

**Cover**



# **Corporate Governance Case Studies**

## **Volume six**

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

Editor

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# Foreword

# Preface

About 15 years ago, when I founded the corporate governance centre at the NUS Business School, a well-known company director asked me why. Singapore had just released her first code of corporate governance not too long ago and as far as he was concerned, corporate governance will go the same way as some management fads. I thought the journey had only just started.

Since then, interest in corporate governance has not waned at all. In fact, it has grown. Today, corporate governance is not only discussed in the context of listed companies, but also unlisted companies, charities, statutory boards, town councils, sports bodies, and other organisations.

Similarly, interest in this annual collection of corporate governance cases, now into its sixth year, has continued to grow. More universities, professional bodies and other organisations involved in corporate governance education here and around the world are using the cases. Selected cases from volumes 1 and 2 have been translated into Chinese for the Hong Kong, People's Republic of China and Taiwan markets. Volume 1 has been translated into Vietnamese, through a collaboration with the stock exchanges in Vietnam, for their listed companies.

Some of the cases in this latest volume cover emerging themes such as cybersecurity and corporate culture, and for the first time, we have cases from Bangladesh, Taiwan and Thailand.

There are 23 cases in total, eight of which are Singapore cases involving Brooke Asia, Celestial Foods, MMP Resources, Natural Cool Holdings, OSIM, SBI Offshore, Swiber Holdings and Tiger Airways. Some deal with corporate governance issues in situations such as a reverse takeover, privatization and insolvency. There is a mix of domestic and foreign listings.



There are also eight Asia Pacific cases, including the Central Bank of Bangladesh case, G-Resources in Hong Kong, Tata Group in India, Hanjin Shipping and Samsung Electronics in South Korea, Evergreen Group and Mega Bank in Taiwan, and CP ALL in Thailand. The Central Bank of Bangladesh cybersecurity breach is considered the largest financial cybercrime in Asia. The G-Resources case deals with a rare display of public activism in Asia by Blackrock, the largest investor in the world. It is the first case which includes inputs from interviews with a central figure in the case. A number of cases deal with corporate governance in large listed family-controlled companies and groups, while the Mega Bank case is about a major money laundering scandal involving a bank with strong government links.

The remaining seven cases are global cases involving companies outside of Asia-Pacific. Companies covered include BHS, Snap Inc., Starbucks, Target, Theranos, Viacom and Wells Fargo. Three of these cases – Snap Inc., Theranos and Viacom – concern companies having shares with different voting rights and allow discussions of the pros and cons of such share structures that some Asian stock exchanges are considering allowing. The Starbucks case involves a company which is widely admired for its ethics accused of reducing its tax through questionable means. BHS looks at corporate governance of a large unlisted UK company, whose collapse has raised issues about whether corporate governance rules applicable to listed companies should also apply to unlisted companies. The Wells Fargo case has the issue of corporate culture at its core.

I would like to thank the students who wrote the original cases, the students who assisted in editing them, and particularly Isabella Ow, who did a great job as my editorial assistant. This initiative would not have been possible without the excellent support from CPA Australia and its team here in Singapore. In particular, I would also like to thank Joanna Chek for her excellent work on this volume, Sheryl Koh who had been consistently excellent over the first five volumes, and Melvin Yong for being a strong champion of this publication.

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# BROOKE ASIA: A SHORT CUT TO CONTROVERSY

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## Case overview

Between 2014 and 2015, Brooke Asia Limited (Brooke Asia) carried out a reverse takeover (RTO) with China Star Food Holdings involving a consideration of S\$168 million through the issuance of 840 million new shares. The RTO came as a saving grace for Brooke Asia, which was facing an imminent delisting as it no longer met the Singapore Catalist Board listing requirements. The RTO was completed on 23 September, 2015. The sponsor of the RTO, PrimePartners Corporate Finance (PrimePartners), received partial payment in the form of 3.5 million shares, which accounted for 0.68% of China Star Food Group's total holding. The objective of this case is to allow a discussion of issues such as the bundling of resolutions; roles and responsibilities of sponsors in listed companies; the impact of a RTO on various relevant stakeholders; design of remuneration schemes; and corporate governance issues relating to the board of directors and ownership structure.

## The rising star

China Star Food Group Limited (CSFG), a Singapore-based company, was previously known as Brooke Asia prior to Brooke Asia's RTO of China Star Food Holdings Group (CSFH) and CSFH's subsidiaries. CSFG is primarily engaged in the manufacture of healthy snack foods in China. The Group's main business is the production and sale of sweet potato snack food products.<sup>1</sup>

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This is the abridged version of a case prepared by Ng Gau Wei, Gary Chia Zong Zhe, Soh Chi Loong Calvin, Rochelle Wong Xi Wen and Ng Jun Ting Shirley 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 Tan Zhe Ren under the supervision of Professor Mak Yuen Teen.

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## A spot of trouble

On 23 January, 2014, Brooke Asia completed the disposal of all its subsidiaries to its former holding company, Latitude Tree Holdings Berhad (LTHB). This was pursuant to a shareholder resolution approved in an extraordinary general meeting (EGM) held on 25 July, 2013 through a sale and purchase agreement.<sup>2</sup>

Under Rule 1017(2) of the Singapore Exchange's (SGX) Catalist Rulebook, "The Exchange will ... remove an issuer from the Official List if it is unable to meet the requirements for a new listing within 12 months from the time it becomes a cash company. The issuer may ... apply to the Exchange for a maximum 6-month extension ... if it has already signed a definitive agreement for the acquisition of a new business. ... In the event the issuer is unable to ... complete the relevant acquisition ... no further extension will be granted and the issuer will be removed from the Official List ...".<sup>3</sup>

As Brooke Asia had disposed of its subsidiaries, it no longer had operating businesses and was considered as a 'cash company'. To prevent its removal from the Catalist Board, Brooke Asia had to acquire a business that satisfied Rule 1017 within the following 12 months.

## Going for Brooke

On 3 October, 2014, Brooke Asia entered into a non-binding term sheet to acquire a "Singapore incorporated investment holding company, together with its subsidiaries and associated companies".<sup>4</sup>

Following the disclosure of the planned acquisition on 5 November, 2014, Brooke Asia's then-CEO and executive director Ng Wei Hwa announced that the company had formally entered into a conditional sale and purchase agreement of CSFH. The purchase consideration was to be satisfied by the issuance of 840 million new and fully paid-up ordinary shares at S\$0.20 per share.<sup>5</sup> As the consideration value far exceeded Brooke Asia's market capitalisation, and the number of shares to be issued was extremely high compared to the existing number of shares, this amounted to a "reverse takeover" or "very substantial acquisition" classification under Rule 1015(1) of the Catalist Rules.<sup>6</sup>

## Saved by the bell

As the deadline for Brooke Asia to meet Rule 1017 loomed closer, the company applied on 5 November, 2014 for an extension to complete the acquisition. This extension was granted less than two months later on 13 January, 2015, and gave Brooke Asia until 22 July, 2015 to complete the RTO.<sup>7</sup>

On the same date as the grant of the extension, CSFH and Liang Chengwang, one of CSFH's major shareholders, entered into a convertible loan agreement (CLA) with Liu Hsu-Chou, a potential investor interested in the RTO, for an aggregate principal amount of S\$3.6 million.<sup>8</sup> This would automatically be converted into fully-paid up new ordinary shares in the share capital of CFSH upon the approval of the RTO.

## A minor hiccup

Unfortunately, the CLA and supplemental agreement were terminated as Liu did not provide the agreed principal amount within 14 days from the date of the CLA.<sup>9</sup>

On 16 April, 2015, Brooke Asia's board of directors announced the termination of the CLA and supplemental agreement with Liu and broke the news of another agreement with a separate, unrelated party, Cheong Chee Hwa, involving a S\$2 million principal amount. The new shareholding structure of CSFH and the number of consideration shares for each vendor would be amended as follows:<sup>10</sup>

Name of shareholder	Number of shares in CSFH	Number of consideration shares to receive at completion
Liang Cheng Wang	1,250,340	321,132,000
Huang Lu	1,314,460	337,596,000
Lee Chee Seng	208,390	53,508,000
Wang Yu Huei	208,390	53,508,000
Yang Meng Yang	160,300	41,160,000
Hoo Sum Hak	32,060	8,232,000
Chiar Choon Teck	32,060	8,232,000
Cheong Chee Hwa	64,761	16,632,000
Total	3,270,761	840,000,000

*Figure 1: Shareholding structure of CSFH and the number of consideration shares to be received by each vendor after the new agreement*

However, there was one last worry left for Yek Siew Liong, the Executive Chairman of Brooke Asia - meeting the extended deadline of 22 July, 2015 to complete the acquisition seemed quite impossible. This was temporarily addressed on 18 June, 2015 as SGX approved a second, albeit shorter, extension to complete the RTO. The new deadline was set to be 22 October, 2015.<sup>11</sup>

## Resolute resolutions

On 26 June, 2015, Brooke Asia issued a notice of an EGM to be held on 20 July, 2015, together with a shareholders' circular. The notice stated a total of 13 resolutions to be passed, of which 10 were ordinary and three were special. The passing of resolutions 1, 2, 3, 4, 5, 6, 7, 8 and 9 was inter-conditional, while resolutions 10, 11, 12 and 13 were conditional on the passing of the inter-conditional resolutions. The following were the resolutions found in the shareholders' circular:<sup>12</sup>

- **Ordinary Resolution 1:** Proposed Acquisition of the entire issued and paid-up share capital of China Star Food Holdings Pte. Ltd. for the Purchase Consideration of S\$168,000,000.
- **Ordinary Resolution 2:** Proposed allotment and issue of (i) 840,000,000 Consideration Shares to the Vendors in satisfaction of the Purchase Consideration for the Proposed Acquisition, (ii) 3,500,000 Shares to the sponsor, PrimePartners Corporate Finance Pte. Ltd. in partial settlement of their fees and (iii) 27,500,000 Arranger Shares to the Arranger in satisfaction of the arranger fees, at the Issue Price of S\$0.20 for each Share.
- **Ordinary Resolution 3:** Proposed Whitewash Resolution for the waiver by Independent Shareholders of their right to receive a mandatory general offer from the Vendors and their concert parties for all the issued and paid-up Shares of the Company following the Completion of the Proposed Acquisition.
- **Ordinary Resolution 4:** Appointment of the Proposed Directors - the appointment of (i) Liang Chengwang as an Executive Director, (ii) Chen Huajing as an Executive Director, (iii) Huang Lu as a Non-Executive Director, (iv) Koh Eng Kheng Victor as an Independent Director, (v) Lim Teck Chai, Danny as an Independent Director, and (vi) Loh Wei Ping as an Independent Director

- **Ordinary Resolution 5:** Proposed allotment and issue of up to 101,000,000 Placement Shares pursuant to the Proposed Compliance Placement
- **Special Resolution 6:** Proposed Change of Company's Name to "China Star Food Group Limited"
- **Special Resolution 7:** Proposed Amendments to the Articles
- **Special Resolution 8:** Proposed Capital Reduction and Proposed Cash Distribution
- **Ordinary Resolution 9:** Proposed Change of Auditors
- **Ordinary Resolution 10:** Proposed Adoption of the China Star Employee Share Option Scheme
- **Ordinary Resolution 11:** Grant of Options at a discount pursuant to the China Star Employee Share Option Scheme
- **Ordinary Resolution 12:** Proposed Adoption of the China Star Performance Share Plan
- **Ordinary Resolution 13:** Proposed Variation of the General Share Issue Mandate upon the Completion of the Proposed Acquisition

If the resolutions were not passed, Brooke Asia would fail to meet the listing requirements under Rule 1017 of the Catalist rules. This would result in the company being delisted, leaving its shareholders with illiquid shares. All the proposed resolutions were subsequently passed during the EGM.<sup>13</sup>

## Take it or leave it

The bundling of resolutions caught the attention of Professor Mak Yuen Teen, a corporate governance advocate, and Chew Yi Hong, an active investor. In a commentary in the Business Times<sup>14</sup>, they noted:

"Some degree of inter-conditionality of resolutions is understandable in RTO situations. However, the extent of inter-conditionality in Brooke Asia's case is far more than what we have observed in other RTO situations and, in our view, unjustified and may set a bad precedent...the company had effectively created an "all or nothing" situation for shareholders voting at the EGM."<sup>15</sup>

They further added: “Resolution 2 bundled the proposed allotment and issue of consideration shares to the vendors with the proposed allotment and issue of shares to the financial adviser and sponsor as partial payment of their fees and also the fees to the “arranger” ... As it is, paying sponsors in the form of shares rather than cash is controversial and has been the subject of media debate in the past ... Should this particular resolution be bundled at all? Should the passing of the other eight resolutions be conditional on the financial adviser/sponsor receiving their partial payment in shares? Are there not perception issues when the sponsor is supposed to review the contents of the notice and circular, and the resolution on payment of fees to itself is bundled and made inter-conditional with other resolutions?”<sup>16</sup>

Perhaps their most damning criticism was that the bundling of the resolutions relating to the proposed appointment of six directors, including three independent directors, breached Section 150 of the Singapore Companies Act. This would make their appointments void, and potentially invalidate the other resolutions given that they were conditional on this resolution.<sup>17</sup>

## **Setting the wheels in motion**

On 1 September, 2015, Brooke Asia announced a proposed capital reduction. This proposal would result in cash being distributed to its shareholders, reducing its paid-up capital from S\$6.37 million to S\$1. This involved returning 6.85 cents for each share held by shareholders as at 1 September, 2015.<sup>18</sup> Given that Brooke Asia’s shares were priced at 74 cents per share on the date of the announcement, the capital reduction saw an aggregate amount of S\$3.67 million returned to shareholders on 17 September, 2015.<sup>19</sup>

## **Brooke Asia gets a new name**

On 22 September, 2015, Brooke Asia was renamed as China Star Food Group Limited and its trading counter name on the Catalist Board was changed from “Brooke Asia” to “China Star Food” on 28 September, 2015.<sup>20</sup>

On 23 September, 2015, a trading halt was requested by the company secretary, Kiar Lee Noi, for CSFG to meet the “minimum distribution and shareholding spread requirements of the Company pursuant to Catalist rules”.<sup>21</sup> The suspension was lifted on 20 April, 2016, when CSFG’s shares debuted<sup>22</sup> after a four-for-one consolidation of the old Brooke Asia shares.<sup>23</sup>

## **New shareholding structure**

Following the RTO, the four substantial shareholders of CSFG were Huang Lu (32.89%), Liang Chengwang (31.25%), Wang Yu Hui (6.06%), and Lee Chee Seng (5.25%). Liang Chengwang and Huang Lu were both considered controlling shareholders as they each held over 30% of CSFG shares.<sup>24</sup>

## **Board shuffle**

After the acquisition and the 2015 annual general meeting, the incumbent directors of Brooke Asia resigned, and were replaced by Liang Chengwang, Huang Lu, Chen Huajing, Koh Eng Kheng Victor, Loh Wei Ping, and Lim Teck Chai, Danny.<sup>25</sup> Subsequently, on 7 April, 2016, Chen resigned as director to pursue other career opportunities.

Following Chen’s resignation, CSFG’s board consists of five directors, three of whom are independent. Liang, the CEO and Executive Chairman of the board, sits on the Nominating Committee (NC). His service agreement would automatically be renewed every three years for another three years unless otherwise terminated. Huang is a non-executive director sitting on the Remuneration Committee (RC) and is also a director of Sino Renewal Energy Investment Pte Ltd.

Koh, Loh, and Lim are the company’s independent directors with Koh being lead independent director. Koh has extensive work experience in portfolio and fund management. He is on the Audit Committee (AC) and is Chairman of the NC. Apart from his position in CSFG, Loh is also the Chairman and director of Sanctuary Memorial Park Berhad. Loh sits on the RC and is the AC Chairman. Independent director Lim has a background in law and is also an equity partner at Rajah & Tann Singapore LLP. Lim is also the RC Chairman and sits on the AC and NC. He also holds multiple directorships in other companies.<sup>26</sup>



## Remuneration

The remuneration of each director and key management personnel is disclosed in bands of S\$250,000 but there **are** no detailed disclosure of the amounts and remuneration mix of its directors as CSFG believes it may be prejudicial to its business interests. Directors' remuneration is based on level of responsibility and scope of work, while executive directors are rewarded based on performance.<sup>27</sup>

CSFG also has in place the China Star Employee Share Option Scheme (China Star ESOS) and the China Star Performance Share Plan (China Star PSP). These schemes serve as long-term incentive schemes and are administered at the absolute discretion of the RC. When a member of the RC is a proposed recipient, the individual would not take part in the RC's deliberations and decisions involving him.<sup>28</sup>

The China Star ESOS grants ordinary shares of CSFG to employees, directors and its subsidiaries, including independent directors and those who may be controlling shareholders. According to the company's annual report, the number of shares that can be granted to controlling shareholders and their associates cannot exceed 25% of the total shares allowed, while the limit for each controlling shareholder is 10% of the total shares allowed under this scheme.<sup>29</sup>

The China Star PSP awards shares to recipients who have met performance targets in the form of either existing shares held as treasury shares and/or the issuance of new shares. It was stated by the company that the performance shares issued to a recipient, in combination with the individual's other share options and performance shares, shall not exceed 15% of CSFG's total issued share capital. No shares would be awarded if the potential award recipient meets the criteria for disqualification as specified in the Statement by Directors in CSFG's 2016 annual report, such as if the RC determines that the individual was found guilty of misconduct.<sup>30</sup>

## **Payment for sponsor**

For the financial year 2016, CSFG paid its sponsor, PrimePartners, non-sponsor fees of S\$220,000 for acting as the financial adviser pursuant to the company's RTO as per 'Ordinary Resolution 2' approved during the EGM on 20 July, 2015. At the same time, they issued 1.75 million shares to PrimePartners, which accounted for 0.68% of the total amount of shares issued.<sup>31</sup>

## **Will the star still shine brightly?**

CSFG's shares performed well on its debut on 20 April, 2016, opening at S\$0.23 and closing at S\$0.29, an approximate increase of 26%.<sup>32</sup>

However, a "Letter of Demand" dated 19 August, 2016 was issued to CSFG from lawyers acting for Cheong Chee Hwa, a former shareholder of CSFH. The letter alleged certain breaches by the company under a sale and purchase agreement dated 5 November, 2014 previously entered into between, inter alia, the company and the claimant. The said purchase agreement was made in relation to the sale of the claimant's shares in CSFH to the company in connection with the company's RTO.<sup>33</sup> Under the Letter of Demand, Cheong was seeking the payment of S\$2.5 million from the company.<sup>34</sup>

While the outcome of this lawsuit has yet to be decided upon, there is no doubt that CSFG is currently riding on the market's growth prospects, underpinned by an increasingly affluent middle class demanding healthier snack options.

## Discussion questions

1. How does a reverse takeover (RTO) work? What are the pros and cons of a RTO? Are there corporate governance concerns with companies listing through a RTO? How did the reverse takeover affect the various stakeholders of Brooke Asia?
2. What is the ownership structure of CSFG? Assess the potential benefits and costs of this form of ownership structure.
3. Comment on the board structure and remuneration schemes of CSFG.
4. What is the purpose and role of sponsor in the context of the Singapore Catalist Board? Do you believe that the sponsor, PrimePartners Corporate Finance, adequately discharge its duties? Critically evaluate whether the payment of fees to sponsors in the form of shares is appropriate. Identify any potential conflicts relating to PrimePartners' role in the RTO.
5. Discuss the issue of the bundled resolutions from a corporate governance standpoint. Did the bundling of resolutions violate any law, rules or the Code of Corporate Governance? Explain.
6. Stock exchanges and other regulators are often seen to be slow or reluctant to act when companies breach listing and other rules. What might explain such reticence to act? In the Brooke Asia case, should the regulators have taken any regulatory action? Explain.

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# CELESTIAL FOODS: FROM HEAVEN TO HELL

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## Case overview

Celestial Nutrifooods Limited (Celestial) was an investor's favourite since its listing on the Singapore Exchange (SGX) in 2004, until its S\$235 million bond default in 2009. The unravelling of Celestial revealed numerous dubious transactions associated with Ming Dequan, the company's Chief Executive Officer (CEO) cum Chairman, and the other directors of Celestial. The objective of the case is to allow a discussion of issues such as non-segregation between the board, management and shareholders; independence of directors; and the challenges in monitoring and enforcing legal action for foreign companies listed in Singapore.

## The black S-chips

S-chips are corporations listed on the SGX which mainly have business operations in China. SGX has actively pursued S-chip listings to boost Singapore's capital markets since the early 2000s. One of these is Celestial, which was officially listed on the SGX on 9 January, 2004.<sup>1</sup>

However, accounting irregularities, fraud and poor corporate governance have plagued many S-chips, resulting in a drop in investor confidence in such listings.<sup>2</sup> In March 2009, Celestial's auditors warned about going concern issues in Celestial, due to the possible early redemption of its convertible bonds.<sup>3</sup>

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This is the abridged version of a case prepared by Leroy Chua Zhe Yu, Lim Sok Chin, Jolynn Lim Yen Ling, Low Ting Wei and Mok Xiao Chou 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 Raffles Ng under the supervision of Professor Mak Yuen Teen.

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# Background

Celestial was incorporated in Bermuda on 8 September, 2003. It specialised in manufacturing a diverse range of soybean protein-based food and beverage products, sold under the brand name of “Sun Moon Star”.<sup>4</sup>

Celestial has three immediate wholly owned subsidiaries incorporated in the British Virgin Islands (BVI), namely Clear Faith Holdings Limited, Max Dragon Investments Limited and Giant Fortune Group Limited (the BVI Subsidiaries).<sup>5</sup> These subsidiaries were the respective investment holding companies for each of their three wholly owned subsidiaries incorporated in the People’s Republic of China (PRC), namely Daqing Sun Moon Star Co Ltd, Daqing Celestial Sun Moon Star Protein Co Ltd, and Daqing Weitian Energy Co Ltd (the PRC Subsidiaries).<sup>6</sup>

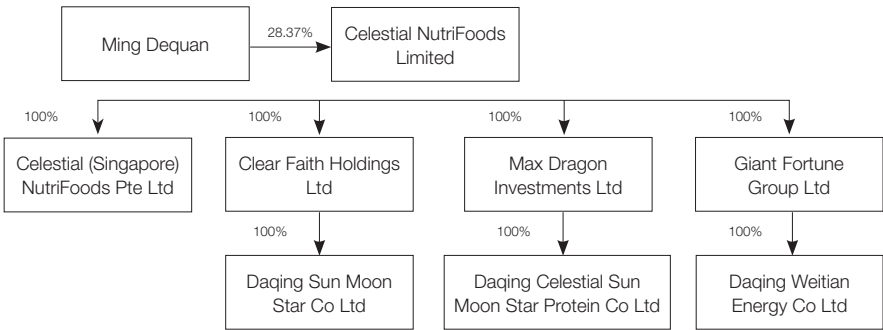


Figure 1: Celestial’s shareholding structure, as at 12 March, 2010

## The rise of Celestial

From 2000 to 2002, Celestial’s sales quadrupled to RMB226.4 million, driven by aggressive marketing and rising consumer health awareness. As at 30 June, 2003, Celestial’s products were distributed in nearly 10,000 supermarkets in more than 130 cities in China.<sup>7</sup> The Daqing government encouraged Celestial to seek a market listing and Singapore was seen as a sensible choice due to its stable regulatory systems.<sup>8</sup>



On 26 December, 2003, Celestial announced its initial public offering (IPO) of 118 million shares at S\$0.28 a share on the SGX Mainboard.<sup>9</sup> Right after its listing on 9 January, 2004<sup>10</sup>, Celestial's share price rose to almost double its IPO price at S\$0.51 per share.<sup>11</sup>

## **Ming Dequan – The visionary leader**

As founder of Celestial, Ming Dequan served as the company's CEO and Executive Chairman.<sup>12</sup> Ming held a 28.37% stake in Celestial as at March 2009, making him a major shareholder. The next largest shareholders collectively only held a 7.67% stake in the soybean processing company.<sup>13</sup> Consequently, Ming's significant interest in Celestial gave him considerable power over any shareholder action or vote.<sup>14</sup>

In 2007, Ming received the 'Asia Brand People of the Year' award for his "entrepreneurial spirit and visionary leadership".<sup>15</sup> Alongside his broad-based education in various disciplines such as food engineering and industrial and commercial management<sup>16</sup>, Ming was highly respected in the soybean-based products industry in China due to his position as deputy president of both the China Soybean Industry Association and the Soybean Food Committee of Chinese Institute of Food Science & Technology.<sup>17</sup>

## **Celestial's board of directors**

In 2009, Celestial's board of directors consisted of six directors. The three executive directors were Ming, Zhao Xianghua, and Zhou Chuannong.<sup>18</sup> The non-executive directors – Lai Seng Kwoon, Ma Wing Yun Bryan, and Loo Choon Chiaw – were all listed as independent. Lai and Ma are both certified accountants, with more than 20 years of experience in accounting, taxation and financial matters.<sup>19</sup> Lai practises under the accounting firm he founded, SK Lai & Co.<sup>20</sup>, while Loo is the managing partner of a law firm in Singapore, Loo & Partners LLP.<sup>21</sup>

There were four board committees in Celestial, namely the Audit Committee, Remuneration Committee, Nominating Committee, and Investment Committee.<sup>22</sup> Loo was the Chairman for the Remuneration Committee and Investment Committee. Ma was the Chairman of the Nominating Committee while Lai was the Chairman of the Audit Committee.

## Embroided in scandals

SGX Listing Rule 221 requires a foreign issuer to have at least two independent directors who are resident in Singapore.<sup>23</sup> Of Celestial's three independent directors, Lai and Loo are based in Singapore. Lai was also concurrently sitting on the boards of five other S-chips, taking on the role of independent director in those entities.<sup>24</sup> Similarly, Loo held multiple directorships, sitting on the boards of seven other listed companies.<sup>25</sup>

In Celestial's 2008 Annual Report, there was a significant payment made to SK Lai & Co. disclosed under 'Interested Person Transactions'.<sup>26</sup> This was not an isolated event; when Lai was an independent director and the Audit Committee Chairman of China Sky Chemical Fibre, another Singapore-listed company, there were also recurring interested party transactions between the company and SK Lai & Co.<sup>27</sup> In addition, both Lai and Loo were the independent directors of China Sun Bio-chem Technology Group Company Ltd when it was hit with an accounting scandal in 2009, which included accounting discrepancies amounting to over RMB900 million.<sup>28</sup>

In Celestial's 2009 Corporate Governance Report, the Nominating Committee deemed the performance and independence of each independent director to be satisfactory.<sup>29</sup> The Nominating Committee was composed of the company's three independent directors.<sup>30</sup>

## Ming's other ventures

CEO-Chairman Ming had several other potentially questionable ventures where he was actively involved in the operations of other companies.

In 2006, Ming established Beijing Tianyuanxinyu International Media Co., Ltd (Tianyuanxinyu), a media and production company. The primary sponsor of Tianyuanxinyu's production was Daqing Celestial Sun Moon Star Co Ltd.<sup>31</sup> Ming was heavily involved in the production of Tianyuanxinyu, having personally written lyrics for two of its song productions, and took on the role of the executive producer of a 2009 movie production, "A Tale of Two Donkeys".<sup>32</sup>

Ming also built the Daqing Manhaway Hotel, which began operations in October 2010.<sup>33</sup> Celestial was the lessor of the land used for the construction of the hotel, but the lease was not disclosed in its Annual Report. This transaction was considered “suspicious and/or irregular and/or undisclosed”, when Celestial was investigated in a 2015 court case.<sup>34</sup>

## **The fall from heaven**

On 12 June, 2006, Celestial issued five-year zero coupon convertible bonds worth S\$235 million, with an option to redeem after three years.<sup>35</sup> Troubles arose when the 2008 global financial crisis caused Celestial's share price to drop considerably. This caused accounting firm PricewaterhouseCoopers (PwC) to include an Emphasis of Matter in their independent auditor's report dated 20 March, 2009, warning stakeholders about the possible early redemption of convertible bonds<sup>36</sup>, which might adversely affect Celestial's “operational existence for the foreseeable future”.<sup>37</sup>

Although the abovementioned risks increased the necessity of cash reserves, Celestial did not hold excess cash, and even increased its capital spending on a massive “Soybean Hi-Tech Industrial Zone” between 2008 to 2009.<sup>38</sup> Despite Celestial's initial cash surplus position in 2008, the RMB1.3 billion investment in this project required Celestial to undertake even more borrowings.<sup>39</sup>

On 23 May, 2009, a significant proportion of Celestial's bondholders exercised their put options amounting to S\$234.8 million.<sup>40</sup> The due date for bond redemption was on 12 June, 2009<sup>41</sup>, but Celestial was unable to redeem the bonds by then.<sup>42</sup> On 16 June, 2009, SGX suspended the trading of Celestial's shares<sup>43</sup>, and subsequently delisted the company in 2010.<sup>44</sup>

In 2010, Celestial was placed under liquidation<sup>45</sup>, with SGX appointing Yit Chee Wah as provisional liquidator.<sup>46</sup> In 2015, Celestial was reported to be under compulsory liquidation.<sup>47</sup>

## Liquidator's woes

With the likelihood of a bond default, the bond trustee, BNY Corporate Trustee Services Ltd, first issued a statutory demand against Celestial for the proceeds, and subsequently initiated winding up proceedings when Celestial failed to pay.<sup>48</sup> As liquidator, Yit sought orders against Ming, the representatives of the PRC subsidiaries, and PwC to investigate the events surrounding the demise of Celestial. However, he faced great difficulty in obtaining cooperation from Celestial's overseas subsidiaries.<sup>49</sup>

Yit first attempted to seek the cooperation of the BVI holding companies by registering a change in their board of directors. However, the registered agent of the BVI subsidiaries refused to acknowledge Yit as Celestial's provisional liquidator. They only cooperated after Yit sought the recognition of his Appointment Order from the Supreme Court of Bermuda on 31 January, 2011.<sup>50</sup>

Through the BVI subsidiaries, Yit then attempted to change the board and legal representatives of the PRC subsidiaries to gain access to their documents. However, this was rejected by the Daqing branch of the Administration for Industry & Commerce (AIC) as it turned out that the BVI subsidiaries no longer owned the PRC subsidiaries. Share transfers registered by the Daqing AIC revealed that 100% of issued shares of the PRC subsidiaries had been transferred to three different companies between August and December 2010. The transfers were mainly the result of the China Construction Bank (CCB) exercising their collateral rights to the shares in the PRC subsidiaries<sup>51</sup>, which were pledged as security for certain loans to the BVI subsidiaries in 2009 and 2010.<sup>52</sup> This resulted in a disposal of Celestial's assets, making Celestial's shares and bonds essentially worthless.<sup>53</sup> The share pledges and share transfers were not disclosed to SGX.<sup>54</sup>

## Other suspicious transactions

Based on the documents that Yit managed to obtain, a few other notable transactions between 2006 and 2010 which involved Celestial were identified, in addition to the undisclosed share transfers.<sup>55</sup>

Firstly, Celestial made three cash payments totalling US\$12.1 million between December 2009 and September 2010 to Power Charm Group Ltd (Power Charm),

one of Celestial's suppliers which was run by Ming Dexin (Ming Dequan's brother) and Ken Okubo. These cash payments were allegedly made for palm acid oil purchases, which were only valued at US\$2 million, and ultimately not delivered. Power Charm was struck off the BVI register of companies on 2 May, 2011.<sup>56</sup>

Secondly, unauthorised cash payments of about RMB70 million were made in December 2009, to purchase technical know-how related to a biodiesel plant. Additionally, a large quantity of goods, totalling RMB691.1 million, were sold but later returned, of which some were resold for only RMB14.8 million. This caused a revenue overstatement in 2009 and 2010. Furthermore, approximately RMB529 million of undocumented cash payments were made towards the construction of the "Soybean Hi-Tech Industrial Zone" in Daqing.<sup>57</sup>

Lastly, the lease of land to construct Daqing Manhaway Hotel was undisclosed.<sup>58</sup>

## **Shrouded in secrecy**

Yit also faced difficulty in obtaining the required documents from Celestial's auditors, PwC. PwC only provided Yit with high-level consolidation schedules and limited financial information at the company and subsidiary level. Yit deemed the files insufficient as PwC had been Celestial's auditors for over seven years. On 10 May, 2013, Yit applied to the High Court to compel PwC to disclose relevant documents, including entity-level documents such as bank records and loan facility documents<sup>59</sup>, as well as PwC's working papers and the documents received from overseas subsidiaries.<sup>60</sup> The High Court approved Yit's application on 6 August, 2014, and subsequently dismissed PwC's appeal on 27 January, 2015.<sup>61</sup>

## **Actions undertaken by SGX**

In June 2009, due to its inability to redeem its convertible debentures, Celestial was suspended from trading on the SGX-ST.<sup>62</sup> It halted trading on 15 June, 2009.<sup>63</sup> Celestial then applied for an extension to submit a trading resumption proposal. However, the SGX rejected this application and removed Celestial from the official listing of the SGX-ST. In accordance with SGX delisting process, the company was required to make all necessary delisting arrangements, which included providing minority shareholders with a reasonable exit option.<sup>64</sup>

## The aftermath

In March 2016, it was reported that Yit, in his capacity as Celestial's liquidator, had taken legal action to sue Ming, Lai and Loo for breach of director duties.<sup>65</sup> In addition to the suspicious transactions which they allegedly authorized, Yit also claimed that they unjustly authorised the company to pay S\$316,022 to SK Lai & Co., and Loo & Partners LLP.<sup>66</sup> They were also accused of taking S\$5.79 million worth of company funds through directors' fees, performance bonuses and expense reimbursements<sup>67</sup>, while creditors affected by the bond defaults only managed to recoup US\$0.07 on the dollar.<sup>68</sup> Yit also sued Ming Dexin and Okubo, who were the directors and shareholders of Power Charm.<sup>69</sup> In an announcement dated 13 June, 2017, it was reported that Yit "has confidentially resolved the action before the High Court of Singapore" against the various abovementioned parties.<sup>70</sup>

## Singapore's regulatory environment

To address the poor investor confidence and concerns over the S-chip scandals caused by poor corporate governance, SGX took steps to improve its listing standards. The required market capitalisation at the time of IPO was raised.<sup>71</sup> SGX also required disclosures of the appointment of legal representatives, their identities and responsibilities, and any obstacles that might prevent their removal.<sup>72</sup> Since 7 October, 2015, SGX is able to impose punishments on companies, such as fines and denial of access to market facilities.<sup>73</sup>

SGX and the China Securities Regulatory Commission also implemented a framework to allow Chinese companies to list directly in Singapore<sup>74</sup>, which made it necessary for them to comply with regulations in both Singapore and China. This could potentially filter out shell companies and attract higher quality Chinese firms.<sup>75</sup>

The Code of Corporate Governance was also revised in 2012 to improve the corporate governance standards in Singapore.<sup>76</sup> However, the 'comply or explain' approach of the Code still generally results in low compliance with the corporate governance guidelines. In respect of this, the gaps in governance standards between S-chips and other companies listed on SGX have become more obvious since then. For instance, the Centre for Governance, Institutions and Organisations

at NUS Business School has found that while 17.2% of non-S-chips adhered to the recommendation of having an independent Chairman in 2015, only 2.7% of S-chips did so.<sup>77</sup>

## **Discussion questions**

1. What are the benefits and risks posed by the non-segregation of shareholders, board, and management? Relate your answer to Ming Dequan's positions as Celestial's Executive Chairman and CEO, as well as a controlling shareholder of Celestial.
2. SGX Listing Rule 221 requires two independent directors to be based in Singapore. In light of the background of the independent directors in this case, is this rule sufficient to ensure good corporate governance? What can be improved?
3. Discuss whether Ming Dequan's actions have led to a breach of director duties. Comment on how this might differ if Celestial was incorporated in Singapore instead. Explain whether the independent directors should be held accountable for the problems in Celestial.
4. As liquidator, Yit Chee Wah faced many roadblocks in investigating Celestial's downfall and the involvement of the directors. Discuss the underlying reasons for these roadblocks and whether the parties involved had a basis for impeding his investigations by not providing him with information.
5. Celestial was listed in Singapore. However, it had subsidiaries in the BVI, and its main operations were carried out by its PRC subsidiaries. To what extent should SGX be responsible for monitoring the activities of subsidiaries of listed companies? Should SGX take extra precaution for companies with a structure similar to Celestial?
6. Are existing regulations in Singapore sufficient with regards to governing S-chips like Celestial? Comment on the application of the Singapore Code of Corporate Governance as well as the SGX Listing Rules to S-chips and suggest possible improvements that can be made.

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# MMP RESOURCES: HEADING TOWARDS A DEAD END?

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## Case overview

On 11 June, 2008, Sino Construction Limited, announced its successful Initial Public Offering (IPO) and listing on the Singapore Exchange (SGX), after incorporating in Singapore in 2006. It later changed its name to MMP Resources Limited (MMP). Unfortunately, following its IPO, MMP was plagued by a plethora of issues such as high board turnover and postponement of its Annual General Meetings (AGMs). MMP also suffered disappointing financial results. There were frequent changes in its business, through investment in unrelated businesses. In early 2014, it announced its third consecutive year of loss. An application to transfer from the Mainboard to Catalist Board was then rejected by SGX. MMP was then placed on the SGX watch-list, which meant that it risk being delisted if it was not able to exit the watch-list within three years. The objective of the case is to allow for discussion of issues such as board structure and competencies; succession planning and board turnover; conflict of interest; and role of the regulator in ensuring disclosure and transparency.

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This is the abridged version of a case prepared by Lim Kai Jie Bryan, Lim Yi Jieh Edna, Loke Jia Jie Caleb, Lester Phua Yuan Xuan and Ong Jia Qi under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Carissa Tan Wei Cui under the supervision of Professor Mak Yuen Teen.

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## **MMP's beginnings**

MMP started out as a construction firm in Daqing, China in 1998, engaged primarily in the construction, civil engineering, project consultancy and management services businesses.<sup>1</sup> MMP was awarded the Heilongjiang Province Outstanding Municipal Engineering Construction Enterprise in 2007 and had completed projects with contracts valued at RMB500 million in China.<sup>2</sup>

## **Board of directors**

The board of directors of MMP comprised of six directors, three of whom were independent directors (ID). The Non-Executive Chairman, Drew Ethan Madacsi, hailed from a multi-generational mining family and has experience in the resources market.<sup>3</sup> Before Madacsi's appointment as Non-Executive Chairman, he was its sole executive director (ED). Prior to his directorship at MMP, Madacsi had no experience as a director of a listed company.<sup>4</sup> Paul Andrew Crosio, who was previously a director of a listed Australian mining company with expertise in the industry and in corporate restructuring<sup>5</sup>, replaced Madacsi as ED on 12 May, 2016.<sup>6</sup> Another non-executive director (NED), Christopher Peck, has experience in the areas of portfolio and asset management, risk management and compliance, though he lacked prior experience as a director of a listed company.<sup>7</sup>

Chong Chee Meng Gerard, the lead ID, and two other IDs, Chan Ying Wei and Toshinori Tanabe, made up the rest of MMP's board. Chong has experience in the areas of public relations and online marketing communications<sup>8</sup>, while Chan has experience in auditing, accounting and taxation, and was previously the Chief Financial Officer of OCK Group Bhd.<sup>9</sup> The latest addition to the board, Toshinori Tanabe, was appointed on 22 September, 2016.<sup>10</sup> Tanabe has been the President of Satoyama Research Institute since April 2016 and has had prior experience working on a credit risk database and did not have prior experience serving on boards of other listed companies.<sup>11</sup>

MMP has three board committees. The Audit Committee, led by Chairman Chan, includes Chong and Tanabe. Both the Nominating Committee and Remuneration Committee were led by Chairman Chong, with Chan and Tanabe making up the other members of these committees.<sup>12</sup>

## Board upheavals

MMP experienced significant changes in board and senior management between 2013 and 2015. On 16 December, 2013, all three IDs on the previous board, namely Yap Wai Ming, Bob Low and Qin Zhong Sheng, resigned simultaneously. SGX queried whether there were specific concerns or information that have come to the attention of the three IDs who had resigned. MMP said there were none.<sup>13</sup>

On the same day, William Joseph Condon was appointed as a new ED, joining the incumbent ED, Zhou Xing Zhong, on the board.<sup>14</sup> Condon was said to be a champion of philanthropic causes and specialised in advertising and marketing but lacked prior experience as a director of a listed company. Three days later, on 19 December 2013, three new IDs – Chan Ying Wei, Rajesh Dilip Wadhvani and Chong Chee Meng Gerard – were appointed to the board.<sup>15</sup>

Zhou Xing Zong resigned on 31 March, 2014 despite being appointed just a year earlier, but continued as the general manager of Daqing Naifei Le Consulting Co. Ltd, which oversees the Group's operations in China<sup>16</sup> while its former financial controller resigned “to pursue other career opportunities”.<sup>17</sup> Condon resigned from MMP's board on 17 November, 2014, less than a year after he took on the role of ED.<sup>18</sup>

In June 2014, Andy Chee Tet Choy was appointed Non-Executive Chairman of the board, after joining the board as a non-executive director on 2 May, 2014<sup>19</sup>, while Kenneth Lim was appointed as an ED.<sup>20</sup> Both individuals resigned from the board on 18 February, 2015, citing personal commitments<sup>21</sup>, after the appointment of Madacsi as an Interim ED on 9 February, 2015.<sup>22</sup> On the same day, MMP announced that it would arrange for Madacsi to attend courses on directorship at the Singapore Institute of Directors (SID).<sup>23</sup> ID Wadhvani resigned from the board on 2 September, 2016, “due to other work commitments”.<sup>24</sup>

## Financial troubles escalate

From 2014, MMP's financial outlook took a turn for the worse. After three successive years of losses, it faced the prospect of being placed on the SGX Watch-list, after which it has three years to exit or risk being delisted.<sup>25</sup> Companies on the SGX Mainboard are placed on the SGX Watch-list based on Financial Entry Criteria or Minimum Trading Price (MTP) Entry Criteria. The SGX Watch-list does not apply to companies listed on Catalist Board.



## The SGX-MMP stare down

On 27 February, 2015, MMP requested for a time extension for the release of its unaudited FY2014 financial results. The reason provided was that Madacsi required more time to develop a better understanding of MMP as he was only appointed as the company's ED two weeks prior.<sup>26</sup>

MMP had also received numerous queries from SGX on a diverse range of issues, including disclosures in its financial statements, unusual trading activities, a lack of disclosure by the Group, and its acquisitions and disposals.<sup>27</sup> These queries also questioned the Group's poor compliance with disclosure requirements, including failure to provide assurance on the company's financial statements<sup>28</sup> and failure to announce an impairment loss due to share dilution in a subsidiary.<sup>29</sup>

In addition, SGX also queried the unusual price and volume movements of the company's shares.<sup>30</sup> SGX questioned whether MMP was aware of the possible causes of the unusual movements and whether they had withheld any material information. MMP said it had not withheld any material information and assured SGX of its compliance with listing rules.<sup>31</sup> However, it suggested that the unusual movements could be explained by market reaction to announcements relating to potential acquisitions<sup>32</sup> or the reorganisation and restructuring of its business.<sup>33</sup>

## Professor Mak's commentary

The deluge of problems in the company attracted the attention of Professor Mak Yuen Teen, a corporate governance advocate. On 18 March, 2015, The Business Times published a commentary by Professor Mak, highlighting the main issues the company faced from a corporate governance standpoint. In his commentary, Professor Mak catalogued a litany of issues with the company, including questionable disclosures, repeated SGX queries, clarifications, disclaimers of opinion from auditors, auditor changes, discrepancies between audited and unaudited results, delays in announcing results and holding AGMs, and high turnover of directors and key officers.<sup>34</sup>

### ***Misstatements and clarifications***

In his commentary, Professor Mak highlighted multiple instances where MMP issued clarifications in response to media statements or SGX queries. On 19 November, 2014, in response to SGX queries about certain information published in a Business Times article which was not previously disclosed or announced, MMP issued a clarification that certain statements were wrongly attributed to its Non-Executive Chairman.<sup>35</sup> On 5 February, 2015, the company yet again clarified in response to a similar SGX query questioning the disclosure of information, that “the quote in the article stating that ‘the company plans to work with the South Korean government on a long-term fixed price contract for power produced out of its biofuel power plant’ was incorrectly attributed to the Company’s Non-Executive Chairman, Mr Andy Chee. Mr Chee did not make this statement.” The repeat incident made Professor Mak question the information source, which “the company was distancing itself from”.<sup>36</sup>

### ***Board experience and turnover***

Professor Mak also highlighted that the company had one ED – Madacsi – on its board who had no previous experience as a director of a listed company, while the other existing IDs did not seem to have any experience in the industry.<sup>37</sup>

In addition, Professor Mak commented on the high board and senior management turnover experienced by the company. He highlighted that the company seemed to have neither appropriate handover procedures nor proper systems in place. Professor Mak further elaborated that “well-governed companies do not scramble to get their financial statements in order when there is senior management turnover”.<sup>38</sup>

## **Conflict of interest**

While Andy Chee Tet Choy was the Non-Executive Chairman of MMP until his resignation in February 2015, he was also a director and shareholder of Quintestellar Re Capital Inc (QRC), which held 20.24% of MMP’s shares.<sup>39</sup> On 17 April, 2015, QRC reduced its interest in MMP to 4.68%.<sup>40</sup>

News later surfaced that MMP had received a letter of demand from QRC for the repayment of loans amounting to S\$4.7 million.<sup>41</sup> It soon evolved into a writ of summons and statement of claim.<sup>42</sup> Fortunately, the company was able to have the application thrown out in court and QRC was ordered to pay its legal costs.<sup>43</sup>

This ordeal came to an end in August 2016 when a notice of discontinuance was subsequently filed by QRC.<sup>44</sup>

## **Strategic realignment**

MMP's business focus has shifted over the years, from construction to mining, and in more recent years, towards renewable energy and even ski resorts. For instance, in 2014, it acquired Elite Bay Sdn Bhd (Elite Bay)<sup>45</sup>, to enter into the Malaysian construction market; Sunny Cove Investment Limited (Sunny Cove), to ease its entrance into the oil and gas industry<sup>46</sup>; and Renaissance Enterprises S.A. (Renaissance Enterprises), to enter the titanium and heavy mineral resources industry.<sup>47</sup>

In early 2015, the company embarked on a restructuring strategic plan to focus on micro power plants, with the aim of becoming a significant player in the global energy market.<sup>48</sup> In April 2015, MMP announced that its subsidiary had completed the construction of its first micro power plant, "Korea MMP One" in South Korea. This was reportedly part of the company's multi-year programme to roll out a number of micro power plants. ED Madacsi claimed that this programme was "important to the company's cash flow, allowing it the opportunity to divest its underperforming assets".<sup>49</sup>

On 11 August, 2015, the company announced a change in name from "Sino Construction Limited" to "MMP Resources Limited". The change of name was in line with the company's strategic realignment, to focus on construction and exploring opportunities in the energy and resources industry.<sup>50</sup>

## **Moving to the Catalist Board**

On 2 November, 2015, MMP applied for a transfer from the SGX Mainboard to the Catalist Board. MMP said that its application was made after taking into account its current state of market capitalisation, company size and its belief that a Catalist sponsor would provide better support for future actions.<sup>51</sup> In early December 2015, a letter to The Business Times by Professor Mak warned that Catalist may become a graveyard for dying companies, thereby harming its reputation, if SGX Mainboard companies that are at risk of being placed on the Watch-list could easily transfer to the Catalist Board. He specifically mentioned the case of MMP.<sup>52</sup>

MMP's application was rejected by the SGX on 2 January, 2016.<sup>53</sup> SGX stated that MMP's application was rejected as its ability to operate as a going concern was questionable, which hinged on its ability to raise funds and the outcome of its legal proceedings against QRC that might result in a claim of up to S\$4.7 million.<sup>54</sup> Furthermore, although MMP announced a net profit of S\$4.71 million for FY2016 in March 2017, the 'net profit' arose mainly from the reversal of two contingent liabilities amounting to S\$5.22 million.<sup>55</sup>

## Further changes in business

In December 2015, MMP released further restructuring initiatives for FY2016, which indicated a shift to renewable fuels, fuel technology, renewable energy generation, commercial and retail construction, and building materials.<sup>56</sup>

In April 2016, MMP stated that the current tariff rates and high capital investment required to continue pursuing renewable power generation opportunities in South Korea would place excessive financial strain on MMP.<sup>57</sup> Following this statement, there were no updates from MMP regarding how this obstacle would be handled or what its future plans for the programme were.

Instead, on 13 April, 2016, the company announced its intentions to acquire a Japanese ski tour operator and a ski lodge in Hokkaido, Japan.<sup>58</sup> This was part of the company's strategic direction to focus on construction opportunities, asset acquisitions and brand growth in Tier-1 markets, particularly in the tourism, hospitality and leisure (THL) industry.<sup>59</sup> On 4 July, 2016, MMP signed a memorandum of understanding to acquire the entire issued share capital of JRT Trading Pty Ltd (JRT Trading), a Hokkaido ski operator and ski lodge owner, for 80 million yen.<sup>60,61</sup>

Further, on 13 September, 2016, MMP announced the formation of a wholly-owned subsidiary incorporated in Japan, MMP Resources Japan K.K. (MMP Japan).<sup>62</sup> The principal activity of the subsidiary was to carry out MMP's corporate strategy of focusing on construction opportunities<sup>63</sup>, asset acquisition and the THL industry.<sup>64</sup> On 14 September, 2016, it was reported that MMP decided to rent some of JRT Trading's premises instead of acquiring the Japanese company's entire issued share capital. The lease agreement allowed for the redevelopment of buildings to "house high value global brand tenants which operate within the lifestyle and aspirational retail space".<sup>65</sup>

On 7 November, 2016, MMP announced that its subsidiary, MMP Japan, entered into a binding term sheet with vendor Iryo Houjin Showakai to purchase a three storey property for redevelopment. The property was located in an area near a number of ski resorts and the Chisenupuri ski fields. MMP elaborated in its announcement that the rationale behind this agreement was to further its corporate strategy of focusing on the THL industry, and assured shareholders that subsequent to redevelopment, the newly acquired property would contribute “immediately” to cash flow and was expected to offer a substantial return on investment.<sup>66</sup> Later in the same month, MMP announced that MMP Japan entered into another agreement with JRT Trading on the operations and management of the Chisenupuri ski field area.<sup>67</sup>

## **Disclaimer of opinion**

Disclaimers of opinion on the Group’s consolidated financial statements were issued by the company’s two external auditors, Ernst & Young LLP (EY) for FY2012, and Moore Stephens LLP (Moore Stephens) for FY2013 to FY2016.

For EY, the disclaimer stemmed from a lack of sufficient evidence for it to perform audit procedures, due to an ongoing tax investigation of the Group’s key operating subsidiaries in China during FY2012.<sup>68</sup> This issue stretched to subsequent financial years, and posed a problem for the new auditors Moore Stephens as well.<sup>69</sup> More acquisitions and disposals of assets and subsidiaries, coupled with a lack of sufficient audit evidence and the uncertainty for the Group and company to continue as a going concern, led the auditors to issue disclaimers for the subsequent financial years.<sup>70,71</sup>


On 4 April, 2017, Moore Stephens issued yet another disclaimer of opinion in respect of the financial statements for FY2016. They were again unable to satisfy themselves as to the ability of the Group and company to operate as a going concern, given insufficient audit evidence on the Group’s impairment charges and receivables, as well as other unresolved issues from previous financial years.<sup>72</sup>

## Darkness or light at the end of the tunnel?

Following the litigation with QRC, a writ of summons amounting to S\$5.22 million was served to MMP from a former major shareholder, Edward Lee Ewe Ming, on 7 October, 2016.<sup>73</sup> Fortunately for MMP, it won an appeal on the S\$5.2 million claim filed by Lee on 16 May, 2017.<sup>74</sup>

However, other recent developments for MMP have not been positive, such as its placement on SGX's Watch-list on 5 June, 2017 for failing to meet the revised MTP Entry requirement announced in December 2016.<sup>75</sup>

## Discussion questions

1. Evaluate the board structure and competencies in relation to MMP's business.
2. What reasons may explain the frequent board turnover in MMP? What impact might this have on the performance of the company?
3. One reason cited for the extension of time to release the unaudited results for FY2014 was that Drew Ethan Madacsi needed to familiarise with the financial statements as he was newly appointed to the company. Is this a valid reason? What concerns does this raise about the company?
4. Evaluate any conflicts of interest arising from Andy Chee Tet Choy's position as Non-Executive Chairman of MMP and his role in QRC. Comment on his actions after leaving MMP.
5. MMP started as a construction business in China, tried to get into the mining business in South Africa, then moved into micro powerplants in South Korea, and most recently bought a ski operator in Japan. How do you view such frequent changes in the business of MMP? What implications do they have from a corporate governance and risk management standpoint?
6. **Do you think the regulators have been effective in discharging its responsibilities**  in the case of MMP? What more could they have done?
7. Comment on MMP's attempt to transfer from the Mainboard to the Catalist Board. What should be the regulator's stance towards such transfers? How can the regulator better filter companies from the Mainboard entering the Catalist Board?

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# NATURAL COOL FACES HEAT

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## Case overview

In February 2017, all directors except the Chief Executive Officer Tsng Joo Peng were removed from the board of Natural Cool Holdings Limited. The ousting of the directors was purportedly a result of shareholders' unhappiness with certain decisions undertaken by the board, including its decision to undertake a share placement at a discount to the incoming Chief Corporate Officer. The objective of this case is to allow a discussion of issues such as duties of directors; interested person transactions; role of independent directors; and shareholders' rights.

## About Natural Cool Holdings

Natural Cool Holdings (NCH) is an investment holding company headquartered in Singapore, with subsidiaries involved in various businesses such as air-conditioning, paint, switchgear and investments.<sup>1</sup>

It was listed on Sesdaq on 10 May, 2006, at a price of 20 Singapore cents per share, raising S\$3.2 million. It subsequently transferred to the Catalist Board. In the 10 years since going public, NCH has made multiple placements and issuances of new shares, warrants and convertible loan notes, with the number of issued shares increasing from 88 million to 223 million. However, NCH has not been without its controversies.

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This is the abridged version of a case prepared by Chen Jing Jing, Choi Jynn Chee, Lewis Nam Yi An, Neo Boon Kit, Tan Xin Joanna and Xanthe Hwang Zi Yun 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.

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On 31 October, 2013, the Monetary Authority of Singapore (MAS) took civil penalty enforcement action against Joseph Ang Choon Cheng, who was then the Chief Executive Officer (CEO) and executive director of NCH. Ang paid a total civil penalty of S\$150,000 for Securities and Futures Act breaches related to false trading and market rigging transactions, and employment of manipulative and deceptive devices relating to the shares of NCH. He also gave an undertaking to the MAS not to be a company director for one year. Ang resigned as director and CEO but remained as an adviser. He rejoined the company as Executive Chairman on 3 November, 2014.<sup>2</sup>

As at 1 June, 2016, NCH had a board of seven directors, including Joseph Ang Choon Cheng, the Executive Chairman, and his brother, Eric Ang Choon Beng, an executive director. Other than the two Angs, there were two other executive directors – CEO Tsng Joo Peng and Chief Investment Officer Choy Bing Choong. The three independent directors – Lim Siang Kai, Wu Chiaw Ching and William de Silva – had all been on the board since 7 March, 2006.<sup>3</sup>

## **Adding colour to the business**

On 30 July, 2015, the board of NCH announced that its wholly-owned subsidiary, Natural Cool Energy Pte Ltd (NCE) would be acquiring Loh & Sons Paint Co (S) Pte Ltd (L&S), for approximately S\$7 million. The board believed that acquiring L&S would result in “better synergy for the Group” and provide NCH with an “additional revenue stream”.<sup>4</sup> Eric Ang assumed the role of Chief Operating Officer of L&S and was responsible for overseeing its expansion and operations.<sup>5</sup>

The acquisition was completed in September 2015 when the Group acquired 100% equity interest of L&S for S\$7.3 million through NCE.<sup>6</sup>

In November 2015, NCH sold its entire switchgear business in Gathergates Group Pte Ltd (Gathergates Group), the switchgear design and manufacturing business of NCH that was headed by Joseph Ang, to a Japanese listed company, Nitto Kogyo Corporation (Nitto) for approximately S\$34 million.<sup>7</sup> The reason provided for the disposal was to “strengthen its financial and capital resources”.<sup>8</sup> Thereafter, NCH announced that its corporate strategy will focus on its core businesses – the air-conditioning and investment business.

## A burst of colours

L&S was profitable before being acquired by NCH. However, it suffered a loss in the first quarter of 2016. On 22 April, 2016, just eight months after the acquisition, the disposal of L&S through the sale of NCE to the Ang brothers for S\$50,000 through an interested person transaction (IPT) between NCH and the Ang brothers was proposed.<sup>9</sup> The proposed disposal would result in NCH recognising a net loss of approximately S\$0.9 million from the transaction. The transaction was governed by Chapter 9 on Interested Person Transactions and Chapter 10 on Acquisitions and Realisations of the Singapore Exchange (SGX) Catalist Rulebook.

In financing the acquisition of L&S, NCH had incurred bank loans amounting to S\$5 million and made an intercompany loan of about S\$2 million to NCE.<sup>10</sup> NCE had recorded acquisition costs for the purchase of L&S in the financial year ended 31 December, 2015 (FY2015) at approximately S\$0.3 million.<sup>11</sup>

Under the proposed disposal, the Ang brothers would assume full responsibility for the bank loans, and a partial repayment of the intercompany loan of approximately S\$1.36 million. However, they would not be repaying the initial S\$0.3 million acquisition costs.

Had the board not agreed to take a haircut on the intercompany loan and had it required the Angs to reimburse the original acquisition costs, the transaction would have amounted to approximately S\$2.6 million. This would have put the transaction at just over the five percent limit under the Catalist Rules for IPT and shareholders' approval would be required.<sup>12</sup> The board would then have to appoint an independent financial adviser to evaluate whether the transaction was on normal commercial terms, and whether it was prejudicial to the interests of the issuer and its minority shareholders.<sup>13</sup>

Instead, it was classified as a non-disclosable transaction.<sup>14</sup> As L&S was loss-making and the transaction represented approximately 1.86% of the latest audited net tangible assets of the Group<sup>15</sup> – short of the five percent threshold for IPTs – no shareholders' approval was required<sup>16</sup> and an extraordinary general meeting (EGM) was not required to be held.



Following scrutiny of the transaction,<sup>17</sup> NCH terminated the proposed transaction on 30 June, 2016.<sup>18</sup>

## Independence of directors

The Singapore Code of Corporate Governance recommends that certain board committees such as the Audit Committee and Remuneration Committee should consist of only non-executive directors.<sup>19</sup> Typically, executive directors who are not part of the board committees may choose to attend the meetings only if invited.<sup>20</sup> However, in FY2015, every executive director in NCH was present for all the board committee meetings held, even for those which they were not members of.<sup>21</sup> This cast doubt on the ability of the board committees to make decisions and recommendations independently from the management.<sup>22</sup>

In addition, during the annual general meeting (AGM) held on 26 April, 2016, a resolution was made for a one-time ex-gratia payment of S\$313,800 to the independent directors for the financial year ended 31 December, 2016. The explanatory note stated that the payment “is a token of appreciation and recognition of their contribution in the past years”.<sup>23</sup>

Both the ex-gratia payment and director fees were approved by 100% of the shares voted at the AGM, and no party was required to abstain from voting on the resolutions.<sup>24</sup> The Ang brothers, who were involved in the IPT had total direct and deemed interests of about 17.8% of the total issued shares, had voted in support of the ex-gratia payment.<sup>25</sup>

The ex-gratia payment amount that was three times of director fees raised concern about the objectivity of the independent directors in “overseeing the various transactions, including serving on the Audit Committee, which is tasked with reviewing IPTs”.<sup>26</sup>

## Heated exchanges between shareholders and the board

By late 2016, the board was facing heavy backlash as underlying resentment of the board's handling of the L&S disposal began to surface.<sup>27</sup> On 13 October, 2016, Lim Teck Chuan, a substantial shareholder holding more than ten percent of the shares of NCH, requisitioned for an EGM to consider a resolution to remove Executive Chairman Joseph Ang<sup>28</sup>, citing the need to refresh the board and "improve operational efficiency".<sup>29</sup> In response, the board claimed it was a move by disgruntled shareholders after the board had resolved to divest a 16% stake in HMK Energy Pte. Ltd. (HMK Energy) a month earlier.<sup>30</sup>

NCH then proposed to bring in a "strategic investor", Ng Quek Peng, who was said to be introduced through the personal connections of lead independent director Lim Siang Kai.<sup>31</sup> On 18 October, 2016, the board announced the issue of 27 million shares at S\$0.065 each to Ng.<sup>32</sup> CEO Tsng voiced his objection to the voting by the board on the proposed share placement, claiming that he was only notified of it on the day voting was conducted.<sup>33</sup> Tsng and Lim Teck Chuan later filed an injunction against NCH and Executive Chairman Joseph Ang in an attempt to void the subscription agreement.<sup>34</sup> The share placement was approved by SGX.<sup>35</sup>

## Further heat

The share placement to Ng raised questions about its timing and purpose as it was proposed at a particularly critical period ahead of the imminent EGM which would potentially have an impact on the shareholder vote.<sup>36</sup> This is because Ng would instantly become the second largest shareholder in NCH after Executive Chairman Joseph Ang and would almost certainly not vote for the latter's removal.<sup>37</sup> Ng was also to be appointed as the Chief Corporate Officer (CCO) of NCH.<sup>38</sup>

The shares were issued at a discount of approximately 7.14% from the volume weighted average price for the day before the subscription agreement was signed. The board stated that the funds of S\$1.7 million would be used to finance the expansion of the Group's air conditioning and paint businesses.<sup>39</sup> It also said that the share issuance would align the interest of Ng as an executive officer with that of the company.<sup>40</sup>

During the EGM on 12 December, 2016, a majority of shareholders voted against the proposal to oust Executive Chairman Joseph Ang. Ng's vote was decisive in determining the outcome as the margin for the resolution was lower than the 10.78% of shares issued to Ng merely a month ago.<sup>41</sup>

Shareholders present at the meeting voiced their dissatisfaction with the board. One shareholder accused lead independent director Lim Siang Kai of perceived bias towards the Executive Chairman, while another exhorted the board to resolve its internal disputes, to which Lim responded jokingly that "within a family, you also don't talk to your wife sometimes".<sup>42</sup>

Before the first EGM was held, a second EGM was called by shareholders Edi Ng and Ong Mun Wah on 22 December, 2016.<sup>43</sup> The EGM was to revoke the general share issue mandate which had been approved by shareholders at NCH's AGM on 26 April, 2016.

## Tables are turned

As the second EGM drew near, NCH's share transactions experienced an unusual increase in volume. The Straits Times speculated that the company's shares were being bought up by substantial shareholders in light of the impending EGM, causing an "upswing in the illiquid market".<sup>44</sup>

The shareholders' intention was achieved in the second EGM and the general share issue mandate was successfully revoked. Executive Chairman Joseph Ang labelled the outcome as a "disappointment" and a "defeat".<sup>45</sup> Shareholders Ng and Ong then pressed on the advantage by requisitioning for another EGM, attempting to remove the entire board with the exception of CEO Tsng.<sup>46</sup>

In anticipation of the EGM announcement, PrimePartners Corporate Finance Pte Ltd (PPCF), NCH's sponsor, intervened and advised NCH to implement a trading halt on its shares on 10 January, 2016. PPCF did not provide further elaboration as to why the halt was deemed necessary or details of its position on NCH's corporate governance matters.<sup>47</sup> Later that day, the trading halt was lifted.<sup>48</sup> Despite the halt, NCH shares experienced a trading surge the following day.<sup>49</sup>

## Final curtain call

The board issued a letter to shareholders vigorously defending the independence of its directors and warned shareholders of business “risk factors” such as the lack of a clear strategy of the proposed new board. The board claimed it had subjected its three independent directors to a “rigorous annual review comprising a holistic assessment of their judgment and character” and were satisfied that all three had remained independent. This was despite the fact that they had served on the board for over nine years.<sup>50</sup>

The board’s last-ditch attempt to prevent its ousting proved to be futile. On 8 February, 2017, the entire board was unceremoniously thrown out except for CEO Tsng. A majority of 78.32% voted for the resolutions to remove all five directors<sup>51</sup>, who were replaced by four new directors.<sup>52</sup> After months of acrimonious infighting between the shareholders and the board, the former finally prevailed. Meanwhile, Ng was sacked as CCO, with the official reason being “misalignment of interests with that of the Company”.<sup>53</sup>

## Has corporate governance truly improved?

Despite the change at NCH, the company continued to face challenges. Uncertainty about the proposed divestment of NCH’s stake in HMK Energy continued to grow<sup>54</sup> and faced media scrutiny. There were questions as to whether the new board would “freeze a contentious proposed sale” of HMK Energy.<sup>55</sup> Doubt was also cast on the new directors’ ability to objectively evaluate the divestment proposal as the previous board had highlighted the shareholders’ connections with HMK Energy and questioned the motives of the requisitioning shareholders in ousting the previous directors. There were also questions as to whether the requisitioning shareholders were parties acting in concert who may have breached the Singapore Code on Take-overs and Mergers by increasing their stakes beyond the thresholds in the Code without making a general offer to all shareholders.<sup>56</sup>

It seems that in spite of a refreshing of the board, stakeholders would still need to ascertain if NCH has truly improved its corporate governance, or whether the perennial issues of the past have merely continued to fester under a new façade.<sup>57</sup>

## Discussion questions

1. Evaluate whether the three independent directors, led by lead independent director Lim Siang Kai, had fulfilled their duties. Discuss the factors that could have compromised their independence.
2. Regarding the acquisition and proposed disposal of L&S, do you believe that the board of directors was acting in the best interests of the shareholders and company? Do you believe that the SGX rules for IPTs and acquisitions/disposals are adequate in protecting minority shareholders? Explain.
3. Evaluate the key corporate governance problems, if any, with respect to the appointment of strategic investor Ng Quek Peng as Chief Corporate Officer and the share issuance to him.
4. Under the Singapore Code of Corporate Governance, the board is allowed to delegate certain responsibilities to committees. However, for NCH, the executive directors have been continuously invited to attend committee meetings. What are the ramifications of such a practice for effective corporate governance and the work of the committees?
5. Unlike directors, shareholders under Singapore law do not have fiduciary duties to act in the best interests of the company. In light of this, evaluate the actions of the directors and shareholders in the NCH case and explain what problems, if any, this may create for good corporate governance.
6. Under Chapter 2 of the SGX Catalist Rulebook, a sponsor is required to comply with certain obligations. Examine the role of NCH's sponsor, Prime Partners Corporate Finance (PPCF), throughout the events described in the case. Do you think that PPCF has effectively fulfilled its duties as required under the Rulebook? More generally, what are the pros and cons of a sponsor-based regime such as that used for Catalist?

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# OSIM'S BUNGLED PRIVATISATION OFFER

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## Case overview

On 7 March, 2016, the CEO-founder of Osim International (Osim), Ron Sim, launched a S\$300 million offer to buy out minority shareholders in his bid to privatise the company. Osim had been performing poorly in the prior few years in its key markets and Sim explained in an interview that the privatisation would enable him to fast-track Osim's growth without hindrance from complying with listed company regulations and protocol. During the delisting process, however, some Osim shareholders were unhappy with the initial offer price of S\$1.31 per share. A subsequent trading bungle resulted in upward revisions of the buy-out offer price. Eventually, after successfully acquiring over 90% of the company's shares on 29 April, 2016, Sim compulsorily acquired the remaining minority shareholders' stake. Osim was delisted four months later, on 29 August, 2016. The objective of this case is to discuss issues such as the 'fairness' of voluntary delisting offers; the role of independent directors and independent financial advisors in delisting exercises; as well as the protection of the interests of minority shareholders.

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This is the abridged version of a case prepared by Bryan Ee Chiun Zhe, Jocelyn Lau Wei Ying, Lee Wan Yi Pearlyn and Yang Xue Ying under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Gary Chia Zong Zhe under the supervision of Professor Mak Yuen Teen.

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## **The man behind Osim: From zero to hero**

Ron Sim, a Singaporean business magnate and investor, is the founder, Chairman, Chief Executive Officer (CEO) and the majority shareholder of Osim whose self-made success is an inspiring rags-to-riches tale. Having gone through numerous hardships, he started his own trading company selling household goods in 1980 but it was forced to shut down during the 1985 global recession. Undeterred, Sim ventured into the healthcare sector in 1987 and set up a company called 'Health Check and Care', which was renamed Osim in 1994.<sup>1</sup> Since then, Osim has grown from a local firm selling household products into an international lifestyle brand with more than 1,100 outlets in over 360 cities.<sup>2</sup>

## **Board structure**

Sim is both the Chairman and CEO of the company. At the time of its privatisation, three out of the eight directors were independent.<sup>3</sup> The three independent directors – Tan Soo Nan, Sin Boon Ann and Colin Low – all held various directorships outside of Osim and all sat on the company's three board committees, namely, the Audit Committee, the Nominating Committee and the Remuneration Committee.<sup>4</sup> The composition of Osim's board of directors had remained largely the same since its initial listing on the Singapore Exchange (SGX) back in 2000. The only non-executive director on the board was Teo Sway Heong, the wife of Sim<sup>5</sup>, with the other three directors being executive directors holding senior positions in Osim's management team.<sup>6</sup>

## **Deteriorating performance**

Osim's share price reached a high of S\$2.94 on May 2014.<sup>7</sup> Over the following two years, however, it had more than halved, and lingered around the S\$1.30 mark.<sup>8</sup> This was attributed to the poor performance of the company due to prolonged weak sales and a drop in earnings in key markets. The group shut down unprofitable stores across the region as a result. Osim's performance in the first quarter of 2016 was dismal, with its revenue sliding by eight percent compared to a year earlier.<sup>9</sup>

## The buyout offer

It was popular opinion amongst market analysts that Sim had been planning to take Osim private for some time as he had been buying back shares from the open market for many years.<sup>10</sup> Speculation about Osim's future before the delisting announcement in March revolved around the choice between privatisation or a spin-off.<sup>11</sup> Like most other delisting processes, Sim opted for the former through a voluntary general offer.

On 7 March, 2016, through his private investment vehicle Vision Three, Sim launched a S\$300 million offer to buy out minority shareholders.<sup>12</sup> As the single largest shareholder, he held 68.31% of the company at the time of offer.<sup>13</sup> In this buy-out of Osim, Credit Suisse acted as the exclusive financial advisor<sup>14</sup> while PricewaterhouseCoopers (PwC) was appointed as the independent financial advisor (IFA).<sup>15</sup> The legal advisor to Sim was Morgan Lewis Stamford.<sup>16</sup>

## Fairness of the initial offer

On behalf of Vision Three, Credit Suisse launched an initial voluntary offer at a price of \$1.32 per share on 7 March, 2016.<sup>17</sup> Based on Osim's recent financial performance, the initial privatisation offer may not have been such a bad deal for other Osim shareholders.<sup>18</sup> However, although a 31.8% premium above the volume-weighted average price (VWAP) per share might have seemed high, the initial offer price was less than half the share price at its peak.<sup>19</sup> Even if Sim did increase his offer price, it would not have been anywhere close to the two-dollar mark.

## **The sweetened deal**

Sim's initial offer to privatise the company was not well-received by other Osim shareholders as reflected in Osim's stock price movement following the announcement. On 8 March, 2016, the day after the Sim's privatisation announcement, Osim shares jumped to a four-month high of S\$1.395, which signalled the market's belief that Sim's offer price was indeed too low.<sup>20</sup> If Sim wanted his privatisation bid to succeed, he had to increase his offer price to entice shareholders, especially long-term shareholders, to sell their stakes in the company. Sim eventually revised his offer upwards by five cents to S\$1.37, only to revise it again shortly after due to a trading slip.<sup>21</sup>

## **The hiccups: An expensive mistake**

The revised offer price of S\$1.37 was apparently not as 'final' as Sim had originally said it would be.<sup>22</sup> The privatisation exercise was only concluded after an additional upward adjustment - this time, a forced upward revision - from the sweetened offer price of S\$1.37 to S\$1.39 ex-dividend on 8 April, 2016, as ordered by the Securities Industry Council (SIC).<sup>23</sup> This was due to a share purchase mistake by Credit Suisse and Vision Three on 5 April, 2016, the very day when Sim voluntarily hiked up his offer price to S\$1.37. On the same day, the Securities Investors Association (Singapore) (SIAS)<sup>24</sup> appealed to the SIC to investigate whether a false market had been created for Osim's shares, and whether shareholders who sold their shares at prices below S\$1.39 that day unjustly suffered any losses and thus needed to be compensated.<sup>25</sup> As a result of this oversight, Sim had to fork out an additional S\$4.7 million to compensate shareholders who had lost out when they sold their shares below the S\$1.39 price point.<sup>26</sup>

Trading of Osim shares was suspended for three days from 6 to 8 April, 2016, immediately after the S\$1.37 counter-offer was made on 5 April, 2016.<sup>27</sup> Shareholders were left in the dark until the following Monday when the trading halt was lifted. According to Credit Suisse, Vision Three had made a mistake by "inadvertently" scooping up nearly 17 million shares in the open market on Sim's behalf on 5 April, 2016 at prices between S\$1.38 and S\$1.39<sup>28</sup>, which meant that Sim had bought back shares above the offer price of S\$1.37.

Subsequently, Vision Three applied for a waiver of compliance with the Take-over Code's rule on overpriced purchases, but the application was not granted.<sup>29</sup> Instead, Vision Three was instructed by the SIC to raise the offer price to no less than S\$1.39 per share in order to match the top end price of the accidental purchase.<sup>30</sup>

On 18 April, 2016, Sim raised his offer to S\$1.39 and made a 'goodwill' payment to shareholders who sold their shares at below the revised price.<sup>31</sup> Given the involvement of highly experienced industry professionals, the trading oversight, which cost Sim S\$4.7 million in compensation to shareholders, was surprising.

## **Role of independent financial advisor**

In February 2017, the SIC issued a Practice Statement on the opinion issued by an IFA in relation to offers, whitewash waivers and disposals of assets under the Code on Take-overs and Mergers (Take-over Code).<sup>32</sup> The Practice Statement provides guidance to an IFA as to whether a takeover offer is, among other things, 'fair and reasonable'. In a situation such as Osim's privatisation, the IFA is also responsible for expressing an opinion as to whether the offer is on normal commercial terms, and whether it prejudices the interests of the company's minority shareholders.<sup>33</sup>

During its delisting, Osim engaged PwC as its IFA.<sup>34</sup> PwC stated that, at the latest practicable date, the offer price was at a premium of 2.9% to the closing price of S\$1.37 per share. In coming to its conclusion as to whether the offer price was reasonable, PwC considered, inter alia, quantitative measurements such as its stock valuation multiples implied by the offer price compared to peer companies, its price-to-earnings ratio implied by the offer price, and its EV/EBITDA ratio implied by the offer price.<sup>35</sup> Based on these evaluations, PwC declared on 15 April, 2016 that the revised offer was fair and reasonable.<sup>36</sup> This was more than a month after the initial offer announcement.

## **Delisting rules: Thou shalt not...**

On 28 April, 2016, almost a month before the final close of offer, Osim announced that Sim and his concert parties together held 90.64% of the company.<sup>37</sup> Sim was then able to compulsorily acquire the remaining dissenting shareholders' stake in Osim, by virtue of Section 215 of the Companies Act, and thereafter assume full ownership of the company.<sup>38,39</sup>

Osim was required to comply with Rule 1307 on the convening of a general meeting and approval by shareholders, and Rule 1309 of the SGX-ST Listing Manual on a reasonable exit alternative and appointment of an IFA, in applying for voluntary delisting from the Mainboard.<sup>40</sup> In addition to the Listing Rulebook, Osim had to adhere to the Take-over Code in relation to its exit offer for the purposes of voluntary delisting, unless it obtained a waiver from the SIC. However, given that Osim and its concert parties were already holding approximately 96.03% of the total shares as at 22 May, 2016, the final closing date<sup>41</sup>, Osim submitted an application to SGX-ST for a waiver of Rule 1307 and to seek confirmation that Rule 1309 was not applicable.<sup>42</sup>

Osim was officially delisted from the SGX on 29 August, 2016.<sup>43</sup>

## **Were minority shareholders disadvantaged?**

Sim had substantial control of the company and stock prices had hit a five-year low figure<sup>44</sup>, which made privatisation attractive. Based on the principles and guidelines on shareholders' rights under the Corporate Governance Code, minority shareholders should be equitably treated. As Osim was chiefly owned by Sim, with a 68% equity ownership prior to its delisting, the reality is that minority shareholders were largely unable to exercise their rights to any significant degree.



## **SIAS comes into the picture**

SIAS became involved in the delisting of Osim when they wrote to the Chairman of the SIC to appeal for a probe into Sim's buyback of Osim's shares that was deemed unfair for affected investors.<sup>45</sup> SIAS lobbied on behalf of shareholders who sold their shares below the revised final offer and appealed for compensation. The SIC was urged to investigate the alleged unintentional purchase of shares on 5 April, 2016 by Sim and to establish if a false market was created that day.<sup>46</sup> On 18 April, 2016, SIAS announced that following their appeal to the SIC, Vision Three decided out of 'goodwill' to compensate all shareholders who sold their shares prior to 5 April, 2016.<sup>47</sup>

## **Role of independent directors in a delisting**

The Take-over Code stipulates that the board, which includes all independent directors, must be provided with "competent, independent advice on any offer", by appropriate parties such as the IFA.<sup>48</sup> It is also the IFA's responsibility to ensure that such advice is accessible to shareholders;<sup>49</sup> otherwise, shareholders may potentially be able to bring a claim against the IFA in relation to a breach of its duty of care under common law, according to Robson Lee, a partner in Gibson Dunn & Crutcher LLP.<sup>50</sup> In the Osim delisting, the IFA was in communication with Osim's independent directors. A circular containing the recommendations of the independent directors on the offer was sent to shareholders.<sup>51</sup>

## **Freedom, finally**

The Osim delisting process occurred over a period of five long months. The saga proved to be a significant source of frustration for all parties involved, in both monetary and reputational terms. Sim fulfilled his wish of pursuing his intended strategies without being bound by listed company rules and regulations.<sup>52</sup>

In April 2017, less than eight months after Osim's official delisting from the SGX, Sim announced that the company will be relisted in Hong Kong as 'V3 Group' in the near future; IPO proceeds would be used to finance other acquisitions and repay the company's 2016 privatisation costs.<sup>53</sup>

## Discussion questions

1. Ron Sim, the founder and largest shareholder of Osim, is both the Chairman and CEO of the company. Discuss whether this may have in any way affected Osim's delisting process.
2. Was Sim's initial offer price of S\$1.32 a move to test the market's response? Are there ethical issues in doing so? Do you think Osim's privatisation bid was expected to fail? On hindsight, do you think that the revised S\$1.37 offer price was the 'correct working offer price' to convince shareholders to sell?
3. What are the applicable rules in place in your jurisdiction governing privatisations and delistings? Do you think that they are adequate in protecting minority investors? In the case of Osim, should there have been more intervention by both relevant regulators and non-regulatory bodies to protect minority shareholders?
4. Who engages the IFA in the event of a delisting? How independent are they?
5. What is the role of independent directors in a delisting situation? How crucial is the role of independent directors in advising minority shareholders in the event of a company undergoing privatisation?
6. In the case of Osim, are there concerns with the independence of the independent directors? Explain.
7. Stock exchanges around the world, including the Singapore Exchange, are facing the problem of an increasing number of delistings. What are the reasons for such delistings? How should stock exchanges respond to this trend?

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# SBI OFFSHORE: WASHED ASHORE

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## Case overview

On 16 September, 2016, an extraordinary general meeting (EGM) called by major shareholder Tan Woo Thian was adjourned by a show of hands, leading to an unsatisfactory conclusion to the boardroom tussle of SBI Offshore Limited. The agenda of the EGM was the removal of the Chief Executive Officer Chan Lai Thong, and the appointment of four new directors, namely Hui Choon Ho, Lau Yoke Mun, Dr Ong Nai Pew and Geoffrey Yeoh Seng Hua.  Questions raised by SBI Offshore's board of directors regarding the suitability of the proposed directors, and the lack of action taken by the sponsor of SBI Offshore exacerbated the situation. The objective of this case is to allow a discussion of issues such as the appointment and suitability of directors; directors' duties; the role of the sponsor in companies listed on the Catalist Board; shareholders' rights; and voting procedures.

## The legacy of SBI Offshore

SBI Offshore (SBIO) was established in 1994 as a marketing and distribution company for offshore and marine equipment. Tan Woo Thian was the founder of the company.

On 17 March, 2008, Hui Choon Ho was appointed as the Executive Chairman and Chief Executive Officer (CEO) of SBIO. During his tenure, the company grew gradually in terms of revenue and capacity. The year 2009 marked a major milestone

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This is the abridged version of a case prepared by Lee Jia Jie, Liu Xuening, Low Hui Ting, Wong Xin Hui and Tan Hai Liang 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 Mok Xiao Chou under the supervision of Professor Mak Yuen Teen.

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for SBIO as the company did an initial public offering (IPO) and became listed on the Catalist Board of SGX. PrimePartners Corporate Finance Pte Ltd (PPCF) was its sponsor. The IPO raised approximately S\$4.3 million in net proceeds, allowing it to expand internationally.<sup>1</sup>

However, when Hui's attempt in setting up a joint venture company with Honghua Group Limited (Honghua) failed, sceptics were quick to cast their doubts on Hui's leadership ability.<sup>2</sup> On 17 August, 2012, Hui was replaced by Chan Lai Thong as the Executive Chairman and by Tan as the CEO.<sup>3</sup> The company later announced the removal of Hui as a company director in September 2012.<sup>4</sup>

In 2013, two additional independent directors, Ahmad Subri Bin Abdullah and Jen Shek Voon, were added to the board.<sup>5,6</sup> The board welcomed another new member when Mirzan Bin Mahathir, who came to hold 12% of SBIO's shares, was appointed to the board as a non-executive director.<sup>7</sup>

The corporate profile of SBIO underwent a drastic change when the company decided to diversify its business into the solar energy industry by forming a 51:49 joint venture with Germany-based Gräss Group on 7 July, 2015, incorporating Graess Energy Pte Ltd in the process.<sup>8</sup> One month later, SBIO announced that it disposed its interest in its associate, Jiangyi Neptune Marine Appliance Co. (NPT), for a consideration of US\$3.5 million.<sup>9</sup>

## **Tan's retreat and re-emergence**

Tan served as SBIO CEO from August 2012 to March 2016 before stepping down "to facilitate the execution of the group's new strategies and model following the diversification into the renewable energy business".<sup>10</sup> Over the years, the company had grown to undertake design, engineering and fabrication work for offshore and marine projects such as drilling equipment system, deck machinery and material handling systems.<sup>11</sup>

On 18 March, 2016, the company announced the resignation of Tan as executive director and CEO of the company. He was re-designated as the commercial manager of the Group. Chan relinquished his role as the Executive Chairman and was re-designated as the CEO.<sup>12</sup> However, the departure of Tan proved to be short-lived and he soon got himself entangled in the affairs of SBIO again.

## **The boardroom tussle**

After various board changes, SBIO's board consisted of five directors in March 2016, three of whom were independent. Mirzan was tasked with the important responsibility of overseeing the charting of new directions for SBIO as the Non-Executive Chairman. The other non-independent director was Chan, the executive director and CEO, who had prior experience in the oil and marine industry.<sup>13</sup> The three independent directors were Basil Chan – an accountant by training, who was the lead independent director and Chairman of the Audit and Risk Management Committee; Mahtani Bhagwandas – a lawyer who was the Chairman of the Remuneration Committee; and Ahmad Subri bin Abdullah – an insurance and financial services veteran who was the Chairman of the Nominating Committee.<sup>14</sup>

On 18 July, 2016, Tan, Hui and Dr Ong filed a requisition notice to the board to convene an EGM to appoint four new directors – Hui, Dr Ong, Lau Yoke Mun and Geoffrey Yeoh Seng Huat – and to remove Chan from the board.<sup>15</sup> The trio accused Chan of, inter alia, travelling business class for all his overseas trips, amending the company policy to allow a spouse to travel on business trips at the company's expense, misstating the economic viability of a solar energy project in a company announcement, and awarding a one-month variable bonus to himself and other staff without approval from the remuneration committee.<sup>16</sup>

## **The first board response**

Following the requisition request, the board released a letter to shareholders on 1 September, 2016. The board stated that it would accept directors who could provide project expertise, especially for solar projects, and recommended that Dr Ong and Yeoh be elected onto the board, but opposed the appointment of Lau and Hui.<sup>17</sup>

Lau was a senior business development manager in SBIO from October 2014 to September 2015. He was later contracted as a service provider of SBIO and designated as vice-president (finance & corporate) of Solar Africa Investments (Pty) Ltd (SAI) in March 2016. According to the board, Lau was deemed unsuitable as director as he failed to perform his duties satisfactorily as a service provider and as the vice-president of SAI. The company raised concerns about his failure to manage the accounting operations of SAI, as well as his non-compliance with

regards to the board's instructions. He was also deemed to lack experience as a director of a listed company.<sup>18</sup>

On the other hand, Hui, as a shareholder, was criticised by the board for exerting authority over the employees of the company by issuing instructions to them even before his appointment as a director was approved at the EGM. This cast doubt over his suitability to act as a director.<sup>19</sup>

The board also commissioned PricewaterhouseCoopers (PwC) to look into the allegations made against Chan. According to PwC, only the amendment of company policy to allow for spousal travel on business trips and the unauthorised awarding of the one-month variable bonus were of concern.<sup>20</sup> Therefore, the board found that the lapses were insufficient to dismiss Chan. Furthermore, they required his expertise in the renewable energy sector. The board thus recommended that shareholders vote against the resolution to remove Chan.<sup>21</sup>

## **The sponsor's first advice**

PPCF noted that Chan's lapses would be remedied according to the recommendations of PwC. Therefore, nothing would prevent the continued appointment of Chan. Conversely, PPCF also advised that there was "nothing materially adverse" that would prevent the appointment of all four proposed directors. PPCF then recommended that Lau attend a relevant training course to familiarise himself with his duties and responsibilities within three months of his appointment.<sup>22</sup>

## **NPT transactions**

SBIO had acquired a 35% equity interest in NPT, a company incorporated in China, for US\$1.75 million through an equity transfer agreement (Undated Acquisition ETA), as disclosed in its IPO Prospectus on 3 March, 2009.<sup>23</sup> The company later announced that it had entered into an Equity Transfer Agreement (ETA) to dispose the 35% equity interest for US\$3.5 million on 18 August, 2015 (First Disposal ETA).<sup>24</sup> Soon after, certain issues regarding the NPT transactions, as well as the involvement of Hui and Tan, were exposed.

According to a review by PwC, the Undated Acquisition ETA bore the signature of then-CEO Hui on behalf of the company, as well as Chen Yen-Ting, who owned 35% of NPT. While the signature date was only stated as the year 2008, the IPO Prospectus set out the date of the acquisition of equity interest in NPT as 3 March, 2009. Furthermore, no evidence of any cash payment of the US\$1.75 million for the acquisition could be found. Apart from the Undated Acquisition ETA, PwC uncovered another ETA (Dated Acquisition ETA) dated 20 October, 2008, involving the acquisition of the same 35% equity interest signed by both Hui and Tan, with a different consideration of US\$350,000. It also bore the signature of Ollie Hua, a representative from Jiangyin Wanjia Yacht Co., Ltd, which owned the other 65% of NPT.<sup>25</sup>

Tan was authorised by the board of SBIO to sign the First Disposal ETA on 18 August, 2015. However, he signed another ETA (Second Disposal ETA) with a different consideration of US\$1.75 million on 8 December, 2015, despite the board expressing its disapproval.<sup>26</sup>

Amy Soh, SBIO's Chief Financial Officer (CFO), came to know about the Dated Acquisition ETA in September 2015 when Hua informed SBIO that a withholding tax of US\$140,000 was payable, based on the consideration stated in the Dated Acquisition ETA and the Second Disposal ETA. Soh had computed the withholding tax based on the consideration stated in the Undated Acquisition ETA and the First Disposal ETA instead of the Dated Acquisition ETA and the Second Disposal ETA.<sup>27</sup>

PwC raised serious concerns as to whether the Undated or Dated Acquisition ETA, and the First or Second Disposal ETA, were valid. If the Undated Acquisition ETA and the First Disposal ETA were valid, there would be a possible breach of PRC tax laws. If the Dated Acquisition ETA and the Second Disposal ETA were valid instead, there might have been a breach of the Securities and Futures Act and the Catalyst listing rules.<sup>28</sup>

The board later appointed UniLegal LLC as its legal advisor to perform a review and provide legal advice regarding the PwC NPT Findings and the conduct of Lau as a service provider.<sup>29</sup>

## The sponsor's second advice

With regards to the PwC NPT Findings, PPCF stated in the board's supplemental letter to shareholders, dated 10 September, 2016, that it would wait for the outcome of the legal advice obtained by the board before concluding about the suitability of Hui as a proposed director. As for Lau, PPCF recommended that the board engage an independent firm to review the board's allegations against him, before it could advise the board on the suitability of Lau as a proposed director.<sup>30</sup>

In an article published on 14 September, 2016, Associate Professor Mak Yuen Teen of the National University of Singapore criticised the stand taken by PPCF as highly disappointing. Professor Mak wrote: "I find it remarkable that PPCF is not prepared to at least express doubt about the suitability of Mr. Hui and Mr. Lau to act as directors given the detailed concerns expressed by the board, and the findings of PwC in the case of Mr. Hui. With the EGM just days away, what PPCF has done (or not done) is almost as good as endorsing the appointment of Mr. Hui and Mr. Lau."<sup>31</sup>

Following PPCF's advice, the board backtracked on its previous recommendation to vote against Lau, deciding to follow PPCF's recommendation to engage a third-party firm to review Lau's conduct as a service provider first. However, the board reaffirmed its recommendation to shareholders to oppose the appointment of Hui.<sup>32</sup>

## Sudden board expansion

The day before the EGM was scheduled to be held, SBIO suddenly announced the appointment of four new independent directors: James Kho Chung Wah, Mark Edward Pawley, Ling Yew Kong and Lawrence Kwan Hon Kay. They were to lead the investigations into the conclusions of the PwC NPT Findings.<sup>33</sup>

Professor Mak raised further questions regarding PPCF's assessment of the suitability of directors following the sudden expansion of the board in an article published on 21 September, 2016. His main concerns touched on Ling's ability to commit time with his 23 other directorships and Pawley's lack of experience as a listed company director. He also noted that Kho and Pawley have backgrounds that are similar to that of several of the current directors. He highlighted that the case raised broader issues as to whether sponsors are truly equipped to fulfil their responsibilities, which included advising on the suitability of individuals for directorship positions. He further questioned the extent to which sponsors assessed the suitability of each director based on his character, competencies and commitment to the board and the company.<sup>34</sup>

The EGM convened on 16 September, 2016 was adjourned by a show of hands.<sup>35</sup> A number of shareholders felt that there was a need to investigate the validity of the PwC NPT Findings, as well as the report to the Commercial Affairs Department, before considering the resolutions set out in the agenda of the EGM.<sup>36</sup> The boardroom tussle and PPCF's advice also led to unease amongst the minority shareholders, causing them to approach the Securities Investors Association of Singapore for assistance regarding these "potential board changes".<sup>37</sup> No date was set for the adjourned EGM.

## Recent developments

On 18 September, 2016, SBIO announced that Basil Chan, the lead independent director, had stepped down to "pave the way for the new slate of directors to move the Company forward".<sup>38</sup> Lawrence Kwan was later appointed as the new lead independent director.<sup>39</sup>

UniLegal LLC found that there were several occasions of breaches and potential breaches of duties and obligations to SBIO and statutory obligations by both Hui and Tan. Most notably, Hui did not inform the board about the presence of the Dated Acquisition ETA when he was obliged to do so. In the case of Tan, UniLegal found that there was a clear breach of director's duties when he signed the Second Disposal ETA without authorisation from the board. UniLegal LLC recommended that the board commence legal action against Hui and Tan.<sup>40</sup>

On 25 April, 2017, SBIO held its annual general meeting for FY 2016. All resolutions, including six resolutions to re-elect directors, were passed with 100% support.<sup>41</sup>

On 9 June, 2017, Mirzan was re-designated from Non-Executive Chairman to Executive Chairman.<sup>42</sup>

It remains to be seen if the board will proceed with legal action against Hui and Tan.

## **Discussion questions**

1. Do you think that Hui Choon Ho and Lau Yoke Man are suitable to be appointed as directors of SBI Offshore? Provide reasons to support your stand.
2. The director fees for a director of a Small and Medium Enterprises (SME) are generally lower than larger listed firms, yet the job scope of an SME director can be more demanding than that expected of a director in a larger listed firm. As such, SMEs might face greater difficulty in attracting competent directors. In view of this, how can SMEs like SBI Offshore attract competent directors to join their boards?
3. Based on the findings by PwC, discuss the possible breaches of directors' duties by Chan, Tan and Hui.
4. What is the role of the sponsor for companies listed on the Catalist? Evaluate the actions taken by SBI Offshore's sponsor, PPCF, during its stint as the company's sponsor.
5. Hui, as a shareholder, exerted managerial powers over employees of SBI Offshore by giving instructions to them even before his appointment as a director was approved at the EGM. How far should a shareholder like Hui be allowed to exercise his rights?
6. Evaluate the appropriateness of SBI Offshore's decision to use a show of hands rather than a poll to adjourn the EGM. What are the pros and cons of each voting system during a shareholder meeting?
7. Do you believe that the board should take legal action against Hui and Tan, as recommended by UniLegal? What factors should the board consider in making this decision?

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# THE FLIGHT TOWARDS PRIVATISATION: TIGER AIRWAYS

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## Case overview

Less than six years after its listing on the Singapore Exchange (SGX) in 2010, Tiger Airways Holdings Ltd (Tigerair) was voluntarily delisted and privatised by its parent company, Singapore Airlines Ltd (SIA). During the takeover negotiations between Tigerair and SIA, the independence of Tigerair's board came into question as a result of the connections that Tigerair's directors had with the SIA Group. The objective of this case is to facilitate discussion of issues such as those relating to the conflicts of interest arising from interlocking directorships and other relationships; the role of the independent financial adviser; methods of privatisation; recent changes to the Singapore Code on Take-overs and Mergers; and minority shareholder protection in takeover situations.

## The age of low-cost carriers

Low-cost carriers (LCC) gained popularity in the Asia Pacific region in the early 2000s, with the launch of AirAsia Berhad (AirAsia) under the helm of Tony Fernandes in 2001. This was due to the increased demand for low cost, budget travel solutions, in favour of existing full-service options offered by incumbent full-service

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This is the abridged version of a case prepared by Ho Wei Yee Sarah, Kee Chuan Kai, Ong Zhang Yao and Yong Jia Hua Jasper 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 Tan Zhe Ren under the supervision of Professor Mak Yuen Teen.

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carriers (FSC). Established in September 2004, Tiger Airways Singapore Pte Ltd is a short-haul LCC founded by SIA (which owned 49%), Indigo Partners (24%), Ireland Investments (16%) and Temasek Holdings (11%).<sup>1</sup> It was subsequently listed on the SGX under the name of 'Tiger Airways Holdings Ltd' (Tigerair) in 2010.<sup>2</sup>

## Taking off

On 22 January, 2010, Tigerair sought to raise funds through an initial public offering (IPO).<sup>3</sup> It was the first LCC to list on the Mainboard of SGX. Public sentiments of individual investors on the growth potential of Tigerair were exuberant, with the public tranche being oversubscribed by 21 times.<sup>4</sup> Priced at S\$1.50 per share, Tigerair raised a total of S\$247.7 million from its IPO.<sup>5</sup>

On Tigerair's first trading day, its stock rose by S\$0.08 to close at S\$1.58. Improvements in Tigerair's operating statistics between June 2009 and June 2010 boosted investors' outlook on the company, further pushing its share price to a high of S\$1.68 on 5 August, 2010.<sup>6</sup>

## The nosedive

Unfortunately, the positive sentiments were short-lived. The S\$1.68 price marked the start of a prolonged decline in Tigerair's share price, which fell approximately 40% from its IPO price over the next one and a half years.

The fiscal quarter of 30 June, 2011 saw Tigerair report its first net loss since its IPO. The S\$20.6 million loss was in stark contrast with its S\$1.9 million profit the previous year.<sup>7</sup> Tigerair blamed the losses on high taxes, increase in fuel prices and flight disruptions caused by volcanic eruptions in Chile.<sup>8</sup>

Tigerair's financial performance continued on its downward spiral in the following few years, and in the financial year ended 31 March, 2014, the company found itself facing its largest ever reported net loss of S\$223 million.<sup>9</sup>

## Controlling the turbulence

In December 2014, SIA converted its perpetual convertible capital securities holdings into shares, which raised its stake in Tigerair from 40% to 55.8%<sup>10</sup>, making Tigerair a subsidiary of SIA.

Less than a year later, on 6 November, 2015, Tigerair's parent company, SIA, made a "Voluntary Conditional General Offer" (the 'offer') of S\$0.41 in cash per share to buy out Tigerair's remaining shareholders. The offer price represented a 15% premium above the highest closing price of Tigerair's shares of S\$0.355 in the one-year period up to and including the last trading day.<sup>11</sup> The offer was conditional on SIA owning more than 90% of Tigerair by the close of the offer.

According to SIA, the decision to privatise Tigerair was to enhance commercial and operational synergies through a full integration of Tiger Airways into the SIA Group. This would be achieved through the integration of short-haul LCC Tigerair and long-haul LCC Scoot, streamlining the use of resources and cooperation within the Group. SIA also said that the privatisation would enable SIA to remain flexible and nimble in tapping all key segments of the market.<sup>12</sup>

## Seeking a second opinion

In response to SIA's offer, the board of Tigerair was required to appoint a committee to assist in the offer process and make recommendations to Tigerair's shareholders in relation to SIA's offer. The committee comprised of the independent directors of Tigerair. These independent directors bore no direct relation with the SIA Group that would have rendered them incapable of providing independent and objective opinions on the offer.

The committee then appointed Maybank Kim Eng Securities (MKES) as the independent financial adviser (IFA), in line with the Singapore Code on Takeovers and Mergers, to provide an independent opinion on the fairness and reasonableness of the offer.

In the IFA report released on 9 December, 2015, MKES concluded that the financial terms of the offer were "on balance, fair and reasonable". Subsequently, the independent directors reviewed and concurred with the advice of the IFA, recommending that shareholders accept the offer.<sup>13</sup>

## A fair offer to minority shareholders?

“The offer price is 39% lower than what long term minority shareholders paid.

This offer, the minority feels, is not reasonable.”

- David Gerald, founder, president and CEO of SIAS<sup>14</sup>

The responses to SIA's offer were mixed. The IFA evaluated that the S\$0.41 offer price was fair as it represented a significant premium over various historical price benchmarks. However, some investors pointed out that shareholders who had held Tigerair's shares since its IPO and subscribed to every round of rights issue would have paid an average of S\$0.67 per share. In this regard, they would receive a 38.8% negative return if they accepted the offer.<sup>15</sup> Some disgruntled shareholders appealed to SIA to consider the interests of these long-term minority shareholders who have “stayed with the company through thick and thin”.<sup>16</sup>

Subsequently on 18 December, 2015, David Gerald, president and Chief Executive Officer (CEO) of the Securities Investors Association (Singapore) (SIAS) wrote an appeal to the SIA board on behalf of Tigerair's minority shareholders. The appeal sought a revision of the offer price to consider the interests of long-term minority shareholders who remained “loyal” to Tigerair.<sup>17</sup>

However, SIA did not accede to the appeal by SIAS. In its statement released three days later, SIA maintained its stance that “the offer is compelling”. This was because the offer price represented premiums of between 32% and 42% over historical price benchmarks. SIA further reinforced that both the independent directors and analysts recommended that shareholders accept the offer, and stressed the “fair and reasonable” opinion in the IFA report.<sup>18</sup>

By the first deadline of the offer on 28 December, 2015, SIA only controlled 74.50% of Tigerair. This was nowhere near the 90% threshold SIA required to delist Tigerair. According to the “Acceptance Condition”, if the 90% condition was not met, shareholders who had already accepted the offer would not be entitled to the offer.<sup>19</sup>

## **SIA's delayed response to the shareholders' appeal**

"We believe our offer to Tiger Airways shareholders is compelling as a significant premium is being offered and hope that it will be considered favourably."

*- Goh Choon Phong, CEO of SIA<sup>20</sup>*

Even after extending the deadline of the offer to 8 January, 2016<sup>21</sup>, SIA was only able to secure a total shareholding of 77.48% in Tigerair.<sup>22</sup> This prompted SIA to overturn its initial reluctance to improve its offer and to increase the offer price to S\$0.45 per share and extend the closing date of the revised offer to 22 January, 2016.<sup>23</sup> The revised offer price represented a 45% premium over Tigerair's last traded share price of S\$0.31.<sup>24</sup> The IFA again concluded that the revised offer price of S\$0.45 was "on balance, fair and reasonable".<sup>25</sup>

On 11 January, 2016, after securing only 79.22% of Tigerair's total issued shares, SIA announced its waiver of the "Acceptance Condition". Thereafter, the offer was declared to be unconditional in all respects. SIA further extended the closing date of the offer to 5 February, 2016, and subsequently to 4 March, 2016.<sup>26</sup>

## **Is "fair value" truly fair?**

Despite the substantial premium, most minority shareholders still felt that the offer price was too low. They reasoned that SIA was willing to buy Temasek Holdings' 7% stake in Tigerair in 2013 at S\$0.678 per share. Moreover, they highlighted that SIA only needed to pay S\$0.565 a share to increase its stake from 40% to 55.8% because minority shareholders had earlier granted a whitewash waiver without making a general offer.<sup>27</sup> Lastly, it was noted that even after the revised offer, minority shareholders who held Tigerair's shares since its IPO would have received a negative return of 32.84%.<sup>28</sup>

Additionally, as indicated in its report, the IFA's evaluation was confined to the financial terms of the offer. The IFA's terms of reference did not require an evaluation of the strategic or commercial merits and risks of the offer. Furthermore, the IFA did not rely on any financial projections or forecasts of Tigerair. They were also not required to express, and did not express, any view on the growth prospects and earnings potential of Tigerair.<sup>29</sup> Minority shareholders were therefore dissatisfied that the IFA did not consider these factors.<sup>30</sup>



## The cockpit

As at the annual general meeting held on 31 July, 2015, Tigerair's board comprised of nine members – one executive director, CEO Lee Lik Hsin, five non-independent directors, and three independent directors, including board Chairman Hsieh Fu Hua.<sup>31</sup>

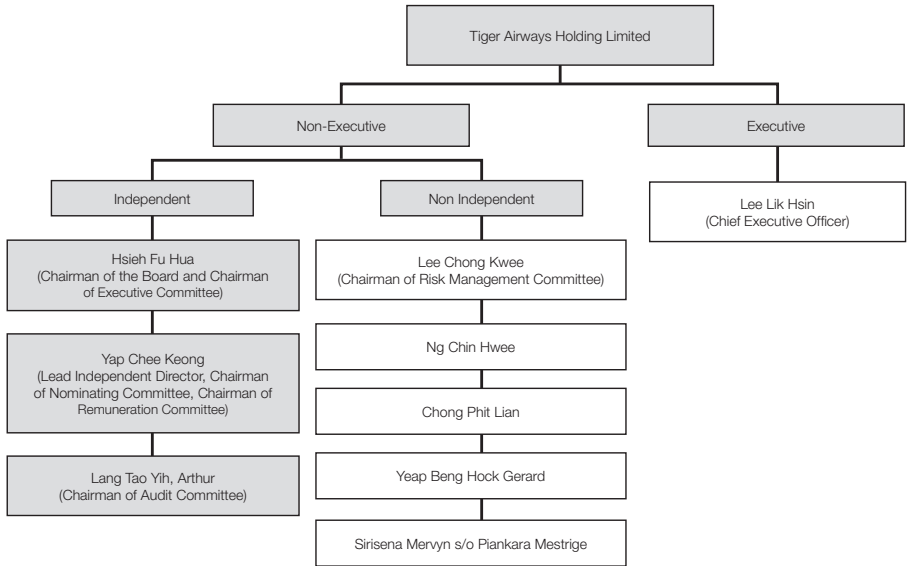


Figure 1: Tigerair board of directors

*\*Clear boxes indicate the directors who are directly connected to the SIA Group.*

While Tigerair's board of directors had outstanding backgrounds, many of them held multiple directorships.<sup>32</sup>

Additionally, six out of nine directors either held other directorship or senior managerial position(s) in the SIA Group in 2015 or the past three financial years, or were directly associated with SIA in 2015. Key connections between members of Tigerair's board and SIA are highlighted below.<sup>33</sup>

- CEO Lee Lik Hsin served as president of SIA Cargo Pte Ltd from August 2013 to May 2014 and also as senior vice-president of corporate planning at SIA from April 2012 to July 2013.
- Chairman of the Risk Management Committee, Lee Chong Kwee, is a nominee director of SIA.
- Director Ng Chin Hwee is the executive vice-president of human resources and operations of SIA, an independent director of SIA Engineering Company Ltd and the board Chairman of SIA Cargo Pte Ltd and Scoot.
- Director Yeap Beng Hock Gerard is a senior vice-president of flight operations at SIA.
- Directors Chong Phit Lian and Sirisena Mervyn s/o Piankara Mestridge are nominee directors of SIA.

Independent director Hsieh Fu Hua was also the president of Temasek Holdings between August 2010 to September 2011, and continued as a non-executive director until 1 February, 2012 before his appointment as an independent director of Tigerair on 4 November, 2011.<sup>34</sup> As at 31 December, 2015, Temasek Holdings held 55.80% of SIA's shares.<sup>35</sup>

## Sealing the deal

By 5 February, 2016, SIA had acquired a combined stake of approximately 93.77% in Tigerair. This meant that SIA had successfully crossed the 90% threshold required for Tigerair's delisting.<sup>36</sup> SIA subsequently announced that it had acquired a 95.62% stake in Tigerair at the close of the offer on 4 March, 2016.<sup>37</sup>

After exceeding the required threshold for delisting, Tigerair made an application to SGX to suspend the trading of its shares and to delist from the SGX Mainboard.<sup>38</sup> SIA also announced that it would exercise its right for the compulsory acquisition of the remaining Tigerair shares.<sup>39</sup>

## Regulators react

On 27 February, 2016, under the advice of the Securities Industry Council (SIC), the Monetary Authority of Singapore issued a revised 'Singapore Code on Takeovers and Mergers' pursuant to Section 139(6) of the Securities and Futures Act (SFA).<sup>40</sup>

Note 5 of Rule 15.1 specifically sets out the criteria for pre-conditional voluntary offers, to prevent the offer from deliberately causing the pre-conditional offer to lapse. In SIA's takeover bid for Tigerair, the initial offer was conditional on SIA being able to obtain 90% of the total shares in order to privatise Tigerair.

Note 5 of Section 7.1 requires the board of directors to seek independent financial advice and to consider sharing management projections and forecasts for the purpose of the IFA's advice on the offer. This requirement was put in place to increase the accuracy in the estimated value of takeover offer by providing the most updated information of the company's performance from the offeree's management. Although this is not binding, the inclusion of this section may impose a possible obligation on management for greater disclosure.<sup>41</sup>

SIC also sought views on measures to encourage the use of forward-looking information in the analysis of an offer. There were suggestions to use the UK's City Code of Takeovers and Mergers' (UK Code) relaxed provisions on the use of forecast profits for the analysis of offers as a model to follow. However, the UK Code also imposes the liability of forecasts on the offeree directors, therefore subjecting the directors to litigation risks.<sup>42</sup>

## A safe landing

On 8 November, 2016, Tigerair was successfully delisted from the SGX Mainboard. Following the delisting, Tigerair had fully redeemed and cancelled its S\$219.7 million worth of two percent perpetual convertible capital securities.<sup>43</sup>

On 25 July, 2017, after a year in the making, Tigerair and Scoot merged their operations under the Scoot brand as the final act of the two LLCs' integration. The merger serves to further SIA's growth strategy and enable a more seamless travel experience for the customers.<sup>44</sup> After the merger, the 'Tiger' has lost its ability to fly, but perhaps Scoot will take off to greater heights.

## Discussion questions

1. In Singapore, there are several ways to privatise a listed company: (i) a voluntary delisting; (ii) a scheme of arrangement; (iii) a general offer; and (iv) an amalgamation. Discuss the pros and cons of each of these methods with regards to the relevant stakeholders in a privatisation. With reference to the case, would the outcome have been different if any of the other methods were used instead?
2. (a) What are the rules governing the roles, responsibilities and practices of Independent Financial Advisers (IFA) in Singapore?  
  
(b) With reference to (a), the details of the offer and the terms of reference of the IFA, discuss the limitations of the IFA in providing:
  - i. An opinion as to the fairness and reasonableness of an offer, and;
  - ii. A useful valuation for Tigerair's minority shareholders.  
(c) How should the role of the IFA be improved in Singapore?
3. Discuss Tigerair's board composition prior to the SIA's takeover offer and any potential conflicts of interests. Evaluate whether the board was effective in protecting the interest of Tigerair's minority shareholders.
4. What are the current requirements in the Singapore Code on Take-overs and Mergers regarding the disclosure of internal projections and forecasts to the IFAs? Will a move towards the provision of such information result in a fairer price for minority shareholders?
5. Compare the protection available to minority shareholders in takeover situations in Singapore compared to Hong Kong, United Kingdom and United States. What avenues are available for minority shareholders to raise their concerns about the fairness of takeover offers in Singapore?

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# SWIBER: THE SHIP HAS SAILED

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## Case overview

Swiber Holdings Limited (Swiber), once a rising star that harboured big dreams of becoming a global player in the oil and gas industry, did not escape unscathed the downturn in the industry. In 2015, Swiber announced a first annual net loss of US\$18.7 million since its listing in 2006. Aside from the poor performance that was a stark contrast to its exponential growth from 2006 to 2013, there were more pertinent issues that would eventually cause Swiber to sink. A series of questionable events in July 2016 prompted the Singapore Exchange (SGX) to launch an investigation into the company. The objective of this case is to allow discussion of issues such as director duties; director resignations; board composition; director independence; remuneration matters; risk management; and disclosure lapses.

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This is the abridged version of a case prepared by Belinda Peh, Janice Lai and Yeo Jing Peng 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.

## Holes in the hull

The offshore and marine industry unravelled when oil prices began to slide in 2014.<sup>1</sup> Amidst the downturn in the oil and gas industry, Singapore's offshore and marine firms suffered a 14.5% fall in total turnover in 2015, a stark contrast from the year before.<sup>2</sup> The protracted downturn resulted in a dearth of projects and diminishing profit margins. The woes of the beleaguered industry had a much greater impact on Swiber, as the Indian monsoon season contributed to even fewer projects in Southeast Asia.<sup>3</sup> Nonetheless, Swiber managed to hide its distress amidst the tumultuous backdrop. While net profits took a dip in 2014 and 2015, Swiber announced its breakthrough into the West African market in 2014 with a US\$710 million field development project.<sup>4</sup> It also said it had managed to clinch approximately US\$880 million worth of contracts in 2015.<sup>5</sup> These contracts were a boost to Swiber's order book, which totalled US\$1.35 billion by the end of February 2016.<sup>6</sup> These figures took the spotlight away from the high leverage that Swiber had used to finance its operations.<sup>7</sup>

However, things took a downward spiral in the second quarter of 2016, when US\$466 million worth of revenue did not materialise.<sup>8</sup> In the face of dwindling cash flows, Swiber approached its principal banker, DBS Bank, for a US\$85 million loan to redeem its S\$130 million note due on 6 June, 2016.<sup>9</sup> Weighed down by macro environmental headwinds, more cracks emerged.

On 9 June, 2016, AMTC Global Investment Solutions (AMTC), a London-based private equity firm, signed an agreement to subscribe for 1,000 preference shares of Swiber's wholly-owned unit, Swiber Investment, for US\$200 million.<sup>10</sup> A day after the deal was signed, AMTC requested for more time to conduct further due diligence. The series of delays in payment compounded Swiber's problems and led it to take on a second loan from DBS. Swiber took yet another loan worth US\$61 million to redeem a S\$75 million loan on 6 July, 2016. The security required for the US\$61 million loan effectively left Swiber without any working capital.<sup>11</sup>

Drowning in debt and uncertainty over the AMTC deal, Swiber's board of directors convened a board meeting on 20 July, 2016 to decide its fate. The board decided to file for liquidation if the US\$200 million from AMTC was not received by 26 July, 2016.<sup>12</sup> Unfortunately, the US\$200 million was not forthcoming by the stipulated timeframe. By then, the firm had been swarmed with queries from SGX as well as letters of demand amounting to US\$25.9 million from creditors seeking payment.<sup>13</sup>

Swiber pulled the trigger and filed for winding-up on 27 July, 2016, making it the first offshore and marine firm in Singapore to be put on voluntary liquidation.<sup>14</sup> The announcement of this decision was posted on SGX at 1.04 am on 28 July, 2016.<sup>15</sup> The provisional liquidator of Swiber then sought a suspension on the trading of Swiber's shares, which were last traded at S\$0.109.<sup>16</sup>

However, on 29 July, 2016, the company announced that after discussions with its major financial creditor, the board had decided to place the company in judicial management instead.<sup>17</sup>

The board's initial decision to apply for a winding-up, followed by a quick U-turn to opt for judicial management instead, was criticised by commentators who felt that the board should have placed the company under judicial management in the first place.<sup>18</sup>

## **Sailing on uncharted waters without lifeboats**

Swiber's assets earmarked to manage liquidity risk accounted for only 12.5% of its total disclosed non-derivative financial liabilities. Moreover, Swiber was at risk of breaching bank covenants for its debt issuance programmes, including a "S\$1 billion Multicurrency Debt Issuance Programme established on 20 July, 2007, and a US\$500 million Multicurrency Islamic Trust Certificates Issuance Programme"<sup>19</sup>, with interest coverage ratio falling from a relatively comfortable 4.1 times at the end of 2011 to only 1.5 times and 1.16 times at end-2014 and end-2015 respectively.<sup>20</sup> This further threatened Swiber's ability to refinance and maintain sufficient cash levels to manage liquidity risk.

Furthermore, Swiber "may not have taken into consideration the risks tied to the stringent conditions" of its engineering, procurement, construction, installation and commissioning contracts (EPCIC) with India's Oil and Natural Gas Corporation Limited. (ONGC). Not only did Swiber depressed margins by securing ONGC's contracts using low bids, Swiber's execution of these EPCIC projects would also further strain the company's operating cash flow and balance sheet.<sup>21</sup>

## All aboard!

Swiber's board consisted of nine directors at the time of its financial troubles – six executive directors and three independent directors. There were four board committees – Executive Committee, Remuneration Committee, Nominating Committee and Audit Committee.

Raymond Kim Goh served as Executive Chairman and had direct and deemed interest of 16.09% stake in the company. The management was led by Chief Executive Officer (CEO) Yeo Chee Neng who had direct and deemed interest of 17.46%.<sup>22</sup> Collectively, both individuals directly and indirectly owned about 18% economic interest in Swiber. However, given their key management positions, they arguably had effective control over the company despite their low economic interest.<sup>23</sup> In 2015, Swiber's board met five times.<sup>24</sup>

## Independent directors in murky waters

All three independent directors (Yeo Jeu Nam, Chia Fook Eng and Oon Thian Seng) were part of the Audit Committee, Nominating Committee and Remuneration Committee. The Executive Committee comprised only of the six executive directors as its members.<sup>25</sup>

In 2006, Yeo was appointed as lead independent director and has served on Swiber's board ever since. Prior to his appointment, Yeo had a consultancy career for over 30 years. He was a director at PricewaterhouseCoopers (PwC) Public Sector Consulting Practice, a senior consulting partner with Ernst & Young (EY) Consultants, and later owned his own firm, Radiance Consulting Pte Ltd.<sup>26</sup> In 2008, Yeo was also appointed as independent director of Vallianz<sup>27</sup>, in which Swiber held a 25.15% stake.<sup>28</sup>

Chia's expertise was in marine engineering, having worked with established firms such as Sime SembCorp, and had more than 40 years of experience in this field. Prior to his board appointment, he served as an advisor to Swiber's board.<sup>29</sup>

Oon is a lawyer by profession, being one of the founding partners of Oon & Bazul LLP, Singapore and of T.S. Oon & Partners in Malaysia. In Swiber's 2015 corporate governance report, it was revealed that Swiber had dealings with Oon's law firm, but Oon was said to have refrained from any involvement, directly or indirectly, in work that his firm does for Swiber.<sup>30</sup>

The makeup of independent directors drew flak from Professor Mak Yuen Teen who questioned their true independence. He also expressed concerns about the relevance of the expertise of the independent directors, and questioned their authority given "the overwhelming dominance of management and controlling shareholders on the board".<sup>31</sup>

## **Abandoning ship**

On 28 July, 2016, about 30 minutes after the company had announced its application for winding-up, Swiber announced the resignation of Francis Wong as executive director and Vice Chairman<sup>32</sup>, Leonard Tay as executive director and Chief Financial Officer<sup>33</sup> and Nitish Gupta as executive director.<sup>34</sup> However, on 29 July, 2016, it announced that the resignation of Tay was an error and also clarified that all three directors remained as directors of certain subsidiaries within the Group.<sup>35</sup> Meanwhile, on 27 July, 2016, Vallianz announced the resignation of Raymond Kim Goh as non-executive director and Chairman of its board for "health reasons", although Goh remained as Executive Chairman of Swiber. The sudden resignations and Goh's reason for resigning from Vallianz's board were questioned by Professor Mak.<sup>36</sup>

On 2 September, 2016, Yeo Chee Neng resigned as CEO, Group president and executive director of Swiber. However, he continued as an advisor to the Group and the judicial managers. He was succeeded by John F. Swinden, an executive with more than four decades of experience in leading marine offshore construction business. Swinden was credited with leading successful projects worth over US\$998 million and the expansion of the Group into Europe, Africa and the Mediterranean.<sup>37</sup>

# The captain and crew get on the lifeboats first

*“The remuneration disclosures and practices of Swiber are even more questionable, with almost a total disregard for the recommendations of the Code.”*

*– Professor Mak Yuen Teen<sup>38</sup>*

Swiber evidently did not pay heed to the age-old adage of ‘giving credit where it is due’. Compensation of key management personnel hovered around an average of US\$12.36 million in recent years (FY2013: US\$21.3 million;<sup>39</sup> FY2014: US\$6.7 million;<sup>40</sup> FY2015: US\$9.1 million<sup>41</sup>) per year, despite lacklustre financial figures. In 2015, remuneration for key management personnel totalled US\$9.086 million<sup>42</sup>, which represented a 36% increase from total remuneration in 2014.<sup>43</sup> In the same period, the earnings of Swiber headed south as Swiber posted a net loss of US\$18.7 million in FY2015, as compared to net profit of US\$31.2 million in FY2014.<sup>44</sup>

This, however, was not the first instance of Swiber’s key management personnel receiving remuneration increases despite the failure to produce favourable financial results. In 2013, key management personnel remuneration jumped from under US\$8.2 million in 2012 to US\$18.5 million. Even though there was a healthy increase in profits that year, operating cash flows had slumped from US\$69 million to a negative US\$87 million.<sup>45</sup>

In its remuneration report, Swiber lumped short term cash bonuses with long term performance incentives into a single category “Performance Incentive/Bonus”. In Swiber’s 2015 annual report, the company cited the “competitive nature of the business” as well as the “sensitivity of information on remuneration” in justifying the non-disclosure of the upper limit of the remuneration band.<sup>46</sup>

Swiber’s inaccurate disclosures could be traced back to 2013 as Professor Mak mentioned in his commentary. In its 2013 annual report, Swiber revealed that only the Chief Financial Officer had received bonus or performance incentives. As key management personnel remuneration was a whopping US\$18.5 million in the same period, Professor Mak posited that Swiber had either misreported or classified additional share remuneration that key management personnel received under salary or other benefits.<sup>47</sup>

## Straddling two boats

In FY2013, Swiber's key management personnel received up to US\$18.51 million worth of "short-term benefits" as compensation.<sup>48</sup> It was not until the next financial year that it was revealed that these benefits comprised of 89.8 million shares of Swiber's associate, Vallianz Holdings. At the effective date of the share transfers on 7 March, 2014, these shares were valued at a fair value of US\$14.1 million. Executive Chairman Goh and Group CEO Yeo occupied board positions in Vallianz Holdings at the time of the share transfers.<sup>49</sup>

On 31 August, 2016, Vallianz declined requests for payments from Swiber totalling US\$63.5 million, citing various reasons such as the fact that extended credit and netting off practices have been "an established course of dealings" between Vallianz and Swiber.<sup>50</sup> A month later, Swiber announced that it would default on the coupon payments for three different note payables.<sup>51,52,53</sup>

## Going against the tide

On 16 August, 2016, SGX questioned Swiber with regard to disclosure lapses regarding the delay of the US\$710 million project and two other litigation claims made against Swiber by Likpin International Ltd (Likpin) and Greene Energy Group Asia Pacific Pte Ltd (Greene Energy) respectively.<sup>54</sup>

The project – aimed at providing engineering, procurement, construction, installation and commissioning (EPCIC) services – was due to be executed from the first quarter of 2015 to the middle of 2017,<sup>55</sup> but it was only in July 2016 that the company disclosed that it was deferred. Furthermore, the US\$710 million project was accounted for "in all (Swiber's) disclosures on the Group's order book without any qualification that the contract has yet to be signed or the project has been delayed", SGX wrote.<sup>56</sup> In response to SGX's queries, Swiber clarified that the project was delayed due to "weaknesses in the oil and gas sector", without specifying when the project is scheduled to continue or further elaboration on causes behind the delay. Swiber also neither identified the name of the contractor nor specified the exact location where the project would take place.<sup>57</sup>

In addition, Swiber failed to make announcements on material litigation claims by Likpin and Greene Energy amounting to S\$10.7 million and S\$9.6 million respectively.<sup>58</sup>

## **Selling a sinking ship**

Aside from the attention on Swiber, the spotlight fell on its major bank, DBS. It was revealed that bond issuers such as Swiber offered undisclosed rebates to private banks to sell their bonds.<sup>59</sup> The practice of performance incentives given to financial advisers for the sale of poor quality, unrated credit of bond issuers has become more prevalent in recent years. This has drawn flak from commentators as the practice of sales commissions may pose a conflict of interest where private bankers may put their own interests before their clients'.<sup>60</sup> While there exists the Private Banking Code of Conduct which includes guidelines on disclosures of conflicts of interest by private banks to customers, such disclosures were previously not mandated. New amendments by the Association of Banks in Singapore will mandate disclosure by private banks on "quantifiable benefits" and fees charged on products to customers.<sup>61</sup> The Monetary Authority of Singapore also announced a review of the regulatory framework of the bond market<sup>62</sup>, as well as an industry review of the practice of undisclosed bond rebates.<sup>63</sup>

## **Can Swiber turn the tide?**

To date, Swiber has defaulted on several bond payments with the latest being a coupon payment for the Series 017 CNY450,000,000 7.75% Fixed Rate Notes that was part of Swiber's S\$1 billion Multicurrency Debt Issuance Programme due on 20 March, 2017.<sup>64</sup> Several of Swiber's subsidiaries have been placed into liquidation<sup>65</sup> or have filed for liquidation.<sup>66</sup> Laden with debt and with directors investigated by the Commercial Affairs Department for possible infringement of the Securities and Futures Act<sup>67</sup>, will Swiber be able to regain profitability? Research has shown that only a small percentage of firms that enter judicial management were able to do so.<sup>68</sup> Given the extended judicial management period to 1 October, 2017,<sup>69</sup> and Swiber's interim judicial managers, KPMG, expressing confidence that all may not be lost with support from Swiber's stakeholders to complete projects on its order books, perhaps Swiber will be able to turn the tide around.<sup>70</sup>



## Discussion questions

1. Evaluate the composition of the board and the board committees in Swiber.
2. Critically evaluate the need for an executive committee. Could the presence of the executive committee in Swiber have impeded the ability of independent directors in discharging their duties?
3. Evaluate the independence and competencies of the independent directors. Discuss how the independence of directors may have affected their ability to effectively discharge their duties.
4. Discuss whether you believe that the directors have effectively discharged their duties. Do you believe the directors who resigned should have done so? Explain.
5. Vallianz Holdings, another company listed on SGX, is an associated company of Swiber, with various dealings and interlocking directorships between the two. What corporate governance issues may arise from such a situation?
6. Comment on Swiber's remuneration policies and the transparency of disclosures for key management personnel's remuneration packages.
7. What were the potential disclosure lapses that Swiber may have committed? Should the board be responsible for such lapses?
8. What factors and who contributed to Swiber's collapse? Should the creditors like banks have better anticipated the impending collapse and also bear some responsibility? Explain.

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# BLACKROCK VS G-RESOURCES: ACTIVE TO ACTIVISM

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## Case overview

In November 2015, G-Resources Group Ltd. (G-Resources) released an unexpected announcement regarding the disposal of the Martabe mine, the company's main source of revenue, and its intended transition from the mining industry into the financial services sector. Investors were left confused and uneasy, as G-Resources failed to provide adequate disclosures and there were questions as to whether the board has properly discharged its duty of care to its shareholders.

BlackRock, Inc. (BlackRock), a minority shareholder, demonstrated uncharacteristic activism and demanded compensation from G-Resources. This campaign was led by the head of the investment stewardship team in BlackRock, Pru Bennett. The objective of the case is to allow a discussion of issues such as the stewardship role of institutional shareholders; disclosure and independence issues; treatment of shareholders; and the role of the Exchange in regulating such companies.

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This is the abridged version of a case prepared by Tan Jia Wei Jamie, Tan Wei Ting, Tan Ying Qi Rachel and Tay Li Lin under the supervision of Professor Mak Yuen Teen. The case was developed from published sources and from information obtained through an interview with Pru Bennett, Head of Investment Stewardship APC at Blackrock, 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 Gary Chia Zong Zhe under the supervision of Professor Mak Yuen Teen.

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## BlackRock - the world's leading fund

In 2013, BlackRock was described by The Economist as the largest investor in the world, directly managing US\$4.1 trillion worth of assets, with another US\$11 trillion invested through Aladdin, its trading platform.<sup>1</sup> Long-term responsibility and sustainability have always been the bloodline of its business model and shareholder value creation framework.<sup>2</sup> BlackRock also prides itself in its “comprehensive range of products and services across asset classes, geographies and investment strategies”.<sup>3</sup>

## G-Resources: Min(d)ing their own business

Incorporated in Bermuda while based and listed in Hong Kong, G-Resources first surfaced as a gold mining and exploration company in 1997.<sup>4</sup> In mid-2009, the company acquired a 95% stake in the Martabe Gold and Silver Project, a gold mine situated in North Sumatra, Indonesia.<sup>5</sup> Costing US\$220 million, the mine was purchased from OZ Minerals Limited upon full exercise of the option agreement with CST Mining Group Limited.<sup>6</sup> This promising purchase was deemed as key in nurturing G-Resources into becoming a “world-class gold company”.<sup>7</sup>

Martabe had a projected production of 250,000 ounces of gold and approximately two to three million ounces of silver per year.<sup>8</sup> The high potential of discovering mineralisation within the Martabe Contract of Work motivated endeavours for discovery.<sup>9</sup> In addition to two adjacent deposits, Baskari and Pelangi, primary gold potential at depth and other virgin targets showed great prospects.<sup>10</sup>

## BlackRock meets G-Resources

BlackRock was first associated with G-Resources in the 2009 capital raising, during which it invested in the business “on behalf of clients seeking exposure to the gold sector”.<sup>11</sup> In August 2012, the Martabe mine started to show great promise upon securing its first gold ore and was en-route to becoming one of the leading mines in Asia.<sup>12</sup> Not only did mining operations deliver fruitful results throughout the year, ore recoveries surpassed expectations at 91.2% and 80.9% respectively in 2012 and 2013.<sup>13</sup> BlackRock was confident in the mine's prospects, and participated in yet another round of capital raising in 2013, eventually owning an eight percent stake in G-Resources.<sup>14</sup>

## **All that glitters is not gold: The shift into financial services**

In August 2015, G-Resources announced its intention to diversify into financial services, specifically investments in lending, securities brokerage, and property.<sup>15</sup> It attributed this decision to significant volatility and downward movement in gold spot prices beyond the control of the company.<sup>16</sup>

This intention was later confirmed in an announcement in November 2015. G-Resources entered into an agreement to dispose of its interest in the mine to a consortium of buyers, including EMR Capital, Farallon Capital and two other Indonesian investors.<sup>17</sup> The prized mine was eventually sold at US\$775 million with a contingent consideration of US\$130 million.<sup>18</sup> As the sale involved a disposal of a large portion of G-Resources' assets, this decision would later be subjected to shareholders' approval in March 2016.<sup>19</sup>

## **The shareholder's perspective**

The announcement of the Martabe mine disposal came as a rude shock to shareholders as Martabe constituted 97.1% of G-Resources' revenue.<sup>20</sup> The crux of the issue was the radical change in business direction. Investors and proxy advisory firms such as BlackRock, Glass Lewis and ISS have questioned the feasibility of such a change and future outlook of the company, especially since G-Resources had a minimal track record in the finance industry.<sup>21</sup> G-Resources responded by emphasising that its primary business had always been dual-focused in both investing and mining, and not merely mining alone.<sup>22</sup>

The announcements made in August 2015 and November 2015 led to an eventual decline in G-Resources' share price.<sup>23</sup> The initial excitement for G-Resources' lucrative mining activities had vanished and investors found themselves involuntarily involved in property, real estate and investments.

In light of this, BlackRock and other minority shareholders wanted to be fairly compensated. While some desired higher yield through reinvesting cash, others demanded special dividends or share buybacks, which G-Resources resisted.<sup>24</sup>

## Owen Hegarty: A long way back with Martabe

Owen Hegarty, a mining professional, was CEO and founder of Oxiana Limited, an Australian mining company.<sup>25</sup> At the beginning of 2007, Oxiana Limited acquired G-Resources' predecessor, PT Agincourt Resources.<sup>26, 27</sup> In 2008, Oxiana Limited merged with another Australian mining firm, Zinifex, to form OZ Minerals.<sup>28</sup> OZ Minerals then sold the Martabe mine to CST Mining in 2009, when Hegarty served as an Executive Vice-Chairman.<sup>29,30</sup> The mine eventually fell into the hands of G-Resources, as CST Mining granted G-Resources the option to purchase the mine for US\$220 million back in 2009.<sup>31,32</sup>

Hegarty had served on G-Resources' board as an executive director and Vice-Chairman from May 2009 to March 2016.<sup>33</sup> Concurrently, he also acted as Chairman of EMR Capital. His independence was subsequently challenged when EMR Capital become one of the two major players in the acquisition of the Martabe mine in 2015.<sup>34</sup>

Hegarty stepped down from G-Resources' board in March 2016 as his actions came under intense scrutiny. Nevertheless, he retained his position as Chairman of EMR Capital. Both companies have, however, made his exclusion in the transaction clear.<sup>35</sup> From the perspectives of shareholders such as Philip Koh, however, Hegarty's involvement was a clear example of an 'interested party transaction'.<sup>36</sup>

## Board independence issues

The Vice-Chairman and independent non-executive director, Dr Or Ching Fai, sat on seven boards across diverse industries.<sup>37</sup> Together with two other independent directors Ma Yin Fan and Leung Hoi Yin, as well as executive director Richard Hui, the four individuals simultaneously sat on the board of China Strategic Holdings Limited.<sup>38,39</sup> Company secretary Jackie Wah and three of the board members of G-Resources also concurrently sat on the board of CST Mining, a major shareholder of the company.<sup>40</sup>

In June 2015, Chiu Tao, a former bankrupt<sup>41</sup>, became the acting CEO of G-Resources and remains as its current board Chairman.<sup>42</sup> His roots in the company were established when he was appointed as Chairman and executive director of the company in 2009.<sup>43</sup>

## **A lack of information**

After the startling announcements in August and November 2015, BlackRock demanded for increased transparency on how the new management planned to run the new business and how the cash generated from the sale of the Martabe mine was to be used.<sup>44</sup> These concerns were especially pertinent as BlackRock had a sizable eight percent stake in G-Resources' staggering after-sale cash position of US\$1 billion.<sup>45</sup>

Disclosures with regards to the proposed disposal of the Martabe mine were eventually delayed by G-Resources, not once but twice, on 7 December, 2015 and 29 January, 2016.<sup>46</sup> Shortly after, the company produced a 200-odd-page explanatory memorandum, which contained only one page on the new business and another on the use of proceeds.<sup>47</sup> Even after taking into consideration the February memorandum, BlackRock still felt that G-Resources "had not provided adequate disclosure and explanations to shareholders on its change of strategy", nor had they provided sufficient details on "how funds from the sale of the mine will be used effectively".<sup>48</sup>

## **An uphill battle: Venturing into uncharted waters**

Like many institutional investors, BlackRock takes on the role of an 'active shareholder' that votes its shares and engages with the company, generally choosing not to participate in shareholder 'activism' which might bring about undue influence on the management of the business.<sup>49</sup> This is characteristic of Asian investors; in 2015, only 24 companies in Asia were subjected to public activist demands, compared to an almost fifteen-fold difference of 350 in the United States.<sup>50</sup>

BlackRock's investment stewardship team generally engages companies behind closed doors when issues arise.<sup>51</sup> Only if private engagement proves unsuccessful would it then proceed to become an 'active shareholder' and vote against the contentious resolution.<sup>52</sup> Negotiation with G-Resources illustrated this instance where BlackRock rallied for public support as the last resort.<sup>53</sup>

BlackRock eventually decided that a more active approach was needed. It thoroughly explored available options - calling for a special general meeting, going through a general counsel, and eventually enforcing a shareholder proposal for special dividends to return shareholders' capital.<sup>54</sup> The bottom line remained that 'doing nothing' was not an option.<sup>55</sup> BlackRock gradually became active through websites, interviews and public campaigns in a bid to convince the other shareholders to vote against the sale of the mine.

In its open letter dated 29 February, 2016<sup>56</sup>, BlackRock cited reasons behind its unusual aggression, such as owing fiduciary duties to its clients, and appealed to shareholders to vote against the sale of the mine. BlackRock also flagged out the inaction of G-Resources in using the funds raised back in 2013, where the proceeds were seemingly not channelled to the intended 'working capital' of the mine development.<sup>57</sup>

## **BlackRock's optimism**

Prior to the special general meeting on 8 March, 2016<sup>58</sup>, BlackRock was confident that its efforts and campaigns would sway minority shareholders to vote against the sale. Its confidence stemmed from two main factors.

Firstly, a closer look at G-Resources' shareholding structure revealed that the block shareholding in the company was not as substantial as typically observed in Asian founder-type firms.<sup>59</sup> Controlling shareholders usually own more than half of the company's outstanding shares, dimming the likelihood of any party overruling their decisions.<sup>60</sup> While G-Resources demonstrated similar block shareholding patterns, Chiu and other directors effectively held only about 19.2% of the total shares<sup>61</sup>, which made BlackRock's task easier.

Secondly, BlackRock had primary access to the proxy voting statistics which were indicative of plausible victory. These statistics revealed the presence of a strong influence from its proxy advisor's 'Against' vote, swaying as much as 38% of shareholders to vote in line with BlackRock.<sup>62</sup> With approximately 70% of shareholders voting, BlackRock was convinced that the 38% swayed was half the battle won.<sup>63</sup>

## A bitter taste of defeat

On 8 March, 2016, BlackRock suffered a huge blow, with only 41.18% of shareholders voting against the sale of the mine.<sup>64</sup>

In hindsight, BlackRock had underestimated the 19.2% stake effectively controlled by G-Resources' directors. The shareholding information did not provide for the directors' individual interests and significant influence in CST Mining, which was a substantial shareholder of G-Resources.<sup>65</sup>

G-Resources' incorporation in Bermuda posed a further challenge for BlackRock. Its access to G-Resources' shareholding structure was severely restricted as it was unable to obtain the company's shareholder registry.<sup>66</sup> BlackRock's sole source of information was its proxy solicitation firm, providing it with institutional filings made in the United States. This allowed BlackRock to glean knowledge of only about 48% of the shareholders, which excluded the board members' individual interests in CST Mining.<sup>67</sup> It therefore had minimal predictive outcome in the resolution for shareholders' approval.

This in itself was a significant obstacle for potential activist institutional shareholders. The Stock Exchange of Hong Kong Limited (HKEx) was no stranger to listing firms incorporated in Bermuda or the Cayman Islands, with over 470 of listed firms incorporated in Bermuda alone.<sup>68</sup> However, inaccessibility to share registries of such firms would deter institutional shareholders from making the first move in activism due to unpredictability and high costs to campaign.

## The aftermath crossfire

Dissatisfied with how G-Resources was treating its shareholders, BlackRock hoped for an explanation as to how HKEx was going to deal with firms which undergo a drastic change in business or hoard excessive cash for no apparent reason.<sup>69</sup> BlackRock suggested for a one-year window period for companies with a compelling case for holding huge sums of cash, after which shareholders should be entitled to vote on how the cash should be handled.<sup>70</sup> If it falls through, a special dividend payout or share buyback should ensue. Other activist investors have echoed similar sentiments, citing that it was 'unreasonable' for firms to hoard large amounts of shareholders' money which could be utilised more effectively.<sup>71</sup>

BlackRock noted that G-Resources' board had failed to "demonstrate any meaningful level of progress or competency"<sup>72</sup> despite initial determination and zest for the new business. It had argued that neither the board nor the senior management team had demonstrated any relevant skills and expertise with regards to financial services.<sup>73</sup> In response, an executive director of G-Resources asserted that financial services had always been a part of G-Resource's business.<sup>74</sup> As HKEx listing rules do not mandate companies to compensate shareholders upon a change in business activity or excessive cash hoarding, the ultimate decision of any payouts lay firmly in the hands of G-Resources.

On 30 June, 2016, HKEx published a regulatory update addressing issues surrounding the adequacy of operations of a company following a major disposal.<sup>75</sup> This was in accordance with HKEx Listing Rule 13.24<sup>76</sup>, which requires companies to demonstrate that the new business would be both 'viable' and 'sustainable'.<sup>77</sup> Taking into consideration that the mine constituted 97.1% of G-Resources' revenue, this disposal would drastically reduce both revenue and scale of business. Furthermore, its 'Principal Investing Business' in financial services was only adopted in late 2014 which constituted 2.9% of its revenue in 2015.<sup>78</sup> Its huge after-sale cash position may also violate Rule 14.82 if the cash was not put to efficient use.<sup>79</sup>

## **What next?**

While post-sale negotiations for special dividends have been ongoing between BlackRock on G-Resources<sup>80</sup>, it remains to be seen whether the company will pay out to its shareholders any form of financial consideration in lieu of its drastic shift in business.

Towards the end of 2016, BlackRock exited from G-Resources. Since G-Resources is no longer a participant in any index, BlackRock no longer hold any shares in the company.

G-Resources held its 2016 annual general meeting (AGM) on 30 June, 2017.<sup>81</sup> One day before, Vice-Chairman Dr Or announced that he would be retiring from the company's board.<sup>82</sup> The AGM's agenda focused on two main matters – the granting of general mandates to the directors on the board to allot, issue, deal, and repurchase shares subject to certain conditions, as well as the proposed re-election of directors.<sup>83</sup> All resolutions were duly passed by the company's shareholders by poll.<sup>84</sup>

## Discussion questions

1. Discuss shareholder activism in Asia and the West. Consider the factors that contribute to differences in the extent of shareholder activism in the two regions.
2. Pru Bennett, BlackRock's APAC Head of Corporate Governance, expressed that an activist stance was the only option for BlackRock. Evaluate the events contributing to BlackRock's activism. With reference to the Hong Kong and Singapore Code of Corporate Governance, examine if G-Resources' treatment of shareholders was fair and appropriate.
3. Suggest and explain the role of institutional investors such as BlackRock in the corporate governance of companies.
4. BlackRock strongly felt that the identity of the new management was an issue and that adequate disclosures should be provided. Do you agree?
5. Evaluate the independence of G-Resources' board. Discuss possible instances of conflict of interests arising from a lack of independence.
6. Discuss the implications of the conversations BlackRock had with HKEx. Examine reasons behind BlackRock's frustrations with HKEx. With reference to other countries' stock exchange listing rules (e.g. Singapore Stock Exchange, New York Stock Exchange), suggest possible improvements for HKEx.



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# CENTRAL BANK OF BANGLADESH: THE BIGGEST CYBER HEIST IN ASIA

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## Case overview

On 4 February, 2016, the Central Bank of Bangladesh (CBB), fell victim to the largest financial cybercrime in Asian history. Hackers attempted to move a total of US\$951 million into fake accounts using the Society for Worldwide Interbank Financial Telecommunication (SWIFT) messaging system. Although the heist was discovered before all the money transfers could be completed, CBB suffered a total loss of US\$81 million. The heist was not limited to the breach of the security system of CBB, but also included the subsequent lapses that had occurred along the communication channel for SWIFT financial messages. The increasing sophistication of cyberattacks is a growing concern to the global payment network. The objective of this case is to allow a discussion of issues such as the increasing need for cybersecurity risk management; and the roles of stakeholders when an organisation is in crisis.

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This is the abridged version of a case prepared by Desmond Teng, Serene Lee, Tan Ai Ling and Ye Keyu 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 Raffles Ng under the supervision of Professor Mak Yuen Teen.

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## Central Bank of Bangladesh

CBB was established under the Bangladesh Bank Order, 1972 (P.O. No. 127 of 1972) on 16 December, 1971. CBB holds the official foreign reserves of Bangladesh and is responsible for the regulation and supervision of banks and financial institutions in Bangladesh.<sup>1</sup>

During the financial year 2015, CBB had nine members on its board of directors. The board was led by Governor, Dr. Atiur Rahman and Deputy Governor, Md. Abul Quasem.

## Crouching tiger

In May 2015, four accounts were opened with the Rizal Commercial Banking Corporation (RCBC) Jupiter branch in Manila, using fake driving licences as identification documents. A fifth account under the name of a Philippines businessman, William So Go, was created on 1 February, 2016. These accounts were dormant until the illegitimate transfer of Bangladeshi funds from the Federal Reserve Bank of New York (FRBNY) in February 2016.<sup>2</sup>

A malware, `evtdiag.exe`<sup>3</sup>, was alleged to have been propagated through Universal Serial Bus (USB) by an insider or technician working with the bank.<sup>4</sup> Other sources speculated that it was done through the use of email spear phishing. According to BAE Systems security researchers, `evtdiag.exe` was custom-made for this heist and is likely part of a broader attack toolkit. A BAE Systems report stated that “the malware registers itself as a service and operates within an environment running SWIFT’s Alliance software suite, powered by an Oracle Database”.<sup>5</sup> The malware was able to function in the system and allowed the hackers to carry out sabotage actions. According to CBB’s officials, the malware likely resided in the system as far back as January 2016, giving the hackers time to study CBB’s system while they remained unnoticed.<sup>6</sup>

The hackers stole local administrative credentials and were able to navigate their way and obtain access to the SWIFT-connected systems, on which a monitoring software was installed. They managed to capture SWIFT-issued digital certificates, enabling them to execute the heist by submitting financial messages over the SWIFT network.<sup>7</sup>



## The fateful day of the hack

On 4 February, 2016, when CBB closed for the day, the hackers logged onto the SWIFT messaging system and attempted to withdraw funds amounting to US\$951 million from CBB's account at the FRBNY.<sup>8</sup> This was performed by issuing 35 separate transfers via SWIFT.<sup>9</sup> The first five transfer requests, which amounted to US\$101 million, were approved and sent to the FRBNY and its correspondent banks.<sup>10</sup>

Out of the five transfer requests sent to FRBNY, four requests amounting to US\$81 million were routed to the four accounts set up in RCBC Jupiter branch in the Philippines.<sup>11</sup> The funds were deposited and consolidated in the account under Go's name.<sup>12</sup>

The fifth request was intended to be made to send US\$20 million to a non-governmental organisation in Sri Lanka. The money had initially reached Pan Asia Banking Corporation (PABC). However, it was later diverted back to routing bank, Deutsche Bank, for further verification due to the unusually large payment size.<sup>13</sup> This later led to the cancellation of the payment and recovery of the money.<sup>14</sup>

The subsequent 30 requested transactions were rejected after suspicions were raised when the name "Jupiter" formed part of the address of the targeted RCBC bank. It was a coincidence that a US-sanctioned Iran oil tanker and shipping company was named "Jupiter". The sanction listing prompted the FRBNY to scrutinise the fake transactions before releasing the funds. FRBNY then sent multiple queries to CBB but did not get a response as it was closed for the day.<sup>15</sup>

A day later, on 5 February, 2016, the malware installed on CBB's servers bought time for the money to be collected and laundered. Incoming confirmation messages that may have alerted the bank about the fraudulent transfers were automatically removed from the SWIFT messaging system.<sup>16</sup>

An apparently broken printer was not an unusual sight. Jubair Bin-Huda, former joint director of CBB, requested for it to be fixed. However, it was a Friday in Bangladesh, which had a Muslim majority, and all the bank officials had left by 12.30pm for their mid-day prayers. The officials thus did not see FRBNY's queries and remained oblivious to the cyber-heist.<sup>17</sup>

It was only over the weekend that the officials at CBB recognise the scale of the problem. They tried to contact the FRBNY but there was no response. SWIFT then fixed the messaging system remotely.<sup>18</sup>

On 8 February, 2016, CBB issued stop orders to the relevant banks. It requested for RCBC to freeze the money in the four accounts. Unfortunately, it was a special non-working day in the Philippines and the messages were not read.<sup>19</sup>

## **Aftermath of the hack**

According to RCBC, the cancellation requests were sent via SWIFT messaging system in the wrong format and not flagged as urgent. As such, priority was not given for their review.<sup>20</sup>

From 5 February to 13 February, 2016, the US\$81 million from Go's account was routed to PhilRem Services Corporation, a money transfer company, and funnelled into the Philippines casino industry.<sup>21</sup> The Philippines casino industry is exempt from many of the anti-money laundering laws in the country. The country also practises some of the world's toughest bank secrecy laws.<sup>22</sup> Under the Philippines Banking Laws, stolen funds cannot be frozen unless a criminal case has been lodged.<sup>23</sup>

According to Julia Bacay Abad of the Anti-Money Laundering Council (AMLC), the money was traced to three different accounts namely: Solaire (US\$29 million), Eastern Hawaii Leisure Company (US\$21.2 million) and Weikang Xu (US\$31.6 million).<sup>24</sup> The trail for the US\$81 million has gone cold as the money disappeared into the Philippine casino industry.

With regards to the incident, Sergio R. Osmeña III, a senator from the Philippines, who heads a committee on banks and financial institutions, said that "They picked [the Philippines] to launder this money because [the Philippines] system is full of loopholes."<sup>25</sup>

## RCBC: A Little Too Late

Since 2013, RCBC has been recognised for its good corporate governance practices and won numerous awards. Under the board of directors, RCBC has eight board committees, two of which are the Audit Committee and the Risk Oversight Committee. By virtue of Bangko Sentral ng Pilipinas (BSP) Circular No. 145<sup>26</sup>, RCBC also has a compliance office, which is tasked to supervise the implementation of the compliance program.

Lorenzo Tan, president and Chief Executive Officer of RCBC, and Ana Luisa Lim, head of the internal audit group, certified that RCBC's internal control system for year ended 2015 complied with PSE Corporate Governance Guidelines for Listed Companies.

Besides conducting regular training, RCBC also regularly revises its policies to comply with the latest Anti-Money Laundering Act. The Money Laundering and Terrorist Financing Prevention Program is approved by the board of directors before being implemented throughout the bank. It aims to prevent RCBC from “being used, intentionally or unintentionally, for money laundering and terrorist financing activities”.<sup>27</sup>

In July 2014, RCBC adopted the Base60 AML Monitoring System (Base60) to facilitate the detection of money laundering or terrorist financing activities by using its rule-based scenarios that include the application of pattern analysis and monetary thresholds. The system's enterprise-wide approach also helps to prevent money-laundering schemes by studying the client's profile and transactions.<sup>28</sup>

## Lapse at RCBC?

Bank officials of RCBC reproached Maia-Santos-Deguito, former manager of the Jupiter branch, and Angela Torres, senior customer relations officer, for delaying the submission of a suspicious transaction report (STR). RCBC's head office requested for the STR on 5 February, 2016, in the hope of freezing the accounts that held the stolen US\$81 million. Both Deguito and Torres were dismissed from their positions for the contravention of bank protocols, falsification of commercial documents and assisting in the transfer of illicit money. Deguito was said to have facilitated the opening of the five bank accounts that stored the heist funds and helped in the withdrawal of the funds.<sup>29</sup>

On 15 March, 2016, the AMLC filed a complaint against Deguito for the breach of BSP Circular No. 706.<sup>30</sup> According to the AMLC, Deguito approved the opening of accounts based on fictitious documents. She violated the Know-Your-Customer rule by failing to verify the identities of the account holders and allowed them to withdraw funds even after knowledge of the stop payment request.<sup>31</sup> Claiming to be a scapegoat, Deguito said she only acted in accordance with Tan's instructions.

Tan and Raul Victor, former RCBC treasurer, resigned from their positions after the incident.<sup>32</sup> Deguito came under the investigation of the prosecutors from the Philippines government for money laundering. If found guilty, she might face the maximum jail sentence of 14 years.<sup>33</sup> On 24 April, 2017, it was reported that the Department of Justice "has resolved to indict" Deguito and a few other individuals linked to the money laundering; they would be charged for violating the Anti-Money Laundering Act. Kam Sim Won, one of the casino junket operators, surrendered a sum of US\$4.63 million and Php488.28 million to the BSP, the Monetary Board of the Philippines, which subsequently returned the monies to the Bangladesh government.<sup>34</sup>

## **The fine**

In relation to the cyber-heist, RCBC's non-compliance with the New Central Bank Act resulted in a record-high fine of one billion pesos imposed by BSP. RCBC also faced a supervisory enforcement action, whereby it was subjected to increased obligations in transparency and documentation.<sup>35</sup>

A week after the announcement of the hefty fine, CBB insisted that it would initiate a lawsuit against RCBC if efforts to recover the funds were not successful.<sup>36</sup>

## **The blame game**

The FRBNY did not have a real-time system to identify unusual transactions immediately. Most transactions are executed automatically, unless a problem is identified and highlighted. The flagged transaction and review usually occurs only one day after the request, which may be after payments have already been made. In the review, the staff would verify SWIFT formatting and authentication, and determine if the US economic sanctions or anti-money laundering laws have been violated.<sup>37</sup>

On 4 February, 2016, the first 35 messages sent by the hackers were rejected by the system due to incorrect formatting. The hackers simply corrected this and resent the messages, of which five were cleared automatically and payments were made. The other 12 payment requests made by CBB were seen as potentially suspicious by the staff and flagged for review. However, a complete manual review only began on the following day.<sup>38</sup>

The Bangladesh government claimed that the Federal Bank did not perform sufficient due diligence, resulting in the funds being stolen. However, FRBNY denied responsibility, stating that it was not their systems that the hackers had compromised.<sup>39</sup>

### ***No firewall and US\$10 switches, CBB?***

Investigations revealed that CBB had no firewall and used second-hand US\$10 switches for network computers connected to the SWIFT global payment network. Cyber consultants such as Jeff Wichman criticised CBB harshly, finding it ironic that CBB was “an organization that has access to billions of dollars and they are not taking even the most basic security precautions.”<sup>40</sup>

Officials at CBB, however, claimed that it was only after the attack did SWIFT advise on the upgrade of its switches.<sup>41</sup>

### ***Why were installations not thorough?***

CBB claimed that its vulnerability to the hackers increased as 13 security measures were not implemented by SWIFT when installing the Real Time Gross Settlement system. SWIFT also made mistakes when setting up a local network.<sup>42</sup>

However, SWIFT rejected all allegations as it was certain that the security of its financial messaging system had not been breached. It emphasised that member banks should be responsible for their own system interfaces.<sup>43</sup>

## **Perpetrators run free, money gone for good?**

Subsequent to the heist, the relevant parties involved had taken measures to prevent a similar attack from repeating in the future. The heist attracted worldwide attention as it targeted the SWIFT messaging system, the pillar of today's international finance operations. Concerns over the integrity of the SWIFT reporting system were also raised, which sent shock waves throughout the global banking community.<sup>44</sup>

In March 2017, it was reported by a US official that the CBB's heist was "state-sponsored".<sup>45</sup> The US federal prosecutors believed that North Korea was behind this heist.<sup>46</sup> It was also reported that CBB managed to recover some funds that were stolen from the heist, "from a casino in the Philippines".<sup>47</sup> However, the pieces of the puzzle have yet to be put together. To date, no one can say with certainty who pulled off this massive cyber-heist that has created chaos in the global financial sector and some funds have yet to be recovered.

## Discussion questions

1. Explain if you would consider the cyber-heist at CBB to be a Black Swan event. In your evaluation, assess the cyber risk management at CBB. With reference to publications made by Bank of International Settlements (BIS), what do you think CBB should do to prevent a similar attack in the future?
2. Explain the significance of a cyberattack on a Central Bank. Discuss some of the cybersecurity measures taken by the Central Bank in your country to protect the country's banking sector.
3. With regards to the cyber-heist at CBB, explain the importance of different stakeholders' roles in an organization's risk management. Provide suggestions on how SWIFT and its member banks can prevent similar future cyberattacks.
4. Identify and explain the roles of the committee(s) and department(s) responsible for RCBC's risk management and anti-money laundering compliance. Discuss the risk management and compliance controls, policies and procedures that were in place before RCBC was implicated in the cyber-heist saga. Explain why you think they had failed in this incident.
5. Who do you think is ultimately to blame for the losses from the cyber-attack? Do you think that the RCBC's board of directors and senior management should be punished for the lapses at the bank?

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# CP ALL: A CASE OF INSIDER TRADING

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## Case overview

In 2013, the Thailand stock market was rocked by the CP All insider trading scandal. Korsak Chairasmisak, who was then CP All's Vice-Chairman and Chairman of the Executive Committee, purchased shares of Siam Makro, a cash-and-carry retailer, before the official announcement of its acquisition. The Securities and Exchange Commission (SEC) uncovered evidence that Korsak had insider knowledge of the deal and subsequently imposed fines on him and other executives involved. However, no criminal sanctions were pursued. The executives guilty of insider trading were eventually allowed to retain their positions. The objective of this case is to allow a discussion of issues such as the appointment and retention of directors who breach rules; regulatory enforcement; and the importance of corporate governance culture.

## Korsak Chairasmisak

Korsak Chairasmisak was a high-flyer within Thailand's corporate circles, holding 12 directorships in various Thai companies as of 2017.<sup>1</sup> CP All is a household name in Thailand and has won numerous awards over the years.<sup>2</sup> As vice-president of CP All, Korsak managed to turn the loss-making convenience store into a profitable business over two decades ago, and has kept it commercially successful ever since.<sup>3</sup>

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This is the abridged version of a case prepared by Aaron Hei, Kerry Tran, Lim Yu Kean and Valerie Lee 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 Gary Chia Zong Zhe under the supervision of Professor Mak Yuen Teen.

## The insider trading scandal

Korsak and two other board members were accused of insider trading by the Securities and Exchange Commission (SEC) in April 2013.<sup>4</sup> In December 2015, the SEC announced that it had imposed fines totaling 34 million Baht on the three CP All directors and three other individuals for using inside information to purchase shares in Siam Makro Plc.<sup>5</sup> These directors - Korsak, along with Piyawat Titasattavorakul and Pittaya Jearavisitkul (both of whom were Vice-Chairmen of CP All's Executive Committee<sup>6</sup>) - had allegedly purchased a large number of shares in Siam Makro using material, non-public information between 10 and 22 April, 2013.<sup>7</sup> This incident occurred just before CP All's announcement on 23 April, 2013 to acquire the company at 15% above the 22 April closing price.<sup>8</sup>

Korsak was fined 30.23 million Baht while Piyawat and Pittaya were fined 725,000 Baht and 979,500 Baht respectively.<sup>9</sup> The other three individuals were fined a total of 1.4 million Baht.<sup>10</sup> No criminal penalties were imposed.<sup>11</sup>

CP All's stock price plunged almost immediately, while the trading volume jumped dramatically from 25 million shares on 2 December, 2015 to 161 million shares the following day<sup>12</sup>, 11.48 times the 30-day average.<sup>13</sup> The adjusted closing price dropped by 5.35% from 46.75 Baht to 44.25 Baht<sup>14</sup>, the largest percentage fall since 2013.<sup>15</sup>

## Pleading ignorance

After the revelations about the insider trading sanctions, CP All immediately held a news conference on 3 December, 2015,<sup>16</sup> during which Korsak claimed that he did not know "it was wrong to buy the shares openly when the takeover deal was in the making" and that he did not know whether the "deal would sail through as there were other bidders".<sup>17</sup> He repeatedly maintained his stance of ignorance on the illegality of insider trading, bringing up the fact that he had bought the stock under his own name as a form of substantiation.<sup>18</sup> He also refused to step down because CP Group "did not require any action for insider trading".<sup>19</sup> Additionally, Korsak questioned investors about their "preference for corporate governance over ability to make a profit".<sup>20</sup>

## Threats by stakeholders

There was a backlash against CP All in the weeks following the SEC's imposition of fines. The Association of Investment Management Companies (AIMC), a trade group of mutual fund companies in Thailand, threatened legal action to remove the members of CP All's board if they refused to take appropriate action against those involved.<sup>21</sup>

AIMC then threatened to call an extraordinary general meeting (EGM) for shareholders to vote to discharge the directors involved if the other members of the board did not "take responsibility"; this was done by pressuring shareholders to "pave the way for new, more trustworthy directors".<sup>22</sup>

Joining the voices of the local investors, Credit Lyonnais Securities Asia stated that if CP All's board did not take action, it will "itself request action".<sup>23</sup> Many foreign fund managers also threatened to freeze all investments in CP All until the company took action.<sup>24</sup>

## CP All's actions

Despite impending threats from shareholders, no punitive action was taken against the directors. CP All's Audit Committee and independent directors released a statement<sup>25</sup> on 21 December, 2015, asserting that the directors involved in the scandal would be able to retain their positions as "[their] exceptional skills and experience [are] difficult to replace".<sup>26</sup>

In addition, the committee stated that CP All needed to "develop and improve its ... corporate governance<sup>27</sup>", and pledged to introduce new corporate governance reforms for the company.<sup>28</sup>

Given CP All's lack of action, the public turned its attention to the five independent directors on the board, focusing mainly on Komain Bhatarabhirom, Chairman of the Audit Committee.<sup>29</sup> Komain formerly served as Thailand's Attorney General and was currently working as a professor in Chulalongkorn University's Faculty of Law.<sup>30</sup> Investors felt that, when push came to shove, he failed to uphold his duties to the company and instead, turned a blind eye to the directors' blatant misconduct.<sup>31</sup>

On 5 February, 2016, CP All convened a meeting of its board of directors.<sup>32</sup> Reassuring the public that the board is “committed to ensuring CP All operates an ethical business with strong governance” and that any “intentional violations by any employee, regardless of tenure or title, will not be tolerated”, a formal admonishment against the executives was issued.<sup>33</sup> This did not include removing them from their positions as “while the three executives in question acted with imprudence and with limited understanding the SEC rules, there was no intention to violate such rules”.<sup>34</sup>

Subsequently, the board also formalised the establishment of a Corporate Governance Committee.<sup>35</sup> Consisting of three directors, the committee’s role was to oversee the process of strengthening existing corporate governance and compliance procedures.<sup>36</sup> The board also appointed EY Corporate Services Ltd (EY) as the committee’s external consultant to ensure its alignment with international standards.<sup>37</sup>

## **Tired of excuses**

Not content with the mere issuance of a formal admonition, institutional investors decided to take matters into their own hands. The AIMC announced that it would freeze all investments in CP All until it takes action against the executives involved.<sup>38</sup>

Two of Thailand’s largest pension fund managers also pushed CP All to take punitive action against the rogue executives.<sup>39</sup> Chavinda Hanratanakool, CEO of Krung Thai Asset Management Co., remarked that “we put very high emphasis [on] corporate governance at all companies we invest in” and hope that “the coordinated actions will have an influence on the company”.<sup>40</sup>

Joining the chorus of local and foreign investors, the Anti-Corruption Organisation of Thailand (ACT) commented that “the case reflects the weaknesses and flaws ... which resulted in dishonest, unethical and immoral image”<sup>41</sup> and that such incidents would undermine anti-corruption efforts.<sup>42</sup> The ACT also applauded the SEC for taking action against CP All.<sup>43</sup>

## Regulators in the spotlight

In the past, convicted executives were not only slapped with ‘criminal’ and ‘social’ sanctions, but were also legally forced to step down from their positions.<sup>44</sup> However, CP All’s directors were merely fined, with no imperative for them to step down, resulting in questions over the seemingly lenient punishment imposed.

Furthermore, although regulations allowed for criminal charges, the most common penalty given out was only a fine of up to twice the amount of illicit gains, and wrongdoers could end up paying much less if they were able to settle their cases early.<sup>45</sup> In fact, statistics released revealed that out of the 47 cases of insider trading in Thailand since 2009, only eight of these cases had further police probes, and merely two resulted in convictions and one in a jail term.<sup>46</sup>

In response to the questions raised about Thailand’s enforcement of insider trading rules, Rapee Sucharitakul, the SEC’s secretary-general, announced that the SEC would examine ways to toughen the country’s regime for punishing insider trading to “make it much more forceful”.<sup>47</sup>

This included plans to ban executives involved in insider trading from office and to pass a law to raise the maximum financial penalties on wrongdoers by 50%.<sup>48</sup> Sucharitakul also acknowledged the lack of transparency in the regulation of such cases, as the law does not allow him to release details such as the amount of illicit profits made or the members of the case settlement committee.<sup>49</sup>

## Public apology: Too little, too late

On 21 April, 2016, shareholders convened for the CP All’s annual general meeting<sup>50</sup>, expecting a long overdue resignation from Korsak. Instead, he only made a formal public apology, stating that he was “sorry for what happened” and “shall strictly comply with the principles of corporate governance” going forward.<sup>51</sup> Korsak reiterated that his act of insider trading “wasn’t [done] on purpose”. Korsak then hurriedly left the meeting before shareholders could interrogate him during the question and answer session.<sup>52</sup>

Disappointed that the three directors did not resign, shareholders questioned the other directors present. Umroong Sanphasitvong, director and member of the Executive Committee, responded by saying that “[CP All’s] culture is to give them a second chance - to forgive and take care of [its] good and smart people”<sup>53</sup> despite the apparent transgressions.

## **All that glitters is not gold**

The insider trading scandal also brought to light issues associated with CP All’s corporate governance. Before the scandal, CP All was named one of the top performers in terms of “good” corporate governance as ranked by institutional investors.<sup>54</sup>

However, after the scandal, gaps in the company’s corporate governance surfaced. As pointed out by Bandid Nijathaworn, CEO of the Thai Institute of Directors, “the case is a good reminder for some companies [that] corporate governance remains a challenge and cannot be taken for granted, even with a top-tier firm”.<sup>55</sup>

## **Reforms in the group: A step in the right direction?**

Dhanin Chearavanont, Chairman of CP All, subsequently released a statement saying that the directors were qualified to retain their positions and had no intention of making such a mistake again.<sup>56</sup> Nevertheless, he recognised the importance of changing mindsets and adopting world-class governance standards to regain the confidence of stakeholders.<sup>57</sup> As such, “to draw a line under the decision taken by the board”<sup>58</sup>, Chearavanont assured shareholders that the promised reforms were already being made in both CP All and the CP Group, with the following four main initiatives:

1. Company-level governance reforms: review of governance practices in CP All and its major listed subsidiaries;
2. Group-level governance reforms: appointment of independent local and international governance experts with Chearavanont’s direct involvement;



3. Formation of a Corporate Governance Committee for CP Group and appointment of EY as the independent external advisor;
4. Enhanced training for all directors and senior employees.

## **A happy ending for Korsak?**

Despite all the negative publicity associated with the insider trading scandal, CP All's shares had since recovered from its historical low of 41 Baht on 9 December, 2015, closing at 61.75 Baht as of 12 June, 2017 – it even surpassed its original price before the scandal broke.<sup>59</sup>

On 27 June, 2016, CP All provided an update on its corporate governance programme to the public<sup>60</sup> as a follow-up in its open letter published in April, during which it promised reforms and a thorough review of the Group's governance practices.<sup>61</sup> A second progress report on the company's governance reform actions was also released on 20 April, 2017.<sup>62</sup>

As of June 2017, Korsak and the other rogue executives have managed to retain their positions on CP All's board and management.<sup>63</sup> Despite repeated calls for their removal, there is a happy ending for Korsak after all.

## Discussion questions

1. In your opinion, do you think the directors charged with insider trading got away too easily? Does possessing exceptional skills and experience sufficiently justify the lack of punishment for insider trading? Is ignorance a valid defence for the actions of the directors?
2. AIMC mentioned that it would attempt to call for an EGM to vote for the dismissal of all the other directors on the board if the company failed to respond to their request. Do you think the other directors should be made accountable for the mistake of a few individuals?
3. What do you think are some potential challenges the newly formed Corporate Governance Committee in CP All will face? Do you think the formation of a Corporate Governance Committee is sufficient to improve the confidence of the company's various stakeholders?
4. As seen from the case of CP All, insider trading offenders in Thailand often face only monetary penalties such as fines. Do you think such penalties are sufficient to deter individuals in positions of power from breaching their fiduciary duties? What other measures should be in place as well?
5. How do Singapore's rules and regulations with regards to insider trading compare to Thailand? What improvements, if any, do you think can be made?

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# SUCCESSION WARS: EVERGREEN GROUP

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## Case overview

Chang Yung-fa was the founder of Taiwan's Evergreen Group, a large conglomerate with businesses in shipping, aviation and freight, amongst other industries. In his will, he left all this wealth and the ownership of the company to his youngest son, Chang Kuo-wei, and distributed nothing to his other three sons. As a result, his three elder sons decided to ignore the will and seize the ownership of the Group from the hands of Chang Kuo-wei. The objective of this case is to allow a discussion of issues such as the corporate governance of a family-owned listed company; complex ownership structures; and the corporate governance weaknesses that led to the failure of the intended succession of Evergreen Group.

## The giant Taiwanese conglomerate

The Evergreen Group comprised of a number of listed companies, such as EVA Airway Corporation (EVA Air) and Evergreen Marine Corporation, as well as private companies, such as UNI Air and Evergreen Logistics Corporation.<sup>1</sup> The Group has a significant cross-ownership structure among these companies, with Evergreen International Corporation acting as the de facto holding firm of many Evergreen subsidiaries.<sup>2</sup> As a major shareholder of Evergreen Marine Corporation and EVA Air, Evergreen International Corporation effectively controls the Evergreen Group as a result of the cross-ownership structure.<sup>3</sup>

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## **The favoured son and the biased will**

Chang Yung-fa had two marriages during his lifetime. His first wife, Kim Zhi-yu, passed away in 2013 and left three sons and one daughter behind, namely Chang Kuo-hua, Chang Kuo-ming, Chang Kuo-cheng, and Chang Shu-hua. A year later, Chang Yung-fa married Lee Yu-mei, his second wife and the mother of his other son, Chang Kuo-wei.<sup>4</sup>

At 11:05 a.m. on 20 January, 2016, Chang Yung-fa passed away, leaving behind his huge business empire and a fortune worth US\$1.6 billion.<sup>5,6</sup> Starting with only a single second-hand 15-year-old bulk vessel in 1968, Chang Yung-fa had built a large conglomerate covering all areas of ocean, air and land transportation.<sup>7</sup> Chang Yung-fa's will left his entire fortune, including shares, properties and cash, to Chang Kuo-wei and also specified that Chang Kuo-wei was to become the CEO of the Evergreen Group while continuing to serve as the Chairman of EVA Air.<sup>8</sup>

## **Events after the death of Chang Yung-fa**

On 18 February, 2016, Chang Kuo-wei released the will to the public without consulting his three elder brothers. With the release of the will, Chang Kuo-Wei assumed the position of the Chairman of the Evergreen Group. Subsequently, his elder brothers, led by Chang Kuo-hua, announced to the media that they felt 'regretful' because of Chang Kuo-wei's solo decision to disclose the will without first negotiating with his other family members. Chang Kuo-hua said that while he acknowledged that the contents of the will were true, the succession process was still under discussion, and the official finalised decision would be released to the public in due course.<sup>9</sup>

Less than a week after the public release of the will, Chang Kuo-hua and the other two elder sons disbanded the management team of the Evergreen Group during an special board meeting, essentially removing the position of Chairman, which was held by Chang Kuo-wei after the release of the will.<sup>10</sup>



Later, the elder sons shifted their target to EVA Air. On 11 March, 2016, while Chang Kuo-wei was on a business trip in Singapore, another special board meeting commenced under the direction of Chang Kuo-hua. At this meeting, the legal representative of the board of EVA Air was replaced with Steve Lin and Chang Kuo-wei was removed from his position as Chairman. Chang Kuo-wei only received the meeting notice two hours before the start of the meeting.<sup>11</sup>

## **The shareholdings of the elder brothers**

The three elder sons each owned 18% of the shares in Evergreen International Corporation, amounting to a combined 54% shareholding. Thus, they had effective control over Evergreen International Corporation. With the cross-ownership structure of the Evergreen Group, whoever controlled Evergreen International Corporation would effectively control the whole Group. This gave the three elder sons enough influence to disband the management team of the Evergreen Group.<sup>12</sup>

Evergreen Marine Corporation and Evergreen International Corporation were the top two shareholders of EVA Air, owning 16.31% and 12.17% of its shares in 2015 respectively. Chang Kuo-cheng and Chang Kuo-ming individually owned 1.94% and 1.24% of shares of EVA Air respectively. Due to the elder sons' control over Evergreen International Corporation, and its influence on Evergreen Marine Corporation, they effectively controlled approximately 32% of EVA Air.<sup>13</sup>

On the other hand, Chang Kuo-wei, through Falcon Investment Services Ltd and Ultra International Investment Holdings, only controlled 12.14% of the shares. Combining his ownership with the shareholdings of his mother and late father would only yield about 15%.<sup>14</sup>

Taipei Times reported that for the Evergreen Group, the “title of Group Chairman is not a management position recognised by the law, and de facto leadership of the companies is largely determined by the size of shareholdings one owns”. As such, the overwhelming combined ownership of the elder sons of Evergreen Group allowed them to turn against Chang Yung-fa's will.<sup>15</sup>

## The battle strategy

Evergreen Marine Corporation was the largest institutional shareholder of EVA Air. In 2015, the three elder sons were among the top ten shareholders of the Evergreen Marine Corporation. Additionally, they had significant indirect influence over Evergreen Marine Corporation through Evergreen International Corporation.<sup>16</sup> Thus, as major shareholders, they had the power to appoint directors to represent Evergreen Marine Corporation on the board of EVA Air.

There were a total of nine directors on EVA Air's board in 2015.<sup>17</sup> Through the Chang Yung-Fa Charity Foundation, the three elder sons re-appointed two directors to the board, replacing the vacant seat left by the late Chang Yung-fa and the Chairman position held by Chang Kuo-wei.<sup>18</sup> According to regulations in Taiwan, there was no clear decision mechanism in such family-owned companies.<sup>19</sup>

Of the remaining seven directors, two represented Evergreen Marine Corporation, which the elder sons had control over. As for the three independent directors, they had sided with the elder sons and decided to vote against Chang Kuo-wei. Thus, out of the nine directors, only two directors were controlled by Chang Kuo-wei, specifically, the directors who represented Falcon Investment Services Ltd.<sup>20</sup>

As a result, during the board meeting held on 11 March, 2016, the three elder brothers had sufficient support to replace Chang Kuo-wei with Steve Lin for the position of Chairman.<sup>21</sup> With these strategies, the elder sons effectively voided the will of Chang Yung-fa and the succession that Chang Yung-fa initially orchestrated eventually failed.

## Issues within the Evergreen Group

Although Chang Yung-fa appointed Chang Kuo-wei to take over the business empire in his will by assuming the leadership roles of the Evergreen Group and EVA Air, the eventual outcome was a 180 degree turn from the original plan.

As reported by China Times, the root cause of the succession battle was the dispersion of share ownership. It was difficult for Chang Kuo-wei to control the business when his elder brothers were able to combine their shares to control and manipulate the board and management of the entities within the Evergreen Group.<sup>22</sup>

## Epilogue

Chang Kuo-wei had expressed intention to stay out of EVA Air since his removal as Chairman. On 28 March, 2016, he resigned from his director position on the EVA Air board, which he still held as a representative of Falcon Investment Services Ltd. Instead, Falcon Investment Services Ltd appointed two lawyers as its legal representatives in EVA Air, which analysts had viewed as an indication of his desire to retaliate by resorting to legal means.<sup>23</sup> However, the two representatives were noticeably missing from the roster of directors for EVA Air's 2017 annual general meeting scheduled for 26 June, 2017, indicating Chang Kuo-wei's complete withdrawal of power in EVA Air.<sup>24,25</sup> Instead, Chang Kuo-wei announced his plans to use his inheritance from Chang Yung-fa to set up his new airline company, StarLux Airlines, to be operational in 2018.<sup>26</sup> Although the willed heir to the Evergreen Group lost his throne, he would soon take on the captain's seat and embark on a brand new flight in the aviation industry, leaving behind a family feud in his wake.

## Discussion questions

1. The Evergreen Group is a successful and large Taiwanese family business group. What advantages does a family-owned and family-controlled business like the Evergreen Group have over non-family type business? What unique challenges must it address to sustain its success?
2. Identify the family ownership structure of EVA Airways. Compare and contrast its strengths and weaknesses with that of the other types of family ownership structures commonly found in similar family-controlled businesses.
3. With the aid of a chart, explain the cross-ownership structure of the Evergreen Group. Discuss the pros and cons of such an ownership structure. Comment on the impact of such a structure on the Chang family's succession battle over the Evergreen Group.
4. In your opinion, what do you think were the factors that contributed to the failure of Chang Kuo-wei's succession, and what governance practices could have helped to enable the smooth succession?

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# HANJIN SHIPPING: THE TITANIC OF KOREA

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## Case overview

Hanjin Shipping Co. Ltd (Hanjin Shipping), once the world's seventh-largest container shipping company, declared bankrupt on 17 February, 2017, having weathered through a number of storms. Following its bankruptcy, Hanjin Shipping was delisted from the Korea Stock Exchange on 7 March, 2017, ending its eight-year trading history. It is the largest shipping bankruptcy in the world to date. Although this came as a surprise to many, there were tell-tale signs leading up to the final announcement of Hanjin Shipping's collapse. Unfortunately, little was done to address it. The objective of this case is to allow a discussion of issues such as the corporate governance of family-managed conglomerates; board independence; succession planning in Chaebols; risk management; and supply chain governance.

## Birth of a new era

In May 1977, Hanjin Container Lines was formed by Hanjin Group. The 1980s saw a major consolidation of the Korean shipping industry due to an impending international shipping recession. In 1988, Hanjin Shipping was created through the merger between Hanjin Container Lines and Korea Shipping Corporation, which were both veterans in the industry.<sup>1,2</sup> At the beginning of the 1990s, with its expanded operations and new competitive strategies, Hanjin Shipping was ranked 12th in the world's container carrier industry.<sup>3</sup>

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## **Approaching choppy waters**

The year 2002 saw major restructuring within Hanjin Group, the holding company of Hanjin Shipping. Since the founding of Hanjin Group by Cho Choong Hoon, Hanjin Shipping and Korean Airlines were operated under the same umbrella. With the passing of the elder Cho, the airline was inherited by his eldest son, Cho Yang-Ho and the shipping line was inherited by his third son, Cho Soo Ho.<sup>4</sup> This marked the transition of Hanjin Shipping's leadership to the second generation, which saw the flourishing of the shipping company. Hanjin Shipping was listed on the Korea Exchange on 29 December, 2009 at 21,300 won per share and subsequently achieved an all-time high share price of 38,694 won in January 2011.<sup>5</sup>

## **Sowing the seeds of demise**

In 2006, Hanjin Shipping was recognised with “Korea's Best Company Award” and “Korea's Value Creating Company Award”.<sup>6</sup> However, Cho Soo Ho's reign came to an end with his passing in November that same year<sup>7</sup> and his wife, Choi Eun Young, then took over as CEO of Hanjin Shipping.<sup>8</sup> She was also appointed as Chairman of the board even though she was a housewife prior to the appointment.<sup>9</sup> As a result of this leadership change, problems started to surface in 2007.

## **Board of directors**

During Choi's tenure, there were seven directors, with three inside directors and four outside directors on the board. Choi was also the largest shareholder, as she had a 9.15% stake through the Yanghyun Foundation and individual shareholdings belonging to herself and her two daughters.<sup>10</sup> During that time, Kim Young Min held the position of president and co-CEO, while Yoon Joo Sik was both an inside director and vice president.<sup>11</sup>

There were two subcommittees under the board of directors, namely the Audit Committee and the External Director Recommendation Committee.<sup>12</sup> The Audit Committee was made up of three outside directors and its main function included independently overseeing the company's business activities. The External Director Recommendation Committee, which was chaired by Kim Young Min, was responsible for reviewing and recommending candidates for the position of



outside director at the general meeting of shareholders. At the management level, the Risk Management Committee, which was responsible for, inter alia, setting trading limits for risk-hedging, making decisions regarding the risk management structure, and approving the purchase of risk-hedging products, was made up of a Chairman and five executive level experts.<sup>13</sup>

## **Warning signs: Faltering economy**

The shipping industry, which experienced growth since 1956, has struggled in an era of sluggish growth since late 2014. The outlook for the shipping industry was further worsened by the considerable slowdown of economic growth worldwide. Declining trade in China, Korea's largest trading partner both in terms of imports and exports, was another pressing issue. The South Korean shipping industry was especially hurt by China's slowing economic growth, which had halved from 14.2% in 2007 to 7.7% in 2013.<sup>14</sup>

## **More is better?**

Overcapacity was the root cause of the problem, as carriers sought to build mega-containerships over the years. The mega-containerships were supposed to offer unprecedented unit economies to these carriers, leading to exponential growth in the industry. Ship volumes grew exponentially since 1975, severely damaging the pricing power of the marine shippers, as the low ocean freight rates made it very difficult to make profits in container shipping.<sup>15</sup>

According to research by the Organization for Economic Cooperation and Development (OECD), there is a "disconnect between what is going on in the boardrooms of shipping lines and the real world".<sup>16</sup> Boards did not seem to realise that the growth of containerised seaborne trade was trailing the growth of the world container fleet by a large margin. Hanjin Shipping itself was guilty of accentuating the problem of oversupply as the board led the company to hop on the bandwagon of building mega-ships. Under Choi's leadership, Hanjin Shipping's fleet size increased nearly twofold, as she sought to increase the market share of Hanjin Shipping.<sup>17</sup> Despite the increasingly challenging demand environment, Hanjin Shipping inducted more ships in 2015 on long-term charters, at a time when the freight rates were not remunerative.<sup>18</sup>

## **The red flag that was ignored**

Hanjin Shipping's board and management turned a blind eye to the company's high leveraging, an obvious red flag. Choi took a gamble that significantly raised Hanjin Shipping's already high debt by significantly expanding Hanjin Shipping's fleet between 2009 and 2013. This had caused Hanjin Shipping's debt-to-equity ratio to shoot through the roof to 1,445% by 2013, from about 155% in 2009.<sup>19</sup>

Over the years, Hanjin Shipping's equity base eroded as a result of persistent losses incurred in container shipping, while its debt load simultaneously spiralled out of control.<sup>20</sup> As of 30 June, 2016, Hanjin Shipping had a working capital deficit of 3.38 trillion won, while its shareholders' equity of 564.66 billion won was well below its long-term debt of 1.8 trillion won.<sup>21</sup> Philip Damas, a director at Drewry Shipping Consultants, said that Hanjin Shipping suffered partly from problems of its own making; the consulting firm had warned since 2013 that the Korean shipping giant was 'living on borrowed time' as its debt-to-equity ratio was over 600%.<sup>22</sup>

In a bid to rescue the crisis-stricken shipping giant, the state-run Korean Development Bank (KDB) had initially invested one trillion won in Hanjin Shipping.<sup>23</sup> It soon became all too apparent, however, that this sum would fail to save Hanjin Shipping.

## **Captain overboard**

Since 2009, Kim Young Min had been serving as the president and CEO of Hanjin Shipping. His tenure came to an end after the company faced two successive years of losses in 2012 and 2013.<sup>24</sup> In 2012, Hanjin Shipping's net loss amounted to 638 billion won.<sup>25</sup> A year later, the shipping giant's net loss increased to an astounding 680.2 billion won.<sup>26</sup> Kim resigned on 10 November, 2013 to take responsibility for the company's persistent losses and failure to secure support from major creditor banks.<sup>27</sup>

## **The struggle to stay afloat**

With his outstanding performance as CEO at Hanjin Transportation, Tai Soo Suk took over as the president and CEO of Hanjin Shipping in 2014.<sup>28</sup> That same year, Cho Yang-Ho took over from his sister-in-law, Choi Eun Young, to become the co-

CEO and Chairman.<sup>29</sup> He was concurrently Korean Airline's CEO and Chairman and he directed Korean Airlines to acquire a 33.2% stake in Hanjin Shipping for 400 billion won, thereby making the airline company Hanjin Shipping's largest shareholder.<sup>30</sup>

In 2015, investors were pleasantly surprised as Hanjin Shipping managed to attain US\$6 million net profit and continued to remain profitable in 2016. This was only made possible by offsetting the declining revenue with lower costs of the carrier and the reorganisation of its service lanes.<sup>31</sup> However, difficulties continued as Cho Yang-Ho was unable to solve the root of the problem arising from the troubled state of the container industry where freight rates have fallen drastically due to weak demand and increase of global capacity. Cho later tried to restructure the company's debt financing to obtain a review of the charters and to sell its non-core assets. However, this was not approved by its creditors, headed by the KDB.<sup>32</sup>

## **Code red**

In a last-ditch attempt to save the shipping giant, the Hanjin Group submitted its plan to Hanjin Shipping's creditors in August 2016, pledging to raise up to 500 billion won and improve its liquidity position. However, creditors found it difficult to accept the plans and decided to pull the plug on the company, claiming that the plans were 'inadequate' and 'lacked conviction' to normalise the company.<sup>33</sup> Representatives from its lead creditor, KDB, indicated they expected Hanjin Shipping to seek court receivership. As a result, the shipping company's shares plummeted, ending down 24%.<sup>34</sup>

Hanjin Shipping's fate was ultimately sealed on 31 August, 2016, when it filed for court receivership just one day after creditors halted funding.<sup>35</sup> The company, along with its assets which include 99 container vessels and over 100 overseas business branches, was expected to be put up for sale.<sup>36</sup> Doubt and confusion permeated down the entire supply chain and paralysed the logistics industry. Hanjin Shipping's ships were denied unloading or docking at ports as port terminal operators, railroads, trucking companies and others refused to do work for Hanjin for fear that they would not get paid.<sup>37</sup>

Hanjin Shipping's bankruptcy represented a severe blow to South Korea's shipping industry. Due to the inherent interdependency in the role of the shipping industry, the bankruptcy effects were far-reaching and it was difficult for companies to determine the extent of their exposure to Hanjin Shipping.<sup>38</sup> There was a ripple effect that disrupted supply chains across retail markets, and it was questionable whether hundreds of tons of goods will reach shelves and alternate means of transporting goods had to be found. The impact was representative of Hanjin Shipping's influence; it was after all, the seventh largest container carrier in the world, with close to 100 containerships and a three percent of the total market share.<sup>39</sup>

According to Rahul Kapoor, a director of a maritime consultancy, Drewry Financial Research Services, "unlike dry cargo, liner shipping is all about marketing and service reliability – we haven't seen any large carriers come back from collapse".<sup>40</sup> Amid uncertainty and a bleak outlook for Hanjin Shipping, Chairman Cho Yang-Ho stepped down as Hanjin Shipping's co-CEO.<sup>41</sup>

## **Cashing out early**

Despite Hanjin Shipping's bankruptcy, the ordeal was not over for the founding family. Regulators started looking into the stock sales by Choi and her daughters after they had disposed of their Hanjin Shipping shares shortly before the company sought a creditor-led restructuring on 25 April, 2016.<sup>42</sup> They sold over 960,000 shares valued at US\$2.7 million between 8 April, 2016 and 20 April, 2016 – which prevented them from incurring at least US\$1 million in losses had she and her family stood by the stock as Hanjin Shipping filed for bankruptcy protection.<sup>43</sup> South Korea's Financial Services Commission alleged Choi to have engaged in insider trading, using insider information of the family business that she had access to when she and her daughters decided to liquidate their shares.<sup>44</sup>

## **Clearing up the shipwreck**

Subsequent to the bankruptcy, the Hanjin Group and Chairman Cho Yang-Ho promised to provide a combined 100 billion won to assist in the rescuing of close to 530,000 Hanjin containers stranded worldwide.<sup>45</sup>

These funds from Korean Airlines, Hanjin Shipping's largest shareholder, did not come by easily. It took the board of Korean Airlines five meetings before finally approving the plan to provide Hanjin Shipping with the loan. Korean Airlines' Chairman and CEO Cho Yang-Ho and three other executive directors backed the proposal, believing it was required to resolve the 'logistical chaos' caused by Hanjin Shipping's court receivership application. This was met with opposition by the six external directors as they argued that Korean Airlines had no legal responsibility to help the distressed shipping company.<sup>46</sup>

The boardroom conflict illustrated the risks posed to Korean Airlines by the founding family, who were substantial shareholders of the company. Analysts expressed that over-involvement with Hanjin Shipping could damage the company's earnings and tarnish its reputation. Notably, since 2014, the Hanjin Group had spent approximately US\$1.8 billion in vain to save Hanjin Shipping.<sup>47</sup>

## **Chaebols are not 'too big to fail'<sup>48</sup>**

"Lazy thinking that the government will have no choice but to help shippers if they run into problems has ended up hurting trading companies."  
– *President Park Geun-Hye*<sup>49</sup>

In the midst of the chaos, then-President of South Korea, Park Geun-Hye said that she would not be quiet about executives "who do not aggressively try to recover their businesses" and instead wait for aid from the government.<sup>50</sup> In the eyes of industry observers, KDB's refusal to hold negotiations with Hanjin was effectively a decision to consolidate South Korea's shipping into one 'national champion' to compete on the global platform.<sup>51</sup>

The close relationship between politics and large conglomerates has emerged as a hallmark of South Korean economics.<sup>52</sup> This can be seen in Seoul's history of giving financial support to South Korean Chaebols. Being a Chaebol, one would think that the South Korean government would go to great lengths to take care of Hanjin Shipping. However, the shipping giant was left to fend for itself despite expectations that KDB would continue to provide financial support.

## No sunken treasure

On 17 February, 2017, Hanjin Shipping was officially declared bankrupt by a South Korean court.<sup>53</sup> Subsequently, the once mighty shipping company was delisted from the main KOSPI market on the Korea Stock Exchange.<sup>54</sup> On the last day of trading, it closed at 12 won, in contrast to its all-time high of 38,694 won on 7 January, 2011. Hanjin Shipping's demise has been the largest container-shipping failure in history, but it signified a warning to both the shipping industry as well as the Chaebol philosophy. Ultimately, it was too little, too late to save the sinking ship.

## Discussion questions

1. Discuss some of the key challenges in the governance of family businesses and Chaebols based on the experience of Hanjin Shipping.
2. Discuss the deficiencies in the board structure in Hanjin Shipping. How does the Chaebol culture affect board independence and composition?
3. From a risk management perspective, what are some key factors that led to Hanjin Shipping's eventual bankruptcy? Evaluate the relative importance of these factors in terms of their contribution to the bankruptcy.
4. Discuss the supply chain impact of the collapse of Hanjin Shipping. What are the lessons from the perspective of supply chain governance?
5. Should Korean Airlines, being Hanjin Shipping's largest shareholder, have injected capital into Hanjin Shipping? How should directors of Korean Airlines have made such a decision? What could the external directors who opposed the injection of capital have done?

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# MEGA BANK, MEGA FAILURE?

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## Case overview

Taiwan's third largest bank, Mega International Commercial Bank Co., Ltd. (Mega Bank), was fined US\$180 million by US regulators on 19 August, 2016. The New York Branch of the bank was penalised for its compliance failure and for violating the US anti-money laundering regulations. This was not the first time that the bank was involved in money laundering scandals. The bank's branches in Australia were previously involved in similar cases as well. The objective of this case is to allow a discussion of issues such as board structure; the impact of strong government influence on corporate institutions; internal control and risk management; and money laundering in the banking industry.

## History of Mega Bank

Mega Bank was formed on 21 August, 2006 from the merger of The International Commercial Bank of China Co., Ltd. (ICBC) and Chiao Tung Bank Co., Ltd. (CTB), both of which were privatised in the 1900s. In 2014, it had 107 domestic branches, and a total of 39 overseas outposts.<sup>1</sup> It was the third largest bank in Taiwan in terms of size of assets in 2016.<sup>2</sup>

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This is the abridged version of a case prepared by Cindy Amelia, Cheryl Tan, Eric Wong, Eugene Soh and Tan Yan Shan 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 Mok Xiao Chou under the supervision of Professor Mak Yuen Teen.

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## Board structure

Mega Financial Holding Company (MFHC), formed in 2002, was the holding company of Mega Bank.<sup>3</sup> The board of MFHC consisted of 15 directors, of which three were independent directors.<sup>4</sup> The independent directors sat on both the Audit Committee and Remuneration Committee. The holding company did not have a separate Nomination Committee.<sup>5</sup>

Mega Bank did not have separate Audit, Remuneration or Nomination Committees. Instead, MFHC's Remuneration Committee approved Mega Bank's remuneration policies, and its Audit Committee assigned supervisors onto Mega Bank's board. Of the five supervisors sitting on the board, three held executive positions in MFHC.<sup>6</sup>

There were a total of 15 directors on the board of Mega Bank in early 2016. The Chairman of the board, Tsai Yeou-Tsair, was also the Chairman of MFHC. Wu Hann-Ching was the president and managing director of both Mega Bank and MFHC. In addition, there were two managing directors, eight other non-independent directors, two independent directors, and an independent managing director on the board. Three of the 10 non-independent directors also held executive positions in MFHC.<sup>7</sup>

In September 2016, both Mega Bank and MFHC reshuffled their boards, re-appointing the majority of the board members.<sup>8</sup> Tsai resigned from his post as Chairman of MFHC and Mega Bank, while Shiu Kuang-si was appointed as his replacement by Taiwan Premier Lin Chuan.<sup>9</sup> Tsai had reportedly offered to resign over 10 times since May 2015, but was repeatedly rejected by Minister of Finance Chang Sheng-ford on the grounds that the January 2016 presidential election was approaching.<sup>10</sup> Mega Bank also carried out an organisational restructuring, which included separating the Risk Management Committee from the Asset Liability and Risk Management Committee as a standalone independent committee, and establishing new departments such as the Anti-Money Laundering Centre.<sup>11</sup>

## Privatisation or a facade?

“Some of the largest state-owned enterprises are becoming almost like private corporations... They are traded in stock exchanges and have boards of directors, maybe even with external managers. We haven’t always understood these changes.”

– Associate Professor Aldo Musacchio, Harvard Business School<sup>12</sup>

To improve the performance of Taiwan’s banking industry, the Taiwan government focused on privatising many state-owned banks in the 1990s.<sup>13</sup> Although Mega Bank became a privatised bank, it still maintained some inextricable links to the Taiwan government.<sup>14</sup> As of September 2016, the Ministry of Finance was the largest single investor of Mega Bank, with an 8.4% share ownership, and was able to appoint seven directors on the MFHC board to represent its interests.<sup>15</sup>

The track records of the two ex-Chairmen of MFHC were indicative of their connections with the government. Tsai, who served as Chairman of MFHC from 1 July, 2010 to 1 April, 2016, had also served in various governmental organisations.<sup>16</sup> In fact, he was appointed to the board by former Taiwan President Ma Ying-jeou.<sup>17</sup> Shiu, who succeeded Tsai as Chairman of MFHC on 16 August, 2016, had served as the Chairman of partially state-owned Hua Nan Financial Holdings and held high-level positions at state-owned banks. Shiu also served as the president of MFHC and Mega Bank previously.<sup>18</sup> Amid criticism over possible conflicts of interests in the Mega Bank scandal, Shiu resigned from his position as Chairman within two weeks of his appointment, on 31 August, 2016.<sup>19</sup>

## The beginning of a mega failure

In June 2009, Mega Bank admitted to breaches of the Australian Financial Transaction Reports Act and the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (AML/CTF). Following this, Mega Bank agreed to enter into an enforceable undertaking with the Australian Transaction Reports and Analysis Centre (AUSTRAC), and its processes and procedures would be reviewed by the Australian Prudential and Regulatory Authority (APRA).<sup>20</sup> An enforceable undertaking was an alternative to criminal or civil enforcement action in ensuring compliance with the AML/CTF Act.<sup>21</sup>

Two months later, Mega Bank entered into another enforceable undertaking with APRA for suspicious transactions identified within the bank. APRA had concerns that Mega Bank's risk management system and internal audit were ineffective. In addition, some of the bank's staff had structured transactions to bypass the anti-money laundering laws. Some staff also knew about the non-compliant practices but did not act upon them.<sup>22</sup>

Despite prior warnings, concerns regarding Mega Bank's compliance with financial services laws were raised for the third time in August 2010, this time by the Australian Securities and Investments Commission. No penalties were imposed, but the bank had to undergo an independent review by PricewaterhouseCoopers.<sup>23</sup>

## **The mega fine**

"DFS will not tolerate the flagrant disregard of anti-money laundering laws and will take decisive and tough action against any institution that fails to have compliance programs in place to prevent illicit transactions."

– *Maria T. Vullo, Financial Services Superintendent*<sup>24</sup>

On 19 August, 2016, The New York State Department of Financial Services (DFS) announced that Mega Bank's New York branch (Mega-New York) was fined US\$180 million for money laundering activities. During the investigation, DFS discovered "numerous deficiencies in Mega-New York's compliance function". These deficiencies were of great concern as Mega Bank also operated branches in Panama, a country often associated with money laundering scandals.<sup>25</sup> A significant number of the bank's "customer entities" were found to be shell companies formed by Mossack Fonseca, the law firm involved in the Panama Papers scandal.<sup>26</sup>

## **Failed risk management and internal controls in Mega-New York**

DFS highlighted several internal control problems present in Mega-New York. Firstly, there was a lack of proper segregation of duties between the compliance and business functions, due to conflicting responsibilities of certain compliance personnel. For instance, Mega-New York's BSA/AML officer was also operations manager of the Business Division.<sup>27</sup>

DFS further found fault in Mega-New York's transaction monitoring systems and policies. Compliance staff failed to regularly review "surveillance monitoring filter criteria designed to detect suspicious transactions".<sup>28</sup> Various documents were also not translated from Chinese to English, impeding effective checks and investigations by regulators.<sup>29</sup>

In addition to these structural deficiencies, the staff at Mega-New York lacked proper knowledge and training with regards to US regulatory requirements. These included executive staff such as the BSA/AML Officer and the Chief Compliance Officer.<sup>30</sup>

## **Suspicious activity involving Panama branches**

The compliance failure identified at Mega-New York further raised concern over suspicious activity involving the Panama branches. Due to the high risk of money laundering in Panama, the bank was supposed to deal with transactions between Mega-New York and the Panama branches with high-level surveillance and diligence. However, the compliance failures in the bank's New York branch raised doubt on whether checks had been carried out properly. This was aggravated by the large sums of financial transactions between the two locations. On top of this, Mega-New York failed to give adequate explanations regarding suspicious "payment reversals" received from its Panama branches.<sup>31</sup>

## **Negotiating the fine**

DFS reportedly intended to impose a larger penalty on Mega-New York, but the penalty amount was negotiated down by Perng Fai-nan, the governor of the Central Bank of the Republic of China. Perng was the brother-in-law of Shiu, the Chairman of MFHC at that time.<sup>32</sup>



Huang Kuo-chang, the New Power Party Executive Chairman, expressed his concerns about “the administrative negligence and the question of who will foot the bill for the US\$180 million fine”. He also raised concerns about the inappropriateness of having Shiu participate in the administrative investigation conducted by the Financial Supervisory Commission (FSC), and the inaction of the Ministry of Finance against former MFHC Chairman Tsai. By not holding the bank’s officers responsible, Huang believed that it was unfair to the shareholders and taxpayers who might end up bearing the burden for the fine.<sup>33</sup>

## **MFHC denial**

After his meeting with US regulators, Shiu, then-Chairman of MFHC, claimed that his US trip was not meant to investigate misconduct at the bank, but to meet with US regulators and clear up any misunderstandings.<sup>34</sup> Moreover, the vice president of MFHC also denied that the bank had any involvement in money laundering activities, claiming that the fine was due to the bank’s failure in adapting to the new and more stringent anti-money laundering regulations in the US.<sup>35</sup>

## **Government involvement in Mega Bank**

As the money laundering saga continued to snowball, Taiwan lawmakers alleged former President Ma Ying-jeou’s involvement in the illegal transactions. Ma was also the Chairman of Kuomintang (KMT), the second largest political party in Taiwan and the ruling party at that time, which was accused to have used Mega Bank to conduct money laundering activities.<sup>36</sup> In its defence, KMT released the results of an investigation by the Legislative Yuan, showing that none of the 174 suspicious transactions flagged by DFS had passed through Taiwan.<sup>37</sup> However, political activists still found it difficult to ignore the possibility that Mega Bank had assisted KMT in cleaning up illicitly gained assets. Democratic Progressive Party (DPP) legislator Luo Chih-cheng alleged that Mega Bank had been used to empty out KMT’s assets, while Mega-New York was used to launder them.<sup>38</sup> Another DPP legislator, Su Chen-ching, also highlighted the fact that the bank had increased its loan to KMT-backed businesses, from NT\$3.68 billion in 2010 to NT\$11.19 billion in 2015.<sup>39</sup>

## Cleaning up the mess

“The amended law shows our country’s resolve to fight economic crimes and money laundering.”

– Premier Lin Chuan<sup>40</sup>

The entire Mega Bank scandal had cast doubt on the integrity of the anti-money laundering protocols in Taiwan.<sup>41</sup> Given the severity of the situation, the Taiwan government undertook several corrective actions. In one notable move, the government passed a bill to amend the country’s anti-money laundering law, which included, *inter alia*, increasing the ceiling for the amount of fine from NT\$1 million to NT\$5 million.<sup>42</sup>

The Ministry of Finance also planned to make several improvements by strengthening mechanisms, requiring government-controlled banks to report serious incidents, assessing the qualifications of board members who represent government-controlled shares, reviewing the responsibilities of the board of the banks, as well as enhancing on-the-job training for staff assigned to overseas branches.<sup>43</sup>

## Conflict of interests: Self-investigation is no investigation

The Executive Yuan was first informed of the fine on 1 August, 2016. Before breaking the news of the Mega-New York scandal to the public on 19 August, 2016, the Executive Yuan appointed Shiu as the new Chairman of MFHC on 11 August, 2016.<sup>44</sup> Premier Lin justified the appointment by asserting that Shiu bore little responsibility in the scandal, and that he had prior experience from dealing with a similar crisis.<sup>45</sup>

Thereafter, in response to the money laundering scandal, the Taiwanese government appointed the FSC to lead an administrative investigation on 21 August, 2016.<sup>46</sup> Tsai, who held office as MFHC’s Chairman when the lapses in compliance occurred, was summoned to the FSC headquarters for questioning on 28 August, 2016. FSC officials claimed to have obtained greater insight into the case after the questioning, but refused to release any details.<sup>47</sup>

As investigations continued, Huang expressed his concern over the fact that the FSC was “an agency that is likely to be found guilty of administrative negligence over past violations”. Furthermore, the fact that Shiu was involved in the investigations was questionable given his alleged involvement in the scandal.<sup>48</sup> Some political activists also pointed out the potential conflict of interests embroiling the FSC-appointed task force since they were reporting to the Ministry of Finance, which had substantial shareholdings in Mega Bank.<sup>49</sup> Furthermore, the Deputy Minister of Finance also stated that there were no plans to level any charges against Tsai.<sup>50</sup>

## **The investigator becomes the investigated**

Amid mounting pressure and criticism on the Executive Yuan, Premier Lin appointed a new cabinet task force, which consisted of legal and finance experts, on 30 August, 2016 to investigate Mega-New York and oversee the ongoing efforts under the FSC and the Ministry of Justice.<sup>51</sup>

On 18 September, 2016, Premier Lin issued a directive to investigate possible negligence of FSC officials in detecting compliance issues in Mega Bank. The political responsibility of FSC and the Ministry of Finance would be reviewed as well. FSC’s claim of ignorance of Mega Bank’s non-compliance could not be overlooked, given its responsibility in overseeing financial institutions. This sent a message to the top financial watchdog that it would be held accountable if it failed to detect serious breaches of regulations made by banks.<sup>52</sup> Indeed, as pointed out by Huang, in addition to the misconduct within the bank itself, the Mega Bank incident had also revealed the shortcomings of Taiwan’s regulatory bodies.<sup>53</sup>

## Discussion questions

1. Critically evaluate the board structure and composition of Mega Bank and its holding company and identify any corporate governance concerns.
2. Despite being privatised, Mega Bank still maintained close ties with the Taiwanese government. Discuss the impact of strong government influence on the quality of corporate governance of Mega Bank and companies in general. Could strong government ties be one of the factors that led to the money laundering scandals in Mega Bank? How can banks strive to mitigate this problem?
3. Given the strong governmental influence on Taiwanese banks, evaluate the effectiveness of the regulators as the fourth line of defence in the financial industry.
4. What were some of the deficiencies in internal controls and risk management within Mega-New York's anti-money laundering system? Suggest possible improvements.
5. Do you think that the US\$180 million fine was appropriate in deterring potential future compliance failures? What are the implications of such a hefty fine on different stakeholders of Mega Bank? Are there alternative measures that regulators can adopt to ensure effective compliance in the banking industry?
6. In light of recent money laundering cases involving several global banks such as HSBC and Deutsche Bank, discuss the efficiency and efficacy of regulators in detecting and reacting to the scandals, drawing comparisons to Mega Bank. What were the underlying factors that perpetuate such a phenomenon?

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# SAMSUNG BLEW IT

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## Case overview

Reports of exploding Samsung Galaxy Note 7 phones (Note 7) due to the overheating of phone batteries started to emerge on 24 August, 2016, with five cases of devices exploding while charging reported worldwide within a week. Users uploaded pictures and videos of their phones overheating, exploding or catching fire on social media platforms. This eventually led Samsung to halt all production of the Note 7 and issue a global recall for their new flagship smartphone. The massive recall cost Samsung billions in lost profits and adversely impacted its reputation and credibility. This case delves into the events surrounding the unprecedented Note 7 recall and allow a discussion of issues such as board composition and corporate governance in Chaebols; corporate culture; supply chain management; and risk and crisis management.

## Samsung's humble beginnings

Samsung Group is a South Korean multinational conglomerate founded on 1 March, 1938 by Byung-chul Lee. The group offers a wide range of products and services under the Samsung brand through a large number of companies, including Samsung Electronics (Samsung).<sup>1</sup> Kun-Hee Lee is the president and Chairman of the Samsung Group and Samsung Electronics. During the 1990s, Samsung achieved several milestones in its mobile phone business. Its first mobile phone handset was launched in 1991<sup>2</sup> and the wireless internet phone in

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This is the abridged version of a case prepared by Eugenie Tan Manqi, Kuah Shun Rong Jasper, Pang Zhi Hui, See Yong Quan Nicholas and Tan Xin Ying under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Carissa Tan Wei Cui under the supervision of Professor Mak Yuen Teen.

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1999.<sup>3</sup> Due to Kun-Hee Lee's belief in the growth potential of the mobile industry, Samsung's main business strategy was to focus on the mobile phone business and by 2012, it became the largest manufacturer of mobile phones.<sup>4</sup> Currently, Samsung has three main business units, namely Consumer Electronics, IT and Mobile Communication, and Device Solutions.<sup>5</sup> The main source of its revenue is the Information Technology and Mobile Communications business unit, which contributed 45% of Samsung's total sales in 2015.<sup>6</sup>

## Board of directors

In 2016, the board of Samsung was made up of nine members and headed by Vice Chairman and Chief Executive Officer, Oh-Hyun Kwon. There were three other executive directors (EDs) – Jong-Kyun Shin and Boo-Keun Yoon headed the three main business units while Jae-Yong Lee was in charge of general business administration. The remaining five members – Jae-Wan Bahk, Han-Joong Kim, Kwang-Soo Song, Byeong-Gi Lee and In-Ho Lee – were independent directors (IDs). The term of office of Samsung's board members was three years.<sup>7</sup> Samsung also established several committees under the main board, such as the management committee comprising of only the three EDs with delegated authorities including but not limited to the development of business strategic plans, acquisition and sales of subsidiaries and basic operating principles.<sup>8</sup>

Kun-Hee Lee is widely known to be the man behind the success of Samsung. He is seen as a visionary who saw the rise of emerging technologies and invested heavily to bring Samsung to the forefront of the technology sector.<sup>9</sup> In private, he demanded a lot of attention, with senior executives welcoming him at the airport on his return from overseas trips.<sup>10</sup> However, following his hospitalisation in 2014, Jae-Yong Lee, the only son of the Chairman, had been considered the de facto leader of Samsung and was nominated to its board on 12 September, 2016.<sup>11</sup> Due to the Korean culture of not succeeding a living parent, the younger Lee did not assume his father's title as president and Chairman of Samsung. As such, the management team of Samsung had not been operating with a clear leader. As the de facto Chairman of Samsung, Jae-Yong Lee does not have full power and authority.<sup>12</sup>

# The Chaebol structure

A Chaebol is a family-run conglomerate organisation structure unique to businesses in South Korea.<sup>13</sup> It involves a highly complex and circular shareholding structure<sup>14</sup>, which typically allows a single founding family to control a wide range of diversified and legally independent affiliates.<sup>15</sup> Through this structure, the Chairman of the Chaebol can effectively control the entire group, giving him significant influence in decision-making despite merely being a minority shareholder. In Samsung's case, as of 2012, the Lee family effectively controlled the entire Samsung group with only 1.67% of the overall group shares.<sup>16</sup> Furthermore, the dynastic dictatorship characteristic of the Chaebol also tends to ensure that power is maintained through family succession of the Chairman position, regardless of his managerial abilities.<sup>17</sup>

The complex circular shareholding structure of most Chaebols also tends to expose itself to frauds, embezzlement and bribery, amongst other issues.<sup>18</sup> The complex structure is also compounded by close political connections with the government, which is a common trait of the Chaebol structure. Power tends to be wielded single-handedly by the Chaebol's Chairman with little legal restraints.<sup>19</sup> Samsung Group's Kun-Hee Lee was convicted twice of bribery and tax evasion but was never placed in jail. Instead, he received a pardon from the Korean president due to his political connections and continued to manage the Group.<sup>20</sup>

Checks and balances on the controlling shareholder family have been found to be severely lacking in Chaebols.<sup>21</sup> The lack of transparency within Chaebols is commonplace as major boardroom decisions are passed without much disclosure to shareholders.<sup>22</sup> Moreover, the lack of transparency also affects Chaebol valuation,<sup>23</sup> with Chaebols such as the Samsung Group often severely undervalued. This phenomenon is known as the "Korean Discount". For instance, after the Note 7 incident, Elliott Associates estimated Samsung's undervaluation to be at least 70%.<sup>24</sup>

## Corporate culture

Samsung's corporate culture has its roots in the Japanese business culture. When Byung-chul Lee founded Samsung, South Korea was a Japanese colony. In the early years, the company competed in nascent industries that were dominated by the Japanese - consumer electronics, memory chips and LCD panels. The Japanese hierarchical labour model was ingrained in Samsung's corporate culture.<sup>25</sup>

Since then, seniority-based compensation and promotion systems were developed. Coupled with a strong Confucian tradition and a lack of upward mobility, the culture is one where mid-level managers were pressured to prove themselves with short-term achievements. In this vein, "executives fret that they may not be able to meet the goals and lose their jobs, even when they know the goals are excessive".<sup>26</sup> Moreover, former employees shared that Samsung engineers and mid-level managers were rarely given opportunities to challenge management goals set by their superiors, even when they disagreed with the goals. In this regard, Samsung, like many other companies in Korea, is viewed as a workplace with high power distance and where saying 'no' is virtually forbidden.<sup>27</sup>

## The dawn of a crisis

Samsung's Note 7's nemesis was the Apple iPhone 7 Plus.<sup>28</sup> In early 2016, after realising that Apple would not be launching new iPhones with revolutionary innovations, Samsung was motivated to seize the opportunity to leap ahead of its competitor. Samsung pushed the limits of engineering and created the Note 7 which had a high-resolution screen wrapped around the edges, iris-recognition security features, and an even more powerful, fast-charging battery.<sup>29</sup>

On 2 August, 2016, Samsung unveiled its flagship smartphone model, the Note 7.<sup>30</sup> On 19 August, 2016, sales started in 10 different markets, including South Korea and the United States (US).<sup>31</sup>

On 24 August, 2016, initial reporting of the smartphone models "exploding" surfaced in the news.<sup>32</sup> Subsequently, users flooded social media platforms such as YouTube<sup>33</sup>, Reddit, and Kakao Story<sup>34</sup> with pictures and videos of their Note 7s overheating, exploding or catching fire.<sup>35</sup>

## **Burn, burn, burn**

By 1 September, 2016, 35 of such incidents were reported worldwide, with “battery cell issues” cited as the main reason for the explosions.<sup>36</sup> Samsung officially suspended sales of the Note 7 just two weeks after its launch in the US and South Korea, and shortly after, began its first recall.<sup>37</sup> In total, 2.5 million Note 7s were sold as at 2 September, 2016.<sup>38</sup> Samsung opted for voluntary replacement of customers’ current devices with one of several options – a new Note 7<sup>39</sup>, a different phone, or refund upon request.<sup>40</sup>

Despite the ongoing barrage of negative media attention, Samsung issued an official statement claiming that the Note 7s in China, Hong Kong and Macau were unaffected and did not require any intervention.<sup>41</sup>

However, days after the ‘all clear’ statement, Samsung Hong Kong released another statement confirming that nearly 500 sets of affected phones were sold between 26 August, 2016 and 1 September, 2016.<sup>42</sup> Samsung reassured consumers that phones sold at approved affiliates or merchants in Hong Kong and Macau after 1 September, 2016 remained unaffected, and advised buyers to use the International Mobile Station Equipment Identity code to verify if their phones were affected by the recall. Samsung also publicly apologised and promised to provide affected customers with new handsets.<sup>43</sup>

By 14 September, 2016, further reports of Note 7s catching fire surfaced in several local media outlets and approximately 1,900 Note 7s were being recalled. Samsung had to deal with yet another blow in consumer confidence in its ability to correctly diagnose and provide solutions to the problem at hand.<sup>44</sup>

## **External parties’ involvement**

Just a week earlier, on 8 September, 2016, the US Federal Aviation Administration and numerous airlines all over the world told flight passengers not to turn on or charge the Note 7 while on board aircrafts. Soon after, due to the ongoing safety concerns, the US Consumer Product Safety Commission (CPSC) issued an announcement urging the suspension of all sales and exchanges of the Note 7.<sup>45</sup> Meanwhile, Samsung announced that it would resume selling the Note 7 in South Korea on 28 September, 2016.<sup>46</sup> In response to Samsung’s voluntary recall,

the former ED of the CPSC, Pamela Gilbert, remarked that “Samsung’s voluntary recall is completely unusual; companies don’t issue recalls without the CPSC. The gap between Samsung’s announcement and the CPSC directive shouldn’t have happened that way at all”.<sup>47</sup>

## Turning point or adding fuel to the fire?

In what seemed to be a critical turning point of the Note 7 saga, Samsung announced on 16 September, 2016 that customers could exchange their Note 7s for “fault-free” replacement phones with green battery indicators to differentiate the new batch of phones from potentially faulty older devices.<sup>48</sup> Moreover, on 29 September, 2016, in a move to recover consumer confidence, Samsung announced that “1 million people globally are using Galaxy Note 7 smartphones with batteries that are not vulnerable to overheating and catching fire”.<sup>49</sup> Two days later, Samsung resumed the sale of the Note 7 smartphone model in South Korea, while the replacement of the Note 7 was in full swing in the US.<sup>50</sup>

However, on 5 October, 2016, a Southwest Airlines flight was evacuated as a Note 7 device made popping noises and started emitting smoke on the plane.<sup>51</sup> Subsequently, more news reports regarding explosions of Note 7 devices surfaced<sup>52</sup> and Samsung was informed by the CPSC that it could face an unusual second recall of the Note 7. With widespread news of exploding Note 7s, many phone carriers such as AT&T and T-Mobile finally decided to cease the sale and replacement of the Note 7 devices from 9 October, 2016.<sup>53</sup>

## Beginning of the end

On 10 October, 2016, Samsung made the decision to temporarily suspend production and halt worldwide sale and replacement of the Note 7.<sup>54</sup> Three days later, CPSC officials expanded the recall to all 1.9 million Note 7 devices in circulation, including all replacement devices.<sup>55</sup> As a result, Samsung slashed its third-quarter profit guidance by a third, to US\$4.63 billion, reflecting the earnings impact from the crisis. Estimated losses for the discontinuation were massive, amounting to US\$9.5 billion in sales and US\$5.1 billion in lost profits.<sup>56</sup>

Furthermore, the US Department of Transportation, with the Federal Aviation Administration and the Pipeline and Hazardous Materials Safety Administration, issued an emergency order to ban all Note 7 smartphones from air transportation in the US.<sup>57</sup> In response, Samsung promptly set up “customer service points” at airports across the globe, where Note 7 users could exchange their devices and obtain refunds.<sup>58</sup>

By 4 November, 2016, nearly 85% of all Note 7 devices in the US were replaced through the US Note 7 Refund and Exchange Program.<sup>59</sup> Samsung also released a software update, limiting the phone’s ability to charge beyond 60%, along with a persistent return reminder message. A month later, Samsung forced existing users to return all Note 7s in circulation. They partnered with telecommunication companies to issue a software update to disable charging of the Note 7 altogether, rendering them useless.<sup>60</sup>

## **After the storm**

On 23 January, 2017, Samsung held a press conference to announce the cause of the Note 7 malfunctions and countermeasures that were put in place. Samsung had testing laboratories in all of its factories and tested more than 200,000 Note 7 batteries. Separately, Samsung worked with three independent test laboratories. Samsung’s test results corresponded to that of independent laboratories, where issues with batteries from two separate manufacturers were identified.<sup>61</sup>

Furthermore, Samsung acknowledged that it was overly aggressive in attempting to create a powerful battery which could fit into the slim design profile of the phone. This stemmed from Kun-Hee Lee’s strong focus on design taking precedence over other matters.<sup>62</sup> Critics have commented that Samsung’s focus on speed and internal demands to surpass its rivals signalled a collapse in its ability to innovate.<sup>63</sup> Yong-Serk Kim, a former Samsung mobile engineer, said that the company’s “overambitious attitude towards battery capacity and charging speeds” resulted in the disastrous Note 7 situation.<sup>64</sup> CPSC Chairman, Elliot F. Kaye, also commented that Samsung had dedicated far greater resources than what the CPSC could have offered in the Note 7 fiasco.<sup>65</sup>



## Supply chain management

The process of producing a Note 7 battery began with Samsung specifying the battery's characteristics such as voltage and physical size to its suppliers. The suppliers would then design and manufacture the batteries with its own unique manufacturing processes. Samsung purchased over 60% of its Note 7 batteries from a single supplier, Samsung SDI.<sup>66</sup>

By allocating a majority of its original lithium battery orders to a single supplier, any quality and safety issues relating to the batteries would pose challenges in selecting another supplier to produce the replacement batteries that matched the quantity and quality required. This challenge proved to be too overwhelming for the replacement battery manufacturer, Hong Kong-based Amperex Technology Limited (Amperex).<sup>67</sup> The initial batteries from Amperex worked fine in the earlier Note 7 devices. However, Samsung increased its order to ten million new batteries, and pushed the battery supplier to become its sole battery provider. The quantity and quality demands proved too much for Amperex to cope with. In the course of meeting the sudden demand, protrusions were left over from the ultrasonic welding process and resulted in the short circuit of the battery.<sup>68</sup> The errors eventually led to the second and final recall of the Samsung Note 7.<sup>69</sup>

Samsung's process of outsourcing the majority of its Note 7 batteries to a single supplier was noted to be rare and differed from other industry leaders such as Apple, which has several suppliers in its battery supply chain. In addition, Apple's battery suppliers are delegated the task of performing either battery cell manufacturing or battery assembly functions, which effectively spreads the risks of product quality problems.<sup>70</sup>

The Note 7 featured hundreds of highly-engineered components manufactured globally. This left Samsung with one of the most complex supply chains. As of January 2015, Samsung ran mobile phone manufacturing facilities in six countries, namely Vietnam, China, India, Brazil, Indonesia, and Korea. Complex supply chain networks created challenges in communication, integration and collaboration between internal departments and third-party vendors.<sup>71</sup> Even though Samsung is based in South Korea, only eight percent of Samsung's mobile phones were manufactured locally as of 2015.<sup>72</sup>

As technology continues to advance, current quality control and management systems in the consumer electronics industry may be inadequate to handle the increasing complex nature of supplier networks.<sup>73</sup> The auditors of Samsung have identified basic failures such as missing or uneven insulation tape, charge level inconsistencies, thinner internal separators and the Note 7 battery's higher energy density as contributing factors to the model malfunctions.<sup>74</sup>

## **The fire in the phone manufacturing giant**

Moving forward, Samsung has undertaken measures to improve its quality assurance process. To address safety, Samsung has introduced an eight-point battery safety check including charge and discharge test.<sup>75</sup> According to the Korean news outlet "Newsis", Samsung may release only one premium model annually to ensure its product quality.<sup>76</sup>

In June 2017, Samsung reportedly has plans to start reselling refurbished Note 7s again.<sup>77</sup> Stakeholders will have to wait and see whether this move by Samsung would pay off. Nevertheless, one thing is certain – Samsung will be under major scrutiny for its upcoming mobile phone launches.

## **Discussion questions**

1. Evaluate the composition of the Samsung Electronics board. What is the role of the management committee in the Samsung Electronics board? Discuss potential challenges of the Chaebol structure to Samsung Electronics' corporate governance.
2. Discuss Samsung's corporate culture and how it may have contributed to the Note 7 crisis. What factors have contributed to its corporate culture? What is the role of the board in fostering the right corporate culture and how can the board ensure that the corporate culture is cascaded throughout the entire organisation?
3. Samsung outsourced its battery manufacturing as part of its complex supply chain. Comment on Samsung's supply chain management and identify some potential red flags. How can Samsung improve its supply chain management?

4. Do you consider the Samsung Note 7 crisis as a black swan event? Explain.
5. Crisis management models generally consists of three steps: identify, fix and prevent recurrence. Comment on the effectiveness of Samsung's crisis management and suggest what Samsung could have done to better manage the crisis.
6. Identify possible key risks and Samsung's risk responses.

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# TATA SONS: UNRAVELLING THE MISTRY

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## Case overview

On 24 October, 2016, Cyrus Pallonji Mistry (Mistry), then Chairman of Tata Group and its holding company Tata Sons, was abruptly removed from his positions. He was subsequently removed from the boards of some Tata Group companies and thereafter resigned from the remaining boards. The day after his removal, Mistry released a letter claiming that he had been nothing more than a “lame duck” Chairman. He questioned the influence of Tata Trusts, Tata Sons’ controlling shareholder, and that of Ratan Tata, his predecessor. Issues relating to fraudulent transactions were also alleged by Mistry, which were refuted by Tata Sons. The objective of the case is to allow a discussion of issues such as corporate governance in family-owned companies; the powers of controlling shareholders; the role of independent directors; the appointment and removal of key management; governance of company groups; and the role of regulatory bodies.

## The man behind the mystery

Mistry was born on 4 July, 1968 to a wealthy Parsi business family. His father, Pallonji Shapoorji Mistry, was the Chairman of the Shapoorji Pallonji Group, a diversified Indian conglomerate. In 1994, Mistry was appointed managing director of his family company.<sup>1</sup>

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The Mistry family first became connected to Tata Sons in 1935 when Mistry's grandfather purchased a company with a 12.5% stake in Tata Sons.<sup>2</sup> As of October 2016, the Shapoorji Pallonji Group was the single largest individual Tata Sons shareholder with a stake of 18.5%.<sup>3</sup> Mistry denied allegations that his family's ownership of a substantial equity stake equated to a special position in Tata Sons.<sup>4</sup> The remaining shares are controlled by Tata Trusts, Tata Group companies and members of the Tata family.<sup>5</sup> The ties between the Mistry and Tata families were further cemented by the marriage of Mistry's sister, Aloo, to Ratan Tata's half-brother, Noel.<sup>6</sup>

In 2006, Mistry joined the board of Tata Sons and was appointed as director in several other Tata Group companies.<sup>7</sup> In 2010, he was placed on a five-member selection committee to search for the successor to Tata Group Chairman Ratan Tata, who was due to retire in December 2012.<sup>8</sup> While the search was ongoing, the committee successfully proposed to lower the retirement age of Tata Sons' non-executive directors, including the Chairman, to 70 years from the current 75 years.<sup>9</sup> This was not the first time the Group had adjusted its mandatory retirement age policy to influence retention and renewal policies.<sup>10</sup>

## **Emerging from the shadows**

The search committee struggled to find a suitable successor for an 'icon', which Ratan Tata had become. One of Tata's longstanding acquaintances said that the Chairman was also convinced that he was 'irreplaceable'.<sup>11</sup> After a long unsuccessful search by the selection committee for a suitable successor, Mistry was approached to take over the role of Chairman by Ratan Tata and Tata's personal friend, Lord Kumar Bhattacharya, a member of the selection committee.<sup>12</sup> Mistry was seen to represent the 'closest possible alternative' to chair Tata Sons<sup>13</sup> and he subsequently recused himself from the selection committee.<sup>14</sup> At that time, Ratan Tata had endorsed the appointment of Mistry as his successor, whom he held in high regard.<sup>15</sup>

In November 2011, Mistry was appointed Deputy Chairman of Tata Group, to be personally groomed by the outgoing Chairman. To avoid potential conflict of interests, Mistry immediately resigned from his family's company.<sup>16</sup> One year later, Mistry took over as the sixth Chairman of Tata Sons. He was the first Chairman in 74 years to have come from outside the Tata family.<sup>17</sup> Upon his retirement as Chairman, Ratan Tata was appointed as Honorary Chairman Emeritus of Tata Sons.<sup>18</sup> It was claimed by Tata Sons that Mistry had invited Ratan Tata to take up this role.<sup>19</sup>

Concurrently, many alterations were being made to Tata Sons' Articles of Association. As a result of these changes, the requirement of approval from nominees of the Tata Trusts, who sit on the board of Tata Sons, was only limited to eight distinct types of decisions.<sup>20</sup> The alterations also gave directors nominated by the Trusts more power in the appointment and removal of the Chairman.<sup>21</sup> These Trustee-nominated directors were also granted a special veto right to oppose any decisions made by the board.<sup>22</sup> In addition, a resolution was passed to allow the Trusts to select the Chairman of the selection committee for Tata Son's Chairman and appoint three members to the selection committee.<sup>23</sup> These changes granted Tata Trusts greater control of Tata Sons. With Ratan Tata still heading the Trusts, this marked the first time the roles of Chairman of Tata Trusts and Tata Sons were occupied by different persons.<sup>24</sup>

## **Back into the dark**

To observers, it was clear that it would be difficult for Mistry to live up to the legacy of his predecessor.<sup>25</sup> The Group's poor performance under Mistry was one of the theories the public had about his abrupt ejection from the helm of Tata Sons on 24 October, 2016.<sup>26</sup> However, earlier in June that year, Tata Sons' Nomination and Remuneration Committee had met with Mistry to assess his performance and it was decided that Mistry would receive a six percent hike in salary and commission.<sup>27</sup>

However, this decision was not representative of Mistry's approval throughout the Group. In a 204-page affidavit issued later, Tata Sons detailed "disturbing facts" which had contributed to Mistry's ouster.<sup>28</sup> Notably, it was said that Mistry was reluctant to apply the terms laid out in Tata Sons' Articles of Association.<sup>29</sup> Mistry

had allegedly reduced the representation of Tata Sons' directors on the boards of other Tata Group companies<sup>30</sup> and structured directorships in the various companies such that he was the only director who sat on the boards of Tata Sons and the Tata Group companies.<sup>31</sup> Other issues highlighted revolved around Mistry's failure to distance himself from his own family business.<sup>32</sup>

Prior to the commencement of the fateful board meeting on 24 October, 2016, Ratan Tata had spoken personally with Mistry and offered him a chance to voluntarily resign as Executive Chairman.<sup>33</sup> However, Mistry had refused.

As soon as the board meeting began, a resolution was moved to remove Mistry as the Chairman of Tata Sons. Six of the nine board members supported the removal of Mistry, including the three newly-inducted directors brought in by Ratan Tata.<sup>34</sup> Two members abstained and Mistry, who could not vote, was ousted. At the meeting, Ratan Tata was also appointed as the interim Chairman of Tata Sons.<sup>35</sup>

Although he was ousted as Chairman, Mistry continued to retain his position as director of various Tata Group companies. These directorships were said to be contingent on his position as the Chairman of Tata Sons, and it was felt that his continued presence as a director would be a "disruptive influence" on these boards due to his hostility towards Tata Sons.<sup>36</sup> In the days which followed, Tata Group companies separately convened extraordinary general meetings (EGMs) to remove Mistry from his directorship roles.<sup>37,38</sup> However, after being ousted from Tata Consultancy Services Ltd.'s board at the first of six planned EGMs, Mistry resigned from the boards of all Tata Group companies, with the exception of Tata Sons, on 19 December, 2016.<sup>39</sup>

## **Conflicting clues**

On 25 October, 2016 - one day after his losing his Chairman position on Tata Sons' board - Mistry wrote a letter to Tata Group stating his views about his ousting. Mistry felt that "it was his duty to place before the stakeholders a full perspective of facts and factors that were in play".<sup>40</sup>

In his letter, Mistry highlighted a number of main points. He raised the issue of 'legacy hotspots', which were legacy companies he had inherited from Ratan Tata's era that were dragging down the Group's economic performance.<sup>41</sup> Mistry also labelled himself as a "lame duck" Chairman as he was unaware of Tata Group's venture into the airlines industry, with approval having been sought from Ratan Tata instead of him.<sup>42</sup> Mistry claimed that, moving forward, the sustainability of Tata Group would depend on a governance reform to conform with company law and global best practices. Most importantly, he called for shareholders' independence to bring about the reforms that he sought.<sup>43</sup>

The leaked letter, which was sent by email to the board, took the Tata boardroom struggles public. As a result, the market regulator, Securities and Exchange Board of India (SEBI), sought detailed explanations from the listed Tata Group companies regarding the allegations contained in Mistry's letter.<sup>44</sup> In response, the companies denied the allegations and claimed no wrongdoing.<sup>45</sup> SEBI and the stock exchanges also monitored the price movements and trading activities of the listed companies of Tata Group.<sup>46</sup>

As stock prices plunged, Ratan Tata issued a letter to employees to explain that Mistry's removal was 'absolutely necessary' for Tata's future success, to reassure them of the conglomerate's stability and to prevent any further reputational damage.<sup>47</sup> He emphasised that Tata's culture and values will hold strong during turbulent times and advised employees to look towards the future rather than the past.<sup>48</sup>

On 10 November, 2016, Tata Sons released a nine-page statement defending its actions to dismiss Mistry as Chairman.<sup>49</sup> With regards to the performance of the Tata Group companies, Tata Sons claimed there was no profit on sale of investments and no noteworthy divestments which had been planned in advance.<sup>50</sup> Furthermore, Mistry should have been aware of these hotspots when he took up the position and yet, after almost four years, there had been no strategic formulation for these legacy companies.<sup>51</sup> The letter also highlighted a decrease in dividend income from the Tata Group companies and an increase in debt, expenses, and write-offs under Mistry's tenure.<sup>52,53</sup> Mistry's investments had not been paying off and his poor leadership was perceived as the primary cause for the deteriorating performance of the Tata Group companies.

The letter also sought to clarify governance issues highlighted by Mistry. It was explained that the role of the Trustee was to protect the assets of Tata Sons, and Tata Trusts was used only to monitor the operations of Tata Sons.<sup>54</sup> Amongst other issues, the recent developments in The Indian Hotels Co. Ltd (IHCL) suggested that Mistry had an ulterior motive to gain the control of IHCL via the backing of independent directors of the board.<sup>55</sup> Mistry was also accused of methodically excluding other representatives from the board, and in so doing, he would be Tata Group's sole representative and hence would be able to seek control of the main operating companies of the Group.<sup>56</sup> The letter deemed that such actions would have been detrimental to Tata Group. The letter again accused Mistry of orchestrating Tata Group's demise during his almost four-year tenure and promised to uphold the highest standards and protect the interests of all stakeholders.<sup>57</sup>

## **Fruitless struggle**

Two months after being removed as Chairman, Mistry still retained his directorship on the board of Tata Sons. However, an EGM had been proposed on 6 February, 2017 to remove him from the board of Tata Sons.<sup>58</sup> In an attempt to prevent this, Mistry petitioned the National Company Law Tribunal (NCLT).<sup>59</sup> He sought interim relief on three counts. Firstly, Tata would not dilute his family current holding of 18.5% by issuing new shares. Secondly, Mistry himself would not be removed from the board of Tata Sons. Thirdly, the Articles of Association of the company would not be altered without the consent of the NCLT.<sup>60</sup>

Unfortunately for Mistry, the NCLT refused to grant him interim relief.<sup>61</sup> His troubles worsened when Tata Sons subsequently sued him for breach of confidentiality. The conglomerate asserted that he had used confidential information and documents in his petition.<sup>62</sup>

Mistry challenged the NCLT's ruling.<sup>63</sup> On 2 February, 2017, he appealed to the National Company Law Appellate Tribunal (NCLAT) for an injunction against the EGM which was to be held on 6 February, 2017.<sup>64</sup> Mistry's appeal, however, was rejected a day later.<sup>65</sup> Without the interim relief, the EGM went forward as planned.

## **Are independent directors truly independent?**

On 6 January, 2017, Nusli Wadia, the Chairman of the Wadia Group of companies, wrote to SEBI, claiming that some of the independent directors of Tata Group companies had a direct conflict of interest and should be removed from the boards.<sup>66</sup> Wadia was an independent director on the boards of Tata Steel, Tata Motors and Tata Chemicals. However, he was removed from the boards of these companies after he backed Mistry when the latter was ousted as Tata Sons' Chairman. Wadia said he had no regrets, that he was not Ratan Tata's 'yes-man' and he had to fulfil his fiduciary duties as an independent director.<sup>67</sup> Wadia also argued that promoters who had moved the resolution for the removal of independent directors should not be allowed to vote.<sup>68</sup>

## **A new beginning**

A month later, on 6 February, 2017, Mistry's reign came to an end at the EGM when he was removed as a director of Tata Sons.<sup>69</sup> At the EGM, 80% of the shareholders voted in favour of his removal.<sup>70</sup> Mistry's ousting came after his predecessor, Ratan Tata, lost confidence in him. As Ratan Tata remained as Chairman of the Tata Trusts, which owned a 65% controlling stake in Tata Sons, the outcome of the shareholder vote was not unexpected.<sup>71</sup>

After the highly tumultuous period for the Indian conglomerate, Ratan Tata returned to take charge as the interim Chairman for four months before a successor was identified. However, some analysts had criticised the move as it potentially implied Ratan Tata's unwillingness to let go of the reins of the company.<sup>72</sup>

## **A new puppet?**

On 21 February, 2017, Natarajan Chandrasekaran became the new Chairman of Tata Sons and was the third non-Tata family member to do so.<sup>73</sup>

Chandrasekaran now faces the challenge of dealing with the reputational carnage left behind in the wake of Mistry's ouster. His software programming background has raised concerns about his ability to run a diversified multinational conglomerate. However, a Trustee of Tata Trusts highlighted that as a veteran, Chandrasekaran



would be able to bring to the table his numerous years of experience in Tata and put to use the benefits of his established association with Ratan Tata.<sup>74</sup>

Meanwhile, Ratan Tata continues to be Chairman of the two powerful Trusts that collectively own two-thirds of Tata Sons and has no plans to step down in the foreseeable future.<sup>75</sup> On the day of his appointment, Tata Sons passed a resolution to ensure Chandrasekaran would automatically cease to be a director of the company and its affiliates when he ceases to hold office as the Chairman.<sup>76</sup>

As leader of arguably India's most well-known conglomerate, which had been headed by a member of the Tata family for most of its 148-year history, it remains to be seen whether Chandrasekaran can truly take the reins and lead Tata to greater heights.

## **Discussion questions**

1. Comment on the challenges of family-owned companies and discuss how this might have contributed to the corporate governance upheaval at Tata Sons.
2. Discuss the role of Tata Trusts in the corporate governance of Tata Sons.
3. Mistry was the Chairman-cum-CEO at Tata Sons. What concerns does this raise? Does the strong presence of the controlling shareholders mitigate these concerns?
4. Is an independent director truly independent when the promoter is permitted to propose and vote for his removal?
5. In light of the leaked email surfacing Tata's struggles to the public, do you think the Tata Group handled the crisis well? What could the Tata Group have done to regain shareholder confidence?
6. Discuss corporate governance issues that arise in the case of a conglomerate like Tata Group, with a holding company structure and various listed and unlisted subsidiaries. What issues might arise from directors serving on the boards of various companies within the Group? Should a director who serve on the boards of a parent and subsidiary, or in multiple companies within the Group, be considered independent?

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# THE COLLAPSE OF BRITISH HOME STORES

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## Case overview

On 25 April, 2016, British Home Stores (BHS), one of Britain's iconic departmental store chains, entered administration, leaving behind debts of £1.3 billion, including pension fund deficits of £571 million. In the wake of BHS' demise, fingers were pointed at its former owners, Dominic Chappell and Philip Green, for "mismanaging the chain and failing to protect the company's pension scheme". The objective of this case is to allow a discussion of issues such as roles of the board and its effectiveness in monitoring management; reliance on consultants; asset stripping; and the applicability of the code of corporate governance to private companies.


## Background of BHS

Founded in 1928, BHS was the brainchild of a group of American entrepreneurs who sought to replicate the highly successful business model of a competitor retail firm, Woolworths. BHS started out offering goods with a maximum price of one shilling, although that price cap was subsequently revised to allow BHS to offer more variety.<sup>1</sup>

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This is the abridged version of a case prepared by Ahad Mehbub Vakil, Ang Chun Xun Marcus, Andrew Tan Zhi Ern and Felicia Degaputri Kurniawan 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 Tan Zhe Ren under the supervision of Professor Mak Yuen Teen.

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The year 1931 saw BHS going public after its listing on the London Stock Exchange.<sup>2</sup> By the 1960s, BHS had over 100 stores in the UK.<sup>3</sup> Beginning in 1985, BHS set its sights internationally as it began franchising its brand to stores worldwide. In 1986, BHS merged with the brands Habitat and Mothercare to form Storehouse Plc. 

Whilst the merger of BHS and Mothercare was structured to bring about economies of scale and see Storehouse reap even larger profits, in reality, it was quite the opposite. In the 1990s, Storehouse fell on hard times. Following years of poor performance and falling profits, Storehouse decided in 1999 that it was time to conduct a fundamental review of its businesses, BHS and Mothercare.<sup>5</sup>

## Green to the rescue

No sooner had Storehouse signalled its intent to sell BHS did Philip Green pounce on the opportunity. So confident was Green of turning BHS' fortunes around that whilst finalising the £200 million purchase, he was quoted as saying "(BHS) is a well-known name that has lost its way, like many others...I think this a good opportunity for a turnaround."<sup>6</sup>

After the purchase, Green promptly decided to de-list BHS from the London Stock Exchange and privatise it, leaving Green and his immediate family members as the only shareholders of the company. Following a "severe retail downturn" in 2009 and declining performance since 2005, Green merged BHS with the Arcadia Group, which he purchased in 2002, in order to "make better use of store space and cut costs".<sup>7</sup> This move, however, was seen by the industry to be "motivated in part by a desire to hide BHS' performance".<sup>8</sup>

The merger failed to revive an ailing BHS, and in 2015, Green sold the business to Retail Acquisitions Limited (RAL), led by Dominic Chappell, for £1, writing off £215 million of BHS' debts in the process.<sup>9</sup>

Barely a year later, on 25 April, 2016, BHS, drowning in £1.3 billion of debt, filed for administration. Creditors were not the only stakeholders who had to bear the brunt of a BHS bankruptcy – employees too were left shell-shocked by the potential impact of BHS' administration. Not only did employees face losing their jobs, they now also had to face losing a substantial portion of their pensions after it was discovered that BHS' pension fund was £571 million in deficit.<sup>10</sup>

## The perils of going Green

From 2000 to 2009, Green's BHS was profitable. However, this was primarily due to cutting necessary expenditure and squeezing suppliers, instead of growing the business, as evident in the flat turnover during Green's ownership.<sup>11</sup> During this time, BHS also saw the value of its assets fall significantly – a direct consequence of Green engaging in sales of BHS' assets.<sup>12</sup>

In the first four years after the acquisition, Green's BHS paid out £423 million in dividends, £307 million of which were to his own family. These dividends were well in excess of BHS' profits, and resulted in not only the reduction of value of the company, but also precluded BHS from using the funds for investments or pension contributions.<sup>13</sup>

## **"The unacceptable face of capitalism"**<sup>14</sup>

Profits in the early years of Green's tenure were boosted by several intercompany transactions to companies owned by the Green family, most of which were incorporated in offshore tax havens. A notable example was the sale-and-leaseback arrangement of 10 BHS stores for £106 million to Carmen Properties Ltd, a company ultimately owned by Green's wife, Lady Christina Green (Lady Green). The arrangement saw BHS pay rent amounting to £153 million to Carmen Properties Ltd for its use.<sup>15</sup> The stores were eventually sold back to BHS as part of the sale to RAL for only £70 million, with the sale proceeds going to Lady Green.<sup>16</sup>

In 2001, BHS also issued a subordinated bond of £19.5 million, at 8% coupon rate paid annually to Tacomer Ltd. Tacomer Ltd was a Jersey-registered company ultimately owned by Lady Green. The bond was fully redeemed in 2006 for approximately £29 million, netting Lady Green and Tacomer Ltd a return of close to £9.5 million.<sup>17</sup>

The purchase of BHS by Taveta Investment, an ultimate holding company owned by Lady Green, for £200 million, was yet another inter-company transaction which had stripped BHS of its assets. The said transaction was funded by borrowing £200 million from three Global Textiles companies at 8% annual interest. All three Global Textiles companies were controlled by Lady Green. This earned Lady Green £8.3 million on top of the £20 million annual loan repayment.<sup>18</sup>

## Pension deficit

Over the period of 14 years under Green, BHS' pension schemes went from being £43 million in surplus to over £345 million in deficit. This was a direct result of Green's refusal to make employer contributions necessary to maintain the sustainability of the pension schemes.<sup>19</sup>

In 2005, the concerned Chairman of the board of trustees, Dr Margaret Downes, wrote to the Chief Operating Officer of BHS, Paul Coackley, about the declining state of the pension fund in an attempt to seek assurance over the long-term commitment of BHS to the pension schemes. However, Dr Downes' concerns and requests were dismissed by Coackley; first by citing the need for BHS to invest in its business, and then subsequently by using BHS' financial struggles to reject calls for BHS to increase contributions to the pension schemes.<sup>20</sup>

When queried about the astronomical deficit upon the sale of BHS to RAL, Green claimed that he had no involvement in the pension scheme before 2012, and the trustees of the pension fund had made "stupid, idiotic mistakes" and were "asleep at the wheel".<sup>21</sup> However, the parliamentary report chastised Green, indicating that he "had a responsibility to be aware" of the unsustainable pension deficit, and that it was "ultimately [Green's] responsibility".<sup>22</sup>

## Project Thor

After the purchase of BHS, Taveta appointed Deloitte to advise BHS on a restructure in response to the company's failing business and increasing pension deficit. This restructure was named Project Thor<sup>23</sup> and consisted of three main strategies: writing-off intra-group BHS debt, re-negotiating with landlords and suppliers, and restructuring BHS' pension schemes.<sup>24</sup>

According to the parliamentary report, "Project Thor was a credible approach to making the company's pension liabilities more manageable" and it "would have resulted in reductions to pension entitlements, but these cuts would have been smaller than what BHS pensioners now face in the Pension Protection Fund (PPF)".<sup>25</sup>

On 5 September, 2014, Deloitte informed the Trustees that Green had placed Project Thor on hold to reassess BHS' situation due to economic uncertainty

around the region. Green also pointed out that the Christmas trading period was nearing, which was the best time to allow BHS' new management a chance to prove themselves.<sup>26</sup>

## Failures of corporate governance

The UK Corporate Governance Code is only applicable to listed companies.<sup>27</sup> This fact was relied on by Lord Grabiner, Chairman of Taveta Investments, when he was accused of failing to perform due diligence for decisions made within BHS. Such duties, he argued, were only on a "comply or explain" basis, and not enforceable onto BHS since it was privately owned.<sup>28</sup>

Investigations into BHS also uncovered a startling fact – since 2013, had it not been for Taveta's financial support, BHS would no longer be a going concern.<sup>29</sup> From the parliamentary report, it was clear that by 2014, BHS was "effectively propped up by debt to other Green family companies totalling around £250 million".<sup>30</sup>

## Sale of BHS to RAL

Grabiner played no effective part in the sale, despite being a director and Chairman.<sup>31</sup> With regards to the sale of BHS to RAL, Grabiner claimed that he was unaware of Dominic Chappell's history of bankruptcy until after the transaction was completed. Furthermore, he was neither present nor even invited to the meeting during which the sale of BHS to RAL was decided, and said his absence should not be "remotely surprising".<sup>32</sup>

While Grabiner was not involved in the sale, he made it clear that he would willingly accept any decision made by the sale sub-committee, as he was not in a position to question the sale sub-committee's competence.<sup>33</sup> The parliamentary report suggests that this was a "remarkably docile attitude"<sup>34</sup> for a person of such authority on the board. There appeared to be a consensus amongst the members of parliament that someone in Grabiner's role should have had some insight into the sale process. Grabiner, they argued, was "content to provide a veneer of establishment credibility to the group while happily disengaging from the key decisions he had a responsibility to scrutinise".<sup>35</sup>

### ***Role of third parties***

Goldman Sachs had enjoyed a professional relationship with Green and his businesses since 2004. This saw Green and his businesses receive informal advice and assistance.<sup>36</sup> Instead of charging for informal advice and assistance provided, Goldman Sachs generated revenue from Green through its involvement in large-scale transactions that Green's businesses would undertake. Additionally, Goldman Sachs provided private wealth management services to Green's family, for which it had received significant fees.<sup>37</sup>

The sale of BHS was an instance in which informal assistance was provided by Goldman Sachs to Green. While refusing to be officially involved in the sale, it provided preliminary observations to Green about the transaction. Goldman Sachs expressed concerns over several issues, most notably Chappell's "lack of retail experience", his history of "bankruptcy", and the "highly preliminary nature of the proposals". However, due to the informal nature of the advice, Goldman Sachs was unable to officially and unambiguously advise against the deal – a fact that Green was well aware of.<sup>38</sup> Despite this, Green mentioned that he was content with Goldman Sachs' support, saying "we one million percent would not have done business with [Chappell] if Goldman Sachs had said not to".<sup>39</sup>

Chappell also used Goldman Sachs' name to justify his perceived level of comfort in the deal and to add credibility to his bid. He referred to the finance company as "gatekeepers" to the bid and even indicated to RAL's board that he would be finalising the deal directly with Green "via Goldman Sachs".<sup>40</sup> Goldman Sachs was aware of the misunderstanding surrounding its role but allowed its name to be cited in order to lend credibility.<sup>41</sup>

Law firm Olswang and accounting firm Grant Thornton were also involved in the deal. A large portion of their fees was contingent upon the deal being completed. The firms were also aware that RAL did not have the resources to pay them if the deal failed to go through.<sup>42</sup> Despite the concerns brought up by all three firms involved, both Green and Chappell went ahead with the sale.

## BHS under RAL

The board under RAL consisted of five directors, including Chappell, his family and friends. The directors received remuneration and management fees from BHS.<sup>43</sup> Chappell justified the fees by stating that they were based on the standards of the retail industry, and were given in accordance with the management services agreement between RAL and BHS.<sup>44</sup>

According to BHS CEO Darren Topp, Chappell treated the company's money as his own and displayed "poor financial governance".<sup>45</sup> He received £2.6 million in salary and fees and also took out a £1.5 million interest-free personal loan without making any repayments.<sup>46</sup> Topp also mentioned that Chappell took a "hardship payment" salary before Chappell's family Christmas vacation to the Bahamas.<sup>47</sup>

Furthermore, Chappell requested for and received a loan of £90,000 from the BHS Treasury to pay off his personal tax bill.<sup>48</sup> The request came when BHS was short of cash and as such, BHS demanded that Chappell return the £90,000, which Chappell subsequently repaid.<sup>49</sup>

BHS' survival plan was contingent on being able to reduce its substantial lease payment, which met with failure.<sup>50</sup> Following this, RAL attempted to inject working capital into BHS by selling properties. However, a majority of the proceeds from the sale were used to pay debts, resulting in no funds being contributed to BHS.

As an alternative, RAL solicited several loans with high interest rates in order to support its purchase of BHS and the necessary daily working capital requirements.<sup>51</sup>

Michael Hitchcock, BHS' financial adviser, commented that RAL drained the company by arranging loans under BHS at a time it could not bear the consequences. RAL drew a total of £11 million in fees and £12 million in loans from BHS under its ownership.<sup>52</sup> When BHS went into administration, the inter-company balance sheet revealed that BHS still had about £6 million payable to RAL.<sup>53</sup>

## ***BHS Sweden***

RAL transferred £1.5 million from BHS to BHS Sweden, a company which was not under the same group. This occurred even after knowing that BHS was facing severe liquidity issues.<sup>54</sup> In reality, the owner of BHS Sweden was Lennart Henningson, Chappell's fellow-director and friend.<sup>55</sup> Topp intervened and the board demanded repayment of the £1.5 million.<sup>56</sup>

## ***Project Herald***

During its short ownership, RAL initiated "Project Herald", which involved stripping BHS of its lucrative elements. This was done through transferring profitable elements of BHS out of the BHS Group and into RAL through the formation of a new company, BHS Global. All this was done without the knowledge of the BHS executives and board.<sup>57</sup> When it was discovered, RAL had already incurred £0.3m in project fees on behalf of BHS.<sup>58</sup> Furthermore, the project also intended for RAL to establish BHS Services, which sole purpose was to provide services to BHS in exchange for fees.<sup>59</sup>

## ***Lack of checks and balances in BHS***

Chappell held a 90% stake in RAL and 100% of BHS shares, which meant that he had "absolute control in any situation or contentious vote".<sup>60</sup> Consequently, RAL hired several of Chappell's friends and family as experts, incurring £2.6 million in fees. However, in Topp's opinion, they were irrelevant to the revival of BHS, and that Chappell's relations with them "denoted a clear nepotistic environment".<sup>61</sup>

The management style and negligence by Chappell and his directors culminated in the pension deficit, which eventually grew to £571 million.<sup>62</sup> Consequently, their actions adversely impacted the employees who are the main stakeholders of the pension fund.

## **The aftermath**

In 2016, an inquiry launched by the House of Commons concluded that the decisions made by the directors and advisors had served their own interests, ultimately affecting employees and the wider public.<sup>63</sup> It mentioned that while the regulations and code of conduct for large private companies are not mandatory, such private companies are still responsible for the impact on other shareholders or stakeholders.<sup>64</sup>



### ***The recovery***

Topp, as part of the inquiry, submitted evidence on the operations of BHS under RAL that outlined the steps he took as CEO to attempt to revive the company. The evidence submitted presented a turnaround plan with four critical factors crucial to the recovery of the company. BHS failed to meet two of the four factors laid out, namely the raising of cash resources and the solution to the pension deficit that BHS had accumulated.<sup>65</sup>

The failure of RAL to raise cash meant that BHS was unable to finance the turnaround plan. At the same time, an ongoing debate between the Pensions Regulator and Arcadia on the pension deficit meant that BHS was unable to seek better credit terms and funding from potential lenders.

## **The future of BHS**

Sports Direct, owned by entrepreneur Mike Ashley, had expressed interest in a takeover of a number of stores under BHS.<sup>66</sup> However, the deal fell through and BHS was subsequently placed into administration.

Even after entering administration, Ashley continued to express interest in taking over BHS. Finally, in September 2016, BHS was purchased by Ashley for £18 million as part of integration with his luxury brand Flannels.<sup>67</sup>

The Pensions Regulator has yet to put the pension fund into the PPF, instead choosing to negotiate with the parties involved to rescue the fund.<sup>68</sup> Green has offered to provide £40 million in cash and the cancellation of a £40 million charge on the assets of BHS. The Pensions Regulator is also considering pursuing Lady Green for responsibility of the pension deficit.<sup>69</sup>

## **Epilogue**

On 28 February, 2017, Green agreed to pay £363 million in cash into the BHS pension scheme as part of a deal with the Pensions Regulator. The deal would see the Pensions Regulator “halt all enforcement action” against Green. Notwithstanding this, numerous members of parliament have demanded that Green be stripped of his knighthood in light of his role in the BHS saga.<sup>70</sup>

The cash injection would represent a “significantly better outcome” for BHS pensioners compared to having the industry bail out BHS’ pension scheme. Despite the cash injection, pensioners would still receive a lower value of around 88% of their original pension benefits.<sup>71</sup>

Members of parliament have also called on the British government to create a “nuclear deterrent” to prevent another “BHS pension fund-style disaster” by trebling the amount employers can be fined.<sup>72</sup> Meanwhile, legal proceedings are continuing against Chappell and RAL.

## Discussion questions

1. Comment on the failure of the board of directors during the sale of BHS to RAL.
2. The owners of BHS sought to extract money out of the company during their ownership of the firm at the expense of the stakeholders. What can be done to protect the interest of stakeholders within a private company?
3. Darren Topp was powerless in his position as CEO and board member. What factors contributed to this and how can this be mitigated?
4. Identify the risks associated with having a contingent fee structure for third-party consultants in cases such as the sale of BHS and how these risks can be mitigated. Should consultants be more strictly regulated and if so, how?
5. Large private companies are not required to comply with the UK Corporate Governance Code. In light of the situation with BHS, should large private companies be subjected to the same corporate governance standards as listed firms? Explain.
6. There is a view that increased regulation of listed companies creates an uneven playing field between listed and unlisted companies and contributes to an increasing trend of privatisations and delistings, and a decline in new listings. Do you agree? If so, what - if anything - should be done?

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# SNAP OUT OF IT!

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## Case overview

On 2 March, 2017, Evan Spiegel and Bobby Murphy, the founders of Snapchat, led Snap Inc. to its initial public offering (IPO) on the New York Stock Exchange (NYSE). Its IPO followed the trend of tech companies going public. However, this was the first time that non-voting shares were issued to the public, which was strongly opposed by investors. The objective of the case is to allow a discussion of issues such as board diversity; the benefits and risks of multi-class shares; the prospect of dual-class companies in different countries; and the role of independent directors in multi-class share companies.

## Snapping into the IPO

On 2 March, 2017, Snap Inc. priced its IPO on the NYSE at US\$17. Its share price climbed as high as 53% above its IPO price on the first day, and closed at US\$24.<sup>1</sup> Snap Inc.'s Chief Executive Officer (CEO), 26-year-old Spiegel, was one of the youngest entrepreneurs in history to take a company public, and perhaps the youngest-ever to lead a US\$30-billion enterprise.<sup>2</sup>

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This is the abridged version of a case prepared by Lee Si Jun, Tay Zhi Jian and Deng Pek Kee 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 Mok Xiao Chou under the supervision of Professor Mak Yuen Teen.

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## The birth of Snapchat

Since his days at Stanford University, Spiegel had always aspired to invent his own software and products. Together with Bobby Murphy and Reggie Brown, Spiegel launched Snapchat – initially named Pictaboo – in July 2011, inspired by Brown’s passing remark about how he wished the photos he had sent a girl would disappear.<sup>3</sup>

Snapchat was a huge hit due to its strong appeal to high schoolers. By the end of spring 2012, it grew from a base of 127 users to 100,000 users in the span of a year.<sup>4</sup> However, as Snapchat’s popularity rose, it was surrounded with negative publicity, with critics painting the app as a “sexting tool”.<sup>5</sup>

Although Snapchat’s reputation was tainted with associations to “sexting”, the app continued to grow in popularity. By the end of 2016, Snapchat had an average of 158 million daily users and 2.5 billion snaps created every single day.<sup>6</sup>

## The board

As at December 2016, the board was made up of nine members, including the two co-founders Spiegel and Murphy. The rest of the board was made up of independent directors, chaired by Michael Lynton, an early investor in the company. The other members on the board were: Alan Lafley, Stanley Meresman, Mitchell Lasky, Joanna Coles, Scott Miller, Christopher Young.<sup>7</sup> The directors were all granted shares, though Spiegel, Murphy, Benchmark Capital and Lightspeed Venture Partners were the only four shareholders with voting power.<sup>8</sup>

Six of the independent directors held Class A shares: Coles, Miller and Young owned 65,106 shares, Lafley and Meresman owned 162,762 shares, while Lynton owned 1,509,820 shares. Lasky owned 65,799,720 Class B shares.<sup>9</sup>

Ahead of its IPO, Snap Inc. was criticised for the lack of diversity in its leadership, as its board consisted primarily of white male directors, as well as for paying its only female director a lot less than her male counterparts.<sup>10</sup>

## The IPO controversy

Along with its IPO announcement, it was revealed that Snap Inc. would be adopting a multi-class share structure, with three classes of shares as shown below:

Class Type	Number of votes per share	Outstanding shares	Total votes
Class A	0	512,516,855	0
Class B	1	283,808,529	283,808,529
Class C	10	215,887,848	2,158,878,480
Total	-	1,012,213,232	2,442,687,009

*Table 1: Snap Inc.'s share structure<sup>11</sup>*

In addition, a term under the registration statement stated that if either Spiegel or Murphy passes away, the remaining co-founder would be able to exercise voting control over the outstanding capital stock nine months later.<sup>12</sup> This meant that the founders would be able to retain their control for a very long time, and it would not be easy to replace them in the event that shareholders were unhappy with them.<sup>13</sup>

## Reaction from investors

Many investors were bewildered at the unprecedented structure that Snap Inc. proposed, labelling it as “the most shareholder unfriendly governance in an initial public offering”.<sup>14</sup> In this structure, Spiegel and Murphy owned all the Class C stock, which gave them the ability to control the outcome of all matters submitted to their shareholders for approval, due to a total of 89% control.<sup>15</sup>

Other potential investors reacted with fury to the news of Class A shares with “no voting power”.<sup>16</sup> While many technology companies had also adopted multi-class share structures, Snap Inc. was asking investors for even more faith to be placed in the company by issuing the Class A shares.<sup>17</sup> In relation to this, concerns on the profitability of Snap Inc. were raised. Despite its growing user base, Snap Inc. had yet to prove that it was able to monetise its business thus far. The company went so far as to state in its filing to NYSE that it “may never achieve or maintain profitability”. In addition, Snap Inc. warned that it “does not expect to declare or pay any cash dividends in the foreseeable future”.<sup>18</sup>

Furthermore, there was an avalanche of criticism from institutional investors. The Council of Institutional Investors was prompted to write a letter urging Snap Inc.'s co-founders to reconsider the company's share structure. The letter stated that "some companies lacking effective accountability to owners soar for a time but others crash and burn, and still others pursue mistaken strategies for far too long".<sup>19</sup> Other detractors, including Kerrie Waring, executive director of the International Corporate Governance Network (ICGN), fiercely criticised the IPO, calling it "a horrible standard moving forward" and commenting that its governance was "more fit for a nursery than one of the world's leading stock exchanges".<sup>20</sup>

## **Multi-class shares: Benefits**

In response, Spiegel and Murphy rationalised their decision by listing the benefits of the multi-class share structure that they had proposed. Most notably, the issuance of a multi-class share structure would enable Snap Inc. to raise equity while retaining control and achieve better firm performance in the long term.

### ***Retaining control while raising equity***

Following the footsteps of successful tech giants like Google and Facebook, Snap Inc. decided to implement a similar corporate structure, which was designed to protect its ability to innovate and retain its unique characteristics.<sup>21</sup> A multi-class structure could allow Snap Inc. to increase its equity without the loss of its founders' control.<sup>22</sup> The super voting rights put in place would be able to entrench the control of dominant shareholders and the CEO; as such, the company's management would be insulated from shareholder pressure for short term profits.<sup>23</sup>

### ***Better firm performance***

Research studies have shown that concentrated shareholding within a company could improve the firm's performance, if certain circumstances were fulfilled. For instance, efficiencies are generated when controlling shareholders work in the interests of the company and when there is a robust legal system to monitor their conduct.<sup>24</sup>

In the case of Snap Inc., the founders wanted to shift investors' focus to the company's long-term vision so that it could continue to focus on innovation rather than growth.<sup>25</sup> With such a focus, the founders warned shareholders that they did not expect to declare or pay any cash dividends in the foreseeable future.<sup>26</sup> With success stories like Google, some investors were hopeful that Snap Inc. could similarly generate value with greater autonomy as well.<sup>27</sup>

## Multi-class shares: Risks

On the other hand, many analysts warned potential investors to steer clear of Snap Inc.'s shares, labelling it as "total junk".<sup>28</sup> They expressed a lack of confidence in the Snap Inc.'s management, arguing that such a structure would not only lead to entrenchment risks, but also worsen the lack of board diversity currently observed in the company.

### *Entrenchment risks*

Investors of Snap Inc. were afraid that there might be too much power vested in Spiegel and Murphy, resulting in high entrenchment risks.<sup>29</sup>

Firstly, the disproportionality between ownership and control could result in the misalignment of interest between the founders and the powerless shareholders. The ICGN asserted that a one-share-one-vote ownership structure is the most ideal model to align voting rights with economic interests, and thus investment risk.

Secondly, with absolutely no say in the company's business strategies, accountability issues might surface in the future, and the absence of shareholder advocacy could threaten the governance of the company.

Other blunt remarks made on Snap Inc.'s unproven strategy to focus on a smaller target audience placed doubt on the credibility of the founders and questioned the direction they were steering Snapchat towards. While Facebook and Google have also steered towards a similar structure as Snap Inc., the critical question remained as to whether Spiegel and Murphy are "true visionaries" who deserved such a level of control.<sup>30</sup>

### ***Risk of lack of board diversity***

The apparent lack of board diversity at Snap Inc. could also persist due to the entrenching control of controlling majority shareholders.

According to a study, in respect of the lack of diversity on Snap Inc.'s board, it has been shown that controlled companies generally have a longer board tenure and lower rate of board seat refreshment than non-controlled companies.<sup>31</sup> Snap Inc.'s corporate governance guidelines stated that the board did not believe in imposing limits on the tenure and retirement age. The company held that a long-serving director would have a deep understanding of the company to contribute effectively.<sup>32</sup>

## **Safeguards in the US**

The US has certain safeguards against abuse by controlling shareholders in companies with multi-class share structures.

In the US, controlling shareholders owe a fiduciary duty of loyalty to both the company and shareholders, and have to act in their best interests. While the majority has the right to control, it occupies a fiduciary relation towards the minority to the same extent as its officers and directors.<sup>33</sup> Hence, with formal laws in place to govern the US business sectors, non-voting shareholders potentially have the power to sue the founders if they misuse shareholder funds or are not acting in the best interest of the company.

Furthermore, the class action system in the US empowers non-voting shareholders with a unique contingency fee-based judicial relief system. By removing the financial burden of litigation expenses, shareholders are given greater motivation to take action when needed.<sup>34</sup>

The strong presence of institutional investors in the US, accompanied by a litigious culture, acts as another check and balance on the company, which would benefit non-voting shareholders.<sup>35</sup>

Lastly, Snap Inc. had also incorporated voluntary restrictions on shares with superior rights. For instance, there were some restrictions imposed on the superior Class C shares held by the co-founders. One such restriction stipulated that on any transfer of shares of Class C common stock, each transferred share will automatically convert into one share of Class B common stock.<sup>36</sup>

## **Role of independent directors in a multi-class share company**

In the event of any wrongdoing, independent directors should have the power to suspend management.<sup>37</sup> However, in a multi-class share company, the independent director is often under the control of the controlling shareholders.<sup>38</sup>

In the US, the NYSE rules are in place to ensure independence of the board. To uphold independence, the listing rules of NYSE state that all listed companies must have a majority of independent directors. In addition, all members of the audit committee, remuneration committee, and nominating committee must be independent directors.<sup>39</sup> However, the US voting mechanism does not have any provisions for minority shareholders to elect a representative to the board.<sup>40</sup> In Snap Inc.'s case, this would imply that Class A shareholders, with no voting rights, would have no say in the appointment of any board members to represent their minority interest.

## **The start of an exciting journey for Snap Inc. — will it snap?**

Snap Inc. persevered with the initial IPO decisions despite the backlash from many analysts and investors, and the result was nevertheless a resounding success.<sup>41</sup> While some analysts remained sceptical about Snap Inc.'s performance, Spiegel expressed confidence in the future of the company by declaring the decision to receive a US\$1 remuneration annually.<sup>42</sup> Labelled as both a 'big success' as well as a 'disaster', the future performance of Snap Inc. remains to be seen.

## Discussion questions

1. Comment on Snap Inc.'s board structure. How could issues concerning Snap Inc.'s board structure be aggravated by its multi-class share structure?
2. Discuss and evaluate the reactions from the investors regarding Snap Inc.'s IPO. What were the concerns raised and why were they being raised?
3. Beyond those mentioned in this case, what are the other benefits and risks of a multi-class share structure? Evaluate and discuss whether a multi-class share structure does more harm than good.
4. Imagine if Snap Inc. had not conducted its IPO in the US, but intended to do so in Singapore instead. Do you think Singapore is ready for an IPO by a company with multi-class structure like Snap Inc.? What are some of the measures or regulatory reforms Singapore should adopt before such an IPO would be allowed here?
5. Discuss the importance of the independence of the board in a multi-class share company like Snap Inc. Do you think independent directors have the ability to oversee management in a multi-class share company in Asia? If not, what can regulators do to empower independent directors?



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# SAVING BIG (STAR) BUCKS

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## Case overview

In 2012, a Reuters investigation found that Starbucks had paid very little tax in the United Kingdom (UK) despite its claims to investors about its profitability in the UK. Investigations revealed that Starbucks had significantly reduced its UK tax liability by shifting profits to entities in lower tax jurisdictions. While it was ultimately ruled that Starbucks complied with UK tax laws, there was public criticism that Starbucks was not paying its fair share of taxes. It was also later found that tax arrangements Starbucks had made with the Netherland tax authorities may have been illegal under European Union (EU) rules. The objective of this case is to discuss issues such as corporate ethics; stakeholder activism; governance of company groups; and transparency of tax structures in multinational corporations with cross-border transactions.

## A star with a conscience

“Acting ethically, even if it costs more, when corners are routinely cut - these are honourable pursuits, at the core of what we set out to be.”

- Howard Schultz, Starbucks CEO<sup>1</sup>

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This is the abridged version of a case prepared by Chin Wei Tieng, Emily Low Yee Chin, Siew Shi Ying and Stephanie Tham Kar Wai under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Isabella Ow under the supervision of Professor Mak Yuen Teen.

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Starbucks Corporation (Starbucks) was founded in 1971 as a humble store selling coffee beans and coffee-making equipment. Four and a half decades later, it has grown into a well-known international coffee giant, with more than 21,500 stores located in 64 countries in 2015.<sup>2</sup> It is a company reputed for its high ethical standards, with numerous corporate social responsibility initiatives such as ethical sourcing and commitment to green practices.<sup>3</sup> In 2016, the Ethisphere Institute announced Starbucks as one of the 'World's Most Ethical Companies' for the tenth consecutive year.<sup>4</sup>

Headquartered in Seattle, Starbucks Corporation is the parent company of the Starbucks Group. The Starbucks retail business had moved to a three-region organisational structure in 2011, comprising of China and the Asia Pacific, the Americas and Europe, and the Middle East and Africa (EMEA).<sup>5</sup> The regional organisations are responsible for monitoring the operations of the Starbucks subsidiaries in their respective regions.<sup>6</sup>

Although intra-group payments are part and parcel of how multinational corporations like Starbucks function, there are rules in place in many countries to ensure that companies do not take unfair advantage of these transactions such that profits are moved to low-tax jurisdictions and costs to higher-tax jurisdictions.<sup>7</sup> Starbucks' application of such transfer pricing rules is the crux of its saga with the UK tax authorities.

## **Two straws in a cup**

On 15 October, 2012, Reuters published a special report following a four-month investigation<sup>8</sup>, revealing that Starbucks paid only £8.6 million in UK taxes over the past 14 years since the opening of its first store in the UK in 1998.<sup>9</sup> Moreover, it had paid no UK income tax at all between 2009 to 2011, despite reporting sales of over £1 billion in the UK.<sup>10</sup> When Reuters reached out to Starbucks' Chief Financial Officer (CFO), Troy Alstead, he claimed that this was due to a poor performance of Starbucks' "very troubled" UK business, resulting in it reporting a loss.<sup>11</sup>

However, this was a stark contrast to what Starbucks officials conveyed to its investors, that its UK business was “profitable”.<sup>12</sup> Furthermore, in 2008, Schultz said that the UK business was so successful that he planned to apply what he had learnt there to further improve the company’s United States (US) business.<sup>13</sup> In 2011, John Culver, President of Starbucks’ International division, informed analysts that they were “very pleased with the performance in the UK” despite Starbucks UK’s accounts for the first three quarters reflecting a whopping £33 million loss.<sup>14</sup>

## The secret recipe

In its investigations, Reuters revealed that Starbucks reduced its UK tax obligations by utilising its group structure to transfer profits from its UK business to other entities located in other jurisdictions with lower tax rates.<sup>15</sup> This was primarily carried out via three tax planning arrangements.

Firstly, Starbucks’ UK subsidiary had an arrangement to pay a six percent royalty premium to Starbucks Manufacturing EMEA B.V., the Starbucks regional headquarters in the Netherlands which is responsible for the roasting and distribution of coffee.<sup>16</sup> Due to an attractive ‘sweetheart’ tax deal with the Dutch tax authorities<sup>17</sup>, Starbucks was able to pay an overall tax rate of approximately 16% tax on these royalty payments, which Alstead admitted to be “very low”.<sup>18</sup> Starbucks UK’s intra-group royalty payments were estimated to be £20 million to £25 million annually<sup>19</sup>, which indicated an significant erosion of its UK tax base.

Additionally, Starbucks UK transferred its profits outside the UK through purchasing coffee from Starbucks Coffee Trading SARL, another of its subsidiaries located in Switzerland. The Swiss subsidiary runs Starbucks’ global buying operations, and all the coffee the group buys globally passes through that central buying operation.<sup>20</sup> The coffee beans sales arrangement involved Starbucks UK paying up to a 20% premium to the Swiss subsidiary.<sup>21</sup> Alstead had argued that this premium was benchmarked ‘based on transfer-pricing regulations in tax authorities all around the world’.<sup>22</sup> The Swiss tax authorities offered Starbucks a very competitive tax rate of approximately 12%<sup>23</sup>, which was significantly lower than the UK tax rate of 25%<sup>24</sup> at that time.

The final way that Starbucks UK transferred its profits was through intra-group loan arrangements. Starbucks UK was entirely funded by debt through a loan from US-based Starbucks Incorporation, which imposed a high interest rate of the London Inter-Bank Offered Rate (LIBOR) plus four percentage points on the loan.<sup>25</sup> Such loan arrangements are beneficial to multinational corporations like Starbucks from a tax perspective as the borrower would be able to offset interest expenses against its taxable income, while the lender could be based in a jurisdiction which does not impose any tax on interest income. This arrangement has reduced Starbucks UK's tax base by several million pounds per year.<sup>26</sup>

## **Power of the media**

Subsequent to the tax avoidance allegations, Starbucks was subjected to public backlash and media scrutiny. Numerous media platforms in the UK began publishing reports on the alleged tax avoidance of Starbucks, together with other large multinational companies. The reports heavily criticised the contrast between what Starbucks was telling the UK tax authorities and what it conveyed to its investors, as well as highlighted potential loopholes with the UK's tax policies.<sup>27</sup>

The tax avoidance allegations were costly to Starbucks in terms of consumer goodwill. Furthermore, as a result of the heavy media attention, campaigns against tax avoidance arose, with politicians and union leaders urging consumers to boycott Starbucks' UK stores and products to place greater pressure on the company to act in a more socially responsible manner.<sup>28,29</sup>

## **Facing a roasting over taxes**

On 12 November, 2012, the British Public Accounts Committee (PAC) invited Starbucks to give evidence in light of the mounting public and political concern about tax avoidance by large multinational companies.<sup>30</sup> MPs on the committee questioned why Starbucks was continuing to invest in a region where it had been making losses for over a decade.<sup>31</sup> Additionally, the MPs sought answers as to whether Starbucks was indeed shifting its profits to lower tax entities with the purpose of avoiding its tax liabilities in the UK. While the committee did not accuse Starbucks of breaking UK tax laws, it accused Starbucks of being 'immoral' in terms of how it handled its tax obligations.<sup>32</sup>



Together with several lawmakers, Margaret Hodge, chairman of the PAC, also advised Her Majesty's Revenue and Customs (HMRC), the UK tax authority, to investigate Starbucks' tax matters.<sup>33</sup> Although HMRC's investigations did not uncover any evidence of Starbucks failing to comply with the UK tax laws,<sup>34</sup> the investigations led to discussions on amendments to tax legislation to close loopholes and prevent companies from shifting profits overseas in order to mitigate tax avoidance behaviour.<sup>35</sup>

## Standing its ground

After facing severe backlash, Starbucks publicly denied all accusations of tax avoidance.<sup>36</sup> At the PAC hearing, Alstead attributed Starbucks UK's reported losses to the high cost of leasing property in the UK and intense competition in the UK coffee market.<sup>37</sup> However, the MPs felt that these arguments fell short as these issues were not solely faced by Starbucks but affected its competitors as well.<sup>38</sup> Furthermore, the MPs felt that based on the positive outlook Starbucks had been communicating to its investors about its UK business, it was more likely that the company believed its UK operations were profitable.

Alstead justified the conflict between profitability as reported in Starbucks' accounts and taxable income by highlighting the differences between the US and UK accounting rules.<sup>39</sup> He explained that under the US accounting rules, the operating margins of its UK division had been low and reached just six percent in 2007, its most profitable year.<sup>40</sup>

Alstead also stressed that the six percent royalty payment Starbucks UK made to its regional headquarters in the Netherlands was at arm's length and comparable to those paid by other multinational companies.<sup>41</sup> However, he declined to disclose in parliamentary hearings how Starbucks' Dutch operations were taxed, citing confidentiality rules.<sup>42</sup>

In addition, Alstead maintained that the margin of 20% that Starbucks' Switzerland division made on coffee sold was consistent amongst all Starbucks entities, and was benchmarked to transfer-pricing regulations by tax authorities worldwide.<sup>43</sup>

With regards to its intra-group loans, Starbucks refuted the argument that its loan arrangement with its ultimate parent company was part of a complex tax avoidance scheme by asserting that the loan did not produce tax savings as the US has a much higher tax regime than the UK.<sup>44</sup>

## **Waking up to smell the coffee**

Following the tax avoidance claims, Starbucks agreed to review its UK tax structure in an attempt to win back public favour.<sup>45</sup> On 6 December, 2012, Starbucks UK pledged to implement changes which would increase the amount of tax paid by Starbucks to an amount higher than that required by law.<sup>46</sup> It announced that it would pay an additional £10 million of taxes in each of the following two years by not claiming tax deductions for royalties and standard intra-group charges made by the UK division.<sup>47</sup>

However, the move to pay ‘voluntary taxes’ invited public backlash; it was regarded as a move which “made a mockery” of the tax system<sup>48</sup> and was seen as “a desperate attempt to deflect public pressure”.<sup>49</sup> Despite its attempts at appeasing its stakeholders, protests continued at Starbucks chains.<sup>50</sup> Most notably, Starbucks was targeted by UK Uncut, a network of protest groups. Operations of Starbucks outlets were affected by the protests, deterring potential customers from visiting its outlets.<sup>51</sup> Consumers who were displeased with the actions of Starbucks turned to social media to spread dissent among the public, further aggravating public resentment.<sup>52</sup>

## **Trouble continues to brew**

On 11 June, 2014, the European Commission announced an in-depth investigation into whether the transfer pricing arrangements validated in the ruling issued by the Dutch tax authorities involved illegal state aid to the benefit of Starbucks Manufacturing EMEA BV.<sup>53</sup>

A year later, on 22 October, 2015, Margrethe Vestager, the EU’s competition commissioner, declared that the Starbucks’ favourable tax agreements with the Netherlands amounted to an illegal form of state subsidy.<sup>54</sup> Specifically,

the commission condemned the Netherlands for allowing Starbucks to use a series of internal transactions to shift profits outside the country to other lower tax jurisdictions.<sup>55</sup> Since 2008, the Dutch tax ruling had artificially lowered the corporate tax levied on Starbucks by €20 million to €30 million.<sup>56</sup> This was made possible by inflating royalty payments to a UK-based Starbucks entity, Alki, and setting unjustifiably high prices for coffee beans purchased from its Swiss subsidiary, Starbucks Coffee Trading SARL.<sup>57</sup> As a result, the Dutch tax authorities were ordered to recover the amount of tax avoided by Starbucks Manufacturing EMEA BV in order to remove the unfair competitive advantage previously accorded to the firm.<sup>58</sup>

## The changing tax landscape

In February 2015, the PAC met with HMRC about the latter's progress in developing a transfer pricing approach to curb tax avoidance in UK.<sup>59</sup> HMRC also set up a joint intelligence group with various tax authorities to gather information and challenge the reasonableness of corporate transfer pricing arrangements made by companies.<sup>60,61</sup> Subsequently, the EU also proposed measures to facilitate communication and more open information exchange of multinational companies' tax-related information amongst European countries.<sup>62</sup>

Arguably the most impactful change to the tax landscape came in October 2015, when the Organisation for Economic Co-operation and Development released the Base Erosion and Profit Shifting (BEPS) package for reform of the international tax system to tackle tax avoidance.<sup>63</sup> The BEPS project addresses numerous taxation issues, including the exploitation of loopholes in corporate tax rules worldwide.<sup>64</sup> One of the BEPS' 15 action plans is the maintenance of transfer pricing documentation by multinational corporations with sizeable intercompany transactions.<sup>65</sup>

With a growing worldwide focus to increase transparency and close loopholes in the existing tax systems, multinational companies would find it more difficult to use their size and international presence to escape paying taxes.<sup>66</sup> In light of this, multinational corporations, tax regulators and consumers alike will continue to keep a watchful eye on how large multinationals embroiled in tax controversies<sup>67</sup> would change their tax structures in light of the evolving tax landscape.

## Discussion questions

1. The PAC accused Starbucks of being 'immoral' in terms of how it handled its tax obligations. Do you think paying a 'fair' share of corporate taxes is part of upholding corporate social responsibility? Does this conflict with Starbucks' objective of maximising shareholder value? What can companies do to strike a balance between their obligations to shareholders and the need to be ethical?
2. Discuss the corporate governance issues arising from contentious transfer pricing arrangements. Given that other multinational corporations may also be using schemes to minimise taxes, does Starbucks have no choice but to follow the norms set by other companies?
3. Starbucks was able to minimize its tax exposure through its complex company group structure. What are some common governance issues faced by complex company group structures and directors in group companies? How can the governance of such company groups be improved?
4. Tax risk governance is becoming increasingly important to companies. What types of tax risks do companies face? What is the role of the board of directors and senior management in ensuring effective tax risk governance? How can companies establish an effective tax framework?

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# A VERY BLACK FRIDAY: TARGET'S CYBER SECURITY BREACH

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## Case overview

In December 2013, the Point of Sale (POS) systems of Target Corporation (Target) were breached and over 11 gigabytes of data were stolen from almost 2,000 Target stores in the United States (US). This included the private data of about 70 million customers as well as 40 million credit and debit card numbers. The attackers gained access to Target's sensitive databases where customers' private data were stored. Throughout this attack, Target staff had ignored multiple internal warnings from its anti-intrusion system and only found out about the breach from the Department of Justice 10 days later. The breach resulted in financial losses and reputational damage for Target. The objective of this case is to enable a discussion of issues such as the board and management structure of Target; the adequacy of its internal controls; the roles and behaviour of its management and employees; and the influence of these factors on the cyber security breach at Target.

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This is the abridged version of a case prepared by Brennan Phua Jia Hao, Lau Mei Fang, Lim Chu Wen and Chandralekha D/O Thanabalan 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 Raffles Ng under the supervision of Professor Mak Yuen Teen.

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## **The big red retail giant**

Founded in 1902, Minneapolis-based discount retailer Target sold household essentials, food and pet supplies, apparel and accessories, and home furnishings and décor as their major product ranges in its 1,790 stores in US and 124 stores in Canada in 2012.<sup>1</sup> With the promise of “expect more, pay less”, Target strived to be the favourite shopping destination in all channels by providing exceptional value, unceasing novelty and extraordinary experiences.<sup>2</sup>

## **An autocratic leadership**

Gregg W. Steinhafel, whose Target career as a merchandise trainee began in 1979, subsequently ascended the ranks to take on the role of president of Target in August 1999, Chief Executive Officer (CEO) in May 2008 and Chairman in February 2009.<sup>3</sup> Industry analysts have commented that under Steinhafel's leadership, Target's corporate culture of “Fast, Fun and Friendly” was clouded by bureaucracy and resistance to change.<sup>4</sup> It has been speculated that several top executives ceased communications with Steinhafel owing to differences in opinion.<sup>5</sup> A comment from the ground that all staff are expected to strictly conform to the instructions and then challenge if they do not agree, further supports the assertion of Target's bureaucratic culture.<sup>6</sup>

## **Tone at the top**

Apart from Steinhafel who was the CEO and Chairman, the other 11 directors on the board were independent from management. Steinhafel was not independent from management and this was a matter raised during the annual general meeting in 2013, the year of the POS attack.<sup>7</sup>

Supported by the four-member Audit Committee (AC), whose role was to oversee risks, as well as the five-member Corporate Responsibility Committee (CRC), which focused on reputational risks<sup>8</sup>, the board undertook the responsibility of ongoing oversight of the business.<sup>9</sup> Among Target's 12 executive officers, the Chief Information officer (CIO), Beth M. Jacob, who also took on the role of senior vice president of technology services, was responsible for online security.<sup>10</sup> Her

prior experience mainly involved “being an assistant buyer in Target's Dayton's department store division, Director of guest contact centers, and vice president of guest operations”.<sup>11</sup>

## **A pretty front porch**

Faced with internal pressures and external challenges during the global financial crisis between 2007 and 2009, Target had to strengthen oversight of its enterprise-wide risks. Furthermore, with its expansion in retail offerings, the firm inevitably increased its portfolio risks. The US Securities and Exchange Commission (SEC) regulations and the requirements in Standard & Poor's (S&P)<sup>12</sup> credit rating process further reinforced the importance for Target to incorporate an Enterprise Risk Management (ERM) program in the organisation. As such, the firm examined diverse ways to reinforce the value of its risk management efforts, placing greater emphasis on risks associated with its core strategies.

In 2012, one of the key objectives of Target's risk management efforts was to “protect the security of personal information about (its) guests and team members”<sup>13</sup>, by preventing unauthorized access and sabotage of its systems and services.<sup>14</sup> It also recognised the significant potential costs resulting from government enforcement actions and private litigation, as well as the reputational damage owing to a potential failure to protect customers' personal information.

## **Self-assurance is your new best friend**

Coincidentally, in the beginning of 2013, the SEC raised the question as to whether any such breaches have occurred in the past.<sup>15</sup> In response, Target's executive vice president and Chief Financial Officer, John J. Mulligan stated that after reviewing the nature, severity and frequency of the data security incidents that they have experienced, the retail giant concluded that these incidents would not individually or in the aggregate be deemed important by a reasonable investor with respect to an investment decision concerning their company.<sup>16</sup> Mulligan also affirmed that the potential data security incidents and the effectiveness of security measures would be closely monitored.<sup>17</sup>

## When Target became a target

It was speculated that before the breach took place, the attackers may have relied on a simple Google search to retrieve information about Target's systems, as well as how the retail giant interacted with its vendors.<sup>18</sup>

Two months before the breach, Fazio Mechanical (Fazio), one of Target's refrigeration vendors, received an email containing a Citadel malware, a password-stealing bot program.<sup>19</sup> This malware could have been easily detected by most versions of anti-malware software. However, unsubstantiated sources found that Fazio used the free version of Malwarebytes anti-malware, which did not offer real-time protection as it was an on-demand scanner.<sup>20</sup> Utilising the Citadel malware, the attackers could eventually gain access into Target's systems through this vendor portal because Target had failed to properly secure or limit such access.<sup>21</sup>

## The hefty price of vulnerabilities

Using information provided by the Microsoft Target case study, the attackers could further infiltrate and manoeuvre through the network via back doors and other vulnerable systems, into the more sensitive networks of Target that held its consumers' data.<sup>22</sup> This could not have been accomplished if Target had employed proper network segmentation practices, to segregate and isolate its sensitive network and assets.<sup>23</sup> It was later discovered that many of its systems were outdated and missing critical security patches. The intruders could exploit these vulnerabilities to surf through Target's internal network without the need for any authentication.<sup>24</sup>

The attackers were believed to have used a series of unsophisticated tactics, such as uploading malicious programs and renaming them to seem like legitimate files, as well as querying Target's Active Directory and DNS server to extract the information and data they required. It was then believed that they created a new domain administrator account by stealing an access token which gave them temporary access to the Active Directory as an administrator. These abnormal behaviours should have been detected and mitigated by a simple process of activity monitoring.<sup>25</sup>

## The first loot and subsequent change of target

The attackers then used a variety of tools and programs to bypass firewalls and network security, and to gain remote access to their targeted system. These activities required user authentication and authorisation from the Active Directory, which implied that anyone monitoring the Active Directory would have detected them. Furthermore, it was found that Target's password policy was not being followed. It had valid network credentials stored on various servers, and it utilised weak or default passwords on its systems and services.<sup>26</sup> Once the attackers gained access into Target's database servers, they managed to steal the private data of 70 million customers. However, due to Target's compliance with the Payment Card Industry (PCI) standards, the attackers did not have access to credit cards as the databases did not store any credit card data.<sup>27</sup>

Having failed to locate the credit card details, the attackers switched their focus to the POS systems, which they accessed using a vulnerable domain controller. A custom-made malware was then installed on these POS systems. This malware then gathered information from credit cards as they were swiped, saved this information to a local file, and periodically copied such local files to a remote file sharing platform which was created on a remote FTP-enabled (File Transfer Protocol) machine.<sup>28</sup>

## Turning a blind (fire) eye

On 2 December, 2013, the attackers began to download the stolen data to Russian servers via FTP, where the attackers retrieved them using a default username and password.<sup>29</sup> Six months prior to the breach, Target spent US\$1.6 million on a sophisticated anti-malware system, FireEye. It detected all malware installed by the attackers, and could automatically eradicate them without any human intervention. However, this feature was turned off, as it was believed that Target's security personnel still had doubts about the newly purchased system.<sup>30</sup>

Upon detecting the malware, FireEye repeatedly alerted Target staff in India, who then notified their counterparts in Minneapolis.<sup>31</sup> Unfortunately, these warnings were ignored and no subsequent action was taken, allowing the attackers to successfully install multiple malware on Target's system and export data from its network.<sup>32</sup> The stolen credit cards were eventually sold on the black market.<sup>33</sup> Had appropriate actions been taken in response to these warnings, the entire heist could have been prevented.<sup>34</sup>

## **Coming out of the closet**

Target was notified of the breach by the US Department of Justice on 12 December, 2013, after the federal law enforcer found data that was carelessly left on the temporary US servers by the attackers. This marked the start of Target's internal investigations.<sup>35</sup>

Amidst the cauldron of media speculation and customers' criticism, Target eventually acknowledged the breach through a press release on 19 December, 2013, a week after the notification of the breach.<sup>36</sup> This marked the beginning of Target's uphill battle to address the consequences that followed. With the payment card information of over 40 million customers compromised, Target would not only suffer from financial losses, but also from the potential damage in reputation and public backlash.

## **Drowning in flames**

In early 2014, the shareholders of Target filed a derivative lawsuit against the directors and officers of Target for inadequate development and inspection of an information security program, as well as failing to provide a timely and transparent disclosure of the breach to its stakeholders.<sup>37</sup>

Simultaneously, Target's customers flooded the retail giant's social media platforms with comments signalling their disappointment and intention to boycott its retail stores in the future.<sup>38</sup> As the number of affected customers continued to spiral during the December peak holiday shopping season, risk averse customers were unwilling to patronise the stores, fearing that a second wave of security breaches may occur. This had a significant impact on Target's fourth quarter financial



performance as it reported a 46% drop in profits compared to the same quarter in the previous year.<sup>39</sup>

## **So long and goodbye, with a hole in the pocket**

On 5 May, 2014, nearly five months after the breach, Target's board announced Steinhafel's resignation from his position as the CEO and Chairman.<sup>40</sup> Jacob had also stepped down from her position as CIO two months before.

By the end of 2014, the cost of the breach amounted to US\$162 million and this was expensed in Target's income statements for 2013 and 2014.<sup>41</sup> However, this figure excluded the related expenses from lawsuits filed against the company, as well as the loss of potential sales and customer goodwill. Daniel Binder, an analyst at Jefferies, estimated the potential financial impact of the breach to be in the billions.<sup>42</sup>

To seek compensatory damages for their financial losses, various parties including customers and banks filed class action lawsuits against Target on the basis of negligence. In 2015, the legal battles finally came to an end. Target had reached settlements with customers for US\$10 million in March 2015, with Visa for US\$67 million in August 2015 and with several US banks which service MasterCard for US\$39 million in December 2015.<sup>43</sup>

## **Target gets a facelift**

Subsequent changes made to the board and senior management positions included the extension of the former CRC to become the Corporate Risk and Responsibility Committee (CRRC).<sup>44</sup> The AC became a team of five directors after the introduction of a new member.<sup>45</sup> Furthermore, two new roles were also introduced to ensure that Target and its stakeholders are safeguarded from internal and external information security threats, as well as to provide a centralised oversight of the ERM, compliance, vendor management and corporate security of Target. They were namely, the Chief Information Security Officer and the Chief Risk & Compliance Officer, taken on by Brad Maiorino<sup>46</sup> and Jacqueline Hourigan Rice<sup>47</sup> respectively. Furthermore, Robert DeRodes and Brian Cornell took up the role of the CIO<sup>48</sup> and CEO and board Chairman<sup>49</sup> respectively.

## The new and improved ‘ERM 2.0’

Target separated its ERM function from its internal audit and finance functions, placing the former under the charge of the CRRC. A new risk associated with cyber-security was also identified and addressed in its annual report, which stated: “A significant disruption in our computer systems and our inability to adequately maintain and update those systems could adversely affect our operations and our ability to maintain guest confidence.”<sup>50</sup> New measures were also introduced to mitigate the risk of cyber-security threats. For instance, it was announced that Target would adapt “chip and PIN” – a significantly more secure and novel debit and credit card technology – by early 2015.<sup>51</sup>

## No longer a target

As of 7 April, 2016, it was reported that the security breach had cost Target a whopping US\$291 million overall, which included legal fees, crisis communications and forensics costs.<sup>52</sup> Unfortunately, only less than one-third of the costs was expected to be covered by cyber insurance. Target would also pay a US\$18.5 million multistate settlement to consumers – the biggest amount for a data breach to date – “to resolve state investigations of the 2013 cyber-attack”.<sup>53</sup> The company would also implement new standards on handling customers’ confidential information. It was indeed an expensive lesson to be learnt by Target. However, with new and improved measures in place, the retail giant has readied itself in the event that it again becomes the target of a cyber-attack.

## Discussion questions

1. Evaluate the adequacy of the board and management structure of Target and their role in Target’s risk management practices before the breach. How would the board’s role in risk governance and management have changed if Target had to comply with SGX Listing Rule 1207, and Principle 11 of Singapore Code of Corporate Governance?
2. “People are always the weakest link in the internal control framework.” To what extent do you agree with this statement with reference to this case? What are some of the other weaknesses in Target’s internal controls and how can they be better managed?

3. "Target passed PCI compliance audits prior to this breach, indicating they had implemented security required by the credit card processing industry." Fazio Mechanical issued a statement claiming Target was compliant with industry standard information security regulations. Do you think compliance with such baseline standards are sufficient to prevent such breaches from happening? Why or why not?
4. Evaluate Target's crisis management plans and suggest how they could have better responded to the breach.
5. In 2014, a year after Target's breach, Home Depot faced a similar security breach. What could Home Depot have learnt from Target to have prevented this similar breach from happening?

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# THERANOS: THE UNICORN THAT LOST ITS HORN

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## Case overview

On 15 October, 2015, the Wall Street Journal published an exposé alleging problems with Theranos' ostensibly revolutionary blood analysis laboratory instrument, Edison. Theranos' fall from grace continued when subsequent investigations led by the US Food and Drug Administration and Centers for Medicare and Medicaid Services uncovered irregularities in Theranos' laboratory procedures and equipment. The objective of this case is to allow for a discussion of issues such as corporate governance in private companies; board composition; and roles of various stakeholders in private companies.

## Birth of a billion-dollar unicorn

Theranos was founded in 2003 by Stanford dropout Elizabeth Holmes, who was then only 19 years old. Holmes, who suffers from trypanophobia – the fear of needles – was determined to invent a product that could help other trypanophobia sufferers undergo blood tests with minimal distress.<sup>1</sup> In the summer of 2003, Holmes worked in a laboratory at the Genome Institute in Singapore. Upon her return to the US that fall, Holmes said to her professor, “Let’s start a company”.<sup>2</sup> Thus began the formation of Theranos.

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This is the abridged version of a case prepared by Linda, Mi Muqing, Moo Lee Yin and Ng Jia Jing Sheena 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 Tan Zhe Ren under the supervision of Professor Mak Yuen Teen.

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Just over a decade later, in 2015, Forbes crowned Holmes the youngest self-made female billionaire, with a reported net worth of US\$4.5 billion.<sup>3</sup>

Holmes belonged to a family whose wealth, power and political connections dated back to the 1890s.<sup>4</sup> She made use of these privileges to obtain much needed funding for Theranos. When many venture capitalists shied away from Theranos due to a lack of transparency over its technology, Holmes called upon her familial connections for funding. The company's first million dollars of investment funds was contributed by Timothy Draper, founding partner of venture capitalist firm, Draper Fisher Juvertson, and former neighbour of the Holmes.<sup>5</sup>

Theranos' unique value proposition lay in its proprietary technology which purportedly allowed it to run thirty laboratory tests using only one small drop of blood obtained through a finger prick. Theranos' services were known to be faster and cheaper than conventional blood tests whilst being at least equally accurate.<sup>6</sup>

In 2013, Walgreens, the second-largest pharmacy store chain in the United States, entered into a partnership with Theranos. At that time, Walgreens was under the leadership of then-CEO Greg Wasson, who was keen on investing in a potentially revolutionary new technology to boost the company's sales.<sup>7</sup> The deal benefited Theranos as well – the relatively new firm had a respected pharmacy ally to boost its brand and technology. The partnership also allowed Theranos to set up “Theranos Wellness Centres” at selected Walgreens stores. This facilitated the collection of blood samples at convenient locations near homes and workplaces.<sup>8</sup>

## **The all-star board**

Theranos's board of directors was mainly made up of Holmes' familial connections. Former US Secretary of State, George P. Schultz joined Theranos' board in 2011. Schultz subsequently recruited esteemed individuals such as Henry Kissinger, another former Secretary of State, Bill Frist, former US Senator, and Richard Kovacevich, former CEO and Chairman of Wells Fargo, to join him on Theranos' board. James Mattis, a four-star Marine General also joined Theranos' board in 2013, after retiring from the military. Mattis had previously helped Theranos dodge a bullet when it was questioned about the presence of unapproved medical devices in its blood testing technology in 2012.<sup>9</sup>

In July 2013, Theranos disclosed major changes in its board composition with the resultant board as shown:<sup>10</sup>

<b>Name of director</b>	<b>Background</b>
George P. Shultz	Former U.S. Secretary of State
Gary Roughead	Retired U.S. Navy Admiral
William J. Perry	Former U.S. Secretary of Defense
Sam Nunn	Former U.S. Senator who served as Chairman of the Senate Armed Services Committee and the Permanent Subcommittee on Investigations
James N. Mattis	Retired U.S. Marine Corps General
Richard Kovacevich	Former CEO of Wells Fargo
Henry A. Kissinger	Former U.S. Secretary of State
William H. Frist	Heart and lung transplant surgeon and former U.S. Senator
William H. Foege	Former director of the U.S. Centre of Disease Control and Prevention
Riley P. Bechtel	Chairman of the board of the Bechtel Group Inc
Sunny Balawani	President and COO of Theranos
Elizabeth Holmes	CEO and Chairman of the board of Theranos

*Table 1: Theranos' board in 2013*

Theranos' new board was heavily criticised by the public as it consisted mainly of ex-politicians with no background in biotechnology or medical testing. Aswath Damodaran, a professor at the Stern School of Business at New York University, expressed his doubts with regards to the board's expertise and abilities in fulfilling its duties. He also questioned Kissinger and Shultz's abilities to serve on the board due to their advanced age.<sup>11</sup>

In July 2015, in light of public criticism, Theranos restructured its board, scaling the size of the newly formed ‘governing board’ down to five members. Five displaced individuals – Kissinger, Shultz, Foege, Nunn and Frist – were re-appointed in different roles in Theranos. Foege and Frist became part of a new medical advisory board, while Kissinger, Nunn and Shultz became members of a new ‘board of counselors’. Both boards would continue to provide advice to Theranos. A new addition to Theranos’ governing board was David Boies, the Chairman of Boies, Schiller & Flexner LLP. Boies was also Theranos’ incumbent legal advisor.<sup>12</sup>

## **Double trouble – dual class shares**

In November 2015, Forbes ran an article detailing changes in the Theranos’ stock structure in 2013. The December 2013 shareholder letter called for shareholders’ agreement to create dual class shares via signing of a consent form:

“Class A Common Stock [would receive] 1 vote per share and Class B Common Stock [holders would get] 100 votes per share, with all of the Class A Common Stock held by Theranos founder and beneficial owner of a majority of our Capital Stock, Elizabeth Holmes, being exchanged for Class B Common Stock.”<sup>13</sup>

Theranos requested for shareholders’ consent to these changes “in anticipation of raising capital”. However, it failed to mention the amount of control Holmes would possess after the change in share structure. Additionally, despite official shareholder communication reporting that the proposal had “unanimous consent”, an interview with a Theranos shareholder revealed that he did not sign the consent form, and there was no mention that the failure to respond was tantamount to consent.<sup>14</sup>

In response to the leaked information, a spokesperson from Theranos highlighted the company’s status as a private company, and stressed that it was not at liberty to provide information about its investors, communications, and fundraising activities. Theranos also disputed allegations that the move was to cement Holmes’ control over the company by disclosing in a statement that Holmes already had a controlling stake in Theranos and that the 2013 consent action merely solidified her position to allow her to pursue long-term value creation for Theranos.<sup>15</sup>

## **Safeguarding Pandora's box**

Holmes employed secrecy and stealth as a preventive countermeasure against theft and corporate espionage. This culture of high confidentiality was extended internally, with departments working in silos. Essentially, the company's culture was one whereby "confidentiality [is] the essence of its existence".<sup>16</sup>

Holmes was also not a person who took criticism well. Several former employees pointed out that Holmes' steely focus made it difficult for her to acknowledge or even consider any potentially serious problems in the company's products. She would become angry and even dismiss employees who pointed out the company's flaws.<sup>17</sup>

## **More hype than reality?**

On 15 October, 2015, the Wall Street Journal (WSJ) ran an exposé that "stuck a pin in the Theranos' balloon".<sup>18,19</sup> Four former employees claimed that Theranos' famed laboratory instrument, Edison, handled just a small fraction of the tests performed by the company. The majority of tests was allegedly carried out using traditional laboratory machines that were purchased from competitors such as Siemens AG.<sup>20</sup>

### ***Cheating on proficiency tests...***

The WSJ reported that in April 2014, the New York State Department of Health received a formal complaint from a former employee with regards to testing practices at Theranos. This was then forwarded to the Centers for Medicare and Medicaid Services (CMS) for investigations.<sup>21</sup>

Further investigations revealed that Theranos had manipulated the proficiency testing processes, and failed to notify the relevant authorities about the imprecise test results from its Edison machines. Test results from the Edison machines differed from results obtained from instruments of other companies; the variance suggested that the Edison results were the ones that deviated from the norm.<sup>22</sup>

Additionally, leaked internal emails revealed that Ramesh Balwani, then President and Chief Operating Officer of Theranos, had instructed employees not to run the test samples on the Edison machines.<sup>23</sup> Former employees also claimed that Balwani specifically ordered laboratory personnel to only submit the test results from instruments of other companies for proficiency testing. Theranos' laboratory personnel admitted to doing what they were told, despite the fact that Theranos routinely used Edison machines for its regular testing for customers. This contravened federal rules.<sup>24</sup>

### ***...And yet again on common tests***

The WSJ also alleged that another 60 tests, including the most common tests, were outsourced to third party facilities for analysis. While Theranos claimed that it only outsources “highly complex” tests, records contradicted the claim.<sup>25</sup>

In addition, to generate a sufficient volume of blood for testing but still stay true to its “finger-prick” blood testing technology, the samples collected by Theranos were alleged to be diluted. This was frequently deemed by professionals to be a “poor laboratory practice”.<sup>26</sup>

### ***The one and only herpes test***

Despite the hype surrounding Theranos and its services, only one of the 100 Theranos tests submitted to the US Food and Drug Administration (FDA) had been approved as at the date of publication of the WSJ exposé – a herpes detection test.

Furthermore, in October 2015, the company was forced to stop drawing blood via finger-pricking for all tests, with the sole exception of the FDA-approved herpes detection test. An inspection conducted by the FDA also revealed that the “nanotainers” made and used by Theranos to collect finger-pricked blood were “unapproved medical device[s]”. The FDA also released two laboratory inspection reports on Theranos, which alleged poor record-keeping, mishandled complaints and a lack of quality audits.<sup>27</sup>

## ***Disputing allegations***

Theranos moved swiftly to dispute the allegations. Heather King, Theranos' general counsel, defended Balwani's instructions, asserting that they were consistent with the company's "alternative assessment procedures" developed to generate more accurate results. King also claimed that dilution of blood for testing was a common practice and that the "methods for preparing samples for analysis [were] trade secrets" and thus, could not be revealed.<sup>28</sup>

In a subsequent interview with Jim Cramer from CNBC, Holmes also responded to the allegations by claiming that the WSJ was trying to "sensationalise a technical issue".<sup>29</sup> She further stated that Theranos had always been upfront and transparent with regulators about its laboratory processes and that the company had always abided by all applicable regulations and industry guidelines.<sup>30</sup>

However, citing a need to protect its trade secrets, Theranos refused to provide evidence which would substantiate their rebuttal. In a press statement, Theranos stated that it was disappointed that the WSJ report relied only on the views of four "anonymous, disgruntled former employees".<sup>31</sup>

## **Public complaints**

The furore surrounding Theranos was further fuelled by prominent members of the public who chimed in with their own experiences using Theranos' services. Former Apple executive, Jean-Louis Gassée, claimed that the test results he obtained from Theranos differed significantly from the ones he had obtained from Stanford Hospital's Hematology Lab.<sup>32</sup> Roger Parloff of Fortune magazine, who earlier published an article praising Theranos, subsequently published another piece retracting his earlier comments and instead lambasted Theranos for "misleading" him through their marketing practices.<sup>33</sup>

In the medical community, an independent study conducted by the Journal of Clinical Investigations on Theranos revealed a higher sample collection rejection rate. Additionally, test results obtained from Theranos were flagged as abnormal 1.6 times more frequently as compared to other commercial laboratories.<sup>34</sup>

## **The last straw - CMS steps in**

On 25 January, 2016, the CMS published a letter highlighting the deficiency in practices of Theranos' laboratory. It advised that the company's practices posed "immediate jeopardy" to patients' health and safety.<sup>35</sup> A plan of correction was subsequently submitted by Theranos, but was deemed by the CMS to be "inadequate".<sup>36</sup> In light of this event, Walgreens temporarily closed one of the Theranos Wellness Centers, and planned to halt sending blood samples to the affected Theranos laboratory.<sup>37</sup>

## **Termination of the Walgreens-Theranos partnership**

In June 2016, Walgreens terminated its partnership with Theranos and closed operations at all Theranos Wellness Centres, believing that it was in Walgreens' customers' best interests to do so.<sup>38</sup> Walgreens mentioned bad test results and a federal investigation as the reasons behind the termination of the partnership, "effective immediately".<sup>39</sup> The pharmacy store chain thereafter sued Theranos for the violation of non-disclosure and confidentiality agreements.<sup>40</sup>

In response, Theranos slammed its former partner, stating in a company statement that "over the years, Walgreens consistently failed to meet its commitments to Theranos," and gave its commitment to "respond vigorously to Walgreens' unfounded allegations".<sup>41</sup>

In the following months, Theranos was hit by several other lawsuits from its major investor Partner Fund Management, as well as two other plaintiffs who invested in the blood-testing startup. The former accused the company of "fraudulently inducing" US\$96 million worth of funds from the hedge fund through "a series of lies, material misstatements, and omissions"<sup>42</sup> while the latter claimed that they were deceived by the company's false promises on the commercial viability of its revolutionary technology.<sup>43</sup>

## Epilogue

On 17 January, 2017, Theranos closed its last blood testing facility after its laboratory reportedly failed a regulatory inspection. Going forward, the company has decided to move away from its blood testing business to portable ‘lab-on-a-chip’ technology.<sup>44</sup>

On 16 May, 2017, Holmes disclosed that Theranos had closed a deal to give a number of its investors new stock in the company in return for them dropping potential legal claims against it. This saw Holmes giving back some of her equity to ensure that investors who did not participate in the aforementioned deal would not see a dilution of their shareholdings.<sup>45</sup>

Theranos was also served a two-year ban from participating in the clinical laboratory business and fined US\$30,000 in civil penalties. Theranos also announced a US\$4.65 million restitution package for all Arizona customers who used its services, as many of them had received faulty blood test results.<sup>46</sup>

In June 2017, Theranos informed its investors an “agreement in principle” was reached with Walgreens to settle its lawsuits for US\$30 million.<sup>47</sup> This placed a strain on Theranos’s diminishing cash reserves, which stood at approximately US\$54 million before the agreed payout. The company was also purportedly spending US\$10 million a month on legal fees. As a result, analysts speculated that unless Theranos is able to raise more cash, it will go completely dry by the end of 2017.<sup>48</sup>

Within a year, the former Silicon Valley darling’s value had dropped from US\$9 billion to US\$800 million in June 2017.<sup>49</sup> Similarly, its founder met with the same fate – Forbes dropped Holmes’ net worth from US\$4.5 billion in 2015 to “nothing” merely a year later.<sup>50</sup> With dwindling cash reserves and unhappy investors taking legal action against Theranos, the situation is all but rosy for the blood-testing startup. Will Theranos be able to revive investor confidence and survive past 2017, or will it go down in history as a sham?



## Discussion questions

1. Most disclosures on corporate governance practices in private US firms are made on a voluntary basis. Should there be rules in place to mandate compliance and disclosure for such companies? Evaluate the costs and benefits of doing so.
2. Consider the board composition in Theranos before and after the 2013 reshuffle. How might the change in the board composition or structure affect Theranos' corporate governance? In your discussion, consider Holmes' position and the directors' respective backgrounds and age.
3. Did any problems arise as a result of the change in Theranos' share structure? Explain its implications for the ownership and control of the company.
4. In light of the regulatory lapses and problems found in Theranos, do you think that the FDA, CMS and/or other regulatory bodies have done enough to prevent these issues? Discuss.
5. How do you think 'soft' corporate culture practices, such as the tone at the top, can influence employees' behaviours and the corporate governance efforts in an organisation?
6. The media played an important role in exposing the alleged fraud in Theranos. Discuss the role of the media in promoting good corporate governance. Are there factors that may limit its effectiveness in doing so?
7. Discuss whether venture capital investors in private companies like Theranos have a role to play in corporate governance.

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# THE VIACOM BLOCKBUSTER

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## Case overview

In June 2016, Sumner Redstone, with the support of his daughter, Shari Redstone, made the move to remove five directors from Viacom Inc's (Viacom) board. This included his long-time confidante and then-CEO of Viacom, Philippe Dauman. Dauman claimed that the move was orchestrated by Shari, who manipulated her father to gain control of Viacom. The global media conglomerate's boardroom tussle became the centre of a corporate saga which captivated the public. There were questions about Sumner's ailments and mental incapacity, and his ability to serve as Viacom's Executive Chairman. The public scrutiny of Viacom intensified and other corporate governance issues surfaced. The objective of the case is to allow discussion of issues such as those relating to founder-controlled companies; board composition and independence; succession planning; board remuneration; dual class shares; and role of activist investors.

## A brief history of Viacom

In 1987, Sumner gained control over Viacom International (the former Viacom) through a hostile takeover via his family business, National Amusements, Inc. (NAI).<sup>1</sup> To sustain the former Viacom's growth post-takeover, Sumner announced that he would split the US\$60 billion conglomerate into two companies in 2005, namely CBS Corporation and Viacom. Viacom was designated to develop high potential growth properties and channels.<sup>2</sup>

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Through Sumner's aggressive expansion strategy and a string of major acquisitions, Viacom grew to be the seventh largest media group globally<sup>3</sup>, running more than 250 channels in more than 180 countries and territories.<sup>4</sup> Some of its iconic assets include Paramount Pictures, Music Television (MTV), Nickelodeon, and Comedy Central.<sup>5</sup>

## The cast of the Viacom saga

As at the financial year (FY) 2015, Viacom had 11 directors on its board, of which six were independent. The board had three committees: the Audit Committee, the Compensation Committee, and the Governance and Nominating Committee. Each of these committees consisted solely of independent directors (ID). One notable ID was Frederic V. Salerno, who was the Chairman of the Compensation Committee and served as a member in the other two committees.<sup>6</sup>

Sumner has been Executive Chairman of Viacom since 2006, a position which he had been holding in the former Viacom from 1987 until its dissolution. According to Viacom's Definitive Proxy Statement, Sumner was re-elected in FY 2016 because of his position as Viacom's controlling shareholder through NAI.<sup>7</sup> Furthermore, Sumner's daughter Shari had also been serving on the board as Non-Executive Vice-Chairperson since 2006.<sup>8</sup> Shari and Sumner shared a tumultuous relationship which was peppered with public feuds.<sup>9</sup>

Another key player is Dauman, who has served as a non-independent director (NID) on the board of the former Viacom since 1987 and the current Viacom since January 2006.<sup>10</sup> He was appointed CEO of Viacom in 2006. Dauman shared a close relationship with the media mogul and was regarded as "the son Sumner wishes he had".<sup>11</sup>

Prior to 2016, both Shari and Dauman had been integral to Sumner's life. In 2015, both individuals were members of the seven-person Trust which would administer Sumner's 80% controlling interest in NAI in the event of his passing. NAI owned 79.8% of Viacom's voting shares while holding only 9.9% of its total outstanding shares.<sup>12</sup> The Trust was created for the benefit of the Sumner's five grandchildren, and was initially made up of Shari Redstone, Tyler Koriff (Shari's son), Philippe Dauman, George Abrams, David Andelman, Leonard Lewin and Norman Jacobs.<sup>13</sup>

## **A fading star of the media industry**

Despite Viacom's ownership of its iconic franchises and networks, it was unable to improve its financial performance in recent years. Viacom's shares tumbled more than 50% from 2014 to 2016.<sup>14</sup> In addition, Viacom's cumulative stock return of 38% since 2006 was lacklustre when compared to industry peers.<sup>15</sup>

## **Behind closed doors: The private life of Sumner Redstone**

Through his aggressive business strategy, Sumner successfully turned what was merely a few drive-in theatres into the global media conglomerate that Viacom is today.<sup>16</sup> Unfortunately, it was not only his business dealings which made the media headlines.

Sumner's colourful private life had long drawn the attention of the public and the press. He was notorious for being a serial womaniser with mistresses whom he showered with more than US\$150 million in gifts between 2010 and 2015. This included properties in Beverly Hills and cash cheques worth millions of dollars.<sup>17</sup> One of his mistresses, Manuela Herzer, eventually became the centre of the latest saga surrounding the media mogul.

Public concerns regarding Sumner's health surfaced when Herzer filed a lawsuit to declare him mentally incompetent. This was done in a bid to overturn Sumner's decision to appoint Dauman as his healthcare agent, effectively discharging Herzer from the position.<sup>18</sup> In addition, Sumner had his estate attorney evict her from his mansion<sup>19</sup> and deprived her of a share in his personal estate, valued at US\$75 million.<sup>20</sup>

## **Sumner, the “living ghost”**

In Herzer's lawsuit against Sumner, she claimed that Sumner was merely a “living ghost”<sup>21</sup> who was mentally incapable of making vital decisions, including the appointment of Dauman as his healthcare agent.<sup>22</sup> However, Dauman continued to reassure the public and shareholders that Sumner was mentally and physically able.<sup>23</sup> Dauman indicated that he regularly consulted Sumner on business matters and board meeting issues.<sup>24</sup>



In 2015, Sumner was absent from Viacom's annual meeting "for the first time in anyone's memory".<sup>25</sup> Subsequently, he did not physically attend any board meetings and was purportedly listening to the meeting discussions via telephone.<sup>26</sup>

Viacom's corporate governance guidelines state that "Directors are encouraged to attend all board and committee meetings in person, but may participate by telephone or video conference as needed".<sup>27</sup> This allowed Viacom to report that Sumner attended at least 75% of the board meetings held in 2015<sup>28</sup> and 2016.<sup>29</sup>

It was later revealed that Viacom continued to pay Sumner exorbitant amounts of compensation despite his questionable capacity to discharge his duties. He was paid US\$13.3 million and US\$2 million in 2014 and 2015 respectively.<sup>30</sup> This led investors to file a lawsuit in Delaware Chancery Court, accusing Viacom's directors of inefficiently spending the firm's resources by authorising an overly generous amount of compensation to Sumner.<sup>31</sup>

## Will Sumner last forever?

Sumner had always claimed that he would never step down from his position<sup>32</sup>, stating that "I have no intention of ever retiring, or of dying."<sup>33</sup> In January 2016, SpringOwl Asset Management (SpringOwl), an activist hedge fund sponsor with a non-voting stake in Viacom, contended that Sumner's non-committal attitude towards succession planning had led to the absence of a concrete succession plan.<sup>34</sup>

However, Dauman insisted that a succession plan had been put in place by Sumner two decades ago. According to Dauman, this succession framework would ensure that Viacom continue to have a "professional governance" after Sumner passes away or becomes incapacitated.<sup>35</sup>

As concerns regarding Sumner's health intensified, the ailing mogul was quoted saying that, "decisions about who will succeed me as chairman of CBS and Viacom will be made by the boards of the respective companies, and not by any individual." In respect of the matter, he further added that, "despite press reports to the contrary, such decisions have not yet been made."<sup>36</sup>

## **Is blood really thicker than water?**

On 11 December, 2015, Sumner sent a letter to Shari seeking to restore their relationship. He wrote, “I am very sorry to hear that others have excluded you ... from my house. That will never happen again.” Considering their infamous rocky relationship in prior years, this represented an abrupt reversal in their relationship.<sup>37</sup>

A few days later, Sumner instructed Dauman to consider Shari’s input when executing his role as his late-stage healthcare agent. As a result, Shari would possess the same responsibilities as Dauman in determining Sumner’s end-of-life care.<sup>38</sup>

On 2 February, 2016, Sumner gave up his Executive Chairmanship and was appointed in a newly created role of Chairman Emeritus two days later. Thereafter, Dauman succeeded him as the Executive Chairman. Dauman’s 2015 employment contract included a clause which required Viacom to compensate him with approximately US\$88 million<sup>39</sup> if he failed to succeed Sumner as the Executive Chairman.<sup>40</sup>

However, Shari cast a vote against Dauman’s nomination<sup>41</sup> citing that Dauman’s position in Sumner’s National Amusement Trust impeded his independence.<sup>42</sup> Shari released a statement stating that, “whoever may succeed my father as Chair...should be someone who is not a trustee of my father’s trust or otherwise intertwined in Redstone family matters...”<sup>43</sup>

## **Trust issues: The tussle over NAI**

During Dauman’s tenure as Executive Chairman, he angered Sumner when he pushed for a sale of a minority stake in Paramount Pictures, claiming that Sumner approved it. Although the sale did not materialise, Sumner made the decision to oust Dauman and George Abrams from the seven voting members of the National Amusement Trust on 21 May, 2016.<sup>44</sup>

On 24 May, 2016, Sumner announced that Thaddeus Jankowski and Jill Krutick would replace Dauman and Abrams in the Trust.<sup>45</sup> The new replacements were long-term allies of Shari. Jankowski, general counsel of NAI, had worked for the Redstone family for 35 years. Krutick was a long-time friend of Shari and a former Wall Street analyst who covered Viacom.<sup>46</sup> The removal of Dauman and Abrams gave Shari greater control of the seven-member Trust in which she, along with her son and her mother's divorce attorney, were already members.<sup>47</sup> According to C. Kerry Fields, a corporate governance expert at the University of Southern California's Marshall School of Business, Shari was "lining up her alliances and pruning those that aren't in agreement. She's trying to line up her alliances for when her father passes."<sup>48</sup>

This triggered the power struggle between Shari and Dauman over the Trust. The winning party would have the power to endorse the current leadership at Viacom, install a new board and executive team or make important decisions in relation to the companies in the event that Sumner passes away or is deemed incapacitated.<sup>49</sup>

With the intention of gaining power over the Trust, Dauman and Abrams filed a lawsuit in Massachusetts to challenge their removal from the Trust. They claimed that Sumner was under the "undue influence" of Shari, who wanted to control his assets.<sup>50</sup>

## **Dauman: A flop in the making?**

Viacom's executive compensation policy was designed to align executives' interests with that of shareholders.<sup>51</sup> However, the compensation structure laid out in Dauman's employment contract was apparently largely composed of non-equity cash remuneration.<sup>52</sup>

Dauman received a total cumulative amount of US\$425 million from FY 2011 to FY 2015, amounting to an average of US\$85 million a year. Dauman was no stranger to the highest-paid CEO list since his appointment as CEO of Viacom. According to the Equilar 200 Highest-Paid CEO Rankings, Dauman was ranked 11th and third in terms of pay for U.S. public companies for FY 2014<sup>53</sup> and FY 2015<sup>54</sup> respectively. Meanwhile, Viacom's shares did not perform as well as its peers in the same period.<sup>55</sup>

The SpringOwl report outlined the relationship between the falling Viacom Class B share price and the leadership of Dauman. After Viacom's board voted ten-to-one in favour of Dauman's promotion, SpringOwl commented that, "as evidenced by the negative reversal in the stock price, the market agrees with the position of both SpringOwl and Shari that someone other than Dauman should be the Chairman."<sup>56</sup> Taking into consideration the close relationship between Dauman and Sumner, shareholders were inclined to believe that the Chairman's excessive compensation was determined by how well he managed Sumner's interests rather than his contributions towards the firm.<sup>57</sup>

On 19 February, 2016, the Institutional Shareholder Services (ISS) opposed the re-election of six directors, including Dauman and the Compensation Committee's members.<sup>58</sup> ISS felt that the equity award component of Dauman's pay did not tie in with the company's performance. In response, Viacom disputed the claim, stating that "the Viacom board pays great attention to its governance and its responsibilities to all stockholders."<sup>59</sup> Eventually, Dauman and the directors were approved for re-appointment at the 2016 annual general meeting.<sup>60</sup>

## **Directors' independence: To be or not to be**

The saga drew the attention of activist shareholders to the independence of Viacom's board members.<sup>61</sup> In 2016, Viacom's board of directors elected Salerno, who had known Sumner for decades<sup>62</sup>, to the newly created role of lead independent director. Salerno had served as a director of the former Viacom since 1994 and continued to hold this position in the current Viacom. During this time, he was also director of other firms such as uPlayMe Inc, Magfusion Inc, Akamai Technologies Inc, and Intercontinental Exchange Inc.<sup>63</sup>

Deborah Norville was another ID of Viacom who was appointed to the board on 21 March, 2013.<sup>64</sup> Norville is a famed television journalist who hosted a show produced by Redstone-controlled CBS.<sup>65</sup>

Other board members such as Blythe J. MacGarvie, Charles E. Phillips and William Schwartz, had been sitting on the current Viacom's board for 9 years, 12 years and 29 years respectively.<sup>66</sup>

## Sumner means business: The board shake-up

In June 2016, Sumner made the move to remove five directors from Viacom's board, including all members of the Governance and Nominating Committee.<sup>67</sup> The Chairs of both the Compensation and Audit Committees were also placed on the chopping block. The five ousted directors include Dauman and Salerno. According to Salerno, the attempt was made without the consent of the Governance and Nominating Committee<sup>68</sup> and the due process set out in Viacom's corporate governance guidelines was not adhered to.<sup>69</sup>

The five new Viacom board members are Kenneth Lerer, Thomas May, Judith McHale, Ronald Nelson and Nicole Seligman. Four of the five new Viacom board members are also board members of five other companies besides Viacom.<sup>70</sup> Some of the new appointees, such as Seligman and Lerer, had a close relationship with Shari.<sup>71</sup> The introduction of these new board members would guarantee Sumner and Shari a seven-to-four board majority for the removal of Salerno, eliminating the possibility of a five-five deadlock if Sumner was deemed incapacitated.<sup>72</sup>

Faced with the removal attempt, Salerno filed a suit in the Delaware Court of Chancery to invalidate the removal.<sup>73</sup> He asserted that "Shari's actions have affirmatively harmed the public stockholders, who collectively held an approximate 90.1% equity interest in Viacom".<sup>74</sup> Salerno and Dauman believed that Shari was manipulating the mentally incapable Sumner to remove the board's directors.<sup>75</sup>

NAI then filed a suit in the Delaware Court of Chancery, seeking an affirmation of its right to remove the five directors.<sup>76</sup> Its lawyers contended that the Viacom's bylaws allowed shareholders to use written consent to "take any action that may be taken at an annual or special meeting."<sup>77</sup>

## Money, money, money, in a rich man's world

Ultimately, Dauman was ousted as CEO in August 2016 and left his position as Non-Executive Chairman in the following month.<sup>78</sup> In 2016, he received US\$93 million in compensation, of which US\$58 million were termination benefits.<sup>79</sup> Investors expressed their concerns<sup>80</sup> over this high severance package as it was not justified considering Viacom's poorly performing shares.<sup>81</sup>

## The tale of the dual class shares

The legal battle for the control of Viacom placed a greater focus on its dual-class share structure.<sup>82</sup> Only Viacom's Class A shares contains voting rights<sup>83</sup>, of which Sumner effectively controls about 79.8% through NAI.<sup>84</sup> Public shareholders who mostly own Class B shares are unable to vote even though they have an ownership of 87.4%.

During Viacom's March 2016 shareholder meeting, Seamus Finn, director of Socially Responsible Investing for Missionary Oblates, submitted a proposal for a share recapitalisation plan to give each shareholder one vote per share.<sup>85</sup> This proposal was opposed by Viacom.<sup>86</sup>

In its 2016 Securities and Exchange Commission filing, Viacom wrote that the dual-class structure “has helped protect our company from short-term pressures and the disruption associated with efforts by activists to challenge control”, which “thereby allowed our board and senior management to focus on our long-term success”.<sup>87</sup>

## The end of an era

In December 2016, Sumner decided to call it quits by leaving Viacom's board.<sup>88</sup> Shari continues to keep her Vice-Chairmanship, and Robert Bakish was appointed as Viacom's new CEO. He enthusiastically claimed that “there's much work to be done, but we are confident we have the plan and people to take our brands to greater heights and build a bright future for our company”.<sup>89</sup> Sumner's reign has ended, but it remains to be seen if Viacom can rise from the ashes.

## Discussion questions

1. Discuss the corporate governance challenges associated with founder-controlled companies such as Viacom.
2. Evaluate Viacom's board composition before the saga. Highlight potential corporate governance issues which may result from the original board composition before the saga and evaluate if the changes to the board composition brought about by the board shake-up in 2016 have addressed the issues.
3. Do you think that Sumner Redstone should keep his seat as the Executive Chairman on the board of Viacom? Is Viacom's current succession plan effective in ensuring a smooth leadership transition? Suggest some improvements that could have been made to the succession plan.
4. Do you think the remuneration packages received by Dauman were appropriate? What changes should Viacom implement in its executive compensation package?
5. Evaluate Viacom's argument for the dual-class shareholding structure in Viacom. Do the benefits justify the costs to the public shareholders? What are some of the safeguards that can be applied by regulators to protect the rights of public shareholders?
6. The role of activist investors in the saga cannot be overlooked. Evaluate the effectiveness of their actions and calls for a better corporate governance in Viacom. Has the board responded effectively to their calls? If not, what would you do, as a board member, to address the concerns raised by the activist investors?

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# WELLS FARGO: FORGONE REPUTATION?

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## Case overview

On 8 September 2016, Wells Fargo announced that it had agreed to pay fines amounting to US\$185 million to the Consumer Financial Protection Bureau, regarding allegations of Wells Fargo's sales practices. Given its outstanding past performance, how did Wells Fargo end up breaking its customers' trust, and how did it respond to the crisis? The objective of the case is to allow a discussion of issues such as corporate culture; the dual roles of Chairman and Chief Executive Officer (CEO); executive remuneration plans; risk management policies; and the role of the board, external regulators and authorities.

## The Wells reputation

“Our values should guide every conversation, decision, and interaction.”

– *The Vision and Values of Wells Fargo*<sup>1</sup>

NYSE-listed Wells Fargo is one of the world's largest financial institutions, serving 70 million customers<sup>2</sup> and boasting total assets amounting to US\$1.9 trillion.<sup>3</sup> Its market capitalisation of around US\$240 billion in early September 2016 made it one of the most valuable banks in the US.<sup>4</sup> It also received accolades such as ‘Best Bank in North America (2016)’ by the Global Finance Magazine.<sup>5</sup>

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This is the abridged version of a case prepared by Dominic Wong Ngiap Chuang, Yeo Jing Wen and Lee Chang Cheng 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.

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Being a largely conservative and conventional lender allowed Wells Fargo to weather the financial crisis of 2008<sup>6</sup> and outperform its competitors in customer satisfaction surveys.<sup>7</sup> In his 2015 letter to shareholders, then-CEO John Stumpf attributed Wells Fargo's success to the relationships fostered with customers, and stated that the trust placed in the bank would never be taken for granted.<sup>8</sup>

## **John Stumpf: The stagecoach driver**

Stumpf worked his way up the corporate ladder in the loan department of Norwest Corp and joined Wells Fargo when the two firms merged in 1998. He was appointed CEO in 2007 and Chairman in 2010<sup>9</sup>, and was subsequently awarded 'Banker of the Year' by American Banker in 2013 and 'CEO of the Year' by Morningstar in 2015.<sup>10</sup> In 2015, his remuneration amounted to US\$19.3 million.<sup>11</sup>

## **Broken trust**

On 8 September, 2016, it was revealed that Wells Fargo's employees had opened about two million unauthorised deposit and credit card accounts since 2011 to satisfy sales goals and earn financial rewards under the bank's incentive-compensation programme.<sup>12</sup> Sales figures were inflated by moving funds from existing accounts into unconsented new ones, and by creating unconsented applications for credit card accounts. This also increased earnings from unwarranted charges such as overdraft fees on original accounts.<sup>13</sup> The fraudulent misconduct was attributed to the obsessive sales-driven culture at Wells Fargo<sup>14</sup>, which previously surfaced in a 2013 report by the Los Angeles Times (LA Times), and may have gone back more than 10 years.<sup>15</sup> Wells Fargo had caught onto the problem internally, with then-CEO and Chairman, John Stumpf, himself unsurprised by the 2013 article.<sup>16</sup>

Fines totalling US\$185 million levied by regulators represented a minor setback for a bank bringing in annual profits of over US\$20 billion.<sup>17</sup> However, Wells Fargo's stock price plunged to a two-and-a-half year low and its reputation was damaged, as reflected in a survey done by consultancy firm cg42, which showed negative perceptions of the bank rising to 52% from 15% during the period prior to the scandal.<sup>18</sup>

## The “Gr-eight initiative”

After the scandal broke, fingers were pointed at Stumpf for allowing a sales-driven culture to perpetuate in the company.<sup>19</sup> Contrary to the prudent approach to managing risk described in Wells Fargo’s annual report<sup>20</sup>, one of Stumpf’s mantras was “eight is great”<sup>21</sup>; employees were pushed to sell at least eight financial products per household in what was known internally as the “Gr-eight initiative”.<sup>22</sup> This cross-selling – pushing different products to the same customer – was a key strategy at Wells Fargo. In 2016, the average retail banking household reportedly used 6.27 Wells Fargo products.<sup>23</sup>

In a hearing with the Senate Banking Committee, Senator Elizabeth Warren of Massachusetts said that Stumpf touted cross-selling as one of the main reasons for investors to buy Wells Fargo’s stock and berated him for squeezing employees to the point that they cheated customers.<sup>24</sup>

## Corporate culture

Former employees alleged that they were trained to “push customers to open multiple accounts”<sup>25</sup> and were even coached on how to “inflate sales numbers”.<sup>26</sup> Branch managers were assigned quotas that were carried forward if targets were not met during the period. The number of new accounts, down to individual employees, were collected by district managers four times a day<sup>27</sup>, with warnings issued for unsatisfactory performance. Furthermore, financial incentives were pegged to cross-selling targets, with personal bankers receiving as much as a 20% bonus.<sup>28</sup> This resulted in a ‘pressure-cooker’ environment where employees sold products that arguably did not serve the best interests of customers.<sup>29</sup>

However, when rumours of the aggressive sales culture first circulated in 2013, executives like then-Chief Financial Officer (CFO) Tim Sloan denied any form of overbearing sales culture in Wells Fargo, adding that there were “multiple controls in place to prevent abuse” such as an ethics program for employees and a whistleblower hotline to notify senior management of potential violations.<sup>30</sup>

Wells Fargo eventually announced a revamped employee compensation and incentive plan effected in January 2017, which would not include any sales goals, and where performance evaluations would be based on customer service, usage and growth, instead of simply the number of new accounts opened. The new head of community banking, Mary Mack, described this as a milestone for Wells Fargo to restore trust both within and outside the organisation.<sup>31</sup>

## **Dual roles**

The dual roles held by Stumpf since 2010 was another point of contention. CtW Investments suggested that splitting the roles with an independent board Chairman “could help repair the bank’s broken compliance systems”.<sup>32</sup> Rafferty Capital, a brokerage firm, lambasted Stumpf’s lack of leadership as Chairman. Although there was a board meeting and the board could have clawed back the pay of the executives involved, no statement was issued on potential clawbacks. Rafferty Capital’s analyst stated that this represented “the strongest argument” for removing Stumpf as Chairman.<sup>33</sup>

After repeated calls, Stumpf resigned as CEO and Chairman of Wells Fargo on 12 October, 2016. Tim Sloan, who served as Chief Operating Officer (COO) from November 2015 to October 2016, was promoted to CEO, while lead independent director Stephen Sanger became the non-executive Chairman of the board. In December 2016, Wells Fargo amended its bylaws to require a separate Chairman and CEO<sup>34</sup>, as well as an independent Chairman and Vice-Chairman of the board. These moves were unconventional for banks in the US but were viewed favourably by analysts, such as Gerard Cassidy of RBC Capital Markets, who felt it “should help relieve some of the political pressures the company has felt.”<sup>35</sup>

However, there were concerns regarding the promotion of Sloan who, as COO, was in charge of the community bank and consumer lending divisions, the centre of the scandal. Among his critics was House Democrat Maxine Waters, who felt that the COO had the potential ability to stop the misbehaviour.<sup>36</sup> FBR Capital Markets also believed that new blood was required to solve the ‘toxic’ cultural problem.<sup>37</sup>

## Executive remuneration and accountability

After the 2008 financial crisis, large banks promised to recover large payouts from top bankers that were obtained through unlawful conduct, underpinned by the Sarbanes-Oxley Act and Dodd-Frank Act. However, Stumpf was walking away with US\$133.1 million<sup>38</sup> upon his resignation, including 2.4 million shares he accumulated<sup>39</sup>, despite a clawback of US\$41 million worth of unvested options.<sup>40</sup>

Stumpf's bonus scheme was designed to be directly tied to Wells Fargo's account growth. He received US\$4 million in awards in 2015 linked to factors such as growing "primary consumer, small business and banking checking customers".<sup>41</sup> Yale's Jeffrey Sonnenfeld believed that Stumpf should be subject to more clawbacks of amounts linked to meeting cross-selling targets, a view strongly shared by Senator Warren, who had accused Stumpf pressuring employees with sales targets to increase the stock value.<sup>42</sup>

Another executive under fire was the head of the community banking division since 2008, Carrie Tolstedt, who led retail operations and cross-selling efforts to customers. Tolstedt had resigned prior to the September revelation, and walked with a US\$125 million payout.<sup>43</sup> In 2014, Wells Fargo specifically disclosed cross-selling as a factor behind her multi-million dollar pay.<sup>44</sup> Having confirmed that Tolstedt's departure was partially linked to the unauthorised accounts, Stumpf and the board were criticised for allowing the huge payout instead of firing her for the misdeed. Eventually, Wells Fargo recovered US\$19 million but Tolstedt still left with US\$43 million in stock.<sup>45</sup>

## Board of directors

Wells Fargo's board faced scrutiny, with proxy advisory firms Institutional Shareholder Services and Glass Lewis calling for shareholders to vote against some or almost all of the incumbent directors.<sup>46</sup> Glass Lewis also advised against the re-election of two directors who were on too many other boards to effectively govern Wells Fargo.<sup>47</sup>

The company's board appeared to be well-equipped; it had a Corporate Responsibility Committee, Risk Committee and Audit Committee.<sup>48</sup> The board composition was also perceived as "admirable", with more than half the board members from minority groups, and its 15 directors boasting diverse backgrounds across industries such as banking, academia and government, including two former banking regulators.<sup>49</sup>

However, the board was seen to be largely inactive. For instance, the Corporate Responsibility Committee met only thrice in 2015, the minimum number set by board rules.<sup>50</sup> The board also remained mainly passive even when early warnings about the company's business practices surfaced in 2013. It took no action in early September to fire Stumpf or clawback his remuneration. Several reasons were cited for the board's inactivity. For example, directors often nominate themselves for re-election in the US, allowing them to remain on the board without difficulty.<sup>51</sup>

Another issue was the closeness of the board with the CEO, which was accentuated by the fact that the CEO himself was the Chairman of the board.<sup>52</sup> This was partially attributed to the directors' long tenures, with Wells Fargo's directors' average tenure of 9.7 years exceeding those of other S&P 500 companies and banks like J.P. Morgan and Citigroup, leading to an insular board and familiarity concerns.<sup>53</sup>

Various suggestions to improve board effectiveness were made. CtW Investment Group suggested the inclusion of new directors with experience linking employees' remuneration to corporate goals<sup>54</sup>, while shareholders such as New York City's pension funds, who found trouble understanding the responsibilities of board committees, called for fewer directors and greater clarity about their duties.<sup>55</sup>

## **Failure of the lines of defence**

All three lines of defence adopted as part of the bank's risk management policies had "let Wells Fargo down", according to the University of Maryland's Professor Rossi.<sup>56</sup> Professor Rossi also remarked that it is worrying for a bank "well known for its risk management prowess" to allow "poorly designed business objectives and incentive compensation" to overpower its strong risk culture.<sup>57</sup>

## Whistleblowing backfired

Stumpf highlighted that the whistleblowing culture at Wells Fargo allowed every employee, regardless of their position in the hierarchy, to “raise their hands” and speak out on issues<sup>58</sup>, and the bank mentioned confidential ethics lines as a platform for employees to submit constructive feedback.<sup>59</sup> However, reports showed otherwise. Ex-employee Bill Bado claimed to have used the hotline and sent an email to human resources (HR) to flag unethical sales activities but had his contract terminated eight days later due to “tardiness”.<sup>60</sup> At least five Wells Fargo employees had also sued the bank or filed complaints with regulators regarding similar treatment.<sup>61</sup> An Occupational Safety and Health Administration investigation also revealed that a former bank manager’s whistleblowing activity contributed to his termination in 2010. The bank was ordered to rehire and pay US\$5.4 million in compensation to the whistleblower.<sup>62</sup>

One former Wells Fargo HR official was also quoted saying that the bank “had a method in place to retaliate against tipsters” and found ways to fire these employees “in retaliation for shining light” on unethical sales practices.<sup>63</sup> In a letter to Sloan, senators reprimanded the bank for filing “defamatory statements to retaliate against employees who questioned the bank’s aggressive cross-selling practices”.<sup>64</sup>

## Regulators and auditors: The fourth line of defence

Much blame had been laid on the shoulders of Wells Fargo’s officers. However, according to the Financial Stability Institute of the Bank of International Settlement, regulatory supervisors and external auditors served as a fourth line of defence for banks.<sup>65</sup>

### *The auditor’s role*

Senator Warren questioned the quality of KPMG’s audit for its failure to detect the fraudulent practices at Wells Fargo.<sup>66</sup> She took particular issue with the internal controls over financial reporting audit, referencing KPMG’s conclusion that Wells Fargo had “maintained ... effective internal control over financial reporting.” while the illegal behaviour was ongoing.<sup>67</sup>

Several points were offered in KPMG's defence. As Forbes noted, auditors are not expected to actively seek out fraud if there is no material effect on the financial statements, which the bank contended were immaterial in this case. In addition, stricter tests on internal controls would unlikely have revealed a fraud either, unless there was a resulting material impact on figures.<sup>68</sup> Former Acting Chairman of the Public Company Accounting Oversight Board Dan Goelzer described such immaterial effects on the financial statements as outside the scope of the auditors' work.<sup>69</sup>

### ***Regulators asleep at the switch***

On 8 September, 2016, the Consumer Financial Protection Bureau (CFPB) announced that it had imposed a US\$100 million fine on Wells Fargo for its illegal actions, along with a US\$35 million fine by the Office of the Comptroller of the Currency (OCC) and another US\$50 million fine by the City and County of Los Angeles. The CFPB also required Wells Fargo to make full refunds to affected customers, and to hire an independent consultant to review and ensure proper sales procedures were in place. CFPB director Richard Cordray asserted that "because of the severity of these violations, Wells Fargo is paying the largest penalty the CFPB has ever imposed".<sup>70</sup> The OCC also imposed new restrictions on the bank, such as the banning of 'golden parachutes' and allowing the government to disapprove the hiring of certain executives.<sup>71</sup>

However, questions were raised as to why the agencies had not stepped in earlier. Referring to the 2013 LA Times report, Republican Jeb Hensarling, Chairman of the House Financial Services Committee, criticised the agencies for failing to uncover the improper sales tactics at Wells Fargo in a timely manner, suggesting that the OCC and the CFPB were "asleep at the switch".<sup>72</sup> On the other hand, Representative Democrat Carolyn Maloney defended the CFPB, indicating that they had maintained data, as well as acted and investigated customer complaints accordingly.<sup>73</sup>

### ***The Securities and Exchange Commission (SEC)***

In late September, three senators of the banking committee called for the SEC to launch an investigation into whether Wells Fargo had violated internal control provisions of the Sarbanes-Oxley Act, securities law, as well as whistleblower protection laws during the scandal.<sup>74</sup> On 3 November, 2016, Wells Fargo disclosed that it was facing a probe by the SEC, but left out details on what the SEC was investigating aside from its "sales practices".<sup>75</sup>

Other agencies involved in the investigation of Wells Fargo included the US Department of Justice<sup>76</sup> and the California Attorney General Office<sup>77</sup>, which could result in potential criminal charges for the bank.<sup>78</sup>

## **Shareholders**

Activist shareholders like Gerald Armstrong were critical about the matter, calling for clawbacks of large payments to top executives, or for an independent Chairman, at the time of the scandal.<sup>79</sup> Institutional investors, such as the California State Teachers' Retirement System, also mentioned that they encountered difficulties understanding the responsibilities of board committees, and felt Wells Fargo's board was slow to tackle the problem and disclose information.<sup>80</sup>

Warren Buffet of Berkshire Hathaway, Wells Fargo's largest shareholder, initially kept mum about the scandal, but broke his silence in November 2016. He revealed that he had not lowered his stake in the bank, calling it "a great bank that made a terrible mistake". Buffett was also supportive of Sloan's promotion, in direct contrast to critics' preference for an outsider.<sup>81</sup>

## **Moving forward: Will all be well?**

Half a year on from the revelation on 8 September, 2016, Wells Fargo has instituted various changes, ranging from new executives to improved company policies. These have placated some observers, but others remain sceptical of the bank's inherent profit-seeking nature. Looking ahead, the bank can be comforted by the fact that other equally sizeable companies have recovered from similar incidents. Yet, trust is something easily broken but not easily earned.

How Wells Fargo will do in the years to come remains to be seen.



## Discussion questions

1. How might John Stumpf's dual role as Chairman and CEO have affected Wells Fargo leading up to the scandal? Why do you think he held both roles despite the potential corporate governance issues? What measures are necessary mitigate the potential risks of combining the two roles and to what extent were those measures in place at Wells Fargo?
2. What is the role of the board of directors in ensuring the right corporate culture? To what extent do you think Wells Fargo's corporate culture contributed to the cross-selling scandal? What could the bank have done differently to avoid this problem?
3. What are the duties of a board of directors in light of this incident? Given the apparently admirable and competent board of directors at Wells Fargo, why did they not address the issue internally before it escalated to the public?
4. Examine the remuneration policies in Wells Fargo for both senior executives and employees. Did they contribute to the cross-selling scandal? What could have been done better?
5. It was said that the three lines of defence had failed at Wells Fargo. Explain the three lines of defence and what factors contributed to their failure. Did the federal regulators and external auditors act appropriately and quickly enough in response to the scandal?

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## About The Editor

Associate Professor Mak Yuen Teen

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.



Professor Mak served on committees that developed and revised the Code of Corporate Governance for listed companies in Singapore. He is a member of the Corporate Governance Council set up by the Monetary Authority of Singapore to review the Code in 2017. He also served on the Charity Council and chaired the subcommittees that developed and refined the Code of Governance for charities in Singapore.

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

Prof Mak developed the Governance and Transparency Index, a ranking of governance of listed companies in Singapore. He was the Singapore expert in the development of the ASEAN Corporate Governance Scorecard and Ranking and advisor for GEMS, a governance rating designed specifically for listed SMEs. In 2017, he also co-developed a new governance ranking for real estate investment trusts and business trusts in Singapore called GIFT, with the support of CPA Australia.

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

Professor Mak received the Corporate Governance Excellence Award from The Securities Investors Association (Singapore) in 2014, in recognition of his contributions to corporate governance in Singapore. In 2015, he received the Regional Recognition Award for Corporate Governance Contribution from the Minority Shareholders Watchdog Group of Malaysia.

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