforming share price and cash flow shortage in developing its healthcare business to its aggressive acquisition strategy. It said that this caused IHC to take on more debt and incur high interest rates, and coupled with its low cash holdings, placed it in a vulnerable position.[31] It indicated its support to oust the board.[32]

Quarz highlighted an absence of active steps taken to prevent the drastic fall in shareholder value, "despite the multiple levers at their disposal".[33] It also attributed the fall in share price to the shareholders' loss of confidence in the management and board due to poor execution of projects. IHC's financial reports also showed an increasing debt-to-equity ratio, suggesting that IHC may experience future refinancing problems.

Lastly, Quarz also criticised the lack of strategic focus in IHC's business operations. Despite the considerable amount of time since its IPO, the management had failed to create significant value. It urged IHC's management to take action to promote the long-term interest of shareholders by addressing the undervaluation issue. It also suggested the sale of IHC's non-core assets in order to focus on its core business.[34]

Responding to the pressure

IHC refuted the claims made by Quarz, explaining that many of the issues highlighted had already existed before the appointment of its current board members and arguing that the appointment of new directors would be detrimental to the continuity of the board's ongoing efforts. Additionally, it pointed out that Quarz's suggestions have been previously considered and it was speculative to assume that a complete change of the board would improve shareholder value.[35]

IHC appealed for more time to improve its performance, asking investors to "vote for continuity".[36] However, by the start of 2017, IHC's share price had dropped more than 85% since its listing in 2013, indicating investors' continuing loss of confidence.[37]

The chaotic EGM

23 January 2017 proved to be a memorable day for IHC, its shareholders and the board.[38] The EGM was finally held and more than 100 shareholders and proxy holders attended.[39]

Earlier that day, IHC had made a pre-market announcement warning that changes to the board may cause IHC's refinancing plans with a Japanese financial institution to fall through.[40] IHC faced significant financial difficulties and was likely to fail to redeem a S$50 million bond due in April 2017.[41]

A proxy holder proposed for the EGM to be adjourned and for the refinancing issue to be prioritised, only to be met with significant opposition from many furious investors demanding answers to IHC's underperforming share price.[42] In response, Chairman Gerald Lim called for the adjournment to be voted by a show of hands. The suggestion was narrowly voted down by a margin of 63 to 58.[43] Eventually, the meeting proceeded[44] and a majority of IHC's shareholders (68.84%) voted to pass eight out of nine resolutions to remove the current directors of the board and appoint three new directors; the only resolution not passed was the appointment of Baker Tilly as the company auditor.[45] The EGM lasted 90 minutes and was a heated affair.[46]

The four directors – Gerald Lim, Lim Beng Choo, Alviedo Rodolfo Jr San Miguel and Leonard Chia – were thus removed from the board. Lim Beng Choo was also suspended from his executive role with immediate effect. Roger Tan Chade Phang, Eric Sho Kian Hin and Jackson Tay Eng Kiat were appointed as the new directors of IHC.[47]

The dramatic aftermath

However, things did not appear to be smooth sailing after the change of the board. The day after the EGM, the new IHC directors lodged a formal police report against Lim Beng Choo, alleging that she was seen leaving the company with her computer and some documents the previous night despite being ousted as the director.[48] Lim Beng Choo argued that she was not formally informed of the suspension of her executive role when she had left the EGM and explained that she had the habit of bringing work home. She retaliated on 27 January 2017 by lodging a police report, claiming to have been harassed and wrongfully detained by the new directors and Eric Low after the EGM.[49]

Separately, OUE acquired a 12.54% stake in IHC, though the reasons behind the sudden acquisition were unclear then. As a result of the significant stake acquired by OUE, on 24 January 2017, IHC called for a sudden trading halt[50] to check for a potential breach of a covenant for the S$100 million outstanding bonds, which could entitle holders of the bonds to demand instant payment.[51] The breach of a covenant would be triggered if the total shareholding of the three co-founders – Fan Kow Hin, Dr Jong Hee Sen, Andrew Aathar – and their immediate family members fell to less than 30%.[52]

To ease IHC's financial situation, Oxley Holdings' Eric Low and Ching Chiat Kwong offered convertible loans to IHC at an interest rate of six percent per annum. They also proposed a loan facility of up to S$5 million to IHC, while Oxley Holdings made available another loan facility of up to S$50 million. The loan was subject to shareholders' approval at an EGM.[53]

The turning point

Since the removal of the board, OUE had been actively acquiring IHC shares. Following its initial acquisition of a 12.54% stake on the same day that IHC's previous board was ousted, OUE raised its stake to 21.83% on 8 February 2017.[54] OUE then made a final offer to purchase shares from Eric Low, Audrey Low, Ching Chiat Kwong and Tan Wee Sien, bringing its ownership in IHC up to 57.6%.[55] Thereafter, OUE launched a cash offer of 10.6 cents per share to acquire the remaining shares that it did not own.[56] Following the successful takeover by OUE, the convertible loan facilities previously provided by Oxley Holdings and its related parties were all terminated.[57] Despite the breach in the covenant on the S$100 million outstanding bonds due to the change in shareholding, OUE calmed creditors and other stakeholders, swiftly issuing a comfort letter which outlined its plans to stabilise IHC's business and finances.[58] IHC changed its name to OUE Lippo Healthcare Limited shortly after.[59]

Rebirth of IHC

The journey of recovery and growth began following the appointment of the new board. The new board consists of six directors, with three independent directors and three non-independent directors. The lead independent director of the board, Roger Tan, is also the Chairman of the Nominating and Remuneration Committee (NRC).[60]

In an open letter after the vote, Quarz conveyed its approval of the new board as it felt that the nominees have diverse skillsets that are highly relevant to IHC. Quarz also expressed confidence in IHC in rebuilding its reputation and leveraging on the vast networks and expertise of the new board and shareholders.[61]

IHC proposed to take a more conservative growth approach by tapping on its current projects, especially on expanding its portfolio of nursing home assets in Japan, and Wuxi, China, which has consistently generated the highest revenue for IHC in previous years.[62] With IHC's existing investments in healthcare well-aligned with emerging trends, the existing portfolio serves as a strong platform for IHC to expand its healthcare services network through acquisitions and new initiatives.

Taking baby steps

Following the changes in the board, several policies have been implemented. New risk management guidelines were introduced, such as requiring certain levels of authorisation for specified transactions, and approval limits for its operating and capital expenditure. Directors are encouraged to proactively seek information through meetings. To ensure proper discharge of duties, directors have to undergo an orientation to acquaint themselves with IHC operations and guidelines. An Audit and Risk Committee (ARC) was also established to oversee IHC's risk management and control systems.[63]

In the pink of health?

Contrary to the former board's claims that the Japanese refinancing plans could be jeopardised due to the change in the board,[64] IHC eventually concluded its Japanese refinancing plans for IHC Japan First TMK, which would help lower financing costs for IHC's expansion in Japan.[65]

However, given IHC's weak cash position, there are still significant uncertainties surrounding its ability to meet its debt obligations. Perhaps what investors really need is clarification of the company's refinancing plans and greater transparency regarding its risk policies.

Discussion questions

1. Identify the red flags pointing to IHC's poor risk management. What factors do you think may have contributed to its poor share price performance?

2. Discuss the role of shareholders like Eric Low in Oxley Holdings and activist investors like Quarz Capital Management in the corporate governance of a company. Evaluate the effectiveness of shareholder activism in IHC.

3. Using the guidelines stipulated in the Code of Corporate Governance, compare the composition of IHC's ousted board with that of the current board. Were the problems of the ousted board adequately addressed with the appointment of the new board? Explain.

4. Discuss the takeover of IHC and evaluate the pros and cons of OUE's takeover for shareholders.

5. Evaluate the adequacy of the policies implemented by the current IHC board in regaining investor confidence. What else do you think the IHC board should do?

6. IHC was created through a spin-off from HMC. What are the pros and cons of such spin-offs? What are the key concerns from the perspective of shareholders of HMC? What corporate governance issues can arise from "chain listings", where a parent and its subsidiary are both listed? What safeguards, if any, should stock market regulators put in place for chain listings?

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KEPPEL CORPORATION: OFFSHORE AND OFF-COURSE

Case overview

On 23 December 2017, corporate Singapore was shocked when Keppel Corporation (Keppel) announced that its wholly-owned subsidiary, Keppel Offshore and Marine (KOM) had reached a global resolution with criminal authorities in the United States, Brazil and Singapore relating to corrupt payments made by a former KOM agent in Brazil. Under this global resolution, KOM was to pay fines totaling US$422 million (S$570 million) to authorities in the three jurisdictions. This was the first time that any Singapore company, let alone a government-linked one, has been caught in a global bribery scandal. It emerged that the corrupt payments started in 2001 and totaled US$55 million, and helped KOM obtain 13 contracts over 13 years. What was equally shocking was the corrupt payments were made with the knowledge or approval of former KOM executives. The objective of this case is to facilitate a discussion of issues such as corporate culture; board composition; remuneration; whistleblowing policies; governance of company groups; governance of governance-linked companies; and effectiveness of regulation and enforcement for bribery.

This case was prepared by Professor Mak Yuen Teen, Goh Yi Fang, Hoo Tian Ning, Luar Zhe Hui Ryan James, and Nguyen Hoang Nhan. 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. It was further edited by Isabella Ow and Professor Mak Yuen Teen.

Rise of the rig builder

"To become a truly global company, we would have to forge a unified team. And it was clear what we had to do. There would be no more in-fighting and competing against each other within the group. We would always focus on the outside - focus on our customers and on the marketplace."

– Choo Chiau Beng, Former CEO of Keppel Corporation and Chairman of KOM[1]

Keppel Corporation (Keppel) had come a long way since its establishment in 1968 as Keppel Shipyard in the ship repair, ship building and offshore business. The 1970s was a period of tremendous growth for Keppel as it acquired Keppel FELS and Singmarine Shipyard and ventured overseas.[2] Keppel Shipyard listed on the Singapore Stock Exchange in 1980 but the years ahead proved to be rough due to the gloomy outlook for the offshore and marine industry, coupled with the major recession hitting Singapore.[3] However, Keppel sailed through the rough storms and clinched several ground-breaking projects before Keppel Shipyard became Keppel Corporation, while Keppel Shipyard remained as a major operating division.[4] Today, Temasek Holdings, the investment company which is wholly owned by the Singapore government, holds 20% of Keppel's shares.[5] As of 18 May, 2018, Keppel has a total market capitalisation of $14.88 billion.[6]

Riding on the wave of globalisation, Keppel entered many strategic partnerships and 2002 marked a significant milestone as it established Keppel Offshore and Marine (KOM).[7] KOM is one of the four key businesses that make up Keppel. It is headquartered in Singapore and was incorporated by combining three different operating businesses of Keppel – Keppel FELS, the rig designer and builder; Keppel Shipyard, the ship repair and conversions specialist; and Keppel Singmarine, the shipbuilding specialist. This was done to harvest the potential synergies and collective competitive advantage that each of the businesses initially possessed.[8]

Keppel Offshore and Marine

With its tremendous growth, KOM has established itself as one of the leading players in the marine and offshore industry.[9] It was undoubtedly the crown jewel of Keppel. Between 2005 and 2015, it contributed between 56.6% and 75.5% of total Group revenues, with the percentage contribution peaking in 2006, while contribution to pre-tax Group profit ranged from 35% to 65.1% during that same period, with its peak in 2011.[10]

However, the global offshore and marine sector has been suffering from sluggish growth in recent years. In addition, volatile and depressed oil prices which fell to a 13-year low of below US$30 at the start of 2016 led to the lack of new projects for KOM.[11] KOM achieved revenues of S$2.9 billion in 2016, which was 54% lower than the previous year.[12] Its revenue contribution to the Group fell from 60.6% in 2015 to 42.2% in 2016, while pre-tax profit contribution fell from 35% to just 8.5%.[13] However, in 2016, it delivered 21 major projects and secured new contracts worth about S$500 million.[14]

Early 2017 saw the start of the recovery of oil prices which rebounded to above US$50. However, there were low expectations for a quick turnaround for the offshore and marine sector, especially since production increases from shale oil producers in the U.S. have impaired the recovery of oil prices.[15] Contributions to the Group continued to tumble, with revenue falling to 30.2% of total Group revenues and KOM reporting a $862 million loss in 2017, which included a $570 million financial penalty from the global resolution with criminal authorities in the U.S., Brazil and Singapore for bribery in Brazil and $49 million of related legal, accounting and forensic costs.[16] In 2017, it secured new contracts of about S$1.2 billion.[17]

KOM board of directors

KOM's board was established in 2002 with 12 members, with half of them being independent.[18] There were four executive directors – the Chairman and CEO, Choo Chiau Beng; the CFO, Sit Peng Sang; the COO, Tong Chong Heong; and the Managing Director of Special Projects, Charles Foo Chee Lee.

The board also had a non-independent, non-executive director, Teo Soon Hoe, who was a Senior Director and Group Finance Director at Keppel Corporation. The independent non-executive directors were Neo Boon Siong, Minoo Homi Patel, Malcolm Sharples, Tan Kim Siew, John Rossman Huff, Stephen Pan Yue Kuo and Bjarne Hansen.[19]

By December 2017, there were nine independent, non-executive directors, taking up more than half of the board.[20] Loh Chin Hua, the Group CEO, was the Non-Executive Chairman and Chow Yew Yuen, the CEO, was the sole executive director. Another non-independent, non-executive director, Chan Hon Chew, was the Group CFO of Keppel Corporation and served on the board of several other Keppel Corporation subsidiaries. Most of the independent non-executive directors who were on the board at the time of KOM's establishment had left, with the exception of Minoo Homi Patel, Malcolm Sharples and Stephan Pan Yue Kuo. New independent, non-executive directors who joined over the years include Po'ad Bin Shaik Abu Bakar Mattar, Tan Ek Kia, Lim Chin Leong, Robert D. Somerville and Kelvin Kwok Khien. Tan Ek Kia was also an independent director on the Keppel Corporation board.[21]

Risk management

"Our proactive risk management system enables us to conduct our business in a sustainable manner and navigate through challenging market conditions."

– KOM's Annual Report 2016[22]

According to KOM, it adopts a well-rounded and proactive Enterprise Risk Management (ERM) framework which provides for identification, analysis and management of risks. The board of directors, together with the Audit and Risk Committee (ARC), has the oversight of the ERM implementation. Every quarter, the management team holds discussions with the ARC regarding KOM's key risks, significant project issues and risk response.[23]

Keppel Corporation's three risk tolerance guiding principles underlie KOM's ERM framework. Firstly, there should be meticulous evaluation of risk taken. Rewards should commensurate with the risk taken and risk taken has to be aligned with the company's core strengths and strategic objectives. Secondly, risk that arises from a single area of operation, investment or undertaking should not be taken if it is so large that it would endanger the company. Lastly, the Group has zero tolerance for "safety breaches or lapses, non-compliance with laws and regulations as well as illegal acts such as fraud, bribery and corruption".[24]

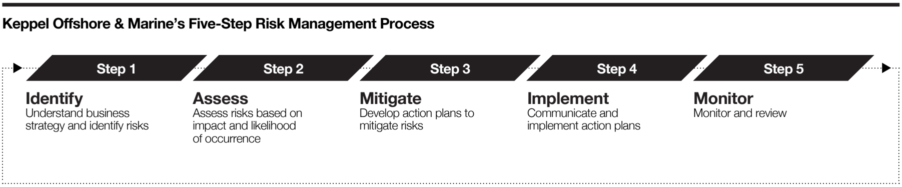

Figure 1: KOM's five-step process[25]

KOM's five-step process from risk identification, assessment, mitigation, implementation and communication to risk monitoring and review in their day-to-day operations and discussions.

In order to develop efficient business solutions, regular reviews of risks across the company are integrated into KOM's strategy discussions to ensure that key risks and mitigating actions are considered. Additionally, projects are only accepted after careful consideration of potential risk in all areas. Project teams also use risk and performance indicators as red flags for project execution risks in the hope of ensuring that "projects are delivered on time, within budget, safely and in accordance with the quality standards and specifications defined in the contracts with our customers".[26] Moreover, for projects which are conducted overseas, there are constant reviews for the changes in operating environment, political and regulatory developments. If required, precautionary measures are implemented to mitigate their exposure in different circumstances. KOM's Risk and Compliance team evaluate the emerging risks with project teams and present the potential issues to the management and ARC. Sharing sessions are conducted across different KOM business units for exposure purposes.[27]

Furthermore, KOM's commitment to fostering a risk-centric culture which emphasises prudent risk-taking in decision-making and business processes is regularly broadcasted on multiple platforms and events.

Regulatory compliance

As a global company with footprints across the world, Keppel adopts a stringent code of conduct with regards to compliance to laws and regulations. It is mandatory for all employees to comply with the relevant laws and regulations and act in line with Keppel's core values and principles. According to KOM, it emphasises ethical actions and has a strong zero-tolerance stance towards any form of illegal activity, including bribery and corruption.[28] KOM has a defined regulatory compliance framework which aids in ensuring an effective compliance culture among employees.[29]

In KOM, the ARC supports the board in its oversight role of compliance controls. The Risk and Compliance team reports to the ARC on key compliance risks as well as mitigating actions as required. The Regulatory Compliance Governance Structure comprises the Regulatory Compliance Management Committee (RCMC) and the Regulatory Compliance Working Team (RCWT). The RCMC consists of the senior management of all key business divisions while the RCWT consists of key representatives from the legal, risk and compliance, human resources, corporate development and finance teams of all key business divisions.[30]

The RCMC directs and supports the development of overarching compliance policies, guidelines and procedures for the Group whereas the RCWT drives the implementation of the Group's code of conduct and compliance programmes and ensures adequate assessments for regulatory compliance risks are conducted. The committees also ensure suitable control measures are implemented to manage all risks.[31]

Keppel Corporation

Keppel Corporation has a code of conduct which guides employees in carrying out their duties and responsibilities with the highest standards of integrity in all decisions and dealings.[32] The code of conduct covers issues regarding anti-corruption and conflict of interest, among others. Business partners and associates that provide services or engage in business activities with Keppel are also required to observe comparable standards.

Across the Keppel Group, compliance messages have been relayed through various initiatives and awareness in regulatory compliance is actively raised during forums and meetings held at the Group level.[33] Training is also a key component of Keppel's regulatory compliance framework and training programmes are consistently refined. Mandatory annual online training along with assessments and declarations relating to the understanding of the company's policies on code of conduct, personal data protection, competition, insider trading, whistle-blowing and conflict of interest is enforced on all employees.[34]

The gold standard for corporate governance

"Keppel is focused on upholding high standards of corporate governance with a strong and independent board, demonstrating its strong commitment to good business ethics and maintaining clear, consistent and regular communication with shareholders."

– Keppel Corporation[35]

Since its inception, Keppel has bagged many corporate governance awards and has often been ranked amongst the top three for the Best Annual Report award and/or Best Managed Board Award for the Singapore Corporate Awards (SCA). During the 2015 SCA, it won the most prestigious award for the Best Managed Board for companies with a market capitalisation of a billion or more.[36]

Keppel has also constantly been ranked amongst the top five in the Singapore Governance and Transparency Index (GTI) throughout the years and in 2017 it was ranked fifth.[37] In 2014, it was named the best governed and most transparent listed company.[38] Keppel was said to have performed well in several corporate governance measures used for the SGTI, including disclosures in its annual report on the details of the process by which it appointed its new CEO, Loh Chin Hua, and criteria considered for CEO succession.[39]

Keppel board of directors

Between 2000 and 2007, Lim Chee Onn (Lim) was the Chairman and CEO of Keppel, holding the title of Executive Chairman.[40] This was highly unusual among government-linked companies in Singapore as Temasek Holdings, its largest shareholder, advocates the separation of the positions of Chairman and CEO and the appointment of a Non-Executive Chairman for its portfolio companies.

Lim started his career in the civil service. He was deputy secretary in the Ministry of Communications before he was elected as a Member of Parliament (MP), and held positions of Political Secretary in the Ministry of Science and Technology, Secretary-General of the National Trades Union Congress and Minister without Portfolio in the Prime Minister's Office before retiring as an MP in 1992.[41]

On 1 January 2009, Lim relinquished his CEO role at Keppel and became its Non-Executive Chairman. He was replaced as CEO by Choo Chiau Beng.[42] On 1 July 2009, Lee Boon Yang (Lee) was appointed as independent Non-Executive Chairman of Keppel, replacing Lim. He had joined the board as an independent non-executive director on 1 May 2009.[43]

Lee worked as a veterinarian after graduation and became an MP in 1984. He held appointments as parliamentary secretary, Minister of State, Senior Minister of State, and various full minister positions, including Minister of Defence and Minister of Labour. He retired from political office on 31 March 2009.[44]

Between 2006 and 2010, Keppel's board had increased from eight to 12 members, before declining from 2012 to its current board size of nine members. Throughout those years, it had a lead independent director. In 2006, half of its eight-member board were independent directors, with one non-independent non-executive director and three executive directors, including the Chairman. The non-independent non-executive director, Tow Heng Tan, was appointed to the Keppel board in 2004, having joined Temasek Holdings in 2002 as Chief Investment Officer. He has remained on the Keppel board after this retirement from Temasek Holdings. Except for part of 2009 when Lim was briefly a non-executive non-independent director, Tow was the only non-independent non-executive director on the board up till today.[45]

Over the years, the percentage of independent directors has increased to about 80%. Before 2013, the board generally had three executive directors, but that declined to two in 2013 and from 2014, the CEO has been the only executive director on the board.[46]

Keppel has the following board committees: Audit Committee, Nominating Committee, Remuneration Committee, Risk Committee and Safety Committee. Except for the Safety Committee, which includes executive directors as members, all other committees have only non-executive directors as members, with a majority including the Chairman being independent directors. Prior to 1 January 2010, the board also had an Executive Committee chaired by the board Chairman, but this was dissolved.[47]

Remuneration policy

Keppel has a strong pay-for-performance culture for senior management. This is reflected in both the relative weightage of fixed and variable remuneration components for senior management and the types of remuneration schemes used. In 2009, which was its best year based on revenues, profits and economic-value added, the total remuneration of its then-CEO, Choo Chiau Beng, was in the range of \$11.5 to \$11.75 million, with his base salary accounting for only nine percent, while variable remuneration components in the form of performance-related bonuses earned and options granted amounted to 91%. Teo Soon Hoe, executive director and Group finance director received total remuneration of \$7.5 to \$7.75 million that year, with variable components comprising 90%, while executive director Tong Chong Heong received total remuneration of \$6.75 to \$7 million, with 88% being variable. All three executive directors were on the KOM board at that time, holding positions of Chairman, non-executive director, and CEO respectively.[48] From 2006 to 2017, the variable components of the CEO remuneration made up between 81% and 91% of his total remuneration, and for FY2017, it was 84%. The CFO (or equivalent position) over that same period received variable remuneration ranging from 74% to 90% over the same period, and for FY2017, it was 80%.[49]

Prior to 2010, Keppel's share incentive scheme was in the form of a share options scheme. Executive directors and employees were eligible to participate. All options that were granted could be exercised after two years and before the expiry date. Choo, Teo and Tong all received share options ranging from between 5% and 15% of their total remuneration. Some key management personnel just below the executive directors received more than 40% of their total remuneration in the form of share option grants in some years.[50]

In 2010, Keppel replaced its share options scheme with two new share incentive plans – a performance share plan and a restricted share plan. Shares awarded under the two plans are based on pre-determined performance targets set over a three-year period and one-year period respectively. For the performance share plans, performance targets include those based on total shareholder return. Changes to these performance and restricted share plans were introduced in recent years.[51]

Performance-related cash bonuses for executive directors and key management included an economic-value added (EVA) and non-EVA component. Prior to FY2012, Keppel disclosed that the annual performance bonuses were linked to company's, business unit's and individual's performances, including a portion which was tied to EVA performance. Performance bonuses were awarded based on the achievement of key performance indicators in four areas: financial and business drivers, process, stakeholders and people. Under the "EVA bank" system used by Keppel, one-third of the current year EVA-bonus and the one-third of the accrued EVA bank was paid out as long as EVA was positive. The remaining two-thirds of the EVA bank was deferred and was at risk, and could become negative if EVA performance be negatively affected. In FY2007 and FY2008, however, one-half of the current EVA bonus and one-third of the accrued EVA bonus was paid out. From FY2009, after Choo was appointed as CEO, the operation of the EVA bank system reverted to the pre-FY2007 formula. In FY2017, the company appears to have ceased the deferral of performance-related cash bonuses earned, although the CEO, Loh Chin Hua, received less total performance-related cash bonuses earned, and more restricted shares and performance shares.[52]

Since FY2006, Keppel has paid its non-executive directors a combination of cash fees and remuneration shares. The remuneration shares are intended to align the interests of non-executive directors with shareholders and the long-term interests of the company. Today, non-executive directors receive 70% of their fees in cash and 30% in remuneration shares.[53]

Whistleblowing policy

Following the release of the revised Singapore Code of Corporate Governance in 2005, which included a guideline recommending that companies have arrangements in place for employees to raise concerns, Keppel introduced the "Keppel: Whistle-Blower Protection Policy".[54] This provides for mechanisms by which employees and other persons may, in confidence, raise concerns about possible improprieties in financial reporting or other matters. This policy is reviewed by the Audit Committee.

The current reporting mechanism under Keppel's whistleblower policy can be found on its website and is shown below.[55]

Home ▸ Whistleblower statement

Whistleblower statement

Whistleblower Policy

Integrity is one of Keppel's core values. Keppel expects its employees to carry out their duties and responsibilities in an ethical manner and in compliance with applicable laws and regulations at all times in the countries where Keppel carries on business.

Keppel has a Whistleblower reporting channel for its customers, suppliers, employees and other stakeholders to report, in good faith, details of any instances of illegal and/or unethical conduct.

Making a Report

Incidents of actual or suspected illegal and/or unethical conduct and violation of laws & regulations should be promptly reported to the Receiving Officer via Keppel's independent reporting channels as follows:

<table>
<tr><td>Email</td><td>Report@kepcorp.com</td></tr>
<tr><td>Hotline</td><td><table>
<tr><th>Country</th><th>Toll Free Number</th></tr>
<tr><td>Singapore</td><td>64136500</td></tr>
<tr><td>Brazil</td><td>08008923174</td></tr>
<tr><td>China</td><td>4001206106</td></tr>
<tr><td>USA</td><td>18338217058</td></tr>
<tr><td>Vietnam</td><td>12065300</td></tr>
</table></td></tr>
<tr><td>Online Form</td><td>Please click here to submit a Report online</td></tr>
</table>

NOTE: *The Whistleblower reporting channel is not intended for reporting issues that are (i) not factual; or (ii) trivial, frivolous and vexatious in nature; or (iii) where the reported matter or subject has no relevance to Keppel Group.*

Sailing into Brazilian waters

KOM's long standing relationship with Brazil began in the 1980s when it took on multiple vessel repair and conversion jobs from Petrobras.[56] In 2000, BrasFELS shipyard and FELS Setal were established in Brazil. BrasFELS shipyard was located in the city of Angra dos Reis to provide upgrading and repair services for the rigs working in the region whilst FELS Setal was a joint venture in Rio de Janeiro between Keppel FELS and Brazil's PEM Setal Group. This joint venture was set out to operate BrasFELS while providing for the booming market of oil and gas exploration and production activities in Brazil and in the west coast of Africa.[57]

After the first year of inception, FELS Setal established itself as the best offshore fabrication and construction yard in Brazil, and acquired repair and conversion contracts exceeding US$120 million.[58] Other than creating jobs, FELS Setal was successful in leading foreign companies in Brazil and allowed local rig owners to increase turnover by sending the jobs to the yard.

Following PEM Setal Group's divestment of its entire interest in the joint venture in 2005, FELS Setal was renamed as Keppel FELS Brasil.[59] In addition, BrasFELS subsequently managed to expand its services to include construction and conversion services. BrasFELS attracted customers locally and internationally and established itself as one of the most prominent offshore and marine facility in the Latin American region.[60]

Unfortunately, it was discovered that 13 contracts of KOM from Petrobras and Sete Brasil were obtained through illicit payments from 2001 to 2014. KOM earned approximately US$351.8 million through this bribery scheme, with illicit payments for these contracts amounting to US$55 million.[61]

KOM's Brazil breakthrough: P-48 Project

"The conversion of P-48 was undertaken at Keppel FELS Brasil's BrasFELS yard between 2003 and 2004 and was the largest conversion project ever carried out in Brazil."

– KOM's 2005 Annual Report[62]

In 2001, KOM's subsidiary, BrasFEL was given the subcontract for Brazil's first floating production storage and offloading (FPSO) conversion and integration project, the P-48 project.[63] The project, reportedly worth US$75 million, was to convert an aging tanker into a floating offshore production centre platform for Petrobras.[64] This FPSO was to be deployed for oil and gas production at Caratinga, Brazil. Former CEO and Chairman Choo Chiau Beng also mentioned in a stakeholder report that its completion in 2004 was a "milestone" for KOM's operations in Brazil. Furthermore, this project was touted by KOM as the "largest and most complex offshore conversion project undertaken to date in Brazil" and was completed by BrasFELS in five million work hours without a loss time incident.[65]

'Tinted glass' of P-48

According to the U.S. District Court, a KOM executive and sub-executive "authorised the payment of bribe amounting to approximately US$300,000 to government officials in Brazil in connection with securing the subcontract for Petrobras' P-48 project".[66]

In one of the emails that was sent to its subsidiary's financial controller from KOM's executive director, it was stated that "[T]here is a commitment to pay US$300k for some governmental guy(s) to help us put pressure for the [P-48 project] to be carried out in Brazil. [KOM Sub Executive] and myself have discussed this and decided to keep to the commitment. [Please] make arrangement for the first US$50k to be paid accordingly…".[67]

On top of this first payment, several more payments were also made for the P-48 project, with the last payment of US$50,000 made on 4 April, 2002.[68] This marked the beginning of KOM's bribery practices.

Mechanism of bribery

Companies (including KOM) that were suppliers to Petrobras formed a cartel in collusion with senior Petrobras officials.[69] The "winner" of the bid would already be predetermined by the cartel, but there was a fake bidding process to keep up the illusion of a competition. Petrobras officials would help in the process by adding unnecessary jobs to inflate contract values and leak confidential information to the cartel to give a clear advantage to their members, while ensuring that non-cartel bidders were disadvantaged.[70]

In accordance with this arrangement, Jeffrey Chow, the then-general manager (legal), drafted agreements containing inflated agency fees on behalf of KOM with consulting companies controlled by Zwi Skornicki (the Consultant).[71] These agreements were co-signed by other KOM executives.[72]

Under the guise of consulting agreements, KOM made payments to bank accounts in the U.S. and elsewhere in the names of shell companies controlled by the Consultant.[73] An example of this scheme was when a KOM subsidiary based in Singapore made seven payments totaling approximately S$17.6 million to a bank account which was controlled by the Consultant.[74] Following this, the Consultant transferred these funds to a bank account outside of the U.S., supposedly to the Brazilian officials.

Companies often disguise bribes to avoid detection. For example, in the ST Marine case, S$24.9 million in bribes were falsely classified as entertainment expenses made to employees of ST Marine's customers in return for ship repair contracts.[75] Reclassifying the expenses and collusion helped hide the existence of the bribes for an extended period of time.[76]

The calm before the storm

Following the bribery for the P-48 Project, the P-51 and P-52 Projects were secured in 2003 through similar underhanded means. The Consultant received explicit authorisation from KOM's executives and the firm's joint venture partner to pay bribes equivalent to a percentage of the contracts' value which amounted to a whopping US$13.3 million.[77] The illegal funds went through an intermediary who would transfer the money from the Consultant to a Brazilian official at Petrobras, who would subsequently split the money amongst himself and the rest of the officials at Petrobras and the Workers' Party.[78]

The pursuit for more contracts through underhanded means did not stop and more payments were made in 2005, 2007 and 2009. In 2007, the P-56 Project was secured through a bribe of US$14.2 million.[79] This amount was similarly determined as a percentage of the project's contract value and paid to a Brazilian official and the Workers' Party. The cost of this bribery payment was shared with KOM's joint venture partner. Payments of approximately US$4.4 million were made for the P-53 and P-58 Projects in 2005 and 2009 to secure portions of two floating platform hull conversion projects.[80] The P-61 Project obtained in 2009 involved payments of about US$8.8 million; the payments were likewise made to the same beneficiaries on the same terms as their previous contracts.[81]

Before KOM ran out of luck with its dirty schemes, it clinched a big project between 2011 and 2012 when its subsidiary was one of the five selected companies for the Sete Brasil Projects to construct the Petrobras's rigs.[82] Court documents revealed negotiations between contracted companies, including KOM, and a Brazilian official where bribes were matched to 0.9% to 1% of the value of their respective contracts.[83] Two-thirds of the payments were made to the Workers' Party while one-third was to be shared equally between the relevant Petrobras and Sete Brasil executives. Throughout the negotiation period, telephone calls were made by KOM's executives to authorise the Consultant to pay bribes equivalent to 1% of the contract value. Consequently, the Consultant received a substantial amount of about US$14.4 million in bribes to the Brazilian officials and the Workers' Party.[84]

Facing the storm

In March 2014, the Brazilian police detained Alberto Youseff, a black-market money dealer during what was seen to be a routine money-laundering investigation in Brazil, where petrol stations were often used as a shell.[85] However, he was no ordinary criminal; further examination of data on his computer revealed a number of substantial money transfers involving hundreds of senior executives and several companies, one of which was Petrobras and its director Paulo Roberto Costa.[86]

Arrested and pressured by investigators, Costa revealed that for more than a decade, Petrobras managers had colluded with ruling politicians and other local companies in illegally accepting hundreds of millions of dollars in exchange for Petrobras contracts.[87]

In 2013, Brazil's Organised Crime Law was introduced and passed, which paved the way for the rising adoption of plea bargain in court and provided a "detailed road map for collaboration by witnesses".[88] As long as what was revealed is true and can be verified thereafter, the witness involved can face a lesser sentence or even receive a judicial pardon. This was what prompted certain Petrobras executives, such as Pedro Jose Barusco Filho, a former executive at Petrobras to divulge extra information to facilitate the investigation.[89] It was through these disclosures that the name of Skornicki was flagged to the investigators. Skornicki was Keppel's former agent in Brazil from 2000 to 2006 and was finally arrested in 2016 under Brazil's massive graft crackdown called "Operation Car Wash".[90]

Keppel ran out of luck as further digging by investigators revealed that KOM and many other global corporations were involved in bribing Petrobras.

The central figures

Although those involved in the bribery scandal were not specifically disclosed by KOM, the court testimonies of Skornicki revealed that some executives of KOM and Keppel Fels Brasil were involved in authorising and directing the illicit payments.[91] The executives named by Skornicki include Choo Chiau Beng, Tong Chong Heong, Chow Yew Yuen, Tay Kim Hock and Kwok Kai Choong. In addition, Jeffrey Chow, a senior member at KOM's legal team from 2009 to 2017, was also found guilty of drafting contracts for the bribery payment.[92]

The executives who authorised these payments were mainly from the top management – Choo Chiau Beng, Tong Chong Heong and Chow Yew Yuen were CEOs of KOM during the period of the scandal. Tong was also Senior Advisor to the board after handing his CEO position to Chow, who was the CEO when the scandal was discovered. The other two executives identified, Tay Kim Hock and Kwok Kai Choong, were previously CEOs of Keppel Fels Brasil.

Skornicki also revealed that KOM approached him with the intention of engaging him as a dealer whereby he could sign contracts with Petrobras on behalf of Keppel. This was evidenced by a contract with Keppel that Skornicki presented in court which stated that he would be rewarded with a percentage of any deals he cut in Brazil.[93] Using the same account which Keppel paid his agency fees to, he then used it to bribe Petrobras officials. Petrobras, a state-owned company, was then controlled by the ruling political party at that time, the Workers' Party. Thus, most Petrobras officials who were bribed were the politicians from the Party, including Joao Vaccari, who was the treasurer of the Workers' Party.[94] Over the years, the ruling Workers' Party had pocketed up to almost US$200 million from bribery.[95]

Where was the board?

This massive bribery went on for years undetected. In response to queries about board accountability, the current boards of directors of Keppel Corporation and its unit KOM said that they were unaware of the illegal payments made to secure the contracts with Petrobras in Brazil as they were disguised as agency fees.[96] These agency fees were said to be "built into the contract values of the respective projects, and bidding for projects is in the ordinary course of KOM's business".[97]

In response, corporate governance experts have highlighted the board's responsibility for overseeing a business in a foreign environment where there is high risk of corruption. They mentioned that although it may be challenging for the board to know everything, the board should not have just relied on information given by the management.[98] According to them, in countries and sectors where there is high risk of corruption, the board should have questioned how the contracts were obtained, rather than adopting the usual approach of only questioning the management when financial targets are not achieved.[99] They also pointed out that the fact that bribery has occurred multiple times over a decade highlights a deeper culture issue in the organisation. Some also mentioned that early warning signs and whistleblowing may have been ignored as employees may feel that if the wrongdoers are from the senior management, then it is pointless for them to report the matter.[100]

Moreover, the public has also raised doubts regarding the effectiveness of KOM's and Keppel Corporation's checks and balances. These include questions as to whether the independent directors were fulfilling their duties to help ensure corporate integrity and good governance.[101]

We didn't know…or maybe we did

Keppel had initially denied all allegations of involvement in making bribe payments.[102] In February 2015, there were media reports in Brazil about the involvement of Keppel FELS in the Petrobras scandal. Pedro Jose Barusco Filho had alleged that illegal payments were made by Skornicki. Keppel made the following statement:[103]

> *We refute allegations made in media reports on Keppel FELS' involvement in the scandal surrounding Petrobras.*
>
> *We would like to emphasize that Keppel Group has a Code of Conduct which prohibits, among others, bribery and corruption. Our employees are required to conduct themselves with integrity, in an ethical and proper manner, and in compliance with the applicable laws and regulations of the countries in which we operate, including anti-bribery laws.*
>
> *We wish to point out that Zwi Skornicki is an employee of Eagle do Brasil, which is the agent of Keppel FELS in Brazil. Keppel FELS had conducted due diligence review of Eagle do Brasil and Zwi Skornicki. Further, the Agency Agreement with Eagle do Brasil categorically states that Eagle do Brasil and Zwi Skornicki 'shall not make, either directly or indirectly, any improper payment of money or anything of value to an Official in connection with the Contract.' In addition, Eagle do Brasil's services are not exclusive to Keppel FELS, and it is also an agent to other reputable multi-national companies.*
>
> *We would also like to clarify that as part of initiatives to contribute to the communities around the world in which we operate, we make various contributions in Brazil, which include social welfare programs, community activities and political donations. All of our various contributions are made according to and within local laws and regulations, which are documented in the respective companies' records and audits.*

In October 2015, Keppel issued another announcement that the Parliamentary Commission of Inquiry had voted to deepen its investigations into 10 companies involved in transactions with Petrobras and Sete Brasil, including Keppel FELS Brasil. It said it would extend full cooperation to the authorities if approached. The company again reiterated its zero-tolerance stance against any form of illegal activity, including bribery and corruption.[104]

Further announcements followed in February, April and May 2016, announcing that the agency relationship with Skornicki had been put on hold, with Keppel continuing to reiterate its zero-tolerance stance. In August 2016, Keppel issued the following announcement after Skornicki alleged in his testimony that bribe payments were done with prior approval and endorsement by the senior management in Keppel:[105]

> *Keppel refers to the Bloomberg article dated 3 August 2016 reporting allegations made by Mr Zwi Skornicki in criminal proceedings brought against him in Brazil. Keppel strongly denies the allegations reportedly made that Keppel executives authorized Mr Skornicki to pay bribes on its behalf. None of the individuals named in the article, including the current CEO of Keppel Offshore and Marine Mr Chow Yew Yuen, have ever authorized Mr Skornicki to make any payments as bribes.*

Finally, on 3 October 2016, Keppel announced that its internal investigation into the allegations involving Skornicki revealed that certain transactions may be suspicious.[106] Keppel also announced at the same time that it had notified the relevant authorities of its intention to cooperate and work towards a resolution of the underlying issues. It yet again reiterated its zero-tolerance stance.

For its cooperation and remediation efforts, Keppel received a 25% discount off the bottom of the applicable fine range, which is the maximum discount allowed.[107]

KOM was given a conditional warning by the Corrupt Practices Investigation Bureau (CPIB) in Singapore, which took into consideration the cooperation KOM had given for the investigations.[108]

KOM paid a penalty of US$422 million (S$567 million) as part of the global resolution reached in 2017 with criminal authorities in the U.S., Brazil and Singapore.[109] The financial penalty and related costs eventually amounted to a whopping S$619 million and had a significant impact on Keppel's bottom line.[110] Keppel recorded a net profit of S$217 million during the FY2017 and this was 72% lower than the net profit of S$784 million recorded in the previous financial year.[111]

Refuelling and overhaul

"The global resolution reached by KOM over past misdeeds in Brazil brings an end to what has been a painful chapter for Keppel - one that we have recognised and dealt firmly with. This is not Keppel. We care not just about results, but also how they are obtained."

– Loh Chin Hua, CEO of Keppel Corporation[112]

In light of this series of incidents, Keppel has taken disciplinary actions against 17 former and current employees, while seven of these individuals have left the company.[113] Keppel chose not to disclose the identity of these individuals, citing confidentiality issues. It was disclosed that demotions and/or written warnings were given to seven employees while financial sanctions of US$8.9 million were imposed on 12 former and/or current employees.[114] Lastly, six employees were ordered to undergo anti-corruption and compliance training.[115]

Moving forward, effective compliance controls were said have been implemented to ensure a corrupt-free and sustainable KOM.[116]

Despite the bribery scandal, KOM said it did not expect any negative impact on its ability to bid for contracts and that it would continue its operations in the U.S., Brazil and Singapore.[117] KOM managed to secure new orders worth over S$1.2 billion in 2017, which was more than double of the S$500 million secured in 2016.[118]

Overall, the Group has also fared well despite the calamity. Excluding the one-off financial penalty and related costs, the Group would have attained a net profit of S$836 million for FY 2017, which is 7% higher compared to S$784 million a year ago.[119] The Group also recorded free cash inflows of S$1,802 million in FY 2017, which was a huge improvement over the inflow of S$540 million in FY 2016.[120]

Discussion questions

1. What factors do you believe contributed to the bribery scandal at Keppel Offshore & Marine?

2. What is the role of the board with regards to bribery and corruption risk? What measures should the board take to minimise the risk of bribery and corruption?

3. Critically evaluate the composition of the boards of both Keppel Corporation and Keppel Offshore & Marine around the period of the scandal. Why might boards that are made up of such accomplished individuals fail to put in place measures to prevent such a massive bribery scandal and detect the serious lapses?

4. What are the different lines of defence that mitigate against bribery and corruption risks? In your view, which line(s) of defence clearly failed and why?

5. What issues might the bribery scandal raise about issues relating to governance of company groups? In your view, what are the roles and responsibilities of the subsidiary management, subsidiary board, group management and group board in ensuring good corporate governance in subsidiaries within a company group? What other governance mechanisms may be useful?

6. Critically evaluate the remuneration policies for senior management in the Keppel Group. To what extent do you believe that they contributed to the bribery scandal?

7. Keppel Corporation has a Group-wide whistleblowing policy in place, which has been implemented since at least the mid-2000s. Critically evaluate the whistleblowing policy. Why did the whistleblowing policy not work to help prevent the bribery scandal?

8. Did Keppel Corporation respond appropriately to the bribery scandal, starting from the time when allegations began to emerge? Explain. Do you believe that its disclosures throughout the whole saga comply with the continuous disclosure obligations for companies listed on the SGX and with best practice?

9. Were the measures taken by Keppel Corporation following the scandal, including actions against those involved and to reduce the risk of future occurrences, adequate? Explain.

10. Evaluate the effectiveness of Singapore's Prevention of Corruption Act (PCA), as well as foreign anti-corruption legislation, in fighting corruption. In addition, assess the response of the Singapore regulators and government to the scandal. Do you believe that they are appropriate? What further action, if any, do you believe should be taken?

11. It has been said that in certain industries and countries, bribes are a necessity in order to do business. Some countries do not enforce their anti-corruption laws which give an unfair advantage to their companies. Therefore, companies and individuals should not be punished for paying bribes if it is a common business practice. Do you agree with this? Explain.

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NEXT STOP FOR SMRT

Case overview

Prior to its first major breakdown in 2011, rail services offered by Singapore's SMRT Corporation Ltd (SMRT) were renowned for their reliability and efficiency. However, things have taken a turn for the worse since then. There had been an increase in frequency of train delays and disruptions, which sparked public criticism towards SMRT. Despite major leadership changes, major disruptions continued to occur, such as the Bishan tunnel flooding incident on 7 October 2017 and a train collision a month later, affecting commuters on a large scale. The objective of this case is to allow a discussion of issues such as internal controls and risk management; the roles of the management and the board in crisis management; and corporate culture.

About SMRT

SMRT is Singapore's premier multi-modal land transport provider. The company was incorporated on 6 March 2000[1] and listed on the Singapore Exchange (SGX) just four months later.[2] Its core businesses comprise rail operations, maintenance and engineering, as well as bus, taxi and automotive services.[3] SMRT Trains Ltd, a fully-owned subsidiary of SMRT Corporation Ltd, started its primary business of rail services on 7 November 1987. It currently operates three Mass Rapid Transit (MRT) systems – the North-South Line (NSL), East-West Line (EWL) and Circle Line, while its subsidiary, SMRT Light Rail Pte Ltd operates the Light Rapid Transit (LRT) system.[4]

This is the abridged version of a case prepared by Chen Qiyang, Liao Mei Ling, Lim Yen Mae, Ng Si Han and Tay Wee Loong Zephan 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 Jacqueline Lor under the supervision of Professor Mak Yuen Teen.

SMRT announced its delisting from SGX in 2016 to refocus on "serving the public, without the distractions of being a listed company".[5] As part of the change in focus, SMRT significantly increased its maintenance efforts, experiencing a plunge of 67.9% in its after-tax profits in 2017 as a result.[6]

A change of leadership

SMRT was under the leadership of Chief Executive Officer (CEO) Saw Phaik Hwa for a decade following her appointment in December 2002.[7] Prior to her stint in SMRT, Saw served as Regional President of luxury retailer DFS Ventures Singapore Pte Ltd between 1984 and 2002.[8]

SMRT experienced a major strategic change under Saw's leadership, turning towards retail business instead of merely focusing on the provision of public transport services. This was demonstrated in the diversification of SMRT's business. Saw re-developed MRT stations into transit retail spaces, such as Raffles Xchange in 2005[9] and Choa Chu Kang Xchange in 2008,[10] to earn rental revenue.[11] During this time, net profit for SMRT grew from S$56.8 million in 2002 to S$161.1 million in 2011, exemplifying the financial success of Saw's strategy.[12]

However, SMRT's emphasis placed on retail expansion led to criticism for neglecting its investment in rail operations and the maintenance of its rail services. Plans to revitalise its rail services did not gain traction until the major breakdowns which happened in 2011 set them into motion.[13]

The arrival of a new captain

In December 2011, Saw resigned after two major MRT breakdowns occurred. The senior management team of SMRT subsequently underwent a major change where the majority of them were replaced. Desmond Kuek, who was former Chief of Defence Force in the Singapore Armed Forces, was then appointed as the new Group CEO and President.[14,15] He then shifted the focus of SMRT back to rail operations.

Two key actions were undertaken by SMRT to improve rail services. Firstly, a holistic maintenance regime was set up in 2013 to implement a more rigorous maintenance schedule for the trains. Secondly, a technical advisory panel was also formed to consult international experts in rail networks to improve rail planning.[16]

Being at the helm of SMRT placed Kuek under considerable pressure. Therefore, the news of Kuek stepping down as CEO[17] came as no surprise to many when it was announced on 18 April 2018.[18] Neo Kian Hong was appointed as Kuek's successor on 1 August 2018. Neo is a senior civil servant and the former Chief of Defence Force in Singapore.[19]

The old board story

Prior to SMRT's delisting, the board had 10 directors with Koh Yong Guan as its Independent Chairman from July 2009 to October 2016. He was a former managing director of the Monetary Authority of Singapore.[20] Kuek and Tan Ek Kia were the only two non-independent directors while the remaining eight members of the board were independent directors.[21]

Most of the independent directors served on the board for less than nine years, apart from Koh and Bob Tan Beng Hai. They had served SMRT for nine and 10 years respectively until 2016. In SMRT's annual independent director review, the Nominating Committee confirmed their independence as they "demonstrated independent judgement".[22]

Many of the directors on the SMRT board held multiple directorships. SMRT decided that full-time directors could hold a maximum of four directorships while non-full-time directors could hold at most six directorships.[23] Half of the members of SMRT's board still held more than six directorships each. Amongst them, Tan Ek Kia and Bob Tan Beng Hai held 10 and 11 directorships respectively, although these included directorships in non-listed companies.[24]

SMRT's board had six committees in 2016.[25] The Audit Committee was made up of four directors, and its Chairman, Bob Tan Beng Hai, is a fellow of the Institute of Chartered Accountants in England and Wales. Other members of the Audit Committee had relevant accounting backgrounds as well.[26] The Board Safety Review Committee and the Board Risk Committee consisted of the same directors, namely Tan Ek Kia, Patrick Ang, Peter Tan Boon Heng and Yap Kim Wah. Tan Ek Kia, who had 30 years of experience in the oil and gas and petrochemical business, was the Chairman of both committees.[27]

Board shake up

Subsequent to the delisting of SMRT in October 2016, there was a change in the SMRT board. Seah Moon Ming took on the role of SMRT Chairman, replacing Koh.[28] While three directors left the board, seven new directors were appointed, bringing in new sets of skills and experiences.[29]

A series of unfortunate events

The deteriorating performance of SMRT's rail services could be observed in the increase in transport delays since 2011.[30] This was further exacerbated by ineffective communication of train delays to commuters.[31] There were instances where SMRT was criticised by the public for failing to utilise its social media sites and other official platforms to inform commuters about the train delays in a timely manner.[32]

Disappointment towards SMRT's rail services continued to grow as train disruptions occurred more frequently.[33] The first major breakdown on 15 December 2011 shook the country and a large proportion of the Singapore population was affected. Just two days later, train services were yet again disrupted on the NSL.[34]

As SMRT was looking to slowly regain public confidence with no major disruptions reported between 2012 and 2014, yet another major incident occurred on 7 July 2015 when intermittent power surges eventually brought down the entire NSL and EWL, affecting 413,000 passengers.[35] These two cross-island rail lines – which accounted for almost two-thirds of the daily MRT ridership – were affected by 22 out of the 37 major train breakdowns that occurred between 2015 and mid-2017. Furthermore, most disruptions occurred during peak hours, with 13 out of the 15 breakdowns in 2017 happening during either the morning or evening peak hours.[36] Such train disruptions occurred repeatedly despite a massive joint effort by SMRT and Singapore's Land Transport Authority (LTA) to utilise new trains, upgrade signalling systems, and replace worn out railway sleepers.[37]

During the major breakdowns, SMRT provided free bus rides to commuters between stations. The bus fares of affected commuters were waived and affected train fares were refunded. However, such breakdowns often caused chaos as commuters found themselves confused by conflicting instructions and directions provided by SMRT staff to alleviate the situations.[38]

Fatal accident on the tracks

On the morning of 22 March 2016, two SMRT maintenance staff were killed by an oncoming train between Pasir Ris and Tampines MRT stations while undergoing on-the-job training. Initially, SMRT offered minimal information other than the fact that they were part of a 15-man technical team which went onto the tracks to investigate a possible fault involving a signalling device on the tracks.[39]

SMRT engaged its accident review panel, which comprised members of the Risk Committee and independent experts to examine the possible causes of the accident.[40] It later emerged that there was a safety lapse during the inspection. SMRT admitted that the team had ignored safety procedures. SMRT's director of control operations, Teo Wee Kiat, who managed and approved all track access requests, was apparently aware that safety protocols were not followed on a regular basis but had chosen to ignore the situation.[41]

Following the accident, Teo took active steps to tighten the safety protocols governing track access during traffic hours. A new department was also set up to coordinate and oversee track access during non-traffic hours.[42] SMRT dismissed the driver of the train that hit the two trainees, as well as the engineer who led the team on the tracks that day,[43] drawing flak from the public as investigations were still ongoing at that time.[44] In response, SMRT's Vice President for corporate communications merely stated that they "do not comment on staff disciplinary measures".[45]

It never rains but it pours

In 2017, the Bishan tunnel flooding landed SMRT in the public spotlight again. The heavy downpour on 7 October 2017 had caused flood waters to rise to one metre high in the tunnel, disrupting train services between Ang Mo Kio and Toa Payoh stations.[46] Over 250,000 commuters were affected during this disruption, which lasted for more than 20 hours.[47] SMRT took action in working together with the Singapore Civil Defence Force (SCDF), National Water Agency and LTA to remove the huge amount of water in the tunnel overnight.[48]

After receiving reports from a train captain and a station manager regarding the sighting of flooding on the northbound tunnel tracks, the SMRT Operations Control Centre took immediate action in cutting off train services along affected tracks. The traction power was also cut off as a safety measure. SMRT transferred all commuters to the nearest station platforms half an hour after discovering the incident. Free public buses were provided along the affected area. Announcements on service disruption and information on bus bridging services were made in stations and on all traditional and online channels of SMRT, as well as on LTA's website.[49]

The severe consequences of the Bishan flooding incident led to an internal probe within SMRT. Investigations revealed that scheduled quarterly maintenance works for the last three quarters were not carried out. Even though maintenance records were signed and submitted, track access approvals were not issued for the corresponding period. Thirteen employees were found responsible after the investigations.[50] Former Vice President Tay Tien Seng and senior manager Ivan Kok were accused of providing insufficient oversight during the period when false pump maintenance documents were made.[51] The falsification of reports led to SMRT dismissing one senior executive, two managers, and five technical staff. Other management executives who were found responsible also faced disciplinary action.[52]

After the incident, SMRT set up a joint readiness inspection team that complemented the existing audit system, and worked independently from SMRT's Audit and Risk Committee. It also employed third-party professionals to raise the quality control standards, especially on all preventive maintenance operations.[53] Furthermore, it conducted a comprehensive analysis of all its important systems. SMRT also enhanced its training program to create a better work responsibility culture.[54] Lastly, SMRT outsourced its water pumps maintenance to an external system manufacturer, leaving SMRT staff to take on an oversight role.[55] It was hoped that such measures would be effective in enhancing the resilience of SMRT's systems and improving the corporate culture within SMRT.

Hitting the brakes: Joo Koon train collision

The peaceful morning of 15 November 2017 was interrupted when a moving train collided into the back of a stationary train at Joo Koon MRT station along the EWL, resulting in 36 injuries.[56]

The collision occurred early that day at 8.20am. SMRT had initially reported the incident as a "train fault" but, at around 11am, SCDF confirmed that there were injured passengers.[57] Later in the day, train services were suspended between Joo Koon and Tuas Link MRT stations to facilitate the recovery of the train.[58]

Based on the joint media briefing by SMRT and LTA on this issue, it was confirmed that the accident had been caused by the unexpected disabling of protective features on the train.[59]

Following the incident, arrangements were made to investigate the train collision. Between 16 and 19 November 2017, train services from Joo Koon to Tuas Link MRT stations were suspended, and free bridging bus services were provided along the disrupted line.[60] A decision was jointly made by SMRT and LTA to isolate the two different signalling systems "for about a month" until a solution to the switching of signalling systems was found.[61]

To accelerate the communications-based train control re-signalling project on the EWL as well as additional engineering works, the operating hours were shortened for sections of the EWL and NSL. This consisted of early closures, late openings and full day closures, with bridging bus services offered to commuters during periods of closure.[62]

SMRT's future

Ever since the first major train disruption in 2011, SMRT had been under intense public scrutiny, facing immense pressure to enhance its risk management and service standards. In view of the numerous train accidents and disruptions during his term of office, Kuek as SMRT's CEO undoubtedly bore the important responsibility of restoring public trust during his tenure. However, it remains to be seen if the appointment of Neo as the new CEO will improve SMRT's performance.

Discussion questions

1. Critically evaluate the board of directors and management of SMRT over the years.

2. What is the SMRT board's role with regards to risk management?

3. Evaluate the tone of SMRT's corporate culture. Further, discuss how such a corporate culture had impacted the risk culture of SMRT.

4. Discuss whether the board of directors and management should be held responsible for the behaviour of their staff when mishaps occur. Propose measures which the board of directors can take to rebuild SMRT's reputation as a world-class transport service provider.

5. Identify three potential risks of SMRT's business model and assess the likelihood and impact of the risks identified.

6. For each identifiable risk, suggest and elaborate on the relevant risk responses associated with the risk.

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SWISSCO HOLDINGS: THE STRUGGLE TO STAY AFLOAT

Case overview

Swissco Holdings Limited (Swissco), an offshore marine services provider, once showed promising growth, having expanded rapidly between 2011 and 2013. However, signs of trouble emerged in October 2016, when Swissco called for the refinancing and restructuring of bonds amounting to S$100 million. Swissco's shares were suspended from trading, and the company faced numerous lawsuits and demands from its creditors. After negotiations with its creditors reached a standstill, Swissco finally filed for interim judicial management, which was approved by a Singapore court. A white knight investor then offered US$28.5 million for the battered company's offshore support vessel business but the deal fell through as terms of the sale and purchase agreement were not satisfied. The objective of the case is to allow a discussion of issues such as risk management; the divergence of interest of shareholders and creditors; and the duties of directors in companies facing insolvency.

This is the abridged version of a case prepared by Linda, Maetini Soon Ruo Bing, Nguyen Cam Hong, Wang Keyi and Zhao Jiaqi under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Yeo Hui Yin Venetia under the supervision of Professor Mak Yuen Teen.

Swissco's beginnings

Swissco started out in the 1970s as a ship supplies company. Over the decades, it grew to become an international, integrated marine company that provides offshore and maritime services for the oil and gas, maritime infrastructure and shipping industries.[1] Headquartered in Singapore, Swissco was listed on the Singapore Exchange (SGX) Catalist Board in 2004 as Swissco International Limited. In 2010, after being acquired by C2O Holdings Limited (C2O), which was also listed on the Catalist Board, C2O was renamed Swissco Holdings Limited. Subsequently, in January 2013, Swissco transferred its listing to the SGX Main Board.[2]

Swissco's business comprised of three main divisions: drilling division, service assets division and offshore support vessels (OSV) division. Swissco's services include the provision of drilling rigs, accommodation jackups and vessel chartering services in the oil and gas industry.[3]

Swissco sails into rough waters

Back in 2008, Swissco had incurred the displeasure of SGX and its shareholders over concerns about its disclosures and corporate governance.[4]

On 13 March 2008, two independent directors had resigned. In the announcements, the company stated that the reason was due to "differences of opinion with the board".[5] Over the course of three weeks, Swissco disclosed facts in a piecemeal manner, providing clarifications only when urged to. The true reasons behind the resignations of independent directors Chiang Hai Ding and Rohan Kamis were only revealed on 31 March 2008.[6] Resignation letters from the two directors were released, presumably at the direction of SGX, along with Swissco's clarification. The resignation letters brought to light a different perspective. One of the directors mentioned outstanding matters that he had pushed for, relating to the appointment of an experienced and competent Chief Financial Officer (CFO) and a change in the formula for determining the annual bonus for the chairman in the new service agreement. The letters alleged that the then-Executive Chairman, Yeo Chong Lin, who was also a major shareholder, had intended to appoint independent directors for one-year terms, and their renewals at the end of each year would be subjected to his evaluation of their performance, at his discretion. This was contrary to Swissco's statement that the one-year appointments were for the purpose of board renewal and were simply a transitional measure.[7]

Less than a month later, Swissco came under fire for yet another disclosure. On 1 April 2008, Swissco announced the grant of 550,000 share options to its employees and directors. However, this came two weeks after the options were granted on 15 March 2008, breaching SGX's listing rule. Based on SGX's Listing Rule 704(27), which came into effect in December 2007, listed companies must announce the grant of options on the date that they are offered. A day later, Swissco clarified that the validity period of the options began on 15 March 2009, as they had been granted at market price and would have a minimum vesting period of a year.[8]

With commentaries urging SGX to take action against Swissco, SGX issued a reprimand on 23 April 2008, stating that Swissco's disclosures "fall short of required standards". Stating that Swissco had contravened disclosure standards and listing rules, it directed Swissco to appoint a compliance advisor to advise it on its continuing listing and disclosure obligations.[9]

This corporate governance storm was perhaps an early warning signal of Swissco's journey into troubled waters a few years later.

The new captain and his crew

As at 31 December 2015, Swissco's board of directors comprised three independent directors and three executive directors with a diverse set of skills and experience.[10]

The lead independent director and Chairman, Lim How Teck, who joined the board in 2010 as an independent director, was appointed Chairman in 2015. He has extensive knowledge and experience within the shipping industry, having been with Neptune Orient Lines, a provider of container shipping and logistics services, from 1979 to 2005. During his term at Swissco, Lim How Teck held a number of directorships outside the company.[11] At the time of his eventual resignation from Swissco in May 2017, he sat on the boards of eight companies and four not-for-profit companies.[12]

Prior to his appointment as Swissco's Chief Executive Officer (CEO), [13] Tan Fuh Gih was a non-executive director on the company's board in 2013.[14] From 2014, he served as an executive director of Swissco, concurrently holding the position as Chairman of the board for four months in 2014. He has extensive experience in the oil and gas industry as well, having worked in KS Energy Group from 1985 to 2009.[15]

A tangle of related companies

KS Energy, a provider of oilfield supply and services,[16] was founded by Tan Fuh Gih's brother, Tan Kim Seng.[17] Tan Kim Seng and his family control Kim Seng Holdings Pte Ltd, which held a 5.85% stake in Swissco Holdings.[18]

Kim Seng Holdings Pte Ltd held a majority stake in Scott and English Energy Pte Ltd (S&E) – a Singapore-incorporated company in the business of owning and leasing mobile offshore drilling units and service rigs to oil and gas companies – through one of its wholly-owned subsidiaries[19] before it was subsequently acquired by Swissco.[20] Furthermore, Tan Fuh Gih and his other brother, Tan Wei Min, the Chief Marketing Officer of Swissco's drilling division, each owned 14.35% and 12.38% of Swissco respectively as at 18 March 2016. Other members of the Tan family were also part of the 20 largest shareholders of Swissco.[21] Due to their significant aggregate shareholdings, Tan Fuh Gih and his family were controlling shareholders of Swissco.

Too much oil?

The offshore and marine industry was greatly affected by the oil price crash in 2014, which continued until 2016. The global benchmark for oil prices, Brent Crude, fell to a 12-year low of under US$28 per barrel in January 2016.[22] The International Energy Agency warned of the severity of the crisis, stating that the oil market could "drown in oversupply".[23]

Many offshore and marine companies worldwide faced years of financial difficulty and even insolvency, as they were mostly service support providers that depended on the oil majors' upstream activities.[24] Swissco was not an exception.

In response to the crisis, many banks began to lower their exposure to the oil and gas industry in early 2015. This made it difficult for offshore and marine companies to raise new funds from debt and capital markets. Many of these companies had large outstanding debt obligations which originated from the period of prosperity when oil prices were above US$100 per barrel. When oil prices remained depressed for longer than expected and orders within the industry declined, many offshore and marine companies were unable to meet their debt obligations and thus faced the threat of liquidation.[25]

In Singapore, the offshore and marine industry also experienced a slump. Large players in the industry announced declining profits,[26] with some going into provisional liquidation and judicial management.[27] In a number of cases, auditors expressed concerns over companies as going concerns.[28]

A new venture

In February 2014, Swissco proposed to acquire S&E for S$285 million as part of its upstream expansion into the offshore rig chartering business. S&E was of a similar size to Swissco.[29]

Swissco's management was optimistic about this major acquisition as they had expected that the "robust momentum in offshore oil and gas sector" would provide Swissco with stable and recurring income.[30] At the time, oil was valued at around US$110 per barrel and the oil industry had enjoyed about five years of stability in oil pricing.[31] Diversification into the oil industry was considered a sound choice by Swissco's board of directors since the market demand for oil had been stable and Swissco was already equipped with vessels.[32]

Four months later, on 27 June 2014, Swissco received the SGX's approval for the proposed acquisition.[33] At that point, oil was still valued at more than US$110 per barrel. On 22 July 2014, Swissco successfully obtained the green light from shareholders for the substantial acquisition,[34] and on 30 July 2014, it acquired 100% of S&E via a reverse takeover.[35]

In order to build its capital base to support its expansion plans, Swissco relied on debt financing. On 24 September 2014, it established a S$300 million Multicurrency Medium Term Note (MTN) Programme. This programme allowed the company to issue bonds more easily.[36]

On 1 October 2014, Swissco announced the acquisition of four mobile offshore drilling units, furthering its expansion upstream.[37] About a week later, the board announced that it had priced S$100,000,000 5.7% notes due in 2018 to be issued under the MTN Programme.[38] This was despite the fact that oil prices had started falling since September that year. As of October 2014, oil prices had dropped by approximately 20% within the previous five months[39] and was about US$90 per barrel.[40]

However, depressed oil prices did not hinder Swissco's expansion plans. In addition to the MTN Programme, it also issued Redeemable Exchangeable Preference Shares (REPS) via its subsidiaries S&E Offshore Investments Pte Ltd and S&E Offshore Investments 2 Pte Ltd, which allowed option holders to exchange the REPS of certain subsidiaries into ordinary shares of the company based on a specified exchange ratio.[41] On 6 November 2014, Swissco announced that the net proceeds from the issuance were used to acquire two more mobile offshore drilling units.[42] At this point, oil prices had further dropped to US$80 per barrel and the downward trend of oil prices showed no sign of abating.[43]

Although oil prices continued to fall in 2015, the board pressed on with its decision to operate its new service assets division. Swissco's board rationalised that amidst the declining oil prices, "oil majors may look into servicing and maintaining their assets during periods of low activity".[44] However, the new division had incurred additional costs from the construction of accommodation rigs and a liftboat that was due for delivery in 2016.[45]

Storm clouds looming

Swissco's first sign of trouble came on 4 October 2016, when the company announced that it was seeking to restructure bonds worth S$100 million,[46] including a S$2.85 million coupon payment due on 16 October 2016.[47] Even though Swissco's bonds would only mature in April 2018, the early call for restructuring suggested difficulties in rolling over short-term debt and also raised doubts about Swissco's cash flows. This announcement took investors by surprise as there was no prior indication that the company was facing any significant financial difficulties. In fact, just a few months earlier in April 2016, Swissco had announced plans to acquire VM Marine International Pte Ltd. However, the acquisition fell through in August 2016. A credit research analyst from OCBC Bank, Nick Wong, commented that "The announcement... at this point in time comes as a surprise to us. Debt restructuring is usually the last resort taken only when other avenues have been considered."[48]

Meanwhile, Swissco appointed accounting firm Ernst & Young Solutions LLP (EY) to advise on the refinancing and restructuring of the notes. In its announcement, Swissco stated that "the refinancing plan is to allow the company to have an optimised debt structure, with sufficient time to manage its liabilities and growth in the present industry conditions." Swissco was also reportedly undergoing discussions with its bank lenders and REPS holders regarding its refinancing plan, as the interest payment date for the notes was approaching. Subsequently, Swissco called for an informal meeting with its noteholders on 10 October 2016.[49] Just hours before the meeting, Swissco called for a trading halt.[50] Its stock price fell by 3.7% or 0.2 cents to close at 5.2 cents prior to the halt.[51]

The main purpose of the first noteholders' meeting was for Swissco to seek cooperation and support from its noteholders. During the meeting, the company highlighted its tight liquidity position and informed the noteholders that it would not be able to pay the interest payment due on 16 October 2016. Swissco also invited noteholders to form an informal Steering Committee that would work closely with Swissco and EY to develop a mutually agreeable restructuring plan with all stakeholders.[52]

However, Swissco's management was criticised for not having a detailed and concrete debt restructuring plan. The attendees reportedly grew frustrated as management mulled over the questions raised during the meeting. EY partner Angela Ee, who was advising on the debt restructuring, said at the meeting, "Ideally, we would have liked to come to this meeting with a plan, but it's an issue of time."[53]

Caught in the storm

A second noteholders' meeting was held about a week later, during which Swissco proposed a comprehensive debt restructuring plan. As part of the plan, Swissco planned to sell its idle oil rigs and reduce its OSV fleet. Swissco also proposed to convert its MTN and REPS to equity. The management explained that the debt to equity conversion was to allow noteholders to share in the upside as the oil and gas sector recovered and improved. The management also urged the noteholders to support further discussions on the proposed plan as it would prevent liquidation and preserve value for all stakeholders. They cautioned that if the noteholders did not support the restructuring, insolvency would most likely occur, resulting in Swissco either having to file for judicial management or undergo liquidation.[54]

However, tensions rose during the meeting as there was a clash between Swissco's management and noteholders. While the board and management attempted to urge noteholders to swap S$64 million in principal for equity, noteholders expressed their frustration. At one point, some noteholders served a notice to the board demanding immediate payment. In response, Chairman Lim How Teck raised his voice, declaring, "I just simply cannot understand that before you hear a restructuring plan, you jump the gun by saying 'I don't care what the hell you guys do, I want to kill the duck'. If that is the thinking and if all of you agree to just shoot the duck, you'll get absolutely nothing." Noteholders also expressed dissatisfaction with the board's decision to initiate negotiation only six days before the bond coupon was due. As such, the company's poor cash flow planning became the focus of the meeting.[55]

During the meeting, the board also offered to draw director's fees of one dollar a year until Swissco turned profitable, to support its turnaround. However, a noteholder pointed out that the director fees had increased more than five-fold from FY2014 to FY2015.[56]

As the sequence of events unfolded, Swissco received various lawsuits and demands from its creditors. On 17 November 2016, Swissco announced that it had received two letters dated 10 November 2016 from some holders of the REPS, alleging a breach of joint venture agreements and demanding payment including a redemption premium. Swissco also announced that it received three statutory demands from S&E's joint venture partner, Ezion Investments Pte Ltd (Ezion), on 9 and 10 November 2016, claiming that Ezion was owed sums for corporate guarantee fees. Swissco announced that it was seeking legal advice for both claims.[57]

Stronger winds ahead

Negotiations over Swissco's financial restructuring came to an impasse when its main lenders rejected the plan. Left with no other option, Swissco announced its intention to file for judicial management on 14 November 2016.[58] Under judicial management, Swissco's businesses and properties would be managed by a court-appointed judicial manager, whose responsibility was to rehabilitate the company.[59]

On 21 November 2016, Swissco filed for itself and its wholly owned subsidiary, Swissco Offshore Pte Ltd, to be placed under judicial management.[60] After being initially placed under interim judicial management, the court finally approved the application on 21 April 2017, after a five-month wait.[61]

On 11 May 2017, following the judicial management order, Chairman Lim How Teck, as well as two other independent directors, resigned from Swissco's board.[62,63,64] Less than a month later, the Group CFO tendered her resignation in order to pursue other career opportunities.[65]

In order to repay its debt obligations, the judicial managers found buyers for five of Swissco's vessels for US$11.2 million. They explained that the disposals would be "a more advantageous realisation of the group's assets than would be effected by a winding up" and would help with Swissco's cash flow problems.[66]

However, on 14 August 2017, the judicial managers announced the provisional liquidation of S&E, after the board of directors of S&E had made a statutory declaration that the entity could no longer continue the business due to failure to meet its liabilities.[67] Resolutions were passed for S&E to be placed under creditors' voluntary winding-up during the Extraordinary General Meeting on 23 August 2017.[68]

The sinking vessel

On 20 September 2017, the judicial managers announced the disposal of a substantial part of Swissco's OSV division to a white knight investor, Asian Strategic Turnaround Ventures Pte Ltd (ASTV), for US$28.5 million. ASTV also agreed to provide a US$4 million loan to Swissco Offshore to discharge part of its mortgages.[69] However, despite high hopes with SGX granting a waiver of shareholders' approval for the disposal,[70] the judicial managers announced on 3 August 2018 that the agreement fell through as the terms of the sale and purchase agreement were not satisfied.[71] Meanwhile, several subsidiaries of S&E underwent creditors' voluntary liquidations.[72,73]

On 8 May 2018, the Singapore High Court granted Swissco Holdings an extension of its judicial management order to 18 March 2019.[74] As Swissco continues its struggle with its huge liabilities, the fate of the embattled company remains uncertain.

Discussion questions

1. Tan Fuh Gih was the controlling shareholder, CEO and executive director of Swissco. Comment on the advantages and disadvantages of such an arrangement.

2. Comment on the multiple directorships held by former Swissco Chairman Lim How Teck. What are the risks of multiple directorships and do you think it could be a contributing factor to the problems faced by Swissco? Explain.

3. Do you think Swissco adequately considered the risks involved with its ambitious expansion plan? Identify the main potential risks that Swissco faced and assess the likelihood and impact of the risks identified.

4. What is the role of the board of directors with regards to risk management? Did the Swissco board carry out its duties with regards to risk management adequately? Consider its decision-making in light of the circumstances faced by the company, such as the state of the oil industry.

5. Do you think the board of directors could have reconciled the difference in interest of the shareholders and creditors better? Do you agree with the board's decision to apply for judicial management?

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TREKKING IN THE WRONG DIRECTION

Case overview

Most well-known for its invention of the ThumbDrive, Trek 2000 International Limited (Trek 2000) is a technology company listed on the Singapore Exchange (SGX). In February 2016, the company announced that the Audit Committee (AC) had discovered certain interested party transactions between the company and T-Data Systems (S) Pte Ltd (T-Data). T-Data's director and initial sole shareholder was the spouse of an executive director of Trek 2000, with Trek 2000's Chairman's son later becoming a major shareholder of T-Data for over a year. Subsequently, other discrepancies relating to Trek 2000's accounts surfaced. Regulatory actions followed and there was considerable turmoil at the board and management levels. The objective of this case is to allow a discussion of issues such as the tone at the top; structure and composition of the board of directors; role of independent directors; internal controls; related party transactions; and succession and corporate governance challenges in founder-controlled and managed companies.

This is the abridged version of a case prepared by Andrea Chan Wen-Lynn, Claudius Kenny, Raffles Ng Phor Chuan, Seng Jia Wei and Zhang Xin Yan 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 and Yeo Hui Yin Venetia under the supervision of Professor Mak Yuen Teen.

Trekking down memory lane

Trek 2000 had humble beginnings as a family-owned electronics business, and was revitalised when the current Chief Executive Officer (CEO) and Chairman, Henn Tan, bought it over in 1995.[1] His vision was to utilise Trek 2000's resources to provide customised engineering solutions to companies. He explored ways to utilise the USB interface to create a device that could replace the floppy disk, eventually leading to the development of the ubiquitous ThumbDrive.[2]

In 2000, Trek 2000's ThumbDrive was launched at the CeBIT international trade fair in Hanover, Germany. Trek 2000 garnered an overwhelming response with its technological breakthrough and gained international recognition. The company grew from a five-men assembly to a global enterprise with offices in over ten countries and having big-name multinational corporations such as Toshiba as its clients.[3]

Trek's shareholders

Trek 2000 has several substantial shareholders. As of 17 March 2015, Henn Tan had direct and deemed interests of 33.95%, Toshiba Corporation had 17.74%, and Creative Technology had 9.26%.[4] On 3 August 2015, Osim International became a substantial shareholder.[5] As of 16 March 2018, Henn Tan had total interests of 31.46%, Toshiba Corporation had 16.32%, Creative Technology had 8.52%, and Ron Sim, founder of Osim International, had 8.79% after Osim International sold its entire stake to him.[6]

Trek's board

As at 31 December 2015, there were eight directors on the board of Trek 2000. Half of them were executive directors, while the other half were non-executive and independent directors. Henn Tan was the Chairman and CEO. Gurcharan Singh, a director since Trek 2000's public listing in 2000, was the Chief Financial Officer (CFO). Other executive directors included Dr Edwin Long and Poo Teng Pin.

Khor Peng Soon was the lead independent director, a member of the Nominating Committee (NC) and the AC, as well as the Chairman of both the Risk Review Committee (RRC) and Remuneration Committee (RC).[7] His educational background lies in engineering and he had experience in the industry. He was a director of Plastoform Holdings Limited,[8] another publicly listed company engaged in manufacturing, research and development of products and solutions of wireless audio systems, mobile applications and Internet of Things.[9] Concurrently, he was the Chairman of ONI Global Pte. Ltd., managing director of JP Ying Advisory and the executive director of Reborne Pte Ltd, giving him a range of experience extending beyond the technology sector to the health and consulting industries. Previously, he had held senior management positions in organisations such as Temasek Holdings, SembCorp Industries, Ernst & Young (EY) and the Economic Development Board.[10]

Other independent, non-executive directors included Francis Heng, Ng Chong Khim and Celine Cha.[11] Francis Heng, a business graduate, had substantial experience in the banking and finance sector, having previously worked at JP Morgan, the Monetary Authority of Singapore and United Overseas Bank. Additionally, he was previously the CFO of firms such as ST Engineering and SingTel. Ng Chong Khim's background lies in management and engineering, having held senior management positions in firms such as ST Electronics and Telecom Equipment, a subsidiary of Singtel. He also served in the Ministry of Defence for nine years, in communication systems development and management services.[12] Celine Cha, who holds an Advanced Diploma in Marketing, was concurrently the Project Director, Merger & Acquisition of OSIM International Ltd, a substantial shareholder of Trek 2000, and had worked there for over 20 years, with experience in development and design of products, and global purchase and shipping operations.[13]

The AC was chaired by Francis Heng, who had been AC Chairman since 19 April 2013, with the other members being Khor Peng Soon and Ng Chong Khim.[14,15]

Off the beaten track

Trek 2000 had been in the black since its public listing in 2000 until 2012, when an unforeseen impairment of intangible assets amounting to US$4.1 million contributed to the Group's first net loss.[16]

On 25 February 2016, Trek 2000's board announced that its AC had uncovered undisclosed interested person transactions (IPTs) between the company and T-Data over the period from 27 November 2007 to 26 March 2014.[17] The interested parties included Loo Soo Hooi – the spouse of then-executive director, Poo Teng Pin, who had since resigned. She was the sole shareholder of T-Data from 27 November 2007 to 18 September 2012. Henn Tan, Trek 2000's Chairman and CEO, also had related persons connected to the undisclosed transactions with T-Data. His son, Tan Joon Yong Wayne's stake in T-Data exceeded 30% from 18 September 2012 to 26 March 2014. The elder Tan's nephew, Tan Chun Chieh Edwin, and niece, Tan Ai Ching, were also shareholders of T-Data. In the same announcement, the board assured shareholders of its commitment to uphold high corporate governance standards and disclosed that it had provisionally appointed Allen & Gledhill LLP to conduct an independent inquiry and review of compliance with legal and regulatory obligations.[18]

Discrepancies in disclosures

The investigations arose because of discrepancies in IPT disclosures. In the company's FY2014 Annual Report, no IPTs had been declared and the shares held by related parties in T-Data had not been mentioned.[19] However, related parties were in the picture. The first of two discreet indications of related parties was the mention that the remuneration of Tan Joon Yong, Wayne, Tan Boon Tat and Tan Boon Siong – all of whom were immediate family members of Henn Tan – exceeded S$50,000 during the FY2014. The only other fact disclosed was that "only Henn Tan was deemed to be interested in shares held by the Company in its subsidiaries according to Section 7 of Singapore Companies Act, where his deemed interest was held through 820,000 shares held by his wife, Ang Poh Tee".[20]

Potential non-compliance with SGX listing rules, especially in terms of IPT disclosures, was a cause of concern for Trek 2000's AC. Under Rule 904(5) of the SGX Rulebook, an interested person transaction is defined as a "transaction between an entity at risk and an interested person". Further, Rule 905 in the SGX Listing Rules states that an "immediate announcement of any IPT of a value equal to or more than, three percent of the group's latest audited net tangible assets" is required. Based on Trek 2000's FY2015 Annual Report, the transactions with T-Data in the FY2014 and FY2015 amounted to values greater than three percent of the audited net tangible assets for each year.[21]

Tracking the transactions

On 28 February 2016, the Group issued a profit warning advising that a net loss was expected for the fourth quarter of 2015 and FY2015 as a whole. This warning was issued following the review of the Group's unaudited financial results for those periods by the independent external auditor, EY.[22] Trek 2000's share price fell sharply by 21% from S$0.25 to S$0.197 within a week.[23]

On 1 March at 12.14 am, the company released an announcement dated 29 February disclosing that it was in the process of applying for an extension of time to release its annual financial results, which was due on 29 February. It said that EY had informed the board that further audit work needed to be carried out due to certain documentation deficiencies.[24] On 14 March, more details came to light as Trek 2000 released a further announcement elaborating that the documentation deficiencies were associated with transactions between a subsidiary of Trek 2000 and a customer. These transactions amounted to approximately US$3.2 million of sales. It explained that additional audit work involves, inter alia, further examination of accounting records and sales documentation relating to the identification of the customer of the mentioned sales transactions, as reflected in the sales systems and books; the acknowledgement of the customer in the delivery orders and the related airway bills for the shipment of goods; and the identity of the payor reflected in certain bank transfer notices showing payments worth approximately US$2.65 million. EY raised concerns over the source and origins of the bank transfer notices received by the Group.[25] SGX granted the application, extending the deadline by two months until 29 April.[26] The market reacted instantaneously to the red flags, marking the start of a 10-day continuous stock price dive from S$0.182 to S$0.166.[27]

On 7 April, Trek 2000 gave an update on the appointment of professional advisers to carry out the IPT inquiry – it had engaged TSMP Law Corporation (TSMP) to review the IPT transactions and TSMP was required to report to the AC.[28]

Auditors take matters into their own hands

On 21 April 2016, EY announced that it had lodged a report with the Accounting and Corporate Regulatory Authority (ACRA), under Section 207(9) of the Companies Act, regarding "matters that have come to the auditors' attention in the course of their audit".[29] In response, Trek 2000 immediately called for a trading halt on its shares,[30] which were then trading at S$0.186.[31] Five days later, the company requested for the voluntary suspension of the trading of its shares.[32]

Regulators step in

While investigations were being conducted by the law and accounting firms on the company's transactions, some of the directors became the subject matter of investigations by the Commercial Affairs Department (CAD).

In May 2016, Trek 2000's CFO and executive director, Gurcharan Singh, was asked to assist in investigations of a potential offence under the Penal Code (Chapter 224), pursuant to the provisions of the Criminal Procedure Code (Chapter 68).[33] On 25 May 2016, he was interviewed about the company's documents and information over the period from 2011 to 2015. In particular, the CAD scrutinised transactions relating to the Taiwanese manufacturing firm, Unimicron Technology, and Indian sign manufacturer, Colite Technology.[34] Trek 2000 had a joint venture with Unimicron Technology through UniMemory Technology (S) Pte Ltd, in which Trek 2000 had a 70% stake.[35] Poo Teng Pin was also interviewed by CAD. A week later, on 30 May, Henn Tan was also subjected to CAD interviews as part of its investigation proceedings.[36]

More delays

On 26 May 2016, SGX approved an additional time extension application from Trek 2000, allowing the company to announce its FY2015 financial statements by 30 June and to convene its Annual General Meeting (AGM) for the FY2015 by 19 August. The time extension was sought to allow sufficient time for TSMP to complete the IPT inquiry, and subsequently for EY to consider the inquiry report as part of the latter's audit procedures.[37]

On 8 June, TSMP presented its initial findings to the AC. It highlighted that an IPT inquiry would only be complete with the review of information on previous transactions of the Group as well. This would require the expertise of a forensic accounting firm to conduct an evaluation of past transactions.[38] Subsequently, Trek 2000 appointed RSM Corporate Advisory Pte. Ltd. (RSM) to conduct independent investigations with an expanded scope of engagement, which included a review of suspicious transactions and internal controls.[39]

In order to allow RSM to conduct its further investigations, a third application to delay the announcement of financial statements for the FY2015 was filed with SGX on 30 June.[40] Eventually, Trek 2000's unaudited financial results for the FY2015 were released on 18 July.[41] Trek 2000's audited financial statements for FY2015 were finally published on 21 September – nearly seven months after the first extension application filed with the SGX.[42] EY issued a disclaimer of opinion and identified a number of significant issues. Firstly, an externally conducted review by professional firms indicated inconsistencies in accounting records associated with IPTs. Secondly, there was insufficient information and evidence to confirm the carrying values of certain assets. EY was therefore unable to gather sufficient and appropriate audit evidence on these significant issues.[43]

On 25 February 2017, Trek 2000 once again applied for a time extension to announce its financial statements for FY2016. The company explained that its external auditors needed more time to audit the financial statements of Racer Technology Pte Ltd (Racer Technology), a subsidiary of Trek 2000.[44]

On 13 March, Trek 2000 announced that a sale and purchase agreement had been entered into with Koh Kee Joo Willy, for the company's 19% stake in Racer Technology. Koh is the CEO of Racer Technology.[45] Two weeks later, on 28 March, Trek 2000 released its financial statements for FY2016, reporting a record US$165.7 million revenue and US$6.1 million in net profit.[46] About a week later, Trek 2000 announced its application for an extension of two months, from 30 April 2017 to 30 June 2017, to convene its AGM. It stated that the auditors required more time to finalise the audit of its former subsidiary, Racer Technology.[47] While SGX gave its approval,[48] ACRA rejected its application and advised Trek 2000 to hold the AGM as soon as possible.[49] Trek 2000 eventually held its AGM and EGM on 29 June 2017.[50,51]

Board and senior management changes

Since the discovery of the IPTs and other questionable transactions, there has been a number of changes to Trek 2000's board and senior management.

On 22 March 2016, two independent directors – Francis Heng and Ng Chong Khim – resigned. Heng's resignation cited "bringing forward pre-planned board retirement" and "to facilitate personal work commitments",[52] while Ng's resignation cited personal reasons arising from "increased family commitment to attend a close family member's care from a recent accident".[53] Succeeding Heng as Chairman of the AC and Ng as Chairman of the NC was Chay Yee Meng, who was appointed non-executive and independent director.[54] Chay was previously an independent, non-executive director of Trek 2000 from 22 March 2001 to 19 April 2013.[55]

On 2 June 2016, there was another series of changes. Gurcharan Singh, the CFO and executive director who had headed the company's finance team since the its listing in 2000, resigned in the midst of the CAD's investigation.[56] According to a SGX filing, the reason for his resignation was "retirement".[57] At the same time, Dr Edwin Long was appointed deputy CEO, in addition to his position as executive director, while Edward Tan was appointed finance director.[58] The board was quick to quell concerns of conflict of interest arising from Dr Long's directorship at a subsidiary of Trek 2000's competitor, stating that Trek 2000 was primarily engaged in the research and development and sales of data storage products and internet-of-things products while the subsidiary of the competitor was primarily engaged in the distribution of information technology products in Thailand. It added that Dr Long had tendered his resignation from the competitor and would continue to abstain from related discussions and decisions.[59]

Following the release of Trek 2000's unaudited financial results for FY2015, further board resignations followed. Executive director Poo Teng Pin, who started his appointment on 24 May 2006, resigned from his directorship with effect from 12 July 2016 and moved to Unimemory Technology (S) Pte. Ltd., a subsidiary of Trek 2000.[60] On 23 July 2016, Edward Tan resigned as Finance Director "to pursue other personal interest", following his short stint of less than two months.[61]

The new financial year ushered in new developments with more resignations and appointments. Tan Kuok Keng, who was appointed CFO on 5 January 2017, resigned to pursue other career opportunities in late July 2017.[62] Chan Leng Wai, who joined the board as non-executive and independent director on 3 June 2016, did not offer himself for re-election and retired at the AGM held on 29 June 2017.[63] Two new independent non-executive directors holding directorships at other companies in the technology sector were appointed during the year – Loh Yih on 31 May 2017[64] and Neo Ghim Kiong on 24 July 2017.[65] The latter had previously been issued a letter of warning by CAD for non-compliance with the Companies Act in relation to his involvement in the granting of a staff loan to a director of a subsidiary of a SGX-listed company without prior shareholders' approval, in his capacity as the then-CEO of that company.[66]

Unwavering support for CEO

Despite questions surrounding Henn Tan's involvement in the IPTs, the last AGM held on 29 June 2017 saw strong endorsement for his continuing appointment as a director, with a resounding 98.74% supporting his re-election.[67] Excluding shares held by Henn Tan himself, 87.8% of the votes were cast in favour of his re-election.[68]

The NC and board also expressed unanimous support for Henn Tan, with assessments by both the previous NC before the reconstitution of the board and the current NC deeming him suitable as a director. They credited Henn Tan for his transformation of Trek 2000 into a leading external storage solutions provider, as well as expanding its range of patented products and solutions globally. Additionally, they highlighted a letter of representation from Henn Tan's solicitors to the NC, which asserted that he did not have any intention to defraud anyone in undertaking the IPTs and had wished to act in the best interest of Trek 2000. Other key considerations included his dedication towards Trek 2000 and its shareholders, his experience, the strong support from shareholders for his re-election at the last AGM and his position as the largest shareholder. This was despite Henn Tan's alleged involvement in the questionable transactions and potential breaches of laws and regulations.[69] RSM's IPT Inquiry Report had shed light on potential breaches of fiduciary duties by Henn Tan, Gurcharan Singh and Poo Teng Pin. The report also highlighted possible liability on Henn Tan's part in relation to profits made by T-Data and S-Com Solutions (Hong Kong) (S-Com HK), which Trek 2000 had IPTs with, as well as compensation to Trek 2000 for losses from transactions with both companies.[70]

In light of the ongoing investigations, the NC added a caveat to its assessment of Henn Tan's suitability, stating that it would re-evaluate its assessment based on findings after the completion of investigations.[71]

Back on Trek?

Trek 2000 implemented internal control procedures recommended by Deloitte and Touche Enterprise Risk Services Pte Ltd, which was engaged in 2016 to review business processes and advise on improvements of policies and procedures.[72]

On 8 September 2017, Trek 2000 announced its intention to resume trading on 11 September, more than a year after opting for a voluntary trading suspension. With ongoing investigations and potential breaches by CEO and Chairman Henn Tan, as well as former executive directors Poo Teng Pin and Gurcharan Singh, Trek 2000 stated that the trio would observe a moratorium on the trading of their shares until the Phase 2 Review by RSM has been published.[73] Its highly anticipated return to the market[74] was met with a flurry of activity – with its share price going up by 29% and 2.5 million shares traded just four hours after it commenced trading.[75]

Since its voluntary suspension, Trek 2000 has turned around from a net loss in 2015 to a net profit position in 2016, with recovery spurred by improvements in revenue and cost control measures.[76]

Trekking towards the truth

A year after its appointment as the forensic accountants responsible for reviewing Trek 2000s IPTs, RSM submitted its IPT Inquiry Report to SGX and the board.[77] The report analysed IPTs involving T-Data and S-Com. Actual and potential breaches of SGX Listing Rules were also detailed in the report.[78]

A later update was made through an announcement on 8 September 2017, containing a brief outline of RSM's Phase 2 Review, which involved the review of suspicious transactions in line with its previous report and CAD investigations, as well as Trek 2000's preliminary quantification of the possible exposure and financial impact.[79]

The release of RSM's final report to the AC of Trek 2000 on suspicious transactions on 23 April 2018 however, threatens to place a dent in Trek 2000's road to recovery. The report, which uncovered a host of issues, utilised the Maxwellisation process whereby involved parties had the opportunity to read the applicable parts of the draft report and respond to findings. This applied to Henn Tan, Gurcharan Singh, Poo Teng Pin and Foo Kok Wah, the President of operations, sales and customised solutions division. However, the report presented doubts over the Maxwellisation responses, due to incoherence, contradicting evidence or inability to find corroborating evidence.[80]

The following issues, which have significant financial impact and involve potential breaches of the law and regulations, were identified:

- Round-tripping transactions involving T-Data and S-Com HK that caused “the overstatements of revenue and assets by US$803,631.15, overstatement of costs of sales and liabilities of US$674,977.80, and overstatement of profits and retained earnings of US$128,653.25 between FY2010 and FY2014”;

- Questionable transactions with two Party B entities, including suspected fabricated transactions and invoices, with purported sales amounting to nearly US$9 million and purported purchases totalling nearly US$2.5 million;

- Suspicious transactions with Colite Technology, including absence of the basis of a sale transaction amounting to US$3,200,000 and evidence of receipt of goods, as well as fabricated or altered documents, such as digitally altered bank advices totalling US$2,650,000, with the likely intention to mislead auditors or others;

- Lack of sufficient care and diligence in the recording of eSD inventories resulting in improper and inaccurate reflection of the value and stock quantity of Trek 2000’s inventory;

- Payments to Key Asic for purported purchases that Key Asic did not issue invoices for, as well as potentially false claims under the Productivity and Innovation Credit Scheme and tax deductions for research and development expenses relating to those purported purchases;

- Digitally altered and fabricated invoices and credit notes with Party C entities along with manipulation of accounting entries and classification, as well as fictitious records of intangible assets to boost Trek 2000’s financials and potential overclaim of GST input tax; and

- 19 FluCard patents erroneously registered under T-Data instead of Trek 2000, which should have been the patent owner.[81]

Further regulatory action and board and management changes

Board and management changes did not stop. On 16 March 2018, Professor Lee Chuen Neng, who has experience in the healthcare and medical engineering industries but no experience as a listed company director, was appointed independent non-executive director.[82] On 26 March, Dr Edwin Long resigned as deputy CEO to pursue other interests and indicated his desire not to seek re-election in the upcoming AGM.[83] Kuan Mun Kwong was appointed executive director on 10 April, taking charge of internal control and strategic business development. He had worked in Trek 2000 since 1999 in areas such as global marketing and sales, and strategic business.[84]

During the AGM on 24 April, Dr Edwin Long, Professor Lee Chuen Neng and Neo Gim Kiong ceased to be directors. Dr Long and Professor Lee retired and did not wish to seek re-election, while Neo was not re-elected as 99.52% of the votes were against his re-election.[85] In the announcement of his cessation as director, an unresolved issue of "difference in opinion with certain board member over the process involving the RSM Corporate Advisory Pte Ltd's report" was mentioned.[86]

On 8 May, independent non-executive director Loh Yih stepped down. It was stated that he was "unable to perform duties due to difficulties in information verification."[87]

Following the release of RSM's report, SGX exercised its administrative powers under Listing Rule 1405. In a Notice of Compliance to Trek 2000, it highlighted its concern over the suitability of Henn Tan and Foo Kok Wah to remain in their present positions. Based on Listing Rule 1405(1)(e), it also objected to the continuing appointment of Henn Tan, Gurcharan Singh, Poo Teng Pin and Foo Kok Wah as directors and/or executive officers in any listed company for a three-year period commencing from 26 April 2018. Further, the SGX required Trek 2000 to hold an EGM for shareholders to vote on Henn Tan's and Foo Kok Wah's continued appointments as director and executive officer respectively. All persons implicated in the RSM report and their associates were to abstain from voting on these resolutions.[88]

SGX also directed the company to engage an independent, professional firm approved by SGX to conduct an independent review of Trek 2000's internal controls and corporate governance practices. Additionally, SGX mandated a confirmation from all board members that internal controls to safeguard Trek 2000's cash are adequate and effective by a stipulated deadline.[89]

SGX's decision to allow shareholders to vote on the continuation of Henn Tan and Foo Kok Wah was questioned in an online article, which contrasted it with Midas Holdings where SGX objected to the continuing appointment of two individuals as director and executive officer and did not ask the company to convene an EGM for shareholders to decide. The two individuals had then resigned. It said that if SGX decided that an individual is unsuitable to be a director or executive officer, that should be the end of the matter and the person should step down.[90]

On 24 May 2018, the company announced the appointment of Henn Tan's 30-year old son, Tan Joon Yong, Wayne, as Group President and executive director.[91] He had earlier been identified as one of the related persons involved in the IPT transactions. That same day, Kwek Swee Heng was appointed as an independent non-executive director. He has an investment background but no prior experience as a director of a listed company. Trek 2000 said that he would "attend training as and when required".[92] On 25 May, Henn Tan stepped down as Chairman, CEO and executive director and Foo Kok Wah stepped down as an executive officer. The former was appointed to the role of Chairman Emeritus and consultant.[93] Khor Peng Soon was then appointed Independent Non-Executive Chairman.[94]

After all the changes, the board consists of five members – three independent, non-executive directors and two executive directors. The present AC is chaired by Chay Yee Meng, with Celine Cha and Kwek Swee Heng as members.[95]

The Trek ahead

The latest financial statements for the financial year ended 31 December 2017 were released on 9 April 2018, with the external auditors issuing a disclaimer of opinion.[96] Uncertainty lies ahead for Trek 2000 as compliance with SGX's requirements, regulatory investigations and the impact of the suspicious transactions have yet to take full effect.

Discussion questions

1. What are some significant corporate governance issues that may arise as a result of the structure and composition of Trek 2000's board of directors before the discovery of the interested party transactions (IPTs) and questionable transactions?

2. What is an IPT? What controls should a company have in place with regards to IPTs? What are the rules governing the disclosure and approval of IPTs or related party transactions for listed companies in your country? For a company such as Trek 2000, what are the risks with regards to IPTs and controls relating to IPTs?

3. Evaluate the effectiveness of the Audit Committee in fulfilling its duties with respect to internal controls and financial reporting prior to the discovery of the IPTs and discrepancies.

4. Consider the changes in board and management after the discovery of the IPTs and the current composition of the board and the management team. What are the challenges in board and management succession for a company in such a situation? Evaluate the current composition of the board and management.

5. Do you think the resignation of the directors, including the independent directors, and the timing of their resignations, is appropriate? Explain.

6. Do you think Henn Tan should continue to be involved in the company as part of its management and a director? What are your views about the strong endorsement by the Nominating Committee and the board for his continuing involvement? Should his continuation as a director be a matter for shareholders?

7. What are the implications of a company being involved in a regulatory investigation? What measures or courses of action should Trek 2000's board have taken while the company is involved in the CAD investigation?

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YUUZOO CORPORATION: A UNIQUELY SINGAPORE LISTING?

Case overview

YuuZoo Corporation Limited (YuuZoo), a company incorporated in Bermuda and listed on the Singapore Exchange (SGX) through a reverse takeover in 2014, has been described by one critic as “a company that has gone where no company has gone”. YuuZoo, which claims to combine e-commerce and social networking, has had numerous problems that have cast it into the public spotlight. These include multiple resignations of its Audit Committee Chairman, independent directors, Chief Financial Officer (CFO) and external auditors; highly questionable disclosures; loss-making acquisitions and investments; and aggressive accounting policies. The issues led to a calamitous decline in the company’s share price and eventually led to regulatory actions and the suspension of trading of its shares. This particular case focuses mainly on the disclosure and accounting-related issues. It allows a discussion of issues such as the choice of accounting policies; related party transactions; external audit; and the role of different players within a company and the broader eco-system in ensuring proper disclosure, accounting and corporate governance.

This is the abridged version of a case written by Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the 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.

Planting a YuuZoo tree

YuuZoo Corporation Limited (YuuZoo) was co-founded in 2008 by Thomas Zilliacus and Ron Creevey. A native Finn, 63-year-old Zilliacus happened to be in the right country in the right decade. After graduating from Hanken School of Economics in the late 1970s, he was hired by Nokia[1,2] – arguably Finland's most famous company – and later became its head of corporate communications. This led him to a career focusing on telecommunications and technology, and brought him to places far-removed from Finland. By 1986, Zilliacus had arrived in Asia[3] – becoming the regional director of Nokia's Asia Pacific operations. He has remained in the region since then, rising to become the managing director of Nokia in Southeast Asia.[4] In 1996, Zilliacus left Nokia and embarked on a series of entrepreneurial ventures, before returning his focus to the mobile and internet sector.[5]

Creevey is an Australian who also has experience in the technology sector,[6] and he was the one who had conceived the company's citric-sounding name during a walk on a beach.[7]

A stillborn listing?

YuuZoo had first attempted to list in the U.S. on 29 June 2011, when Alanco Technologies Inc. (Alanco), a U.S. publicly traded corporation listed on NASDAQ, announced a definitive merger agreement with YuuZoo Corporation BVI.[8] Alanco is an Arizona-incorporated company which was involved in data storage, wireless asset management and RFID technology. In 2009, it became a holding company without any business after it divested its operations. However, on 20 September 2011, Alanco announced that the merger agreement had been mutually terminated.[9]

Zilliacus then decided to seek a listing of YuuZoo on the SGX. It was listed on 16 September 2014 through a reverse takeover (RTO) of W Corporation, a Bermuda-incorporated company with its principal place of business in the People's Republic of China (PRC). W Corporation had changed its name from Contel Corporation Limited (Contel) on 17 September 2013 and became an investment holding company after it disposed of its original equipment manufacturing business and digital media products business. Contel had been listed on SGX since 2005.[10,11]

The RTO involved the allotment and issuance of up to 100 million shares to raise not less than S$25 million. Things subsequently went downhill for YuuZoo, with its share price falling from an initial S$0.51, to an all-time low of S$0.038 until the suspension of the trading of its shares by SGX on 19 March 2018.[12]

Ownership structure

As at 26 May 2017, Zilliacus had direct and deemed interest of 17.67% in YuuZoo, with most of his shares held through Mobile Futureworks Inc., a company owned by Zilliacus. This is in contrast with the 28.22% that Zilliacus held directly and indirectly as at 30 April 2015. There are no other substantial shareholders in YuuZoo.[13,14]

The business of YuuZoo

YuuZoo dubs itself as providing the world's first third generation social e-commerce network,[15] combining e-commerce and social networking to effectively monetise online interactions for brands. According to the company, it offers its customers a unique blend of interest-based social networking, demand-driven commerce, streaming video, games and payments in a mobile-optimised, fully localised virtual platform, created using its in-house-built technology.[16] YuuZoo develops two types of networks—Yuu-Branded Networks and Client Branded Networks, and they are collectively known as YuuZoo networks.

YuuZoo claimed to have 42 million users in 164 countries.[17] It operates through four operating segments as follows:

a) Licensing

Yuu-Branded Networks are networks developed by the YuuZoo Group directly for consumers. YuuZoo sells licenses to franchisees to operate these Yuu-Branded Networks exclusively in a specific geographic region. These franchisees are supposedly reputable firms within the social media and communications industries locally, with ample know-how of local marketing channels as well as merchandise offerings.[18]

YuuZoo's payment model allows franchisees to pay for the license fee in shares, which it believes can be sold for a profit when the franchisees increase in value over time, thereby delivering better returns to shareholders.

b) Network development

Client-Branded Networks are networks specially developed by YuuZoo for corporate clients, businesses and brands. The sales and marketing of these Client-Branded Networks are handled by resellers, who are well-established locally and enjoy the necessary expertise and relationships within their areas of focus.[19]

YuuZoo receives a network development fee for the sale of these networks, which can be paid in the form of advertising rights. The fair value of these rights is said to be determined by an independent third-party valuer and recorded as revenue.[20]

c) Payments

YuuZoo provides the payment platforms used for processing transactions conducted on its YuuZoo networks. It also develops a range of other standalone online and mobile payment processing solutions under YuuPay.[21] Some of these are:

- YuuCollect, an offline wire solution which accepts third party client funds via bank wire transfer to several bank accounts in Asia, Europe and GCC.[22]

- YuuPayout, which allows entities to securely manage payout requirements.

- YuuWallet, an electronic wallet facilitating easy and secure transactions without credit cards. This is YuuPay's latest product, launched in December 2016, and was designed for use in developing markets.[23]

- Mobile payment solutions to enable payments on mobile applications or trigger payments between two devices using transaction-specific signals (i.e. QR code).[24]

In addition, YuuPay offers bespoke IT projects involving all type of online payment solutions, which are tailored to the unique needs of its clients.

***d) Other income*[25]**

In addition to the one-time license fee, YuuZoo also receives from franchisees a recurring share of revenue derived from the platform, including e-commerce margins, advertising income, payment margins and gaming revenue.[26]

In its 2016 annual report, YuuZoo classified its revenues into e-commerce revenue, franchise revenue and celebrity branded network revenue.[27]

Despite its appearance of success, YuuZoo was plagued by many issues. These issues are primarily related to its corporate governance, disclosures and accounting practices.

Breaking up is never easy – Changes in external auditors

YuuZoo also faced problems retaining its external auditors.

The first red flag in external audit appeared in FY2014 when BDO LLP did not seek reappointment at the company's Annual General Meeting (AGM), despite the unqualified opinion it gave YuuZoo.[28] Eventually, after a five-month delay, YuuZoo found a new external auditor to take BDO LLP's place – Moore Stephens LLP.

However, YuuZoo did not fare any better in its new relationship. Moore Stephens LLP issued a disclaimer in opinion for FY2015, in which it stated that it had "not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion."[29] Moore Stephens listed several reasons for ending its relationship with YuuZoo – such as the lack of comparable business models, and the valuation models' sensitivity[30] – all of which related to YuuZoo's use of franchises. Like BDO LLP, Moore Stephens LLP ended its relationship with YuuZoo, not seeking reappointment after just one year. YuuZoo's share price fell by 12%, from S$0.20 to S$0.176.[31]

YuuZoo tried explaining its business model and how it accounted for franchise revenue. According to the company, the business model was developed by a “Big 4” accounting firm which advised YuuZoo to recognise the shares it received from franchisees as revenue.[32] Furthermore, YuuZoo claimed that these shares were valued by two separate independent valuation experts. As their valuations were within the same range, YuuZoo said it used them as the basis for determining the fair value of the shares.[33]

Yuuzoo appointed RT LLP (RT) as its third auditor in January 2017, after a delay of more than half a year after Moore Stephens LLP expressed its desire to not seek reappointment at the May 2016 AGM.[34]

Misunderstood or misleading? – Issues with franchises

“Our primary strategy is to build, hold and ultimately sell companies that use our unique, and in many cases, patented technology. The way we do this is partly by setting up companies that are run in each market by franchisees.”

– Zilliacus, on YuuZoo’s franchising strategy[35]

Zilliacus has constantly claimed that YuuZoo’s business is misunderstood by the average retail investor in Singapore, and has also made similar claims about external auditors and regulators.

“We are the only social media company listed in the Singapore Exchange…the challenge is that when you are the only one, and investors don’t understand your business, then you are lost,” he lamented in 2014,[36] shortly after YuuZoo’s listing on SGX. His sentiments were similarly echoed by Sundram, YuuZoo’s former CEO, who said that “YuuZoo is a misunderstood company…(and) many people, including investors, don’t get us.”[37]

One way that YuuZoo derives its revenues is from selling licenses to franchisees. These franchisees acquire the right to operate YuuZoo’s social media platforms in their respective markets. In exchange, they are charged licensing fees, which are either in the form of cash or shares in the franchisees.[38]

Many of the franchisees are in emerging markets where YuuZoo asserts that there is significant potential for growth of its business. However, doubts were raised about the commercial substance of the franchisees. For example, on 21 April 2016, YuuZoo announced a franchise agreement with Media Rock SA de CV (Media Rock). There was little specific information about Media Rock. Instead, as with many of YuuZoo's announcements, it mentioned the population in the country and the total size of the market. YuuZoo said it would have access to Mexico's 120 million population and 34.4 million gamers. A search of the internet had found no website for Media Rock even though it was described as "a leading digital entertainment agency" and no information at all about Media Rock online.[39]

Another example was the announcement on 24 January 2017 of a franchise licence sale to Telkonex, which was called "an emerging telco player in Congo". Again, an internet search found a private limited company with that name based in India. On its very basic website, there was no information about the nature of its business and the contact e-mail was a Gmail address. A website providing business information stated that Telkonex last held its AGM on 30 November 2009, and its balance sheet was last filed on 31 August 2009. It had a paid-up capital of just 100,000 Indian rupees (S$2,135).[40]

The franchising arrangement also raised other issues. In 2013, prior to YuuZoo's listing, it sold franchises to YZ Group. YZ Group was a group of companies beneficially owned by Mark Cramer-Roberts – a director of YuuZoo Nigeria, one of YuuZoo's subsidiaries. YuuZoo recognised a receivable of S$17.3 million, but did not receive cash payments throughout the whole of 2014. Subsequently in 2015, YZ Group returned the franchises to YuuZoo valued at S$14.9 million. That amount was offset against the original receivable of S$17.3 million, while the remaining S$2.4 million was then deemed impaired by the company.[41,42] This was discussed with YuuZoo's auditor under key audit matters. The returns were not recorded in 2015 and were treated as correction of errors in the restated 2015 financial statements in the latest accounts.[43]

At YuuZoo's AGM in July 2017, YuuZoo's board and external auditors, RT, were asked the following questions about this series of transactions:

- How was such a large transaction (return) missed by management and the auditors in preparing the accounts in 2015?
- Did YZ Group have essentially an unlimited right of return with full credit when they bought the franchises in 2013? If so, should revenues have been recognised in 2013 before the RTO?
- If not, why are they now allowed to return franchises that are intangible assets with a useful life of 2 years (based on amortisation period) and to offset that fully against receivables?
- Are other franchise sales done on similar terms with full right of return?
- When the franchises were returned, they were recorded as additions to intangible assets (essentially under platforms). However, no corresponding impairment charge was made in 2015. About half the amount was amortised in 2016. How can such assets that fall so rapidly in value not be impaired in 2015 when they were "returned"?[44]

In 2006, Cramer-Roberts and Creevey, the co-founder of YuuZoo, had petitioned for bankruptcy after the catering firm they co-founded in Sydney, Australia crashed with debts of more than A$16 million, affecting more than 400 creditors who were individuals and businesses.[45]

One plus one truly equals 10? – Making sense of the financial statements

In YuuZoo's 2014 annual report, it reported total group revenue of US$37.736 million for FY2014, compared to US$32.780 million for FY2013. The breakdown of revenue was as follows:[46]

Revenue	**Group**	
	2014 US'000	**2013 US'000**
Merchant fee	10,906	12,286
Network development fee	8,697	8,568
E-commerce	18,133	11,926
	37,736	32,780

On its balance sheet, total intangible assets for the Group increased from US$5.749 million to US$10.971 million while trade and other receivables increased from US$17.806 million to US$24.689 million, between the end of FY2013 and end of FY2014. The bulk of the intangible assets was in the form of "advertising rights for celebrity branded network" using "valuation determined by an independent third-party valuer". These were based on agreements with various parties for sales of networks in exchange for advertising rights. For FY2014, advertising rights amounted to US$9.292 million, compared to US$5.925 million for FY2013. These advertising rights were amortised on a straight-line basis over 24 to 36 months.[47]

In its 2015 annual report, YuuZoo reported a huge increase in Group revenue to S$90.061 million for FY2015, compared to restated Group revenue of S$47.766 million for FY2014 as shown below:[48]

Revenue	**Group**	
	2015	**2014**
	SGD'000	**SGD'000 (Restated)**
E-commerce	35,120	36,757
Network development fees and franchise sales	54,941	11,009
	90,061	47,766

Group intangible assets at the end of FY2015 was S$11.953 million compared to the restated amount of S$14.438 million at the end of FY2014, while FY2015 trade and other receivables and the restated FY2014 amounts were S$34.714 million and S$32.491 million respectively.[49] For FY2015, advertising rights for celebrity branded networks amounted to S$5.471 million, compared to S$11.762 million for FY2014.

YuuZoo again re-stated its financial statements in its 2016 annual report, with its FY2016 and re-stated FY2015 revenue as follows:[50]

Revenue	**Group**	
	2016	**2015**
	SGD'000	**SGD'000 (Restated)**
E-commerce	51,827	34,550
Network development fees and franchise sales	51,373	19,465
	103,200	54,015

Group intangible assets at the end of FY2016 was S$41.018 million compared to re-stated FY2015 balance of S$24.746 million. Trade and other receivables amounted to S$12.214 million for FY2016 while the re-stated amount for FY2015 was S$18.879 million. For FY2016, advertising rights for celebrity branded networks amounted to S$28.369 million, a huge increase compared to S$5.471 million for FY2014.

On 18 May 2017, YuuZoo explained changes to its business model for franchise sales and revenue recognition from these sales. It said that prior to 2015, the company sold its franchise packages for cash. In 2015, it changed to selling its franchise packages in return for shares in the companies that operate the franchise. This was purportedly based on advice received from a "Big 4" accounting firm (which it named in its 2016 annual report as KPMG).[51] YuuZoo claimed that it then used another "Big 4" accounting firm and a "leading U.S. expert" to value those shares. The U.S. firm had previously been identified by YuuZoo as Charfi Valuation Services LLC (Charfi), which it called "a recognised New York-based investment bank". According to an article, the New York Department of State website showed that Charfi filed as a domestic limited liability company in New York on 11 July 2014 but there was little information online about it.[52]

Under YuuZoo's 2015 revenue recognition policy for franchise sales, the shares issued by the franchisees valued by the unnamed "Big 4" accounting firm and Charfi were recognised on the balance sheet as asset available for sales (AFS). The change in accounting policy for franchise sales in 2015 contributed to "network development fees and franchise sales" on its income statement increasing from S$11 million (restated) in 2014 to S$55 million in 2015, and AFS increasing from zero to S$55 million.[53]

In 2016, as a result of the accounting policy change, YuuZoo restated its 2015 revenue downwards by S$35.5 million or 39 per cent of FY2015 revenue and its AFS by the same amount, which represents 65 per cent of the FY2015 balance.[54]

While RT, YuuZoo's external auditor, issued an unqualified opinion for its financial results for the year ending 2016, it highlighted two emphasis of matter paragraphs. One of these paragraphs concerned its revenue recognition policies.[55]

There were other issues when it came to accounting for YuuZoo's results, including recognising revenues from YuuCollect. YuuCollect functions like PayPal, facilitating the transfer of payments between buyers and merchants using YuuZoo's platform. The merchant is then charged a transaction fee.[56]

Financial Reporting Standards (FRS) 118 states that only commissions constitute revenue – not payments which are collected on behalf of other companies.[57] However, YuuZoo recognised the cash collected on behalf of merchants as revenue, justifying this by stating that it undertook an element of credit risk, due to its unique platform.[58] RT emphasised that significant judgment is required with regards to recognition of revenue on a gross basis or net basis based on the relevant standard.[59]

On 19 May 2017, YuuZoo announced that it was adopting a less aggressive revenue recognition policy – particularly with the way it recognised franchise revenue.[60] Its franchise revenue recognition policy was therefore changed – now recognising a one-time franchise fee based on the cost of developing the franchise packages, instead of recognising the value of its franchisees' share payments.[61]

As a result, YuuZoo retrospectively restated its 2015 revenue downwards by S$35.5 million – 39% of its revenue that year. It also revised the value of the shares it had received from franchisees by the same amount, which now represented 65% of the original 2015 balance.[62]

Growing the YuuZoo family – Failed acquisitions

"This transaction has a tremendous fit where 1 plus 1 does truly equal 10 … Through this transaction, YuuZoo just became a full-service technology and content play. It is a game-changing transaction for us and we couldn't be more thrilled."

–Zilliacus, on the Relativity Media acquisition[63]

Over the years, embarked on a series of acquisitions purportedly aimed at cementing its position in e-commerce and social networking and also diversifying into related industries[64]. However, controversies soon followed.

YuuZoo first eyed Infocomm Asia Holdings (IAH). With its rights to distribute popular games across South East Asia – such as Grand Theft Auto V and NBA 2K14[65,66] – along with its reportedly large base of over 35 million users in the region, IAH looked to be a promising member of YuuZoo's extended family. Its adoption into YuuZoo's family would also allow YuuZoo to expand the use of its YuuCollect payment platform.[67]

YuuZoo was to fully acquire IAH on 16 February 2015,[68] with an effective consideration of S$18 million.[69] Zilliacus was particularly excited, saying that "the acquisition of IAH will add value to YuuZoo in many ways".[70]

However, YuuZoo's bliss was not to last. IAH chalked up significant debts – it owed US$995,868 in net tangible liabilities, together with a US$1.436 million loss.[71] It also owed its new parent S$6,461,300, which led to legal action in July 2015.[72] While the lawsuit was settled in December 2015,[73] YuuZoo decided that it no longer wanted to fully adopt IAH – announcing that it was only acquiring 30% of IAH, with an effective consideration of S$2.895 million.[74]

YuuZoo recognised impairment losses of S$7,493,000 on IAH a year later[75] – both on its investment in IAH, as well as the amount IAH owed it.

YuuZoo then decided to turn its attention to movie studios, apparently eyeing synergies between e-commerce and entertainment products.[76] On 19 October 2015, YuuZoo paid S$4,677,000 for a five percent stake in RS Media & Entertainment Group (RS Media)[77] – which produced movies with both Chinese and Western themes.[78] This, however, had a sudden and mysterious ending – with YuuZoo impairing the full amount of its investment.[79]

YuuZoo continued to expressed hope that its acquisition strategy would pay off. It signed an agreement to acquire a 33.3% stake in Relativity Media on 31 October 2016, for an amount between US$50 million and US$150 million.[80]

However, the investment amount was later reduced to S$15 million on 25 November 2016.[81] More bad news soon followed. On 28 February 2017, YuuZoo aborted its planned investment in Relativity Media after earlier disclosing that it had closed the deal, blaming the failed acquisition on unmet conditions.[82] It had already paid US$2.5 million to Relativity Media's receiving party.[83,84] This amount was not impaired because YuuZoo's management said that it believed it to be recoverable based on the advice of its in-house legal counsel, as well as the law firm in which one of its independent directors is a partner.[85]

Related party transactions

Zilliacus, the Chairman of YuuZoo, is also the Chairman and controlling shareholder of Mobile FutureWorks Inc. (MFW) (the substantial shareholder of YuuZoo), Sandbox Global Company Ltd. (Sandbox) and Circle of Champions, Inc. (CoC).[86] The latter two companies are subsidiaries of MFW.[87] There were various interested person transactions (IPTs) between YuuZoo and these companies.[88] In FY2014, there was an IPT of US$250,000 with MFW, which occurred before the RTO.[89] In FY2015, IPTs with Sandbox and CoC amounted to $225,973 and S$707,250 respectively.[90] No IPTs were disclosed for FY2016 in the IPT section of the annual report.[91] However, in the notes to the financial statements, it was disclosed that there was a S$267,000 service fee paid to companies controlled by one of the directors under related party transactions.[92] This inconsistency was queried by SGX.

In response, the company disclosed that under the service agreement with Sandbox for services and development work related to mobile games, YuuZoo pays Sandbox a fixed monthly fee of US$15,000 and has also placed its own Bangkok-based employees in Sandbox for which it pays for an agreed portion of the general office expenses. It also disclosed that under an agreement signed with CoC in 2015, YuuZoo received certain benefits from CoC. In February 2017, the valuation determined that YuuZoo gained S$16.96 million from the contract, which it disclosed as a significant related party transaction in the notes to the financial statements. It did not disclose who undertook the valuation.[93]

Telling it like it is?

YuuZoo's results announcements also frequently attracted queries from SGX. For example, on 14 August 2017, YuuZoo released its restated 1Q 2017 and 2Q 2017 financial statements.

In its press release for the 2Q 2017 and 1H 2017 results on 15 August 2017, Yuuzoo said: "For the half year ended in 30 June 2017, the Company's net profit increased by 342 per cent to S$15.9 million from S$3.6 million in the corresponding period in 2016. The increase was mainly driven by franchise sales in Hungary, Slovakia and Czech Republic."[94]

SGX asked YuuZoo to give a breakdown of the total revenue of S$36.8 million for 1H 2017 and to attribute the franchise sales in 1Q 2017 and 2Q 2017 to Hungary, Slovakia and Czech Republic, which it had earlier said are the countries where franchise sales had driven the huge increase in revenue compared to the corresponding 2016 period.

In response, YuuZoo then said there was in fact no revenue contribution from Slovakia during that period.[95] Further, it now disclosed that the remaining two countries of Hungary and Czech Republic only contributed S$838,000 in revenue each.

The remaining S$22.5 million in franchise sales – which made up 93% of the franchise revenue – are now said to be from "Other Regions", with no specific breakdown given for individual regions. An observer questioned how YuuZoo could have said in its 1H 2017 announcement that the increase in net profit was driven by franchise sales mainly in Hungary, Slovakia and Czech Republic when contributions were 3.46%, zero percent and 3.46% respectively for these three countries.[96]

YuuZoo now said that “the increase was also driven by franchise sales in other regions being: South Korea, United Kingdom, Bulgaria, Congo, India, Poland and Romania”.[97] However, the observer pointed out that franchise sales from these same countries had been mentioned in various announcements from 1Q 2015 onwards and asked if YuuZoo had multiple franchises in these countries.[98]

YuuZoo’s restated 1Q 2017 results showed that revenue declined by 50% compared to 1Q 2016, while its 2Q 2017 revenue declined by 17% compared to 2Q 2016. When it announced its restated 1Q 2017 results, it said that “the decrease in revenue is mainly due to the change in recognition policy of the Group. The Group has adopted a more prudent means of revenue recognition which resulted in the decrease in revenue”. When it announced its 2Q 2017 and 1H 2017 results, it said (twice) that “the decrease was mainly due to the change in recognition policy of the Group and lower payment revenue”.[99]

However, when queried by SGX, YuuZoo now said financial statements for FY2016 and FY2017 were prepared on the same basis, which contradicted their earlier announcement. It now said the decrease in revenue is actually due to lower payment revenue. YuuZoo did not mention what payment revenue meant but presumably this refers to its e-commerce revenue.[100]

YuuZoo also said in its 1H 2017 results announcement: “Growth is expected to continue to be strong in all key areas YuuZoo operates in: tribal social networking, e-commerce, online and mobile payments, mobile games and streaming video services.”[101] The observer said that this seemed at odds with the significant declines in total revenues for the first two quarters of 2017 compared to 2016. When SGX asked YuuZoo to substantiate the statement that growth is expected to be strong in e-commerce, its only explanation is that e-commerce is expected to be strong as franchisees and marketing partners start to market YuuZoo’s services.[102]

More recently in March 2018, Yuuzoo's full year 2017 and Q4 2017 results drew further scrutiny from SGX for its inconsistencies and ambiguities. SGX pointed out multiple errors in the company's result announcement and ordered the relevant amendments to be made. For example, Yuuzoo incorrectly stated FY2017 e-commerce revenue to be S$0.4m when it was S$3.9m instead.[103]

The segmental breakdown for 2017 shows that e-commerce revenue was S$3.85 million, compared to S$51.83 million in the audited FY2016 results. The company first said that this huge drop was due to the suspension of certain payment-related services during the year.

When queried by SGX, it said: "In 2017, the Company decided to suspend the bulk of its core payment business channel for its YuuPay subsidiary, which primarily transacted in the Binary Options and Forex Industry. This was due to the rise in poorly regulated merchants over the last two years in the Binary Options and Forex Industry, and the subsequent decision by the Company to withdraw from a business space it found increasingly unethical."[104]

Further, for the first time ever, the company's financial statements show income tax expenses, with the amounts being S$774,000 and S$818,000 respectively for Q4 2017 and FY 2017. This prompted the question as to why there were no tax expenses shown in previous years and whether the company is liable for any unpaid taxes for prior years' income.[105]

It was also pointed out that the numbers in the unaudited Q4 2016 results which the company had shown as comparatives in its latest results announcement were "totally different" from those in the Q4 2016 results the company announced the previous year. Further, the unaudited full-year numbers announced by the company last year were also very different from the audited numbers that eventually appeared in the annual report. An observer said that this suggests that "the company's unaudited results cannot be relied upon and also raises questions about its internal controls over financial reporting and the competency of its finance function".[106]

On 7 March 2018, the Securities Investors Association (Singapore) (SIAS) hosted a dialogue session between the management of YuuZoo and its shareholders. YuuZoo Chairman Zilliacus addressed shareholders at the session. The following day, the company issued a press statement on SGX which said that a real estate project that it is embarking in Harbin, China, with its Chinese joint venture partner could have a market value exceeding S$4 billion when fully completed.[107]

It also said that its joint venture in the logistics business in France – what it called "end-to-end digilogistics" – could bring the revenue of YuuZoo's French operations to more than S$600 million annually, from the current entertainment products alone. However, it did not provide any details to substantiate the numbers.[108]

Regulatory actions

On 17 July 2017, YuuZoo announced that it was appointing an independent third party to investigate a number of claims made by several parties on the corporate governance practices within the company. The scope of review includes addressing issues raised in several Business Times articles and by the former financial controller, including those in an email sent by the latter to SGX, and complaints made by Yuuzoo's employees against its former financial controller. The reviewer was to report the findings to the company's lead independent director. It continued to call the claims and statements "inaccurate or misleading". It also said that the Executive Chairman would step down from his executive position for the duration of the independent review. [109]

YuuZoo announced the appointment of Ernst & Young Advisory Pte Ltd (EY) on 19 October 2017.[110] It said that it had consulted with SGX with regards to the scope of the review and the appointment of the independent reviewer. The scope was expanded to include queries raised by SGX with regards to several accounting issues.

While the EY review was ongoing, SGX issued a notice of compliance (NOC) to YuuZoo following FY2017 results announcement and SGX queries about these results.[111] The NOC related to two items. First, "other income" increased from S$159,000 in Q4 2016 to S$8 million in Q4 2017. YuuZoo had recognised a gain of nearly S$8 million from the "bargain purchase of assets" for YuuLog France.[112] During Q4 2016, it had paid S$135,000 to purchase property, plant and equipment.[113]

Secondly, SGX also drew attention to “the increase of assets available for sale (AFS) from S$33.3 million at a 31 December 2016 to S$54.2 million as at 31 December 2017, notwithstanding an impairment of S$17.5 million during FY2017. In this regard, an additional amount of S$38.4 million has been recognised in revenue and AFS during FY2017”.[114]

YuuZoo was asked by SGX to engage its external auditors to provide an opinion of the “veracity and reasonableness” of these items by 19 March 2018.[115]

On 19 March 2018, when the deadline for the NOC was reached and YuuZoo had not responded, SGX promptly suspended trading in the shares of YuuZoo.[116] YuuZoo issued a “clarification announcement” on 22 March, saying that it had informed SGX that more time was needed to get the necessary documents and for the external auditors to review them. The company had asked SGX for an extension but it had been rejected. It said that SGX had suspended the shares before it could make an announcement on the above.[117] On 28 March, YuuZoo issued another announcement saying that it had reached an agreement in principle with the auditor on the other income of S$8 million and was awaiting a response from the French component auditor, and on the issue of the AFS and corresponding revenue, it had provided updated evidence to the auditor.[118] On 22 May 2018, YuuZoo announced that after discussions with the auditors, it had decided to reduce “other income” from S$8 million to S$7 million, 100% of the AFS or S$54.2 million was to be impaired, and it will not book any value from the 2017 sale of network development and franchise licenses. It did not disclose any opinion from the auditors.[119]

On 2 April 2018, SGX issued a second NOC to YuuZoo, this time relating to the third-party review. The exchange noted from the draft report that EY was not given the necessary access to information and data as required. The review was also restricted by YuuZoo’s scope exclusions which were inconsistent with an independent review. The exchange ordered YuuZoo to release the executive summary of the initial findings to SGX and the Audit Committee as soon as it was finalised, and the Audit Committee was to release the interim report on SGXNet once it is received from EY. A failure to do that would be a contravention of the listing rules.[120] The same day, it was announced that SGX had referred YuuZoo to the relevant authorities.[121]

On 3 April, another announcement said that YuuZoo had on 2 April received a notice from the Commercial Affairs Department (CAD) informing it that is being investigated for a potential offence under the Securities and Futures Act (SFA). The CAD required YuuZoo to provide access to "certain documents or information relating to the Company, its subsidiaries and associates from financial years 2013 to 2016 including all records and correspondence relating to franchises, franchising arrangements and the companies in which shareholdings interest were held (i.e. operating companies)".[122] It also said that Zilliacus had also received a notice from CAD relating to CAD investigations into the same matter. Two days later, another announcement clarified the documents or information required by listing them in detail. It also said that CAD had seized copies of documents, valuation reports, valuation plans, materials prepared by various professionals, various hard disks, laptops, chargers and/or adapters of certain employees. Thomas Zilliacus and the company's 2015 head of franchise management, Sebastian Zilliacus (who is the former's nephew) have both been interviewed.[123]

While the CAD investigations were ongoing, YuuZoo announced that Thomas Zilliacus had provided a bond to report back to the CAD on 4 June and that his passport had been released for the purposes of overseas travel. It said that Zilliacus had "voluntarily provided the CAD with a complete chronological summary relating to all financial announcements of YuuZoo during 2015-2017 and has informed the CAD of his desire to continue to share with the CAD all information he has in relation to their investigation".[124]

Still business as usual?

Even after YuuZoo's shares have been suspended from trading and as the company was facing regulatory action, it appeared to be business as usual. On 22 March 2018, the company issued an announcement with the headline "23 YuuZoo franchisees outperform expected usual growth by over 7,000%, and significantly exceed budgeted financial numbers". A closer reading indicates that the number of registered users for these 23 franchisees had increased from a forecasted number of 34,004 to 2,732,722 for 2017, while the total loss was just over US$30,000 compared to a budgeted loss of US$1.9 million.[125] The company did not previously disclose any budgeted numbers for these franchisees.

On 17 April, YuuZoo announced that the company, in partnership with its Singapore franchisees Singnet Solutions Pte Ltd and Hub International Pte Ltd, have launched YuuHalal, Singapore's and South-East Asia's first Social Commerce Halal Lifestyle App.[126] YuuHalal was designed to give companies a platform to "showcase a wide range of businesses, products and services that cater to the global Islamic economy" through a "combination of social networking and eCommerce".[127] It remains unclear how YuuHalal actually works and how it can impact the global Muslim market. The YuuHalal Youtube channel did not provide much clarification either and merely consists of several videos showcasing halal food at the Ramadan markets around Singapore and short clips of merchants and partners at the Muslim World Event 2018.

YuuZoo appointed a new independent director, 39-year-old Lee Sien Liang Joseph, on 4 July 2018. Lee, a practising lawyer, was appointed as Chairman of the Nominating Committee and a member of the Audit and Governance Committee.[128] On 2 August, the company announced that SGX has rejected its application for a further extension of time to hold its AGM and directed it to hold it "as soon as possible". YuuZoo said that it is still finalising its accounts with the auditors and that it "shall use its best endeavours" to hold its AGM by 14 September 2018.[129]

On 13 August, YuuZoo announced that its application for discontinuance from Bermuda and its continuation into British Virgins Island as part of its restructuring has been completed. The company's name was also changed to YuuZoo Networks Group Corporation.[130] That same day, it issued profit guidance indicating that it was expecting a loss for the financial year ended 31 December 2017 which is "mainly attributable to amortisation and impairment of intangible assets due to write-offs of advertising rights".[131] In another announcement that day, it also said that it had applied for an extension of time to announce its results for the second quarter ended 30 June 2018.[132]

Meanwhile, there has been no update about the regulatory investigations into the company. No director or officer of the company has been held accountable for the debacle. The former Chairman, Thomas Zilliacus, has meanwhile posted photos on Instagram which show that he is somewhere in Capri, Italy.

Discussion questions

1. What are the key differences between listing through an initial public offering and through an reverse takeover (RTO)? What are the key risks to investors from a listing through an RTO?

2. Critically evaluate the ownership structure of YuuZoo. What are the key corporate governance risks? Explain.

3. It is frequently said that one of the key risks associated with companies with controlling shareholders are the risks associated with related party transactions. Why is this so? Use the related party transactions in the case to explain why related party transactions may be harmful to minority shareholders.

4. Critically evaluate the business model of YuuZoo. What are the key risks associated with its business model? How does its business model impact its accounting policies? Critically evaluate YuuZoo's accounting policies.

5. What are the key red flags relating to YuuZoo's disclosures, accounting policies and external audit?

6. What are the roles of the management, board of directors, Audit Committee, internal auditor, external auditor and regulators in ensuring proper disclosure, accounting and corporate governance? In your opinion, who bears the greatest responsibility for the lapses in YuuZoo? Who are other key players within the corporate governance system of a company and in the broader eco-system and what are their roles?

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FELDA VENTURES INTO THE UNKNOWN

Case overview

On 5 June 2017, the Chief Executive Officer (CEO) of Felda Global Ventures (FGV), Zakaria Arshad, was abruptly asked to resign from his position, following allegations of impropriety and breach of fiduciary duties. His tenure only lasted slightly over a year. This marked the start of a boardroom tussle, leading to a series of investigations by the Malaysian Anti-Corruption Commission (MACC). Transparency International Malaysia (TI-M) even declared 2017 as “FELDA Year”, due to the “endless saga” of malpractice and corruption cases. Amidst the chaos, serious questions were raised on accountability and risk management practices within the Federal Land Development Authority (FELDA) and its subsidiaries. The objective of this case is to allow a discussion of issues such as the the relationship between public governance and corporate governance, duties and responsibilities of directors; risk management; accountability; and tone at the top.

This is the abridged version of a case prepared by Chung Wei Le, Tan Li Yin, Tan Yi An, and Yap Ying Ning 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 Jacqueline Lor under the supervision of Professor Mak Yuen Teen.

FELDA: Settlers' bedrock

FELDA was formed in 1956 to resettle the rural poor into newly developed areas and organise smallholder farms growing cash crops in Malaysia.[1] It eventually developed 317 schemes that benefitted 1.6 million people, increasing the average family income to RM3,047 per month in 2010.[2] Not only did FELDA's resettlement schemes alleviate poverty amongst settlers, the efforts also contributed significantly to Malaysia's palm oil industry.[3] Since the 1990s, FELDA has diversified into other economic activities and launched several private corporate entities.

FGV was incorporated as a private limited company on 19 December 2007 as the commercial arm of FELDA for overseas investments.[4,5] FGV's main business operations are in plantations, logistics, and sugar, with a global presence in more than 10 countries across three continents.[6]

Fresh blood: Off to a steady start

Datuk Zakaria Arshad was appointed as CEO and Group President of FGV on 1 April 2016,[7] after ex-CEO Mohd Emir Mavani Abdullah stepped down following a failed controversial deal which involved the purchase of loss-making Indonesian planter, PT Eagle High Plantations TBK.[8]

As the son of a first-generation FELDA settler, Zakaria was popular amongst settlers.[9] After graduating from university in 1984, he kickstarted his career by managing a FELDA subsidiary, and worked his way up the corporate ladder over the next 32 years.[10] More recently, he assumed the role of CEO of FELDA subsidiaries Delima Oil Products Sdn. Bhd. (Delima Oil) and FELDA Vegetable Oil Products Sdn Bhd. He also held the position of Executive Vice President of palm downstream cluster.[11]

In January 2017, Tan Sri Shahrir Abdul Samad was appointed as the new Chairman of FELDA. He emphasised that FELDA would not be micromanaging FGV, despite being its majority shareholder. Although the continued success of FGV was important to FELDA, FGV had its own set of rules to follow as a listed company. Shahrir expressed trust that Zakaria would execute his plans of reform and reassured the public that FELDA would keep a watchful eye on the happenings in FGV.[12]

The floodgates open

On 5 June 2017, FGV made news headlines when Zakaria was abruptly asked to resign, following claims that he had breached his fiduciary duties.[13]

It was revealed that the Afghan company, Safitex Trading LLC (Safitex), had delayed payments amounting to almost US$11.7 million owed to FGV's subsidiary, Delima Oil, for a shipment of palm oil in 2016. Zakaria had reportedly allowed Safitex a longer credit term of 60 days, as opposed to FGV's usual 30-day policy, without any evidence of evaluation of the debtor's ability to repay the debt.[14] He was also accused of allowing sales to Safitex to continue despite unsettled payments in 2014, causing debt levels to soar to US$8.3 million by late 2015.[15]

On 11 April 2016, Zakaria allegedly approved a proposal to further raise the credit limit to US$9.52 million.[16] Thereafter, the external auditors repeatedly highlighted the matter in quarterly review reports, but the management expressed confidence regarding the debt's recoverability.[17] On 20 April 2017, the board instructed FGV's internal audit team to conduct further investigations into the matter.[18] This resulted in the detection of "possible contraventions of Group policies".[19]

Boardroom showdown

On 31 May 2017, a board meeting was held without Zakaria to discuss matters pertaining to Safitex's debts. Subsequently, FGV's Chairman, Isa Samad, reportedly summoned Zakaria into his office and requested him to resign,[20] citing the alleged breach of corporate governance codes.[21] Riled up by Isa's requests, Zakaria defended himself by stating that, "it's a bit ridiculous he asked me to… resign, based on just the internal audit report".[22]

Thereafter, Zakaria publicly declared his innocence. Firstly, he clarified that the credit facility had been offered to Safitex by the previous management, pointing out that he was not the only one involved in dealings with Safitex.[23,24] He also expressed the view that it was unreasonable to expect him to micromanage all of FGV's subsidiaries.[25] In addition, Zakaria highlighted that Safitex's debt amounted to less than 0.2% of FGV's total earnings, and that the owner of Safitex had been overseas and was hence unable to settle the payment on time.[26] Zakaria further added that Safitex was a large company, which gave FGV's management the confidence that the firm would fully repay the debt.[27]

In response, Isa denied ever requesting Zakaria to resign. Isa clarified that the board's intention was to protect FGV's reputation and had merely suggested Zakaria's resignation to prevent the matter from blowing up, adding that this move by the board was not an attempt to "cover up"[28] the Safitex scandal.[29]

Despite attempts to clear his name, on 6 June 2017, Zakaria, as well as three other management personnel, received letters mandating an indefinite leave of absence.[30] This was reported as a collective decision by the board, to allow FGV's internal audit team to further investigate purported irregularities involving Safitex.[31]

Zakaria publicly expressed that he believed FGV had blown the issue out of proportion to place pressure on him to resign – given that he had disagreed with the board on several matters in the past.[32]

Raking up the past: Suspicious transactions

Taking matters into his own hands, Zakaria proceeded to reveal a series of suspicious transactions that the board had made despite his opposition.

On 12 November 2013, Cambridge Nanosystems revealed a contract signed with FGV in a bid to harness an alternative form of clean energy.[33] While this seemed to support sustainability efforts, the subsidiary involved had been making losses of up to RM117 million in the previous few years. Further, the agreement required FGV to invest another £100 million into the subsidiary. Zakaria said that the basis for the joint venture was weak, especially given that FGV was operating in the plantations industry. Zakaria had initially managed to convince the board of his views and prevented the transaction. However, a few weeks later, the board changed its stand and gave its go-ahead for the investment.[34]

On another occasion, Zakaria was presented with an investment proposal to acquire a 30% stake in a creamer factory for RM300 million. Again, Zakaria did not agree with investing RM300 million in a non-core business.[35] He discussed his concerns with the board. Although the executives expressed their disapproval towards the investment during the meeting, he was later notified that the investment had been approved.[36] Zakaria hinted that the repeated over-ruling of contracts and investments were the works of "invisible hands" behind the scenes.[37]

The Prime Minister's Office then invited Datuk Seri Idris Jala, an independent third party, to conduct an investigation and provide recommendations for FGV.[38] Due to his past successes, all major parties involved widely supported this move.[39]

On 14 June 2017, Idris Jala presented the findings from his investigations to Malaysian Prime Minister Najib Razak, stating that there were "reasonable grounds"[40] to proceed with disciplinary actions against Zakaria and the other officers who were on leave of absence. In response, the Prime Minister highlighted broadly that the ultimate decision would be made based on "company laws, good governance and fair process".[41]

Resigned to fate

Just days after Zakaria was given an indefinite leave of absence, Isa found himself faced with repeated calls to step down. Many claimed that it was only fair for Isa to leave FGV while the MACC continued its investigations. In an initial response, Isa proclaimed his innocence and stated that he had no reason to resign.[42]

A group of second-generation FELDA settlers, Suara Generasi ke-2 Felda (SGK2F), urged Isa to step down given his "bad track record".[43] The leader of the group, Hamaruddin Abdul Aziz voiced concerns that the share price of FGV would continue to spiral downwards, given that it had already fallen by more than 60% since its listing in mid-2012.[44]

In addition, the group's advisor, Datuk Zulkefli Nordin, lamented the lack of accountability during Isa's tenure, citing that proper debt statements were not presented to settlers, making it difficult for them to monitor debt levels.[45]

The group also defended Zakaria and questioned the need for his temporary suspension. Speaking on behalf of the group, Hamaruddin recalled Zakaria's display of grit in carrying out his duties, despite having taken over as CEO during a time when FGV faced losses and failed business ventures. During his tenure, Zakaria had turned losses of over RM81 million into a profit of over RM2 million for FGV.[46]

The group also called for the reappointment of FELDA's Chairman Shahrir as FGV Chairman. This was to allow FELDA, FGV's biggest shareholder, to be better represented on the board.[47] This would ensure that decisions made in FGV were aligned with the interest of settlers, who were its minority shareholders.[48]

Eventually, on 19 June 2017, following recommendations by a special counsel, Isa voluntarily resigned as Chairman of FGV,[49] as well as from his other positions in the Group. An acting Chairman, Tan Sri Sulaiman Mahbob, was appointed in his place.[50]

Bumpy road: A brief history of Isa

In 1978, Isa first stepped foot into the political scene after winning the Linggi state seat in Negri Sembilan, where he served as a member of the state executive council until 1983. For the next 22 years, Isa went on to assume the title of Menteri Besar, otherwise known as the First Minister.[51] Often described as a charismatic "old-school politician",[52] Isa enjoyed a good start in his career. Nevertheless, old school politics later proved to be insufficient in preparing him for challenges brought about by new century politics and corporate management.[53]

In 2005, Isa had contested for the post of the United Malays National Organisation (UMNO) Vice President to further his political career. However, things took an unexpected turn when he was charged for being involved in "money politics".[54] He was found guilty of five out of nine corruption charges involving vote-buying and the organisation of prohibited campaign meetings. The UMNO Disciplinary Board punished Isa with a six-year suspension of his membership, which was later reduced to three years after an appeal.[55] Despite his involvement in graft, Isa was appointed as Chairman and non-executive independent director of FGV on 1 January 2011.[56]

A soft landing for Isa

After Isa's resignation as FGV Chairman on 19 June 2017, Prime Minister Najib reappointed him as acting Chairman of the Land Public Transport Commission (SPAD), to express his gratitude for Isa's past contributions.[57]

This decision raised many concerns. Former SPAD Chairman, Hamid Albar, said that the government ought to "exercise wisdom" in the selection of a successor and should provide answers to the public surrounding Isa's involvement in the recent scandals.[58] Lawmaker Liew Chin Tong also suggested that Isa should not be accorded with such a prestigious position amidst the allegations of corruption in FGV, as this could "further erode public confidence towards the government".[59]

Isa was also implicated in two other scandals. These had occurred within FELDA Investment Corporation Sdn Bhd (FIC) during Isa's term as the Chairman of FIC in 2014.[60] FIC serves as the investment arm of FELDA and was incorporated in 2 July 2013. It is primarily engaged in property development, hospitality, and other strategic investments.[61]

In August 2017, MACC arrested Isa due to his alleged connections with FIC's controversial purchases of overpriced hotels. FIC was reported to have purchased a four-star hotel in Kensington, London, at an inflated price of RM330 million in December 2014.[62] This was three times the market price of RM110 million.[63] Additionally, FIC purchased a hotel in Kuching for RM160 million, which exceeded its actual market value by RM50 million.[64]

Questionable land transfers

Public confidence in FELDA faced another blow in December 2017 due to the revelation of the fraudulent transfers of four plots of land in Kuala Lumpur, Malaysia. The total value of the plots of land was estimated to be RM1 billion[65] but they were transferred for a mere RM 270 million to private developer Synergy Promenade Sdn Bhd (SPSB).[66]

It was later revealed that FELDA's board of directors were kept in the dark about the land transfer – they only found out about it through mass media platforms.[67] According to a report, however, the FELDA board was informed about the proposal to develop the land, but was not updated about the choice of developer and the ultimate decision to transfer the land.[68]

FELDA regained ownership of the land in January 2018, a month after the transfer was discovered. SPSB had agreed to sign a memorandum of understanding and returned all land ownership documents back to FELDA at no cost.[69] FELDA Chairman Shahrir reassured the public that it had no intention of withdrawing from the ongoing police investigation regarding the land transfer in order to "identify any possible mismanagement".[70]

No light at the end of the tunnel

In October 2017, Zakaria was reinstated as Group President and CEO.[71] A major board overhaul took place during his four-month absence, leaving FGV in the hands of new Chairman Datuk Wira Azhar Abdul Hamid and fresh-faced directors.[72]

However, some remained sceptical about the new board. President of TI-M, Akhbar Satar, felt that drastic actions to strengthen the board composition must be accompanied with genuine intention to make "sincerity and integrity an integral part of the corporate culture",[73] emphasising the importance of setting the tone at the top.

On 20 March 2018, FELDA Chairman Shahrir declared that FELDA had recovered from its troubles, having managed to regain confidence from the public and the marketplace.[74] Ten days later, FGV's board announced that its subsidiary, Delima Oil, had commenced legal proceedings against Safitex, seeking a claim of more than US$10 million.[75] Meanwhile, findings from MACC's investigations into the series of scandals have yet to be disclosed.

Were these scandals the result of isolated acts orchestrated by a few black sheep? Are there more severe underlying issues that require immediate attention? Perhaps Chairman Shahrir was right – it was time to focus on the fundamentals and strip things back down to the basics.[76]

Discussion questions

1. Discuss the factors that led to the accumulation of debt from Safitex. What could the various stakeholders have done to prevent this?

2. Discuss the different roles of the board and management in a company. Was there a clear division of responsibilities between FGV's board and management?

3. After the scandal surfaced, Zakaria said that he did not agree with several investment decisions made by the board in the past. Discuss whether Zakaria and the board had effectively discharged their respective responsibilities.

4. Comment on the adequacy and effectiveness of existing risk management and internal control practices within FGV. Suggest ways to improve risk governance in the company.

5. What are the pros and cons of having representation from the parent company on the board of its subsidiary, and having the Chairman of the parent company chairing the board of the subsidiary?

6. Based on this case, discuss how public governance is related to corporate governance?

7. Evaluate the effectiveness of the Malaysian Anti-Corruption Commission in investigating the scandals and protecting the interests of minority shareholders. Would greater public oversight be effective in increasing board accountability?

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INFOSYS LIMITED: MURTHY'S LAW

Case overview

A company once known for its corporate governance, Infosys Limited (Infosys) was thrust into the spotlight when its first non-founder CEO was accused of overpaying for an acquisition of a company where he has a conflict of interest. Other issues soon arose, including criticisms about severance packages paid to departing senior executives and a significant increase in remuneration for the CEO. The founder, former CEO and former Executive Chairman, N.R. Narayana Murthy, publicly criticised the company. The objective of this case is to allow a discussion of issues such as remuneration policies; golden handshakes; conflict of interest; roles of founders in governance; outsider CEOs; roles of the board and management; and importance of transparency and disclosure.

The birth of a tech giant

Infosys is an Indian multinational company, providing business consulting, outsourcing and information technology services. It was co-founded by Nagavara Ramarao Narayana Murthy, along with six other co-founders in 1981. Infosys was the first Indian company to be listed on the NASDAQ Stock Market.[1] It is currently India's second largest IT services company,[2] with a market capitalisation of US$42.4 billion.[3]

This is the abridged version of a case prepared by Chester Ng Keng Hao, Nio Jing Rong, Sally Choo Qing Lei and Ung Zi Qing 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.

The gold standard in corporate governance

"Good corporate governance is about maximizing shareholder value on a sustainable basis while ensuring fairness to all stakeholders: customers, vendor partners, investors, employees, government and society."

– N. R. Narayana Murthy, founder of Infosys[4]

Since its inception, Infosys has bagged many corporate governance awards such as the Corporate Award for Corporate Governance from the Bombay Stock Exchange (BSE) in 2000 and the Golden Peacock Award at the 16th London Global Convention on 'Corporate Governance and Sustainability' in 2016.[5,6] Infosys' corporate governance framework aims to effectively engage with stakeholders and help the company evolve with changing times. The company makes the board of directors the core of its corporate governance practice to oversee its management, ensuring that long-term interests of stakeholders are fulfilled.[7]

Remuneration policy

Infosys' remuneration policy states that the remuneration of its Chief Executive Officer (CEO) is tied to performance. According to the company's annual report, performance-based equity and stock options for FY2017 were granted to the CEO while restricted stock units and employee stock ownership plans were used for the Chief Operating Officer (COO). The approvals of both the board and shareholders were sought through a postal ballot. Remuneration of key managerial personnel was also clearly disclosed in the annual report.[8]

Key personnel

As one of the company's co-founders, Murthy led Infosys for 21 years as CEO till March 2002. Subsequently, from 2002 to 2006, Murthy was Infosys' Executive Chairman and Chief Mentor.[9] In 2011, Murthy retired and was conferred the title of Chairman Emeritus.[10] His successor, Ramaswami Seshasayee, served as the company's Non-Executive Chairman[11] from 2011 to 2017. However, during that period, Murthy returned to Infosys on 1 June 2013 as Executive Chairman to lead the company into a high-growth trajectory following a slip in its performance.[12] Slightly over a year later, on 11 October 2014, Murthy abruptly announced his 'second retirement' and reverted to his position as Chairman Emeritus.[13]

Nandan Nilekani, another of Infosys' celebrated co-founders, served as the company's CEO from 2002 to 2007, after taking over the position from Murthy. During his tenure, the company's revenue grew from Rs 2,603.6 crore in 2002 to Rs 13,149 crore in 2007. Subsequently, Nilekani was the company's co-chairman and a member of its board. After leaving Infosys in 2009, he became the first Chairman of the Unique Identification Authority of India with the rank of a cabinet minister in India.[14]

In June 2014, Dr Vishal Sikka was appointed CEO and managing director of Infosys.[15,16] Prior to joining Infosys, he had strong credentials at software corporation SAP AG (SAP) and played a part in developing one of SAP's most successful products, SAP HANA.[17] With Sikka's track record, Infosys believed that he would play a key role in developing the company and securing its future success.[18] Sikka's appointment was significant as it was the first time in Infosys' history that it would be led by a non-founder.[19] However, Sikka's tenure was peppered with a number of unfortunate incidents, resulting in doubts being raised on his leadership.

Revolution and innovation

"We can be the next generation services company, as differentiated and iconic as we once were, a company that admires its past and builds on it, or we can be a somewhat improved, but dying, previous generation company that is mired in the past."

– Vishal Sikka, CEO of Infosys[20]

As the new CEO of Infosys, Sikka had different ideas and strategies for the company. The Infosys founders had built the company on a more conservative approach; being cautious in acquiring firms, and having in place a remuneration structure where the highest compensation in the firm hovered around the median. In contrast, Sikka had ambitious goals for the IT company. He laid down a blueprint for Infosys to become a US$20 billion company by 2020 with a strategy of "new, renew". Its plans included prioritising and greater allocation of resources for its top 100 clients, pushing towards automation in its existing commoditised businesses, providing new services such as big data, analytics, and digital asset management, as well as to make more acquisitions.[21]

A glitch in the matrix

In 2015, Infosys acquired Panaya Ltd (Panaya), an Israeli software-as-a-service company that offers automation and enterprise software solutions. Infosys paid US$200 million, even though a previous estimation valued it at only US$162 million. The acquisition was in line with Infosys' redeveloped "new, renew" strategy, to bring in innovation and to stay competitive.[22,23]

The valuation of US$162 million was made by private equity firm Israel Growth Partners, one of Panaya's shareholders with a 12.31% stake in the company. It was also reported that Hasso Plattner, SAP's co-founder and Sikka's former boss, had an 8.33% stake in Panaya at the time.[24]

On 19 February 2015, a whistleblower sent information to the Securities and Exchange Board of India and the U.S. Securities Exchange Commission, questioning the high price of the acquisition and alleging that Infosys' board did not address "serious corporate governance issues and conflict of interest issues" regarding Sikka.[25,26]

It was reported that Infosys' then-Chief Financial Officer (CFO), Rajiv Bansal, had walked out of the board meeting regarding the Panaya acquisition as he felt that Infosys overpaid for the acquisition and was upset that he was not involved in the due diligence process prior to the acquisition.[27,28] Further, Bansal believed that the acquisition was ill-conceived and would not add value to Infosys.[29]

In response to the allegations, Infosys issued a media response denying any wrongdoing, asserting that the allegations were "false, malicious and defamatory".[30] The company further justified the acquisition price, stating that a third-party valuation was done by Deutsche Bank, and that the acquisition price was within the recommended range.[31]

A golden handshake or two

"This concern was dismissed by the former chairman as a mere "housekeeping" matter. So much for good governance!"

– N. R. Narayana Murthy [32]

In October 2015, Bansal left the company with a severance pay of Rs 17.38 crore.[33] It was noted that even though the severance was agreed upon in October 2015, meeting minutes were only recorded in January 2016 and the details were only disclosed in June 2016.[34] In view of this, then-Chairman Seshasayee reportedly said that it was merely a "housekeeping matter", and the late recording "was not a cause for concern".[35] Infosys mentioned in a statement that the minutes were not disclosed due to the sum of his compensation package and an "enhanced non-compete and non-disclosure agreement" but declined to clarify what the agreement was.[36] Furthermore, it was the first time Infosys offered such severance package to former heads of finance and CFOs.[37]

Murthy, however, viewed this as a corporate governance issue and alleged that the severance package was "hush money".[38] Two investigations, conducted by Indian law firm Cyril Amarchand Mangaldas and accounting firm KMPG, were launched. However, both investigations revealed no wrongdoing.[39] When questioned about this incident again in November 2016, Sikka mentioned that in retrospect the "[the severance package] was larger than it should have been", and admitted that the decision, made over a two-day period, felt fair at the time.[40]

In December 2016, a similar incident happened when the Chief Compliance Officer and Executive Vice President of Infosys, David Kennedy, was offered US$868,250 as part of a generous severance package, which again drew flak.[41] Infosys justified that the severance was paid out in accordance with an agreement included in Kennedy's employment contract.[42]

"Compassionate capitalism"

In February 2016, Infosys gave Sikka a significant pay increase, purportedly for helping the company to "regain industry-leading numbers". Post-revision, Sikka's compensation jumped to US$11 million in 2017, from US$7.08 million the year prior.[43] Defending the decision, Seshasayee commented that Sikka's compensation was benchmarked against comparable U.S. companies.[44]

During the company's 2016 Annual General Meeting, Murthy and three other co-founders abstained from voting on this matter. Murthy was reported to have said that by proposing such a significant increase in CEO compensation, the board placed him in a "moral dilemma".[45] Infosys was previously built on Murthy's philosophy of "compassionate capitalism" – the ratio between the median salary and the highest compensation paid out should ideally be 50 to 60. Under the new compensation structure, the CEO compensation sharply increased by 55%, in contrast with the former average salary increment of six percent to eight percent.[46]

New blood

Apart from questions raised on the company's remuneration policies, other aspects of Infosys' corporate governance came under scrutiny as well. In January 2016, Punita Sinha, wife of India's Minister of State of Finance, Jayant Sinha, was appointed as an independent director of Infosys.[47] In India, the Ministry of Finance would screen applications and approve tenders for government contracts.[48] Murthy abstained from voting as it went against his principle of not accepting any politically-connected individuals onto Infosys' board. Sikka and the rest of the board voted in favour of Punita's appointment as she came from a good academic and investment background.[49]

In July 2016, Murthy recommended Seshasayee to appoint D. N. Prahlad, one of the company's longest-tenured employees, as an independent director. This raised scepticism as Prahlad is a distant relative of Murthy.[50] Three months later, in October 2016, Infosys announced the appointment of Prahlad as director. Several proxy advisory firms were dissatisfied as it seemed that Murthy was finding attempts to gain control of the board.[51] Later, in January 2017, Prahlad was made the fifth member of the nominations and remuneration panel, responsible for the pay of the executives, including the CEO.[52]

System incompatibility

In February 2017, it was reported that Infosys' founders, specifically Murthy, had voiced concerns about the drop in governance standards in Infosys. According to Murthy, several former and current employees, former directors and investors were disappointed with the board and the management's governance.[53]

Murthy believed that since the Nomination and Remuneration Committee held a meeting to discuss the prevailing severance pay practices of the company, Bansal's severance pay should not have been given the green light. He cited examples of eminent CFOs and key employees who held important "secrets", as Bansal did, but did not receive such generous severance payments when they left.[54]

In view of the founders' concerns, Seshasayee refuted all claims of corporate governance weaknesses raised and emphasised a "commitment to maintaining the gold standard of governance that this company is known for".[55] Furthermore, in respect of Sikka's pay hike, Seshasayee pointed out that 98% of shareholders had approved his remuneration.[56] Later that month, Infosys announced that the concerns with executive pay have been addressed.[57]

In a public interview held in mid-July 2017, Murthy publicly expressed regret for leaving Infosys in 2014.[58] He had earlier sent a letter to the Infosys board on 8 July 2017, addressing the whistleblower's complaint and requested for the publication of the investigation into the Panaya deal and high severance packages.[59]

Murthy highlighted that the whistleblower accused various stakeholders such as the Chairman of the Board, Chairman of the Audit Committee, Chairman of the Remuneration Committee, CEO, and others of being complicit to a certain extent in the series of events. In his letter, he further wrote that when the whistleblower's complaints surfaced, his advice to Seshasayee to conduct the investigation in a transparent way was disregarded. Furthermore, Murthy expressed dissatisfaction that his queries about the special treatment of Bansal went unanswered.[60] The whistleblower also contended that there was an email from Kennedy to Sikka saying that Kennedy "could not hide the Bansal agreement from the board and the CFO any longer". Lastly, the whistleblower alleged that the auditors, KPMG, had brought this email to the attention of Kennedy and Sikka, requesting for clarification.[61] In his letter, Murthy also raised certain outstanding questions on corporate governance issues he felt the company should address, and offered his take on how the company should proceed to correct its corporate governance lapses.[62]

It was also reported that Murthy had sent an email to his advisors stating that three independent directors on Infosys' board had informed him numerous times that Sikka "is not CEO material but CTO material".[63]

Reboot required

Between June and July 2017, four senior-level executives resigned from Infosys consecutively. These included head of Americas, Sandeep Dadlani, who oversaw nearly one-third of the company's annual business. Dadlani's resignation was followed by the that of Yusuf Bashir, managing director of Infosys' US$500 million innovation fund, and Ritika Suri, head of mergers and acquisitions.[64]

The relentless disputes between the Infosys' board and Murthy eventually culminated in CEO Sikka's resignation on 18 August 2017.[65] According to Sikka, he "grew tired of constantly defending against unrelenting, baseless and increasing personal attacks", resulting in a shift in focus away from his original aim of growing the company.[66]

Infosys' board disclosed that "Murthy's continuous assault, including this latest letter" was the primary reason for Sikka's resignation. In the board's statement to the BSE, it stated that "Murthy's letter contains factual inaccuracies, already-disproved rumours, and statements extracted out of context from his conversations with board members".[67] The board referred to Murthy's previous statements over corporate governance weaknesses as a "misguided campaign" and reassured stakeholders that the company would continue to uphold the highest corporate governance standards.[68]

Upon the announcement of Sikka's resignation, Infosys' stock price fell by 9.6%[69] and dropped again by 5.4% during the following week to a three-year low of Rs 874,[70] resulting in a US$5.2 billion plunge in total market value.[71]

Less than a week after Sikka's resignation, there were calls for Seshasayee's departure and Nilekani's return due to investors' lack of confidence in the company.[72] On 24 August 2017, Nilekani took over from Seshasayee as Chairman, and Murthy was finally convinced that corrective actions on corporate governance had begun.[73] To soothe investors' concerns, Nilekani said that the board would deliberate on a shareholder consultation process to engage the company's stakeholders.[74] It was also reported that a majority of Infosys' board had offered to resign as part of a board restructuring to revert it to a 'clean slate' before Nilekani's return.[75]

Following the Nilekani's return, Infosys' share price rose 3.14% to Rs 941.15 on BSE. Investors were relieved by the promise of stability returning to the company.[76]

Return of the old guard and inception of the new

With Nilekani taking over, the focus is once again on Infosys' values, CLIFE – "client value, leadership by example, integrity and transparency, fairness and excellence".[77] Nilekani highlighted his intention to bring back the good corporate governance principles the company once had and to find a suitable CEO for Infosys.

However, months after Sikka's resignation, Nilekani still did not make the investigation about the Panaya acquisition public. In October 2017, the company stated: "After careful reconsideration, the company has concluded that publishing additional details of the investigation would inhibit the company's ability to conduct effective investigations into any matter in the future".[78] Infosys still stood by the fact that there was no wrongdoing on its part.[79] This again drew negative comments from Murthy, with him expressing his disappointment in co-founder Nilekani.[80]

In the same statement, Infosys confirmed that it had adopted a practice of disclosing severance payments to key managerial personnel at the time of their departure.[81]

On 2 January 2018, Salil Parekh took over the reins of Infosys as the new CEO. With over three decades of experience in the IT services industry, Infosys was confident of his abilities to lead the company.[82] With new leaders taking the wheel, all eyes are now on Infosys as it moves forward, hopefully still with its priorities on corporate governance in place.

Discussion questions

1. Infosys has won multiple awards for good corporate governance. What were some red flags that could have signalled the deteriorating corporate governance standards in the company?

2. Identify the conflicts of interest in the case, and discuss what each key player should have done to uphold high corporate governance standards.

3. Discuss the role and importance of the Remuneration Committee in the context of the case. Comment on the decisions made by the Remuneration Committee on the remuneration and severance packages of the company's executives.

4. How could Infosys have better managed succession of CEOs? In your discussion, draw parallels to family-type companies that have successfully transitioned to being professionally managed by outsiders.

5. Identify and comment on some of the key corporate governance challenges in companies with highly influential founders.

6. Were the actions of N.R. Narayana Murthy, the founder, former CEO and former Executive Chairman, justified? Explain.

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REAL (KOBE) STEEL, FAKE RESULTS

Case overview

In the latest of Japan's string of corporate scandals, Kobe Steel, Ltd. (Kobe Steel) admitted to falsifying data for its products to meet customer requirements. This had gone on for almost five decades. Kobe Steel's overemphasis on profitability, coupled with its lack of regard for corporate governance and its insular organisational structure, were seen to have contributed to the repeated occurrences of data falsification. Not only did the scandal adversely affect Kobe Steel's business and financial performance, it also caused problems for customers across various industries as they scrambled to check for compromises in the safety and performance of products manufactured with Kobe Steel's materials. Although no major lapses were reported, the episode prompted companies to evaluate their approaches towards supply chain risk management. The objective of this case is to facilitate a discussion of issues such as corporate culture; crisis management; supply chain risk management and the role of the board of directors.

This is the abridged version of a case prepared by Chen Shenghui, Shane, Lydia Lim Tien Li, Shaun Tan Wei Wen and Teo Fu Jie 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.

Time to go

Hiroya Kawasaki bowed long and low as he offered his resignation in light of the Kobe Steel scandal, which occurred when he was Chief Executive Officer (CEO) and Chairman of the company.[1] "I feel heavy responsibility," he told the news conference. "I've offered my resignation … as I think preventive measures should be done under a new management".[2] Kawasaki left the Japanese steel manufacturer on 1 April 2018,[3] exactly five years after his appointment as President on 1 April 2013.[4] Bogged down by compliance issues, malfeasance, and a battered reputation, perhaps – as the number five suggests in Japanese – it was time for Kawasaki to go.

Forged from steel

Kobe Steel is Japan's third-largest steelmaker, supplying steel and other metals to numerous airline and automobile manufacturers worldwide.[5] The company engages in several business activities, including iron and steel, machinery, welding, and aluminium.[6] The steel manufacturer had its beginnings in the early 1900s, and steadily grew after World War II to establish itself as a leading manufacturer of steel, nonferrous metals and machinery.[7] However, the 2000s brought new challenges for Kobe Steel, ranging from project bid-rigging to data falsification.[8]

Constructing the organisation

Kobe Steel had in place its own "Basic Policy and Initiatives on Corporate Governance".[9] The document detailed the execution of policies and functions of various players, as well as the philosophy behind such measures and structures.

The company had a silo-like organisational structure, which facilitated specialisation within each unit, with minimal data exchange and personnel interaction between them.[10] Such a system allowed divisions to function outside management oversight. As such, management personnel were not aware of happenings in other divisions apart from those they oversee.[11]

The board of directors consisted of the Chairman, President, various executive directors who were in charge of the various divisions, and outside directors. CEOs and Presidents were often picked from long-serving executives in its mainstay steel business or general affairs division – Kawasaki was no exception.[12,13]

The Audit and Supervisory Committee (ASC) was responsible for the company's internal control system, group compliance and risk management. It had "investigation authority without complete separation between supervision and execution", with those in charge of audits granted voting rights on the board. Meanwhile, the Compliance Committee (CC), with the majority of the committee coming from outside the company, dealt with compliance and ethical issues and advised the board.[14]

All employees were required to report material risks occurring in business activities and the response status to the ASC. An "outside attorney without a retainer fee arrangement" manned the internal reporting system. Anonymous reporting was permitted, and search and retaliation against internal whistleblowers was prohibited.[15]

The core values of Kobe Steel

Kobe Steel's core values[16] clarified its corporate philosophy of providing satisfactory products and supporting employees,[17] with the Six Pledges of KOBELCO Men and Women valuing ethics, professionalism and quality products among others.[18] Quality of products was guided by the Quality Charter.[19] Kobe Steel also established a Corporate Code of Ethics that required employees to "operate business fairly and honestly", with the Standards of Corporate Conduct reiterating the need for quality products and compliance with laws. [20]

With its insistence on company-wide compliance and harsh actions taken against non-compliance, Kobe Steel's data fabrication scandal came as a surprise. However, according to a retired employee, Kobe Steel's corporate culture was "to look the other way even while you saw what was going on."[21]

Digging through the steel pile

The Kobe Steel saga began in August 2017, when the Aluminium and Copper Business' (ACB) self-inspection of past records first revealed quality inspection misconduct. The President was informed and shipping of non-conforming products ceased. On 12 September 2017, the company conducted an emergency audit on its businesses, and informed customers of data inaccuracies.[22]

On 8 October 2017, Kobe Steel publicly admitted to falsifying strength and durability data to meet customer specifications – of the 20,000 tonnes of metals shipped in the year leading up to August 2017,[23] four percent had false certifications of certain properties such as tensile strength levels.[24] Upon hearing the news, the Japanese authorities acted fast. Within the same month, the Ministry of Economy, Trade and Industry had ordered the company to deliver a report on the data fabrication and detail the steps it would take to prevent such misconduct from occurring in the future.[25] After the submission of the report, Kawasaki attempted to regain investor confidence at a press briefing by stating that "improving (Kobe Steel's) management and corporate governance and instilling a culture where employees can say anything are imperative" and asserting that he would make such improvements his utmost priority.[26]

On 26 October 2017, Kobe Steel set up an Independent Investigation Committee (IIC) consisting purely of outside members to investigate self-inspections and misconduct.[27] This was due to a tip-off by a whistleblower, who had suggested that workers were obstructing internal inspections by concealing data.[28,29] On 6 March 2018, the company released the "Report on the Kobe Steel Group's Misconduct", revealing its long history of data falsification.

The first fallen domino

The scandal's eruption almost burned Kobe Steel's reputation to ashes and trust in the steel manufacturing giant had effectively "fallen to zero" when its corrosive business practices came to light.[30] The company had Japanese government-sanctioned seals of quality revoked on many products, faced lawsuits, and was subject to a U.S. Justice Department inquiry.[31] Furthermore, it estimated that 525 firms – including aeroplane and car manufacturers – had been affected by the instances of data fabrication.[32]

Investors who were concerned about the potential financial impact from product recalls or replacements and possible litigation, began dumping Kobe Steel stock.[33] Within a week of the breaking of the data fabrication news, Kobe Steel's share price plummeted over 42%, reaching a five-year low on 16 October, 2017.[34]

The domino effect

In the grand scheme of things, Kobe Steel was embedded in a highly intricate global supply chain system. The scandal sparked concern across supply chains in various industries such as aviation, automobiles, railways and nuclear power.[35] Customers scrambled to check for any compromised safety and performance aspects in their products.[36] While no major safety risks were raised,[37] the incident clashed with Japan's Corporate Governance Code (Principle 2), which expects Japan-listed companies like Kobe Steel to duly regard the wider group of stakeholders' interests.[38]

Elements of the steel-faking process

Nearly five months later, on 6 March 2018, Kobe Steel released a report following the IIC's investigation. With the admission of data falsification since the 1970s, misconduct occurring in various departments, and at least two directors being aware, there is no doubt the problems were deeply rooted in the organisation.[39] The report suggested causes of the misconduct, as well as proposed measures to prevent possible recurrences.[40]

Overemphasis on profitability

The head office's overemphasis on profitability pressured individual business divisions to adopt a 'production over quality' attitude, causing them to accept orders beyond their capabilities. Employees had limited understanding of plant process capabilities and were unable to carry out adequate feasibility evaluations on orders. It became common for employees to falsify test data for products that failed to meet the unattainably strict internal standards, which were usually higher than customer specifications. The lack of appropriate quality-related training and disciplinary actions created the false assumption that data falsification had no consequences.[41]

Working in silos

The operational, manufacturing and development functions were self-contained at spread out locations. This resulted in an 'insular organisational culture', creating opportunity for misconduct to manifest.[42] Since substantial management authority was transferred to each individual business division, the head office failed to maintain centralised control over the Group and run a compliance program effectively, so plants could only rely on their own existing controls. Various major business departments within the plants lacked proper audit functions and did not have adequate internal inspection processes to detect data falsification incidents.[43]

Little emphasis on corporate governance

In general, insufficient emphasis was placed on corporate governance by the company's upper management; as long as divisions were profitable, higher management did little to get involved.[44] Questions were raised over the effectiveness of the company's internal controls and whether the board fulfilled its supervisory role.[45] As such, extended periods of silence, combined with the Group's segmented structure, made the detection of any data falsification very difficult.

De-rusting the governance system

In response to the uncovering of the widespread data falsification incidents, Kobe Steel has implemented continual remedial actions to prevent future occurrences of such misconduct. The company aimed to restore trust by promoting the Next 100 Project, aimed at spreading the company's core values and Six Pledges of KOBELCO Men and Women throughout the Group. Activities under the project include direct communication between management and employees. Additionally, the month of October had been selected to be 'Core Values of KOBELCO Month' to constantly remind employees about the lessons learned from past compliance incidents. The Six Pledges of KOBELCO will also be revised to include expressions emphasising customer satisfaction and contribution to the society.[46,47]

To better comply with Japan's Corporate Governance Code (Principle 4) highlighting "effective oversight of directors and management from an independent and objective standpoint", Kobe Steel vowed to ensure that at least a third of the board members are independent outside directors. The Chairman would be elected from the aforementioned pool of independent outside directors. The company also said that it would abolish the Office of Executive Chairman and establish a Nominating and Compensation Committee to act as an advisory body to the board.[48]

Another revision made by the company to its existing structure is that division heads would not necessarily be elected as directors now. Instead, the materials, machinery and electric power businesses, as well as compliance and quality management would each be assigned and overseen by a director. Additionally, an independent Quality Supervision Committee consisting of external experts would be set up.[49]

Further, Kobe Steel promised to regularly conduct compliance awareness surveys to improve risk management based on internal standards, formulate the 'KOBELCO Quality Guidelines', and set up a Compliance Management Department under the counsel of a dedicated executive officer. Issues with the existing silo system would be addressed through personnel rotation amongst divisions, and problems at worksites would be resolved through procedures such as employee awareness surveys.[50]

Strengthening quality management

Kobe Steel introduced the 'Quality Charter' to restore trust in the Group. Kobe Steel also established a Quality Management Department (QMD); led by an outside officer, its role includes the planning of personnel development, division quality education and training, as well as rotation plans of quality assurance personnel. The company also implemented a quality assurance section directly controlled by each division to reinforce the quality assurance system at plants, factories, divisions, and the head office.[51]

Kobe Steel also stated that it would automate test and inspection data records and eradicate one-man data entry processes. It would eliminate the presence of double shipment standards – customer specifications and internally set standards – which was believed to have caused the misconduct and will instead maintain a single shipment standard. Moreover, the company would also revise its authorisation process for new orders and for switching manufacturing processes affecting product quality, and ensure that employees compare the company's process capabilities with the customer specifications when obtaining orders.[52]

The aftermath

In December 2017, Kobe Steel demoted three executives from the aluminium and copper business divisions, who were aware of the widespread data fabrication.[53]

In March 2018, Chairman Kawasaki and Vice President Akira Kaneko resigned, two managing executive officers were dismissed, and another executive officer faced a four-month long remuneration reduction of 80%. All other directors and executive officers – apart from outside directors and directors on the ASC – faced a 10% to 50% remuneration reduction for a period between one and four months.[54]

Kobe Steel and the Japan corporate environment

Although Japan's Corporate Governance Code was only established recently in 2015, Japan's earnest push to improve corporate governance has seen fruitful changes in the country's business landscape. Kobe Steel is only one of the many examples of Japanese companies enveloped by corporate scandal while going through corporate governance reforms due to pressures from various stakeholders.[55]

Indeed, the comprehensive remedial action plan and numerous departures of key personnel reflect the gravity of the situation and the embattled steelmaker's seriousness in addressing the scandal. Although some critics remain sceptical about the sufficiency of Kobe Steel's resolutions in addressing the root causes and the larger Japanese corporate culture, others remain optimistic, viewing the string of Japanese scandals as attempts at greater transparency and progressive change.

Discussion questions

1. In light of the numerous corporate scandals occurring in Japanese companies, Japan's corporate culture has come under great scrutiny. Given that the Kobe Steel had core values which placed emphasis on ethics, professionalism, and reliability in providing quality products to customers, identify and discuss the various factors within Kobe Steel's corporate culture that might have led to the data fraud.

2. Do you think Kobe Steel's board of directors had fulfilled its supervisory role? As a result of its actions (or lack thereof), to what extent did the board contribute to the widespread data fabrication in the company?

3. The effects of Kobe Steel's data falsification were felt far and wide by hundreds of companies globally, both directly and indirectly. In what ways could these companies have better protected themselves from the supply chain risks involved?

4. Comment on the adequacy of Kobe Steel's response to the scandal. To what extent would the measures outlined in Kobe Steel's remedial action plan prevent similar incidents in the future? What additional measures could Kobe Steel have implemented in response to the scandal?

5. With reference to Japan's Corporate Governance Code, in what respects did Kobe Steel fail to observe the stipulated guidelines? Taking its remedial action plan into consideration, how does Kobe Steel aim to achieve compliance with the Code?

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LIVING ON THE RAZER'S EDGE

Case overview

On 13 November 2017, Razer made its official debut as a public company on the Hong Kong Stock Exchange (HKEx). Days prior to its Initial Public Offering (IPO), Razer's shares were already oversubscribed an overwhelming 289 times. This was in stark contrast from its IPO attempt in the U.S. just three years earlier in 2014, when the IPO was allegedly called off due to market difficulties. The objective of this case is to allow a discussion of issues such as board structure and composition; dual role of Chairman and CEO; corporate governance standards across countries; and factors affecting the selection of IPO location.

Player one begin

Razer had its beginnings as a subsidiary of Kärna LLC in 1998, developing high-end computing mice targeted at computer gamers. In 1999, Singaporean Min-Liang Tan met Robert Krakoff, an American gamer, and through a collaborative effort, they developed the world's first gaming mouse, the Razer Boomslang. After Kärna ceased its operations due to financial difficulties, Tan and Krakoff procured the rights to the Razer brand and established Razer Inc. in 2005.[1,2] Tan assumed the roles of CEO, Chairman of the board and executive director, while Krakoff held the role of President in the gaming hardware manufacturing company.[3]

This is the abridged version of a case prepared by Khong Zhan Qing, Lim Ze Hao, Neo Zhao Zhi Bryce, Ng Wei Yang Jonathan and Thoo Sheng Jie Jeremy 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.

Over the years, Razer amassed a cult-like status in gaming circles worldwide through developing iconic cutting-edge computer hardware products, from gaming peripherals such as headphones and keyboards to laptops and a gaming phone.[4] With its growing success, Razer moved beyond hardware into software systems and services such as Razer zGold, a virtual credit services for gamers.[5] Beyond its gaming products, Razer is also recognised as a global leader and pioneer in esports.[6]

Razer is currently dual-headquartered in Singapore and San Francisco. It has a global presence with 14 offices and 840 staff worldwide.[7,8]

Different flute, same tune

Before its IPO on the HKEx, Razer underwent six rounds of investments, which saw prominent investors such as the likes of Lee Hsien Yang and Singapore state-owned fund Temasek Holdings taking a stake in the company. However, majority ownership and control was still effectively held by Tan.[9]

In 2014, Razer first contemplated going public in the U.S. to fund its expansion efforts. However, the company ultimately called off the listing in the second quarter of 2015 due to "unfavourable capital market conditions" and instead decided to go for private financing. Approximately US$3.35 million in expenses were incurred in relation to the aborted U.S. listing.[10]

In spite of the failed U.S. IPO, Razer continued to expand its product line through key partnerships and acquisitions. In 2015, Razer entered into a technology services agreement with, among others, Minus Inc. – developer of MeowChat, a mobile chat and photo sharing application – for provision of its services to Razer and for its licences relating to the application.[11] Further, between 2016 and 2017, Razer acquired certain key assets from Slot Speaker Technologies, Inc. (SST) to exploit operational synergies arising from SST's capabilities in sound systems technology, and Nextbit Systems Inc. (Nextbit) to gain access to Nextbit's existing intellectual property rights to develop its mobile devices strategy.[12]

The IPO attempt and ambitious product offering expansion efforts took a toll on Razer's bottom line. In 2015, the company reported a loss of US$20.4 million. It continued to post a US$59.6 million loss in 2016.[13] Revenue growth from 2016 to 2017, however, remained strong at 29.7%.[14]

Money's the name of the game

Between 2007 and 2014, Razer underwent four rounds of financing via the issuance of preferred shares. In 2007, it entered a series of share agreements and allotted Series A preferred shares. Following that, it underwent three more rounds of financing by issuing preferred shares in Series B-1 (2011), Series B-2 (2013), and Series B-3 (2014).[15]

To continue financing its product developments, Razer underwent two additional rounds of financing via the issuance of preferred shares in 2016 and 2017 respectively.[16] During these rounds of financing, notable investors such as Li Ka-Shing, Indonesia's wealthy Hartono brothers, as well as Intel Corporation's venture capital firm Middlefield Ventures Inc acquired stakes in Razer.[17] Razer's growing repertoire of prominent backers helped to boost its profile, placing it in a better position for its second IPO attempt in 2017.

Post IPO: The 'board' game

Razer's board of directors consists of seven individuals, comprising three executive directors (Razer's CEO, CFO, and COO), one non-executive director and three independent non-executive directors (INED).[18] Razer also established three board committees.

Committee	Members
Audit and Risk Management Committee	• Chau Kwok Fun, Kevin (INED) • Gideon Yu (INED) • Lee Yong Sun (INED)
Remuneration Committee	• Gideon Yu (INED) • Chau Kwok Fun, Kevin (INED) • Min-Liang Tan (Executive director)
Nomination Committee	• Chau Kwok Fun, Kevin (INED) • Lee Yong Sun (INED) • Lim Kaling (Non-executive director)

Figure 1: Nomination and Remuneration Committee[19]

Largest shareholders
Tan is the sole director of Chen Family (Hivemind) Holdings Limited, an investment holding company which directly holds 33% of shares in Razer Inc. post-IPO.[20] After the IPO, Tan remains the largest and controlling shareholder of Razer Inc., [21] and retains his dual roles as the company's Chairman and CEO.[22] The next largest shareholder is Lim Kaling, a founding investor and non-executive director of Razer, with an effective ownership of 24%.[23]

Remuneration
Remuneration for directors and senior management is in the form of salaries, allowances, bonuses, share-based remuneration and other benefits-in-kind.[24] Razer disclosed the aggregate remuneration paid to senior management, board directors, and the company's five highest paid individuals.[25] The aggregate amount of remuneration paid to directors for the financial years 2014, 2015 and 2016 and for the six months ended 30 June 2017 were approximately US$2.0 million, US$5.2 million, US$12.1 million and US$6.4 million, respectively.[26]

In 2016, Razer introduced an equity incentive plan which grants share-based awards to its employees, directors and consultants, to align interests and incentivise good performance. The restricted stock units vest at a rate of 25% each year, subject to certain terms and conditions.[27]

Second time is the charm

Razer sought to raise US$545 million via its IPO on the HKEx. The IPO comprised 1.06 billion shares, equivalent to 12% of Razer's share capital.[28]

Having endured losses arising from its unsuccessful IPO in the U.S., it was not surprising that Razer did not return to the U.S. when deciding to go public the second time. However, the decision to list the company in Hong Kong begs the question of why Singapore was left out of the equation. Has Razer's Singaporean founder truly forgotten his roots in Singapore, or has the Singapore Exchange (SGX) failed to capture the heart of her very own gaming brand?

Characteristics	HKEx	SGX
Liquidity: Average daily volume of shares traded in dollar[29]	S$10.5 billion	S$1.05 billion
Market capitalization[30]	S$5.2 trillion	S$926 billion
Number of IPO deals in 2016[31]	115	16
2016 Total deal size[32]	S$34.5 billion	S$1.9 billion
Percentage of technology stocks on the exchange (%)[33]	4	3

Figure 2: Differences between HKEx and SGX

Razer stated in its IPO prospectus that its choice of Hong Kong as a listing location was due to strategic reasons such as having "better access and exposure to the Hong Kong and Mainland China markets" and that it would "enhance [its] profile as a company and tap into the global base of investors".[34] China has been identified as a key growth market for esports and with approximately 13% of Razer's total revenue arising from China markets, the company expects to solidify its position as the top gaming accessories brand in China.[35] In addition, among Razer's most prominent investors is Hong Kong business magnate, Li Ka-Shing, with whom Razer has a partnership to target the huge esports market in Hong Kong.[36]

Stringency of due diligence process

Although it was reported that the number of Singapore companies considering an IPO in Hong Kong has doubled in 2017, some analysts say there is no win-lose competition between both stock exchanges.[37] Others say that the HKEx has an edge due to its role as a capital-raising centre[38] and Hong Kong's deep ties with the Chinese mainland and thus access to the huge Chinese market.[39]

Furthermore, there has been an ongoing debate on how extensive disclosure requirements impose costs on companies that might in turn deter them from an IPO. While a stricter due diligence process instils investor confidence,[40] it may cause private companies to shun listing opportunities. The strictness of a location's due diligence processes can be assessed in two areas – corporate governance standards, and regulatory and listing requirements.

Corporate governance standards

Singapore and Hong Kong are similar in that both countries have their own Corporate Governance Code that augments listing rules and company legislation.[41,42]

Independence of board

In Hong Kong, directors' independence definitions and requirements are included in its listing rules.[43] This makes it stricter in this regard compared to the 'comply or explain'[44] approach practised in Singapore. In terms of board independence, Hong Kong requires a minimum of three independent directors as compared to the mandated two in Singapore.[45]

Moreover, HKEx listing rules also require at least one independent director to possess professional accounting or financial qualifications with prior accounting or finance-related job experience such as with internal controls, preparing or auditing financial statements, or analysing audited financial statements of public companies.[46] These attributes are not explicitly specified in the Singapore corporate governance standards.

Directors' fiduciary duties, skills and diligence

In the case of Hong Kong, fiduciary duties and duties of care, skill and diligence of directors are defined in both the Companies Ordinance and listing rules. Foreign companies seeking a listing on the HKEx are thus subject to these requirements. In Singapore's case, such fiduciary duties and duties of care are only reflected in the Companies Act, which applies to all Singapore-incorporated companies.[47]

Remuneration and its disclosures

The Hong Kong listing rules require the disclosure of the exact aggregate remuneration for each and every director, by name, with the breakdown of various remuneration components. This is in contrast with remuneration disclosures being a matter for the Code of Corporate Governance in Singapore, with band disclosures generally practised in Singapore.[48]

Internal controls disclosures

Lastly, both the HKEx and SGX require declarations or opinions on the adequacy of a listed company's internal controls. In Hong Kong, an auditor's report to management on internal controls and accounting systems is required as part of a listing application.[49]

Regulatory and listing requirements

Companies have to abide by regulatory and listing requirements before they can successfully get listed on any stock exchange. Across different bourses, the stringency and areas of emphasis of such requirements differ.

While both HKEx and SGX require profit forecasts and working capital disclosures, HKEx also requires disclosures on ownership of assets.[50]

For mainboard listings, requirements based on revenue and market capitalisation are stricter for HKEx compared to SGX. HKEx has an additional requirement for companies to submit a profit forecast for review, as well as possess ownership continuity and control of assets for at least the most recent audited financial year.[51]

Regulatory requirements for International Issuers on the HKEx are also more cumbersome as they require the appointment of a process agent, an authorised representative, and the maintenance of a record of holders in Hong Kong.[52]

Razer's date with destiny

With several finance Goliaths backing the gaming company, Razer's IPO was well-poised to take flight. On 7 November 2017, days before its official IPO, it was reported that both the retail and institutional tranches of shares were already over-subscribed by multiple folds, with the Hong Kong public tranche oversubscribed by an overwhelming 289 times.[53] With the IPO attracting such a strong response, it is certain that expectations are sky high for the gaming company's future performance.

Razer's debut on the HKEx on 13 November 2017 was positive, with its stock rising to as high as HK$5.49, 41% higher than its HK$3.88 IPO price.[54] Off to a good start, the journey in the public realm had only begun for the gaming hardware manufacturing company. Unfortunately, the euphoria did not last as its stock price trended downwards in the year following its IPO, with no sign of recovery.

In April 2018, Tan said that Razer's focus has moved to "getting the Hong Kong investment public to be more educated on tech companies".[55] With some investors expressing that this aim is particularly challenging for Razer compared to other technology companies due to its focus on emerging technological products,[56] Razer faces challenges in developing a lasting presence and instilling investor confidence in its brand.

Discussion questions

1. In Razer's case, co-founder Min-Liang Tan assumes a duality of roles – as Razer's Chairman and CEO. Identify the possible governance issues that may arise from this arrangement. Do you believe such a leadership structure is suitable for certain types of companies? Explain.

2. The case explains differences in corporate governance standards, listing requirements and other characteristics between the Hong Kong and Singapore stock exchanges. Analyse the possible main considerations for companies in deciding on their listing location. Why do you think Razer decided to list in Hong Kong? Was it because of lower standards? Explain.

3. The current listing requirements and corporate governance standards of different countries vary in stringency. Suggest possible reasons behind such varying levels of stringency across countries. Evaluate the trade-offs that come with stricter listing standards.

4. With larger stock exchanges in Hong Kong and the U.S. adopting a more prescriptive approach to their corporate governance framework, should SGX contemplate a move towards a more prescriptive approach, or are there other possible avenues for improvement in its 'comply or explain' approach?

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CAN IT “TRIVE” AGAIN?

Case overview

In 2013 and 2015, Bursa Malaysia, reprimanded Trive Property Group Berhad (Trive) and its directors for breaching its listing rules. The breaches were mainly in respect of internal audit deficiencies, untimely announcements relating to credit defaults, delayed announcement of financial statements, and the furnishing of false or misleading statements due to the failure to perform an impairment assessment. Securities Commission Malaysia subsequently stepped in with further sanctions. The objective of this case is to allow a discussion of issues such as duties and responsibilities of directors in ensuring proper risk management processes and compliance with regulations; the role of the internal audit function and Audit Committee (AC); the role of external regulators in ensuring compliance to its listing rules and regulations; and the company’s corporate governance.

The life of Trive

Trive is an investment holding firm that provides management services to its subsidiary companies.[1] Its subsidiaries are engaged in a range of activities, from the trading, design and marketing of battery management system for rechargeable energy storage solutions, to property development, construction and property investment.[2] The company prides itself as a premier green energy solution provider.[3] It expanded beyond Malaysia into countries such as Taiwan, United Arab Emirates, India, Singapore and Australia. Trive also worked with companies from diverse industries in telecommunications, healthcare, power utilities, aero-models, and robotics.[4]

This is the abridged version of a case prepared by Chew Wei Chun, Lee Leong Hui, Neo Kai Tan Ivan, Ng Jian Her (Alcan) and Ng Ee Zhen under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Yeo Hui Yin Venetia under the supervision of Professor Mak Yuen Teen.

A t(h)riving start

In 2002, Dato' Dennis Chuah, Lee Kah Kheng and Mansor Bin Padin founded ETI Tech (M) Sdn Bhd (ETI Tech (M)).[5] Under their leadership, ETI Tech (M) won various awards such as the SMI Recognition Award and Best Emerging Brand Award (2004).[6] In 2004, they co-founded ETI Tech Corporation Berhad (ETICB) and ETI Tech (M) became a wholly owned subsidiary of ETICB in the following year. ETICB listed on Bursa Malaysia on 28 March 2006.[7] In March 2015, ETICB changed its name to Trive.

The early years of Trive were nothing short of spectacular. After its listing, Trive's share price rose by approximately seven times in about two years.[8] However, Trive's rise came to a screeching halt when Bursa Malaysia took various actions, including suspending the trading of its shares and issuing reprimands in 2013 and 2015. Various issues within the company, especially the lack of due diligence of its directors, were brought to light.

The three musketeers

Dato' Chuah is an experienced sales executive in the semiconductor and electronics industry. Previously the marketing director of Zapstat Sdn Bhd, he assumed the position of business development director of the company and subsequently the Group.[9] Lee, a member of the Malaysian Institute of Certified Public Accountants (MICPA) with many years of accounting experience, was the managing director.[10] Mansor, an executive director, was involved in the Project Management Team due to his years of experience in the engineering field.[11]

The three co-founders formed the Executive Committee. The Executive Committee assisted the managing director with day-to-day operations and executing operational plans. Dato' Chuah and Lee were the two largest shareholders of the company, holding 19.984% and 19.287% of the total issued shares respectively.[12]

Trouble with internal audit

On 29 October 2015, a public reprimand by Bursa Malaysia revealed weak monitoring in Trive in relation to its internal audit function, AC, board of directors as well as the external auditor.[13]

Finfield Corporate Services Sdn Bhd (Finfield) was Trive’s internal auditor. On 9 December 2011, Finfield issued its final internal audit report for Trive for the quarter ending 31 August 2011. Finfield resigned a year later on 3 August 2012.[14] That year, Trive changed its financial year end to 28 February.[15]

After the resignation of Finfield, Trive assigned one of its internal accountants to handle the internal audit function.[16] This was in breach of Paragraph 15.27 of the Bursa Malaysia’s Main Listing Requirements (Main LR) which states that “a listed issuer must establish an internal audit function which is independent of the activities it audits”.[17] The role of the internal auditor, as defined in Paragraph 28 of the Statement on Internal Control – Guidance for Directors of Public Listed Companies, is to provide independent and objective assurance for the effectiveness of risk management, control and governance processes.[18]

The internal accountant resigned in January 2013, six months after being assigned the role.[19] This left Trive with no internal audit function.

‘Pres’sing issue

Preston Advisory Sdn Bhd (Preston) was then appointed as the internal auditor on 29 April 2013, three months after the resignation of the internal accountant.[20]

In the section titled “Principle Six of the Corporate Governance Disclosures” in its 2014 Annual Report, Trive stated that the “cost incurred for the internal audit function for the financial period ended 31 July 2014 was RM10,000”.[21] However, it appears that Trive failed to pay Preston when the latter resigned from its position, citing outstanding fees as the reason.[22]

On 9 July 2014, Trive appointed Kloo Point Risk Management Services Sdn Bhd (Kloo Point) as its internal auditor. Kloo Point reviewed the internal control system covering the six months prior to its appointment and prepared the internal audit plan for the fiscal year ended 31 July 2014.[23]

However, for the 18-month period ended 28 February 2013 and the following financial year, there was no evidence of internal audit work being carried out up until the appointment of Kloo Point. Bursa Malaysia asserted that the fact that the position of the internal auditor was filled, initially by Finfield in 2011 until its resignation in 2012 and subsequently by the internal accountant and Preston, did not meet the requirement of Paragraph 15.27(1) of the Main LR which requires the company to establish an internal audit function. According to Bursa Malaysia, "the mere existence ... and assignment of the internal accountant to take on the internal audit function … in the absence of any activities … would not satisfy the requirement under Paragraph 15.27(1) of the Main LR for the company to establish an internal audit function."[24]

Misleading statements

Trive's 2013 Annual Report made misleading statements which hid the fact that the internal accountant was appointed as its internal auditor, compromising independence and objectivity of its internal audit. This was reiterated in both the statement on corporate governance and the AC statement which stated that the internal audit function had been outsourced to an independent professional internal audit service provider firm.[25] While this statement was true when referring to the period for which Finfield was the internal auditor, Trive made no mention about the other six months for which there was no independent internal auditor.

Failure of directors in exercising due diligence

Additionally, the AC was alleged to have failed to carry out its duties with diligence. Under Paragraph 15.12(1) of the Main LR, the AC is expected to review and report on the internal audit program, processes and the competency of the internal audit function.[26]

The AC statement in the 2013 Annual Report stated that the AC shall "evaluate the quality of the audit conducted by the internal and external auditors".[27] However, Bursa Malaysia highlighted that these statements were not supported.[28]

All the AC members who were implicated resigned between April 2013 and July 2014.[29]

Multiple breaches

The breach of Paragraphs 15.27(1) and 15.12(1) of the Main LR relating to the establishment of an independent internal audit function and the AC reviewing and reporting to the board on internal audit, led Bursa Malaysia to issue a public reprimand in 2015 to 10 former directors, imposing fines on some. Directors involved included: Dato’ Ahmad Shukri Bin Tajuddin, Lee, Nordin Bin Mohamad Desa, Baqir Hussain Bin Hatim Ali, Brig Gen (B) Datuk Muhamad Yasin bin Yahya, Woo Kok Boon, Khor Yee Kwang, Dato’ Chuah, Dato’ Chang Lik Sean and Lim Mei Theng. According to Bursa Malaysia, they were or should have been aware of the lack of an internal audit function and it was not shown that they had taken reasonable steps to remedy the issue.[30]

Moreover, five directors – Lee, Nordin, Dato’ Chang, Yasin and Woo – were found to have breached Paragraph 2.18(1)(a) and (c) of the Main LR. They had approved misrepresentations and misleading statements in the Statement of Risk Management & Internal Control and the AC Statement in the 2013 Annual Report of Trive.[31]

Further, Trive failed to comply with Paragraph 15.23 of the Main LR as it did not ensure that the Statement of Internal Control had been reviewed by its external auditor.[32]

Credit default

Internal audit deficiencies were not the only problems plaguing Trive. On 30 November 2012 and 28 February 2013, ETI Tech (M) had defaulted on the credit facilities granted by Standard Chartered Bank Malaysia Berhad (SCB), Maybank Islamic Berhad (MIB) and Malayan Banking Berhad (MBB).[33]

However, it was only on 9 January 2013 and 25 March 2013 that Trive announced these defaults. This was in breach of the now defunct Practice Note 1 (PN1) of the Main LR, which required defaults in payments of credit facilities amounting to 5% or more of the net assets to be immediately announced.[34] As of 31 December 2012, ETI Tech (M) owed SCB RM4,358,234 in overdraft and US$929,490 in export bills discounting. This was attributed to delays in the collection of receivables and a slowdown in its current business.[35]

The default to SCB led to a cross default under the agreement of indebtedness with two other banks, Hong Leong Bank Berhad (HLB) and MBB.[36] Trive's share price dropped 25% from RM0.08 to RM0.06 in one day.[37]

Reprimand

On 26 June 2013, Bursa Malaysia reprimanded the company for failing to make an immediate announcement in respect to the default of payments of credit facilities by its subsidiary, ETI Tech (M). This was in breach of Paragraphs 9.03(1) and 9.04(l) of the Main LR, read together with Paragraph 2.1(d) of PN1.[38]

The public reprimand was issued pursuant to Paragraph 16.19(1) of the Main LR after taking into consideration all facts and circumstances of the matter. While the regulator recognised that the directors had not instigated or approved the breach, it is their duty to uphold appropriate standards of responsibility and accountability in ensuring compliance.[39]

The announcement of the reprimand led to the company's share price falling 43% from RM0.08 to RM0.045 within a week.[40]

Trive goes to court

Following the default of the credit facilities, a series of Writs of Summons and Statements of Claims were filed by MBB, MIB, HLBB, SCB against ETI Tech (M) as first defendant and Trive as second defendant.[41,42,43,44]

On 14 October 2013, the Shah Alam High Court granted a restraining order for Trive and ETI Tech (M) to allow Trive to focus on formalising the proposed scheme of arrangements unhindered.[45] The restraining order was further extended to 27 June 2014.[46]

After multiple postponements of the hearings, judgment was reached on 27 January 2014 when the High Court delivered judgment in favour of HLB and MBB.[47,48] Trive was to provide for the claim of RM11,145,342 and RM6,121,530 to HLB and MBB respectively.[49,50]

Subsequently, proposals were made for a debt restructuring, an increase in authorised share capital and amendments to the memorandum of association. On 17 December 2014, the Shah Alam High Court approved and sanctioned the scheme of arrangement in a Sanction Order.[51]

On 8 June 2016, the board announced that ETI Tech (M) had fully paid the sum it owed to its scheme creditors. Meanwhile, the default in payment pursuant to Paragraph 9.19A of the Main LR status was regularised and lifted.[52]

On 5 September 2016, SCB and HLB confirmed in writing that the compromised settlement for the amount due and payable under the Judgement had been fully settled.[53,54] In this regard, HLB no longer had any claim against ETI Tech (M) and Trive as corporate guarantor, and the case ended.[55]

Delayed announcement of financial statements

In accordance with Paragraph 9.23(1) of the Main LR, "a listed issuer must issue its annual report…, to the Exchange and shareholders within 4 months from the close of the financial year of the listed issuer".[56] For Trive, this meant four months from 28 February 2013.[57]

Further, Paragraph 9.28(5) states that if a company fails to comply with Paragraph 9.23(1), "the Exchange shall suspend trading in the securities of such listed issuer".[58] On 5 July 2013, Bursa Malaysia released a notice announcing the suspension of trading for Trive starting from 8 July 2013. Trive was criticised for failing to submit its annual audited accounts for the financial period ended 28 February 2013 within the required timeframe.[59] The trading of Trive's shares resumed almost one month later on 5 August 2013,[60] following the submission of its annual audited accounts on 1 August 2013[61] and qualified auditors' report on 2 August 2013.[62]

As a result of the breaches, the four directors were fined a total of RM22,800 on top of a reprimand.[63]

The reasons

Trive's management cited difficulties faced by the company in resolving audit issues with its external auditors in a timely manner. These included:

– Failure to reclassify the assets in relation to a proposed disposal of an indirect wholly-owned subsidiary as required by accounting standards, which had been approved and entered into before the deadline for the announcement of the audited financial statements, 30 June 2013;

– Failure to provide the three years of profit and cash flow projections for the group to determine the reasonableness of the RM32 million dollars of development expenditure made by the company; and

– Inventory stock count delays.[64]

External auditors – changing hands over the years

Qualified opinions were issued for Trive's financial statements for FY2013, 2014, and 2016 by the external auditors.[65,66,67]

There have been several changes in external auditors for Trive. UHY was appointed for FY2013 and resigned on 4 July 2014.[68] This led to the appointment of Baker Tilly Monteiro Heng (Baker Tilly), which resigned on 23 October 2015. Siew Boon Yeong & Associates then took over Baker Tilly to become Trive's current auditor.[69]

All the external auditors expressed the lack of adequate information provided to them by the management or lack of evidence for them to be able to confirm the balances in the accounts.

The dive of Trive

Before the saga in 2012, Trive was already experiencing decreases in its net profits from 2009 to 2011.[70,71,72] One of its co-founders, Mansor, retired on 25 February 2010.[73]

During FY2012, Trive's two remaining co-founders began selling off their stakes in the company. The selling of shares occurred during the so-called 'closed' time frame of a month before a quarterly results release. It coincided with the stock price falling to a low of RM0.09 on 8 October from a peak of RM0.215 on 14 February 2012.[74] However, the second quarter report of FY2012 indicated that Trive was expected to reach satisfactory performance levels provided there was no unforeseen circumstances as the company embarked on more deals and its green technology batteries initiative.[75]

Thereafter, Trive announced its first quarter end loss in August 2012 with a net loss of RM8.3 million. This large loss was attributed to the impairment losses on inventories and development expenditures, and the provisions for bad debts.[76] Trive also changed its financial year end from August 2012 to February 2013.[77]

After the end of FY2013, executive director Dato' Chuah resigned on 18 June 2013.[78] At the following Annual General Meeting held on 23 September 2013, managing director Lee expressed his intention to retire and was hence not re-elected.[79] As such, the founding core and Executive Committee of Trive had all left the company after it posted its worst loss of RM55 million in FY2013.[80] Their retirement coincided with the period of the default in credit facilities and litigation.

New Trive, new drive?

On 9 June 2016, Trive entered into a memorandum of understanding to establish a joint venture company with Fortunate Solar Technology Ltd, a company established and registered in China well-known for its expertise in solar and silicon products and services.[81] In addition, Trive acquired a local housing developer, Pakadiri Sdn Bhd, on 26 January 2017[82] and Daima Fujing New Energy Technology Sdn. Bhd, a company involved in solar power systems on 5 October 2017.[83]

To further its transformation, there were multiple changes to the board. Currently, three independent non-executive directors, Wong Kok Seong, Thu Soon Shien and Chen Chee Peng; one non-independent non-executive director, Doris Wong Sing Ee; and one executive director, Kua Khai Shyuan, sit on the board.[84,85] Wong Kok Seong and Thu Soon Shien had been appointed to the AC on 18 June 2014 and 15 August 2014 respectively,[86] while Chen Chee Peng[87] joined both the AC[88] and Nomination Committee[89] on 6 February 2017. While Wong Kok Seong and Thu Soon Shien have a background in accounting – Wong Kok Seong being a chartered accountant, Fellow of the Association of Chartered Certified Accountants and member of the Malaysian Institute of Accountants (MIA), and Thu Soon Shien being a member of the MIA and Association of Chartered Certified Accountants (ACCA) – Chen Chee Peng's background lies in information systems and engineering.[90] Doris Wong Sing Ee, who does not sit on any board committee, joined as an independent non-executive director on 6 February 2017[91] and has since been re-designated to a non-independent, non-executive director on 17 October 2017.[92]

Statutory regulator steps in

The bad news for Trive did not end. Five current and former directors of Trive were slapped with yet another round of fines totalling RM2.55 million and a reprimand by the capital markets regulator, Securities Commission Malaysia (SC), on 4 December 2017. This was in relation to Trive's failure to perform an impairment assessment for a sum of RM21.1 million of development expenditure as at its financial year ending on 31 July 2014.[93] Trive and the five directors failed to comply with the Malaysia Financial Reporting Standards (MFRS) 136: Impairment of Assets and knowingly furnished false or misleading statements in relation to the non-impairment of the development expenditure to both SC and Bursa Malaysia. This constituted breaches of Regulation 4(1) of the Securities Industry (Compliance with Approved Accounting Standards) Regulations 1999 and Section 369(b)(B) of the Capital Markets and Services Act 2007 (CMSA) respectively. The aforementioned also breached Section 354(1)(a) of the CMSA.[94] The AC members at that time, present AC members Wong Kok Seong and Thu Soon Shien, as well as former director, Datuk Mohamad Amin Mohamad Salleh, were given a higher penalty.[95]

In light of the breaches, SC directives were issued to Trive in relation to its financial reporting function. These included the appointment of an external auditor registered with the Audit Oversight Board to assess the adequacy of Trive's financial reporting function and to make appropriate recommendations; the assessment of the external auditor’s findings and recommendations by the AC to the board; and to highlight in its subsequent audited financial statements to Bursa Malaysia the actions taken by Trive and its AC in addressing SC’s directive relating to CMSA breaches.[96] Following the announcement, Trive’s shares fell by 9.09% the next morning.[97]

Given the series of breaches and enforcement actions, shareholders of Trive must wonder whether they have seen the last of Trive’s troubles.

Discussion questions

1. Comment on the lack of separation of the board, management and shareholders in Trive. Discuss how this can impact the company’s corporate governance.

2. Explain the role of an internal audit function and Audit Committee. Discuss the significance of an internal audit function in the risk management of a company.

3. Using the four lines of defence, assess the defences (or rather, their failure) in Trive with reference to the three events that have occurred.

4. In the codes and listing rules of Singapore and Malaysia, there is reference to the role of the board in the risk management process. Assess the actions of the directors in light of these events and discuss the extent to which they should be held responsible. Consider the other stakeholders as well (mainly the internal audit function and risk management function).

5. Comment on the multiple resignations of the external auditors, internal auditors and directors. What does this reveal about the corporate governance of the company?

6. Comment on the effectiveness of Bursa Malaysia and Securities Commission Malaysia in ensuring compliance to its listing rules and regulations. Assess whether the penalties imposed on Trive were adequate to dissuade similar companies from non-compliance. Comment on whether you believe that the actions taken against Trive and the directors were fair.

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FINDING THE WHISTLE AT BARCLAYS

Case overview

In January 2017, a whistleblower contacted Barclays' board of directors, finding fault with the British bank's entire whistleblowing process. According to the whistleblower, Barclays Group Chief Executive (CEO), Jes Staley, had attempted to uncover another whistleblower who had sent in whistleblowing letters concerning Staley himself. Following the whistleblowing incident, more questions surrounding Staley emerged, questioning his suitability to remain as CEO. Barclays' history of scandals and fines was also brought to stakeholders' attention, raising concerns about Barclays' corporate governance. The objective of this case is to facilitate a discussion of issues such as whistleblowing and the effectiveness of whistleblowers; conflict of interests; the role and effectiveness of the board; and the board's influence on corporate culture.

The whistle is blown

In June 2016, two anonymous letters were sent from the U.S. to a number of Barclays board members and a senior executive. The letters concerned the recruitment of Tim Main, the Chairman of the bank's global financial institutions group in New York, who was also Staley's friend and former colleague from JP Morgan. The letter contained complaints about Main's behaviour during his time at JP Morgan and touched on Main's personal history while he was working at JP Morgan.[1] They further questioned the appropriateness of his recruitment to Barclays.[2]

This is the abridged version of a case prepared by Ang Jia Xuan, Fang Zhou, Sharon Goh Xin Yi, Sitoh Zi En Pamela and Zhang Danran 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.

Although the letters were reported not to have contained any new information that people did not already know, the bank's compliance team proceeded with investigations on the whistleblowing issue. Sources described the letters as being "very simple, very crude", and "very malicious".[3]

When Staley obtained access to a copy of the letters, he accused the whistleblower of harassment and alleged that his intent was to "maliciously smear" Main.[4] He then made multiple attempts to identify the whistleblower. His first attempt to identify the whistleblower was put to a stop after Staley and the information security team were informed that their actions were inappropriate due to the protection of whistleblower anonymity and against reprisal in the firm. A month later, Staley took another stab at the matter by instructing the information security team, led by Troels Oerting[5], a former Europol official, to track down the identity of the writer, after being informed that the whistleblowing probe had been closed. The security specialists at Barclays then requested for assistance from the U.S. Postal Inspection Service through video footages. However, the hunt proved to be fruitless and was eventually called off.[6]

Reforms in the U.K.

In March 2016, a new regime was introduced by the Bank of England and the Financial Conduct Authority of Britain (FCA) for strengthening accountability in banks and the financial sector.[7] The regime sought to reinforce the accountability of managers on an ongoing basis – entities are required to issue an annual certificate to staff, under prescribed functions, to deem them fit and proper to fulfil their professional duties.[8]

The purpose of the Senior Management Arrangements, Systems and Controls was to encourage directors and senior management of companies to take appropriate responsibility for the company's arrangements on matters likely to be of interest to the Financial Services Authority, making them accountable for the control of the company's affairs.[9,10]

Additionally, under Section 60A(1) of the Financial Services and Markets Act, entities are required to be satisfied that the person is a fit and proper person to perform the required function.[11] A wide range of checks are required to prove that a person is fit and proper, and the onus is on the entity to show regulators that the applicant is a fit and proper person to perform his or her required functions.[12]

Whistleblower champion

The attempts made by Staley to uncover the whistleblower came as a slap to Barclays as the bank had just appointed a 'whistleblower champion', Mike Ashley, as the Chairman of its Audit Committee in 2016. As the 'whistleblower champion', he is held responsible for "the integrity, independence and effectiveness of the Barclays' policies and procedures on whistleblowing, including the procedures for protecting employees who raise concerns from detrimental treatment".[13] Upon his appointment, Ashley sent all employees a video to highlight and raise awareness of Barclays' policies and procedures regarding whistleblowers.[14]

The second coming

In January 2017, Barclays' board was contacted by yet another anonymous whistleblower. The whistleblower touched on issues with Barclay's whistleblowing process, highlighting Staley's treatment of the previous whistleblowing letters the year prior. In light of the new complaint on Staley's potential misconduct, Barclays' directors employed the assistance of a London legal firm to investigate. The legal firm issued a findings statement on 10 April, 2017, which stated that Staley had "honestly but mistakenly" sought to uncover the letter writer's identity without fully understanding the implications of his doing so. The explanation was accepted by Barclays' board. In the following month at the annual shareholder meeting, Barclays' Chairman, John McFarlane, defended Staley, despite condemnation from some investors.[15]

In the midst of the intense scrutiny from various stakeholders, Staley fell victim to emails sent by a prankster who pretended to be the bank Chairman. The prankster was later revealed to be a disgruntled customer of Barclays, who emailed Staley using an email address containing the Chairman's name. Staley responded to the joke emails without realising he had been duped. The emails made their way onto the social media and eventually got published in the media.[16,17]

Barking at Barclays: Investigations launched by financial watchdogs

Upon the eruption of Staley's whistleblowing scandal, the FCA and the Bank of England's Prudential Regulation Authority (PRA) stepped in to investigate the matter. The Department of Financial Services in New York was also looking into this incident. If Staley is found to be guilty of the claims, the authorities could decide to ban him from working in the financial services in the future and this verdict would cost him his job.[18]

Amidst ongoing investigations, Jonathan Cox, Barclays' global head of whistleblowing when the scandal took place, filed a lawsuit against the bank but subsequently agreed on an out-of-court settlement and was set to leave Barclays. Richard Atterbury, formerly a FCA official, subsequently took over from Cox as global head of whistleblowing at Barclays.[19]

The shareholders react

While awaiting the decision from regulators on whether Staley should be allowed to remain as CEO, the bank's shareholders expressed dissatisfaction with Staley's investment banking strategy and poor share performance.[20]

Apart from the whistleblowing incident, Barclays' share price was negatively affected by other problems – the bank faced a potential multibillion-dollar U.S. civil lawsuit over the alleged mis-selling of mortgage securities and a criminal lawsuit in the U.K. over the controversial terms of its emergency fundraising from Qatari investors during the 2008 financial crisis.[21]

Poaching friends

After Staley became Barclays' CEO, there were several senior defections from JP Morgan, Staley's previous firm, to Barclays. Following the defections, an email was sent by a managing director at Barclays' New York office to colleagues worldwide, including some of Barclays' top managers, in September 2016. The email stated that both parties "have agreed to a 1-year ban on hiring any JPMC employee by Barclays" in key areas like corporate and investment banking. Less than a week after the initial email was sent, a follow-up email was blasted to recipients, informing them to disregard the original email.[22]

Under the U.S. antitrust laws, such ‘no poach’ agreements are illegal. The claims of non-poaching agreements between Barclays and JP Morgan had prompted the U.S. Department of Justice (DoJ) to scrutinise Barclays’ actions to determine whether it had breached antitrust laws. On the other hand, the U.K. authorities did not pursue the affair as ‘no poach’ agreements are included widely in U.K. contracts for mid-to-senior ranking employees, especially within the finance industry.[23]

Caught in the middle

Shortly after the whistleblowing scandal came to light, Staley was embroiled in a dispute with one of Barclays’ important clients in May 2017. The dispute centred around KKR & Co (KKR), a private equity giant, and Aceco TI (Aceco), a Brazilian company founded by Staley’s father-in-law.

The conflict between KKR and the Nitzan family arose due to a US$700 million investment gone wrong. In 2014, KKR had purchased a majority stake in Aceco from three sellers. Two of the three sellers were Staley’s wife – Debora Staley – and Staley’s brother-in-law – Jorge Nitzan, who was the CEO of Aceco. However, within two years, KKR had written off the investment and accused Nitzan, who had been dismissed as CEO, of foul play. KKR further alleged the occurrence of accounting fraud and bribery at Aceco after receiving information from an anonymous whistleblower.[24] Nitzan had denied the accusations and blamed Aceco’s travails on the crashing Brazilian economy.[25]

Staley then became involved in the row in a personal capacity. A legal dispute between KKR and Nitzan had ensued, and KKR had approached Staley to listen to the discoveries arising from its investigation, believing that he would convince Nitzan to settle. Alexander Navab, KKR’s private equity chief for the Americas, had also asked Staley why he was aiding Nitzan despite serious allegations of fraud. Staley countered that he was acting not in his capacity as a Barclays representative but was instead acting privately to defend a family member.[26] However, KKR, viewing the situation as a conflict of interests as a client of Barclays,[27] dismissed the notion and accused him of acting against client interests.[28]

Not only did Staley refuse to assist in the settlement of KKR and Nitzan, he even introduced a potential investor, Timothy Collins of New York firm Ripplewood Advisors, to Nitzan. Additionally, KKR later found out that Staley had also discussed the Aceco matter with some KKR's co-investors in the Brazilian company. Staley had vouched for Nitzan, conveying his belief that his brother-in-law would not be involved in fraud.[29]

As a result of Staley's actions, KKR was reported to have barred Barclays from joining potentially lucrative deals until the dispute was resolved, dealing a huge blow to Barclays' already shaky business.[30]

A history of scandals and fines

Prior to the whistleblowing scandal, the British bank was already said to have "suffered from a perception of a flawed culture",[31] due to its role in the London Interbank Offer Rate (LIBOR) scandal and other regulatory troubles.

On 27 June, 2012, Barclays was fined £59.5 million by the FSA[32] and US$200 million by the U.S. Commodity Futures Trading Commission for attempted manipulation of the LIBOR.[33] The then-Chairman Marcus Agius and former Chief Executive Bob Diamonds resigned the following week.[34] Barclays started to collude with other banks to manipulate the LIBOR for the benefit of its traders during the global economic upturn in 2005. After the 2008 global financial crisis, Barclays artificially lowered the LIBOR to generate an illusion of a lower borrowing rate and hence the perception of a less risky bank.[35]

During the 2008 financial crisis, Barclay's former Chief Executive John Varley and three ex-senior executives conspired to provide a US$3 billion unlawful loan facility to the Qatari investors in exchange for a £12 billion capital injection over two legs to the bank.[36] The raised funds partially offset Barclays' losses and saved it from accepting a government bailout while its strongest competitors in U.K. – Royal Bank of Scotland and Lloyds Banking Group – had to do so. However, the raised funds were not fully disclosed to the market. Upon the uncovering of its actions, Barclays faced three counts of criminal charges by the U.K. Serious Fraud Office, including illegal financial assistance and conspiracy to carry out fraud by false representation.[37]

In 2014, Barclays was fined £26 million by the FCA for failure to manage conflicts of interest with its customers, and systems and control faults in respect of the London Gold Fixing.[38] Between 2004 and 2013, Barclays trader Daniel Plunkett exploited weaknesses inherent in the firm's systems to influence Gold Fixing. As a result, Barclays did not have to pay US$3.9 million to its customer and Plunkett's own trading book was significantly improved. Plunkett was fined £95,600 and banned from carrying out any function related to regulated activities.[39]

Staley pay a price

In May 2018, it was reported that Staley was fined a total of £642,430 by the FCA and the PRA, and Barclays had clawed back £500,000 of his bonus over the matter. The bank would also have to report annually to the regulators, detailing how it handles whistleblowing matters after the watchdogs expressed concerns about its existing systems. The regulators said Staley failed to act with due skill, care and diligence. Staley became the first CEO of a major financial institution to be fined by the financial regulators and keep his job.[40]

Staley survived a bruising annual meeting on 10 May, 2017, which threatened the loss of his CEO position in the bank. However, fortunately for Staley, with Chairman McFarlane's strong support, 95% of shareholders backed Staley staying in his position.[41]

New York's Department of Financial Services – known for its heavy penalties on banks – is still investigating and has yet to publish its findings.

Have things changed?

Against the backdrop of an increasingly competitive banking landscape, will Barclays and its management personnel be able to resist the temptations of gains – be it financial or otherwise – derived from unlawful misconduct and instead establish good corporate governance to be accountable to all its stakeholders?

Perhaps there is a glimmer of hope with big boss Staley seeking repentance and setting the tone in Barclays in his statement: "I have consistently acknowledged that my personal involvement in this matter was inappropriate and I have apologised for mistakes which I made. I accept the conclusions of the board, the FCA and PRA … and the sanctions which they have each applied."[42]

Discussion questions

1. What measures can an organisation put in place to ensure that a whistleblowing system is effective? How can whistleblowers be protected and should employees be incentivised to blow the whistle?

2. Identify the different stakeholders involved in the whistleblowing scandal and evaluate their conduct and responses to the incident.

3. Evaluate Staley's conduct relating to the whistleblowing scandal and his involvement in the dispute involving KKR & Co and Aceco TI.

4. Given the number of scandals Barclays had faced, comment on the board's response. Were the directors and Chairman performing their duties? Should the board have fired the CEO? Explain.

5. What is the role of the board in setting the right corporate culture in a company? How should the board go about doing this and ensuring that it is embedded in the company?

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BELL POTTINGER: A DEAL WITH THE DEVIL

Case overview

In July 2017, a video interview with the Gupta brothers – Ajay, Atul and Rajesh "Tony" Gupta (the Guptas) – and a number of Bell Pottinger's internal emails and documents were leaked, uncovering a scandal that shook South African race relations. The leaked information revealed Bell Pottinger's involvement with its highly controversial clients, the Guptas, in masterminding an "economic emancipation" campaign by smearing white capitalist businesses to intentionally escalate racial tensions. The Public Relations and Communications Association (PRCA), the body responsible for regulating public relations and communications work in Europe, condemned Bell Pottinger for its lack of ethics, immoral behaviour and poor management oversight, as the firm denied responsibility and pushed the blame around. The objective of the case is to allow a discussion of issues such as ethics and tone at the top; risk management; and the role of management and the board of directors.

A magnet for controversy

Bell Pottinger Private (BPP) was a large British public relations, reputation management and marketing limited liability partnership headquartered in London, U.K., with subsidiary offices in North America, the Middle East and South-East Asia. The company offers services such as lobbying, speech writing, reputation management, and search engine optimisation to its clients, including companies, governments and wealthy individuals.[1]

This is the abridged version of a case prepared by Abigail Tee Ren Hui, Adeline Ong, Ang Rui Hao and Stephenie Theng 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.

BPP was known for being an "aggressive" PR firm,[2] having the "most controversial client list" in the PR industry,[3] and willing to take on "highly sensitive geo-political PR accounts and other controversial clients" that others feared to represent.[4] Its past clientele include the Sri Lankan government, right after the devastating civil war; South African Paralympian Oscar Pistorius, who was convicted of murdering his girlfriend; and Alexander Lukashenko, dictator of Belarus.[5,6] In addition to its controversial clientele, its campaign tactics became increasingly contentious as well. In 2011, BPP was accused of breaking Wikipedia's conflict-of-interest guidelines and employing search engine optimisation tactics to hide information regarding Uzbek human rights abuses on behalf of the Uzbek government.[7,8]

Due to its well-known reputation for accepting controversial clients, BPP earned the London PR industry a "reputation for unscrupulousness" that many in the field felt decidedly uneasy about.[9]

The internal conflict

BPP's board of directors was chaired by founder Lord Timothy Bell, with Chief Executive Officer (CEO) James Henderson as an executive director. There were four other board members as of 11 April 2016. On the six-member board, one director had a background in finance, another was a chartered accountant, and the remaining four directors specialised in public relations.[10]

In 2012, Henderson became CEO following a £20 million management buyout which gave him the largest individual shareholding in the company (with 37% ownership between him and his fiancée).[11,12] It was clear that Chairman Lord Bell and CEO Henderson did not get along, with both parties trying to force the other out of the company. The conflict stemmed from their disagreement over business strategy and the polarity of management styles of both men – Lord Bell had a more old-school and relaxed management style, while Henderson was more ambitious and growth-driven.[13,14] The power struggle between the two leaders worsened as Henderson, backed by other executives, voiced concerns over whether Lord Bell's generous salary and expenses were justified.[15]

BPP's internal struggles and contentious business practices were ultimately exposed when it decided to accept an engagement with Oakbay Investments, an investment holding company run by the Guptas.

The poisoned client

The Gupta brothers come from a wealthy Indian family. In 1993, they migrated from India to South Africa and developed close ties with Jacob Zuma when the latter was the President of South Africa. After achieving much success, the Guptas established Oakbay Investments in 2006 and made use of their close relationship with Zuma to advance their own interests, amassing a huge fortune. The Guptas' close ties with Zuma led to them being accused of corruption and state capture,[16] and they were labelled the "most hated family of South Africa".[17]

In January 2016, the Guptas were looking for assistance in communications and public relations. Lord Bell responded to this engagement call and led a team to Johannesburg to deliver a business pitch to them.[18] It was reported that this business meeting was important for Lord Bell as he needed to prove to Henderson that he was bringing in sufficient business deals to justify his high annual executive remuneration of £1 million.[19] The Gupta contract was worth £100,000 a month – over 10 times more than the average PR contract with a typical listed company in the U.K., which was generally around £5,000 to £10,000 a month.[20] The contract with the Guptas was initially signed in January 2016 for three months.

What's in the deal

The PR effort that the Guptas initially communicated to BPP was to help the underprivileged black population in South Africa, which Lord Bell thought was a good cause. However, the hidden agenda of the Guptas was slowly revealed. As the influence of the Guptas and Oakbay Investments attracted unwanted public attention, the real motive for engaging BPP was to set up a campaign to distract the public from allegations of corruption. This was to be done by championing the underprivileged blacks' economic interests, painting the Guptas in a better light. In turn, the attention was shifted to Guptas' white capitalist competitors instead.[21]

To this end, an "economic emancipation" campaign was devised and led by Victoria Geoghegan, a partner at BPP, who met frequently with Jacob Zuma's son – Duduzane Zuma – to discuss and execute the campaign.[22] The "economic emancipation" campaign stirred racial tensions, most notably aggression aimed at the wealthy white population.[23] Taking advantage of the wide reach of social media, more than 100 fake twitter accounts with provocative names were created. In total, more than 220,000 tweets with racially sensitive hashtags such as "#WhiteMonopolyCapital" and "#RespectGuptas" were posted to spread anti-white sentiments.[24] The campaign promoted a toxic narrative – South Africa's whites had seized resources and wealth resulting in the depravation of jobs and education opportunities for the country's blacks.[25]

Initial response

Given the sensitivity of the work due to its racial slant, many of BPP's South African clients were perturbed when they learned that BPP was managing the Guptas' PR account. The adverse feedback from other clients made Lord Bell lose enthusiasm for the project. However, he was more concerned about the loss of clients rather than the ethical implications of the campaign. His only consideration was whether the losses incurred from the departure of clients outweighed the revenue earned from the Gupta contract.[26] To his relief, only one customer terminated its contract with BPP by March 2016. Since the losses from the lost contract were insignificant, Lord Bell sought a compromise by signing a new agreement with the Guptas, including an additional "anti-embarrassment clause" which gave BPP the right to terminate the contract with immediate effect if the campaign were to tarnish its reputation.[27]

Breakdown of relationships

Although the campaign was successful and the business deal was profitable, Lord Bell felt increasingly uncomfortable with the racist elements of the campaign. When he warned senior management that he sensed something amiss about the campaign, his concerns were repeatedly dismissed.[28] Lord Bell felt belittled by Henderson, and in August 2016, he gave up his position as Chairman after being offered a generous £3.5 million exit package.[29]

Exposing the scandal

In November 2016 – just three months after Lord Bell's departure – BPP's role in the "economic emancipation" campaign was exposed when a video of the firm interviewing the Guptas was anonymously leaked to the media.[30] The video itself was evidence of BPP's relations with the Guptas and its involvement in the "economic emancipation" campaign. The video leak shocked Henderson as the video could only be accessed via the firm's internal server. Suspicion then fell on two executives – Jonathan Lehrle and Darren Murphy – who subsequently left BPP in December 2016 to start a new firm, Sans Frontières Associates, a geopolitical PR agency, with Lord Bell. Although both men denied leaking the video, many suspected that they were the source of the leak due to speculation that their actions were largely motivated by Lord Bell's attempt to regain control over BPP.[31]

The 21-page mysterious report

More details about BPP's relations with the Guptas were revealed in March 2017, when a mysterious 21-page report was posted on the website of the South African Communist Party. Written anonymously, the report clearly laid out the history of BPP's work for the Guptas.[32] The report outlined the unethical techniques employed by the firm to distract the public from the Guptas, mainly through the use of fake twitter accounts, fake bloggers and commentators, to influence public opinion. The report exposed BPP as the brains behind the entire malevolent "economic emancipation" campaign.[33]

Within the firm, there was suspicion that Lord Bell had something to do with the leaked report as he may have had the intention of damaging BPP's reputation, undermining Henderson's role as CEO, and ultimately pushing for a change of leadership. However, Lord Bell denied allegations of such involvement.[34]

#GuptaLeaks

In late May 2017, investigative journalists obtained over 200,000 emails and documents relating to the Guptas' corrupt dealings from an undisclosed source, termed '#GuptaLeaks'.[35] #GuptaLeaks provided evidence of BPP's use of unethical tactics for the "economic emancipation" campaign and the underlying goal of tarnishing the reputation of Guptas' rivals.[36] In response to the revelations, the opposition Democratic Alliance Party complained to PRCA in July 2017, highlighting that BPP planned a campaign that targeted predominantly white individuals and businesses as proponents of "white monopoly capital". It subsequently came to light that those targeted also happened to be the Guptas' business rivals, revealing the hidden agenda behind the campaign.[37]

Damage control

After the reports were published, nationwide anti-Zuma demonstrations took place, alongside an anti-BPP agenda. Demonstrations also took place outside BPP's office in London.[38] In an attempt to respond to the rising backlash, BPP backed out of the Gupta contract in April 2017. A statement released by Henderson refuted the mysterious 21-page report and stressed that the highest ethical standards were consistently employed in the firm's dealings.[39] However, in July 2017, when the #GuptaLeaks emails became irrefutable, Henderson changed his tune, issuing a full and unequivocal apology and claiming that "senior management [had] been misled about what [had] been done".[40]

The aftermath

In response, international law firm Herbert Smith Freehills LLP (Herbert Smith) was commissioned by BPP to undertake an independent review of its work on the Oakbay account. Soon after, lead partner Geoghegan and three other employees who dealt directly with the account were dismissed. On 3 September 2017, CEO Henderson resigned.[41] A day after his resignation, the report by Herbert Smith was published. The document reported that the scandal arose when BPP spent more time devising the strategy for "economic emancipation" instead of a pure intent of regular corporate communications for its client.[42]

On 5 September 2017, the results of the Democratic Alliance Party's complaint were released. BPP was found guilty of four breaches of the PRCA Professional Charter and Codes of Conduct. The PRCA Professional Practices Committee found that the lack of a well-designed campaign which upheld best practices led to the occurrence of the problem, and that the very nature of the campaign had a high probability of triggering racial discord.[43] Consequently, BPP faced disciplinary action by having its PRCA membership revoked for five years, the most severe punishment applicable.[44] BPP acknowledged the decision, but could not agree with "the basis on which the ruling was made".[45] Instead, it said that it was still willing to comply with the PRCA's code on a "voluntary basis" in the future, in a bid to gain acceptance and recover its lost reputation.

BPP suffered a severe loss of clients both in South Africa[46] and worldwide.[47] Moreover, the company's second-largest shareholder, Chime Communications Limited, decided to forego its 27% investment in the firm after it was unable to sell its stake but was unwilling to retain any interest in the disgraced firm.[48,49]

Pointing fingers

Although the departure of both Lord Bell and Henderson following the scandal brought their five-year personal feud to an end, against the backdrop of the bitter conflict lies the key question – who was ultimately responsible for the scandal?

Both Lord Bell and Henderson consistently denied any involvement or awareness of the true nature of the campaign. Lord Bell claimed that he detached himself from the account while Henderson maintained that he was deceived by the head of the account, Geoghegan, into thinking it was a typical corporate reputation brief and had no idea of the harmful racial elements of the campaign.[50] To date, no one is quite certain who exactly was accountable for the scandal.[51]

With all the finger-pointing taking place, both the PRCA and Herbert Smith, in their independent reports, highlighted the lack of oversight from senior management for the account of a client they knew to be contentious.[52,53] Although the Herbert Smith report stated that taking on an engagement with such a client was not unethical per se, senior management should have been aware of the risks involved. Moreover, the lack of safeguards, oversight and ethical standards resulted in the company's inability to stop the scandal. Subsequently, BPP expressed its commitment to review policies to improve its ethical standards, such as establishing an Ethics Committee and training staff on social media engagements.[54]

Corporate culture

"Morality is a job for priests, not PR men."

– Lord Bell[55]

In the wake of scandal, stories about the toxic, Machiavellian working culture within the firm and stories of racial and gender discrimination have surfaced. For example, it was reported that a male director screamed in outrage at a woman of colour for having the nerve to question his expenses. Additionally, there were suspected nepotistic hiring practices related to the company's highly competitive and cut-throat graduate intern scheme.[56]

The scandal also highlighted the unique challenges that firms in the PR industry face when selecting clients and employing certain public communication practices, which in turn influence the PR agency's culture. While there is an argument to be made that everyone deserves PR representation, there is a line to be drawn on how morality, ethics and integrity have a part to play in PR and communications.[57]

Who else were affected?

The Guptas were accused of "state capture" – political corruption whereby they used their ties to influence government decision-making and to obtain profitable state contracts. These inquiries came about in light of President Zuma's loss of power over the ruling African National Congress (ANC) to his presidential successor, Cyril Ramaphosa.[58] The new South African President was said to hold the view that corruption was the primary reason for the country's ailing economy and strived towards stamping out corruption from the South African government.[59]

In the aftermath of #GuptaLeaks and related investigations, South Africa's corporate registry also accused audit firm KPMG South Africa, management consulting firm McKinsey and software company SAP, of breaching South African company law. Investigations were subsequently launched to examine the three global professional services firms' ties to the Guptas.[60]

KPMG South Africa was the external auditor for a number of Gupta-owned firms for 15 years until the audit firm resigned in March 2016. Despite its resignation, its past dealings with the Guptas were subjected to public scrutiny. The Companies and Intellectual Property Commission (CIPC) accused the audit firm of "knowingly failing to appropriately apply its own risk management and quality controls".[61] Further investigations by KPMG International into its South African arm revealed that while there was no evidence of illegal behaviour or corruption, work done "fell considerably short of KPMG's standards", and there were instances of failure to sufficiently apply professional scepticism and to comply with auditing standards. KPMG was found not guilty of assisting the Guptas in tax evasion.[62]

McKinsey was subject to South African state prosecutors' asset seizure order, over its association with sub-contractor Trillian, which was owned by a Gupta associate.[63] It had worked with Trillian on a contract providing services to Eskom, the state-owned energy firm.[64] McKinsey claimed that it never engaged in corruption, paid bribes or entered into any formal contracts with Trillian. However, it cut all ties with Trillian and later admitted to have made "several errors of judgement" in its work with Eskom.[65]

SAP was reported to have roughly US$11 million worth of contracts with companies linked to the Guptas. The software company was found to have made 'commission' payments to third parties on contracts with Eskom and ports and rail operator Transnet SOC Ltd. The commission amounts were between 10% and 14.9% of contract values – just slightly less than the level that would have prompted an internal investigation. In addition, the CIPC found that a contract between SAP and a Gupta-associated company regarding work with another state-owned group contravened the South African Companies Act.[66]

Epilogue

With losses accumulating, increasing debt and an exodus of clients, BPP was unable to find a buyer despite a fire sale.[67] On 12 September 2017, BPP was put into administration and the administrators, BDO, announced that it had laid off more than 250 staff. BDO also started working with partners and employees on an orderly transfer of clients to other firms.[68] As a separate legal entity, BPP Middle East is looking at a management buyout of the firm. Its Singapore-based Asian subsidiary which had high-profile clients such as Temasek Holdings and Noble Group, made a formal separation from BPP and changed its name to Klareco Communications on 8 September 2017.[69,70] That was the end of BPP.

McKinsey and SAP have since identified staff who may have been involved and suspended them or put them on leave, while also initiating internal investigations. Similarly, KPMG International's Chairman apologised and vowed to strengthen the monitoring and selection of "potentially sensitive client engagements".[71] Furthermore, Trevor Hoole, KPMG South Africa Chief Executive, resigned on 15 September 2017. He acknowledged that the audit firm "should have stopped working for the Gupta companies sooner than [it] did".[72] Nhlamulo Dlomu was appointed as the new Chief Executive, after the resignation of eight senior partners over audit work relating to the Guptas.[73] KPMG has also been banned from auditing South African public institutions, due to "significant reputational risks" associated with the audit firm in light of its role in the high-profile scandal and its ties to the controversial Gupta family.[74]

Discussion questions

1. Evaluate the composition of the board of directors in Bell Pottinger.

2. Discuss the different roles of the Chairman and the CEO in managing a company. What are the pros and cons of having two individuals assume the different roles? Make specific reference to the constant conflict between the Chairman Lord Bell and CEO Henderson.

3. Lord Bell claimed that he held no responsibility for the account since he intentionally distanced himself from the campaign. As a director, to what extent should he be held responsible? Discuss his decision to leave the firm while the campaign was ongoing.

4. Discuss the importance of the tone at the top and corporate culture in influencing a company's standard of conduct. What do you think is Bell Pottinger's tone at the top and corporate culture? How has Bell Pottinger's corporate culture contributed to the scandal?

5. Using the four lines of defence, discuss the risk management policies that PR companies like Bell Pottinger should implement to prevent such a situation from occurring.

6. Despite the presence of a whistle-blowing policy in Bell Pottinger, sensitive internal information was exposed to the outside media instead of through the internal whistle-blowing channel. In view of the ineffective whistle-blowing policy in Bell Pottinger, suggest ways in which companies can improve the effectiveness of their whistle-blowing policy.

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BT GROUP: THE ITALIAN JOB

Case overview

In late January 2017, BT Group's share price fell 20% following news of an increased impairment within its Italian subsidiary, BT Italia, from £145 million to £530 million. Citing a series of "complex" fraudulent transactions that were covered up through collusions between management, employees and third parties, the announcements sparked a public outcry, resulting in shareholder unhappiness and the eventual departure of several key executive members within BT Group. The objective of this case is to facilitate a discussion of issues such as the complexities in managing a corporate group with global operations, the importance of internal controls in prevention of management misbehaviour, and the roles of the board and various stakeholders in maintaining good corporate governance.

BT Group

BT Group plc, primarily listed on the London Stock Exchange and secondarily listed on the New York Stock Exchange[1], is the holding company for the BT group of companies which provides communications services solutions, serving customers in more than 180 countries.[2] It is a constituent of the FTSE 100 Index[3] and owns British Telecommunications plc (BT), which includes virtually all of BT Group's businesses and assets.[4]

This is the abridged version of a case prepared by Benny Chew Kwong Hang, Dewin Goh Zhong Zhe, Kaline Lim Jia Yi, Kenneth Low Xin Hong and Tan Zhen Hwee Terence 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.

BT Group's main activities include the provision of fixed-line services, broadband, mobile and TV products and services, as well as networked IT services. These activities are segregated into four main lines of business: Consumer, Enterprise, Global Services, and Openreach, all of which are supported by BT's internal service unit, Technology, Service & Operations.[5]

Today, BT's major customers include the likes of Unilever, British American Tobacco and Fiat.[6] At the helm of BT Group is the Group's Chief Executive, Gavin Patterson, who has been holding the position since September 2013. Patterson was appointed Chief Executive of BT Retail in May 2008 before being nominated onto the Group's board in June 2008.[7]

BT Italia

BT Italia, the Italian subsidiary of BT Group, is one of the key business telecommunication operators in the country and has its headquarters in Milan.[8] BT Italia was formed as a result of a series of mergers and tie-ups between BT plc and local players since the 1990s.[9] The entity was initially founded as BT Albacom S.p.A. in 1995.[10]

The company offers telecommunication services to corporate clients, as well as integrated Information and Communications Technology (ICT) services and solutions to businesses and public administrations. Additionally, BT Italia also operates metropolitan networks and data centers in Italy.[11]

A spark between the wires

BT Group was first made aware of problems in BT Italia in June 2016, when a whistleblower[12] from BT Italia reported various accounting inconsistencies to the Group headquarters in London.[13] During that time, the Group was already investigating previous accusations of bullying and inappropriate behaviour within the Italian subsidiary.[14] The scope of investigation was later expanded to include accounting irregularities.[15]

This discovery only came about in 2016 despite the fact that Nick Rose, Chairman of the Audit and Risk Committee, had raised internal control issues in the Italian subsidiary yearly since 2013.[16]

The public was first alerted to signs of trouble when a few former BT Italia key executives were suspended by the Group after several red flags emerged in September 2016. In particular, both Chief Executive Gianluca Cimini and Chief Operating Officer Stefania Truzzoli were suspended on 29 September 2016, following the global spotlight on BT Italia's accounting scandal.[17]

Investigations

On 27 October 2016, BT Group's investigations revealed a huge accounting black hole, forcing the Group to announce an impairment charge of £145 million as an estimate of the financial losses arising from "inappropriate management behaviour" and "historical accounting errors".[18] The Group's Audit and Risk Committee also hired external advisors from accounting firm KPMG to assist in conducting a full investigation of BT Italia's financial processes, systems and controls to gain a better understanding of the situation faced by the Italian subsidiary.[19]

KPMG's forensic accountants unearthed a number of shocking facts about BT Italia. Significant collusion, circumvention and override of controls took place in BT Italia, none of which were picked up over the past years.[20] This had allowed a series of inappropriate accounting practices and complex sales, purchase, factoring and leasing transactions to take place in BT Italia.[21] The accounting frauds were undertaken by key executives to reduce costs and inflate transaction values.[22] The true performance of the business was hence masked, resulting in a severe overstatement of the subsidiary's past-year profits. In its 2017 annual report, BT stated that the overstatement in its Italian subsidiary was quantified to be £268 million.[23] The investigations later indicated that the accounting misstatements would lead to a write-down of its Italian operations by £530 million, which was significantly larger than the Group's initial estimate of £145 million in October 2016.[24,25]

Telecommunications breakdown

On 24 January 2017, news of the £530 million write-down of BT Italia and a poor business outlook were announced by BT Group.[26] The resulting negative sentiments were clearly reflected in BT Group's stock price. Following the announcement, BT Group's shares on the London Stock Exchange plunged by approximately 20%, from 382.55p to 303p, its lowest level since June 2013.[27] The drop in share price caused the Group to lose approximately £8 billion in market capitalisation.[28] This marked the largest decrease in BT's share price in a single day in the Group's history.[29]

Unfortunately for the BT Group, its woes did not end there. Merely two days after the negative announcement, on 26 January 2017, leading ratings agency Moody's downgraded BT Group's credit outlook from 'stable' to 'negative', further hurting the Group's prospects.[30]

As BT Group reeled from the impact of the BT Italia scandal, it sought to regain its standing. Later that week, Patterson announced that the Group's third-quarter profits had decreased by 37%, largely due to the BT Italia scandal and a decline in U.K. public sector work and global corporate businesses.[31] He stated that shareholders had the right to be enraged by the BT Italia scandal, but reassured investors that the rest of the BT Group was performing well.[32] However, Patterson was not so forthcoming about whether he should repay a portion of the bonus payments received during the period of mismanagement in a bid to take responsibility for missing targets. Instead, he merely referred the matter to the Group's remuneration committee.[33]

Moreover, when it was pointed out that PricewaterhouseCoopers (PwC), the Group's external auditors, failed to uncover the accounting irregularities, Patterson responded that there was no intention to terminate the Group's contract with PwC prematurely. The Chief Executive further said that it was difficult for the Group to uncover the accounting malpractices plaguing BT Italia unless forensic accountants were brought in.[34]

Enforcement actions

In January 2017, prosecutors in Milan announced that they had begun investigating BT Italia over claims of false accounting and embezzlement,[35] with BT Group's cooperation.[36] It was reported that Gareth Tipton, BT Group's Director of Ethics, Compliance and Governance, was in Milan to give evidence in February 2017. BT Group also handed over computer records collected during an internal investigation conducted at BT Italia in 2016.[37]

In February 2017, Corrado Sciolla, BT Global Services' President of Continental Europe, who was responsible for overseeing BT Italia, left the business. BT Group believed that his departure was appropriate as the scandal "happened on his watch". The Group then appointed Luis Alvarez, Chief Executive of BT Global Services – the entity which oversees BT Italia – to take over Sciolla's responsibilities temporarily.[38]

On 21 March 2017, BT Group acted against ex-BT Italia executives Cimini, Truzzoli, former Chief Financial Officer Luca Sebastiani and some employees by filing a criminal complaint with Italian prosecutors.[39] According to a Reuters report, Cimini was accused of violating corporate governance rules in respect of contracts and suppliers, as well as for intimidation of staff. Truzzoli was alleged to have manipulated results which affected staff bonuses and financial results that were reported to BT Europe.[40] It was reported that Cimini and Truzzoli denied all wrongdoing.[41]

In addition, Sebastiani was accused of failing to report financial irregularities and inducing an employee, Giacomo Ingannamorte, to issue fake invoices. Employee Luca Torrigiani, who oversaw a number of large accounts, including BT Italia's government clients, was also accused of violating BT's rules in the process by which he selected suppliers and for receiving a payment from an agent of BT Italy. In the criminal complaint, BT Group wrote that it was a "victim" of these employees' unlawful actions; it suffered financially by paying taxes beyond actual financial performance and giving out bonuses to undeserving employees. The complaint also mentioned that Cimini, Truzzoli, Sebastiani, Ingannamorte and Torrigiani were all dismissed from the company.[42]

A couple of months later, in May 2017, the Guardia di Finanza, Italy's tax police, conducted a raid on BT Italia's office and seized boxes of documents. Key BT suppliers were also raided in the same month. These included U.S. technology group IBM, IT company Var Group, and building products supplier ITF Srl. Interviews with former BT Italia employees were also part of the investigation process.[43]

Further media scrutiny

BT Group and the Italian authorities were not the only parties who were investigating the BT Italia scandal. News agency Reuters also simultaneously conducted its own independent journalism research by gathering and interviewing sources familiar with the BT Italia scandal. On 30 March 2017, Reuters separately announced the findings from its own investigation into the BT Italia scandal.[44]

According to its findings, there were various forms of fraudulent behaviour within BT Italia. Revenues from certain BT-installed phone lines were overstated in internal records by client-account managers. In addition, contract renewals with clients and invoices were falsified, and supplier transactions were fabricated to reach bonus targets. Reuter's findings corroborated with those of KPMG's.[45]

Indications of pervasive bullying in BT Italia that came from top management were also reported. If employees missed their targets, they would be reprimanded publicly in front of the colleagues. Reuter's sources stated that such performance pressures heightened after Cimini became Chief Executive of BT Italia. The procurement office was also involved in fraudulent accounting, sending purchase orders to suppliers without the intention to receive the goods. They would then cancel the purchase orders and request for a refund through a credit note, before selling these credit notes to factoring companies for cash. Reuters' sources believed that these malpractices had been going on since 2013.[46]

Auditor in the spotlight

The big reveal of the accounting scandal in BT Group placed its long-time auditor, PwC, under public scrutiny. In June 2017, BT Group announced plans to terminate its 33-year auditor-client relationship with PwC and instead appoint KPMG as its new auditors.[47] According to sources from BT, the board felt "very let down" by PwC due to its failure to detect such transgressions in BT Italia. This was despite the fact that PwC had conducted a "full-scope" auditing of the Italian subsidiary in 2015.[48] The incident had also drawn the attention of both U.K. and U.S. accounting watchdogs, who launched investigations into PwC's auditing practices.[49]

The malpractice incident in BT Italia involved different methods of hiding and minimising operational expenses. While some were complex, others were viewed as very basic – one improper accounting practice method involved classifying expenses as "capital expenditure". However, none of these types of fraudulent and improper accounting practices were picked up by the auditing firm.[50]

Shareholder resentment

Shareholders, who were greatly affected by the share price collapse, sought redress at BT Group's Annual General Meeting, held in London in July 2017. A general "lack of confidence" in BT's ability to resolve such incidents surfaced and BT came under pressure from shareholders to explain its lack of ability to "clearly state and clarify why nobody has taken responsibility for the issues". Despite reassurances from BT Group's management that such incidents would not happen again, there was a clear decline in support for a key resolution to approve BT Group's accounts, directors' report and appointment of auditor for the year. Although BT Group managed to garner a majority vote of 81.49%, it was still significantly lower than past years. Shareholders also expressed their displeasure with BT Group's engagement of PwC's auditing services until 2018 – 21.15% of votes were cast against the reappointment of PwC as auditors. However, shareholders continued to have faith in Patterson's leadership as 98.47% supported his re-election.[51]

BT shareholders in the U.S. also launched class action lawsuits to obtain redress. They accused the Group of failure to disclose the accounting irregularities at BT Italia in a timely manner.[52]

Corrective actions

In the wake of the accounting scandal, BT Group took into consideration KPMG's recommendations and undertook comprehensive balance sheet reviews in seven countries which the Global Services division had a presence in. With the assistance of Ernst & Young, it was concluded that such fraudulent activities and other areas of concern were not present in any other country apart from Italy.[53]

In its 2017 annual report, BT Group also indicated that it had begun to take additional steps to tighten its controls, governance and compliance procedures. The Group committed that it would allocate more resources to strengthen the controlling and audit functions beyond the U.K. and that senior management would be rotated to different countries in order to minimise any familiarity threat.[54]

With the decline in annual profits following the accounting scandal, BT Group announced plans to reduce BT Italia's workforce by more than 20%.[55] The streamlining of the workforce aimed to improve the Italian subsidiary's performance in light of a potential sale of the business unit to a local competitor firm. As a result of the incident in BT Italia, analysts were also prompted to question whether BT should overhaul its entire Global Services division.[56]

In a surprise turn of events in December 2017, Cimini, who was fired by BT Italia in light of the accounting scandal, was awarded €1.8m in compensation for wrongful dismissal by a labour tribunal court, which ruled the dismissal as illegitimate. BT has yet to learn the basis for this decision.[57]

Further, in June 2018, it was announced that Patterson would step down as BT Group's Chief Executive in view of the Group Chairman's remark that a change in leadership was required.[58]

With the scrutiny that BT Group continues to face to-date, the question of whether investors' trust and confidence in the Group will ever be regained remains unanswered. Perhaps a change in leadership is truly the solution that the Group needs.

Discussion questions

1. Discuss the lapses in internal controls at BT Group and BT Italia that led to the accounting scandal in BT Italia. What do you think BT Group and BT Italia could have done to improve their internal controls?

2. With reference to the U.K. Corporate Governance Code, evaluate the extent to which the board of directors fulfilled its roles and responsibilities during the BT Italia accounting scandal.

3. Under European Commission rules that came into force in 2014, companies must change their auditors at least once every 20 years. Considering that PwC has been BT Group's auditor for more than 33 years since its privatisation, comment on PwC's long-standing relationship with BT Group. What are the benefits and risks involved? What are some considerations a company should take into account when changing auditor?

4. What are some actions that other stakeholders can consider in the light of management misbehaviour resulting in fraud and a loss of shareholder value?

5. When the BT Italia scandal surfaced, BT Group insisted that management in London were "kept in the dark" by its Italian subsidiary. With reference to BT Group's relationship with BT Italia, discuss the possible factors that could have created problems in the Group's governance of subsidiaries. How could BT Group have strengthened its governance over its subsidiaries?

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DEUTSCHE BANK: A RUSSIAN AFFAIR

Case overview

In 2015, Deutsche Bank (DB) started investigations after the bank received reports of suspected "mirror trades" in DB Moscow. The internal investigation, known as "Project Square", revealed that Tim Wiswell, the head of equities for DB Moscow, helped Russians divert an approximate US$10 billion out of the country, through a series of mirror trades between 2011 and 2015. This scheme was facilitated by long-standing inadequate compliance procedures in DB. The objective of the case is to allow a discussion of issues such as anti-money laundering (AML); know-your-customer (KYC) policies; internal controls; dual board structure; compliance culture in banks; and risk management issues.

The American dream

Tim Wiswell grew up in Old Saybrook, Connecticut. As a child, he occupied his time with sports and sailing. Wiswell and his sister often travelled to Russia to live with their father. He went on to study for a year at the Anglo-American School of Moscow, where he picked up Russian. He then continued his studies in Colby College in Maine, United States (U.S.).[1]

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Upon graduation, Wiswell found a job at United Financial Group in Russia, which was bought over by DB in the mid-2000s.[2] In 2008, Wiswell was promoted to head of equities in Russia[3] at the age of 29.[4] He was "loyal and reliable", working well with the London equities management team and acting as a "straightforward Western presence" to "bridge the cultural gap" between Moscow and London. Meanwhile, economic conditions in Russia worsened. The previous years of spectacular growth backed by a global commodities boom came to an end with the onset of the financial crisis, and Russian clients grew "desperate to get money out of the country".[5]

The rise of Deutsche Bank

In 1870, DB was incorporated as a German global banking and financial services company in Berlin.[6,7] As of 31 March 2018, DB has a total of 2,407 branches, including branches in emerging markets such as the Asia Pacific, Central and Eastern Europe, and Latin America.[8]

Board composition

DB has maintained a dual board structure since its inception,[9] as mandated by German law which came into force in 1870.[10] In 2014, DB's supervisory board consisted of approximately 20 members, headed by Chairman Dr Paul Achleitner and Alfred Herling, who was the deputy Chairman then.[11] The supervisory board had established seven standing committees, with Dr Achleitner being involved in all committees.[12] Meanwhile, the management board had seven members.[13] DB had two CEOs, Jürgen Fitschen and Anshuman Jain.[14] Up till October 2015, DB also had a Group Executive Committee that comprised of the members of the management board and senior representatives appointed by management board. However, this committee was dissolved to reduce the organisational complexity of DB.[15]

On 7 June 2015, the supervisory board of DB appointed John Cryan to the position of co-CEO. The co-Chairmen of the management board and co-CEOs, Jain and Fitschen, stepped down from their positions on 30 June 2015 and 19 May 2016 respectively,[16,17] following news releases on DB's mirror trades scandal.[18]

Proliferation of scandals

Since 2008, DB has paid fines and settlements amounting to more than US$9 billion, as a result of improprieties such as its involvement in the conspiracy to manipulate the price of gold and silver, and the violation of U.S. sanctions by trading in Iran, Syria, Myanmar, Libya and Sudan. In April 2015, the U.S. and United Kingdom (U.K.) regulators fined DB US$2.5 billion over alleged benchmark interest rate rigging.[19]

A tale of two cities - The scandal of mirror trades in DB

The "mirror trades" in DB went by largely undetected and unchecked until the beginning of 2015, when DB organised an internal investigation. The checks revealed that DB had ignored signs of dubious transactions and more than two thousand transactions did not comply with internal AML control procedures. Although DB Moscow passed the audit in 2014, it received warnings from its independent auditors that there were "serious shortcomings" in its system of vetting its clients.[20]

Between 2011 and 2015, a Russian broker, Igor Volkov, called a sales trader of the equities desk of DB's Moscow headquarters, Dina Maksutova, nearly every weekday and instructed her to place two trades simultaneously. He would buy a Russian blue-chip stock with Russian rubles on behalf of a Russian company, where the order was usually approximately US$10 million worth of the stock. Meanwhile, Volkov, who was acting on behalf of a different company typically registered in an offshore territory such as the British Virgin Islands, would sell the same amount of that Russian blue-chip stock in London, receiving U.S. dollars, euros or British pounds in exchange.[21]

Initially, the trades seemed trite and pointless, as the transactions yielded little to no profit. However, these transactions had a deeper underlying purpose: to turn rubles in Russia into dollars abroad. The counterparties actually had the same owner, so DB was essentially helping Volkov to buy and sell stocks to himself.[22] At least 12 entities were involved[23] and three members of the Russian equities desk were suspended afterwards for their involvement in the mirror trades.[24] Overall, around US$10 billion was squirrelled out of Russia through these trades from 2011 to 2015.[25]

The New York Department of Financial Services (DFS) discovered that DB and its senior managers missed numerous opportunities to detect, investigate and intercept the mirror trading scheme due to serious compliance failures.[26]

According to a former manager at DB, the mirror trades' clients were willing to repeatedly lose small amounts of money, which was the difference between the Moscow and London stock prices, in addition to paying DB a commission for each transaction. These obvious signs of a recurring pattern should have been a red flag for DB and should have warranted a rigorous "client review" process. However, all the clients were deemed satisfactory by DB's compliance team.[27]

Both the DFS and the U.K. Financial Conduct Authority (FCA) expressed the view that DB should have suspected improprieties in mirror trading as early as 2011, when the license of one of the counterparties, Westminster Capital Management, was suspended and subsequently revoked by Russian regulators.[28]

More red flags appeared in early 2014, when a Cypriot bank sent a query to a senior AML manager at London's DB, regarding "suspicious high-volume transactions" through a particular U.K.-registered company's account. However, no follow-up action was taken by the manager and the inquiry was eventually handled by the equities trading desk in Moscow, which replied to the Cypriot bank that the trades were in compliance with the rules.[29]

The revelation

Following the revelation of DB's shocking five-year scheme, three DB employees – Wiswell, Maksutova, and Georgiy Buznik – were suspended.[30]

The suspension of Wiswell, the then-head of the equities desk at the Moscow branch, came as no surprise. In 2011, the year which the mirror trades started, revenues on Wiswell's desk had been declining drastically and it was suggested that the mirror trading started as a consequence of the pressure on Wiswell to boost the performance of his desk.[31] An internal investigation, known as "Project Square", confirmed that Wiswell's desk had indeed helped to expatriate billions of Russian rubles out of the country through mirror trades.[32] Despite the role Wiswell played in the scheme, he filed a lawsuit against DB over his dismissal soon after he was fired.[33]

While Wiswell stood to benefit from the mirror trades through bonuses or even bribes,[34] there was no clear financial benefit for the sales traders on the Russian equities desk conducting the mirror trades.[35] Interestingly, neither of Wiswell's supervisors nor DB's compliance managers had faced similar disciplinary action.[36]

As part of the consent order entered with DFS following the massive scandal, DB had to engage an independent monitor approved by DFS and submit an engagement letter that provides for the independent monitor to review and report on the following: the areas in DB's corporate governance that might have led to or fuelled the improper conduct; revamps to corporate governance that DB had made since the improper conduct and the impact they have on DB's AML compliance; and the coverage of the bank's current global AML compliance programs. The submission of a written action plan to enhance DB's existing global AML compliance programs was also required.[37]

The DFS and FCA also imposed nearly US$630 million of fines on DB for various money laundering offences in Russia.[38]

Mirror mirror on the wall: A time for reflection

"We will do what is right – not just what is allowed."

– Deutsche Bank[39]

Mirror trading is not always illegal.[40] If DB had remained firm with its values and beliefs, what might then explain how it got itself into one of the largest scandals for funnelling Russian rubles offshore? Was the scandal a result of a few rogue sales traders, or did DB play a role as well?

Several reasons had been cited for the motivation behind the bank's misconduct. First, the New York authorities suggested that DB's sales traders were driven by "greed and corruption", having received sluggish business following the slump in oil and gas prices and the global financial crisis. A trader admitted to being "focused on commission" during the time of "slow markets" and hence continued these trades despite doubts. The earning of commissions was seemingly also the reason why the traders had refrained from questioning suspicious trades.[41]

Although the DB head office in Germany had not been directly involved in the mirror trades, its lack of participation did not absolve it from being accountable for the scandal – in fact, DB Moscow could conduct mirror trades undetected for such a considerable period because of extensive inadequacies in the AML control framework, as revealed in investigation findings by both the FCA and DFS.[42,43]

Deficiencies in know-your-customer policies and procedures

DB adopted the risk-based approach to KYC procedures,[44] which was in line with the application of Regulation 7 of the Money Laundering Regulations 2007.[45] However, the due diligence for onboarding customers was not appropriately performed. In particular, there was inadequate documentation by DB Moscow's securities desk for its onboarding files and there were many lapses in DB's KYC procedures.[46] Investigations revealed that many customers were only asked to provide cursory or informal documentation on the source of funds.[47] Additionally, there were insufficient resources and infrastructure to facilitate the KYC process.[48] DB's onboarding staff also faced threats when they did not expedite processes to facilitate the mirror trade transactions. Although the senior management were aware of the deficiencies for years, DB did not take steps to implement any proper reforms until 2016, after the scandal had been uncovered.[49]

Flaws in AML risk rating system

DB's AML risk rating system was not precise in providing risk ratings for the relevant countries and customers. DB also did not have a global policy with benchmarked risk appetites, which led to significant inconsistencies and the absence of a methodology for updating the ratings. DB was also not on the same page as peer banks, which classified Russia as a high-risk country, before DB did so in late 2014.[50]

Inadequate compliance and internal audit resources

DB's anti-financial crime, anti-money laundering and compliance units were ineffective and understaffed. A single personnel had to handle multiple roles simultaneously, and employees in leadership positions of the units were inexperienced in their respective roles and lacked necessary training.[51] They also had no real authority to challenge suspicious actions or clients that they discovered.[52]

Furthermore, the bank's third line of defence – its group audit – was unable to fulfil its key role of ensuring compliance and effectiveness of controls.[53]

Inadequate KYC and AML IT structure

DB did not have a shared repository for KYC information, and thus a reconciliation between trading and the customer onboarding system was not possible. Moreover, DB did not have an automated system to monitor securities transactions, which further increased the risk of using the remote booking model.[54]

Flaws in corporate structure and organisation

DB's decentralised, non-global AML framework resulted in inconsistencies in the formulation and application of policies and procedures across the bank. This created the potential for a lack of compliance with international or other countries' regulatory requirements.[55]

The dual reporting structure and lack of clear delegation of roles and responsibilities also led to excessive reliance on the supervisor for the management of trading activities at DB Moscow's securities desk. The London supervisor of Wiswell had effectively failed in his supervisory role. When they praised Wiswell for promoting global products among Russian clients, an adverse culture was created that gave rise to the mirror trades and enabled the proliferation and continuation of the improper trading over a five-year period. There were also indications that DB had a corporate culture which permitted "short-term profiteering through improper conduct", at the expense of strict compliance, which could incur higher costs in the long term.[56]

An end to a chapter?

"Where we encounter...business lines that are not controlled to the standards we demand, we will exit them, even if this means closing them down."

– John Cryan, CEO of Deutsche Bank [57]

DB's latest strategic plan, "Strategy 2020", was released in October 2015, focusing on strengthening individual accountability and discipline within the bank by reducing the complexity of DB's management structure.[58]

In 2015, DB enhanced its "Three Lines of Defense" model, with the overall goal of decreasing the risks associated with its people, systems and conduct-related failures.[59] DB has also agreed with the Federal Reserve to engage an outside monitor to review transactions with international banks in the second half of 2016 and to review DB's compliance with anti-money laundering laws.[60]

Although the regulatory authorities have concluded that there was no evidence that any of the senior management or employees of DB in London had been aware of or involved in the suspicious trading,[61] the shareholder advisory group, Institutional Shareholder Services, called for an independent audit into the conduct of DB's management in handling this issue and previous scandals.[62]

A game of Russian roulette

Can DB escape this difficult game of Russian Roulette unscathed? Unfortunately, it appears not to be the case, as the mirror trades have been linked to other major global money laundering schemes.

As further investigations into the mirror trades continue, it has been revealed that DB might not be the only international lender found to have conducted such mirror trades in Russia.[63] This might just be the start of something much bigger.

Aside from the mirror trade scandal, DB was also involved in other scandals, such as the mis-selling of toxic bonds, as well as using insolvent shell companies to hide significant tax liabilities in recent years.[64]

In light of all these problems, is DB really too big to govern?

Discussion questions

1. Discuss the implications of a dual board structure and the advantages and disadvantages. In addition, consider the effectiveness of the board structure in Deutsche Bank and discuss any board structure issues.

2. Evaluate Deutsche Bank's risk management framework and discuss the effectiveness of the "Three Lines of Defense" model adopted by Deutsche Bank. What are the possible reasons that led to the failure of the third line of defense?

3. Deutsche Bank has a whistleblower policy. Why were there no whistleblowers in the case of mirror trades, despite suspicions over the trades that were booked at the Moscow securities desk? How can financial institutions like Deutsche Bank strengthen their compliance culture?

4. Discuss how financial institutions can strengthen their anti-money laundering policies and know-your-customer procedures. Is the risk-based approach truly effective?

5. Do you think the shareholder advisory group's action to call for a special audit on management's conduct is justified? Should the blame solely be on Wiswell and two of his team members? Explain.

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EQUIFAX DISCREDITED

Case overview

On 7 September 2017, Equifax Inc. (Equifax) announced a major cybersecurity breach which caused personal data losses for over 143 million American customers. Further investigations revealed that the breach began four months earlier. Equifax's poor response to the consumer backlash, insider trading scandal, and questions raised about its compensation policies caused its share price and consumer confidence to plummet. The objective of this case is to allow a discussion of issues such as tone at the top; board expertise and leadership; compensation of key executives; cybersecurity risk; and crisis management.

History of Equifax

A pioneer in the consumer credit rating industry, Equifax started out in 1899 in Atlanta, United States (U.S.), as the Retail Credit Company (RCC).[1] In 1975, RCC changed its name to Equifax. The company maintains records on U.S. citizens' credit histories by gathering data from corporations which issue credit, such as banks and credit card companies. Over the next 60 years, it amassed data of millions of U.S. citizens and became one of the three major U.S. credit agencies.[2]

Through aggressive expansion and acquisitions both domestically and worldwide, Equifax grew its operations across countries.[3] Equifax's business model relied heavily on mining of consumer data to identify consumer behavioral patterns and selling such information to companies such as lenders.[4] This transformation into an information technology powerhouse resulted in Equifax's exceptional growth throughout Chief Executive Officer (CEO) Richard Smith's tenure.[5]

This is the abridged version of a case prepared by Clarissa Yeo Yee Cheng, Galileo Yap Jia Yi, Goh Ying Xuan, Lee Jihyun and Oon Ming Shen 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.

Board of directors

Equifax's board structure comprised the Chairman of the board and CEO, Richard Smith, the Independent Presiding Director – elected annually by a majority of independent directors – and other directors. Of the 12 directors on its board, 11 were independent.[6] Smith had served as Chairman and CEO for nearly 12 years before stepping down in September 2017.[7] Excluding Smith, the average tenure of the other directors was 9.2 years.

The company had five board committees – Audit Committee; Governance Committee; Compensation; Human Resources and Management Succession Committee; Technology Committee; and Executive Committee.[8]

It had been noted that Equifax's board did not meet as regularly as other Standard and Poor's 500 companies. Further, most Equifax's Technology Committee members lacked experience in the technology sector and three members of the committee had no expertise in risk management.[9]

Management

Richard Smith joined Equifax as its CEO and Chairman in 2005. Before joining Equifax, Smith assumed various management positions at General Electric Corporation and General Electric Insurance Solutions.[10] It was believed that Smith's broad exposure in technology, risk management and financial services would assist him in exercising effective leadership in Equifax.[11]

Susan Mauldin served as Equifax's Chief Security Officer. She studied music composition in university and has a bachelor's degree in arts and a master's degree in fine arts. While her lack of formal training in technology had been criticised, many IT experts argued that it was not rare for people without technology degrees to work in the IT field.[12]

Corporate culture

With Smith at the helm, Equifax became more profit-driven. Employees were expected to perform; they were laid off if they missed key performance indicators. Data security was viewed as a selling point, and Smith once boasted at a conference in 2005 that the company was "blessed in [its] rich history to never have a major breach".[13]

Equifax also disclosed that it had a comprehensive Enterprise Risk Management (ERM) framework, and the board had the responsibility to set an appropriate 'tone from the top' and to conduct enterprise-wide risk assessments annually.[14]

Executive compensation

Equifax's compensation policy was determined by the Compensation Committee, taking into consideration shareholders' 'say-on-pay' vote. The compensation of named executive officers (NEOs) consisted of fixed and variable components, as well as long-term incentives. Performance metrics included operating revenue, adjusted earnings per share and relative total shareholder return.[15]

During his 12-year tenure, Smith received more than US$165 million in compensation.[16] He had also earned US$68.9 million from sales of Equifax shares at the beginning of 2016.[17] Despite Smith's compensation being higher than his peers', Equifax believed that Smith was deserving of such a high compensation and it was deemed reasonable. His base salary had been constant since 2008 and the annual cash incentive opportunity remained unchanged since 2011. This ensured that Smith's pay was performance-based with a long-term focus.[18]

Warning signs

Despite Equifax's strong financial standing, it had cases of non-compliance with the Fair Credit Reporting Act (FCRA), among other infractions.[19,20] Regulatory scrutiny increased with the establishment of the Consumer Financial Protection Bureau (CFPB) in 2010.[21] It was also reported that complaints to the CFPB against Equifax had increased year-on-year since 2013. The majority of these complaints related to incorrect or incomplete information.[22]

Equifax breaks the news

On 7 September 2017, Equifax raised the alarm of a major cybersecurity breach estimated to have affected almost 143 million U.S. customers. Hackers stole a slew of highly personal information, including names, birth dates, Social Security numbers, driver's license numbers, addresses and credit card numbers.[23]

Angry customers filed a class-action lawsuit against Equifax on the grounds of negligence in consumer data security, accusing the company of compromising consumer data security to increase its profits.[24]

Equifax's initial response

Smith expressed his dismay over the data breach, calling it a "disappointing event", and vowed to continue providing quality support and services to consumers. He also mentioned that Equifax "prides [itself] on being a leader in managing and protecting data" and reassured consumers that the company was analysing its security systems to resolve the issue.[25,26]

In response to the data breach, a website (www.equifaxsecurity2017.com) was set up for the purpose of assisting U.S. consumers to determine if their data had been compromised during the breach.[27] Equifax also promised to send direct mail notices to affected consumers.[28] A post-announcement frenzy ensued as consumers rushed to seek answers through Equifax's website and customer help line.[29]

Fissures become apparent

Problems with the website were revealed when the website's 'captcha' program failed to work effectively.[30] The data breach checker was reportedly unreliable,[31] and new malware was found on Equifax's website.[32] Moreover, the company's Twitter account had responded to customer inquiries on the platform by leading them to a fake phishing site, www.securityequifax2017.com, which further eroded the public's trust in the company's data security system.[33]

Equifax continued to face technical glitches and ineffective customer service in 2018 when it introduced a complimentary consumer service that allowed individuals to lock access to their personal credit files on the mobile phone platform.[34]

Earlier in March 2017, Equifax uncovered a separate unrelated breach in its computer system. However, it only publicly announced the breach on 29 July 2017 – nearly five months after the discovery.[35] Equifax hired Mandiant, a cybersecurity company, to investigate the breach. While experts believed the probe might have failed to show that sensitive personal data had been compromised, others criticised Equifax for wrapping up the probe too hastily.[36]

On 2 October 2017, Mandiant finally completed the investigation. It was reported that 2.5 million more consumers than originally reported were affected by the breach. This shocking announcement was accompanied by Smith's apology.[37]

Insider trading?

Equifax's reputation further deteriorated when it was reported that three senior executives sold almost US$1.8 million worth of shares just days before public disclosure of the breach.[38] However, the company refuted insider trading claims on the basis that these executives "had no knowledge" of the breach then.[39] Following this, the U.S. Department of Justice quickly launched a criminal investigation into the Equifax security breach and potential insider trading.[40]

Meanwhile, Equifax performed its own investigations by creating a special committee consisting of non-executive board members and advised by an independent counsel. The findings, released two months later, cleared the senior executives of insider trading.[41] However, three months later, the U.S. Attorney's Office for the Northern District of Georgia and the U.S. Securities and Exchange Commission (SEC) filed criminal and civil charges against then-Equifax Chief Information Officer (CIO) for the credit company's U.S. information solutions business, Jun Ying,[42] alleging his use of insider information. Ying allegedly dumped his shares prior to the announcement of the data breach to prevent US$117,000 of losses.[43]

Escaping a sinking ship

In the wake of the data breach and following public demands for the CEO and the board to resign,[44] Equifax's CIO and Chief Security Officer tendered their resignations on 16 September 2017.[45] Smith resigned ten days later.[46] His departure meant giving up approximately US$3 million in performance bonuses as there was no severance package. However, the public outcry continued as Smith's forgone bonuses was insignificant relative to his US$7.2 million parting gift from the damaged company.[47] Since his stock compensation was not forfeited as he was not fired by the company,[48] the board deliberated on recouping compensation received by Smith, as well as monies from the retired executives, under clawback policies. [49,50]

Congressional and senate hearings

Before Smith's resignation, multiple law and privacy committees issued a letter requesting for Smith's testimony regarding the high-profile breach over two days of hearing.[51] During the hearing held on 3 October 2017 with the House Energy and Commerce Subcommittee – and despite Smith's repeated apologies[52] – his attempt to downplay the impact of the breach and avoid questions on compensation to affected consumers[53] irked the subcommittee members. It was felt that there was an attempt to shirk responsibility, despite Smith's declaration to take "full responsibility" for the breach.[54]

The hearings revealed the root cause of the security breach – a bug in Equifax's systems that remained unpatched for several months. This was traceable to the vulnerability in Apache Struts announced by Chinese cybersecurity researchers in March 2017,[55] which allowed "remote threat actors to execute commands to the back-end systems of Equifax's webservers through online form fields".[56] Apache Struts was a web application used by Equifax for customers to dispute their credit report contents.[57]

Equifax was first notified of the vulnerability by the U.S. Computer Emergency Response Team (US CERT). Its security team then tried searching for security flaws without any success, even after two separate attempts.[58] This unpatched vulnerability gained the attention of hackers, who proceeded to breach the system multiple times.[59] Smith confessed that Equifax did not act in a timely manner to fix the software; it was only corrected in July, when the credit company first observed suspicious activity on its system. Despite disconnecting the web application from the internet, the damage had already been done.[60,61]

Delay in announcements

Smith claimed that the CIO informed him of suspicious traffic on 31 July 2017, without knowing the extent of the attack. Equifax then informed the Federal Bureau of Investigation (FBI) of the breach while simultaneously appointing Mandiant to work with Equifax's security team to investigate.[62]

Despite engaging Mandiant to tackle the breach, crisis management was further hampered by a dispute between Equifax and Mandiant on Mandiant's competency levels. While this gave the hackers additional time to further infiltrate the systems, investigators ultimately found that the hackers compromised Equifax's security systems by planting web shells in Equifax's Apache Struts system, shielding them from detection as they accessed Equifax's network. More than 30 web shells were installed and were apparently impossible to eradicate. This implied that the fixing of the vulnerability in the Apache Struts system would not have resolved the problem.[63]

On 11 August 2017, results of the investigations confirmed that hackers might have accessed private and confidential consumer information, but Smith was only informed of the findings four days later. The lead board member, Mark Feidler, was only informed of the security breach on 22 August 2017, while the entire board was notified even later. While Equifax informed the FBI of investigation results and actions, it delayed official announcements of the breach for fear of others imitating the hackers after the news became widespread. It was only on 7 September 2017 that Equifax officially announced the cyberattack.[64]

Equifax's system and controls

Before Tony Spinelli, a famous cybersecurity expert, left Equifax in 2013, he revamped Equifax's cybersecurity system, and practised crisis management drills with the cybersecurity team to familiarise them with breach protocols. Despite his successors' improvements on the system after his departure, the efforts seemed futile when more breaches were uncovered and Equifax's Environment, Social and Governance rating was lowered to a dismal 'CCC'.[65] Equifax did not reveal any plans to improve its risk monitoring or data breach management.

That being said, some might suggest that the blame should not be placed entirely on Equifax's lack of risk management – a U.S. government official postulated that an Equifax insider assisted hackers in the data breach. This was because the breach involved advanced hacking methods that bypassed a dedicated operations centre and state-of-the-art anti-intrusion software.[66]

Pointing fingers

Further investigations suggested that after preliminary hacking attempts, a more sophisticated group of hackers took over. Suspects included a nation-state, possibly China, since web-shells were commonly used by Chinese state hackers. Furthermore, unlike the usual purposes of data hacking, no data was listed in the black market. This further raised the suspicion that the hacking was orchestrated by a nation-state. [67]

Such a discovery raised questions on Equifax's role as a public company liable to shareholders but trading data sensitive enough to be seen as a "national asset".[68] The viability of its existing credit-worthiness business model, where consumers are the source of profits but do not have any say in the use of their data, was also debatable.[69] As Smith admitted, "data security is a national security problem".[70] The question of whether Equifax could and should still be trusted with personal data remains unanswered.[71]

Future actions

The Equifax data breach scandal was undoubtedly one of the most significant in recent years, with approximately 44% of the American population being affected in one way or another.[72] It was thus no surprise that the company drew fire for how it reacted to the crisis. Regardless of who carried out the hacking attempts, Equifax continues to suffer the consequences of the massive data breach. By incurring the wrath of consumers and losing the trust of an entire nation, its core business model – data collection – was placed at risk. The outstanding issue now is how the company should proceed to clean up the huge mess.

Discussion questions

1. Comment on the compensation received by Equifax's management.

2. Was Equifax's crisis management in response to the breach sufficient? What more could Equifax have done after the first known cybersecurity breach?

3. Was Equifax ethical? Comment on how Equifax could have responded to address consumers' concerns immediately after the announcements disclosing the data breaches.

4. Did the board carry out its duties sufficiently in light of the data breaches? Explain.

5. Do you think Equifax invested adequately in cybersecurity? To what extent was the Equifax board of directors responsible for the data breach?

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RIO TINTO: A CANARY IN THE COAL MINE

Case overview

After a costly major acquisition in 2007 which resulted in a huge impairment, Rio Tinto made the US$3.7 billion acquisition of Rio Tinto Coal Mozambique (RTCM) in 2011. Subsequently, Rio Tinto wrote off US$2.86 billion in impairment charges for the RTCM acquisition in February 2013, before finally selling the Mozambique coal assets for US$50 million in 2014. This was followed by the resignation of its Chief Executive Officer (CEO) and Chief Financial Officer (CFO). The U.S. Securities and Exchange Commission (SEC) later charged Rio Tinto, its ex-CEO and ex-CFO, with fraud in October 2017. The charges relate to the failure to promptly disclose the nature and extent of unfavourable developments in the valuation of RTCM to the board of directors, the Audit Committee and investors. The objective of this case is to allow a discussion of issues such as the role of the board and external regulatory bodies; conflict of interests; due diligence in acquisitions; competencies of the board and management; and the importance of timely and objective disclosures.

This is the abridged version of a case prepared by Alwyn Thu Naung Zaw, Andy Chang Guang Hao, Bernardus Christianto and Brent Thu Nyi Zaw 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.

Mining giant Rio Tinto

Founded in 1873, Rio Tinto is one of the world's largest mining corporations.[1] Its core business is to find, mine and process mineral resources. The Rio Tinto Group consists of Rio Tinto plc and Rio Tinto Limited – the former is registered in England and Wales, while the latter is registered in Australia. Despite its dual company structure, both business entities are managed together, with them sharing the same board of directors. Rio Tinto is listed on three stock exchanges – the New York Stock Exchange, the London Stock Exchange and the Australian Stock Exchange.[2]

Tom Albanese was Rio Tinto's CEO, having been appointed in May 2007.[3] He was a member of the board of directors.[4] Prior to this, he had been an executive within Rio Tinto, having worked his way up the organisational ladder over 13 years.[5]

Albanese's right-hand man was CFO Guy Elliott. Elliott was appointed Finance Director in 2002,[6] and had experience in marketing, operations management and strategy. He was one of the few FTSE 100 CFOs who was neither a qualified accountant nor had any background in finance.[7] Elliott had been a member of the board since 2002.[8] Since 2010, he had also been a non-executive director of Royal Dutch Shell plc, and was the Chairman of its Audit Committee since May 2011.[9]

Bad judgement or bad timing?

Just a few months into his job, Albanese got into a bidding war for the acquisition of Canadian mining company and aluminium manufacturer Alcan Inc (Alcan).[10] Eventually, Rio Tinto bought Alcan for US$38.1 billion, which included a hefty 65% premium. In a Wall Street Journal interview, Dick Evans, former CEO of Alcan, said that the Alcan acquisition was the "worst decision ever, the largest metals and mining transaction in the history of the world at the high point in the commodity cycle".[11]

Shareholders approved the Alcan acquisition as it was a period when commodity markets were booming. However, after the acquisition, China made its entrance into the aluminium industry and flooded the market with low-cost aluminium, and aluminium prices subsequently fell. The global financial crisis that followed soon after sent commodity prices crashing further.[12]

As a result of the series of negative external factors, Rio Tinto took some US$29 billion in impairment on Alcan.[13] From then on, the stakes were high for Albanese, as another costly acquisition mistake could mean a loss of reputation.[14]

Once bitten, not shy

Four years later, in April 2011, Rio Tinto acquired RTCM – a coal business in Mozambique – from Australian mining company Riversdale Mining, for US$3.7 billion.[15] This transaction represented the second large-scale acquisition under Albanese's leadership at Rio Tinto. At that time, the acquisition seemed to be in line with senior management's strategy of finding undervalued assets and turning them around.[16] It was speculated that the acquisition went ahead in part to restore market confidence in Albanese's deal-making capabilities following the disastrous Alcan acquisition.[17]

Post-acquisition, Rio Tinto had expected to mine, transport and sell over 40 million tonnes of coal annually by moving the coal down the Zambezi River to a port on the Indian Ocean.[18] Unfortunately, in October that same year, Rio Tinto realised that its barging assumptions were not realistic, with the value of the acquired assets estimated to be approximately US$2.1 billion.[19] More bad news came when the Mozambique government rejected Rio Tinto's proposal to use the Zambezi River for coal transportation in December 2011, citing environmental concerns.[20] By the end of 2011, Rio Tinto realised that it was only able to transport and sell five percent of the coal originally assumed.[21]

In January 2013, Rio Tinto announced a US$14 billion write-down, which mainly related to Alcan and the Mozambique coal assets.[22] A further write-off of US$470 million was recognised for the Mozambique coal assets in February 2014[23] before Rio Tinto eventually sold them for US$50 million in August 2014, washing its hands off the bad mistake.[24]

Albanese stepped down as CEO in January 2013,[25] before Elliott followed suit three months later.[26] Australian Sam Walsh, who previously headed Rio Tinto's iron ore operations, then took over the CEO position. Walsh managed to cut operating costs by US$2 billion, reducing exploration and development costs by US$1 billion and reducing capital expenditure from US$17.5 billion to US$13 billion in the financial year 2013.[27] During his three-year term, Walsh steered Rio Tinto back on track and left the company in "reasonably good shape"[28] for his successor, Jean-Sebastien Jacques.

Compensation structure

The compensation structures of both top executives consisted of four components – base salary, short-term incentive plan (STIP), long-term incentive plan (LTIP), and "others".[29,30] While the STIP focuses on the achievement of annual performance goals based on certain key performance indicators, the LTIP incentivises executives to meet long-term strategic goals and encourages retention of the executive team.[31]

During the saga, the amount of compensation derived from the STIP was inherently tied to impartment charges that the Group took. In 2011, Albanese and Elliott voluntarily chose to forgo being considered for the STIP due to the impairment charges for the Alcan acquisition,[32] and in the following year, Elliott's STIP was revoked after the Remuneration Committee took the RTCM impairment charges into consideration.[33]

In Rio Tinto's 2012 Annual Report issued on 6 March 2013, the Remuneration Committee stated that it undertook a wide-ranging review of its LTIP arrangements and implemented changes. The LTIP was simplified by reducing the number of performance share plans (PSP) from two to one. An additional performance metric – Earnings Before Interest and Tax (EBIT) margin – was also added to measure the long-term performance of Rio Tinto. The vesting and performance period for PSP awards were also increased by a year to five years.

In addition, malus and clawback provisions were introduced to give the Remuneration Committee the authority to reduce or cancel LTIP under certain circumstances. PSP awards will be reduced or cancelled "in the event of gross misconduct, a materially adverse error in the Company's or a product group's financial statements, or exceptional events that have a materially detrimental impact on the value of any Group company".[34] A clawback, which recovers the value of shares vested under the PSP, will occur when there is a "deliberate misconduct by a participant which has a material impact on the value of reputation of a Group company".[35]

Is anyone listening?

The Audit Committee

In financial year 2011, Rio Tinto's Audit Committee consisted of Ann Godbehere as its Chairman, as well as Michael Fitzpatrick, Lord Kerr, Paul Tellier, and Vivienne Cox.[36] They shared many years of relevant work experience in energy giants such as BP plc and Royal Dutch Shell plc, and possessed financial and accounting backgrounds.[37] In its 2011 Annual Report, Rio Tinto had disclosed that one of the tasks that the Audit Committee engaged in during the year was to "focus on impairment, acquisitions and the Annual Report."[38]

External auditors

PricewaterhouseCoopers (PwC) has been the external auditors of Rio Tinto since 1995. In its 2011 Annual Report, Rio Tinto disclosed that "PwC has followed the requirements of the Sarbanes-Oxley and APB Ethical Standards and rotated the audit partner at least every five years".[39]

The 'whistleblower'

In August 2012, Rio Tinto's former head of technology and innovation, Preston Chiaro, together with his team, conducted an in-house review of the RTCM acquisition, before concluding that the Mozambique assets' value ranged from negative US$300 million to US$4.9 billion.[40] Chiaro then communicated the adverse findings to Elliott via a phone call in November 2012. Elliott responded that he would raise the valuation issues at the Audit Committee meeting.[41]

Unfortunately, Elliott neither disclosed the negative valuation findings to the Audit Committee nor took any action to address the issues flagged out by the technology and innovation division. As a result, Chiaro bypassed the chain of command and went directly to Chairman Jan du Plessis to voice his concerns in December 2012. Upon hearing the shocking findings, du Plessis launched an investigation, resulting in a heavy impairment of the Mozambique assets.[42]

Uh oh, was it fraud?

"They tried to save their own careers at the expense of investors by hiding the truth,"

– U.S. SEC, October 2017[43]

On 17 October 2017, fraud charges relating to inaccurate disclosures on the value of RTCM were brought against Rio Tinto, Albanese, and Elliott by the SEC. The SEC alleged that Rio Tinto "failed to follow accounting standards and company policies to accurately value and record" the Mozambique assets. Further, Albanese and Elliott were accused of delaying disclosure of the adverse valuation to Rio Tinto's board of directors, Audit Committee, independent auditors, and investors in order to save their own careers.[44]

The SEC also alleged that Rio Tinto used materially misleading statements and omissions concerning RTCM's valuation to raise a total of US$5.5 billion from investors through U.S. debt offerings. Furthermore, of the total amount raised, approximately US$3 billion was obtained in an offering that was launched immediately after Albanese and Elliott learnt of RTCM's negative US$680 million valuation.[45]

There were critics who questioned the nature of the SEC's allegations and claims made against Rio Tinto, Albanese and Elliott. They said they found it curious that the SEC had moved beyond the facts of the case by stating what it believed to be the motives of Albanese and Elliott in committing the alleged fraud.[46,47]

Others join the action

Apart from the SEC, other authorities in the United Kingdom and Australia have also taken action against Rio Tinto. In October 2017, the United Kingdom's Financial Conduct Authority (FCA) found Rio Tinto guilty of breaching the FCA's Disclosure and Transparency Rules by not carrying out an impairment test and failing to recognise an impairment loss on the value of its Mozambique assets when it released its 2012 interim results on 8 August 2012. In a statement issued, the FCA said that Rio Tinto's decision not to carry out an impairment test on the assets despite the dismal internal financial modelling results "demonstrated a serious lack of judgement". As a result, Rio Tinto paid a £27.4 million fine.[48,49]

The mining giant also faced charges by the Australian Securities and Investments Commission (ASIC).[50] The ASIC's investigation, launched in March 2018, had initially focused on the disclosures in the March 2012 annual report about the extent of coal resources in Mozambique. The case evolved over the following few months, and in May 2018, the ASIC alleged that Rio Tinto had engaged in "misleading and deceptive conduct". Albanese and Elliott were also accused of breaching the Corporations Act.[51]

Lessons learnt?

As the legal battles with the authorities waged on, Rio Tinto strongly defended itself against the accusations and charges, denying that it had withheld information from shareholders.[52] Regardless of the eventual outcome, the reputational damage on Rio Tinto, Albanese and Elliott has been done. The Rio Tinto case is a reminder to companies and executives alike on the importance of making timely disclosures as well as the importance of corporate governance.

Discussion questions

1. Albanese was the CEO and a member of the Rio Tinto board, as was CFO Elliott. Critically evaluate the pros and cons of having the CEO and CFO serving on the board.

2. Elliot was also a non-executive director at another large company and the Chairman of its Audit Committee. Should companies allow their senior executives to serve on other boards and should there be limits? If so, what should be the limits? Explain what should be the limits? Explain.

3. Do you think CEO Albanese and CFO Elliott should have been given another chance at the helm after the company suffered losses from the Alcan acquisition? Explain.

4. Critically evaluate the changes in the compensation structure for Rio Tinto's top executives. What other changes should Rio Tinto implement in the compensation of its top executives?

5. Comment on whether Rio Tinto's Audit Committee has fulfilled its oversight responsibility. What is the role of the board and the Audit Committee in ensuring proper due diligence prior to making acquisitions and in monitoring the post-acquisition performance of acquired companies? Use the Alcan and Mozambique acquisitions to illustrate.

6. Discuss how companies should test for impairment relating to acquisitions and the roles of management, the Audit Committee, the board of directors and the external auditors in relation to this.

7. Do you think the U.S. SEC was justified in its accusations that Rio Tinto, Albanese and Elliott committed fraud?

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ROLLS-ROYCE: TURBULENCE AHEAD

Case overview

Former Rolls-Royce engineer, Dick Taylor, recollected his time back in Rolls-Royce. For years, he was tormented by the immorality of his actions in deciding not to report the bribery and corruption acts by his co-workers. The day had come for Taylor to uphold his morals and he spilled the beans to his superiors about the bribery he had witnessed. Their response was not what he hoped to hear – that he "would be sacked, no matter what". It turned out that what he had alleged would haunt Rolls-Royce in the years to come. The objective of this case is to allow a discussion of issues such as corporate culture; challenges in doing business in countries with high levels of corruption; safeguards against bribery and corruption; and role of regulators in creating a corruption-free business environment.

Rolls-Royce's bumpy road to success

Rolls-Royce was founded in 1904 by Charles Stewart Rolls and Frederick Henry Royce. The company has developed a solid reputation for building superior car engines.[1] In 1971, Rolls-Royce Limited entered into voluntary liquidation[2] and was subsequently nationalised by the British government. Today, Rolls-Royce plc is the main trading company under Rolls-Royce Holdings plc, which is a holding company.[3]

This is the abridged version of a case prepared by Carmen Lum, Clarissa Loo, Indrajaya Tjendra and Joshua 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 Yeo Hui Yin Venetia under the supervision of Professor Mak Yuen Teen.

Rolls-Royce was an engineering powerhouse entering into the twenty-first century.[4] Sir John Rose helmed the leadership position as Chief Executive Officer (CEO) during the company's time of rapid growth in international markets from 1996 to 2011.[5] Rose contributed significantly to the company's development as a global player.[6] As the second-largest aircraft engine manufacturer in the world,[7] Rolls-Royce had businesses spanning across aviation, marine and energy sectors. The energy sector was handled by Rolls-Royce Energy Systems Inc before the subsidiary was sold to Siemens in December 2014.[8]

Jewel in the U.K.'s industrial crown

As the "jewel in the U.K.'s industrial crown",[9] Rolls-Royce had always been under pressure to perform. With declining financial performance in the 1990s, it started to invest heavily in developing the Trent family of engines[10] for its civil aerospace business to compete against other industry giants such as General Electric and Pratt & Whitney.[11] The investment paid off, with its civil aerospace business accumulating 25% of the market share, while its Trent engine accounts for 50% of its market.[12] Rolls-Royce's profit-driven strategy, however, became an impetus[13] for its employees to engage in bribery in order to secure contracts with certainty in a competitive industry.

Signs of cracking

Rolls-Royce was suspected of engaging in bribery and corruption practices despite a seemingly rosy financial situation. The first signs of suspicion arose from allegations regarding bribery posted by Taylor, who had been campaigning online for six years.[14]

In February 2012, the U.K.'s Serious Fraud Office (SFO) was alerted by the online allegations and contacted the company for more information.[15] Both the SFO and Rolls-Royce's compliance department launched investigations. The results of Rolls-Royce's internal investigation into its civil and defence businesses[16] were voluntarily given to the SFO.[17]

Emission of corruptive fumes

Rolls-Royce's corrupt acts in Indonesia was a substantial part of the investigation, resulting in the company's first act of corruption being exposed. These were linked to the sale of Trent aero-engines for civil aircraft between 1989 and 2006.[18]

It was speculated that a payment by the company relating to a Trent 700 engine deal on 1 January 1989 involved Tommy Suharto, the son of the former Indonesian President.[19] A first payment amounting to 25% of the commission was made in August 1989 to secure a deal with Garuda Indonesia (Garuda), Indonesia's national airline. Subsequent payments totalling US$2,254,044 were made in 1991.[20]

Besides monetary rewards, Tommy Suharto was promised a Rolls-Royce Silver Spirit II.[21] In 1997, the last two payments amounting to US$779,784 were made for the engine deals and six A330 aircraft installed with Rolls-Royce engines that were delivered from 1996 to 1998.[22]

The corruption runway

In October 2008, with the help of another intermediary, Soetikno Soedarjo,[23] Rolls-Royce secured a major Total Care Agreement (TCA) contract with Garuda.[24] Using companies where he assumed the CEO position, Soedarjo entered two Commercial Adviser Agreements (CAA) with Rolls-Royce,[25] enabling him to secure contracts on behalf of the company. Under pressure from Rolls-Royce, Soedarjo renewed the CAA through another company he controlled, Connaught International Pte Ltd (Connaught International), to include commission payments for the TCA deal.[26] The commission amounted to around three percent of the TCA revenue[27] instead of a portion based on engine sale price.[28]

Rolls-Royce paid US$1,232,182 to Connaught International,[29] which acted as a broker for the deal. Shortly after, Soedarjo demanded an additional sum of US$500,000 as commission for the TCA.[30] Rolls-Royce suggested paying through another commission for an expected lease of four aircrafts to Garuda.[31] Soedarjo proceeded to disburse US$500,000 to make bribery payments to Garuda employees.[32]

With the impending shuffle of Garuda's management team, Rolls-Royce was pressed for time to secure upcoming TCA contracts.[33] Soedarjo was once again tasked to secure the deal with an incentive of US$500,000 advance payment.[34] Up to 2011, TCAs for eight new leased aircrafts were signed and Soedarjo was reported to have received additional advances of US$293,910.[35]

The winds of change

In October 2010, Rolls-Royce's compliance department raised the risk rating associated with Soedarjo to "high risk" as he had previously registered a company in Singapore while operating solely in Indonesia.[36] In December 2010, Rolls-Royce enacted its Global Intermediaries Policy to address bribery and corruption. The policy states that any renewal of a CAA with a high-risk company would require an approval from a higher-level personnel.[37] Nevertheless, the CAA renewal with Soedarjo was approved.[38]

In February 2011, a due diligence report by an independent risk consultancy firm exposed Soedarjo's connections to President Suharto.[39] Soedarjo, however, denied any bribery allegations. In March 2011, Soedarjo was reclassified as "low risk" and granted a new CAA.[40] Shortly after, Soedarjo received another payment of US$463,561 for the 2008 TCA of the Trent 700 engines through Connaught's account, which was immediately transferred to Garuda officials.[41]

Rolls-Royce's list of payments to Soedarjo was discovered following the investigation by its compliance department.[42] Concurrently, Soedarjo's close connection with a senior Garuda employee also came to light as a result of the investigations by SFO and the company's compliance department.[43] After making two final outstanding payments of US$397,000 and US$617,000,[44] Rolls-Royce terminated its connections with Soedarjo in March 2012 to stop any further actions undertaken on behalf of the company.[45]

Corruption spreading its wings

In Indonesia, corruption is deeply ingrained in societal culture due to poor enforcement of corruption legislation. Bribery is commonplace in the public service and procurement sector.[46] During Susilo Bambang Yudhoyono's presidential term between 2004 and 2014, Indonesia's Gallup Corruption Index score worsened despite his pledge to curb corruption.[47] Unlike Suharto's highly centralised corruption, Yudhoyono faced decentralised corruption.[48] This resulted in a lack of public trust in the government and made it difficult for businesses to predict the costs of corruption, with an increase in individuals pursuing bribes and kickbacks.[49] To make matters worse, the effectiveness of Indonesia's judicial system in limiting corruption was underwhelming – given the lax implementation, narrow scope and deep-rootedness of corruption throughout the political scene.[50]

In addition to weaknesses in the legal system, whistleblower protection in Indonesia is lacklustre due to underfunding of the agency providing protection under the law and the prevalence of agencies with politically involved appointees.[51] Despite the presence of the 2006 Witness and Victim Protection Law, many whistleblowers were prosecuted instead of protected in Indonesia.[52]

Air turbulence

The rivalry between firms in the aerospace industry is intense,[53] with a few large players vying for deals that provide a significant long-term competitive edge.[54] Employees in the industry face pressure to obtain an advantage over their competitors.[55] Bribery is often seen as a solution due to the certainty and long-term effects it provides, as securing an initial deal increases the possibility of securing subsequent deals. Bribery was entrenched in the industry as few companies are willing to be disadvantaged.[56] The risk appetite for corruption in these firms is often huge, as it was believed that harsh actions would not be taken even if corruption were to occur.[57]

Incompetence of the crew

Many have speculated that Rolls-Royce's board was aware of the company's questionable conduct but opted not to notify the relevant authorities.[58] Most board members disassociated themselves from the scandal and declined to comment on why the SFO was not informed of the dubious actions within the company.[59]

Another weakness in Rolls-Royce's defence against corruption was its marketing services department (MSD). This department was responsible for checking and maintaining a master list of intermediaries engaged by the company as well as formulating the appointment procedure.[60] The initial policy regarding the use of intermediaries issued by the MSD was weak, with no due diligence process, and any senior company employee was able to approve any proposed payment exceeding five percent of the contract price.[61,62] Consequently, the MSD imposed clearer guidelines on how each relevant business unit should set procedures and maintain records of dealings with intermediaries.[63]

In 2007, Rolls-Royce had attempted to curb unethical practices through the issuance of a Global Code of Business Ethics with a section dedicated to bribery and corruption.[64] Within this code, there were two notable changes to the company's intermediary policy. Firstly, advisors and consultants were clearly differentiated and secondly, fixed fee arrangements that exceeded £150,000 now required additional approval by senior management.[65]

In 2008, the company established an Ethics Committee which consisted exclusively of non-independent directors,[66,67] except for Peter Byrom, who had served as a director in the company since 1997. The board of directors vetted for his independence.[68]

Despite these efforts, a 2009 Anti-Bribery and Corruption Compliance Review by one of the big four accounting firms found that bribery remained rampant in daily operations in the company.[69] This was mainly due to insufficient accountability for intermediaries and lack of due diligence in high-risk situations.[70] Various business units lacked a clear understanding about the MSD's compliance function and the MSD was unable to sufficiently conduct compliance checks on business units.[71]

Brittle windscreen for whistleblowers

The Association of Certified Fraud Examiners (ACFE) stated that in 2016, 39.1% of occupational fraud, which includes corruption, was detected through tip-offs.[72] Being a whistleblower, however, seemed to be exceptionally risky and detrimental as 90% of whistleblowers were treated with hostility, often resulting in demotion or dismissal.[73]

Taylor was forced into "early retirement" in 2004 due to his online allegations that prompted the SFO's investigation of Rolls-Royce.[74] He was the technical liaison manager and chief services representative between 1996 and 2002 in Indonesia. Upon returning to U.K., Taylor protested that a manager was manipulating the company's expenses account in Indonesia. Taylor was threatened with dismissal by his colleagues.[75] Under the U.K. legal system, Taylor should have been protected specifically under Section 1 of U.K.'s Public Interest Disclosure Act.[76] In actual fact, there was virtually no protection, reflecting an unconducive environment for whistleblowing in both the company and the country.

Overhaul at the hangar

From 2010, Rolls-Royce made major changes to its board of directors, such that no current board members were involved in the company's previous unethical conduct.[77] Since January 2014, the CEO, Chief Financial Officer, Company Secretary and Group President have been re-appointed.[78] Together with these changes, Rolls-Royce declared a "cultural change" within the company.

Significant changes in the management structure were made to curb corruption. The MSD and Committee for Approval of High Risk Intermediaries were dissolved and replaced by Rolls-Royce Compliance in 2010.[79] The compliance department implemented new, stricter policies such as prohibition of commissions exceeding 10% of contract prices.[80] The department also rolled out strict approval processes for intermediaries based on risk rating, with extensive recording of information such as the business case, risk assessments and proper identification.[81] A robust compliance programme costing up to £15 million was also implemented in line with efforts to prevent bribery.[82] The programme emphasised the importance of reviewing relationships with intermediaries, replacing senior management and changing Rolls-Royce's corporate culture.

Rolls-Royce also engaged Lord Gold, an expert in corporate and ethics compliance, to conduct an independent review of Rolls-Royce's compliance and ethics approach.[83] The recommendations in his interim report were used to update and refine Rolls-Royce's anti-corruption policies.[84]

These measures potentially decreased the risk of corruption by strengthening Rolls-Royce's second line of defence. With the comprehensive compliance programme in place, independent reviews ensured compliance throughout the company and provided assurance to the board.

Painting a new coat of ethics

Despite being newly formed in 2008, Rolls-Royce's Ethics Committee worked tirelessly to review and enhance policies to eliminate corruption in the company. The committee implemented staff training to familiarise employees with ethical issues and updated policies.[85] Such courses became mandatory, alongside periodic refresher courses. Taking a no-tolerance stance on corruption, Rolls-Royce's employees who do not comply with the Global Code of Conduct were given disciplinary warnings and penalties. For more severe cases, employment can be terminated, demonstrating Rolls-Royce's increased commitment in ensuring that all its employees complied with the company's ethical standards.[86]

Rolls-Royce also launched a 24-hour Ethics Line as a platform for whistleblowers to voice their concerns[87] and introduced a speak-up policy.[88] The Ethics Committee regularly reviews the effectiveness of the Ethics Line, which saw a significant increase in usage in recent years.[89]

Grounded

Rolls-Royce admitted to six bribery and corruption allegations from 1989 to 2013 in various countries.[90]

In January 2017, the company agreed to a Deferred Prosecution Agreement (DPA), under which it was fined £671 million, to avoid prosecution.[91] The fine was discounted considering the company's cooperation in assisting the SFO to gather key internal documents and other documentary evidence.[92] However, this agreement did not exempt culpable individual executives from facing charges.

The SFO's rather lenient stance was seen to be due to the fact that a full criminal prosecution may result in a ban from bidding for any public contracts,[93] which when combined with Rolls-Royce's declining financial performance, may severely cripple the U.K. economy, especially its defence industry.[94]

Various anti-corruption advocates claimed that the lenient punishment stemmed from the U.K.'s unwillingness to prosecute companies with strong political connections.[95] Rolls-Royce's central role in the U.K. economy may have been an important factor in considering whether it was in the public's interest to prosecute it.[96] Some critics felt that the SFO had unintentionally created a situation where large, international companies like Rolls-Royce are seen to be "too big to prosecute" and therefore able to get away with wrongdoing.[97] The SFO, however, resumed its investigation into the unethical conduct of individuals in the company.[98]

Navigating the miles ahead

Despite the remedial actions, many remained sceptical whether Rolls-Royce finally resolved its corporate governance issues.[99] The engineering giant seemed unfazed by the entire saga as it remains as one of the most prestigious and treasured U.K. companies despite the bribery allegations and setbacks caused by the DPA. Its share value even increased by around eight percent right after the DPA agreement was signed,[100] raising concerns whether the DPA was too light a punishment.

In statements following the DPA, current CEO Warren East promised that "past practices that have been uncovered do not reflect the manner" that Rolls-Royce undertakes its business today.[101] Rolls-Royce admitted responsibility for "egregious criminality over decades" due to its widespread corrupt practices and Rose could be stripped of his knighthood.[102] With the SFO's attention now cast on suspected high-ranking individuals,[103] and external auditor KPMG coming under the scrutiny of the U.K.'s financial reporting watchdog,[104] perhaps Rolls-Royce is truly on its way to turning over a new leaf.

Discussion questions

1. To what extent do you think the corporate culture contributed to bribery and corruption at Rolls-Royce? What do you think the company could have done differently to avoid this problem?

2. Evaluate the role of the marketing services department, which was later renamed as the compliance department, in monitoring the intermediary activities at Rolls-Royce.

3. How can (i) directors, (ii) internal audit, and (iii) external audit help prevent corruption and other corporate governance-related issues? In company groups, what are the roles of the parent's directors and subsidiary's directors in reducing the risk of bribery and corruption?

4. Comment on the weaknesses in Rolls-Royce's whistleblowing policy and how it may have impeded the revelation of the company's acts of corruption. Discuss whether the current U.K. or Indonesian legal system provides sufficient protection for whistleblowers and what improvements can be made.

5. Rolls-Royce entered into a Deferred Prosecution Agreement with the SFO in response to the bribery allegations brought against the company. Do you think that the actions taken by the SFO against Rolls-Royce are appropriate in curbing bribery and corruption? Explain.

6. Rolls-Royce made significant changes in its policies and procedures in preventing corruption following the scandal. Explain how these changes can help mitigate bribery and corruption risk. Are there other areas that the company needs to look into? Explain.

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BROKEN FURNITURE: THE COLLAPSE OF STEINHOFF

Case overview

In August 2017, it was reported that Steinhoff's Chief Executive Officer (CEO), Markus Jooste, was among the employees being investigated for suspected accounting fraud. The alleged accounting fraud mainly involved the use of off-balance sheet transactions with undisclosed related party entities to inflate earnings. Four months later, Steinhoff publicly announced that its 2017 financial statements would be released unaudited, which resulted in the value of Steinhoff's shares plunging by more than 80%. Shortly after, Jooste suddenly resigned overnight, after failing to explain the accounting irregularities. The objective of this case is to allow a discussion of issues such as dual board structure; corporate governance rules across countries; corporate governance of company groups; roles of stakeholders; fraud; and ethics.

This is the abridged version of a case prepared by Jacinta Pang Sze Hui, Jerlyn Chai Yu Shan, Jeslyn Lee Xin Yi and Jillian Kau Jie Yi under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

Steinhoff: The furniture company

Established in 1964, Steinhoff Investment Holdings Ltd is a South African international retail holding company which produces and distributes furniture. It currently operates in Africa, Asia, Australia, Europe, New Zealand and the United States, with over 12,000 stores in 30 countries and employing over 130,000 people.[1] Steinhoff Investment Holdings Ltd initially listed on the Johannesburg Stock Exchange (JSE), but later moved its primary listing to Frankfurt Stock Exchange (FSE) in December 2015, retaining a secondary listing on the JSE.[2] It later established a new Dutch holding company, Steinhoff International Holdings N.V. (Steinhoff), domiciled and incorporated in the Netherlands.[3] As such, Steinhoff follows the Dutch Code of Corporate Governance (Dutch Code).

Board of directors

In accordance with Dutch Code, Steinhoff has a dual board structure with separate management and supervisory boards.[4]

As of 2016, the management board comprised three executive managing directors – CEO Markus Jooste, Chief Financial Officer (CFO) Ben La Grange and Chief Operating Officer (COO) Daniel van der Merwe. All three executive directors possess a wide range of business-related expertise and experience in a variety of activities, including financial, commercial, retail and logistics activities. The members of the management board also concurrently serve as directors on the boards of other companies outside the Steinhoff Group. An Executive Committee comprising 14 members – including the three executive managing directors – was set up by Steinhoff to assist the management board in fulfilling its responsibilities.[5]

The supervisory board, consisting of Chairman Christoffel Wiese, Deputy Chairman Deenadayalen Konar, and nine other supervisory directors, supervises and advises the management board in the course of carrying out its responsibilities. As such, the supervisory board is accountable to the company and its shareholders. Although all 11 members of the supervisory board are non-executive directors, only six are independent.[6] The composition of the supervisory board is in accordance with the Dutch Code. Furthermore, the board consists of at least six chartered accountants and the majority of the board has extensive business experience, having taken on executive roles at other companies.[7]

Due to his ownership of 23.1% of Steinhoff's shares,[8] Wiese used to be Steinhoff's largest shareholder. Concurrently, he was the Chairman of the supervisory board and the Nomination Committee.[9]

'Enron' of South Africa

In August 2017, news broke that CEO Jooste was among the employees being investigated for suspected accounting fraud. The alleged accounting fraud mainly involved the use of off-balance sheet transactions with undisclosed related party entities to inflate earnings.

Prior to that, Steinhoff had gone on an aggressive acquisition spree. In 2011, Steinhoff acquired Conforama, France's furniture and electronics retail chain. It then bought South Africa's retail chain, Pepkor, in 2015. In 2016, Steinhoff acquired the United Kingdom's Poundland Group, the United States' Mattress Firm, South Africa's Tekkie Town and Australia's Fantastic Holdings.[10,11] Due to its numerous acquisitions, Steinhoff became Europe's second-largest furniture retailer after IKEA.[12] Steinhoff's acquisition-led growth strategy[13] seemed to have been highly successful. However, cracks started to appear in the conglomerate's business model.

Steinhoff's aggressive expansion came with a price – an increase in debt. The acquisitions were mainly funded by the issuance of debt raised through Steinhoff's numerous subsidiaries.[14] However, the amount of debt was not disclosed. Instead, it was hidden among its shell companies. Consequently, Steinhoff's liabilities were understated. Its complicated network of subsidiaries further presented Steinhoff with opportunities for concealing related party transactions.[15]

Brewing trouble

In December 2015, just weeks before its listing on the FSE, German authorities had raided the Westerstede offices of Steinhoff Europe Group Services GmbH (SEGS), a German subsidiary of Steinhoff.[16,17] Both existing and former Steinhoff employees were investigated for alleged criminal fraud involving the forging of documents. However, this probe faded from the public's attention as Steinhoff performed above expectations for the financial year 2016 and its financial statements were given an unqualified opinion by its external auditor, Deloitte & Touche (Deloitte).[18]

However, the accounting scandal resurfaced in August 2017 when Manager Magazin – a German business magazine – reported that Jooste was among employees being investigated by German prosecutors for suspected accounting fraud. In response to the publication, Steinhoff denied any wrongdoing, stating that allegations made by Manager Magazin were misleading or plain incorrect. Steinhoff further said that it had engaged legal and audit firms to conduct an internal investigation after the raid in 2015, but no evidence of transactions that would contravene German commercial law was found.[19]

In the same month, the public prosecutor's office of Oldenburg in Germany released a statement suggesting that Steinhoff's revenue figures might have been inflated by the sale of assets to purported external parties, but were in fact sales to parties associated with Steinhoff, resulting in a misstatement of hundreds of millions of euros.[20]

Concurrently, short seller Viceroy Research conducted its own investigation on Steinhoff and concluded that the furniture giant had been using off-balance sheet related party entities to inflate earnings.[21]

Sweeping under the carpet

Steinhoff reportedly used off-balance sheet entities to overstate its interest revenue on loans given to these entities and transferred liabilities off Steinhoff's consolidated financial statements to these entities. Among the various entities associated with Steinhoff, Campion Capital (Campion) was the main vehicle used to conceal Steinhoff's substantial liabilities.

Campion Capital

Since its incorporation, Campion had made three investments into companies that were formerly owned by Steinhoff – GT Global Trademarks, JD Consumer Finance, and Southern View Finance (SVF). Campion has two subsidiaries, Fulcrum Investment Partners and Fulcrum Financial Services. Fulcrum Investments Partners is the holding company for SVF and JD Consumer Finance. Fulcrum Financial Services holds GT Branding Holding – the holding company of GT Global Trademarks. As such, Campion is the ultimate parent of GT Branding Holding, JD Consumer Finance and SVF.[22]

Despite Campion's claims of being an independent company, the founding directors of Campion and its direct subsidiaries – Siegmar Schmidt and George Alan Evans – have close ties with Steinhoff.[23] Schmidt was the former CEO and CFO of Steinhoff while Evans is a close associate of the Group.

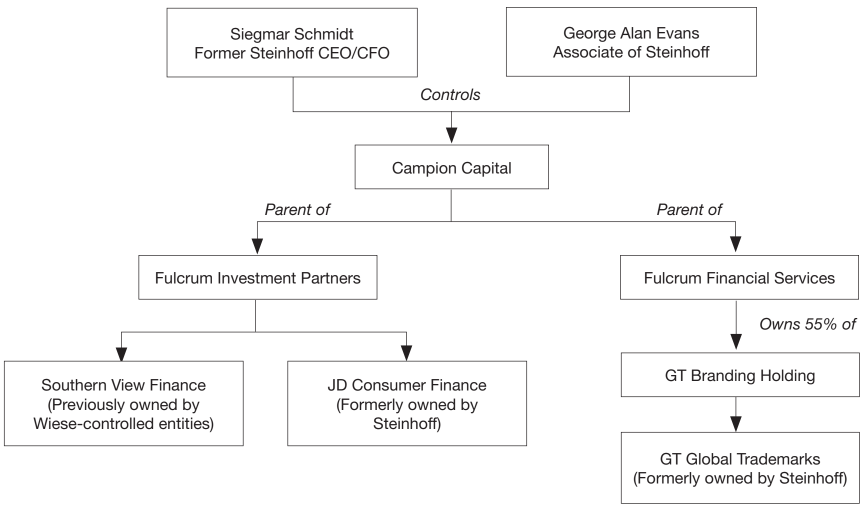

Figure 1: Campion Capital's structure[24]

GT Branding Holding and GT Global Trademarks

In 2015, Steinhoff loaned €673 million to GT Branding Holding, a subsidiary of Campion, for the sole purpose of acquiring one of Steinhoff's subsidiaries, GT Global Trademarks. Steinhoff then charged an exorbitant level of interest for the loan. However, the transaction was not disclosed as a related party transaction even though Campion was controlled by Steinhoff's former CEO and associates.[25]

JD Group and JD Consumer Finance

In addition, Steinhoff's acquisition of JD Group and its subsidiary, JD Consumer Finance, in 2012 also came under scrutiny. JD Consumer Finance provided unsecured consumer loans to JD Group customers – and by extension, Steinhoff's customers. These customers were usually unwilling or unable to provide proof of income, raising the risk of default for the consumer loans.[26] As these consumer loans were unsecured, JD Consumer Finance faced huge losses in 2014 and 2015.

In January 2016, Steinhoff disposed of JD Consumer Finance to Wands Investment (Pty) Ltd, an investment vehicle owned by Fulcrum Financial Services.[27] Prior to the sale, Steinhoff had listed JD Consumer Finance as a "discontinued operation" and its losses were not reflected in Steinhoff's "continuing operation" gross profit. Hence, the €155 million loss suffered by JD Consumer Finance in 2015 was not properly reflected in Steinhoff's financial statements.[28,29]

Southern View Finance

SVF also allegedly played a part in Steinhoff's off-balance manipulation. SVF's main business was to provide unsecured lending services under the legal name Capfin in South Africa. Through a private placement, SVF was effectively controlled by Steinhoff's Chairman Wiese. SVF's subsidiary, SVF UK, had an exclusive agreement with Pepkor, one of Steinhoff's subsidiaries, to provide unsecured lending with high interest rates to low-income customers of Pepkor.[30] Through SVF UK, Steinhoff was able to effectively avoid reflecting the high credit risk nature of these sales transactions in its balance sheet and financial statements. SVF UK had also been writing off significant amounts of bad debts.[31]

Due to its questionable lending practices, the National Credit Regulator (NCR) in South Africa suspended Capfin's license in February 2015.[32] As part of the settlement with the NCR, SVF transferred all its subsidiaries to Fulcrum Financial Services. Instead of a cash settlement, the sale of SVF to Fulcrum was settled by way of a ZAR 4.6 billion loan claim, to be subsequently distributed to its shareholders.[33] Due to his large stake in SVF, indirectly held through several investment vehicles, Wiese was the biggest beneficiary of the loan claim distribution.[34]

Furthermore, SVF UK had received significant amounts of funding from Steinhoff's various subsidiaries. Steinhoff was effectively settling SVF UK's liabilities of over ZAR 500 million without any clear benefit to Steinhoff or its shareholders in return.[35] Eventually, SVF UK was purchased by Steinhoff in 2017.[36]

Earlier in 2016, Steinhoff had acquired SVF SA, which provided administrative and money collecting services to Capfin, from Campion. As a result of this acquisition, Steinhoff was able to record more income from the consumer loans while Campion bore the liabilities, as Campion's financials were not recorded in Steinhoff's consolidated financial statements.[37]

Genesis Investment Holdings

Last but not the least, Genesis Investment Holding GmbH (Genesis), controlled by Schmidt, also had a role in the Steinhoff accounting scandal. Shortly after its incorporation in 2013, Steinhoff announced that it had "facilitated the independent acquisition" of Kika-Leiner Group by Genesis. Instead of a direct acquisition, Steinhoff issued 120 million of its own shares and loaned Genesis €375 million to fund the "unrelated" Genesis' acquisition of Kika-Leiner. Prior to the acquisition, Genesis had neither been generating any revenue nor had any clear operations. After six months, Steinhoff acquired Kika-Leiner's property portfolio for €452 million. Subsequently, Steinhoff went on to acquire Genesis.[38] Thereafter, Genesis became the reverse takeover vehicle through which Steinhoff listed on the FSE in December 2015.[39]

Yet another acquisition?

In December 2016, it was reported that Steinhoff and Shoprite Holdings Ltd (Shoprite), South Africa's largest grocery chain, were discussing plans for a possible merger of both firms' African retail businesses.[40] However, the deal was called off two months later in February 2017 as investors were not able to come to an agreement on the value of the share exchange for both firms.[41] At that point of time, Wiese was the largest shareholder in Steinhoff and Shoprite, and held the role of Chairman in both companies.[42]

In August 2017, Steinhoff switched its approach to instead acquire a controlling stake in Shoprite via Steinhoff Africa Retail Ltd. (STAR) – Steinhoff's African subsidiary – in an all-share deal amounting to ZAR 35.5 billion.[43] On 2 December 2017, STAR exercised call options to acquire a 23.1% shareholding and 50.6% voting control in Shoprite.[44] However, two weeks later, Weise dropped out of the bid for STAR to acquire the stake in Shoprite.[45]

On 21 December 2017, Wiese sold 5 million shares of Shoprite at an average price of ZAR 221.5 each.[46] This occurred after his exposure to Steinhoff's loss in shareholder value made a dent on his fortune.[47]

Question marks abound

Steinhoff allegedly made undisclosed payments of €325 million to Wiese for the merger plans between STAR and Shoprite.[48] Dutch Law, which governs companies incorporated in the Netherlands, does not require supervisory board approval for director loans. This is unlike South African Law which "requires a board resolution and also requires that shareholders agree to any payments made to directors".[49]

Leaked emails revealing how former CEO Jooste conspired with other executives to manipulate Steinhoff accounts as far back as 2014 surfaced during the uncovering of the accounting scandal. Jooste had tried to remove liabilities off Steinhoff's balance sheet and shift revenue figures around Steinhoff's subsidiaries to inflate profits by €100 million.[50]

Jooste was also reported to have repeatedly lied to investors, the South African Revenue Service and international regulators by giving the various stakeholders the assurance of "the sound financial health and ethical business practices at Steinhoff".[51]

Surprising turn of events

On 4 December 2017, Steinhoff's board announced that the company's FY2017 financial statements would be released unaudited as its external auditor, Deloitte, had refused to sign off.[52] Thereafter, Steinhoff appointed Pricewaterhouse Coopers (PwC) to investigate the accounting irregularities.[53]

Deloitte had been Steinhoff's external auditors for over 18 years.[54] After the accounting scandal was uncovered, Deloitte (South Africa) was subjected to investigations by the South African watchdog, the Independent Regulatory Board for Auditors (IRBA).[55] As Deloitte had previously provided an unqualified opinion for Steinhoff's FY2016 financial statements which have been found to be materially misstated, an investigation by the Dutch Authority for the Financial Markets was carried out on the Big Four accounting firm for "suspected corruption".[56]

The aftermath

On 6 December 2017, amid the investigations into Steinhoff's accounting irregularities, Jooste resigned.[57] Shortly after, on 15 December 2017, Wiese also stepped down from his role as Chairman, stating that he did so "to reinforce independent governance and address any possible conflict of interest".[58] CFO La Grange followed suit and tendered his resignation on 4 January 2018.[59]

Wiese claimed that he had no prior knowledge of the accounting irregularities which "came like a bolt from the blue".[60] He defended himself, stating that "to detect fraud in a company is an extremely difficult if not impossible task, and it becomes more difficult when, as is alleged in this case, the CEO is directly involved".[61]

After the accounting irregularities were exposed in December 2017, Steinhoff's share price plunged by more than 80%, and the company lost €10 billion in market value.[62] Wiese, being Steinhoff's largest shareholder, suffered a steep fall in his net worth from €5 billion to €2.1 billion. In April 2018, Wiese sued Steinhoff for ZAR 59 billion.[63] Steinhoff shareholders also sued Deloitte for damages in a Dutch court, stating that its failure to detect the accounting irregularities brought Steinhoff to the brink of collapse.[64]

New furniture

A new sub-committee called the Independent Committee,[65] headed by a non-executive director Johan van Zyl, was established to improve Steinhoff's corporate governance. Two other independent non-executive directors – Steve Booysen and Heather Sonn – were also appointed to the committee. However, on 18 April 2018, van Zyl stepped down from the committee to allow Steinhoff to "build for the future". The sub-committee was subsequently dissolved, following the selection of a new supervisory board.[66]

In March 2018, Steinhoff proposed to pay its directors a sizeable sum of money to compensate them for the amount of extra work they had to do due to the discovery of the accounting irregularities and the "exceptional demands" being placed on them. It also proposed to reward the members of Steinhoff's supervisory board for the extra meetings and the shareholder meeting that were going to take place.[67]

Curtain call

Steinhoff is currently facing investigations by regulators from South Africa and Europe, as well as class action suits in Germany and Netherlands.[68] PwC has since concluded its investigation into Steinhoff's accounts in June 2018. As a result, Steinhoff restated about €11 billion of equity and wrote down the value of assets from €34.7 billion to €22.3 billion in the restated accounts for financial year 2017.[69] Further, it was revealed that Steinhoff only had approximately €600 million in cash, a significant decrease from the €3 billion disclosed previously.[70] While Steinhoff continues to fight for its survival, many lessons can certainly be drawn from what is arguably the biggest corporate failure in South Africa.

Discussion questions

1. What are the pros and cons of a dual board structure? Do you think Steinhoff's dual board structure may have contributed to its accounting scandal? Explain. In your opinion, is a dual or unitary board structure preferable for Steinhoff, and for companies around the world generally?

2. What are some corporate governance risks faced by Steinhoff due to its status as a "South Africa-headquartered, Dutch-incorporated and German-listed company"?

3. How does the Code of Corporate Governance operate in the Netherlands? Is it based on "comply or explain"? Are there any differences in approach to application of the Code in the Netherlands compared to Singapore? [Note: For this question, you are expected to do some additional research on the Dutch Code of Corporate Governance.]

4. Explain how the accounting fraud occurred. What are some of the corporate governance challenges in company groups? To what extent is the accounting fraud related to governance issues in company groups? Explain.

5. Discuss whether Steinhoff's supervisory board and external auditors have adequately fulfilled their roles. What other players within a company and the corporate governance eco-system have a role to play in mitigating the risks of accounting fraud at Steinhoff? Explain their roles.

6. Comment on the effectiveness of Steinhoff's efforts to improve corporate governance following the scandal.

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TESLA MOTORS: FULL SPEED AHEAD

Case overview

Founded in 2003 by Martin Eberhard and Marc Tarpenning, Tesla Inc., formerly known as Tesla Motors, is most well-known for being a market leader in the electric vehicles industry. Led by Chief Executive Officer (CEO) and Chairman Elon Musk, Tesla's mission is to "accelerate the world's transition to sustainable energy". In 2016, Tesla proposed the acquisition of SolarCity, a solar power company founded by Musk's cousins, Peter and Lyndon Rive. Tesla's proposition prompted widespread criticism about the motive behind the acquisition, given the strong connections between the two entities. The objective of this case is to allow a discussion of issues such as the dual roles of Chairman and CEO; board structure; board independence; directors' duties; and risk management.

Revving up Tesla's engine

What first started out as merely an interest in electric vehicles eventually led Tarpenning and Eberhard to set up Tesla in June 2003. The duo's initial plan was to begin developing a two-seater sports car before subsequently shifting into more accessible markets. Tesla's electric car venture turned out to be a technological breakthrough and placed the possibility of electric vehicles on the consumer map.[1]

This is the abridged version of a case prepared by Aminah Nuraddina Baagil, Lee En Ying, Shawn Yong Yi Wen and Shi Chen 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 2004, Musk entered the picture by investing US$6.35 million in Tesla,[2] thus becoming its largest shareholder. He also joined the company's board of directors as Chairman. Musk took an active role in the company, taking charge of the design of Tesla's flagship sports car, Roadster,[3] and subsequent rounds of company financing.[4] He started to increasingly assert himself and slowly replaced then-CEO Eberhard in importance at Tesla.[5]

With Tesla continuing to face financial difficulties, it was reported that Musk grew progressively frustrated with Eberhard's leadership.[6] In August 2007, Musk organised a board meeting without Eberhard being present, and fired him with the board's support.[7] Musk then formally took over the CEO position in October 2008.[8]

In June 2010, Tesla became the first U.S. automobile company to go public since 1956, successfully raising over US$225 million in its Initial Public Offering.[9]

Solar-powered electric cars?

The high-profile company grew astronomically. In a bid to further develop Tesla into a vertically integrated energy production, storage and transport company, Musk presented to Tesla's board on 29 February 2016 potential "synergies" that Tesla and SolarCity could achieve through an acquisition.[10] The proposal was rejected by the board. Despite this, Musk revisited the topic three months later,[11] asserting that the deal would make Tesla the first vertically-integrated renewable energy company.[12]

SolarCity, one of the biggest rooftop solar companies in the U.S., was started in 2006 by Musk's cousins, Peter and Lyndon Rive.[13] The company had continually suffered losses since going public in December 2012[14] and accumulated over US$3 billion of debt.[15] It was estimated that SolarCity had to obtain US$2 billion of fresh capital in 2016, or face bankruptcy.[16] As a result, the SolarCity acquisition was widely viewed by various stakeholders as a bailout.[17] The fact that Tesla itself already faced a significant cash crunch from its own investments did not help the situation.[18]

In addition, Musk and his cousins owned US$100 million of SolarCity bonds, which were to be bought back by Tesla.[19] Should the acquisition proceed, the conversion of Musk's US$22.2 million worth of SolarCity shares into Tesla shares would result in a significant financial gain for Musk as Tesla's value was skyrocketing.[20]

The acquisition proceeds

On 21 June 2016, Musk announced Tesla's offer to acquire solar power company SolarCity via an all-stock offer from Tesla.[21] Tesla shares tumbled by nearly 13%.[22]

Concerns over conflicts of interest arose in view of the transaction. Musk owned 26.5% of Tesla and 22.2% of SolarCity prior to the acquisition, placing him as the single largest shareholder of both firms.[23] Although Musk asserted that directors with personal interests in the transaction would recuse themselves from voting, scepticism surrounded the proposal as nearly the entire Tesla board had either personal or professional connections with Musk.[24] Furthermore, only one of SolarCity's eight-member board had no connection – past or present – to its potential acquirer.[25]

On 27 June 2018, to tackle any potential conflicts of interest, SolarCity announced the setting up of a special committee of directors with "exclusive authority" to consider Tesla's acquisition offer.[26] The committee was made up of two directors from SolarCity's eight-member board, one of whom was previously on Tesla's board.[27] In view of this, legal experts highlighted the challenges in developing a transaction which is at arm's length in both form and substance, and cautioned about the inevitability of shareholder lawsuits. It was also notable that Brad Buss, who previously held the position of Chief Financial Officer (CFO) in SolarCity, sat on Tesla's board, while Tesla's Chief Technology Officer (CTO), J. B. Straubel, was a director on SolarCity's board. In order to alleviate shareholders' concerns, Musk personally represented that both companies were "going beyond what's legally required…to make this not just legally correct, morally correct".[28]

Obtaining approvals

In just slightly over a week following Musk's statement, SolarCity's special committee had approved Tesla's US$2.6 billion offer. The solar power company was allowed a 45-day "go shop" period to contemplate other potential offers.[29] The transaction would also need to be approved by the majority of shareholders of both parties involved.[30]

On 17 November 2016, Tesla's independent shareholders approved the acquisition, with over 85% of Tesla's independent shareholders voting in favour of the acquisition.[31,32] SolarCity's shareholders also gave the green light to the transaction.[33] Although Musk and other related parties recused themselves from voting, some viewed the results as being heavily influenced by them as they had continued to play an active role in discussions on the acquisition.[34] Analysts were also unsettled about the judgement behind combining both capital-intensive companies.[35]

Trouble in the Musk empire

In 2017, two shareholders filed a lawsuit against Musk and other officials, alleging that the financial statements presented in light of the acquisition were untrue and misleading.[36] They claimed that Tesla's officers and directors "manipulated the valuation analyses of both companies, and failed to disclose numerous significant facts regarding SolarCity's operations",[37] which led to Tesla significantly overpaying for SolarCity.

In the two years after the November 2016 approval, other lawsuits have also been filed against Musk and Tesla's board of directors, accusing them of "orchestrating" approval of the acquisition[38] and breaching their fiduciary duty.[39] In a notable case, Tesla's shareholders argued that the acquisition did not serve their best interests; the deal benefitted the SolarCity shareholders at the expense of Tesla's shareholders. In response, Musk's legal team contended that the complaint did not demonstrate that Musk was a controlling shareholder of Tesla at the time of the acquisition.[40] However, a Delaware court allowed the lawsuit to go ahead. The lawsuit is proceeding to trial.[41]

The Elon Musk show, featuring Tesla

Steering Tesla's wheel

Musk is widely recognised as a keyman of Tesla and the face of the company. Having been described as a charismatic visionary, the immense hype surrounding Tesla's electric vehicles may be largely attributable to Musk's skilful promotion of Tesla as more than just a car company. With Musk driving the company forward, investors have bought into Tesla's mission, propelling the company to become one of the U.S.' most valuable automobile companies. The company has even surpassed mature players in the motor vehicle industry such as Ford Motors – despite reporting significantly smaller sales volumes. [42,43] In 2015, analysts from Bank of America Merrill Lynch published a note highlighting Musk's role in Tesla's success; the note mentioned "In our view, many bulls view Elon Musk's leadership and business acumen as the crux of their investment thesis in Tesla shares".[44]

Additionally, Musk's significant ownership in Tesla makes him the firm's largest shareholder.[45] While Tesla only has a single class of stock, its bylaws contain supermajority provisions which make it extremely difficult for shareholders to instigate any major changes without obtaining more than two-thirds of shareholder support. As the Wall Street Journal highlighted, "Musk (and related parties) owns enough stock that it's very unlikely the rest of the shareholders would enact something he doesn't want".[46]

Tesla has a dual role arrangement, with Musk taking on the role of both Chairman and CEO. Musk has served as Tesla's Chairman since 2004 and as its CEO since 2008.[47] This was a contentious issue brought up by CtW Investment Group, which had called for the split of the two roles, as well as for additional independent directors to be added to Tesla's board, while the SolarCity acquisition discussions were ongoing.[48]

Backseat drivers? Tesla's board of directors

Concerns about the structure of Tesla's board reached fevered pitch in the wake of its announcement to acquire SolarCity. Corporate governance watchdogs took issue with the close business and personal relationships between Musk and his fellow directors, citing the lack of an independent voice on the board. One prominent investor wrote to Tesla's lead independent director, citing that "five of Musk's six fellow board members have personal or professional connections to Musk, which could jeopardize their independence".[49]

Firstly, Kimbal Musk is Musk's brother.[50] Additionally, Valor Management Corp. (Valor), a private equity firm whose founder and CEO is Antonio J. Gracias – Tesla's independent director – spent over 100 days in Tesla's battery factory in 2017 to assist in its Model 3 sedan production. In return, the electric vehicles company reimbursed Valor US$34,347 for travel, equipment and lodging near the factory. This prompted shareholder activist CtW Investment Group to oppose Gracias' re-election to Tesla's board in May 2018.[51] In another instance, Musk disclosed on social media platform Twitter that the rights to the first Model 3 sedan were acquired by Ira Ehrenpreis – an independent director on Tesla's board and friend of Musk – but Ehrenpreis relinquished those rights to Musk as a birthday gift.[52] Furthermore, Steve Jurvetson was reported to have invested in a number of Musk's companies.[53] Finally, while serving on Tesla's board, Brad W. Buss also served as CFO of SolarCity from August 2014 to February 2016.[54]

Musk was also said to "dominate the board", and CtW Investment Group went so far as to say that he "sits at the heart of a complex web of relationships among board members and other companies controlled by him and/or family members".[55] The close ties amongst the board members caused uneasiness among critics, who perceived its lack of independence as counterintuitive to a board's ultimate purpose of providing management oversight and representation of shareholder interest.[56]

In July 2017, Tesla added two new directors to its board – Linda Johnson Rice, CEO of Johnson Publishing Co, and James Murdoch, CEO of 21st Century Fox.[57] The changes in Tesla's board came about after activist shareholder groups, including the California State Teachers' Retirement System, issued a letter to Tesla in April 2017, requesting for the appointment of two new independent directors without direct connections to Musk.[58] However, both Rice and Murdoch lack prior automotive or engineering experience.[59,60]

Less than a year later, in May 2018, three Tesla directors – Kimbal Musk, James Murdoch, and Antonio Gracias – were up for re-election in the company's annual meeting. The largest proxy advisory firm, Institutional Shareholder Services (ISS), recommended that investors oppose the election of Gracias and Murdoch. Its basis for doing so is that Tesla's executive pay program seemed to lack of performance-based components, while Murdoch was considered by the advisory firm to be "overboarded" by taking on roles on too many other boards. ISS also pushed for an independent Chairman.[61] Concurrently, CtW Investment Group also recommended the rejection of all three potential directors as they were "incapable or unwilling to contradict Elon Musk's whims".[62] The shareholder activism came in the wake of Tesla's struggle with the mass manufacturing of its latest Model 3 cars. The activists were prompted to take action due to the board's alleged inaction, failing to hold Musk accountable for Tesla's finances and business performance.[63]

One-track mind drivers

While companies have increasingly transited to a de-classified board structure in a bid to ensure boards do not remain stagnant,[64] Tesla has maintained a classified board election,[65] whereby each board class is elected every three years, instead of annually.[66] Advisory firm Glass Lewis issued a statement against Tesla in 2017, highlighting that "classified boards result in shareholders being deprived of their right to voice opinions regarding the oversight exercised by all of their representatives".[67]

Additionally, Tesla's board has remained largely unchanged over the years, even after going public. There are also no term limits on the length that a director can serve, as Tesla believes that "long-standing directors would have developed increasing insights about Tesla and its operations, enabling them to contribute even more". [68] Investors were also apprehensive about the lack of diversity in Tesla's board, with CtW Investment advocating for "a thoroughly independent board to provide a check on dysfunctional group dynamics, such as groupthink".[69]

Reckless driving

On overdrive: Hazardous working conditions

Musk's vision to disrupt the carbon-reliant automobile industry has shot Tesla into prominence and resulted in an expanded public appetite for more electric cars. This has translated into aggressive production goals to meet demand, exerting gruelling pressure on factory workers.[70]

It has been reported that ambulances have been summoned more than a hundred times since 2014 for workplace injuries and other medical issues.[71] Additionally, Tesla's total "recordable incidence rate" was 8.8% in 2015 — 31% more than the 6.7% total recordable incidence rate for the automobile industry.[72] Beyond issues of overworking and safety concerns, workers were paid only US$18 per hour, well below the national average of US$25.58 per hour.[73]

Roadkill: Poor quality control

Quality control problems continually posed a significant challenge as Tesla transitioned from boutique automaker to mass manufacturer. In April 2017, Tesla's shareholders filed a lawsuit against Tesla for misrepresentation of its Autopilot 2 technology. They contested that the advertised "safe and stress-free" feature was "unusable and dangerous" to consumers.[74] That same month, the automaker also recalled 53,000 cars with parking brake problems.[75] In 2016, Tesla's Model X was also reported to have serious concerns pertaining to quality control and multiple usability issues.[76]

A fatal accident involving Tesla's autopilot system in May 2016 resulted in intense scrutiny of the technology by various stakeholders. Upon investigation, the National Transportation Safety Board said that the cause of the accident was threefold: the semitrailer failed to yield the right of way to the Tesla driver, the Tesla driver had overly depended on the car's autopilot system, and the autopilot system did not warn the Tesla driver about the oncoming vehicle.[77]

Accelerating ahead

As Tesla and Musk continue to fight fire caused by defective technology and operational mishaps while managing expectations from its various stakeholders, only time will tell whether the hype surrounding the innovative electric vehicles company is merited. Until the long and arduous shift towards becoming a mass manufacturer of electric cars is complete, the future performance of Tesla remains to be seen.

Appendix A: Tesla's board of directors

Tesla board of directors

As at 30 June 2017 – before the addition of two new independent directors	**At present** – after the addition of two new independent directors
Elon Musk	Elon Musk
Kimbal Musk	Kimbal Musk
Brad W. Buss	Brad W. Buss
Robyn M. Denholm	Robyn M. Denholm
Ira Ehrenpreis	Ira Ehrenpreis
Antonio J. Gracias	Antonio J. Gracias
Steve Jurvetson	Steve Jurvetson
	James Murdoch
	Linda Johnson Rice

Profile of the board[78]

Board member	Background
Elon Musk *Chairman, Product Architect and CEO*	• Co-founded Tesla and continues to oversee the company's product strategy - including design, engineering and manufacturing, and daily operations • Currently serves as CEO and CTO of SpaceX, and Chairman of SolarCity • Graduated with Bachelor's in Physics and Business from the University of Pennsylvania
Kimbal Musk *Director since April 2004*	• Co-founded The Kitchen, a group of food businesses, and Square Roots, an urban farming accelerator • Currently serves on the board for Chipotle, Tesla, and SpaceX • Graduated with a Business degree from Queen's University

Antonio J. Gracias *Lead Independent Director since May 2007* *Member of the Audit Committee* *Member of the Nominating and Governance Committee* *Member of the Compensation Committee*	• Over 15 years' experience in investing into private equity, public equity, and real estate • Founded Valor Equity Partners and MG Capital • Currently serves as Valor's CEO and Chairman of the Investment Committee • Currently a member of the Commercial Club of Chicago, a member of the board of firectors of the Grand Victoria Foundation, a member of the Board of Trustees of the Illinois Institute of Technology, a member of the board of directors of The Economic Club of Chicago, a Trustee of the Field Museum, and a member of the Board of Visitors of the University of Chicago Law School • Previously served as the CEO of MG Capital's electronic connector holdings, Connector Service Corporation; CEO of Industrial Powder Coatings, Inc., an auto parts supplier; Associate with Goldman, Sachs & Co in their International Equity Division • Graduated with a joint B.S. and M.S.F.S. (honours degree) in International Finance and Economics from the Georgetown University School of Foreign Service, and concurrently holds a J.D. from the University of Chicago Law School

Ira Ehrenpreis *Independent Director since May 2007* *Chair of the Nominating and Governance Committee* *Chair of the Compensation Committee*	• General Partner with Technology Partners since 1996 • Recognised leader in both the venture capital industry and the Cleantech sector • Currently serves on the board and Executive Committee of the National Venture Capital Association (NVCA) and on the board of the Western Association of Venture Capitalists (WAVC) • Currently the Co-Chairman of both VCNetwork and YVCA, two non-profit organizations comprising more than 1,000 venture capitalists • Previously served on several industry CleanTech Boards and the Advisory Boards of the Southern California Tech Coast Alliance, Forum for Women Entrepreneurs (FWE), and the Comerica Venture Capital Advisory Board • Graduated with a JD/MBA from Stanford Graduate School of Business and Stanford Law School. Holds a B.A. from the University of California, Los Angeles, graduating Phi Beta Kappa and Summa Cum Laude. Summa Cum Laude
Steve Jurvetson *Independent Director since June 2009* *Member of the Audit Committee*	• Managing director of Draper Fisher Jurvetson, a leading venture capital firm and an active energy and clean tech investor • Founding venture investor in Hotmail, Interwoven and Kana • Previously an R&D engineer at Hewlett-Packard, and a product marketer at Apple and NeXT • Previously served as President of the Western Association of Venture Capitalists • Graduated with a Bachelor of Science in Electrical Engineering. Received a Master's of Science in Electrical Engineering, and a Master's of Business Administration from Stanford

Robyn M. Denholm *Independent Director since August 2014* *Chair of the Audit Committee* *Member of the Nominating and Governance Committee* *Member of the Compensation Committee*	• COO of Telstra Corporation Limited, a telecommunications company from January 2017 • Previously, from August 2007 to February 2016, served in various roles at Juniper Networks as the Executive Vice President and CFO and then as its Executive Vice President and Chief Financial and Operations Officer • Previously also served in various executive roles at Sun Microsystems, Inc. from January 1996 to August 2007 • Previously also served at Toyota Motor Corporation Australia for seven years and at Arthur Andersen & Company for five years in various finance assignments. • Previously from April 2016 until April 2017, also served as the director of ABB Ltd • Fellow of the Institute of Chartered Accountants of Australia • Graduated with a Bachelor's in Economics from the University of Sydney and a Master's in Commerce from the University of New South Wales
Brad W. Buss *Independent Director since November 2009* *Member of the Audit Committee* *Member of the Nominating and Governance Committee* *Member of the Compensation Committee*	• Retired as the CFO of SolarCity Corporation in February 2016 • Previously served as the Executive Vice President of Finance and Administration and CFO of Cypress Semiconductor Corporation from 2005 to 2014 • Previously held prior financial leadership roles with Altera Corporation, Veba Electronics LLC and Wyle Electronics, Inc. • Currently also serves as a director for Advance Auto Parts, Inc. and Cavium, Inc. • Graduated with a B.A. in Economics from McMaster University and an Honors Business Administration degree, majoring in Finance and Accounting, from the University of Windsor

James Murdoch *Independent Director since July 2017* *Member of the Audit Committee*	• Currently CEO of 21st Century Fox • Previously served in 21st Century Fox as Co-COO, Chairman and CEO for Europe and Asia • Previously served as Chairman of BSkyB, Sky Deutschland, and Sky Italia, as well as CEO of BSkyB and STAR
Linda Johnson Rice *Independent Director since July 2017* *Member of the Compensation Committee*	• Currently Chairman and CEO of Johnson Publishing Company and Fashion Fair Cosmetics, as well as CEO of Ebony Media Operations and Chairman Emeritus of EBONY Media Holdings • Currently serving on the boards of Omnicom Group and Grubhub • Currently a Trustee at the Art Institute of Chicago, President of the Chicago Public Library Board of Directors, Council Member of The Smithsonian's National Museum of African American History and Culture, and board member of After School Matters and Northwestern Memorial Corporation • Previously served on the boards of Bausch & Lomb, Continental Bank, Quaker Oats, Dial Corporation, MoneyGram and Kimberly-Clark Corporation

Discussion questions

1. Evaluate the board structure of Tesla in terms of size, diversity, independence, and competencies before and after the addition of the two new directors.

2. Did the board fail in carrying out its duties which resulted in the controversial SolarCity acquisition? Would a more independent board have prevented the acquisition from happening?

3. What are the rights of shareholders in approving an acquisition like SolarCity in the U.S.? How is the situation different in Singapore?

4. Do you agree with the assertions made by Institutional Shareholder Services and CtW Investment Group? How do you think Tesla's board structure can be improved?

5. Discuss the importance of the tone at the top and corporate culture in influencing a company's standard of conduct, using Tesla's case as an example. How has this affected ethical standards, implementation and enforcement of the code of conduct at Tesla?

6. In light of the quality issues relating to Tesla's electric cars, will having a Risk Committee help mitigate these issues? Explain.

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A ROUGH UBER RIDE

"I love Uber more than anything in the world and at this difficult moment in my personal life I have accepted the investors' request to step aside so that Uber can go back to building rather than be distracted with another fight."

– Uber's founder, Travis Kalanick, June 2017 [1]

Case overview

On 21 June 2017, Uber's founder Travis Kalanick resigned from his position as Chief Executive Officer (CEO) amidst a barrage of controversy surrounding the company. Kalanick's sudden resignation came as a result of a shareholder revolt, with five of Uber's major investors demanding his resignation. Under Kalanick's leadership, allegations of workplace sexual harassment and gender discrimination were rife. Its business ethics were also called into question following a major lawsuit filed by Google's Waymo accusing it of intellectual property theft, and suspicions that Uber was using an illegal software tool, "Greyball", to evade governmental regulators. Escalating investor pressure on Uber and its management led to a series of senior executive resignations, culminating finally in Kalanick's departure. The objective of this case is to allow a discussion of issues such as ownership structure; corporate culture; tone at the top; board composition and diversity; role of the board and senior management; and crisis management.

This is the abridged version of a case prepared by Christine Lim, Ng Shi Hui, Vincent Giovanius Chenardy and Zhou Si Jia 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.

The start of a joyride

In 2009, Travis Kalanick launched a ride-hailing startup named UberCab in San Francisco, with co-founders Ryan Graves and Garrett Camp. One of Silicon Valley's entrepreneurial success stories, the startup transformed into a global leader in ride-hailing services today. Operating in 600 cities worldwide, Uber Technologies, Inc. (Uber) is valued at almost US$70 billion.[2] The company runs a ride-sharing platform which connects riders with drivers using the riders' GPS function.

Uber adopted a dual-class share structure in which one class of shares carries one vote per share, while another class carries ten votes or more per share.[3] These super-voting shares allowed Uber's founders and early investors to maintain significant control over key decisions. Kalanick owned 10% of the company's stock and 35% of its super-voting shares, and held approximately 16% of the company's total voting power.[4]

Uber's articles of incorporation stated that Uber's board would consist of 11 board seats, and 9 seats would hold super-voting shares. Kalanick and his allies Garrett Camp – co-founder and Chairman of Uber – and Ryan Graves – Senior Vice President of Global Operations – occupied three seats. Besides the board seat occupied by Kalanick which was reserved for the company's CEO, Kalanick also had control over three other super-voting board seats, which remained vacant during his term as CEO.[5]

The board faced constant criticism for its lack of diversity, in particular the lack of female members, since its inception.[6] In response, on 27 April 2016, Uber added Arianna Huffington, the co-founder and editor-in-chief of The Huffington Post as Uber's first female independent director,[7] followed by Wan Ling Martello, the Executive Vice President of Asia, Oceania and sub-Saharan Africa at Nestle, who joined on 12 June 2017.[8]

Allegations of sexual harassment and the investigation

Uber's troubles began in February 2017 when Susan Fowler, then an employee at Uber, brought to light instances of sexual harassment and workplace gender bias in the company through a public blog post.[9] Fowler detailed the sexual harassment she had faced from her manager, who had repeatedly propositioned her for sex. Her post also highlighted the failure of the company's human resource (HR) department to take any disciplinary action. Instead, the HR department merely dismissed her complaints on the grounds that the manager had been a "high performer" and this was his "first offence".[10]

Fowler further detailed in her blog post that the HR department had dismissed numerous sexual harassment claims against the same manager on the grounds of it being his "first offence", after meeting with several female engineers who had made similar claims of sexual harassment. Fowler was also threatened with dismissal if she continued to make sexual harassment reports, which prompted her to seek another job. By the time Fowler left the company, the percentage of female employees in Uber had dropped significantly from when she first joined.[11]

Following the public accusation, Kalanick immediately responded by stating that the incidents Fowler described in her blogpost were "abhorrent and against everything we believe in". In addition, he issued a statement to employees that mentioned his belief in "creating a workplace where a deep sense of justice underpins everything we do."[12] He then enlisted former U.S. Attorney General Eric Holder to assist with conducting an investigation into Susan Fowler's allegations, while also looking into specific issues relating to diversity and inclusion in the workplace environment at Uber.[13]

Kalanick's leadership under fire

Kalanick's leadership has been heavily criticised by individuals inside and outside the company. He had been known to have bragged about sexual conquests enabled by his status, and had a reputation for being "combative, aggressive and impatient", contributing to Uber's toxic culture.[14] In late February 2017, Kalanick came under fire when Bloomberg released a video of him lashing out at an Uber driver after the driver lamented about the difficulty of making a living with Uber's fare cuts. Kalanick eventually apologised for his behavior, conceding that he needed "leadership help".[15]

Questionable business practices

Waymo lawsuit

Following the sexual harassment allegations and Kalanick's outburst, Uber was jolted by several other controversies that called its business ethics into question. One was a lawsuit by Waymo, Google's self-driving technology development company, which accused Uber of intellectual property (IP) theft. The lawsuit claimed that Waymo's ex-employee Anthony Levandowski – among other former employees who are now employed by Uber or its subsidiary, Otto – had stolen the Waymo's design for a lidar sensor which allows self-driving cars to map their environments. This was to advance Uber's own autonomous car development.[16] However, Uber denied Waymo's claims and filed its opposition to the injunction.[17] On 15 May 2017, a California district court judge ruled that Uber did not have to stop its self-driving tests, but ruled that Levandowski must not be involved in work on the company's lidar technology until the conclusion of the lawsuit between Google and Uber.[18]

Greyball

Subsequently, Uber faced federal investigations for skirting the law in cities where the service was banned. The New York Times published an investigation report describing how Uber had been using a tool called "Greyball" to deceive authorities over the years. Greyball was initially used by Uber as early as 2014 to identify and deny services to certain riders, who were suspected to have violated its terms of services.[19] However, on 3 March 2017, it became public that Uber had been using Greyball to evade local government authorities in countries across the globe by showing the rider a different version of the phone application view.[20]

Greyball uses a variety of methods, such as geofencing and device identification, to identify and deny services to government authorities who were investigating the company for potential violations of local laws.[21] It was only after the published reports that Uber admitted to the use of Greyball to thwart regulators, and promised to stop using the tool. The use of the Greyball software tool raised questions as to whether the company crossed ethical and legal lines in its early efforts to grow its market share.[22]

Release of the Holder report

The Holder Investigation, sparked by Fowler's blog post about sexual harassment and workplace discrimination, was released on 13 June 2017.[23]

Based on more than 200 interviews with current and former employees who had knowledge of the sexual harassment scandal that took place in Uber, the report aimed to initiate change in the following main areas of Uber: senior leadership, board oversight of the company, enhancement of internal control, training, increasing diversity and inclusion.[24] In the report, Holder outlined the problems with Uber's 14 cultural values, which include "let builders build", "always be hustlin'", "meritocracy and toe-tapping" and "principled confrontation", and identified those as "redundant and having been used to justify poor behaviors".[25] The recommendations in the report were considered very rudimentary for such a large and established company.[26]

Subsequently, the board of directors voted unanimously to adopt all 47 of Holder's recommendations.[27] Following this, Kalanick announced that he would take an indefinite leave of absence, in order to "work on Travis 2.0 to become the leader that this company needs".[28]

Over 20 employees were fired by Uber as a result of the investigation for a variety of infractions, including sexual harassment and unprofessional behavior.[29]

The wolf in sheep's clothing

As the scandals continued to pile on Uber, its business practices were once again drawn into the spotlight when an Indian woman, who was allegedly raped by an Uber driver in New Delhi in 2014, accused its executives of stealing her medical records in an attempt to cast doubt on her credibility. The rape victim filed a lawsuit against Kalanick and former Uber executives Eric Alexander and Emil Michael for invading her privacy and defaming her character. The lawsuit was filed after Alexander, President of business (Asia Pacific), was dismissed by Uber.[30] Michael, Uber's Senior Vice President of business, also left the company on 12 June 2017 after four years of driving Uber's business strategy, three days prior to the filing of the lawsuit.[31]

Although the Uber driver was eventually sentenced to life in prison, New Delhi's police found fault with Uber's lax background checks, resulting in Uber being banned in India's capital city shortly after the incident until June 2015.[32] While Uber expressed apologetic sentiments and support for the victim at that time, it was theorised within the company that the rape incident was a conspiracy by Ola, a rival firm in India, to undermine Uber's reputation. Alexander had obtained the rape victim's confidential medical records and shared them with Kalanick and Michael, before reportedly carrying the files with him for months before they were destroyed.[33]

A driverless company

Since the beginning of 2017, when Uber was rocked by a series of scandals, the company has been further weakened by a series of resignations by many key personnel who were linked to controversies. Several senior management positions were left vacant.

Apart from Alexander and Michael, Amit Singhal, Uber's Senior Vice President of engineering, was asked to resign by Kalanick on 27 February 2017 due to his history of sexual harassment allegations.[34] On 3 March 2017, Uber's Vice President of product and growth, Ed Baker, left after allegedly engaging in a sexual encounter with another employee.[35] A few weeks later, on 19 March 2017, Jeff Jones, Uber's President, issued a public statement saying that he was leaving because "the beliefs and approach to leadership that have guided [his] career are inconsistent with what [he] saw and experienced at Uber,"[36] and Uber was "not the situation he signed on for".[37]

On 17 April 2017, Sherif Marakby, the Vice President of global vehicle programs, who helped start Uber's self-driving car program, left the company as well. His departure came during the period when Uber was dealing with the Waymo lawsuit over IP rights.[38] Finally, Uber's head of finance, Gautam Gupta, left the company on 31 May 2017.[39]

Letting go of the driver's seat

The succession of scandals had weakened investors' trust in Kalanick. As Kalanick took his indefinite leave of absence, he was oblivious to the fact that Bill Gurley – a partner from venture capitalist firm Benchmark – who occupied the firm's seat at Uber's board of directors, had been leading a multi-week long campaign aimed at ousting Kalanick. Gurley believed that it would be impossible for Uber to change its toxic corporate culture with Kalanick at the helm. He then rounded up the support of four other key investors – First Round Capital, Lowercase Capital, Menlo Ventures and Fidelity Ventures – which accounted for 40% of Uber's shareholder votes, to join Benchmark in calling for Kalanick's resignation.[40] On 20 June 2017, Benchmark presented Kalanick with a letter titled "Moving Uber Forward", holding him accountable for his leadership missteps which placed Uber in legal peril. It sought Kalanick's resignation as CEO and for him to relinquish the board seats he controlled. While this came as a shock to Kalanick, the founder agreed to step down.[41]

Despite resigning from his role as CEO and the board seat associated with that position, Kalanick re-appointed himself to one of the three Uber board seats over which he had control. He also retained ownership of 10% of the company's issued stock and control of 16% of the total voting rights.[42]

Road to recovery?

Following Kalanick's resignation, Uber's board embarked on a series of changes in a bid to improve the company's corporate governance. The proposal for change included alterations in Uber's board structure and the abolishment of the dual-class share regime, which would leave shareholders with one vote per share. This would dramatically reduce Kalanick's influence over Uber. The plan would also increase Uber's board size to 17 members.[43]

Before the proposed changes could go to a vote, Kalanick appointed two new board members without consulting the company's board, claiming a full board was needed to deliberate the board changes.[44] His actions appeared to be an act of defiance against Benchmark, which claimed that Kalanick had agreed to accede the two board seats to appoint independent directors, but failed to follow through. Benchmark then sued Kalanick on the grounds of fraud, breach of contract, and breach of fiduciary duty.[45]

In the lawsuit, Benchmark attempted to nullify Kalanick's decision in June 2016 to increase the size of the board by three new voting seats, to be held by individuals appointed by Kalanick. Benchmark claimed that Kalanick had deliberately concealed his mismanagement and acts of misconduct, and that it would not have approved the increase in board seats had it known about the scandals. Through the lawsuit, Benchmark wanted to remove Kalanick from the board and ban his participation in the selection process for Uber's new CEO.[46] In response, Kalanick dismissed Benchmark's claims. The court eventually allowed the case to be moved to private arbitration, and Kalanick managed to avoid a public high-profile lawsuit against Benchmark.[47]

While the results of the arbitration remain unknown, Uber appointed former Expedia CEO Dara Khosrowshahi as the new CEO in August 2017. With 12 years of experience at Expedia, Khosrowshahi was thought to be more than qualified to bring an end to a company culture built on founder control.[48] Khosrowshahi has the unenviable task of rebuilding Uber's tarnished public image, repairing strained investor relationships, and cleaning up its corporate culture, while trying to turn its losses into profits.[49]

Discussion questions

1. 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.

2. Comment on Uber's board composition, independence and the lack of separation between ownership and control.

3. Who should be held responsible for setting and upholding the ethical and corporate culture of a company? How did Uber's corporate culture contribute to the occurrence of the series of scandals?

4. Moving forward, how can Uber improve the accountability of its board of directors and senior management, as well as its corporate governance?

5. What steps do you think Uber should take to reinforce the importance of upholding good business ethics and corporate governance to its employees?

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THE KRAFTY TAKEOVER OF UNILEVER

Case overview

On 17 February 2017, Kraft-Heinz Company (Kraft-Heinz) took the world by surprise with a US$143 billion takeover bid for Unilever, an ambitious manoeuvre that would consolidate well-known brand names in consumer goods under one roof. However, just two days after the public announcement was made, the acquisition fell through after Unilever dismissed Kraft-Heinz's proposal. Kraft-Heinz ultimately decided to walk away from the deal on "amicable" terms. The objective of this case is to allow a discussion of issues such as the role of takeovers in corporate governance; cross-border mergers and acquisitions; the role of the board of directors in acquisitions; and divergence of interests between shareholders and other stakeholders.

When Kraft met Heinz

In 2015, H. J. Heinz, a company owned by Berkshire Hathaway and Brazilian investment firm 3G Capital, purchased multinational consumables company Kraft Foods Group Inc.[1] This resulted in the creation of the world's fifth largest food and beverage company, Kraft-Heinz.[2] The American food conglomerate is currently headquartered in Chicago and Pittsburgh, and has a portfolio of more than 200 brands, with eight of its more prominent brands each drawing in more than US$1 billion of annual revenue.[3]

This is the abridged version of a case prepared by Chan Zhi Yi, Leong Hui Ling, Tee Su Jin, and Ng Mei 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 Jacqueline Lor under the supervision of Professor Mak Yuen Teen.

Prior to the merger, when 3G Capital took control of Heinz's operations, it gave Heinz the "3G cultural makeover". Actions taken included laying off 11 of 12 top executives, and replacing them with executives of its own who had previously overseen other 3G Capital-owned companies.[4] 3G Capital proceeded to announce its plans to cut 350 of 1,200 full-time jobs at Heinz's Pittsburgh headquarters and another 250 from other parts of North America the following month, in order to reduce costs.[5] Two years later, when Heinz acquired Kraft, this cost-cutting culture spread throughout Kraft-Heinz. Due to this cost-cutting strategy, Kraft-Heinz achieved its fourth straight quarter of double-digit decline in expenses in July 2017 and experienced a jump in net income to US$1.16 billion.[6]

The big friendly giant

Unilever, an Anglo-Dutch company, is one of the largest firms listed in the United Kingdom (U.K.). Founded in 1930 through the merger of Lever Brothers and Margarine Unie, the firm operates under a unique dual structure with one company publicly traded in London, and the other in Rotterdam, the Netherlands.[7] This dual structure meant that Unilever has two separate legal identities and stock exchange listings with two sets of corporate laws and governance rules to follow, while operating as a single entity.[8] In recent years, Unilever suffered from slowing growth and saw a decline in sales volume in 2016.[9] Its underwhelming financial performance from slowing sales growth affected shareholders as its share price took a hit.[10]

The three ringmasters

The two masterminds behind the proposed bid for Unilever were Berkshire Hathaway's iconic founder and CEO, Warren Buffett, and 3G Capital's founder, Jorge Paulo Lemann.[11]

Lemann is known for his ruthless chase for operational efficiency.[12] While enraging staff and customers due to his modus operandi which ignores the interests of these stakeholders, Lemann has a record of pleasing investors through boosting shareholder value in the companies owned by 3G Capital.[13] Together with Berkshire Hathaway's Buffett, who has a long-time aversion against hostile takeovers, the two masterminded the bid for Unilever.[14] The history of collaborations between the duo dates back to the Kraft-Heinz merger in 2013, and both are part of Kraft-Heinz's 11-member board of directors.[15]

On the other side of the negotiation table was Paul Polman, the CEO of Unilever, who has been at the forefront of corporate social responsibility at Unilever, embracing sustainability initiatives such as environmental and human rights efforts.[16] The Unilever Sustainable Living Plan (USLP) was initiated in 2010 and serves as the backbone of Unilever's sustainable operations.[17] In order to align Unilever's organisational goals with its overarching company value – sustainability – Polman decided to forego quarterly profit targets. This was justified with the argument that quarterly targets would create a tunnel vision phenomenon, resulting in a shift in focus to increase share price, with diminishing emphasis placed on long term goals that Unilever values most.[18]

Brief courtship

Kraft-Heinz's US$143 billion bid to take over Unilever represented a premium of 18% to Unilever's share price at that time.[19] Consisting of a mix of US$30.23 billion in cash and 0.222 Kraft-Heinz shares per existing Unilever share, each Unilever share was valued at US$49.61.[20] Additionally, Kraft-Heinz also prepared a comprehensive proposal on the merger, maintaining that the takeover could create a leading consumer goods company which would focus on long-term growth, while keeping Unilever's sustainable living plans in sight. After the bid was announced, share prices of both Kraft-Heinz and Unilever increased significantly,[21] indicating that investors of both companies were in support of this union.[22]

Marmite and ketchup

A successful combination of Kraft-Heinz and Unilever would have created the world's second largest consumer food company,[23] and set the record for the largest takeover of a British company. With Kraft-Heinz's geographic strength in North America complementing Unilever's stronger sales in Europe, the Middle East and Asia, a merger would increase the geographic presence for both companies.[24]

Increasing market competition from emerging competitors, deflation in developed markets and consumers' shift towards health consciousness pose as threats in the global packaged food industry, which has been faced with slowing sales.[25] Unilever is no exception to these changing trends, as its share price tumbled by almost five percent on 26 January 2017, after the company reported lacklustre financial results.[26]

Additionally, Brexit – the U.K.'s decision to leave the European Union – led to a weakening of the pound sterling, making British companies more vulnerable to takeovers as they became relatively cheaper for foreign investors to acquire.[27] On top of that, low interest rates and cheaper costs of borrowings have also fuelled many of such cross-border takeover attempts in 2017.[28]

Unilever's struggle amidst slowing growth, fall in share price and a weakened pound encouraged Kraft-Heinz to seize the opportunity to make a move to acquire it.

A one-sided deal?

After the unsolicited bid by Kraft-Heinz, Unilever was quick to issue a firm rebuke. It immediately issued a press release rejecting the offer, stating that the US$49.61 cash-and-stock offer "fundamentally undervalues Unilever",[29] and that it saw neither financial nor strategic merit in the offer for Unilever's shareholders.[30]

Unilever also perceived the bid to be a strategic play by Kraft-Heinz, capitalising on its weakened share price without placing the company's long-term interests at heart.[31] Even when Kraft-Heinz offered to make concessions, including raising its offer and keeping Unilever's headquarters in London and Rotterdam, Unilever maintained its firm resistance against the deal, indicating its unwillingness to proceed at any price.[32]

Culture clash

Unilever's strong objection against the takeover was largely attributed to the jarring differences in governance model and corporate culture of the two industry giants.[33] Unilever places strong emphasis on a long-term approach, upholding the basic principle of sustainability. Its culture of value creation through the amalgamation of sustainability practices is embedded in its business model.[34] While 3G Capital's mission statement includes "[focusing] on long-term value",[35] the private equity group has an entirely different take on sustainable growth and is known to take a "lean and mean" approach when cutting costs and jobs.[36] Evidently, Kraft-Heinz seems to be focusing on minimising costs while maximising shareholder value, which could imply a momentary boost in profits without a long-term orientation.[37]

As such, it was not surprising that Kraft-Heinz's acquisition of Unilever fell through due to their fundamentally different cultures. With such incompatibilities in priorities and business strategies, some analysts commented that if the takeover were to succeed, Unilever's sustainable business model would have been significantly hindered.[38]

Warning sign

Mirroring Unilever's resistance to the takeover offer was Britain's largest trade union, Unite the Union (Unite), which raised fears that over 9,000 jobs in Britain could be affected if the deal went through.[39] British Prime Minister, Theresa May, called for the government to play a more active role in assessing foreign takeovers and ordered for a meeting with both companies to examine if the proposed takeover should trigger government intervention due to its significant potential effects on the U.K. economy.[40]-

Furthermore, the bid was reminiscent of Kraft's hostile takeover of U.K. chocolate maker Cadbury in 2010, and its complete disregard for Cadbury's name and products.[41] Kraft also reneged on its promise to retain Cadbury's Somerdale factory, resulting in the loss of 400 jobs and arguably a drop in product quality.[42]

Changing the U.K. Takeover Code

The U.K.'s traditional open-door policy allows foreign companies to mount a takeover with greater ease than in most other economies.[43] The takeover of Cadbury in 2010 sparked extensive debate with regards to the U.K.'s Takeover Code. That episode brought about pressure to tighten the Takeover Code and strengthen the Takeover Panel's powers to safeguard jobs and businesses from "asset-stripping" by foreign firms.[44]

Subsequently, substantial changes were made to the Takeover Code in 2011. Firstly, stringent oversight of takeovers was put in place, requiring more transparent disclosures of fees and financing arrangements.[45] Secondly, an announcement of a takeover bid commences an offer period, during which all potential bidders have to be named. Thirdly, the panel introduced a 28-day deadline to the offer period, known as the "put up or shut up" rule, to shorten the period of uncertainty hanging over a potential target. A bidder would effectively be committed to making an offer once it announces an intention to make a bid.[46]

“Amicable” parting of ways

Under the U.K. takeover rules, Kraft-Heinz had until 17 March 2017, or 28 days after disclosing its intentions of the takeover, to announce its official offer for the deal.[47] However, a mere two days after the announcement, on 19 February 2017, Kraft-Heinz swiftly withdrew its takeover bid after Unilever’s strong objections to its proposal.[48] While many analysts on Wall Street had assumed that Kraft-Heinz and 3G Capital were prepared to fight for Unilever, Kraft-Heinz and its backers did not have intentions of waging a hostile battle.[49] Following the withdrawal of the bid, Unilever’s share price fell by seven percent in London and Rotterdam.[50]

Defences up by Unilever

Undoubtedly, Unilever’s focus on stakeholder interests has brought about positive effects for both consumers and the environment. However, many shareholders have expressed their discontent about excessive resources being channelled into promoting sustainable efforts at the expense of shareholder interests.[51] In recent years, there have been calls by investors to sell underperforming businesses which have been lagging behind other European home and personal care companies, or performing large acquisitions to boost shareholder returns.[52] The attempted takeover only mounted additional pressure on Unilever to boost its shareholder returns.

In view of this, Unilever issued a press release on 22 February 2017, stating that it would conduct a comprehensive review of options available to “capture more quickly the value we see in Unilever”.[53] Subsequently, Unilever announced a series of measures on 6 April 2017[54] to accelerate sustainable shareholder value creation. These measures were implemented to ensure that shareholders would not be swayed by future takeovers, especially by companies whose company cultures are the polar opposites of Unilever’s. If well implemented, the measures would also help in maintaining shareholder confidence towards Unilever’s ability to operate profitably while pursuing sustainability. Furthermore, Unilever announced that it had begun an accelerated cost-saving plan, targeting an approximate five percent increase in operational profits by 2020.[55] The company also intends to establish an integrated foods and refreshment unit to cut costs and improve efficiency.[56] Due to shifting consumer trends leading to stagnant growth in certain business units, efforts would be made to further cut costs through the sale of these units in order to increase operating profit margins.[57] In line with these cost-cutting strategies, on 22 September 2017, Unilever sold its South Africa's spreads business to Remgro Group.[58]

Additionally, in a bid to increase earnings per share, Unilever commenced the implementation of a programme to buy back shares with a market equivalent of five billion euros,[59] reducing the capital of both Unilever PLC and Unilever N.V..[60] Additionally, Unilever also reviewed its dual structure, citing that a simplified structure would potentially increase its strategic flexibility, especially in terms of large-ticket merger and acquisitions, as well as demergers of businesses.[61]

Defences up by regulators

Unilever may have dodged a bullet with the failed Kraft-Heinz's takeover bid. However, the attempted takeover indicated that political issues were still embedded in foreign takeovers of U.K. companies[62] despite the changes made to the Takeover Code in 2011.

Secretary of State for Business, Vince Cable, summed up the key issue in the Takeover Code by saying that the public interest tests were still too narrow.[63] Similarly, Polman pointed to the Netherlands, where takeovers are subjected to much broader stakeholder interest tests. Polman then called for greater protectionist measures in the U.K.,[64] adding that the Takeover Code should consider the interests of stakeholders beyond shareholders to level the playing field for target companies.[65]

In response, the Takeover Panel launched a series of new changes to the takeover rules. Previously, the details of plans for the target company, called the offer document, could be published on the same day as the formal offer. Unions and target companies only have two weeks to put forward their views and defences on the deal within a circular, which must be sent to shareholders under a set Takeover Panel timetable.[66]

Under the new rules, the offer document cannot be posted within 14 days after the intention to make an offer unless agreed by the target company. This thus gives more time for the target company and unions to respond. The new rules guarantee at least 28 days for target companies of hostile bids to respond and make their case to shareholders.[67]

Labour lawmaker and business spokesman, Chuka Umunna, went further to state that the Takeover Code should also be extended to transactions with a material impact on the economy and those that affect research and development and innovation.[68]

The Takeover Panel now requires bidders to be especially clear about their intentions, with the need to lay out specific information and detailed plans for their targets. This includes the disclosure of any intention for the research and development functions of the target company and headquarter locations.[69,70]

These rule changes were proposed to make bidders accountable for their promised actions when they decide to propose a deal.[71] Updates to the Takeover Code were filed by the Takeover Panel on 31 October 2017.[72]

A second chance for Kraft-Heinz?

In the case of the Unilever takeover attempt, the six-month ban on making a second takeover attempt[73] – as per British takeover rules – expired on 19 August 2017, freeing Kraft-Heinz to make a follow-up bid if it decided to do so. There was much speculation that Kraft-Heinz would announce another offer for Unilever in the range of US$200 billion. However, in September 2017, Kraft-Heinz said that it was no longer interested in acquiring Unilever.[74]

Up and away

Although the proposal did not end on a sweet note, Unilever walked away with an enlightened view of its stakeholders' desires. CEO Polman mentioned that after the failed takeover, and as a result of the U.K.'s reforms[75] to prevent future takeovers from occurring, Unilever's performance has been constantly improving. The company has broadened its focus to include operational margins to factor in shareholders' concerns about profitability, while continuing its pursuit of sustainable business practices – a core value it intends to keep under any circumstances.

Discussion questions

1. Takeovers are seen to be an important external corporate governance mechanism. What are the pros and cons of takeovers as a corporate governance mechanism? In the case of Kraft-Heinz's attempted takeover of Unilever, do you believe it is good or bad for corporate governance if it had succeeded?

2. Warren Buffett has a long-time aversion to hostile takeovers. What are pros and cons of hostile and friendly takeovers?

3. What are the key risks and corporate governance issues that might arise from cross-border acquisitions?

4. The U.K.'s traditional open-door policy allows foreign companies to mount a takeover in the U.K. much more easily than in most other major economies. What are some similarities and differences between takeover rules in the U.K. and the U.S.?

5. What is the role of the board versus shareholders in approving takeovers in the U.K., U.S. and Singapore? Explain.

6. In a takeover, the interests of different stakeholders may diverge. Explain the divergence of interests for different stakeholder groups. In the case of the proposed Kraft-Heinz and Unilever merger, which stakeholders would favour the takeover and why?

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Professor Mak Yuen Teen is an Associate Professor of Accounting at the NUS Business School, National University of Singapore and a former Vice Dean of the School, where he founded Singapore's first corporate governance centre in 2003. He holds first class honours and master degrees in accounting and finance and a doctorate degree in accounting, and is a fellow of CPA Australia.

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Professor Mak is a regular commentator and speaker on governance issues in the corporate, public and charity sectors. He conducts professional development programmes for new and experienced directors, regulators and other professionals. Professor Mak has been commissioned by the government, regulators, professional associations and private sector firms to lead research and provide recommendations on various corporate governance issues. He has also published extensively in academic and professional journals.

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