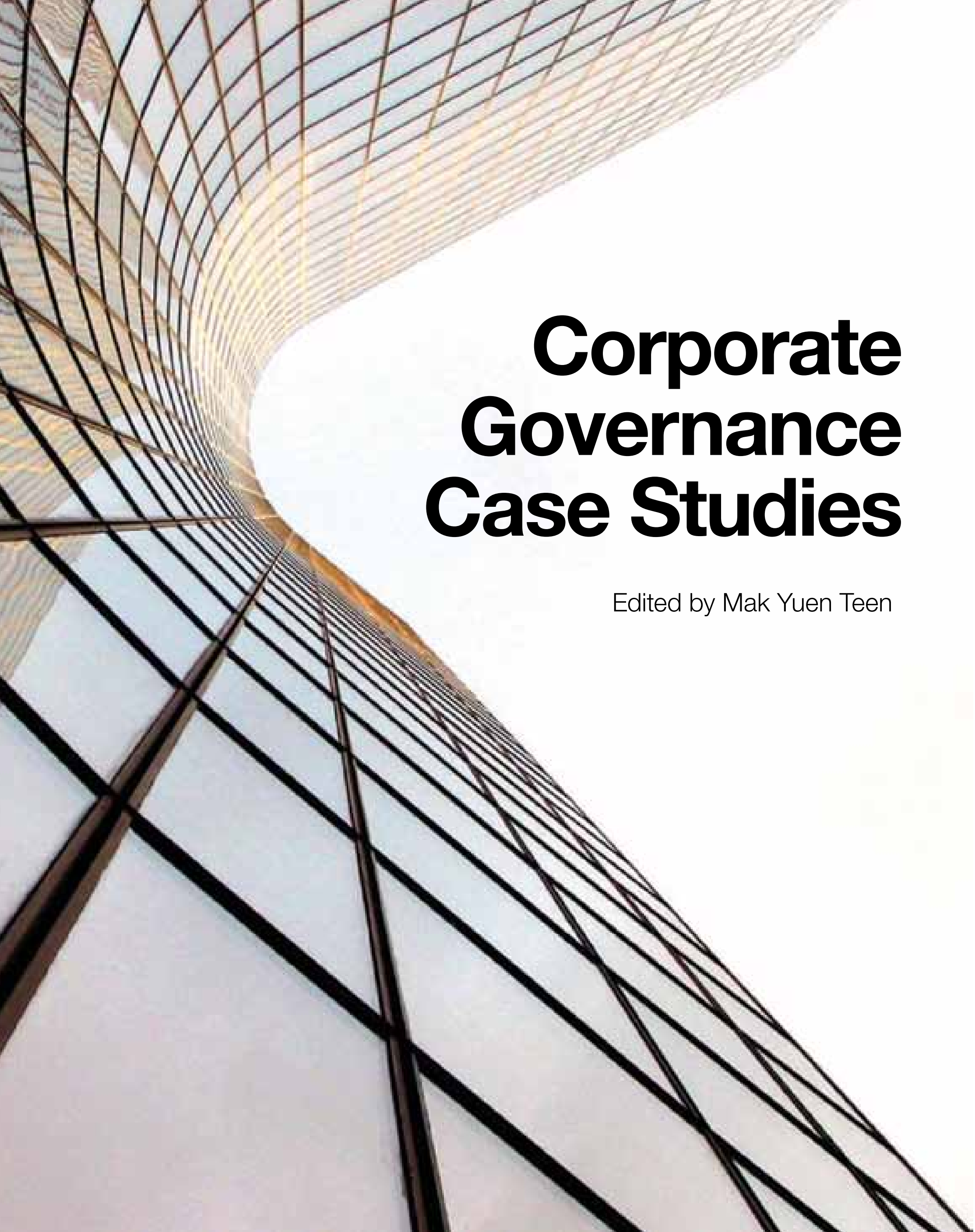

Corporate Governance Case Studies

Edited by Mak Yuen Teen

think+create

CPA AUSTRALIA

Foreward

Strong corporate governance and transparency are critical for business success. For investors, good governance is a good indicator of well-managed, resilient businesses. For companies, a measure of success is the ability to internalise the values, spirit and purpose behind governance rules.

While the governance standards in Singapore have brought us to where we are today, we have some way to go if we want to be seen as leaders in this area. Regulators, directors, management, investors, industry groups and professional bodies all have a part to play. The collective efforts of all these stakeholders will be needed to sustain the drive to improve governance and support the government's vision of positioning Singapore as a global financial centre.

This inaugural collection of teaching case studies aims to raise awareness and promote thoughtful discussions on key corporate governance issues in companies across several markets, particularly in Asia. The authors have endeavoured to present the facts and issues based on publicly-available information covering matters such as the board, board committees, ownership structure, corporate governance rules and regulations, auditors and remuneration. Following each case study are discussion questions which we hope will facilitate a robust exchange of views to help lead efforts to advance corporate governance standards and best practices in Singapore.

We would like to thank Associate Professor Mak Yuen Teen for supervising and editing the case studies produced by students of the NUS Business School. We trust you will find the cases a good starting point to study governance issues that may be relevant to your professional roles.

Deborah Ong FCPA (Aust.)
President – Singapore
CPA Australia

April 2012

Preface

In early 2010, I started coordinating and teaching the Corporate Governance and Ethics course at the NUS Business School. This is a compulsory third-level course for all students in the BBA (Accountancy) programme at the school. I thought that a great way for the students to learn is through case studies. Unfortunately, there are very few case studies in corporate governance, and even fewer which are Singapore- or Asian-focused. The lack of good Asian case studies in corporate governance has also been raised by practising directors and others involved in training programmes for directors. I therefore decided to incorporate a case writing component into the course by getting the students to form groups and write comprehensive cases as part of their course assessment.

This publication contains the abridged versions of 18 of these cases. The cases are diverse in many ways. Eight of these cases involve companies listed in Singapore, including some foreign companies. Five involve other Asian companies in Hong Kong, India and Malaysia, while the remaining five involve non-Asian companies. However, this is a simplification as the cases often cross national boundaries. For example, there is a bribery case which involves a Singapore company and Apple in the US. The case on the failed merger between SGX and ASX is really an international case. The reason why I also included non-Asian cases is because, while there are differences in rules, regulations and norms and unique corporate governance issues in Asia, the international cases allow the learning of differences around the world and also a comparison with Singapore and Asia. In any case, with globalisation, executives, accountants and regulators will increasingly need to understand corporate governance from a more international perspective.

The cases are also diverse in terms of issues raised. They illustrate that corporate governance is much more than about just rules and regulations or about legal duties and liabilities of directors. At the risk of simplification, four of the cases deal with mergers and acquisitions, two with privatisation, three with bribery, ethics and corporate responsibility, three with boardroom issues or conflicts, and five deal with corporate governance crises or scandals. However, each case inevitably touches on other issues, including regulatory frameworks; roles of directors, auditors, and regulators; executive and director compensation; shareholder activism; and so on.

It should be noted that the cases are written for the purpose of generating discussion and are intended to be used for analysis. Therefore, they do not include analysis or interpretation of the situations. Teaching notes which include some analysis and interpretation have been prepared. These teaching notes are only available to the instructor or facilitator using the cases for teaching or training. I believe the abridged versions will be useful for qualifying and continuing education programmes for directors, CFOs, accountants, regulators and other professionals.

Although the copyright for the cases resides with CPA Australia and me, it is not our intention to restrict the use of these cases or to profit from the copyright. Our general principle is that programmes which are commercial in nature should pay to use these cases so that funds can be generated to further this initiative or benefit charity. We would be open to free use of these cases in programmes which are non-commercial in nature, subject to permission being obtained from CPA Australia or me. Any surpluses generated from the publication of the cases will either be donated to charity or reinvested into this initiative.

I would like to thank CPA Australia for its generous support of this project. I am also grateful to the students who helped in editing these cases and, of course, to the students who helped in preparing the initial cases. They are acknowledged in the first footnote of each case. I would also like to specifically mention the capable support provided by the project manager, Kellynn Khor, who is doing a BBA degree in finance at the NUS Business School and a Master of Public Policy degree at the Lee Kuan Yew School of Public Policy.

I hope you will find this collection to be useful.

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April 2012

Content

Singapore Cases

Asia Cases

World Cases

C.K. Tang: The Fight towards Privatisation

Case Overview

In 2009, Tang Wee Sung, the majority shareholder of C.K. Tang Limited, along with his brother, Tang Wee Kit, finally succeeded in privatising the company after two failed attempts in 2003 and 2006. The major controversy surrounding the privatisation was the valuation of Tangs Plaza, a commercial property located in the prime shopping district of Orchard Road. Minority shareholders cited its undervaluation as the primary reason for rejecting the cash offer by the Tang brothers. The minority shareholders felt that the redevelopment potential of the property should have been taken into consideration. In 2011, the Tang brothers failed in their attempt to cancel out all remaining shares held by minority shareholders through a capital reduction exercise. The objective of this case is to allow a discussion of issues such as the divergence of interests between controlling and minority shareholders, the manifestation of this divergence in a privatisation situation, the different methods of privatisation which can be used and the extent to which they protect the interests of minority shareholders, and the role of the board, audit committee, independent financial adviser, regulator and shareholders in a privatisation.

This is the abridged version of a case prepared by Chew Yi Ling, Goh Theng Hoon and Thomas Sim Joo Huat 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. Consequently, 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 prepared by Koh Kian Sin under the supervision of Professor Mak Yuen Teen.

About C.K. Tang

C.K. Tang Limited is a Singapore-based company founded by Tang Choon Keng in 1932. The company is in the business of departmental store retailing and general merchandising. Since 1958, the company has been operating at its flagship building, Tangs Plaza, along Orchard Road[1]. C.K. Tang is a company characterised by the presence of a major controlling shareholder. For example, in June 2003, then CEO-Chairman Tang Wee Sung, the second son of the founder, owned 69.95 per cent of the company's shares[2].

In 1975, C.K. Tang was listed on the then Singapore Stock Exchange, which later became the Singapore Exchange (SGX)[3]. However, since 2003, the Tang family had been trying to delist and privatise the company[4]. After two failed attempts, the Tang family finally succeeded and the company was delisted on 24 August 2009[5].

In 2011, C.K. Tang made an offer to about 500 minority shareholders who had held on to the shares of the delisted company. This offer represented a 15 per cent premium over its fair value and well above the price offered to other shareholders for the delisting in 2009. However, some of these minority shareholders were still unwilling to take up the share buyback offer, and were holding out for a better offer[6].

Board of Directors

During the third and successful privatisation attempt, the board of C.K. Tang was chaired by Ernest Seow, a former PricewaterhouseCoopers (PwC) partner. Apart from Seow, there were three other directors with experience in accounting, business management and the retail industry. Among the four directors, three of them were serving as non-executive independent directors.

During the company's history, there was at least one Tang family member on the board[7]. However, in 2008, Tang Wee Sung, CEO and the majority shareholder of the company since 1987[8], stepped down from the board, after he was alleged to be involved in an illegal organ trading scandal.

With this development, for the first time in the company's history, there was no Tang family member on the board.

According to C.K. Tang's Corporate Governance Report in 2009, the board would be responsible for enhancing long-term shareholder value and the overall management of the Group. This includes reviewing the Group's performance, approval of corporate strategies and promoting high standards of corporate governance. The board delegated some of its functions to the board committees, namely the audit committee, nominating committee and remuneration committee.

First Privatisation Attempt: Scheme of Arrangement

On 29 October 2003, Tang Wee Sung offered minority shareholders S$0.42 per share via a scheme of arrangement[9]. This represented a premium of about 35 per cent above the average closing price over the last five trading days[10]. This price also meant a 19.2 per cent discount against the company's net tangible assets as at 30 September 2002[11]. However, the resolution failed to pass, as the shareholders felt the offer price was too low and wanted more information on the company's prospects[12].

Second Privatisation Attempt: Unconditional Cash Offer

In December 2006, Tang Wee Sung and his brother Tang Wee Kit, offered shareholders S$0.65 per share through Kerith Holdings[13], a company equally controlled by the brothers. This second attempt was in the form of a voluntary unconditional cash offer[14]. The S$0.65 per share offer reflected a 16.1 per cent premium to C.K. Tang's latest closing price at that time. It also represented a 9.4 per cent premium to the company's net asset value, based on its annual report for the financial year ending 31 March 2006[15]. When the offer deadline expired, insufficient acceptances had been received[16]. The reason was widely believed to be the undervaluation of the commercial property Tangs Plaza[17]. As a result, the company continued its listing on SGX.

On 15 July 2008, at an Annual General Meeting (AGM), minority shareholders questioned the board about the company's financial losses, as well as its plans to delist the company from SGX. The board declared that a privatisation exercise is solely the decision of the majority shareholder. The board said it owed a fiduciary duty to shareholders, which is to look after the business of the company.[18] Attempts to vote against standard resolutions such as advance payment of directors' fees were defeated, because of the Tang family's majority holdings[19].

Third Privatisation Attempt: Voluntary Delisting

On 8 May 2009, the Tang brothers made their third privatisation attempt through an investment holding vehicle, Tang UnityThree, which submitted a delisting proposal to the company. The remaining shareholders were offered S$0.83 per share[20], which represented a 22 per cent premium over the company's last traded share price of S$0.68 prior to the offer, and a 21 per cent discount to the firm's net asset per share price of S$1.05 as of 31 December 2008[21]. The board recommended that the minority shareholders accept the offer, based on an evaluation of the offer provided by the independent financial adviser PwC[22].

At an Extraordinary General Meeting (EGM) held on 31 July 2009, minority shareholders questioned if the offer was reasonable, given that the shares had closed at a price above the offer at that point in time. Nonetheless, the board retained its recommendation, saying that market prices typically varied[23]. This was despite earlier statements by the Tangs saying that the privatisation offer was to allow shareholders to monetise the value of their investments at a premium over its historical trading prices[24].

Shareholders also reproached the directors for failing to clarify with the Tangs about their redevelopment plans for Tangs Plaza after its privatisation. They expressed disappointment with the independent directors, saying that they had insufficiently analysed the issue.

Doubts were raised about the independence and neutrality of the CEO of the company at the time, Foo Tiang Sooi, because he was personally related to Tang Wee Sung. Foo had worked under Tang from 1999 to 2006. He and Tang were also former schoolmates[25]. However, he dismissed these facts as irrelevant[26]. Foo also added that he was related to the shareholder who posed the question, but this fact was irrelevant as well[27].

Another shareholder called for a vote of no-confidence against the board chairman. After consulting with legal advisors, the board rejected the motion, with the chairman saying that the action was an attempt to frustrate the meeting[28]. Even as shareholders tried to probe further, the chairman called for the vote to be taken[29]. The resolution to privatise the company was passed with 96.25 per cent of votes in favour of the proposal[30].

Key Area of Controversy: Tangs Plaza

The Singapore Code on Takeovers and Mergers (the Code) governs all takeover activity in Singapore involving public companies. Under Rule 26.2(a) of the Code, "a property which is occupied for purposes of the business must be valued at the open market value for its existing use". However, Rule 26.2(c) provides for the case in which "such a property is valued for an alternative use. For such a case, the costs of conversion and/or adaptation should be estimated and shown" [31].

During all three privatisation attempts by the Tang brothers, the offer price reflected an undervaluation of Tangs Plaza[32]. The board stood by its stand of valuing the property according to its "existing use", as there was no intention of deviating from it. One investor had brought up the fact that in C.K. Tang's 2007 annual report, a property valuation report had taken into consideration the redevelopment potential of Tangs Plaza. In response, the board's legal adviser, Yeo Wee Kiong, said it was not legally required to put a redevelopment valuation on the report[33].

PwC stated that the property was valued at S$340 million on 25 May 2009[34]. This was much lower than other nearby sites. In contrast, minority shareholders contested that the site was easily worth at least S$400 million, according to an independent valuer. This value did not take into account the potential value arising from redeveloping the site, and did not consider the potential value from sub-dividing the site into small retail units and leasing them to specialty tenants[35]. The board, however, stated that regulators had told the directors that any such redevelopment was not applicable[36].

Unhappiness Amongst Minority Shareholders

Several shareholders were unhappy about the perceived undervaluation of the Tangs Plaza site, as well as the fact that the offer price was less than the company's net asset per share. Thus, they met with the Securities Investors Association (Singapore) (SIAS)[37]. SIAS stated that it objected to the exit price and that the minority shareholders had been treated with no dignity[38]. SIAS had also called for regulators to intervene[39].

Ten shareholders had also signed a petition to SGX and the Ministry of Finance questioning the basis of the valuation on the property's "existing use"[40], in a bid to convince the regulators to allow them to obtain an alternative valuation report[41]. SGX's reply was that C.K. Tang's move to delist was purely commercial, and that the company had complied with the listing and delisting rules[42].

The Capital Reduction Exercise

On 19 August 2011, C.K. Tang embarked on a capital reduction exercise to cancel out all remaining shares held by minority shareholders. C.K. Tang would pay each investor S$1.30 per share, which represents an increase of 56.6 per cent on the exit offer in 2009. PwC had indicated that the S$1.30 offer is 15 per cent above its fair market value[43]. The rationale behind the exercise was to reduce administrative burdens. Additionally, the company reaffirmed that there are no plans for the redevelopment of Tangs Plaza, and the buyout had no hidden agenda.

However, only 39 per cent of the minority shareholders in attendance agreed to the price for the share buyback, far below the 75 per cent required. Some minority shareholders cited the undervaluation of the Tangs Plaza property as the reason for rejecting the offer[44]. C.K. Tang would have to do more to convince these shareholders for the buyout to succeed.

Discussion Questions

1. In cases of companies where there are controlling shareholders, explain why the interest of controlling and minority shareholders may diverge, using the CK Tang case as an example.
2. Should independent directors be primarily concerned with the interests of the minority shareholders?
3. Evaluate the independence of C.K. Tang's board during the third privatisation attempt. Do you think this affected the actions of the board during the privatisation process?
4. Do you believe that the basis of valuation was fair? Explain.
5. With regards to the privatisation episode, suggest improvements that would help protect minority shareholders in the future.
6. C.K. Tang used three different privatisation methods. Explain how these different methods work and the pros and cons of these different methods from the viewpoints of the shareholder(s) wanting to take a company private versus minority shareholders who may prefer that the company remain listed.

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In Deep Water: Boardroom Tussle at Asia Water Technology

Case Overview

Listed on the Singapore Exchange in March 2005[1], Asia Water Technology Ltd (AWT) faced problems such as rapidly deteriorating operating cash flow problems and a breach of financial covenants relating to the bonds it issued. The board then proposed to accept an injection of funds from a new investor that involved the issue of a large number of new shares and a non-renounceable rights issue, which would substantially dilute existing shareholders. This led a substantial shareholder to propose the removal of directors on the basis that the directors had not acted in the best interests of the company. A boardroom tussle then ensued. The objective of this case is to allow a discussion of issues such as the evaluation of financing options, duties of directors in an insolvency situation, board composition, the removal of directors by shareholders and the resignation of directors.

Background

AWT is a water treatment specialist, providing comprehensive and integrated engineering solutions for water purification and wastewater treatment systems. Its business was conducted primarily in the People's Republic of China through its subsidiary, Wuhan Kaidi Water Services

This is an abridged version of a case initially prepared by Lim Wan Jou and Tan Pei Shi 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. Consequently, 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 prepared by Lee Yinsean Vanessa under the supervision of Professor Mak Yuen Teen.

Co Ltd. The company's main revenues came from three core business segments: water purification, wastewater treatment and other auxiliary projects. Before June 2004, AWT specialised in engineering, procurement and commissioning (EPC) contracts for water purification treatment systems. However, business opportunities presented AWT a chance to expand its business model. In 2004, AWT shifted from pure contracting to a mixture of ownership of projects and providing EPC services.

Bond Subscription Agreement (BSA)

As AWT's projects were generally capital-intensive and required considerable upfront capital commitments, the company took on substantial financing. Although the shift of business model was initially successful, AWT's business went downhill when it gradually expended its available capital. To reduce the risk of relying too much on short-term borrowing to finance long-term projects, and to access additional longer term capital to fund its expansion, AWT entered into a Bond Subscription Agreement (BSA) on 8 August 2007 with shareholders' approval. Structured and convertible bonds worth US$60 million were to be issued in two tranches, with the proceeds to be utilised for various water treatment projects. The issuance of Series 1 bonds gave AWT a capital inflow of US$25.4 million, allowing the company to secure 54 new projects.

Deteriorating Business

Challenging economic conditions surfaced soon after and AWT was faced with rapidly deteriorating operating cash flow problems. In December 2007, AWT exceeded a gearing ratio, breaching a financial covenant relating to the Series 1 bonds issued. Although AWT obtained a waiver on the covenant breach, it breached another covenant due to the failure to complete a restructuring plan. As a result, the second US$30 million tranche of bonds was cancelled. However, at the request of AWT, bondholders agreed to observe a standstill period, where they would not terminate the BSA or demand for the outstanding amounts. In exchange, the company was restricted from further investments in any projects and prohibited from executing any related EPC contracts.

An official waiver was subsequently obtained on 31 December 2008 but AWT was subjected to a revised set of financial covenants, requiring it to repay specific principal amounts with accrued interest on stipulated dates. For such repayments, a redemption amount of US$2 million was scheduled for payment on 31 March 2009. However, unable to pick up its business within such a short time, AWT failed to meet the repayment again. It obtained an extension until 5 June 2009, pending the conclusion of an agreement for new injection of funds into the company by potential investors. When AWT did not meet the second payment deadline, bondholders granted a further extension on condition that AWT entered into a legally binding written contract with potential investors. After conducting numerous meetings and negotiations, AWT received two written offers, including an offer from SI Infrastructure.

Offer from SI Infrastructure

The board considered SI Infrastructure's offer to be superior, given the latter's financial stability and the potential for synergy. Under a deal[2] signed on 16 June 2009, SI Infrastructure would subscribe for up to 1.67 billion new shares and a non-renounceable rights issue of 98.45 million new shares at an exercise price of 2 cents per share, on the basis of one rights share for every two existing shares held. Net proceeds from this issue were estimated to be between US$21.2 million and US$23.9 million. With the successful completion of the deal, SI Infrastructure would hold not less than 83.3 per cent and up to 85 per cent of AWT's enlarged share capital.

The injection of capital by SI Infrastructure would improve the financial condition of AWT and allow its principal business to remain as wastewater treatment and water purification in China. AWT would be able to leverage on SI Infrastructure's network and business expertise to expand into the waste water treatment and water purification industry.

Boardroom Tussle

The boardroom tussle began when a substantial shareholder of AWT objected to the financial rescue plan[3]. Through EGN Nominees Pte Ltd (EGN), Kareti Venkataramana started buying AWT shares from early June 2009. At the highest point of ownership, EGN held 24.38 per cent[4,5,6] of AWT. On 2 July 2009, EGN issued a notice for an Extraordinary General Meeting (EGM). It proposed the removal of four directors (Addyson Xue, Ng Fook Ai Victor, Simon Littlewood and Sha Guangwen) and the appointment of two new directors (Venkataramana and Peter Lai), as well as the rejection of SI Infrastructure's offer[7]. SI Infrastructure's offer was questioned as the proposal involved a 77.8 per cent share price discount and virtually all of the share value of AWT's current shareholders would be eroded. The last transacted share price was 9 cents on 12 June 2009[8].

Venkataramana felt that AWT's directors had acted without considering the best interests of the company, and believed that the board should be held accountable for failing to justify the issue of shares at the grossly discounted price to SI Infrastructure.

> "Why should you think that heads should not roll for such financial mismanagement?"[9]
> — Shareholder, Mr Ong C.H., 30 July 2009 (Today, Singapore)

In addition, Venkataramana felt that the significant deterioration of AWT's financial health over the past three years indicated poor leadership. He cast doubt on the board's ability to lead the company, citing repeatedly bad corporate decisions that he argued had been made. In Venkataramana's view, the board has also not undertaken adequate project financing planning, given the bad cash flow management in the company.

> "Nobody has said that this is a bad company or that it lacks strong fundamentals. But the company is in trouble because of poor cash flow management."
> — AWT Investor, 31 July 2009 (The Business Times, Singapore)

Venkataramana further argued that the board's dealings with bondholders were questionable, as the monies received from the issuance of Series 1 bonds should have been used to repay short-term lending instead of securing new projects. As a result, in the same month when the issue of the Series 1 bonds was completed, the company had already breached a financial covenant relating to the bond. He argued that the severe lack of judgment on the part of the board also led to AWT's failure to complete the restructuring exercise, resulting in the cancellation of the Series 2 bonds.

Another issue raised was SI Infrastructure's motive behind the investment. SI Infrastructure's subsidiary, General Water of China (GWC), had separately signed a letter of undertaking with AWT's bondholders to purchase US$29 million worth of AWT's assets if the proposed refinancing deal was vetoed by shareholders[10]. As such, Venkataramana questioned if the deal would protect AWT's interests, as it appeared that SI Infrastructure was only interested in AWT's assets.

Following the notice issued by EGN, the directors of AWT made an announcement in response to Venkataramana's claims. They sought to explain their actions to improve AWT's liquidity, citing the challenging macro environment conditions that the company faced. At the EGM held on 29 July 2009, investors holding over 50 per cent of the issued share capital shot down the proposal to remove the directors[11]. However, Venkataramana wrote to AWT on 12 August, calling for the resignation of the four directors, failing which a second EGM[12] would be called. On the same day, AWT announced that three of its directors – Ng Fook Lai Victor, Simon Littlewood and Addyson Xue – had resigned on 11 August. In another letter dated 13 August, EGN called for the appointment of Venkataramana and Peter Lai as the non-executive and independent directors respectively. The letter also carried the same threat - if AWT did not comply, EGN would call for another EGM to effect the appointment and remove the remaining two directors, CEO Huang Hanguang and Sha Guangwen. On 17 August, EGN called for an EGM to be held on 23 September. Eventually, Huang Hanguang was removed from the board and as CEO[13], and four new directors were appointed. The proposed investment by SI Infrastructure was also aborted.

Changes in the Board

The old board comprised six directors, with one executive director, two non-executive directors and three independent directors. Most of the directors had related energy industry knowledge. There was diversity of competencies, with qualifications in the areas of engineering, science, economics, banking and business. The board members held many other directorships and some also had prior working experience together.

During the boardroom tussle, Tan Tew Han and Huang Hanguang said that they would voluntarily resign[14] if the other four directors were to be removed. Eventually, Huang Hanguang was removed by shareholders in a resolution, while Simon Littlewood, Victor Ng, Sha Guangwen and Addyson Xue resigned. All four directors gave similar reasons for resigning – “the need for an extensive time commitment to the distressed company was something that they were unable to handle”. Also, Victor Ng and Tan Tew Han cited health reasons. Time commitment was also cited in the resignation of the newly-appointed independent director, Peter Lai.

At the end of the struggle for control, a new board was formed with a non-executive chairman, three other independent directors and an interim executive director, Venkataramana. In November and December 2009, two more non-executive directors were appointed.

AWT’s Share Price

Beginning in late 2007, AWT’s share price started declining. The fall persisted through 2008 and stabilised somewhat in 2009. AWT’s financial health deteriorated with a negative growth of 20 per cent from 2008 to 2009, and losses increased 9 fold in the one-year period, attributable to the rise in doubtful debt expenses and finance expenses, and the 50 per cent drop in gross profit for its main power plant business[15]. For the second half of 2008, high construction costs in the power plant water purification projects in China and the delay in earnings from two other major projects affected AWT’s performance. Furthermore, a major earthquake in Sichuan in 2008 threatened the progress of their water infrastructure projects, and higher loans and borrowings caused the Group to breach its debt covenants during the quarters ended 30 June and 30 September 2008. The company's share price fell from over 20 cents to below 10 cents[16].

In June 2009, at the beginning of the boardroom tussle, the company's share price was at 9 cents. To raise his stake past 30 per cent, where he would be able to trigger a general takeover offer of AWT under the Code of Mergers and Takeovers, Venkataramana purchased shares in the open market. On news of a possible takeover, AWT's share hit a five-month high of 12.5 cents and a total of 1.25 million shares were traded on 22 July 2009[17]. While the peak in August and September 2009 could be due to Venkataramana's continuous purchase of shares, it might also be attributable to investors' rising confidence in the firm and the possibility of a takeover by EGN. In addition, the Group announced in late August a loan of RMB158 million obtained from the Industrial and Commercial Bank of China and Chinese Bohai Bank[18]. With additional working capital for its projects, it was good news for the market.

However, AWT's shares were suspended for trading on 8 September 2009, with its last traded price at 20 cents. The company went into receivership in the same month.

Discussion Questions

1. When considering financing options for a company seeking to expand or trying to stay afloat, what are the key factors that the board and management should consider?

2. In your view, did the old AWT board adequately discharge its duties? Do you think the board acted appropriately when the business started to deteriorate?

3. Do you think the board could have done more to avoid the boardroom tussle?

4. Do you think the directors were resigning too easily? Do you find the reasons for their resignation acceptable? Under what circumstances should a director resign?

5. Identify any corporate governance deficiencies in AWT's board of directors - both the old and new board.

6. A common complaint amongst shareholder activists in the U.S. is that shareholders have no rights because it is difficult for them to appoint directors of their choice or to remove directors. To what extent should shareholders be given the power to appoint or remove directors? In AWT's case, do you think the substantial shareholder's action in removing incumbent directors and appointing new directors was beneficial to AWT?

7. In situations such as the above, do you think regulators (such as the stock exchange or securities regulator) should have intervened or responded in any way? If so, how?

8. Who do you think is most responsible for the failure of AWT?

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Japan Land: The Setting Sun

Case Overview

Corporate governance issues surrounding the independence and conflict of interest within the board in Japan Land surfaced in 2009, following the successive resignations of its Deputy Managing Director, Chief Financial Officer, external auditor and an independent director. Following the revelations of these corporate governance issues, the company's share price fell from $0.37 in July to close at an all time low of $0.27 at the end of November. On 30 March 2010, Japan Land suspended the trading of shares[1] in the face of financial woes affecting one of its subsidiaries, Jurong Data Centre Development (JDD). By the end of June 2011, Japan Land was delisted from the Singapore Exchange. The objective of this case is to allow a discussion of issues such as board composition and director independence, resignations of independent directors, auditors and key officers and whether they are "red flags", internal control and risk management, conflicts of interest and ethics.

Company Overview

Japan Land Limited was incorporated on 28 October 1997 as a business-to-business (B2B) company and was listed on the Singapore Exchange (SGX) Mainboard in 2000. In 2004, Japan Land added the real estate and related sector to the Group's core business, with an emphasis on the Japanese property market. Through its subsidiaries and associated

Jiang Xinyan, Beatrice Kwek Pei Shan and Teo Yonghui prepared this case 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. Consequently, 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 prepared by Joanna Ng Yi Mei under the supervision of Professor Mak Yuen Teen.

companies, Japan Land's businesses spanned property development, project management and customised housing in Japan, Singapore and Vietnam. The company's three main areas of investment are development projects for both commercial and industrial purposes, corporate capital investments (which also includes investing in the provision of human resources and technical/management know-how), and provision of management services, including cash flow management, procurement, development and operations.

Group Structure

The many key subsidiaries that Japan Land has for development and investment purposes are held through Japan Asia Land Limited (JALL), a wholly-owned subsidiary of Japan Land which was incorporated in Japan. JALL is an investment holding company that owns 50 per cent of Lux Partners Co. Ltd. (Lux Partners), 75.5 per cent of Japan Asia (Vietnam) Company Ltd (JAVCO), 83.33 per cent of Jurong Data Centre Development Pte Ltd (JDD) and 20 per cent of Katsumi Housing Corporation Limited (KHC). It oversees the operations of these companies and plays a central role in promoting development projects in Japan, in addition to providing advisory services on corporate revitalisation programmes and underscoring Japan Land's focus on becoming a leading real estate player.

Initially focused on customised housing and real estate development through its associate KHC Limited, Japan Land ventured into developing and managing data centres in Asia. Following the success of one of its largest data centre projects in Tokyo, the Group went on to develop a data centre, JDD, in Singapore to strengthen its position in the data centre segment. It planned to participate in more of such projects in the region.

Board of Directors

Japan Land's board was made up of seven members, five of whom are non-executive directors. Of the five non-executive directors, the company considered three as independent directors, whose status was reviewed annually by the nominating committee. The board consisted of directors with diverse experience and background, with a majority holding business and management or accountancy degrees from reputable universities. The board was chaired by Tetsuo Yamashita, who was also the founder and Chairman of Japan Asia Holdings Limited. Yamashita had over 25 years of broad and in-depth experience in the financial industry and had held roles with Japan's Ministry of Finance and Nomura Securities Co. Ltd.[2]

The board of JALL was chaired by the Managing Director of Japan Land, Mitsutoshi Ono, since 2005. Junya Kitada was the Executive Director-cum-Chief Financial Officer of JALL, as well as the principal of 'Accounting Factory', the accounting firm which has been providing accounting services to JALL for an undisclosed number of years.

Remuneration Policy

The board of directors in Japan Land was compensated in the form of basic director's fees, committee, attendance fees and share options. The director's fee policy was based on a scale of fees divided into basic retainer fees as director and additional fees for attendance and serving on specialised committees.[3] Executive directors did not receive director fees and instead receive a mix of salary, allowances, bonuses and share options. The proposed director's fee for 2009 was S$279,686, which covered a period of 14 months[4]. In 2010, the proposed fee was S$304,074[5].

The company had a 2000 Japan Land Limited Share Option Scheme ("2000 scheme") which was approved and implemented in 2000. This scheme granted stock options to employees of the Group and both executive and non-executive directors of the company. In the case where the directors receiving options are controlling shareholders or associates of the company, it required the approval of shareholders in the general meeting.

Audit and Nominating Committees

As at the end of its 2009 financial year, Japan Land's audit committee (AC) comprised two non-executive independent directors, including the chairman of the AC. Members of the AC had a background in accounting and finance, and AC meetings were typically held several times during the financial year. According to the company's corporate governance report, the AC reviewed a wide range of reports and relevant papers from the management and external auditors. Management staff and the company's auditors, who could provide additional insight into the matters to be discussed, were also invited from time to time to attend such meetings.

Japan Land's nominating committee (NC) comprised two non-executive independent directors, including the chairman of the NC and one executive director. NC meetings were held at least once a year. The NC made recommendations to the board for the re-election of directors and the appointment of potential candidates as directors and members of the committees, and evaluated the performance of the board.

Issues Within the Group

Review and oversight of the accounting practices

One of the issues faced by both the JALL's and Japan Land's boards was the review and oversight of the accounting practices of the company. Junya Kitada and the JALL board would draw up the accounts, which would then be approved by the staff of Accounting Factory. Mitsutoshi Ono also set up an audit committee authorising Kitada as an internal auditor to perform audits on JALL and its subsidiaries, without notifying the AC of Japan Land.[6]

Lack of proper monitoring and reporting of subsidiaries

In September 2009, Ernst & Young, Japan Land's auditor since 2000, raised the issue of lack of timely communication and sharing of information between the finance department of the head office and the AC with regard to its subsidiaries, particularly JALL[7]. The issue of the lack of accounting knowledge and compliance from overseas reporting entities was raised.

Investment proposals by JALL in Fuchu in Japan and JDD in Singapore and Vietnam were not presented to the Japan Land board for evaluation and approval. In addition, the budget report of the Vietnam project did not include proper detailed budgeting and projections and there was no timely cashflows and project reporting by JALL to its parent. Further, an inter-company loan of S$10 million taken to finance the Fuchu Data Centre, which matured in May 2009[8], was signed and extended to 2011 by Mitsutoshi Ono on behalf of Japan Land and JALL's Executive Director, Yoko Yamashita, without notifying the Japan Land board. Proceeds received from the Data Centre were also not utilised for the repayment of the S$10 million loan. In June 2009, JALL issued JPY700 million worth of bonds to Aizawa (a related party to Japan Land) using Japan Land's investments as its security, which was also not presented to the board of Japan Land.

Resignation of Management Committee and External Auditor

Successive resignations of members of Japan Land Management Committee unfolded in July 2009, with the resignation of its Deputy Managing Director, Junichiro Meno[9]. Subsequently in August, the Chief Financial Officer of Japan Land, Tan Boon Hua, submitted his resignation to the board[10], which took effect on 1 September 2009. Both parties cited personal reasons for their departure from the company.

On 2 October 2009, Ernst & Young gave notice to the company of its intention to resign as the company's auditor[11], just three days after its re-appointment in the company's Annual General Meeting. However, in a news announcement dated 14 October, Japan Land said the reason for the change in auditor was to improve the corporate governance of the company[12,13]. KPMG LLP was then appointed to be the external auditor of Japan Land Limited.

In November 2009, Sin Boon Ann resigned as Japan Land's independent director, barely completing a one year term on the board. In a regulatory announcement, Sin Boon Ann said he was dissatisfied with the company's management control over its operating subsidiary, JALL[14]. Edward Tiong Yung Suh, who had over 11 years of experience in civil and commercial litigation, banking litigation, insolvency and restructuring as well as property disputes[15], was eventually nominated to the board as the new independent and non-executive director on 11 January 2010. He was also appointed as a member of the AC.

In late November, Junya Kitada resigned from JALL[16]. Mitsutoshi Ono also resigned as Japan Land's Director and Managing Director but remained as President of JALL[17]. In December 2009, Leow Tet Sin was appointed as the new Managing Director of Japan Land.

Japan Land then acknowledged the existence of several conflicts of interests, including the conflict posed by the duality of roles held by Mitsushito Ono and the inadequacy of control over JALL. It also admitted to the lack of prompt disclosure of project cashflows from JALL .[18] In June 2010, Ono also stepped down as President of JALL.

Delisting of Japan Land Shares

Problems continued to surface in Japan Land, despite its bid to manage and improve the corporate governance of the company. During the period from July to November 2009, the share price of Japan Land fluctuated unsteadily. By the end of November, it had fallen by about 25 per cent from S$0.36 to S$0.27. It share price remained unstable and on 30 March 2010, trading in its shares was suspended on SGX at the request of the company, after closing at an all-time low of S$0.26.

Japan Land was on track to sell an 85 per cent stake in JDD to ConnectedPlanet Holding Limited (ConnectedPlanet). However, the latter repeatedly failed to complete its investment agreement. This led to Japan Land being unable to use the proceeds to pay its debt of about S$44.4 million owed to main contractor, M+W Singapore Pte Ltd.[19]

On 31 March 2010, Japan Land issued a profit warning, saying it expected to post full-year losses for its financial year ending 31 May 2010 due mainly to losses in its underlying businesses[20]. It reported a full-year net loss of S$65.7 million for year ended 2010,[21] due to the writing-off of loan and interest receivables from the liquidation of JDD and higher finance expenses related to financial restructuring.

To resume the trading of the company's shares, Japan Land was to submit a proposal by 29 March 2011, failing which SGX would have the option to delist the company[22]. On 25 May 2011, Japan Land's application for time extension in the Preliminary Resumption Proposal submission was rejected by SGX. Among the reasons cited, SGX said it was uncertain of Japan Land's ability to meet the continuing listing requirements, due to the negative working capital and poor operating cashflow position for the financial years ended 31 January 2010 and 31 January 2011.[23]

As of April 2010, the outstanding sum that Japan Land owed to the main contractor, M+W Singapore amounted to S$200 million[24]. The company kept its negotiations with M+W Singapore Pte Ltd going until a decision was reached to wind up JDD. Due to the troubled financial standing of Japan Land, JDD was eventually sold to M+W Singapore on 15 November 2010 for S$145 million.[25]

Japan Land was notified by SGX that its shares will be delisted with effect from 30 June 2011. Japan Land then became an unlisted public limited company with its existing shareholders still holding shares in the company.[26]

Discussion Questions

1. What are the key corporate governance issues raised in the Japan Land case? What are the major underlying causes of these issues?

2. Explain the key potential conflicts of interest highlighted in the case and explain why they undermine corporate governance in the company.

3. There were a succession of resignations from the company. To what extent did these resignations indicate systemic corporate governance issues within the company?

4. Do you think the independent director should have resigned? Under what circumstances should a director resign and how should he communicate this decision?

5. Do you think the company and the external auditors acted appropriately when the external auditors resigned just three days after accepting re-appointment?

6. In your opinion, were the financial woes faced by the company caused by its corporate governance problems?

7. Recently, there was a major scandal involving Olympus, a large Japanese listed company. Do you believe that there are certain cultural or business norms involving Japanese companies which may pose systemic corporate governance issues in Japanese companies?

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JLJ Holdings Limited: Poisoned by Its Rotten Apple

Case Overview

On 6 July 2009, JLJ Holdings launched its Initial Public Offering (IPO) of 19 million shares at S$0.27 each. The shares were highly popular and sold out fully. However, just a year later, the company's popularity turned into infamy when a global supply manager of Apple was arrested and charged with bribery. One of JLJ's employees was also indicted for his active involvement in the bribery scheme. The objective of this case is to allow a discussion of issues such as the impact of corruption-related risks on companies, measures that company can take to mitigate such risks, the role of the board in setting the right tone, and how the board should deal with the investigation and communication of a corruption scandal.

The History of JLJ Holdings Ltd

JLJ Holdings was first incorporated as a private limited company under the Singapore Companies Act on 18 March 2009. On 19 May 2009, it was converted into a public limited company.

This is the abridged version of a case prepared by Athena Chan, Elaine Ang, Elicia Ng, Emily Sim, and Regina Lin under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management. Consequently, 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 prepared by Amanda Aw Yong under the supervision of Professor Mak Yuen Teen.

The history of JLJ can be traced back to July 1993, when Jin Li Mould was founded by JLJ's Executive Chairman Chua Kim Guan and his group of friends. It targeted the niche market for Mould Design and Fabrication (MDF), where Chua saw immense growth potential. Despite its size and limited resources, Jin Li Mould quickly built a reputation for high quality standards in its services and capabilities. In 1997, it secured a contract with Hewlett Packard. This was soon followed by a supply contract with Apple in 2001, paving the way for a profitable long-term business relationship.

In 2003, Chua identified business opportunities in China and commenced operations in Jiangsu province with the establishment of EMold Kunshan, where Chua was the sole shareholder.

"Growth in Tandem with Apple"

By 2008, Jin Li Mould was heavily involved in the production of components for a majority of Apple's products, including the iPod and iPhone range of devices, and the Macintosh range of personal computers. To meet the increasing demand from Apple, EMold Kunshan eventually focused on producing Apple-related components. Its close proximity to Apple's outsourced manufacturing facilities in China enabled it to provide more efficient support for Apple's operations[1]. This business relationship with Apple proved to be crucial for the group of companies. Between 2006 and 2008, revenues derived from contracts with Apple grew from 70.8 per cent of total revenue to 82.5 per cent of total revenue[2].

As Apple posted a record US$1.21 billion net profit for Q2/FY2009, coupled with forecasts that the global consumer electronics market will be worth US$260.7 billion by 2012[3], expectations were high for the continued growth and performance of Chua's companies. In Chua's own words,

> "Given our well established relationship with Apple, we are well positioned to ride on the continued growth in tandem with the global demand for Apple products". [4]

JLJ's Initial Public Offering

In November 2008, EMold Holdings was incorporated and acquired the entire issued share capital of EMold Kunshan from Chua. A series of share swap agreements then saw JLJ acquiring the entire equity interest of Jin Li Mould, EMold Holdings, and EMold Plastics from Chua. The restructuring exercise thus resulted in JLJ becoming the holding company of the Group.

On 6 July 2009, JLJ launched its Initial Public Offering (IPO) of 19 million placement shares at S$0.27 each to much excitement. These placement shares were fully subscribed by institutional and private investors, raising S$5.1 million for the company[5]. On 10 July 2009, JLJ's shares made their debut on the Singapore Exchange Catalist board at S$0.26 each, with public investors holding 15.4 per cent of JLJ's issued share capital.

With proceeds raised from the listing, JLJ was now ready to execute the plans outlined by its board of directors for expansions at EMold Kunshan, Jubilee and Jin Li Mould over 2010 and 2011, and to explore new opportunities in the automotive and medical devices industry[6].

The Birth of a Fraudulent Scheme

After listing, revenues from contracts with Apple continued to be the key driver of growth in the Group, particularly through business dealings involving Jin Li Mould. A key party that facilitated Jin Li Mould's partnership with Apple was Paul S. Devine, a Global Supply Manager (GSM) at Apple, and an employee of Apple since 2005. Devine was involved in selecting suppliers of materials for Apple's iPhone and iPod earphones, and in his capacity as GSM, had access to confidential company information and also Apple's private third-party information.

In October 2006, Devine collaborated with Andrew Ang, an assistant manager of Jin Li Mould, to devise a scheme where Devine would supply confidential Apple information to Jin Li Mould and five other Apple suppliers in Asia. The confidential information exchanged included product forecasts, pricing targets, product specifications, and data obtained from

Apple's business partners[7]. The information enabled these five suppliers to gain an upper hand against competing suppliers in bids for contracts with Apple. In return, Devine was to receive kickback payments from the suppliers, determined as a percentage of the businesses they did with Apple[8]. Ang agreed to serve as the middleman between Devine and the suppliers. For his role, it was agreed that Ang would share the total sum that Devine received in kickback payments.

From October 2006 to August 2010, Devine communicated with Ang through his personal Hotmail and Gmail accounts on his Apple-supplied laptop. Certain code words were used to avoid any suspicion in case others chanced upon their correspondence – the code word "sample" was used to refer to a kickback payment. "Consulting services" contracts were also structured with one of the suppliers involved, so as to mask the nature of the kickback payments.

How Devine Concealed the Kickback Payments

To receive the kickback payments, Devine instructed the suppliers to make payments via wire transfer to a bank account that was opened under his wife's name. Increasingly worried that accumulation of a large sum of money in one account would attract the attention of banks or regulatory authorities, Devine then set up multiple bank accounts in countries around Asia under his wife's name, and directed some payments to those accounts. He also made it clear to the suppliers involved that each wire transfer payment must not exceed US$10,000. In an email sent to a supplier in October 2007, Devine wrote,

> "I still haven't received Sept payment. Can you check with your Accounting Dept? Please do not send the Sept and Oct payment together in one wire transfer. Anything over $10,000 wired could draw too much attention."[9]

At the same time, Devine also received payments directly from some suppliers and their agents. Between them, Devine and Ang coordinated meetings in Asia to exchange payments. In an email from Devine to Ang on 22 January 2008, it was 'business as usual' for the two,

> "We probably have to meet in Macau for the samples (i.e. payments)."[10]

Devine undertook significant measures to conceal the scheme he had devised with Ang. He eventually set up a company, CPK Engineering Corporation, and opened bank accounts using the business name. The accounts were used to collect the kickback payments, which were then redirected to his personal account. This covered his tracks by disguising the source, ownership and nature of the payments received. Throughout the scheme, the kickbacks were distributed among at least 14 bank accounts held in his wife's and CPK's names in the US, South Korea and Singapore[11].

When the Cat Got Out of the Bag

Until this point, Devine had his kickback payments while Ang shared in those kickbacks, everything seemed smooth sailing until April 2009, when Ang resigned from Jin Li Mould. To continue this scheme, Devine contacted Chua, and entered into an agreement with Chua to maintain the covert agreements. In an email to Chua in June 2009, Devine wrote,

> "I will continue to provide [Jin Li Mould] with information & opportunities to keep your business growing."[12]

He then thanked Chua for a US$90,000 payment and reminded him of the outstanding balance owed of US$310,000 cash and US$400,000 worth of Jin Li Mould shares[13]. This was immediately followed by an email containing price information from a Jin Li Mould competitor.

The scheme finally broke apart in April 2010[14], when Apple launched a probe into Devine's actions. A Microsoft Entourage database of emails and a cache of Hotmail and Gmail messages on Devine's Apple-supplied laptop were uncovered. The email messages contained payment details, as well as correspondence with Ang, Chua and other suppliers that contained confidential Apple information. It was also discovered that Devine had demanded and received over a million dollars of illicit payments, throughout his five years in Apple.

In August 2010, Apple filed a civil suit against Devine. Among the allegations made against Devine was a breach of his duty to Apple regarding the obligation to report "real or apparent conflicts of interest, actions that may compromise relationships or confidential and proprietary information, lack of impartiality between suppliers, reciprocity and self-dealing". These terms were contained in the Business Conduct Policy that Devine had signed when he joined Apple in 2005. His scheme with Ang was a clear violation of these duties. Steve Dowling, Apple's spokesman, expressed the company's displeasure,

> "Apple is committed to the highest ethical standards in the way we do business and we have zero tolerance for dishonest behaviour inside or outside the company."[15]

The civil suit by Apple was soon followed by an investigation involving the FBI and IRS. Ang's involvement and the identification of him as an employee of Jin Li Mould raised questions about the role that JLJ had in the scheme, and cast an "unwanted spotlight"[16] on JLJ and the other Singapore companies named in the suit.

JLJ's Shares Plunge

On the day of Devine's arrest, 25.6 million shares of JLJ were traded compared to an average daily volume of about 496,000 shares over the previous month. In a filing to the Singapore Exchange (SGX) on 16 August 2010, JLJ acknowledged the civil and criminal suits in the US that "apparently named" Ang, and sought to reassure investors that there was no clear adverse impact on JLJ's business with Apple[17]. On 18 August 2010, it filed another statement with the SGX to reiterate that,

> "Neither (JLJ) nor Jin Li Mould nor any other member of the Group is a party to any suit by Apple or the subject of any indictment whatsoever".[18]

Despite repeated assurances and claims of no involvement, these did not stop the downward spiral in JLJ's share price. In the days after Devine's arrest and the indictment, JLJ had to request for a trading halt twice – first on 19 August and then again on 24 August. By 19 August 2010, JLJ's share price had fallen to S$0.12, and hit a low of S$0.10 at the market close on 30 August 2010.

Management Reshuffle

On 19 August 2010, Chua voluntarily relinquished his duties as Executive Chairman when the Corrupt Practices Investigation Bureau (CPIB) started investigations into the case. A statement by JLJ filed with the SGX stated that,

> "Andrew Ang is the brother in law of the Company's Executive Chairman. In order to facilitate the impartial review of all activities relating to the Apple Claim that may involve the Company and its subsidiaries, the Company's Executive Chairman has also voluntarily relinquished all executive duties in the Company for the time being."[19]

Meanwhile, CEO Ng Boon Leng did not step down from his role. JLJ explained that,

> "There has been no evidence to suggest that (he) had knowledge of or was involved in the alleged payments related to Apple's civil suit."[20]

Five days later, on 24 August 2010, Foo Say Tun, who sits on the board of a few listed companies in Singapore, was appointed as the new Independent Non-Executive Chairman of JLJ[21]. With no indication on whether Chua's relinquishing of duties was merely a temporary arrangement, Foo was to lead JLJ through its present difficulties.

JLJ Claims No Involvement in Kickback Scheme

Following its independent investigations, JLJ filed an announcement with the SGX on 8 November 2010, claiming that,

> "On the facts known to the Company, which have been reviewed and confirmed by the Company's Audit Committee and Chief Financial Officer, neither Jin Li Mould Manufacturing Pte Ltd nor any of the Company's subsidiaries had at, any point, made payments to Devine personally and/or Devine's 'vehicles' referred to in Apple Inc's civil suit."

While Ang's whereabouts remained unknown, JLJ emphasised that Ang was a former employee of Jin Li Mould who had left since 28 May 2009. An operations manager at JLJ pointed out that "(Ang) had not been with (JLJ) for over a year and (everyone was) unaware of his whereabouts[22]."

Devine Pleads Guilty to Criminal Charges

On 28 February 2011, Devine finally pleaded guilty to wire fraud, conspiracy and money laundering. The scheme that Devine "(defrauded) Apple of its money, property and right to his honest services" reportedly cost Apple over US$2.4 million[23]. Under his plea agreement, Devine agreed to surrender about US$2.28 million of his proceeds from the scheme, and will potentially face up to 20 years in prison[24]. However, Ang's whereabouts remains a mystery.

JLJ's Financial Performance after the Bribery Scandal

JLJ's net profit attributable to shareholders for the financial year ending 31 December 2010 showed an impressive 847.2 per cent year-on-year growth compared to the previous period, increasing from S$0.3 million to S$2.9 million. Revenue grew 6.6 per cent, from S$60.1 million to S$64 million. JLJ's financial results continued to remain strong in the first half of 2011, with net profit attributable to shareholders increasing 3.2 per cent and revenues growing 14.9 per cent compared to the previous corresponding period. On 30 December 2011, the last trading day of the year, JLJ's share price closed at S$0.08. Whether the bribery scandal will have a long-term impact on JLJ remains to be seen.

Discussion Questions

1. What steps should a company like JLJ take to minimise corruption-related risks?

2. What is the likely business impact on JLJ?

3. Evaluate the actions taken by the board in response to this event.

4. Evaluate the role of the board in defining an organisation's ethical environment.

5. Whistle-blowing arrangements are increasingly seen as an important component of an organisation's corporate governance framework. To what extent can a whistle-blowing policy help deter or uncover such instances of bribery or fraud?

6. With legislation in various countries relating to bribery and fraud, and international companies enforcing their own codes of conduct for suppliers, how will this impact the way Singapore companies do business overseas?

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Sino-Environment: An S-Chip Scandal

Case Overview

A loan default by the CEO and Chairman of Sino-Environment, Sun Jianrong, triggered a series of events that led to the unraveling of yet another S-Chip scandal plaguing the Singapore stock market. The objective of this case is to allow a discussion of issues such as the business practices and corporate governance of Chinese companies that seek a listing in Singapore, the role of independent directors, and enforcement challenges for foreign companies listed on the Singapore Exchange

About Sino-Environment

> "With our new factory due to complete by end 2006, our manufacturing capacity will more than double, from the current approximately three devices per month to approximately seven devices per month. We will also diversify into the treatment and management of other types of industrial waste gases, in particular, sulphur dioxide, which is emitted from power generating facilities. With our strong R&D capabilities and dedicated management team, we are well positioned to benefit and grow in tandem with the continuing industrialisation and increasing awareness of environmental protection in the PRC."
>
> – Sun Jianrong when Sino first sought listing in Singapore.

This is the abridged version of a case prepared by Chong Jie Ying, Goh Ai Ling, and Koh Kai Ling 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. Consequently, 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 prepared by Elaine Kok Shin Yean under the supervision of Professor Mak Yuen Teen.

Sino-Environment is an environmental solutions specialist in four main areas: (1) industrial waste gas treatment, management and recovery of volatile organic compounds, (2) industrial and municipal waste water treatment and management, (3) dust elimination, and (4) industrial waste gas treatment and management of sulphur dioxide and oxidised forms of nitrogen.

The company adopts a product differentiation strategy. It uses its research and development capabilities to stay ahead of technological competition and continuously improves its technological and innovative applications.

The Board of Directors

The board consisted of seven directors, with three independent directors (IDs): Goh Chee Wee, Wong Chiang Yin and Pan Jinquan. Goh was appointed as the lead independent director. He sat on the boards of nine other listed companies and also held other key appointments, such as being a director of the National Trades Union Congress (NTUC) cooperatives. Wong sat on the boards of other listed companies and was a senior executive in a healthcare group based in Malaysia, holding positions such as executive director and CEO in hospitals and companies in the group. He was also President of the Singapore Medical Association. The third ID, Pan, had no prior experience sitting on the board of a listed company.

The remaining four executive directors also held key management positions: Sun Jiangrong, Executive Chairman and CEO; You Shengquan, Chief Operating Officer (COO); Professor Li Shouxin, Chief Technology Officer (CTO) and Tan Tar Wuei, Chief Financial Officer (CFO). All three IDs sat on the Remuneration, Nominating and Audit Committees. The board had diverse competencies in business management, science, engineering, accountancy, medicine and economics and at least one had experience in the waste management industry.

Throughout the year, four meetings were held.

The Beginning of the End

The troubles at Sino-Environment started when Sun Jiangrong, CEO and Chairman of Sino-Environment, pledged his entire majority stake of 56.29 per cent (190.8 million shares)[1] in Sino-Environment as part of collateral for a personal loan from a hedge fund. A S$120 million loan default by Thumb (China) Holding Group Ltd (TCH) triggered the unraveling of Sino-Environment. Unknown to many, TCH was a controlling shareholder of Sino-Environment and was, in fact, an investment firm wholly and beneficially owned by Sun.[2]

When Sun defaulted on the loan in early March 2009, the hedge fund seized his shares in Sino-Environment and sold off the entire stake in the open market, causing Sun to lose control of the company[3]. The forced sale of his shares triggered a premature redemption of convertible bonds worth S$149 million, as the agreement for the bonds included a covenant which requires Sun to remain in control of the company[4].

The severity of the issue emerged when PricewaterhouseCoopers (PwC) issued an audit disclaimer on Sino-Environment's financial statements due to going concern issues. nTan Corporate Advisory Pte Ltd was then appointed as Sino-Environment's independent financial advisor to assess the implication of the default, as well as implement measures to safeguard the assets of Sino-Environment[5].

Seeing Red

PwC was engaged to review "significant cash transactions" between January and March 2009, which coincided with Sun's loan default[6], when Sino-Environment failed to produce its first quarter results in May 2009. This raised doubts on CFO Tan Tar Wuei's resignation at end April for 'personal reasons'. No action was taken to appoint a new CFO by management.

The other executive directors (EDs) - the CEO, CTO and COO -, dropped a bombshell in the market on 5 May 2009, when they tendered their resignation en-masse without giving any reasons[7]. The independent directors (IDs) pleaded with the executives to remain on board to ensure that operations ran smoothly[8]. On 29 May 2009, all three executives were reinstated while Tan, the former CFO, was reinstated as a non-executive director[9]. However, it emerged that during the period after they had tendered their resignation, the key management had retained control of the PRC subsidiaries and held access to the company's bank accounts.

Sino-Environment's shares finally ceased trading in September 2009. Things took a turn for the worse when PwC's special audit revealed that at least S$85 million worth of cash transactions were made without any approval or authorisation from the board[10], amongst other dubious transactions where cash was evidently siphoned off the company's books.

Roadblocks

The individuals responsible for the questionable transactions made things difficult when PwC went to China to conduct audits. "Special" bank officers were pre-arranged to "deal" with the auditors, forced them to leave the bank premises, and were unwilling or unable to verify statements shown to them. As a result, PwC had to cease further investigations.

Back in Singapore, accusations and counter-accusations were thrown in public. The IDs accused the EDs of mis-using their power as directors. The EDs responded that the financial controller appointed by the board had mis-used the company's funds by paying professional fees to PwC and nTan instead of repaying the outstanding convertible bonds. This time, the IDs called for the immediate resignation of the EDs.[11,12]

Taking Action

To protect their interests, the minority shareholders of Sino-Environment called for an Extraordinary General Meeting (EGM) at the end of November 2009[13]. In his attempt to appease the shareholders, Sun told David Gerald, President and CEO of the Securities Investors Association (Singapore) (SIAS) that Sino-Environment had a cash reserve of S$40 million in its China bank account although the actual amount turned out to be only S$31 million.[14,15]. Sun's actions led to Sino-Environment being rapped by the market regulator, Singapore Exchange, for not providing full disclosure to the public but selective disclosure to Gerald[16].

The IDs decided to seek legal recourse to remove the EDs in December 2009 but this proved unnecessary as the EDs resigned en-masse for the second time before the EGM could be held. On 10 February 2010, Sam Chong Keen was appointed as the new CEO of Sino-Environment[17].

The End of the Road?

Barely six months into his two-year term, Sam, the new CEO who was hired to restructure the company, stepped down on 11 May 2010[18]. Fresh roadblocks arose when the new management flew to China to obtain authorisation letters for access to the company's bank accounts and to locate missing documents, but the only letter obtained was for a new bank account controlled by Sam[19].

Furthermore, a substantial number of staff members with in-depth knowledge about the company had resigned and little help was forthcoming from the PRC authorities and Sun. Despite evidence of money being moved around in two different accounts, the Fuzhou investigation bureau found Sun not guilty of misappropriation[20].

After concluding that it was unable to facilitate the cash and special audits by PwC, the board finally decided to place Sino-Environment under judicial management[21].

Discussion Questions

1. Comment on the composition of Sino-Environment's board of directors before the scandal. Are there red flags that should have raised concerns with investors?
2. Based on this case, what are some of the key challenges faced by directors and auditors in Chinese companies listed in Singapore?
3. To what extent should the independent directors be held accountable for the problems in Sino-Environment?
4. What are the challenges faced by Singapore regulators for Chinese companies listed in Singapore?
5. Based on this case, are there any changes in corporate governance rules that should be introduced?
6. Should Chinese companies listed in Singapore be subject to a different regulatory framework and different corporate governance rules?

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The Battle for Parkway

Case Overview

On 11 March 2010, Fortis Healthcare acquired a strategic 23.9 per cent stake in Parkway Holdings. It proceeded to install four of its directors on the Parkway Board and make a deal with three others to increase its control of the Board. Coupled with open market purchases that raised its stake in Parkway further to 25.37 per cent, Fortis' position posed a worry for Khazanah Nasional Berhad, which by now had become the second largest shareholder in Parkway. This forced Khazanah to mount a takeover offer for Parkway. The ensuing bidding war not only caused regulatory bodies to intervene but also raised questions about corporate governance and director independence. The objective of this case is to allow a discussion of issues such as the rules and procedures governing takeovers, the definition of independent directors, and the duties of directors in a takeover situation.

Parkway's Beginnings

Parkway Holdings was founded by the Tan Family of IGB Corporation and the Ang Family from Petaling Garden. It moved into the private hospital business with the acquisition of Singapore's Gleneagles Hospital in 1987, followed by Mount Elizabeth Hospital and Parkway East Hospital in 1995, quickly becoming Southeast Asia's largest private healthcare provider[1].

This is the abridged version of a case prepared by Ryan Tan, Faith Chia, Ada Tan and Yuan Yi under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management. Consequently, 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 prepared by Kellynn Khor under the supervision of Professor Mak Yuen Teen.

In 2005[2], Texas Pacific Group (TPG Capital)[3] invested just under S$500 million in Parkway and installed four directors representing TPG's interest on Parkway's Board. The new board then decided to acquire a 30 per cent stake in Pantai Holdings. It formed a Special Purpose Vehicle (SPV) with the Malaysian National Treasury, Khazanah Nasional Berhad, to hold Pantai. Through this SPV, Khazanah wound up with a 23.2 per cent stake in Parkway Holdings.

On March 2010, TPG's agreement with Parkway came to an end. When Khazanah declined TPG's offer to buy the latter's stake for RM2 billion[4], billionaire Malvinder Mohan Singh, Chairman of Fortis Healthcare, acted swiftly and acquired TPG's 23.9 per cent ownership for S$959.4 million[5].

Let's Make A Deal

Days after their successful acquisition, Malvinder Singh, and his brother, Shivinder, met with the management of Parkway Holdings. The brothers invited three of the board directors – then-Chairman Richard Seow[6], executive vice-chairman Lim Cheok Peng, and chief executive officer (designate) Tan See Leng[7] – to enter into a co-investment arrangement. The deal was structured to secure the retention of Seow's, Lim's and Tan's respective roles in the company[8] with entitlement to certain "economic benefits".[9] In return, the three directors would give Fortis the "right to direct" how they vote and agree "in general" to vote with Fortis, subject to discharging their fiduciary duties as directors. Fortis also took over TPG's Board positions and installed four new Fortis Directors: Sunil Godhwani, Balinder Singh Dhillon and Shivinder Mohan Singh, with Malvinder being the fourth. Malvinder was thus appointed the Chairman of the now 13-strong Parkway Board (excluding alternates)[10] . Fortis thus gained effective control of 7 votes in the 13-man board.

Growing Tensions

Khazanah now had approximately half the representation on the board as compared to Fortis. It asked to have two more of its directors installed to the board, nominating Michael Fernandes, Director of Investments and Country Head of India, and Tunku Mahmood Fawzy[11]. The Parkway Board deferred the decision over several occasions, before finally rejecting it. Things came to a head on 16 April 2010, when a Khazanah representative publicly expressed "the fund's dissatisfaction over the board structure from the governance standpoint"[12] at Parkway's AGM and wanted a formal examination of the Parkway Board's corporate governance.

In May, Malvinder Singh met Khazanah's Managing Director and CEO Tan Sri Dato' Azman Mokhtar for the first time in the latter's office at the Petronas Twin Towers. However, the meeting proved fruitless as both men could not reach an agreement on Parkway's future. With negotiations breaking down, Khazanah was forced to choose between lying down, exiting, or fighting for control.

Bidding Wars

27 May 2010 – Khazanah Makes First Bid, Parkway Trading Suspended on SGX

Khazanah presented a S$1.18[13] billion voluntary conditional cash partial takeover offer[14] for Parkway Holdings via one of its investment units, Integrated Healthcare Holdings (IHH). The offer, which had a tentative closing date of 8 July 2010[15], was set to acquire no less than 313 million shares from Parkway shareholders at S$3.78[16] per share – a 25.2 per cent premium over the last traded price of S$3.02[17]. A successful bid[18] would give Khazanah a majority controlling interest of 51.5 per cent, up from its current 23.9 per cent stake[19]. Khazanah's surprise move signalled the start of a bidding war.

Under the Singapore Code on Take-overs and Mergers, parties that have bought shares in a company in the last 6 months are not normally allowed to make a partial offer to shareholders[20]. Thus, if Fortis wanted to make a counter offer, it would have to make an offer to buy all the shares through a general offer, which would be very costly.

31 May to 10 June 2010 – Market Speculation Abound

Meanwhile, market speculation of Fortis launching a counter offer helped to propel Parkway's share price to a high of S$3.79 on 31 May 2010. The speculation was fuelled by a number of moves that suggested that Fortis was building a war-chest to fund a possible counter-offer. On 9 June 2010, Fortis' board approved a fresh issue of securities of up to INR27.50 billion (US$585 million)[21], a proposal to raise its borrowing limit to INR60 billon (US$1.8 billion)[22], and a plan to raise INR3.8 billion (US$114.2 million) by issuing around 22.35 million preferential shares to an affiliated investment vehicle of GIC Special Investments Pte Ltd[23]. These helped to boost Parkway's share price to peak at S$3.87 on 10 June 2010[24].

15 June 2010- Fortis Considers Its Options

Amidst the speculation, Fortis announced on 15 June 2010 that it was 'keeping all options open in relation to the [Khazanah's] Partial Offer and that it would continue to evaluate its options in the best interests of its shareholders'[25]. There were also market rumours of Fortis teaming up with India's wealthiest man, Mukesh Ambani, to buy a stake in Parkway.[26]

16 June 2010 - SIC Steps In

The next day, Singapore's Securities Industry Council (SIC) stepped in. The SIC directed Fortis to announce, by 30 July 2010, whether it would make a general offer for Parkway[27]. This was to ensure that Parkway shareholders were given "sufficient information, advice and time" to reach an informed decision on the offer without disrupting the "tactical balance between IHH and Fortis"[28].

21 June to 5 July 2010 – A Question Of Independence

Parkway disseminated a circular[29] to shareholders. This revealed Fortis' co-investment arrangement with the three directors on the Board. The report prompted some shareholders to question both the directors' ability to exercise their voting rights independently as well as Parkway's corporate governance[30]. The three directors responded on 24 June 2010, clarifying that the arrangements did not "impact [their] fiduciary obligations", and that they "adhere to the governance standards required" in their capacity as directors "in the best interests of the Company"[31].

The response failed to pacify minority shareholders and led corporate governance observers to raise the issue of director independence. Associate Professor Mak Yuen Teen, then Co-Director of the Corporate Governance and Financial Reporting Centre at the National University of Singapore, questioned the independence of the directors.[32]. He also supported a suggestion by Jamie Allen, Secretary General of the Asian Corporate Governance Association, for the definition of independence to be tightened[33] in Singapore's Code of Corporate Governance.

The Securities Investors Association (Singapore) (SIAS) weighed in on the issue on 30 June 2010 to help address minority investors' concerns[34]. It met with the three directors on 1 July 2010 to discuss "what is being canvassed in the media arising from the partial offer by Khazanah"[35]. In another meeting on 5 July 2010, the directors met with SIAS officials and the media "to answer all questions and issues that have been raised to-date … that may have a significant impact on their ability to act independently and discharge their fiduciary duties as required by law"[36]. Although SIAS found the directors to have "acted correctly within the law"[37], it nevertheless requested "that authorities review the laws pertaining to independent directors".

1 July 2010 – Fortis Makes a Counter Offer

Slightly over a month after Khazanah's offer, on 1 July 2010, Fortis made a S$3.2 billion voluntary conditional cash offer to acquire the other 74.73 per cent of Parkway shares that it did not already own at S$3.80 per share. This represented a 6.4 per cent premium over the last traded price of S$3.57 per share on 30 June 2010[38]. Although the offer is conditional on Fortis acquiring at least 50 per cent[39] of Parkway, the healthcare provider's share price still rose 3 per cent[40] as soon as the news broke. However, trading was subsequently suspended for the day[41]. On 2 July 2010, Parkway's shares surged 7.3 per cent to close at S$3.83[42], higher than Fortis' offer.

8 July 2010 – Khazanah Extends its Bid

By 8 July 2010, Khazanah had only received 4.5 per cent acceptance for its partial takeover bid[43] and extended the deadline to 26 July 2010[44]. Although no reason was given for this extension, the market nonetheless remained hopeful of another counter offer by Khazanah as the share price rose by 0.3 per cent[45] to close at S$3.88[46].

26 July 2010 – Khazanah Makes a Counter Offer, Trading Suspended Again

At 9am (Singapore time) on 26 July 2010, acting through IHH, Khazanah requested a trading suspension of Parkway shares on SGX, pending the release of a material announcement.[47] A few hours later, Khazanah proceeded to top Fortis' last offer in a S$3.5 billion voluntary cash general offer. It proposed to pay S$3.95[48] per share for the remaining 76.1 per cent of Parkway shares that it did not already own. This would value Parkway at S$4.5 billion[49].

In its offer document, Khazanah highlighted its interest and experience in the healthcare industry. It said its takeover offer for Parkway is 'in line with its core commercial objectives to enhance its presence in the regional healthcare industry and will help it move towards building a more integrated regional healthcare platform'[50]. Khazanah also put forward its intention to maintain Parkway's present listing status on the Singapore Exchange[51]. The offer was slated to expire at 5.30 pm (Singapore time) on 16 August 2010.

The Battle Ends

On 27 July, the trading halt was lifted. News had already broken that Fortis had decided to cash out its 25.37 per cent stake in Parkway Holdings for a profit of S$116.7 million[52].

After Fortis' exit, Khazanah's ownership of Parkway shares increased to around 95 per cent as of 16 August 2010, with the right to "compulsorily acquire the remaining shares". As Parkway no longer met the minimum public float[53] of 10 per cent required for an SGX listing, trading of its shares was suspended "pursuant to Rules 724, 1105, and 1303(1) of the Listing

Manual"[54] on the same day. With the departure of all Fortis executives from the Board, a new Chairman and Directors were appointed on 25 August 2010[55]. Parkway Holdings was ultimately delisted from the SGX on 24 November 2010.

Discussion Questions

1. Analyse the takeover process of Parkway Holdings and discuss if shareholders' interest was protected.

2. Comment if it was appropriate for the Parkway Board to have three directors and one chairman from Fortis. What are the benefits and costs of such an arrangement? What do you think should be the best practice?

3. Discuss the importance of the independence of directors in making decisions for the company. Comment on the independence of Richard Seow and the Singh brothers on the Parkway Board in relation to the Code of Governance in Singapore and international best practice.

4. Comment on the agreement between Fortis and the three Parkway directors that gave "Fortis the 'right to direct' how they [directors] vote", "subject to their fiduciary duty as directors to act in the best interests of the company". What is the paradox here? What are the implications for fulfilment of directors' duties?

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The Failed SGX-ASX "Merger"

> "Money has started to go cross-border much faster than we as exchanges have helped it to do so, and exchanges have been a little bit behind on that. We come from an environment where we are not used to helping our clients facilitate their business."
>
> — Magnus Bocker, on why he believes the SGX-ASX merger is essential[1]

Case Overview

In what Magnus Bocker, CEO of the Singapore Stock Exchange (SGX), regarded as the biggest acquisition move of the decade, the proposed merger between the Australian Stock Exchange (ASX) and SGX was considered by him to be beneficial to both parties. However, Australian Treasurer Wayne Swan rejected the proposed takeover. The objective of this case is to allow a discussion of issues such as the role of the boards of acquiring and target companies in a merger or acquisition deal, whether the proposed merger was beneficial to shareholders of SGX and ASX, the divergence of interests of different stakeholders, the role of shareholders in approving a merger or acquisition, and corporate governance issues surrounding mergers and acquisitions.

This is an abridged version of a case initially prepared by Cheong Jian Jie, Ong Ying Min, and Yu Chenghui 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. Consequently, 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 prepared by Amanda Seah Jia Hui under the supervision of Professor Mak Yuen Teen.

The Growth of SGX

Founded in 1991 through the merger of the Stock Exchange of Singapore (SES) and the Singapore International Monetary Exchange (SIMEX), SGX began operations with a listing of 307 companies having a total market capitalisation of S$263 billion. It was demutualised in 1999. In 2000, it became the first publicly-held exchange in Asia-Pacific with its shares listed on its own exchange. One of the major shareholders resulting from SGX's IPO was SEL Holdings Pte Ltd, with a 29 per cent stake. SEL is a wholly-owned subsidiary of Temasek Holdings Pte Ltd[2]. Following its listing, SGX expanded its presence in the global securities markets and the diversity of share offerings.

SGX also entered into joint ventures with the American Stock Exchange (AMEX) in June 1999[3] and Chi-X Global in October 2010[4], allowing it to improve its competiveness against its key regional competitor, the Hong Kong Stock Exchange (HKSE). The joint venture with Chi-X created a platform for 'dark pool' trading. Apart from joint ventures, acquisition was also on SGX's agenda. Over the years, SGX has acquired a stake in foreign exchanges such as Bombay Stock Exchange, Chicago Mercantile Exchange (CME) and Philippine Dealing System Holding Corporation. Within Singapore, SGX also acquired the Singapore Commodity Exchange Ltd on 30 June 2008[5]. All these enhanced SGX's market attractiveness, increased its market depth and liquidity, and provided more product offerings to investors.

One of the results of the rapid expansion was the listing of 774 companies in SGX with a total market capitalisation of S$650 billion[6] as of 2010, up from 307 companies when it began operations in 1991. Notwithstanding this, SGX continued to look for alliance and acquisition opportunities that will help it to grow and compete with neighbouring exchanges.

Then came the opportunity to acquire the Australian Stock Exchange (ASX)[7].

The Deal of the Decade

On 23 October 2010, major newspapers and media across Singapore and Australia were filled with headlines on the potential merger between SGX and ASX. SGX had proposed to acquire all the shares of ASX in a deal that SGX argued was in the best interests of the shareholders of both parties. Under the proposal, SGX offered A$48 per ASX share, paying in both cash and SGX shares[8]. The result of the merger would be a combined entity with a market value of US$12.3 billion[9], making it the second largest stock exchange in Asia after the Hong Kong Stock Exchange by market value. The united bourses would also be the second largest exchange in the region after the Bombay Stock Exchange in terms of the number of listed companies[10].

The merger would give SGX a total listing of 2,700 companies from over 20 countries. The proposed merger would also create the largest number of listings of real estate investment trusts (REITs) in Asia Pacific, and the widest range of Asia Pacific derivatives in the world[11].

However, the deal had to overcome a number of hurdles. First, the approval of Australian Treasurer Wayne Swan was required for the merger to go through. Second, the Australian parliament had to approve altering the 15 per cent foreign shareholding limit in ASX to accommodate the merger[12]. Finally, the approval from shareholders of both exchanges was needed.

Reaction from Down Under

There were mixed reactions from Australia. ASX CEO Robert Elstone tried to convince ASX shareholders and the relevant regulatory bodies on the merits of the deal. He argued that the merger would benefit both ASX and the country.

Elstone was well aware that the looming competition at its doorstep would pose a significant threat to ASX after it lost its market supervisory power to the Australian Securities and Investment Commission (ASIC), the national securities regulator[13].

Elstone also knew that ASX would lose its monopoly by 2011 with the high speed trading platform, Chi-X Global, poised to enter the Australia market[14]. As Chi-X waited three years[15] for its license to be approved, ASX upgraded its technology systems, introduced new order types and reduced trading fees[16]. Facing mostly negative comments in Australia about the proposed merger, Elstone still continued to argue that it was in Australia's national interest.

He called on the politicians to decide whether "is the national interest best served by boxing the domestic exchange into its existing strong but confined-to-Australia franchise, or should it allow its domestic exchange to truly internationalise?"[17] According to Elstone:

"We can't see how this is contrary to the national interest. The combined exchange will be both more regionally relevant and globally relevant than the sum of its parts. The attractiveness of a combined pool of listings and a combined pool of liquidity would make this combination unique."[18]

To further bolster support for SGX's bid, ASX commissioned a report by Access Economics to assess whether the merger was in Australia's national interest.[19] On 6 December 2010, the report by Access Economics concluded that the "formation would promote Australia's national interest since it is highly likely to raise the economic welfare of Australians.[20]" According to ASX, the deal will help Australia become an Asian financial hub, allow Australians to diversify their savings, and lower local companies' capital costs.[21] Ian Harper, director at Access Economics, argued that the takeover will "open the pipe or channel between the Australian financial markets and the markets in Asia"[22]

On the other hand, some ASX shareholders felt that SGX was taking advantage of ASX[23]. While SGX was a bigger exchange in terms of market value[24], ASX had a larger market of 2,000 listed companies[25] compared to 774 companies listed on SGX[26]. The subsequent increase in ASX's share price from A$34.96 on 22 October 2010 to A$41.75 on 25 October 2010[27] when the announcement was made public also meant that SGX would appear to be buying ASX shares on the cheap. This did not go down well with retail investors, who owned half of ASX.

The Australian Stockbrokers Association was also sceptical of the proposal. According to the association, the deal would undermine the Australian market and benefits for Australian companies were not apparent. There was uncertainty over issues such as how capital raising opportunities would be made easier or cheaper, how clients dealing with the region would be protected, and the effect on Australia's status as a regional financial centre given that the proposal would essentially mean that the Australian market would be under the control of Singapore[28].

Australian lawmaker Bob Katter lashed out at the deal, saying that it was a sell-out of national assets and "lunacy on a grand scale"[29].

Concessions by SGX

Many commentators had expressed the view that the proposed merger was, in fact, a takeover by SGX[30]. In the initial proposal, SGX was to assume greater control of the board, with Chew Choon Seng, the current SGX Chairman becoming the Chairman of the combined entity, the current ASX Chairman David Gonski becoming the Deputy Chairman, and Magnus Bocker becoming the CEO. However, the 15-member board will include only four Australian directors.

On 15 February 2011, SGX announced a revised proposal under which there will be an equal number of Australian and Singaporean directors on the new board. The 13-member board will comprise five Australian citizens, five Singaporeans and three international directors[31].

On 11 March 2011, SGX submitted a formal application to the Foreign Investment Review Board (FIRB) based on the amended terms[32]. The FIRB's decision was set to be announced on 11 April 2011[33].

Rejection on the Cards

By early April, it was becoming clear that the deal was falling apart. On 5 April 2011, the long awaited silence was broken when the FIRB said that Australian Treasurer Wayne Swan was "disposed to reject the proposed merger between ASX and SGX as contrary to Australia's national interest"[34].

Although the final decision had not been made at the time, the comment triggered a positive response in SGX's share price, which jumped as much as 6.5 per cent to S$8.53, while ASX's share price fell 3.3 per cent to A$33.70[35]. This was a contrast to the market reaction when the deal was announced, with SGX's share price falling and ASX share price increasing.

Bocker, however, was optimistic. He said that no further amendments would be made to the existing proposal, and that there did not seem to be criticism of the proposed structure from Swan[36]. SGX also announced that, should the deal be aborted, they "will continue to pursue organic as well as other strategic growth opportunities, including further dialogue with ASX on other forms of co-operation."[37]

The (Un)Expected Verdict?

On 8 April 2011, Australian Treasurer Wayne Swan rejected the proposed deal[38].

According to Swan, "This is not a merger. It's a takeover that would see Australia's financial sector become a subsidiary to a competitor in Asia.[39]" Swan added that "this takeover would not enhance our access to global financial markets". The claims made by the applicants didn't stack up. I had no hesitation in rejecting it.[40]" According to Swan, "the deal would not provide a gateway to Asian capital flows as SGX has limited flows to the rest of Asia.[41]" The approval of the merger would also see ASX as the "junior partner".

To some observers, the strong disapproval of the FIRB against the tie-up was surprising. In Swan's words, that was "not normally the attitude of the FIRB"[42]. Concerns were also raised by the Treasury, Reserve Bank of Australia, and the Australian Securities and Investment Commission with regard to the regulatory oversight[43].

Swan was sceptical about being able to have full regulatory sovereignty over the ASX-SGX holding company and this could present significant risks and supervisory issues when it comes to regulating the exchange operations effectively. To him, it was an irony to have ASX becoming a subsidiary to a smaller regional competitor in Asia.

The announcement on 8 April shattered the dream of SGX in becoming one of the largest exchanges in the world. Shortly after the announcement, SGX shares rose 2.82 per cent and closed at S$8.38, while ASX shares fell 0.45 per cent and closed at A$33.33[44].

The merger attempt had cost SGX an estimated S$12 million[45].

SGX Moving Forward

Over the nine months to March 2011, SGX's average daily turnover was S$1.68 billion, which fell short of the projected S$1.95 billion per day. SGX felt it needed to embark on its growth strategy to increase turnover[46]. This is especially so when cross-border deals have become prevalent among exchanges around the world[47], allowing other exchanges to build up scale and cut cost to maintain competitiveness. SGX also had to seek similar growth opportunities in increasing its cross-listing platforms with other exchanges to attract more regional companies to list on SGX.

Discussion Questions

1. What are the roles and responsibilities of the board of directors in a merger or takeover situation?

2. In a merger or takeover situation, the interests of different stakeholders and even different shareholders may diverge. In the case of the proposed SGX-ASX merger, which stakeholders favoured the merger and which did not? Why?

3. To what extent should shareholders of the two exchanges be allowed to decide on whether the SGX-ASX merger should proceed, or should other stakeholders also have a say? Explain.

4. In general, what are the key corporate governance issues faced in a merger or takeover?

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The Sour Apple: The Fall and Fall of New Lakeside

Case Overview

Ever since its SESDAQ[1] listing at a price of 32 cents per share in March 2004, New Lakeside Holdings Limited (New Lakeside) had issued a number of profit warnings and had been plagued by corporate governance issues and audit qualifications. Things worsened when its statutory auditor, LTC LLP (LTC), claimed that the Group had made "fraudulent misrepresentations"[2] in their 2009 financial statements. By the time LTC reported the matter to the Minister of Finance for possible breach of the Companies Act in September 2010, the share price had plunged to 2 cents per share[3]. Despite a major restructuring exercise, the situation was beyond salvage for New Lakeside. On 1 November 2010, New Lakeside filed with the High Court to be placed under judicial management. The objective of this case is to allow a discussion of issues such as challenges for independent directors in a management-controlled company, accounting and auditing issues, and the roles of directors, auditors, regulators and other intermediaries.

The Beginnings of New Lakeside

Incorporated in Singapore in 2002, New Lakeside produced and sold apple juice concentrate to multinational corporations in the food & beverages industry. The Group had two wholly-owned subsidiaries - Sanmenxia Lakeside Fruit Juice Co. Ltd (LFJ) and New Lakeside (Sanmenxia) Co.

This is the abridged version of a case prepared by Athena Chan, Elaine Ang, Elicia Ng, Emily Sim, and Regina Lin under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management. Consequently, 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 prepared by Amanda Aw Yong under the supervision of Professor Mak Yuen Teen.

Ltd (NLS). The apple juice concentrate produced was used to make packet juice drinks, soft drinks, cider, yoghurt and candies. The Group also produced animal feed using apple pomace from the production of apple juice concentrate to supplement its main business. New Lakeside had customers in North America, Southeast Asia and Western Europe.

In March 2004, New Lakeside became the first company (since August 2003) to close below its initial public offer (IPO) price, at 30.5 cents per share compared to its IPO price of 32 cents per share. Several other listings also fell below their IPO prices. Poor market confidence after a terrorist attack in Spain, a political standstill in Taiwan and correction on Wall Street were cited as reasons for the bearish Singapore market. Other analysts, however, attributed New Lakeside's low IPO price to inherent problems with its business model – a single-product business which was highly leveraged.

Absence of Profit Warning

As 30 June 2004 approached, many Chinese companies listed on the Singapore Exchange began to issue profit warnings. As New Lakeside did not issue a profit warning, its reported net loss of RMB 9.4 million (S$1.95 million) for the six-month period ended 30 June 2004 shocked the market. In a statement to the SGX[4], New Lakeside attributed the loss to the increase in administrative expenses, selling and distributing expenses, and finance costs. Revenue also decreased due to the unusually higher sales for financial year (FY) 2003, which in turn was due to U.S. orders taken in 2002 but fulfilled in 2003.

The independent directors (IDs) – Chairman Alan Yeo, Hwang Soo Chin and Leong Siew Loon – were unaware of the loss until four days before the release of the financial results. In reaction to the shock loss, the directors commissioned a special audit, carried out by China-based auditors Henan Chenghe Accounting Firm, to review the circumstances surrounding the loss. They also commissioned a physical stock count in the Group's subsidiaries.

The First Special Audit

The special audit uncovered numerous accounting irregularities, and reactions from Moore Stephens (the external auditors) and the directors of New Lakeside in response to the irregularities, were as follows:

Special Audit Findings by Chenghe	Responses from Moore Stephens and Directors
Failure of subsidiary LFJ to abide by China's enterprise accounting system resulted in an understatement of cost of sales (COS) and overstatement of profits amounting to RMB 24.4 million (S$4.9 million).	Moore Stephens: Chenghe had not computed the COS on a consolidated basis. With the exclusion of the accounts of Lingyi factory, a branch of LFJ, it was difficult to prove a substantial misstatement of COS. Directors: Agreed.
Asset inflation - Assets bought for RMB 6.4 million were recorded at about RMB 47.4 million.	Moore Stephens: A reversal for the difference was done. Directors: Satisfied at the reversal of the entry.
Prepaid freight charges (on behalf of customers) of RMB 16.3 million were classified as receivables in LFJ's accounts when the recovery was uncertain.	Moore Stephen: Made a provision of RMB 4.1 million for long outstanding receivables. Directors: To continue to monitor the recoverability of these receivables and review the policy of freight prepayment.
(a) Two unusual sales transactions (b) A physical stock count showed an overstatement of LFJ's stock of approximately RMB 2.8 million.	(a) Directors believed those sales were provided for by Moore Stephens. (b) Directors assured that measures have been taken to ensure proper bookkeeping.

Trouble Brewing in the Boardroom

The IDs called for a meeting to review the findings of the special audit. Unconvinced by the "inadequate explanations"[5] provided by the then-MD Sun Jiwei and Chief Financial Officer (CFO) Xu Lixin, the IDs discharged them from their duties to avoid "a dereliction of our duties for all shareholders"[6]. However, later in the same month, Sun was unexpectedly reinstated as the joint-MD, together with the appointment of another MD Go Twan Heng, who was also the majority shareholder.

The directors of the subsidiaries were also reappointed, together with other new directors on the New Lakeside board[7]. In the end, the IDs did not cast their vote to oust Sun and the directors of the subsidiaries, as they realised that their votes could not influence the decisions made as the executive directors held the majority of the Group's shares[8].

Joint-MD Sun Sacked Over First Profit Warning

Though New Lakeside appeared to be heading towards better times with the new structure, the Group released its first profit warning for the half-year ended 30 June 2005. While sales had increased, the larger increase in cost of production had eroded its profits. The Group expected the losses to persist in the subsequent half-year. Believing that its loss of RMB 66.2 million (S$13.7 million) in the first half of 2005 was due to Sun's incompetence, the board of directors terminated Sun's position as the joint-MD[9]. Go then assumed the post of the sole MD. Following that, Professor Wang Sixin, an executive director, and general manager and director of two subsidiaries, also resigned.

Shaken Confidence

To make matters worse, the Group reported that it might suffer an estimated loss of RMB10 million in its second half-year due to the shortage in raw materials and unfavourable weather conditions. In the end, FY2005 ended with an accumulated loss of RMB98 million (S$19.7 million). External auditors TeoFoongWongLCLoong also raised going concern issues, suggesting that New Lakeside might not be able to meet its financial obligations.

The profit warnings continued into the first half of 2006, with a reported net loss of RMB12 million. However, the Group incurred lower losses, as compared to the first half of 2005, due to the measures taken by the new management to minimise costs. Despite having implemented those steps, the Group still performed below market expectations. Coupled with the unauthorised RMB250 million guarantees made by LFJ (approved by MD Sun), the financial position of New Lakeside could not be any worse.

Restructuring Exercise

In 2006, Go implemented a major restructuring strategy across the firm in hopes of turning things around. Two loss-making subsidiaries in China[10] were sold for a token amount of RMB5 (S$1) each, along with their net liabilities. The gain on disposal of the two subsidiaries totalled RMB86.96 million, which more than offset the loss from operations for FY2006. Under the SGX listing rules, companies which suffered losses for three consecutive years would be placed on its watchlist, while those which reported losses for five consecutive years would be delisted[11]. Due to the gain from disposals, New Lakeside saw its first profit in three years.

The other business of manufacturing animal feed, which required coal to dry the apple pulp, was closed down to limit the risk exposure of the escalating cost of coal. The fiscal year end was also changed from 31 December to 30 June - the reason given was to align the fiscal year to the apple pressing season in order to better reflect the Group's operating cycles[12].

Joint Venture with Zhonglu

Go's efforts in rebuilding the Group initially appeared to be effective, based on the return to profitability in 2006 and 2007. Good news came in July 2008 when Shanghai-listed SDIC Zhonglu Fruit Juice Co. (Zhonglu) decided to invest S$12.25 million of its manufacturing assets in New Lakeside, thereby acquiring a 24.57 per cent stake (98 million shares). As a producer and seller of fruit juice concentrates, Zhonglu was a leading player in the apple juice concentrate industry, with 14 per cent of the Chinese market[13]. Having an established industry player as a major shareholder could potentially help resolve New Lakeside's financing woes, improve its management support, and significantly increase its production in the short-run. New Lakeside, in turn, was able to offer Zhonglu better access to international capital through its SGX listing.

Go expected the joint venture to generate immediate cost savings and increased profits through the ability to buy cheaper apples. Together with tighter cost control and a commercially - profitable arrangement, FY2008 was the second profitable year for New Lakeside since its 2004 listing.

The Point of No Return

However, the joint venture with Zhonglu was not able to turn the situation around for the Group. More profit warnings came in July 2009 and again in January 2010. New Lakeside's financial statements raised a red flag, with net current liabilities reported at RMB93.16 million (S$19.1 million) and negative operating cashflows of RMB12.74 million. This prompted the newly-appointed auditors, LTC, to warn investors of potential going concern risks.

The situation worsened in January 2010 when the Group could not pay its debts. NLX was under pressure from a claim of RMB22.75 million arising from a guarantee given to a former subsidiary of the Group, LFJ. This reduced NLX to a state of insolvency, which sparked further immediate claims amounting to RMB24.5 million from two other banks[14]. To make matters worse, two other individual lenders[15] also demanded the repayment of a S$6.56 million loan they had given to the Group in 2006. This raised significant going concern issues for New Lakeside.

Amid the mounting cash flow problems, CFO Oh Gim Teck resigned on 11 June 2010, after the failure to reach a consensus among the executive directors on how to resolve the issue[16].

A Trail of Audit Qualifications

New Lakeside had several qualified auditors' opinions relating to significant accounting-related issues[17]. However, New Lakeside was not required to take mandatory courses of action to address those issues. Regulators also did not act.

In April 2005, Moore Stephens issued an opinion with an emphasis of matter relating to trade debtors of RMB7.3 million which had been outstanding for more than a year. In April 2006, the new auditors, TeoFoongWongLCLoong, qualified their opinion for FY2005, citing going-concern issues and their inability to form an opinion on the existence of inventories which were written off, write-off of freight charges, and validity and treatment of certain expenses. In April 2007, Baker Tilly also qualified their opinion, citing going-concern issues and inability to verify unaudited management accounts of subsidiaries, which had been disposed of during the year. In October 2007, New Lakeside changed its financial year-end from December to June.The set of accounts issued in October 2008 were again qualified by Baker Tilly, this time citing their inability to verify financial guarantees given by a subsidiary and the recoverability of sundry receivables. Their report also contained an emphasis of matter relating to the company's ability to meet its financial obligations.

In April 2009, New Lakeside changed its auditors to LTC, and in October 2009, when the company reported a net loss of RMB84.9 million, the external auditors' opinion contained only an emphasis of matter, albeit an important one relating to 'material uncertainty which may cast significant doubt about ability to continue as going concern'. However, in September 2010, LTC informed the audit committee chairman that fraudulent representations may have been made in the course of the 2009 audit and therefore their audit opinion for 2009 could no longer be relied upon. LTC also made a report to the Minister of Finance.

No More Juice

With a net loss of RMB84.9 million in FY2009 followed by another net loss of RMB64.1 million for the following financial year, the situation spiralled out of control. New Lakeside finally filed with the Court to be placed under judicial management[18], and the Group's shares were officially suspended from trading.

> "We are of the view that the company will be unable to pay its debts as a result of recent developments."
>
> — Board of New Lakeside in its filing to SGX,
> 2 November 2010 (The Business Times)

This spelt the end of New Lakeside's precarious, short-lived existence.

Discussion Questions

1. What are the challenges faced by independent directors in a company like New Lakeside, where management are also significant shareholders?

2. "The tone of at the top significantly influences a company's corporate governance." How much would you attribute the downfall of New Lakeside to the weak tone at the top? Who do you think was ultimately responsible for the demise of the Group?

3. What actions could have been taken after the first Special Audit findings were revealed?

4. Given the legal requirement for companies to comply with accounting standards and the accounting-related provisions in the Companies Act, do you think the company has broken any laws?

5. Given the trail of audit qualifications before New Lakeside was placed under judicial management, could more have been done? If so, what and by whom?

6. Discuss the roles of the auditors, regulators and New Lakeside's sponsor, CNP Compliance, in this case. Do you believe they had performed their roles effectively?

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[3] Bloomberg. 2011. http://www.bloomberg.com/apps/quote?ticker=NLH:SP, accessed on April 2011.

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[5] Goh Eng Yeow. “New Lakeside relieves MD and CFO of their duties; Execs may be removed from board for ‘inadequate’ answers to queries by directors”, 3 November 2004. *The Straits Times Singapore*, via LexisNexis Academic. April 2011. <http://www.lexisnexis.com.libproxy1.nus.edu.sg/ap/academic>.

[6] Lim, Kenneth. “New Lakeside independent directors lauded; Stock rises after they call for ouster of two key directors”, 3 November 2004. *The Business Times Singapore*, via LexisNexis Academic. April 2011. <http://www.lexisnexis.com.libproxy1.nus.edu.sg/ap/academic>.

[7] Lim, Kenneth. “New Lakeside CFO quits, MD reinstated; Directors of its subsidiaries who were removed earlier were also re-appointed”, 26 November 2004. *The Business Times Singapore*, via LexisNexis Academic. April 2011. <http://www.lexisnexis.com.libproxy1.nus.edu.sg/ap/academic>.

[8] As of the date of Prospectus, 12 March 2004, Go held 58.79 per cent deemed interest in New Lakeside, Sun Held 10.06 per cent whereas Xu held 5.34 per cent.

[9] Wong, Kelvin. “New Lakeside axes joint MD after $14m loss”, 15 August 2005. *The Business Times Singapore*, via LexisNexis Academic. April 2011. <http://www.lexisnexis.com.libproxy1.nus.edu.sg/ap/academic>.

[10] The two loss-making subsidiaries, Sanmexia Lakeside Fruit Juice Co (LFJ) and New Lakeside (Sanmexia) Co Ltd (NLS), were sold to Tecko Technology Ltd for a nominal consideration of S$1 each.

[11] Howells, Chris. "SGX announces delisting of 5 loss-making firms on its watch list", 30 March 2010. *Channel NewsAsia*. April 2011. <http://www.channelnewsasia.com/stories/singaporebusinessnews/view/1046884/1/.html>.

[12] New Lakeside Holdings Limited. Annual Report 2008.

[13] Cheong, Angeline. "Corporate: Asset injection by major shareholder will give New Lakeside more bite", 13 October 2008 *The Edge Singapore*, via LexisNexis Academic. April 2011. <http://www.lexisnexis.com.libproxy1.nus.edu.sg/ap/academic>.

[14] China Construction Bank and Industrial & Commercial Bank of China, for a total sum of RMB24.5 million.

[15] Ho Kam Har (MD Go's wife) and Go Wei Ho.

[16] Khoo, L. "New Lakeside CFO hands in quit notice; Move comes in wake of board differences over cashflow problems", 7 April 2010. *The Business Times Singapore*, via LexisNexis Academic. April 2011. <http://www.lexisnexis.com.libproxy1.nus.edu.sg/ap/academic>.

[17] Mak Yuen Teen. "Souring of an apple juice maker", 27 December 2010. *The Business Times* Singapore, p7

[18] "New Lakeside Holdings files for judicial management", 2 November 2010. *The Business Times Singapore*, via LexisNexis Academic. April 2011. <http://www.lexisnexis.com.libproxy1.nus.edu.sg/ap/academic>.

CITIC PACIFIC: Foreign Exchange Scandal

Case Overview

In February 2008, CITIC Pacific's (CP) stock price sat at a high of HK$43. But within a mere 8 months, it plunged by 92 per cent to HK$3.66 after a foreign exchange scandal which led to a loss of some US$2 billion. This loss was attributed to the unauthorised betting on foreign exchange derivative contracts that were supposedly hedges against currency risks. The objective of this case is to allow a discussion of issues such as board composition, risk management, executive compensation and other corporate governance practices.

Unauthorised Bets on Foreign Exchange Derivative Contracts

CP's investment in a Western Australia iron ore mining project involved an estimated capital commitment of A$1.6 billion and €85 million[1]. In addition, annual operating expenditure of at least A$1 billion for up to 25 years was projected.

CP's cash projections were denominated in USD, but these expenses were paid in Australian dollars and Euros, thus exposing CP to fluctuations in foreign exchange rates. To hedge against these risks, CP entered into

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contracts to deliver USD in return for AUD and EUR. These actions were common to mitigate business risks. The unique problem faced by CP, however, arose from its use of "foreign exchange accumulators".

Accumulators, including currency target redemption forward contracts and daily accrual contracts, were employed by CP. Unlike regular derivatives, accumulators have a unique characteristic: the knock-out clause. The knock-out feature causes the contracts to expire once CP achieves a stipulated profit from the contracts. While the upside gain of the hedging instrument was confined, losses could be unlimited, thus resulting in an asymmetrical payoff.

"This wasn't a hedge, this was an outright bet," said David Webb, a well-known corporate governance activist in Hong Kong.[2] CP's transactions involved substantial risks that far exceeded its actual hedging needs. The mining project required only an initial capital expenditure of A$1.6 billion, yet it entered into contracts for over A$9 billion.[3] 90 per cent of these hedging contracts were entered into when the Australian Dollar hit a high of 87 cents against the USD in October 2008. Hence, when the Australian dollar fell by 20 percent to 70 cents against the USD, a loss of HK$15.5 billion was expected.[4]

This news alarmed investors, who were unaware of the extent of exposure to these leveraged Australian Dollar contracts[5]. It also became clear that the company knew of the exposure as early as 7 September 2008, six weeks before giving a profit warning.

The profit warning caused a 74.8 per cent plunge in CP's share price from HK$14.52 to a record low of HK$3.66, compared with its HK$43 peak in February 2008.

CP's Board of Directors

CP had 19 directors on the board. The board was led by the Chairman, Larry Yung Chi-Kin, who is also an executive director. There were 12 executive directors and seven non-executive directors, four of whom are deemed independent pursuant to the Listing Rules. Two of the independent directors were brothers.

CP's board appeared to comprise qualified and competent individuals. Their competencies and industry expertise indicated that they should be familiar with Hong Kong's regulations. Despite this, the board failed to announce CP's loss immediately, violating Listing Rule 13.09 that requires prompt disclosure of price-sensitive information[6].

Executive Compensation

CP's compensation strategy was set to cultivate a pay-for-performance culture[7]. CP's senior management personnel had a substantial portion of cash compensation linked to performance-based variables to reflect their contribution to the firm's financial performance. Yung's total remuneration was made up of 94 per cent of discretionary bonuses and share-based payment, while for Managing Director Henry Fan Hung Ling, it was 95 per cent. On top of his compensation, Yung received an additional HK$569 million in dividends from his 19 per cent stake in CP.

Amalgamation of Ownership and Management

Control of the company rested in the hands of Yung and CP's major corporate shareholder, CITIC Group[8]. This was a situation where the major shareholders held both ownership and management control over the company.

The failure to separate ownership and management enabled the controllers to benefit from the asymmetric information. Before the derivative losses occurred, CP's two largest individual shareholders frequently raised their stakes in the company. However, they suddenly stopped these moves in early September[9].

The Yung family appeared to be influential in CP's management, with founder Larry Yung helming the Chairman position and his son Carl Yung as the Deputy Managing Director. Before the foreign exchange controversy, Frances Yung, the daughter of Larry Yung, also occupied a senior management position of Director, Group Finance.

Regulatory Policies in Place

In the profit warning dated 20 October 2008, the Company indicated that it was "a*ware of the exposure arising from these contracts on 7 September 2008"*[10]*.* That the company needed six weeks to comprehend the financial parameters and risks of its derivatives contracts was a non-realistically long time. The failure to promptly disclose price-sensitive information violated Listing Rule 13.09. However, the Hong Kong Stock Exchange (HKSE) does not have the power to investigate breaches of disclosure requirements. There are no legal penalties for non-disclosure of price-sensitive information.[11]

In an unrelated circular dated 16 September 2008, the directors expressed a view that there were "no material adverse changes in the company during the year up to 9 September 2008"[12]. This contradicts the profit warning which indicated the Company had known of the losses as early as 7 September 2008. This indicates a possible false and misleading statement, which may subject directors to liability under section 298 of the Securities and Futures Ordinance.

Failed Internal Controls

The effectiveness of CP's internal control system is reviewed regularly by the Group Internal Audit Department. The department also conducts systematic independent evaluations of all business units and subsidiaries in the Group on a continual basis. However, internal controls can only provide reasonable, but not absolute, assurance against any material misstatements or elimination of risks, as seen from the failure of these controls.

The foreign derivatives contracts were made without proper authorisation and adequate evaluation of its potential risk exposure. Chang, the Group's Finance Director, did not follow CP's hedging policy: he failed to adhere to standard procedures of obtaining prior approval of the Chairman before committing to contracts. Furthermore, monitoring mechanisms failed to serve their purpose. The Group Financial Controller's purpose as a check and balance fell through when Group Financial Controller Chau Chi Yin did not notify the Chairman of any unusual hedging transactions.

Steps Taken Towards Recovery

Management reshuffle

On 8 April 2009, CP announced a top management reshuffle. This involved the resignations of CP's founding chairman, Yung, and Managing Director, Fan. The resignations came at a time of police investigations. In a statement to the Hong Kong Stock Exchange, CITIC Pacific said "Mr Yung believed that his resignation would be in the best interests of the company." Chang Zhenming, the vice chairman and president of CITIC group, took over as chairman of CP. Zhang Jijing stepped up as the company's managing director. By the end of 2009, CP had appointed a new financial controller, treasurer and several new executives. In addition, CP committed itself to appointing more independent board directors in the long run. Frances Yung, the Director of Group Finance, was not forced to leave the company but was instead demoted and took a salary cut.

Internal control improvements

CP underwent a major restructuring of its financial control teams via the recruitment of seasoned professionals. They took on roles in identifying, reporting and managing the Group's treasury activities and financial risks[13].

Accounting firm PricewaterhouseCoopers (PwC) was engaged to review CP's financial risk management and company-level corporate controls. Following recommendations from PwC, the Group Internal Audit expanded its scope of risk-based internal audit services provided to the Audit Committee. Additionally, CP appointed a consulting firm to conduct a thorough study and assessment of CP's finance function[14].

CP also updated its terms of reference (TOR) of the audit committee. The updated TOR expanded the committee's oversight function to include the duty to discuss with management the company's internal control systems and the responsibility to ensure that management has taken the internal control measures into consideration when implementing policies and programmes.

These efforts aimed at improving internal control and corporate governance seemed to have done well in restoring investor confidence, as seen from the 19 per cent increase in share price a day after the management reshuffle was announced. Despite suffering losses amounting to HK$10billion and incurring a debt of HK$9.38billion[15] from its unauthorised currency trading bets, CP continued to show positive results in 2009. These are attributable to profits from its steel business, property projects in mainland China and the progress of its iron ore mine in Australia.

Discussion Questions

1. How has the failure to separate ownership, the board and management impaired the corporate governance of the company?

2. Discuss how the compensation system may have impacted the risk appetite and corporate governance of the company.

3. Which do you think played the biggest role in CP's scandal — weak board oversight, failed internal control, or a flawed compensation system?

4. Other than those already taken by the company, how else can they improve corporate governance and internal control?

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Dialling for Votes: The PCCW Privatisation Scandal

Case Overview

After a 97 per cent fall in its share price over eight years, the management of PCCW Limited proposed to privatise the company by buying out the shares held by minority shareholders. In doing so, the company management, led by Richard Li Tzar-kai, allotted shares to insurance agents on condition that they would vote in favour of the resolution, thus going against the spirit of the prevailing corporate governance rules in Hong Kong. After a protracted legal battle, the courts disallowed the controversial vote. The objective of this case is to allow a discussion of issues such as corporate governance in a management-controlled company, the roles and effectiveness of different corporate governance mechanisms, the protection of minority shareholders' interests in a privatisation situation, and business ethics.

PCCW: A Chequered Past

Founded by Richard Li Tzar-kai, the son of Hong Kong tycoon Li Ka-shing, PCCW Limited (PCCW) is the holding company of HKT Group Holdings Limited (HKT), which operates primarily in the telecom, broadband and multimedia industries. It also has interests in the broadband sector in the United Kingdom and a property development company in Hong Kong.

This is an abridged version of a case initially prepared by Keh Guat Teing Jasmine and Lee Yi Wen under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management. Consequently, 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 prepared by Sreevardhan Agarwal under the supervision of Professor Mak Yuen Teen.

In 1999, PCCW acquired highly-prized waterfront real estate from the government without a public auction. This was highly criticised by the media and other property developers.[1] In 2000, the company acquired Hong Kong Telecom (HKT) for US$41 billion, marking the largest merger in Asia at the time. However, due to debt incurred during the process, intense competition in the local telecom sector and the challenge of an international joint venture with the Australian telecommunications company Telstra Corporation, the share price plunged 97 per cent from a peak adjusted price of $131.75 between 2000 and 2008. PCCW was removed from Hong Kong's benchmark Hang Seng Index in June 2008[2].

Richard Li attempted to sell his stake in the company in 2006. The Chinese Government thwarted this attempt by blocking the sale through its control of China Netcom, which owned a 20 per cent stake in PCCW[3].

In 2008, PCCW's businesses were hit hard by the global recession. Profit slumped 20 per cent in the first half of the year[4]. However, some key financial indicators, such as EBIDTA and earnings per share remained stable. After declaring a dividend of HK$0.133 per share, PCCW ended the year with a stable financial position despite the impact of the crisis.

The Board of Directors

As at 31 December 2009, the PCCW board comprised a total of 15 directors, including five executive directors, four non-executive directors and six independent non-executive directors.

40 per cent of the board is made up of independent non-executive directors, although the sixth independent non-executive director, Edmund Tse Sze Wing, was only appointed in September 2009. This fulfilled the minimum standards specified in both the Hong Kong Listing Rules and Hong Kong Code of Corporate Governance. PCCW requires each independent non-executive director to submit an annual written confirmation of his independence from the company. In accordance with the Company's Articles of Association, at each annual general meeting, one third of directors are subject to retirement by rotation. Each non-

executive director also has a term of three years and the maximum term of office for each non-executive director is three years[5].

The Vote Buying Scandal

After his attempt to sell his stake in PCCW was thwarted by the Chinese government, Richard Li began a three-year campaign to privatise the company. Since PCCW is listed on the Hong Kong Stock Exchange, the privatisation scheme was governed by both the Companies Ordinance (CO) as well as the Code of Takeovers and Mergers (Takeovers Code). Under the headcount rule of the Companies Ordinance, if three-fourths of members vote either in person or by proxy in favour of a proposal, it is binding on all members. In other words, at least 75 per cent of the shareholders, regardless of the number of shares each shareholder owns, were required to approve the privatisation proposal[6].

Under a scheme announced on 30 October 2008, Li and China Netcom offered to pay HK$15.9 billion to buy out minority shareholders. This would lift Li's stake in PCCW from 27.7 per cent to 66.7 per cent and Netcom's stake from 19.8 per cent to 33.3 per cent. Minority shareholders were offered HK$4.50 per share, representing a huge discount from the peak share price of HK$131.75 attained before the merger with HKT in 2000. However, in response to the offer, the price of PCCW shares increased from HK$2.90 on 14 October 2008 before trading of the counter was suspended to HK$3.58 on 5 November 2008 when trading resumed. At the shareholders' meeting to approve the proposal, management was accused of vote manipulation and rigging. Yet, the proposal was eventually approved with 80 per cent support[7].

On receiving a complaint from the well-known HK governance activist David Webb, the Securities and Futures Commission (SFC) investigated allegations of vote buying. Investigations revealed that 1,000 share board lots were distributed to insurance agents of Fortis Insurance Company (Asia), previously owned by PCCW. The shares were given in return for the assurance that the agents would sign proxy forms to vote in favour of the proposal. This scheme was allegedly conceived by Francis Yuen, part of Richard Li's buyout group, and instructions were given to Inneo Lam, Regional Director at Fortis, to distribute the shares to 500 Fortis agents. Without these insurance agents, the buyout plan would only gain marginal support, with 903 approving and 854 opposing[8]. Such a slim majority would not have met the headcount rule's requirement of 75 per cent support by number of shareholders.

Initially, the Court of First Instance approved the privatisation plan. Following the ruling, the Court of Appeals granted leave to the SFC to appeal against the verdict[9]. The SFC applied to the court to veto the results of the shareholder meeting. On 11 May 2009, the Court of Appeal ruled that there was a clear manipulation of the vote and the extent of the manipulation raised doubts on the fairness of the voting results. In addition, the court said that vote manipulation is an act of dishonesty and the court could not sanction such an act. The judge made the following observation, referring to elderly minority investors who had invested in PCCW:

> "These people have put their life savings into it, and they've got nothing left. Look what happened - it [the stock price of PCCW] has gone down from HK$120 to nothing! It's pathetic … there's a difference between a takeover and a squeezing out[10]."

Questions of Shareholders' Rights, Ethics and Legality

The scandal raised questions about how privatisation proposals should be determined and whether the splitting of votes violates the letter or spirit of rules designed to protect minority shareholders.

Many institutional investors, having invested for the short term, accepted the proposal due to the premium of the offer price over the prevailing market price. However, the Court of Appeals highlighted the plight of retail investors, saying, "These small shareholders are not realising their investment but in fact are being left behind ... I can't see it's going to do the company any good."[11]

Another important issue was that the buyout plan was drafted in a manner that would greatly benefit Richard Li and China Netcom. According to the proposal, after PCCW was privatised, Richard Li and China Netcom would be awarded a special dividend that would cover the entire cost of taking the company private, plus provide an extra HK$2.9 billion once the process was completed.[12] Since management did not justify the decision to award the special dividend to the parties making the buyout offer, one of the judges hearing the case commented that the proposal was "outrageous"[13]. These issues exacerbated the concerns of minority shareholders, many of whom were elderly investors who had to leave the meeting before casting their vote since it dragged on for more than 7 hours[14].

The evidence of vote rigging did not technically violate Hong Kong's market regulations because there were no laws against splitting shareholder votes. However, since it went against the spirit of the headcount rule, Richard Li and China Netcom had to withdraw the proposal based on the Court of Appeal judgement.

Discussion Questions

1. What is the "agency" problem typically confronting companies like PCCW with a controlling shareholder?

2. To what extent is there a separation between shareholders, the board and management in PCCW? How might this have contributed to the near success of the privatisation plans?

3. Consider how PCCW's failed privatisation illustrates the effectiveness or ineffectiveness of key corporate governance mechanisms.

4. In major corporate transactions, such as the PCCW privatisation, different shareholders may have different interests and preferences. How should the board and regulators balance the interests of these different shareholders?

5. The privatisation of PCCW requires the approval of 75 per cent of shareholders (or their proxies) present at the shareholders' meeting. In your view, is this fair to small shareholders? How about large shareholders?

6. Did the board and management of PCCW act ethically in the privatisation attempt?

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GOME: A Boardroom Fight from Prison

Case Overview

Founder and former chairman of GOME Electrical Appliance Holdings (GOME), Huang Guangyu, was sentenced to 14 years' jail on 18 May 2010[1]. This was a huge fall from grace for one of the richest men in China. After Huang's arrest in late 2008, the then CEO Chen Xiao replaced him as Chairman of GOME's board in January 2009. Under Chen, GOME began deviating from the company's original strategies, whilst external investors such as Bain Capital LLC were invited to invest in the firm. From Huang's perspective, these developments threatened his control of the company[2]. Huang then waged a boardroom fight from prison. The objective of this case is to allow a discussion of issues such as corporate governance in founder-managed companies; business practices and corporate governance in Chinese companies; bribery, insider trading and market manipulation; and board composition and control.

The Growth of GOME

Founded in 1987, the success of GOME could be largely attributed to its 'best price' strategy. According to Huang Guangyu, the founder and former Chairman, "by offering lower prices, customers are happy and support you, (and) tell other people about you.[3]" Under Huang's management, GOME gradually became known as the electrical appliance store that

This is an abridged version of a case initially prepared by Teo Chun Peng Justin, Khong Xiang Zheng, Ker Wanling, Chiu Weiqi, and Abdul Hakeem 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. Consequently, 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 prepared by Amanda Seah Jia Hui under the supervision of Professor Mak Yuen Teen.

sold its goods at the lowest price. Huang was then known as the “Price Butcher”[4] and the “Sam Walton of China”[5].

With the rapid growth of the company, Huang opted to list the GOME Group on the Hong Kong Stock Exchange (HKSE) in 2004. Approximately 90 of GOME’s highest grossing stores were included in the listed GOME Group, while the remaining unlisted stores were under Huang’s personal control[6]. The unlisted stores were managed by the company via a management memorandum agreement. When this agreement expired, control would return to Huang. GOME experienced tremendous growth, surging to a market leadership position in China’s electronics retail industry[7]. The ultimate measure of Huang’s success came in 2005 when he was ranked the richest man in China by Time Magazine[8], a title he held until his arrest in November 2008. At that time, Huang’s estimated personal wealth stood at US$6.3 billion[9].

The Arrest of Huang

In 2008, under the Chinese government’s enforcement actions against corporate corruption[10], Huang was arrested and placed “under investigation”[11] for suspicion of bribery, insider trading and money laundering, among other breaches. Trading of GOME’s shares was suspended on the HKSE on 24 November 2008 following the news of Huang’s 18-month detention[12]. GOME’s share price plummeted to a low of HK$1.12 on 25 November 2008[13].

The Bribery Scandal

The investigations revealed that Huang had engaged in both direct bribery and indirect instigation of bribery of five government officials[14], involving a total of RMB 4.56 million worth of cash and properties in return for special consideration and business favours[15].

In June 2006, the Beijing Municipal State Taxation Bureau had ordered six provincial taxation bureaus to investigate GOME over tax evasion issues[16]. Two of the key members of the assigned team, Liang Conglin and Ling Wei, were approached by Jing Hongli, a senior officer with the Economic Crime Investigation Department of the Beijing police, with a request for them to be "lenient" in reporting their findings on GOME[17]. The pair subsequently had dinner with Huang and his key business partner, Xu Zhongmin, the former chairman of Beijing Centergate[18].

Following Liang and Ling's official inquiry, GOME's Beijing branch was fined a very lenient sum of less than RMB 2 million for injecting capital into a shell company for tax evasion purposes. Liang and Ling each received bank cards with RMB 500,000 worth of credit[19]. Xu Zhongmin was also found to have been instigated by Huang to bribe police and tax officials. In addition, senior tax officials Jing Hongli and Sun Haiting received RMB 1.5 million and RMB 1 million[20] respectively from Xu in connection with GOME's and Huang's misdeeds.

Insider Trading and Other Offences

Huang was also found to have engaged in insider trading from April to September 2007, involving shares in Shenzhen-listed Beijing Centergate Technologies Holding Company Limited ('Centergate'), in which he was a major shareholder[21]. Huang instructed others, including Beijing Eagle Investment Co Ltd[22], a company controlled by Huang himself[23], to buy substantial quantities of Centergate's shares amounting to RMB 1.415 billion[24]. This illegal trading was conducted prior to public disclosures concerning the restructuring plans for Centergate. Centergate's share price soared after these plans were officially announced. Using similar strategies involving restructuring and swaps, Huang also engaged in insider trading in the shares of Sanlian Commercial[25]. By acting on the insider knowledge he had in these two cases, Huang made illegal profits of more than RMB 309 million[26].

In addition to insider trading, Huang was also found guilty of money laundering. From September to December 2007, Huang channelled RMB 800 million to Hong Kong, where the money was converted to HK$822 million through illegal channels such as 'underground banks'[27].

Huang was found guilty by the Beijing Second Intermediate People's Court with respect to charges of bribery and insider trading and sentenced to 14 years in prison[28], fined RMB 600 million and had RMB 200 million of his assets frozen[29].

Share Repurchase Scandal

Besides the criminal offences committed in China, Huang also engaged in unlawful activities outside Mainland China[30]. Huang had organised a large share repurchase with his wife, Du Juan, to sell their shares in GOME back to the company, so as to repay Huang's personal loan of HK$2.4 billion. On 28 January 2008, Huang transferred 50 million GOME shares to his wife's wholly owned company. At the same time, he and Shine Group Ltd, which was wholly-owned by Huang, transferred around 900,000[31] and 136 million shares[32] of GOME respectively to other "family members". As Huang's interest in GOME shares decreased by the same amount, this suggested that these "family members" did not, in fact, include his wife and children[33].

During the period between 22 January 2008 and 5 February 2008, GOME initiated a share buyback from the market. The company bought back 129.8 million of its shares at an average price of HK$17.23, at an approximate cost of HK$2.2 billion to the company.[34] This buyback scheme caught the attention of Hong Kong's Securities and Futures Commission (SFC), even though Huang himself did not directly sell any of his personal shares to the company. The SFC regarded this share buyback as having a negative impact on GOME's financial position and not in the best interests of the company and its shareholders[35]. It had resulted in an artificial upward manipulation of GOME's share price, allowing Huang to dispose of his shares at higher prices through indirect means. Indeed, after the last day of buybacks, GOME's share price plummeted by 74.6 per cent from HK$4.405 to HK$1.12, resulting in a loss of about HK$1.6 billion dollars to shareholders[36].

On 7 August 2009, the SFC applied to the court under Section 213 of the Securities and Futures Ordinance to freeze movement of Huang's stake in GOME, valued at around HK$1.655 billion[37]. In response to this news, GOME's share price fell by 7.8 per cent on 7 August 2009 from HK$2.57 to HK$2.37[38]. It was a costly ruling for the non-controlling shareholders, despite the ruling's intention to protect minority interests.

The Boardroom Shuffle

Following Huang's resignation due to his "inability to perform his duties as a director" on 16 January 2009[39], Huang's successor Chen Xiao started to steer GOME in a different direction, against the wishes of Huang. In 2009, Chen implemented a strategy to transform GOME, through giving priority to network rationalisation and individual store profitability. He built stronger relationships with suppliers to reap economies of scale and also paid more attention to investors. Chen's focus was on cutting down expenses and making GOME a much leaner and more efficient company. Hence, instead of choosing to expand GOME's retail outlets as Huang would have done, Chen decided to close down 189 stores which were deemed to be insufficiently profitable[40].

Huang's second point of contention, also the more crucial one, was with regard to Chen's intention to "broaden (GOME's) shareholder base and shore up its finances"[41] by scouting for private equity investors to boost GOME's declining financial performance and to solve its debt issues. Chen's intention was to attract investments by reputable investors with an interest in management of the company in order to convince the HK regulators of GOME's recovery and restore investor confidence. Chen therefore invited investments from institutional investors, with Kohlberg Kravis Roberts and Bain Capital coming forward as interested parties[42].

On 22 June 2009, an agreement with Bain Capital was struck, despite vehement opposition from Huang[43]. As Huang owned just over a third of the shares, he was unable to swing the board resolution which was in favour of Chen's proposal. Bain was hence able to invest up to US$418 million in GOME, acquiring up to a 23 per cent stake[44], while also subscribing to 12 per cent of GOME's convertible bonds at a huge discount[45]. As expected, market opinions were bullish following this investment. "The worst is over," declared Merrill Lynch analysts Chen Luo and Denise Chai[46]. Following the announcement of Bain's investment, GOME shares soared as much as 107 per cent to a peak of HK$2.32 on 23 June 2009[47].

The investment gave Bain a foothold in the Chinese equity market that was already paying off richly, with the surge in GOME's share price. Bain also had the option to convert its debt instruments into equity, or to continue holding the debt for a 5 percent coupon that "guaranteed it a return of at least 1.5 times its outlay[48]". In addition, Bain was given the right to nominate three directors to GOME's board[49], providing it a good buffer against any action by the majority shareholder which may harm Bain's interests.

Huang appeared to be losing control of the company he had founded, with Bain now the second largest shareholder in GOME, after Huang. However, there was not yet any direct confrontation between both parties.

Jailed, But Still in the Game

The peace was broken on 11 May 2010[50] following Huang's sentencing. Through his representatives, Huang acted to veto a move by Bain to nominate its three allotted directorships[51]. This ultimately proved to be a futile attempt, as Bain's rights to appoint its directors were guaranteed through the contractual agreement made in June 2009.

On 5 August 2010[52], the GOME board filed a lawsuit against Huang for breaches of fiduciary duties as a director and damages for the illegal share repurchase[53]. In response, the convicted Huang launched an attempt to oust Chen using his large shareholding (held by Shinning Crown Holdings Inc)[54]. Yet again, Huang's attempts came to nought, as shareholders voted against this resolution. Huang did, however, succeed in preventing his shareholding from being further diluted, by voting against a mandate to issue new shares "without first offering them to current shareholders"[55].

With Huang and a Bain-backed Chen cancelling each other out in the boardroom, the battle for control soon evolved into a battle for a majority control. Industry insiders saw the potential for a proxy fight, as Bain was gradually accumulating support from GOME's institutional investors who jointly held almost 45 percent of GOME's shares[56]. Bain further added to its voting power by exercising its convertible debt options, converting the bonds to an additional 9.98 percent stake.[57]

However, Huang considered himself to still have a few bargaining chips on hand. Firstly, he had maintained personal ownership over 300 GOME stores that were not listed in 2004[58]. These stores were only run by the listed entity via a management contract that was expiring soon, and Huang could use the uncertainty surrounding its renewal to his advantage. Secondly, Huang continued to have full ownership over the GOME trademark. Without his approval, GOME would be forced to rebuild its brand from scratch.

A few options were open to Huang. He could simply purchase an outright majority of shares, adding to his existing 32.4 per cent ownership[59] which he shared with his wife. However, this action would prove to be costly especially when GOME's share price peaked after the resumption of trading on 23 June 2009[60]. Huang would have to sell some of his unlisted assets to finance such a move[61]. The last option was a co-operative truce.

The End of the Power Struggle

On 11 November 2010, GOME announced its agreement in allowing two of Huang's representatives onto the board[62]. A memorandum of understanding with Huang-controlled Shinning Crown was signed and GOME's board was enlarged from 11 to 13 directors. Huang's sister, Huang Yanhong, was appointed as a non-executive director, while Huang's associate, Zou Xiaochun, was appointed an executive director on the board. It seemed that the concession made would end the power struggle. This agreement would help remove uncertainty about the future of GOME and allow less disruption by avoiding a vicious boardroom fight.

Huang's initial fruitless attempt to oust Chen saw a sudden turn of events when Chairman Chen tendered his resignation on 9 March 2011[63]. The founder of Beijing Dazhong Electrical Appliances Co., Zhang Dazhong, succeeded Chen as Chairman, effective on 10 March 2011[64]. For Huang, Chen's departure meant a removal of a bone of contention and could probably mean a return to GOME's original direction[65].

Under Zhang, a five-year plan for GOME was developed to expand the company's presence to tier-two and tier-three cities in China, with 60 per cent of new shop openings in those cities[66]. In a recent announcement, GOME appears poised to embrace a series of internal reforms, which include a new share option plan. It appears that these plans would see a shift from the "Chen-plan" to the "Huang-plan", marking a personal victory for Huang against Chen[67]. Bain Capital, with a 10 percent stake in GOME, also announced its long-term commitment in the Beijing-based retailer[68].

Discussion Questions

1. For a family-controlled company seeking capital, the pros of a public listing would likely outweigh the cons. Do you agree with this statement?

2. Under the OECD Principles of corporate governance, the board of directors should be able to exercise objective judgement independently, especially from management. This outlines the importance of having a clear separation between board and management. To what extent can Huang's actions in relation to GOME be attributed to the lack of such a separation?

3. "This fight has no winners … GOME is undervalued and its share price will reflect how quickly they remove uncertainties,"[69] remarked BNP Paribas analyst Charlie Chen in response to GOME's boardroom battle. How were minority shareholders hurt in the entire GOME saga? Would any of GOME's existing shareholders be considered "winners" in this leadership struggle?

4. Huang vehemently opposed Bain's investment in GOME in June 2009, a stark contrast to his receptiveness to institutional investors a few years ago. Taking into account the roles played by private equity investors and institutional investors in a company, explain possible reasons for Huang's strong opposition to Bain's investment. Were Huang's motivations in the best interests of the company?

5. Identify the regulatory parties involved in the GOME scandal. Do you think these regulators played effective roles in monitoring and enforcement?

6. At the end of the case, several options were open to Huang. In your opinion, which of these options would be in the best interests of GOME's shareholders?

7. What are the risks for minority shareholders investing in a company like GOME? Given the recent developments, would you be prepared to invest in GOME?

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RINO: Reversing into Trouble

Case Overview

The stock of RINO International Corporation (RINO) traded at more than US$30 during its heyday. However, RINO was not spared in 2010 which saw the uncovering of questionable business practices in many Chinese companies listed in the United States and Canada through reverse mergers. As of 22 July 2011, RINO's stock had fallen to US$0.40. The objective of this case is to allow a discussion of issues such as the method used by Chinese companies to list on stock exchanges in the US using reverse mergers, the risks associated with complex corporate structures that are used to facilitate such listings, and corporate governance and accounting issues in Chinese companies listing in the US through reverse mergers.

A R(H)INO's Route to NASDAQ

Reverse mergers are an alternative route to initial public offerings (IPOs) for companies seeking to list on the US markets, and it has become a popular way for many Chinese companies like RINO to seek additional capital because of its more relaxed requirements.

In 2006, Zou Dejun began to look for opportunities to list his firm Dalian RINO Environment Engineering Science and Technology Co. Ltd. (Dalian

This is the abridged version of a case prepared by Heng Kang Wei Glen, Hong Yuan-Zhang, Liu Zhiyuan, and Tang Xin Yi Wynne under the supervision of Professor Mak Yuen Teen and Dr. Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management. Consequently, 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 prepared by Elaine Kok Shin Yean under the supervision of Professor Mak Yuen Teen.

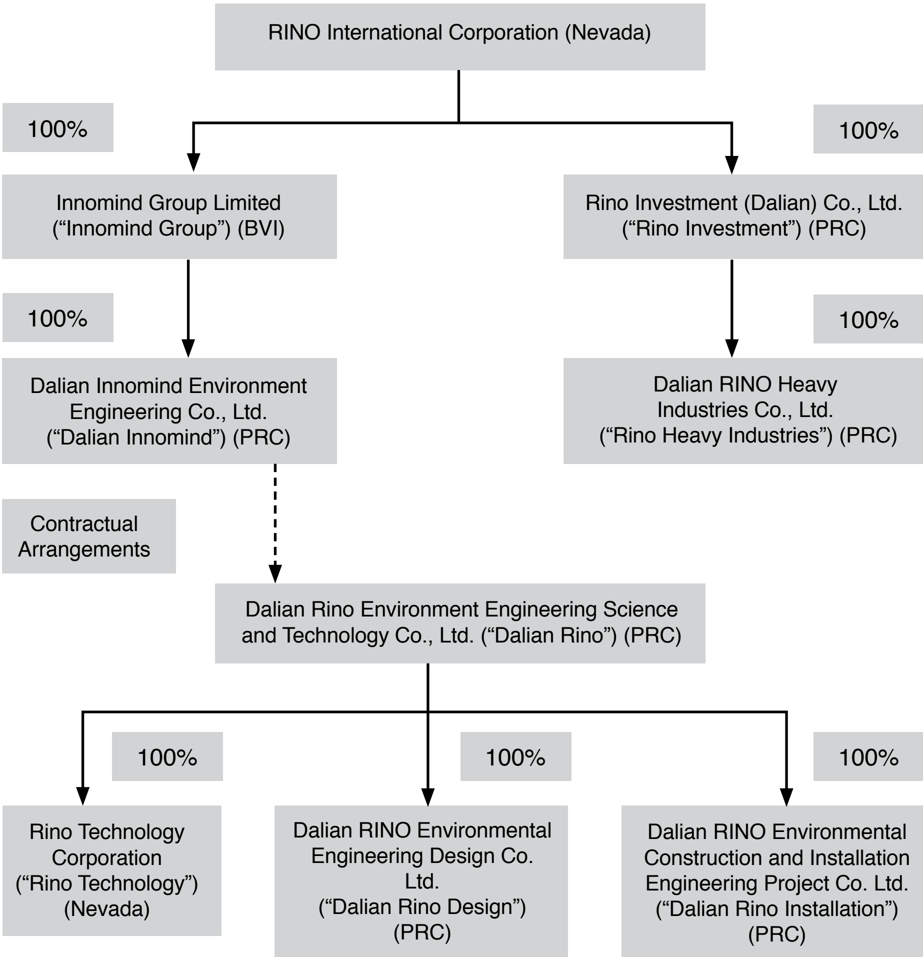

Figure 1: RINO Group Structure

Source: 2009 RINO Annual Report

RINO) on the US markets to access funding. Through a contact, Zou found a Nevada-based shell company, Jade Mountain Corporation, that was listed on the Over-the-Counter Bulletin Board (OTCBB) but which was largely inactive.

On 5 October 2007, the reverse merger between Dalian RINO and Jade Mountain Corporation took place through Innomind Group Ltd (Innomind), a single shareholder company[1]. A share exchange transaction of 17,899,643 shares of common stock was issued to Innomind Trust, essentially giving Innomind control as the trust's beneficiaries were Zou and his wife, Qiu Jianping[2]. When the reverse merger was completed, Jade Mountain changed its name to RINO International Corporation[3] (see Figure 1 for the group structure).

RINO's only source of operating profits is through a contractual arrangement with the China-incorporated company Dalian RINO, which dictated that 100 per cent of Dalian RINO's profits was to be channeled into Innomind's wholly-owned subsidiary.[4] The Chairman of RINO was Qiu, while the CEO was Zou. Zou was also the CEO of Dalian RINO. Innomind's sole shareholder is a relative of Zou and Qiu.

Although trading on the OTCBB did bring in new capital, Zou had set his sights on a listing on NASDAQ. He took steps to ensure that RINO met NASDAQ's listing requirements. In 2008, Frazer Frost, a US-based audit firm and Rodman & Renshaw, an investment bank with experience in helping Chinese companies list on the NASDAQ, were hired. In July 2009, RINO was successfully upgraded from the OTCBB to the mainboard of NASDAQ. In the first six months of its listing on NASDAQ, RINO raised about US$1 billion through share issues and stock warrants.[5]

The Man Behind The Wheel

Zou is well-known in his home country and was viewed as a promising star in the environmental engineering industry. His background is a classic rags-to-riches story, having worked his way up from serving in the navy to a technician in a local machine repair shop, before obtaining a degree in Electronic Automation at Liaoning Broadcast University. He saw great potential in the waste water treatment industry and started his first venture, Dalian Yingkun Energy and Environmental Engineering soon after. In 2003, he founded Dalian RINO and became its CEO.[6]

Board Composition

RINO's board comprised three independent directors – Professor Quan Xie, Kennith Johnson and Zhang Weiguo – and two non-independent directors, Zou and Qiu[7].

The husband-wife pair of Zou and Qiu had a large presence in RINO's management and board through their shareholdings and positions in RINO's subsidiaries. The three independent directors lacked industry experience although they were from diverse backgrounds. Professor Quan was an academic in the environmental and life sciences discipline, Johnson was a CPA and had extensive experience in public and corporate auditing, while Zhang was the Chief Operating Officer of the Chinese milk formula company, Synutra, and was responsible for its US operations and strategy.

Board Committees

The audit, nomination and compensation committees were made up of the same people: Johnson, Zhang and Professor Quan. This fulfilled NASDAQ's requirements of having at least 3 independent directors on the audit Committee[8]. The directors each chaired a committee. Johnson was the chairman of the audit committee; Zhang chaired the nomination committee and Professor Quan the compensation committee.

Director Compensation

The independent directors were each paid cash retainers of US$2,000 per quarter and US$500 for each board or committee meeting attended[9]. On top of this, Johnson received 2,000 shares in 2009 for his role as chairman of the audit committee but there were no additional fees or benefits for other directors. The non-independent directors did not receive director fees or benefits.

Although the 2009 annual report indicated that the board of directors met six times during the year, it reported that the fees paid to both Zhang and Professor Quan's to be only US$8,000 – which was only the guaranteed basic cash retainer amount for a year.

CFO Turnover

RINO had three different chief financial officers (CFO) in three years: Bruce Carlton Richardson served from October 2007 to September 2008, Qiu from October 2008 to April 2010, and Ben Wang from May 2010.

Trouble Looms in Muddy Waters[10]

On 10 November 2010, Muddy Waters, a short-seller, issued a report which questioned RINO's actual financial situation. Among the allegations were accounting irregularities in RINO's 2009 revenues, which differed substantially between its results reported in the US (US$193 million) and its results in its Chinese regulatory filings (US$11 million). Muddy Waters estimated its actual 2009 revenues to be under US$15 million.

To make matters worse, none of this income was transferred from Dalian RINO to RINO as agreed. Instead, the capital raised by RINO was diverted to fund Dalian RINO's China operations. In addition, RINO's CEO, Zou, publicly confirmed that of its six major flue gas desulphurisation (FGD) contracts, two were non-existent and the remaining four had "issues"[11].

Suspicions were heightened when RINO did not report any tangible assets as would be consistent with a manufacturing firm. RINO's tax disclosures to the SEC and RINO's reported zero tax in China, both of which did not match its reported revenues.

Questions About the Auditor's Role

The discovery of these irregularities by a short-seller firm, instead of an audit firm, begs the question as to the competency of RINO's auditor. First and foremost, Frazer Frost is a relatively small firm and did not have local operations or an office in China. Instead, employees travelled to China from their California headquarters to perform audits, which cast doubts on their capability in performing audits effectively.

The audit partner, Susan Woo, did not have significant experience in auditing listed companies in the US, much less overseas-based companies. She had 13 years of accounting experience specialising in international tax and finance. Moreover, checks revealed that almost all of Frazer Frost's listed clients were China-based companies.

The Fallout

One day after the release of the Muddy Waters' report, RINO stated that it had begun an internal review[12] and five days later, RINO decided to postpone its Q3 2010 earnings conference call. After the confirmation of fraudulent accounting practices, RINO's audit committee issued a statement declaring that it will conduct a thorough investigation.

After the allegations by Muddy Waters, RINO's stock collapsed by 60 per cent from US$15.52 to US$6.07 over six days. On 11 April 2011, SEC suspended RINO from trading[13]. Compared to a year ago, RINO's stock had fallen almost 80 per cent.

Closing the Loophole

The discovery of RINO's accounting fraud, together with scandals involving many other Chinese reverse merger companies, led the US Securities and Exchange Commission (SEC) to tighten requirements for listing through reverse mergers. The new rules required companies to:

1. complete at least one year of "seasoning period" trading in either the US over-the-counter market or on another US-regulated or foreign exchange;

2. maintain a minimum closing stock price of US$4 (US$3 or US$2 in the case of NYSE and Amex, depending on the listing standard) per share for 30 of the 60 days before the date that listing begins; and

3. timely file all required periodic financial reports with the SEC or other regulatory authority, including at least one annual report containing audited financial statements for a full fiscal year commencing after the filing of the above information.[14]

Cross-Border Issues

The SEC and the China Securities Regulatory Committee (CSRC) had signed a memorandum of understanding to improve cross-border cooperation and collaboration in 1994. However, the SEC does not have any say on the reporting procedures of Chinese companies to China's State Administration for Industry and Commerce (SAIC), which requires all local and foreign companies to submit their business operating reports (including annual financial statements) annually.

Before the new rules, NASDAQ did not require foreign companies to submit reports that were lodged in their home countries. This meant that RINO had needed to comply only with the Sarbanes-Oxley Act, NASDAQ listing rules and other applicable corporate laws in US.

Discussion Questions

1. What are the key corporate governance issues with RINO?
2. What additional corporate governance issues could arise from a Chinese foreign listing through a reverse merger in the US?
3. The reverse merger occurred in 2007 but the irregularity was only uncovered in 2010. Why did it take so long to uncover the accounting irregularities? Which parties failed in their responsibilities?
4. From a corporate governance perspective, what are some of the key red flags that indicated fraud in RINO International?
5. Going forward, what are the consequences of such fraud cases for Chinese companies? What can such Chinese companies do to attract investors?

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The Satyam Fiasco

> "It was like riding a tiger, not knowing how to get off without being eaten ... I am now prepared to subject myself to the laws of the land and face the consequences thereof."
>
> — Ramalinga Raju, Satyam Founder and Chairman

Case Overview

In January 2009, Byrraju Ramalinga Raju, the Chairman and Founder of Satyam, resigned after confessing to having orchestrated an accounting fraud since 2001. He admitted to manipulating the firm's accounts to report profits that were more than 10 times the actual figures and reported a cash balance of US$1.5 billion that was non-existent. This case describes the nature of the fraud, the role of different parties involved and the aftermath of the scandal. The objective of this case is to allow a discussion of issues such as business practices and the corporate governance environment in India, accounting fraud, board composition, director compensation, and the role of independent directors and auditors.

Satyam and Its Founder

In 2009, Satyam, translated as 'Truth' in Sanskrit, was considered among the pioneers of the information technology (IT) sector in India, with revenues of over US$2 billion. It was the only Indian company to be listed on three international stock exchanges and had even received the greatly-admired Golden Peacock Award for its achievements in corporate

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governance.[1] It competed with the largest global technology firms such as Infosys and Wipro.

Satyam was founded by Ramalinga Raju, one of the most respected Indian business leaders. He belongs to a family that owned vast tracts of land and land continued to be his passion even after the global success of Satyam. He also maintained a spotless public image. A reporter who covered Satyam said of his impression of Raju, “It’s difficult to find a more soft-spoken Indian CEO ... he opens up only when you ask him about corporate governance issues.”[2] Due to such an image, he was promoted as the icon of Hyderabad, the IT hub of India, by its Chief Minister at the time.

However, Raju’s public image was in sharp contrast to several controversies that had dogged his career. He was investigated for swindling funds from the public offering of Satyam on NYSE and Satyam Infoway on NASDAQ. He was also convicted in a tax evasion case. In addition, in 2008, the World Bank blacklisted Satyam for providing “improper benefits” to its staff.[3] His shares in Satyam were pledged to financial institutions to raise funds to buy land at prices higher than the market price, creating an effect similar to that of rigging prices. Yet, despite these, he received various prestigious awards including the Ernst & Young Entrepreneur of the Year in 2007.[4]

The Board of Directors

Satyam’s board of directors was responsible for overseeing strategy, approving major corporate initiatives and reviewing performance. A Wharton professor, Saikat Chaudhuri, notes that in Indian firms such as Satyam, the board is involved only at the strategic level while it is the founder who runs the show[5].

There were three board committees - the Audit, Remuneration and Investors Grievance Committees. Contrary to the prevailing best practices, there was no Nominating Committee. Other than Raju, Satyam had two other executive directors - his brother, B. Rama Raju, and Ram Mynampati.

Of the six non-executive directors on the board, five were considered independent. An independent director, according to rules issued by the Securities and Exchange Board of India (SEBI), is required to be a person who has no material pecuniary relationship or transactions with the company, its promoters, its management or subsidiaries. One of the non-executive directors, Krishna Palepu, a professor of accounting and specialist in corporate governance at Harvard, worked as a consultant for Satyam and thus was not considered an independent director.

Among the five independent directors, Srinivasan was the longest serving, having been on the board since 1991.[6] He, together with Rao and V.S Raju, sat on both the Audit and Remuneration Committees. In addition, Rao was the Dean of the Indian School of Business (ISB) where Raju was a board member. The ISB had received a generous grant of Rs35 crore (US$6.6 million) from Srini Raju, the brother-in-law of Ramalinga Raju and Chief Technical Officer at Satyam, for research done by its Centre for IT & Networked Economy (CITNE).[7] Interestingly, according to the disclosure of directors' remuneration for 2008, Rao was paid a basic fee called "commission" of Rs100,000 (or about US$1,800), while the other non-executive directors were paid basic fees ranging from Rs1,133,333 (about US$21,200) to Rs1,200,000(about US$22,500).

The non-executive directors also received small meeting fees called "sitting fees". Krishna Palepu was paid Rs9.1 million (US$173,500) and 10,000 shares (equivalent to 5,000 ADR) of which Rs7.9 million (US$150,000) was professional fees for consulting services he provided. All other directors received compensation in the range of Rs1.2-1.3 million (US$22500-24500) in addition to at least 5,000 shares of share-based compensation in the form of restricted stock units.[8]

Being highly respected in the industry, Satyam's directors were in high demand to sit on well-known listed companies. Vinod K Dham (Dham) was the Vice President and General Manager of Intel and sat on a total of eight boards. The former cabinet secretary to the Government of India and a member of the 12th Finance Commission, T.R. Prasad (Prasad), also sat on eight boards of local listed companies.

Business Culture in India

With deep roots in the structure of social hierarchy derived from influences of Hinduism, the workplace was characterised by junior employees obeying orders from their seniors. Discussions and decisions were initiated by the senior most executives. For junior employees to say "no" could be perceived as being impolite and offensive to those in authority.

From India's Crown Jewel to Biggest Fraud

Ramalinga Raju had been manipulating Satyam's books since 2001 to report results that would compare favourably with those of Infosys and Wipro. This was to maintain the firm's corporate image as being among India's IT pioneers. In addition, higher corporate profits would result in higher share prices, helping Raju obtain more funds to purchase land.

Raju had hoped to cover the fictitious assets he showed on Satyam's books with real cash from Maytas Infra and Maytas Properties, companies owned by his sons, by merging the two firms with Satyam. On 16 December 2008, he convened a board meeting to seek approval for this transaction with a combined value of US$1.6 billion. Since he and his brother Rama were interested parties, they were absent from the meeting.[9] The non-executive and independent directors present voiced strong concerns against the proposal:[10]

> "You can't treat us as a mere rubber stamp and expect us to say "yes" to whatever you decide. What is the use of having directors like us, when you are not going to consult us at all?"
>
> — Srinivasan

> "Will this move result in diluting the core competency of the company? What are the risks involved?"
>
> — Rao

However, the senior managers of Maytas making the presentation were duly briefed by Raju on how to successfully gain in-principle approval from the board.

After the approval was received, Raju made an announcement on NYSE regarding the company's plans to merge with Maytas. Investors disapproved strongly, believing that the transaction was intended to benefit the Raju family.

The house of cards began to collapse from this point on. Amidst the chaotic situation, Satyam lost public trust, its share price tumbled and the Maytas deal was abandoned. The World Bank soon announced that it had blacklisted Satyam for providing "improper benefits" to its staff.[11] In addition, three of its directors, Srinivasan, Dham and Palepu, resigned from the board after the announcement of the merger, making stern statements which questioned the promoters' actions:

> "I (Srinivasan) am left with no option but to resign with immediate effect. I had raised many issues related to procedures and had expressed reservations during the board meeting. I had not cast a dissenting vote against the deal for which I take moral responsibility.[12]"

Interestingly, Palepu dramatically changed his stance regarding the reason for his resignation. Originally he attributed his resignation to not being able to fulfil all his duties at Satyam due to his teaching commitments at Harvard. However, he later said that his resignation was prompted by the revelation that Ramalinga Raju and other promoters had pledged their shares in Satyam to financial institutions, which were later sold due to margin call pressures.[13]

With few options remaining, Raju engaged Merrill Lynch to seek strategic options for the future of Satyam. Merrill Lynch found material irregularities in Satyam's accounts. On realising that his fraud had come to light, Raju resigned from his position and confessed to inflating profits, reporting a US$1.5 billion cash balance that was non-existent, overstating interest income and understating liabilities.

Satyam's Compartmentalised Structure: Key to the Fraud

Crucial to the successful commission of the fraud was that Raju had compartmentalised the structure of Satyam such that among its reported 51,000 employees[14], only a handful would really know what was going on within the firm. Each department had its own Finance unit which would report to a central Finance team headed by the CFO, Srinivasa Vadlamani. Each unit was unaware of the performance of other departments. Raju handpicked the top management which consisted of a few professionals and his family members. In addition, they were allotted large quantities of Satyam shares to ensure that they had incentives to take actions that would help boost the stock price.

Satyam had a whistleblower policy supervised by the Audit Committee. Under this policy, an employee had written to Krishna Palepu stating that the books of the firm had been manipulated. Although this letter was circulated among the board, no action was taken.[15]

Cleaning up the Mess

On the day the scandal became public, Satyam's stock price fell from Rs179.1 (US$3.40) to Rs23.85 (US$0.45), an 87 per cent fall in value in one day[16]. On 10 January, the Company Law Board decided to bar the existing Satyam board from operating and appointed 10 nominee directors[17]. The swift action was taken due to the significance of both Satyam and the IT sector to India's economy and image abroad. The regulator for Chartered Accountants in India issued a show-cause notice to Satyam's auditor PricewaterhouseCoopers (PwC) for its complicity in the fraud as it had certified Satyam's accounts as being true and fair[18]. Ramalinga Raju was arrested and charged with several counts, including forgery, breach of trust and criminal conspiracy. During the trial, it was revealed that although Satyam claimed to have 51,000 employees, the actual number was 40,000. It was alleged that Raju was withdrawing a sum of Rs20 Crore (US$4 million) each month to pay these non-existent employees[19].

After the scandal, the Golden Peacock award for best corporate governance was stripped from Satyam. After a public auction in 2009, Satyam was taken over by Tech Mahindra, the technological arm of the conglomerate Mahindra & Mahindra.

Regulatory Reforms and Impact on Independent Directors

The case raised a multitude of questions on the role of independent directors on the boards of even the highest echelon of Indian companies. Professor Jitendra Singh, a management professor at Wharton, notes that on some Indian boards, there exists an attitude that board members work for those who brought them on to the board. This could have been the problem with the Satyam board itself[20].

In reaction to the scandal, the Indian government introduced the Companies Bill 2009 to address corporate governance, among other issues. The Bill added several criteria to the appointment requirements for an independent director. These include not being an employee of the firm for three preceding years from appointment; an employee of an auditing, legal or consulting firm associated with the company; holding more than 2 per cent of the voting power of the company; or being a member of an organisation receiving more than 25 per cent of its income from the company.[21]

Rajesh Chakrabarti, professor at the Indian School of Business, wrote an article in the Economic Times highlighting the shortage of independent directors in Indian boardrooms after the scandal. In the month following the scandal, resignations by independent directors rose to 109 from the average of 30. Over a longer period, resignations increased by 20 per cent. He noted that the prevailing consensus among independent directors was that they were reassessing the risks of a board seat - a lifetime of reputation built could be tarnished by the actions of a single unscrupulous promoter like Ramalinga Raju.[22] These changes, he asserts, do not bode well for the future of corporate governance in Indian enterprises.

Recent Developments

In November 2011, after spending almost 3 years in prison, Ramalinga Raju, Rama Raju and Srinivasa Vadlamani were granted bail. The reason cited by the court was that they had already served a large portion of their possible sentence since the maximum punishment for their offence was 7 years' imprisonment. In addition, as the investigation of the case was nearing its end, it was felt that they could not influence the investigation in any manner.[23] In January 2012, Satyam Computer Services, now owned by the Tech Mahindra group, filed a lawsuit against its former board of directors, certain former employees and PwC its statutory auditor, for "perpetrating fraud, breach of fiduciary responsibility, obligations and negligence in performance of duties." This followed a penalty of US$17.5 million imposed jointly on Satyam, PwC and its other partners by the US Securities and Exchange Commission in April 2011 for fraudulently overstating the company's accounts.[24]

Discussion Questions

1. Describe India's environment that investors should consider when investing in companies like Satyam.

2. Discuss the areas of the company culture and structure that could have raised some red flags about Satyam's situation.

3. Satyam had a whistleblower policy in place and an employee had written to one of the directors claiming that the accounts had been manipulated. What are the challenges of effective implementation of a whistleblower policy in a company such as Satyam? How should directors react to whistleblower complaints?

4. Analyse the independence of the board and the ability of the board to exercise independent judgment on the corporate affairs of Satyam. Given the credentials of the non-executive directors, why would they still have missed the fraud perpetrated in the company over a number of years?

5. A number of directors resigned from the company after the aborted Maytas merger and before the fraud became public. Should they have resigned and could they have done more to protect shareholders' interests?

6. Who is responsible for the loss in shareholder value?

7. Are the regulatory reforms undertaken after the scandal likely to have a positive effect on corporate governance in India? How can the role of independent directors be enhanced without making it too onerous to be an independent director?

8. Should the non-executive and independent directors be held accountable for the fraud perpetrated in Satyam?

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The Sime Darby Financial Fiasco

Case Overview

In May 2010, Sime Darby Berhad announced that its earnings may be cut by up to RM964 million due to losses in its Energy & Utilities Division, from cost overruns in four projects. Following the announcement, its share price plunged to RM7.47 on 27 May 2010, a 10-month low. In this case, we look at some of the events leading to the loss as well as the actions taken by the board of directors in response. The objective of this case is to allow a discussion of issues such as board composition, the board's role in oversight, and responsibilities of the board versus management.

Where It All Began

In September 2002, the Malaysia-China Hydro JV consortium, led by Sime Engineering, was awarded a contract to construct the Bakun Hydroelectric dam[1]. During the course of the project, plans for the construction of an undersea high voltage direct current (HVDC) cable was also initiated for the dam to relay power to Peninsular Malaysia. Although the project was scheduled for completion in the third quarter of 2007, delays in impoundment, as well as changes to the plans and disagreements over the cost of the dam, caused a significant setback to the date of completion[2].

This is the abridged version of a case prepared by Goh Ming Jing, Muhammed Ameer S/O Mohd Noor, Muhammad Ali Idaham, and Kesmond Goh Zhi Peng under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management. Consequently, 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 prepared by Cheryl Nio Yi Hui under the supervision of Professor Mak Yuen Teen.

Towards the end of 2005, the management of Sime Engineering decided to bid for an engineering, procurement, construction, installation and commissioning (EPCIC) contract, commissioned by Qatar Petroleum AS (QP) for its Bulhanine Project. It was the first time that Sime Engineering had attempted to undertake a project of such scale and magnitude. The project required substantial Transportation and Installation (T&I) work, which Sime Engineering neither had the expertise nor the resources to handle. Hence, the company invited tenders from T&I subcontractors[3].

However, several issues plagued the company during the tender. Only one T&I subcontractor offered to carry out the full scope of work for the T&I project and the contractor was rejected by QP due to political implications. QP gave Sime Engineering time to source for new subcontractors and issued the letter of acceptance to Sime Engineering for the project in April 2006. The amounts to be received would be paid upon completion and the project was scheduled for completion in August 2008.

A month later, Sime Engineering submitted a bid for another EPCIC project, commissioned by Maersk Oil Qatar AS (MOQ) and QP. Similar to the EPCIC works that they had just signed with QP, Sime Engineering had very little know-how or the resources to deal with the colossal MOQ project. Nonetheless, MOQ awarded the project to Sime Engineering in February 2007, with completion scheduled for October 2009[4].

With these two projects in the works, Sime Darby's Energy & Utilities (E&U) division, which included Sime Engineering after the merger, undertook a strategic decision to become a full service provider for EPCIC projects in the future. The first keystone in the plan was for Sime Marine, a subsidiary of Sime Energy & Utilities, to construct or acquire several vessels to allow for T&I capabilities within the division. Management proposed building the vessels as that would entail 27.5 per cent lower cost compared to buying the vessels at market price. On the flip side, the time taken to build the vessels would span a number of years while immediate purchase of the vessels would enable Sime Marine to provide Sime Engineering with the T&I capabilities required for the MOQ Project[5].

The Sime Darby Board

The board of directors had 13 members in 2009. Of the group, 12 including the chairman were non-executive. The lone executive director was the Group's CEO. Six of those directors were independent directors. The percentage of independent directors was higher than the one-third required under Bursa Malaysia's Main Board Listing Requirements.

The non-executive directors included many big names. The independent Chairman, Tun Musa Hitam, had held several ministerial positions, including deputy prime minister of Malaysia, before his appointment. He was also chairman of several other listed companies. The Deputy Chairman, Tun Ahmad Sarji Abdul Hamid, was considered a non-independent non-executive director because he was a nominee of Permodalan Nasional Berhad, the Malaysian government's investment arm. He was also a chairman and director of several other listed companies. Another high-profile director was Datuk Seri Panglima Sheng Len Tao, who was an independent non-executive director. Also known as Andrew Sheng, he is a chartered accountant by training, and had served as Chairman of the Securities and Futures Commission of Hong Kong, Deputy Chief Executive at the Hong Kong Monetary Authority and held various other positions at the World Bank and Bank Negara Malaysia.

Trouble Looms for the Company

In April 2008, potential cost overruns exceeding RM150 million on Sime Engineering's MOQ project was reported in The Edge[6]. Sime Darby Berhad responded by issuing a statement denying the allegations[7].

In August 2008, Sime Darby's internal auditor issued a report on losses in the Oil and Gas Segment (O&G) of the E&U division, which was then brought to the attention of the Audit Committee at the board level[8]. The group chief financial officer then, Tong Poh Keow, together with the external auditors, PricewaterhouseCoopers, had wanted a higher provision for losses than was reflected in the accounts, but did not pursue the issue as management said the losses could be recovered.

In addition, the external auditors had supposedly delayed signing off the audited accounts of the division for FY2008[9].

In May 2010, Sime Darby announced that its second half earnings might take a big hit amounting to RM964 million[10] due to losses in its E&U division. The losses were mainly due to cost overruns on projects. Of the RM964 million, RM200 million was due to a reversal of revenue recognised in the 2009 financial statements for the QP project which had already incurred losses exceeding RM500 million, RM159 million was due to the MOQ project which had already recorded a loss of RM367 million in the first half of the fiscal year, RM450 million was due to the Bakun hydroelectric dam project, and RM155 million was due to losses from the construction of some vessels in a third Qatar project[11]. Sime Darby's shares hit a 10-month low at RM7.47 per share ahead of its earnings report on 27 May 2010[12].

The Board's Response

> "No one would criticise or point out mistakes, which proved to be Ahmad Zubir's downfall. For some top people, their loyalty was to the CEO of the day, not the company."
>
> — Sime Darby Official[13]

Faced with the report from the internal auditor, the board queried the E&U division on the issue. The management team, led by Datuk Seri Ahmad Zubir Murshid, explained that the company need not make full provisions as the client had agreed to reimburse some of the cost overruns in due time[14]. Since it was normal industry practice in Malaysia to have cost overruns, especially in large contracts, and this method of reimbursement had worked well for other contracts within Malaysia, the board accepted the explanation and did not pursue the matter.

In August 2009, after the internal auditor issued a second report that voiced grave concerns about the E&U division[15], a work group was set up to review the operations of the division. Nine months later, a special board meeting was called to review the findings of the work group.

After the 13-hour meeting, the board asked Datuk Seri Ahmad Zubir Murshid to take a leave of absence. Sime Darby Berhad then called a news conference, two weeks before the scheduled announcement of its second quarter results, to announce the losses and Datuk Seri Ahmad Zubir Murshid's leave of absence[16].

In the Wake of the Aftermath

After the announcement, many ministers and concerned investors petitioned Sime Darby to take more action.

Faced with mounting pressure, Sime Darby called in KPMG and Deloitte to conduct forensic audits in June 2010[17]. The audit investigations were concluded in November 2010. Following the investigations, Sime Darby released a statement on its website stating that the forensic audits revealed breaches of duties and misconduct within the E&U division[18]. However, on the advice of the Group's legal counsel, Sime Darby declined to disclose more information on the matter.

In December 2010, the group filed a civil suit against its former CEO and four executives in relation to the cost overruns, seeking damages and relief totalling at least RM340 million over three loss-making projects[19]. The damages sought included US$30.81 million for consultancy fees wrongly paid in the MOQ Project, RM80.51million for consultancy fees wrongly paid in the QP Project and US$48 million for losses arising from the failure to deliver the three marine vessels[20]. The four executives in the civil suit were Datuk Mohamad Shukri Baharom (former executive vice-president of the group's E&U division), Abdul Rahim Ismail (former chief financial officer of the group's E&U division), Abdul Kadir Alias (former head of the oil & gas business unit of the E&U division), and Mohd Zaki bin Othman (former senior general manager of Sime Darby Engineering)[21].

A Twisted Tale

> "The decision-making process went through many levels of detailed discussion and approval which culminated in the approval by the main board of Sime Group,"[22]
>
> — Datuk Seri Ahmad Zubir Murshid

In response to the civil suit filed by Sime Darby, Datuk Seri Ahmad Zubir Murshid served third party notices to 22 other directors on the grounds that they had breached their duty as directors to exercise due skill, care and diligence and that the other directors should be held responsible as they were the highest and ultimate decision making authority[23].

Into a New Beginning

> "All announcements made by the group are being implemented, particularly in the way Sime Darby is reorganised. Each one of the divisions will have an independent board but not listed."[24]
>
> — Datuk Mohd Bakke Salleh

Following the termination of Datuk Seri Ahmad Zubir Murshid, Datuk Mohd Bakke Salleh was appointed as the President and Group Chief Executive of Sime Darby. He was quick to implement changes. Under his leadership, Sime Darby emerged with a reorganised new look.

The divisions of Sime Darby were separated and a chairman was appointed for each of the respective divisions. An amicable settlement with Maersk Oil Qatar AS regarding a dispute over claims and payment issues related to a 2007 contract was also reached. In addition, a pending lawsuit with Maersk Oil Qatar was settled with a payment of RM100 million[25].

The board of directors at Sime Darby also underwent many changes, with only four out of the previous 13 members keeping their positions, namely the Chairman Tun Musa Hitam, Tan Sri Samsudin Osman, Tan Sri Dato Dr Wan Mohd Zahid Mohd Noordin, and Dato Henry Sackville Barlow. New names on the Sime Darby Board included Tan Sri Dato' Sri

Hamad Kama Piah bin Che Othman, currently the President and Chief Executive of Permodalan Nasional Berhad, as well as Tan Sri Datuk Dr. Yusof Basiran, currently CEO of the Malaysian Palm Oil Council (MPOC).

Discussion Questions

1. The board of Sime Darby includes very experienced and high profile directors. How can such a board fail so spectacularly to safeguard the interests of the company?
2. What are the critical attributes of an effective board? To what extent does the Sime Darby board possess such attributes?
3. Should the board members also be held accountable and not just Datuk Seri Ahmad Zubir Murshid?
4. On hindsight, if you were one of the directors on the main board of Sime Darby, what would you have done back in 2005?

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Cadbury and Kraft: A Bittersweet Moment

Case Overview

After four months of bitter resistance, Cadbury shook hands with Kraft at midnight on 18 January 2010. Cadbury's board "unanimously" recommended that the final takeover bid of US$19.5 billion or 840p per share be accepted by Cadbury's shareholders. The combined group would own 40 confectionery brands each with annual sales of more than $100 million, making the group the world's largest candy maker. However, public discontent brought Kraft under fire from British politicians, together with increased fears of job cuts in Britain. Time will tell whether the takeover truly created value. The objective of this case is to allow a discussion of issues such as the role of takeovers as a corporate governance mechanism; the pros and cons of a takeover from the viewpoint of different stakeholders; the role of the board, shareholders and regulators in takeovers; the powers of the board and shareholders of acquiring and target companies in takeover situations; and differences in the governance of takeovers in different jurisdictions.

The Story of Cadbury plc

For many years, Cadbury had been the leading global confectionery company. Cadbury was an ever-present member of the FTSE100 since the commencement of the index in 1984. It produces 7.3 per cent of the world's chocolate, 27 per cent of the world's gum, and 7.4 per cent of

Felyna Lee, Joshua Lim and Kevin Teo prepared this case 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.. Consequently, 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 prepared by Joanna Ng Yi Mei under the supervision of Professor Mak Yuen Teen.

the world's candy. Cadbury had a market share of 10.1 per cent of the global confectionery market, more than 1 percentage point higher than its closest competitor, Mars. Under the leadership of CEO Todd Stitzer, Cadbury's revenue in 2008 was a whopping £5.384 billion with a profit of £366 million[1]. Compared to its competitors like Hershey's, Mars and Nestlé, Cadbury was also less reliant on holiday season sales because of its numerous year-round products like Halls cough drops.

In 2008, family-controlled Mars announced its merger with Wrigley to form the world's leading confectionery company, relegating Cadbury to second place. In May 2008, the company completed the demerger of its confectionery and beverage businesses. Under this demerger, the confectionery unit was separated from its North American beverage unit which was renamed Dr Pepper Snapple Group (DPS). This reversed the initial merger of the two companies, Schweppes and Cadbury, to create Cadbury Schweppes in 1969. According to Stitzer: "Separating these two great businesses will enable two outstanding management teams to focus on generating further revenue growth, increasing margin, and enhancing returns for their respective shareowners".[2] Larry Young became the President and CEO of DPS. The demerger followed calls by some institutional investors for the two businesses to be split up. The increased competition and the decrease in Cadbury's size following the demerger made the company an open target for potential takeovers.

Kraft Launches First Takeover Bid

Kraft Foods Inc was the second largest confectionery, food and beverage corporation in the world after Nestlé SA, with revenues of US$40.4 billion and profit of US$3.02 billion in 2008. On 7 September 2009, Kraft initiated its takeover bid of Cadbury for US$16.7 billion (£9.8 billion), offering US$4.92 in cash and 0.2589 new Kraft shares per Cadbury share. This was a premium of 31 per cent from Cadbury's closing price of £5.68. Kraft believed a takeover would significantly expand the global reach of both businesses and create synergies worth US$625 million in the form of cost savings in operations, administration and marketing. In return, Kraft vowed to save workers' jobs at Cadbury's factory in Somerdale, Bristol that was to close as production was shifted to Poland.

Analysts, however, suggested that the initial offer by Kraft significantly undervalued Cadbury as it valued Cadbury at less than 15 times EBITDA when Cadbury arguably deserved more than 19.5 times EBITDA. Kraft's offer was "emphatically rejected" by Cadbury's board, led by Roger Carr. Cadbury's board was made up of 9 members, 6 of whom were independent directors. Calling the offer "derisory", the board claimed that Kraft was attempting "to buy Cadbury on the cheap."[3]

Bank of America Merrill Lynch sales specialist Simon Archer published a note revealing that "Stitzer admitted that there is some strategic sense in combining the two companies and he doesn't expect Kraft to walk away, so he said his job is to get as much value as possible"[4]. Stitzer also spoke of the "complementary elements" of the two companies, which conflicted with Cadbury's original stance that Kraft's offer is "fundamentally undervalued" and "made no strategic or financial sense".

Although the Cadbury family does not own Cadbury anymore, Cadbury family members had been hostile to the takeover. However, the family had little influence on the deal, as family representation on the board ended in 2000 when Chairman Dominic Cadbury retired.

Approaching the UK Takeover Panel

On 22 September 2009, Cadbury approached the UK Takeover Panel, asking it to impose a deadline for Kraft to make a formal offer. The City Takeover Code governs any firm bidding for a company that is listed on the London Stock Exchange and any company on the receiving end of such an approach. Cadbury wanted a "put-up-or-shut-up" action, which would force Kraft to make a bid within one month or thereafter stay away from Cadbury for at least six months. Cadbury shares hovered around £7.90 (US$12.80) and analysts suggested that Cadbury would worry about losing this premium if a potential takeover dragged on.

On 30 September, 2009, the UK Takeover Panel agreed to Cadbury's request and announced a deadline of 9 November for Kraft to make a bid for Cadbury. Cadbury's share price then rose to £7.96 following the Takeover Panel's decision, 11 per cent above Kraft's original offer.

The Government Voices Its Concerns

The UK government, which usually takes an open approach to takeovers by overseas firms in light of its commitment to open markets for trade and investment, seemed not in favour of the takeover of home-grown chocolate champion Cadbury. UK Business Secretary Lord Mandelson slammed Kraft's takeover attempt of Cadbury and cautioned against the long-term effects and obligations of transparency and accountability of foreign ownership.

The Financial Services Secretary (City Minister) Paul Myners was also apprehensive that too many British companies were being lost to foreign hands because their shares are owned by international funds which do not care much for domestic heritage. He said, "It is easier to take over a company here than anywhere else in the world.[5]"

Kraft's Second Takeover Bid Offer

Kraft officially launched a takeover bid for Cadbury on 9 November 2009, just hours before the 5pm GMT deadline imposed by the UK Takeover Panel. This second offer valued Cadbury at 717p (£7.17) per share, lower than the initial 745p per share offer that was rejected in September. Cadbury's management was naturally against this but Kraft wanted to appeal to Cadbury's shareholders this time. Irene Rosenfeld, CEO and Chairman of Kraft Foods, said,

> "We believe that our proposal offers the best immediate and long-term value for Cadbury's shareholders and for the company itself compared with any other option currently available, including Cadbury remaining independent."[6]

The official launch of this hostile takeover bid gave Kraft 28 days to publish an offer document detailing the offer for shareholders. It then had up to 60 days to gather enough shares to complete the deal. Kraft offered Cadbury shareholders 300p and 0.2589 new Kraft shares for each Cadbury share, which was the exact offer as that in September.

However, the decreased value of Kraft shares and currency shifts meant that it was now worth less.

Carr did not back down and described Cadbury as “an exceptional standalone business”[7]. Cadbury also had home ground advantage, with Lord Mandelson warning that Kraft would face a backlash if it tried to buy Cadbury on the cheap.

The Potential Arrival of the White Knights and Share Price Fluctuations

On 18 November 2009, confectionery conglomerates Hershey and Ferrero were holding preliminary talks about a possible bid.

Nomura analyst Alex Smith commented that investors might have a preference to back the alliance with family-owned Ferrero. This acquisition aided Cadbury, as it was weak in the Ferrero strongholds of France, Germany and Italy. However, it was doubtful whether family-controlled Ferrero had the financial means to support this merger.

On the other hand, Hershey and Cadbury had a strong cultural fit, which meant fewer job cuts than a Kraft takeover. Cadbury’s American chief executive had twice attempted unsuccessfully to merge both companies. Hershey had the licence to sell Cadbury products in the US, and the controlling trust behind Hershey was rumoured to have wanted to create a consolidated global confectionery market.

On 23 November 2009, Nestlé also joined the Cadbury takeover game as a potential counter-bidder, a move that sent Cadbury shares to a two-month high since September. Bloomberg reported that Nestlé was considering its options with bankers aiming to participate in a break-up bid for Cadbury.

Excited by the prospect of a bidding war, investors pushed Cadbury’s share price up 13.5p to 814p overnight. Cadbury shares were then worth 43 per cent more than in early September, before Cadbury had rejected Kraft’s first offer.

In the meantime, Kraft started the formal 60-day timetable for its takeover bid by issuing a 180-page circular stating that Kraft and Cadbury would be a good fit, creating a "global powerhouse"[8] in confectionery. Also, Kraft was optimistic about the acquisition benefitting each other in their various stronghold markets.

Escalating Resistance To The Takeover

The increased possibility of Cadbury being sold to a foreign firm stirred strong emotions from Cadbury's stakeholders. The general public lamented the loss of 186 years of British heritage, while politicians and the 4,500 UK and Irish workers feared the worst for their jobs and pay cuts.

On 10 December 2009, Cadbury's workers union Unite announced a "Keep Cadbury Independent" campaign to resist Kraft's advancement. "We must see off the Kraft bid and any others which do not have this company and its workforce's best interests at heart," said Len McCluskey, Unite's assistant general secretary. It was a well-known fact that despite whatever good intentions Kraft may have had, mergers and acquisitions have historically led to job losses during restructuring and integration. Further, the amount of debt that Kraft would be assuming to realise this deal left an "irresistible imperative"[9] to cut expenses and streamline the workforce. After garnering much support from the public, Unite and the workers later took the campaign to the UK Parliament on 16 December.

UK nationalistic sentiment ran high, with Liberal Democrat leader Nick Clegg leading the pack in stating that it was "plain wrong" that the state-owned Royal Bank of Scotland helped Kraft raise the money. RBS was one of a few banks which shared £120 million in fees to aid the takeover. Clegg referred to Lord Mandelson's statement that the government would mount a huge opposition to Kraft's takeover and asked "Why is it RBS should now want to lend vast amounts of our money to Kraft to fund it?"[10]

Cadbury put up a strong fight and issued an official Defence Document on 14 December against Kraft's bid. The chocolate maker raised targets for the next four years and pledged to hand more cash to shareholders if it could remain independent. Cadbury repeatedly insisted that the US$16.3 billion (£9.8 billion) bid was far too low, and Carr urged shareholders at a news conference not to sell themselves short.

Kraft Sells Pizza Business to Nestle to Fund Cadbury Offer

As the 19 January deadline imposed by British takeover rules loomed near, Kraft needed to win over at least 50 per cent of Cadbury's shareholders or stay away from Cadbury for at least six months. On 5 January 2010, Kraft sold its pizza business to Nestlé for US$3.9 billion to help fund its offer for Cadbury. Kraft's North American pizza business was the world's largest, reaping US$291 million in profits for 2009. It was an attractive offer Nestlé did not reject. Reports deemed this as Kraft's move to dissuade Nestlé from competing in the bid for Cadbury.

Following its successful sale, Kraft sweetened the deal for Cadbury shareholders and announced that those who elected to accept the "Partial Cash Alternative" would get more cash in lieu of stock - 60p more per Cadbury share or 240p more per Cadbury American depository share (ADS)[11].

However, not all of Kraft's shareholders supported the acquisition. Renowned investor Warren Buffett, one of Cadbury's major shareholders, was one of them. Owning a 9.4 per cent stake in Cadbury, Buffett said if he had the chance to vote against the deal he would, as the proposed "bad deal" has left him feeling "poor". Kraft's proposed bid risked undervaluing Kraft's stock, and he sent an indirect warning to the company not to pay too much in cash or shares on the deal.

Cadbury Releases Final Defence Document

On 12 January 2010, Cadbury's board published another document, which was seen as the last line of defence to reject Kraft's bid. It reiterated the board's opinion of Kraft's "derisory" offer, attacking Kraft's management and revealing that it beat its own target for operating margins in 2009.

Carr mentioned that Kraft's latest offer was even more unattractive than it was when Kraft made its formal offer in December.

At this point, attempts to thwart the completion of the deal were becoming increasingly futile. Hedge and mutual funds bought up more than 25 per cent of Cadbury's shares in hopes of a deal. The final straw came when Franklin Templeton, a large mutual fund with a 7 per cent stake, indicated it would accept an offer of 830p (£8.30).

The Kraft Takeover

On 19 January 2010, Cadbury board advised its shareholders to accept a new offer of 840p a share - valuing the company at £11.5bn ($18.9bn).[12] The deal was a significant increase on earlier Kraft bids. Consequently, Hershey dropped its plans to acquire Cadbury.

The deal became final after Kraft secured acceptances from shareholders representing 71.73 per cent of Cadbury. On 2 February 2010, Cadbury officially became a part of Kraft and was delisted from the London Stock Exchange on 8 March 2010.[13]

The takeover of Cadbury by Kraft was met with continued disapproval from the UK public, as Cadbury was regarded as part of British culture. To them, losing Cadbury to Kraft was akin to losing a part of British legacy.

On 3 February 2010, Stitzer announced his intention to stand down as CEO of Cadbury after a 27-year career at the company. Andrew Bonfield also announced his intention to step down as CFO. Stitzer, on his resignation, thanked everyone for being involved in a good fight for the Cadbury bid defence and wished Rosenfeld all the best in taking Cadbury to greater heights. On the same day, Carr announced his intention to step down as Chairman of Cadbury.

Discussion Questions

1. Hostile takeovers are often argued to be an important corporate governance mechanism. Do you agree?

2. Was the takeover of Cadbury by Kraft good from a corporate governance standpoint? Who benefited from the takeover? Explain the divergence of interests for different stakeholder groups.

3. What should be the role of government in regulating takeovers?

4. The UK Financial Services Secretary said: “It is easier to take over a company here than anywhere else in the world”. How might the scenario be different if Cadbury were to launch a takeover bid for a US company such as Kraft?

5. Warren Buffett, a major shareholder of Kraft, said if he had the chance to vote against the deal he would. How much say should the shareholders of acquiring and target firms have in takeovers? How is the situation different between the US and UK?

6. Why are hostile takeovers relatively rare in Asia?

7. What are the rules governing takeovers in your country? Are they similar to the US or UK or neither?

8. What are the powers of the board versus shareholders of the acquiring and target companies in a takeover situation in your country?

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Drilling into Disaster: BP in the Gulf of Mexico

Case Overview

On 20 April 2010, a massive explosion occurred on the Deepwater Horizon oil rig in the Gulf of Mexico. Eleven workers perished[1]. Two days later, the rig sank, snapping the riser pipe and creating a massive oil spill. Although the Macondo well was effectively killed by 19 September 2010, the incident had tarnished BP's reputation and prompted further questions on the company's safety and environmental record. It also produced the largest accidental marine oil spill in history, at 19 times the size of the 1989 Exxon Valdez spill[2]. In this case study, we examine the factors that led to this incident and BP's responses in its aftermath. The objective of this case is to allow a discussion of issues such as board and management accountability, corporate responsibility, risk management, code of conduct and whistleblowing, compensation practices, and stakeholder communications.

A History of Mistakes

The Deepwater Horizon spill was not the only disaster that had afflicted BP in its recent troubled history. The company had previously racked up a number of safety breaches over the years. In March 2005, a fire and explosion in its Texas City Refinery killed 15 people and injured more than 170 workers. It resulted in financial losses exceeding US$1.5 billion[3].

This is the abridged version of a case prepared by Chua Yi Eugene, Nguyen Minh Bao, Vu Thi Hong Nga, and Tamanna Haque 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. Consequently, 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 prepared by Kellynn Khor under the supervision of Professor Mak Yuen Teen.

A few months later in July, a wrongly-installed valve and shoddy welding[4] in underwater parts of BP's Thunder Horse oil platform caused the vessel to flood and almost sink when Hurricane Dennis hit. While BP and its minority partner Exxon Mobil had to pay hundreds of millions of dollars in repairs[5], and with oil production being set back 3 years, it appeared BP had yet to learn its lesson. Months later, in March 2006, BP's operations in Prudhoe Bay, Alaska, experienced an oil spill, with up to 267,000 gallons of thick crude oil[6] deposited, due to widespread corrosion in under-maintained and poorly inspected pipes – a situation which could have been prevented.

In May 2007, Tony Hayward replaced John Browne as CEO and made a commitment to focus on "safety and reliability" like a "laser"[7]. Under his reign, BP showed improvements in safety and had begun to improve its reputation.

It all came crashing down with the Deepwater Horizon incident at BP's Macondo well.

"I'd Like to Get My Life Back"[8]

In the immediate aftermath of the incident, it was determined that the best possible solution was a relief well. However, this would take about three months to complete[9]. BP sought a faster solution by organising a massive team of about "48,000 spill responders and deployed more than 6,900 vessels to collect and contain oil and lay out more than 13 million feet of protective boom"[10].

While BP was focused on containing the spill, the unfolding crisis was exacerbated by the company's mishandling of the media and lack of communication with stakeholders. BP initially reported that the well was leaking 1,000 barrels a day[11]; while the US government discovered that the actual rate was 12,000 to 19,000 barrels a day[12]. That essentially was "the moment the American administration exposed BP's crude lie [and] was the moment the company's fate was sealed"[13], and the public turned on BP.

Perhaps the largest uproar was created when Hayward remarked at the height of the disaster on 30 April 2010, “I’d like my life back”, which was viewed as yet another indication of how out of touch the BP management was with the situation.

Communication with Shareholders

When the US Christian Brothers Investment Services resorted to register a protest vote[14], BP tried to convince them that more information would be found in the group’s financial report. However, when it was published, the situation was not much clearer. Further, BP’s method of communication through its financial report did not satisfy its shareholders as “little information is provided on issues with significant reputational and financial implications, such as the short - and long-term toxicity concerns related to BP’s substantial dispersant use, efforts to revive the Gulf Coast economy, and backlogs for claimants”[15].

Directors’ Remuneration

The BP’s Directors’ Remuneration Report of 2009 showed that the top level managers of BP were receiving bonuses averaging 170 per cent of their salary. 15 per cent of this was based on safety measures while about 70 per cent of the bonus was a reflection of the Group’s financial and operating performance[16].

Reflecting the emphasis on performance and financial results above all other operating metrics, significant efforts were made in 2009 to reduce cash costs substantially. Production increased by more than 4 per cent while unit production costs were reduced by 12 per cent. The reserves replacement ratio was 129 per cent, continuing an industry-leading performance. Refining and marketing cash costs were reduced by 15 per cent, and refining availability increased to 94 per cent. While BP now had one of the best performance figures of the big oil companies, safety seems to have become second to profit.

In Too "Deep": Safety Measures and Whistle-blowing

A confidential survey of workers on the Deepwater Horizon in the weeks before the oil rig exploded showed that many of them were concerned about safety practices. Only about half of the workers interviewed felt they could report actions leading to a potentially "risky" situation without reprisal. "This fear was seen to be driven by decisions made in Houston, rather than those made by rig based leaders," the report said[17].

During the subsequent investigations, it was found that safety documentation required by Minerals Management Service (MMS) regulations, and information on emergency procedures was not available. Furthermore, Transocean Ltd, which owned the rig and leased it to BP, would not provide detailed accounting of the Deepwater rig's activity history[18]. Lead federal investigator Hung Nguyen chastised BP officials after they failed to point out who was responsible for ensuring safety for the company's deep? water operations.[19]

As Stuart Sneed, a pipeline safety technician who was removed from the company in 2006 when he ordered work to stop due to safety concerns[20] remarked in an interview about BP's corporate culture:

> "They say it's your duty to come forward, but then when you do come forward, they screw you. They'll destroy your life. No one up there is ever going to say anything if there is something they see is unsafe … They are not going to say a word."[21]

The Aftermath

Dividend Policy

Following a meeting with President Barack Obama on 16 June 2010, BP announced an agreement with the US government where it will set aside a US$20-billion fund to pay all legitimate claims for compensation. It also committed US$500 million to a 10-year independent research programme that will examine the long-term environmental impact of the oil spilled and dispersants used[22]. As a consequence of the liabilities, the BP board released a statement to cancel the previously declared first quarter dividend payment. A further announcement declared that there would be no interim dividends for the second and third quarters of 2010[23]. The board, however, also provided a "strong commitment"[24] in a media statement on the payment of future dividends once the long-term impact of the Deepwater Horizon spill was better assessed at the end of 2010.

Rewards for failed leadership

On 27 July 2010, the board announced Tony Hayward's departure from his position as Group CEO with effect from 1 October 2010. This decision was made by a "mutual agreement" between the board and Hayward[25]. The board also approved a plan to name Robert Dudley, who was already in charge of the Gulf cleanup, as CEO.

The board was legally obliged to honour Hayward's contractual terms[26], which entitled him to a severance payment of a year's salary at about £1million. Hayward was allowed to immediately take out £600,000 from his pension pot (valued at £11 million)[27]. His cash-based compensation alone amounted to about £12 million and he retained his rights to a long-term share performance plan. Hayward would be nominated as a non-executive director at TNK-BP, BP's joint venture in Russia[28,29].

Commentators wondered why Hayward was rewarded for his "failed" leadership when he had put the oil giant in the midst of a severe political storm and was responsible for a 40 per cent loss in market capitalisation[30]. The potential increase in his wealth – a result of a recent share price rally which saw BP's stock price rise to 467p, driving up the value of his performance shares' value to £8 million[31] - also revived public anger towards the issue of excessive executive payments by BP.

The BP board was thus heavily criticised. The directors' commitment and effectiveness in handling the crisis were questioned, with the lack of oversight in operational activities, slow reaction in resolving the disaster and excessive executive compensation, cited as reasons[32].

To reduce public dissatisfaction, it was announced that no annual cash bonus for 2010 was awarded to Dudley, Hayward and Andy Inglis, a board member who left the board on 31 October 2010[33]. Furthermore, no shares under a long-term incentive plan would be vested for any executive director. Dudley also announced a review of all employee remuneration for the fourth quarter of the year 2010. The sole criterion for assessing employee performance and bonuses in the fourth quarter would be based on reducing operational risks and achieving excellent safety and compliance standards.

The board itself promised to improve the effectiveness of its discharge of duties. It would increase the number of its work site visits, especially for troubled Exploration & Production operations; and revamp and enhance the safety committee with new blood. The board would also play a more significant role in crisis planning and management[34]. For example, the board would require more informative reports on the Company's operating activities to help it better oversee the likelihood of future disasters.

Storm on the Horizon

BP's constant false promises and failures to improve safety led shareholders to bring derivative suits on behalf of the company on the grounds of misrepresentation, and securities fraud suits for the loss of BP's market value[35]. The board was also a target of these law suits as they were viewed as not having fulfilled their duties in exercising oversight over management. As at 20 January 2012, analysts at Morgan Stanley estimated that the total amount of litigation damages BP could potentially incur from all criminal and civil lawsuits could be as much as US$25 billion[36].

The remedial efforts performed by the company seemed to be insufficient as executives faced angry protesters, including fishermen and women from the Gulf and climate change activists, during its annual meeting in London on 14 April 2011[37]. The company denied entry to protesters on the grounds that it had an obligation to run an orderly AGM[38]. Meanwhile, inside, hundreds of BP investors – individual, corporate and institutional alike – questioned board members about the excessive executive pay, a lack of transparency on safety improvements, and lack of disclosure on the full environmental impact of BP's projects.

The Journey Ahead

While BP had effectively killed the Macondo well by 19 September 2010, hundreds of ongoing lawsuits and fines could yet add billions of dollars to its already staggering liabilities, while the findings of several investigations in progress could further damage its reputation. BP has estimated that the spill would cost the company at least US$40.9 billion[39] and the company could ill-afford another disaster of this scale. As of 9 January 2012, BP disclosed that it had spent an estimated US$14 billion on the response to the disaster, and that it had set aside US$20 billion for economic claims and natural resource restoration and US$1 billion for early restoration projects.[40]

The funding for early restoration projects was to signal the company's commitment to mitigate its actions and the impact on the environment, and in conjunction with this, BP signed an agreement with federal and state agencies for these early restoration projects aimed at the recovery of areas along the Gulf Coast[41]. BP also stepped up its corporate social responsibility by renewing its focus on safety and risk management. The Safety and Operational Risk (S&OR) unit created by Dudley upon his appointment as CEO went "live" on 31 March 2011 and became fully operational as of May 2011, with "sweeping powers to oversee and audit [BP's] operations around the world"[42].

On 15 July 2011, the company made a pledge to the Bureau of Ocean Energy Management, Regulation and Enforcement (BOEMRE) to implement a "new set of deepwater oil and gas drilling standards for its operations in the US Gulf of Mexico"[43]. The pledge appeared to work, as BP was granted its first permit to drill for oil in the Gulf on 26 October 2011[44]. Still, BP was issued citations by the Bureau of Safety and Environmental Enforcement on 12 October, with the very high possibility of paying "multimillion-dollar fines" for causing the spill. Should the Clean Water Act be invoked at a later date, BP would be required to pay heftier fines of up to US$4,300 for every barrel of oil spilled or up to US$21 billion altogether[45].

While BP has taken some significant steps to rebuild public trust and investor confidence and mend its tattered reputation with the award of "67 new exploration licences in 11 countries"[46], it remains to be seen if BP will continue to project credible commitment through its actions towards improving its safety standards and preventing another "Deepwater".

Discussion Questions

1. With regard to the disaster, do you think the BP CEO behaved appropriately?
2. Should the board and its Chairman, Carl-Henric Svanberg, be held equally responsible along with the CEO?
3. BP had a comprehensive code of conduct and a whistleblower policy but did not implement them effectively. Why do you think this is so? What steps should a company like BP take to ensure that its code of conduct and whistleblower policy are effectively implemented?
4. To what extent do you think BP's remuneration policies contributed to the disaster?
5. Was the compensation package awarded to Tony Hayward when he left BP reasonable? How should companies manage the rewards for failed leadership?
6. Evaluate how BP communicated with stakeholders following the disaster.
7. What measures do you think the BP board should implement to mitigate the chances of such a catastrophic accident happening in the future?

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HP: The Mark Hurd Saga

> "The HP board just made the worst personnel decision since the idiots on the Apple board fired Steve Jobs many years ago"
> — Lawrence Ellison, CEO of Oracle

Case Overview

In 2005, HP hired Mark Hurd as CEO, replacing Carly Fiorina. In contrast to HP's long company policy of employee retention known as "The HP Way", Hurd embarked on a series of cost-cutting measures which included the retrenchment of 15,000 workers. Hurd was also widely credited for improving HP's performance, increasing HP's stock price twofold within two years. However, in June 2010, Hurd was alleged to have submitted inaccurate expense reports to conceal a personal relationship with an HP marketing consultant. This was deemed to have violated HP's standards of business conduct. As a result, Hurd resigned from his positions as Chairman, CEO and President. This was followed by much controversy surrounding Hurd's lucrative severance package. Hurd then proceeded to join one of HP's main rivals, Oracle, as its co-president and director. The objective of this case is to allow a discussion of issues such as ethics, the role of the board in developing and enforcing the right culture and "tone at the top", the challenges faced by a board in holding the CEO to account, and executive compensation.

This is the abridged version of a case prepared by Alan Khor, Tan Ruizhi, Darren Low and Lin Junliang 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. Consequently, 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 prepared by Koh Kian Sin under the supervision of Professor Mak Yuen Teen.

About HP

Hewlett-Packard Company, commonly known as HP, is a multinational information technology (IT) corporation headquartered in California, USA. The company was founded by Bill Hewlett and Dave Packard in 1939 and is listed on the New York Stock Exchange (NYSE). It is one of the world's largest IT companies. HP's core business is built around the development and manufacturing of computers, data storage, networking hardware, the design of software and delivery services. HP also offers after-sales support for its products and partner products, especially in the provision of consulting services.

The HP Way

On 1 January 1939, electrical engineers Bill Hewlett and Dave Packard founded the Hewlett-Packard Company. From the company's early days, the founders had decided that its employees deserved a share of HP's success[12]. This would be done through production bonuses and company-wide profit-sharing plans. The founders also ran the company based on the principle of "management by objective", where employees were provided with overall objectives and the flexibility to choose their own direction.

The founders decided that HP should be built on a loyal and dedicated work force. Thus, HP implemented a policy to facilitate employee retention[3]. When HP became a publicly traded company in 1957, all employees with six months of service received an automatic stock grant and qualified for a stock option programme. After going public, Bill and Dave held a company meeting with 20 senior managers to decide on the company's objectives. These objectives eventually formed the basis of "The HP Way". It comprised seven aspects: profit, customers, field of interests, growth, employees, management and citizenship.

HP under Hurd: The Re-Awakening of a Giant

On 1 April 2005, HP announced the arrival of Mark Hurd, replacing Carly Fiorina as the CEO of HP. Little was known about Hurd, and many stakeholders were concerned about HP's future in the fast-paced and competitive industry. Hurd was described as "aggressive" and "ruthlessly efficient" by Forbes[4] and true enough, Hurd embarked on an aggressive cost-cutting strategy. This included the retrenchment of 15,200 workers.[5] Hurd's retail strategy for HP was simple: to make HP's retail outlets a one-stop centre for consumers, combining product sales with superior customer services.

As a result of Hurd's clear and direct approach, HP's stock price increased more than twofold from US$20 at the time of his appointment in 2005 to US$53 in late 2007[6]. HP's profits soared not merely because of cost cutting, but from real growth across its different business segments as well. In 2007, HP's annual revenue reached a high of US$104 billion and HP overtook its long-time rival IBM.[7] In 2009, Hurd was named one of the "TopGun CEOs" by Brendan Wood International.

The Scandal

In June 2010, Jodie Fisher, a contractor of HP, made a claim of sexual harassment against Hurd. Fisher was a marketing consultant with HP for the past two years and was assigned to organise company functions for high-value customers. The HP board of directors responded immediately by forming an investigation team that comprised HP's General Counsel's office together with an outside counsel. While there was insufficient evidence that Hurd had violated HP's policy on sexual harassment, the probe found instances of Hurd submitting inaccurate expense reports to conceal a personal relationship with Fisher. HP also alleged that there were numerous instances where Fisher received compensation and reimbursement without a legitimate business purpose[8]. These violated HP's standards of business conduct.

The Fallout

On 6 Aug 2010, HP announced that Mark Hurd will resign from his positions as Chairman, CEO and President with immediate effect. The board concluded that "Mark's conduct demonstrated a profound lack of judgement"[9]. In a conference call with analysts, General Counsel Michael Holston said that "the board concluded, and Mark agreed, it would be impossible for him to be an effective leader moving forward and that he had to step down"[10]. Yet, in spite of his resignation, Hurd was awarded a lucrative severance package consisting of cash severance payments, stock options, performance-based stock units and restricted stock units. When medical and dental benefits were included, the total amount of compensation would exceed US$34 million[11].

When CFO Cathie Lesjak was subsequently appointed as CEO on an interim basis, the board expressed confidence in HP's strategy of profitable growth, as well as in the senior management team and their ability to perform. In a move to allay potential fears from Wall Street, HP simultaneously raised its full-year outlook for revenues and earnings-per-share. These forecasts topped analysts' expectations, signalling the company's belief that Hurd's resignation would not put a dent on HP's performance.

The Aftermath

In spite of the efforts of HP, Wall Street remained unconvinced. The announcement of Mark Hurd's departure had caught shareholders by surprise. HP's share price immediately tumbled 10 per cent from US$46.30 to US$41.85. By the next trading day, HP lost over US$9 billion in market capitalisation. On 12 August 2010, shareholders filed a derivative lawsuit against HP's board, accusing the directors of breaching fiduciary duties in the way they had handled Hurd's resignation. The main area of contention involved the large severance package that Hurd was entitled to. Given that Hurd had willingly resigned in light of the investigation findings, the company was not obligated to compensate Hurd with the severance package. The shareholders felt that the compensation was undeserving, especially since Hurd's resignation was due to his own misconduct.

The Future of Mark Hurd

On 6 September 2010, slightly more than a month after Mark Hurd's resignation as CEO of HP, Oracle Corporation announced it had appointed Hurd as the company's co-president and director[12]. Oracle had been regarded as HP's rival, after Oracle's acquisition of Sun Microsystems. Oracle's employment of Hurd further aggravated the ties between these two giants in the industry.

A few days after the announcement, HP filed a lawsuit against Oracle and Hurd, claiming that Hurd would not be able to perform his role fully at Oracle without giving away HP's trade secrets and confidential information. This therefore violated a confidentiality agreement in the employment contract when Hurd first joined HP[13]. Nevertheless, investors of Oracle welcomed Hurd's appointment, sending the company's share price surging 6 per cent to US$24.29 on the day of the announcement.

Was the Firing of Hurd a Mistake?

The HP board was afraid that Hurd's indiscretion could set an inappropriate example within the company if he was allowed to remain as CEO. The tolerance of misconduct, regardless of its magnitude, could erode the strong corporate culture in HP. Through the company's inception, HP has been known for doing things "the HP Way". One of HP's shared values was "trust and respect for individuals", described as "[working] together to create a culture of inclusion built on trust, respect and dignity for all"[14]. HP's shared values also included "uncompromising integrity", and HP should make no exceptions so as to set the "right tone at the top". The resignation of Hurd would reinforce this strong culture[15]. However, given the many scandals in HP's history, it is questionable how much of "the HP Way" still remains relevant today.

"The HP Way": Still Relevant?

On 3 September 2001, then-CEO Carly Fiorina announced a merger with Compaq, a personal computer company. The merger would involve the retrenchment of 15,000 workers[16]. This move was met with intense opposition from shareholders, including Walter Hewlett, son of Bill Hewlett. "The HP Way" was felt to have been endangered under Fiorina's management. However, this would continue even after Fiorina's departure.

Shortly after his arrival, Mark Hurd, who was previously CEO of National Cash Register (NCR), announced a series of aggressive cost cutting measures, such as laying off around 15,000 workers and the reorganisation of the sales force into a more product-specific focus[17][18]. Thus, it could be seen in many instances that "The HP Way" was losing its influence on HP's company culture.

In 2006, HP made headlines when it admitted to the use of "pre-texting" in its internal investigation to discover the source of leaked board room discussions. Hurd, who was CEO at the time of the scandal, claimed he was unaware of the use of "pre-texting" in the investigations. On 18 January 2007, Hurd took over Patricia Dunn's role as Chairman of the board[19]. Hurd was subsequently involved in a lawsuit by HP's investors who claimed that the senior executives and directors engaged in insider trading. He was alleged to have sold US$1.4 million worth of HP stock on 25 August 2006, shortly before HP announced the details of the board spying scandal. Hurd claimed that the August sale of shares was made in the regular course of an investment strategy. These shares had merely represented 5 per cent of his HP holdings and did not directly cause the stock price to decline[20]. This raised doubts about the moral integrity of Hurd and the HP board.

Looking Ahead

On 30 September 2010, HP appointed Léo Apotheker, former CEO of SAP, as CEO and President. The board also elected Ray Lane, Managing Partner at Kleiner Perkins Caufield & Byers, as non-executive Chairman of the board[21]. Investors' reaction to Apotheker's appointment was mixed, and many wondered if he would be able to fill the shoes of Hurd. It would be up to Apotheker to re-establish "the HP Way", or even to define his own "The Leo Way", as the Economist puts it, of doing things.

However, Apotheker did not last long. On 22 September 2011, he was fired and Meg Whitman, the former CEO of eBay and a current board member of HP, replaced him. This came at a difficult time for HP, when its US$1.2 billion mobile operating system had been floundering and HP had been considering spinning off its PC business[22].

Discussion Questions

1. Comment on the fall of HP's share price after Mark Hurd's resignation. Does this mean that the decision to ask Hurd to leave was a poor decision from the shareholders' point of view?

2. Should managers be required to behave ethically even if their actions do not directly affect the company? How does HP expect its employees to behave?

3. The case suggests that the "HP Way" may no longer be relevant today for HP. What is the "HP Way"? Do you think any company can operate successfully today based on similar values?

4. Who should be responsible for setting and upholding the ethical culture of a company? How can a company ensure that such a culture is practised on a day-to-day basis?

5. Based on the events that have transpired, did Mark Hurd deserve the severance package he received? Why do you think the board gave him such a generous severance package?

6. Do you think that HP was justified in forcing Mark Hurd to resign?

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MicroHoo!: The Attempted Takeover of Yahoo! By Microsoft

Case Overview

In February 2008, Microsoft launched an unsolicited bid for Yahoo at US$31 per share. With Yahoo's share price closing at US$19.18 the previous day, this represented a 62 per cent premium and seemed like a deal not to be missed. However, Yahoo's management resisted all of Microsoft's efforts to take over the company, resulting in Microsoft withdrawing its offer in May 2008. The objective of this case is to allow a discussion of issues such as the role of the board and management in a takeover situation in the US and compare it with the situation in Singapore, the use of anti-takeover defences, and whether the takeover benefits shareholders of the acquiring and/or target company.

The Drama Unfolds: Sequence of Events[1]

On 1 February 2008, Microsoft launched an unsolicited takeover bid for Yahoo, hoping to tap on Yahoo's search engine and online advertising resources which would allow it to compete more effectively with Google. Microsoft offered to pay US$44.6 billion, effectively setting the bid price at US$31 per share. This represented a 62 per cent premium over Yahoo's closing price the previous day. Yahoo's share price immediately skyrocketed

This is the abridged version of a case prepared by Parsley Ong Rui Hua, Hang Yuan Yuan and Chua Bixia 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. Consequently, 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 prepared by Cheryl Nio Yi Hui under the supervision of Professor Mak Yuen Teen.

In mid-February 2008, Yahoo formally rejected Microsoft's offer, claiming that Microsoft had substantially undervalued Yahoo's shares. Reports had indicated that Yahoo's minimum asking price was US$40 a share[2]. Yahoo co-founder and CEO Jerry Yang was seen by many as the main obstacle to the merger. Under Yang's leadership, Yahoo had enacted a controversial "poison pill" severance plan[3] and it commenced a search for a white knight investor.

With the fall in Microsoft's own share price as well as to induce Yahoo shareholders to pressure the board to sell[4], Microsoft raised its offer to US$33 per share. However, Yahoo's board rejected the offer, insisting on no less than US$37 a share[5].

On 3 May 2008, Microsoft said it was withdrawing its bid. On the same day, Yahoo's share price fell to US$23 and its share price dropped further to below US$20 in the following few months. A number of shareholder lawsuits against Yahoo's board followed.

On 3 June 2008, shareholder activist Carl Icahn joined the fray. Icahn echoed the charges in several lawsuits' that "Yang's deep hostility toward Microsoft" and his "defensive and self-interested conduct" had scuttled the deal. Icahn also told *The Wall Street Journal* that should his proxy campaign prove successful, he would try to oust Yang, under whom Yahoo's stock had plummeted from US$33.63 a share in October 2007 to US$26.15 a share, representing a drop of over 22 per cent[6].

Microsoft's Interest in Yahoo

Microsoft CEO Steve Ballmer viewed the merger between Microsoft and Yahoo as an opportunity to strengthen Microsoft's market position in the burgeoning online advertising market, which was at that time dominated by Google.

A merger of the two companies would raise the combined entity's advertising revenues to US$4.74 billion. Although this still trailed Google's US$6.12 billion[7], it would serve as a more solid foothold for Microsoft in the lucrative US$40 billion online advertising market over which Google currently holds sway. As allies, "Microhoo!" would reach 86 per cent of US Internet users and control 59 per cent of the online display advertisement market[8].

Although Microsoft seemed to be offering what looked like an exorbitant premium, especially considering Yahoo's performance over the years, Microsoft expected to realise synergies that would more than make up for it.

A letter from Microsoft's Ballmer to Yahoo's board of directors highlighted the benefits that were expected from the merger, including: (1) scale economics, (2) expanded R&D capacity, (3) operational efficiencies and (4) emerging user experiences[9].

The merger was also purported to bring about cost savings amounting to US$1 billion a year[10]. Microsoft would also be able to leverage on Yahoo's existing technologies and cut back on some capital-intensive projects such as the building of massive data centres.

Though Microsoft initially pursued the deal believing that it would help it enter the lucrative online advertising market, the resistance of the Yahoo board was proving difficult. Many Microsoft shareholders were displeased at the company's attempt to diversify its business. Whilst diversifying would theoretically reduce risk to Microsoft and, by extension, to its stakeholders, diversification was something its shareholders could potentially do more effectively on their own.

The protracted battle with Yahoo eventually took its toll on Microsoft, with its share price falling substantially over the 6 month period following the takeover offer, from US$30.45 per share to less than US$26 per share.

Yahoo's Resistance

In spite of the benefits of the merger and overwhelming positive shareholder sentiment towards the merger, Microsoft's takeover attempt met with strong resistance from Yahoo executives. Even after Microsoft sweetened the deal by raising its offer to $33 per share, Yahoo executives insisted on a minimum asking price of $37 per share, which was viewed as being absurdly high. Given that the 52-week high at that point in time was $33.63, an offer of $37 would represent a 93 per cent premium over Yahoo's closing price as at 31 Jan 2008 ($19.18). They went on to enact a controversial severance plan[11] and pursued alternative tie-ups with Google and AOL[12] in an effort to put a stop to the takeover by Microsoft.

Yahoo executives cited regulatory hurdles, pricing and strategic issues, undervaluation of Yahoo, and the loss of human capital and impact on employee morale in defence of their actions.

CEO Jerry Yang expressed concerns over potential regulatory hurdles that could delay or even squash the merger with Microsoft, leaving Yahoo high and dry should they agree to the deal and move toward it, only to subsequently have it fall through.

The pricing of the deal was also of concern to Yahoo executives. Microsoft's original bid was half cash and half stock. As Microsoft's share price dropped with the announcement of the takeover bid, so too did the value of the deal. Yahoo was also wary of being acquired by a much larger firm with little relevant expertise in its field. Despite its poor recent performance, Yahoo continued to remain profitable[13]. The same, however, could not be said for Microsoft's loss-making internet division[14] and comparatively low share of search queries (9.9 per cent compared to Yahoo's share of 16.3 per cent in April 2009)[15].

Another disincentive for Yahoo to agree to the merger is the perceived undervaluation by Microsoft, as vehemently argued by CEO Jerry Yang. Sandeep Aggarwal, an analyst with financial-services firm Collins Stewart, estimated that if Microsoft paid US$15 billion for Yahoo's search operation and US$3 billion a year to run ads on Yahoo Web pages, such a deal could add up to US$9 a share to Yahoo's stock price – well north of Microsoft's last offer of US$33 a share[16].

Concerns about lowered employee morale and the loss of human capital were also cited, as a merger with Microsoft would undoubtedly see a large reduction in Yahoo's workforce as similar projects and departments were combined.

On a more personal note, CEO Jerry Yang's emotional attachment to the company he co-founded, his deep-seated hatred of Microsoft, and even perhaps his hope to establish his legacy as an Internet visionary[17], also played a part in the decision to rebuff Microsoft's takeover attempt.

The Reaction of Yahoo Shareholders

In light of Yahoo's recent poor performance, many shareholders saw Microsoft's offer as a good way to cash out on their investment, and thus were baffled by Yahoo executives' continued resistance to accepting the offer.

In the wake of the failed merger attempt, many shareholders filed lawsuits against Yahoo for breach of fiduciary duties[18]. In mid-2008, Carl Icahn, who held about 5 per cent of Yahoo stock, initiated a proxy fight to unseat all of the existing board of directors. However, even in light of perceived executive incompetence, diminishing shareholder value and widespread shareholder dissent, it is often difficult to replace the board of directors in a large public company like Yahoo. With one of Yahoo's largest and most influential shareholders backing the existing board, Mr Icahn finally dropped his proxy bid in July 2008 in exchange for three seats on Yahoo's expanded board, not having been able to achieve his initial goals.

Looking Forward…

In November 2008, Yahoo announced it had begun a search to replace co-founder Jerry Yang as chief executive[19]. In January 2009, Carol Bartz was named CEO[20]. Yahoo and Microsoft subsequently reopened talks and inked a partnership in internet search and advertising in July 2009[21]. Yahoo's performance continued to deteriorate, however, with revenues decreasing year on year[22], cumulating in the firing of Carol Bartz, with CFO Tim Morse stepping in as interim chief[23] in September 2011.

Since October 2011, there have been talks of certain groups of private equity firms looking to buy out Yahoo[24]. In November 2011, it was reported that Microsoft had renewed its interest in Yahoo.

On 4 January 2012, Scott Thompson, the President of PayPal, was named as the chief executive of Yahoo.[25] This was soon followed by the departure of Jerry Yang from Yahoo's board on 17 January. [26] Analysts said that Yang's departure might speed up discussions to sell Yahoo's prized assets, in particular, its 40 per cent stake in Alibaba and its investment in Yahoo Japan. Whether or not any deal pans out remains to be seen.

Discussion Questions

1. Did Yahoo's management and board act in the best interest of shareholders when rejecting Microsoft's takeover offer?
2. Discuss the actions taken by Yahoo's management and board to block the takeover by Microsoft. Should such actions be prohibited?
3. In your opinion, do you believe that the offer by Microsoft is good for (a) the shareholders of Yahoo, and (b) the shareholders of Microsoft?
4. What are some of the key differences in rules governing takeovers between the US and Singapore?
5. Place yourself in Carl Icahn's shoes. What are some of the difficulties a minority shareholder faces when dealing with a board like Yahoo's? Are these difficulties similar in Singapore?

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Prof Mak developed the Governance and Transparency Index (GTI) which rates the corporate governance of listed companies in Singapore. He is currently involved in an initiative driven by regional regulators to develop a corporate governance scorecard and ranking of large listed companies in ASEAN.

His report on improving the implementation of corporate governance practices in Singapore, commissioned by the Monetary Authority of Singapore and Singapore Exchange, was published in June 2007. His book "From Conformance to Performance: Best Corporate Governance Practices for Asian Companies" was published by McGraw-Hill in 2005. He was also recently commissioned to write a primer on governance for social enterprrises in Singapore.

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