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# Contemporary Challenges in Corporate Governance

Philippa Wells · Jens Mueller

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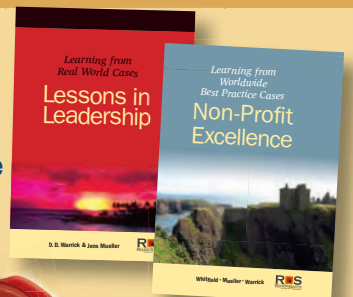
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GOVERNANCE

**Philippa Wells**  
**Jens Mueller**



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TABLE OF CONTENTS

*Learning through Cases,*  
**CONTEMPORARY CHALLENGES  
IN CORPORATE GOVERNANCE**

<i>Foreword</i>	<i>i</i>
<i>About the authors</i>	<i>ii</i>
<hr/>	
<b>CONFLICT AND DECISIONMAKING</b>	<b>1</b>
<b>1 The Board of Directors' Dynamics: Conflicts and Coalitions: The Case of 2 Tunisian Companies</b>	<b>1</b>
<i>Ines Belghith Masmoudi</i> Institute of accounting and business management in Manouba University (ISCAE,) Tunisia	
<hr/>	
<b>2 HalKa Resort – Board and CEO, Fight to (Hotel) Death!</b>	<b>13</b>
<i>Wafa Khlif</i> Université de Toulouse, Toulouse Business School, Barcelona Campus, France	
<i>Coral Inglej</i> Auckland AUT University, New Zealand	
<i>Lotfi Karoui</i> Groupe ESC Troyes, France	
<hr/>	
<b>3 Complicated Ownership and Voting Structure in an International Partnership: Case of Turkcell</b>	<b>23</b>
<i>Aylin Ataay</i> Galatasaray University, Istanbul, Turkey	

- 
- 4 Opera Performance Company: Passion and Emotion as the Driver for Decision-making and Management Processes in a Not-For-Profit Performing Arts Company** 31

*Sally Rosenberg*

Camberg Consulting, Hamilton, New Zealand

---

- 5 The Gome Electrical Appliances Holding Case** 43

*James S. Ang*

Department of Finance, Florida State University, USA

*Shi Li*

School of Management, Xiamen University, China

*Chaopeng Wu*

School of Management, Xiamen University, China

---

## GOVERNANCE IN TRANSITION

2

- 6 Governance Mechanisms and Generational Transitions in Family Firms: The case of De Matteis AgroAlimentare S.p.a.** 51

*Nicola Moscariello*

Dept. of Management and Accounting,  
University of Naples II, Italy

---

- 7 Living Without Regrets: How An Efficient Governance Wins The Succession Dilemma and The Economic Crisis** 63

*Cristina Bettinelli*

Bergamo University, Bergamo, Italy

*Andrea Giuliani*

University of Bergamo, Department of Business Administration,  
Entrepreneurial Laboratory Research Center, Italy

- 
- 8 Formal and Informal Governance** 77  
**Mechanisms behind Successful Family  
Firms' International Expansions:  
The Case of CMD S.p.a.**

*Michele Pizzo*

Dept. of Management and Accounting, University of Naples II, Italy

---

- 9 Building a communication platform: the use** 89  
**of a 'Bricks and Mortar' model of formal and  
informal communication in an organisation.**

*Sasha K. Grebe,*

Professional Affairs and Advocacy,  
The Royal Australasian College of Physicians and former  
AWB Limited Government Relations and National  
Regulatory Affairs Manager, Australia

---

- 10 Permo-Drive: Governance under Innovation** 101

*Jerry Courvisanos and Angela Hipwell*

The Business School, University of Ballarat, Australia

---

GOVERNANCE IN THE PUBLIC SECTOR

- 11 Public Sector Governance: The Case of** 119  
**Light Rail Expansion in the City of Angels**

*Stuart C. Strother*

School of Business and Management  
at Azusa Pacific University, California, USA

---

- 12 Council Water Co.:** 131  
**Changing the Charges for Water**

*Frances Schwartzkopff, Peter Smith  
& Ljiljana Erakovic*

The University of Auckland Business School,  
The University of Auckland, New Zealand

<b>13</b>	<b>Wrangling Along: Governance and Leadership Principles and Applications</b> <i>Larry W. Ettner and Mark J. Ahn</i> Atkinson Graduate School of Management, Willamette University, USA	<b>151</b>
<b>14</b>	<b>Ethical issues at the Independent Commission Against Corruption</b> <i>Geetanee Napal</i> Faculty of Law and Management, University of Mauritius, Réduit, Mauritius	<b>161</b>
<b>15</b>	<b>The Emerging Oil Industry in Uganda; A Blessing or a Curse?</b> <i>Pamela K. Mbabazi</i> DVC, Mbarara University, Uganda	<b>165</b>
<b>16</b>	<b>Where Private Gain Leads to Social Cost: The Case of Natural Gas Fracking in Central Pennsylvania</b> <i>Mark A. Heuer</i> Sigmund Weis School of Business, Susquehanna University, Selinsgrove, USA	<b>181</b>
<b>GOVERNANCE AND VALUE CREATION</b>		<b>4</b>
<b>17</b>	<b>Design Co.: The Art of Balancing Creativity and Control</b> <i>Frances Schwartzkopff, Ljiljana Erakovic and Srimaye Kudumula-Arora</i> The University of Auckland Business School, The University of Auckland, Auckland, New Zealand	<b>187</b>

---

<b>18</b>	<b>Corporate Governance in NTUC FairPrice Co-operative Ltd, Singapore</b>	<b>201</b>
	<i>Huong Ha</i> University of Newcastle, Singapore	
<b>19</b>	<b>On Defining a Strategy for Push/Pull Allocation of Promotion Expenses</b>	<b>213</b>
	<i>C. M. Ehrman</i> Jerusalem College of Technology, Israel	
	<b>GOVERNANCE IN PRACTICE</b>	<b>5</b>
<b>20</b>	<b>The B &amp; W Ventures LLC Case: Business Dispute Resolution using ADR</b>	<b>221</b>
	<i>Peter Geoffrey Bowen</i> University of Denver, Denver, United States of America	
<b>21</b>	<b>The EU Labor Requirements for Turkey: What are the Implications for Corporate Governance?</b>	<b>235</b>
	<i>Helen LaVan</i> DePaul University, Chicago, USA	
	<i>Margaret Oppenheimer</i> DePaul University, Chicago, USA	
<b>22</b>	<b>Developing a Business Governance Model by Aligning Systems and Practice: An Australian Case Study</b>	<b>251</b>
	<i>Ron Fisher</i> Griffith Business School, Griffith University, Queensland, Australia	

## FOREWORD

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**There is no doubt** that the emergence in the last 15-20 years of corporate governance as a focus for academic and managerial concern has been significant: the collapses of such large companies as Enron and the scandals to hit others such as WorldCom, sent shudders through investor markets, Governments and boards of Directors alike. Theoretical and applied outputs have examined the reasons for such failures, offered models for “good” corporate governance and reported on skills, intentions and activities good and bad, of those involved in governance.

Notorious though these failures might be in terms of their exposure of failures in governance and control they are merely manifestations of failure in particular aspects of governance within particular structures in particular contexts: most often the large Anglo-American publicly owned company or corporation. However, governance as a term, concept and construct is much broader: with its definition as “a set of relationships between a company’s management, its Board, its shareholders and other stakeholders...also providing the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined” (OECD 2004, p.11), principles of governance have a general significance in a wide range of cultural and management contexts. That governance can be described as “good” when and if the policies and procedures of governance implemented and observed increase value: debate continues around what how such value can be measured and to whom it should first and foremost accrue.

Hence this collection of case studies. The title to this book is carefully chosen to reflect our intention in providing them: to offer an opportunity for readers to understand and appreciate the breadth and complexity of contexts in which issues of governance arise and to explore strategies for addressing those issues. It includes studies that focus on governance scenarios in emerging economies, public sector

## FOREWORD

businesses and those that explore governance concerns for society more generally, both in terms of government and the environment. Finally, we include three that explore governance from different perspectives. The case studies also raise questions for readers to consider as to their implications for corporate governance more generally.

The studies fall into several distinct categories. The first includes those that consider how board conflicts can affect decision-making – not necessarily always negatively. Ines Masdmoudi (in *“The board of directors’ dynamics: conflicts and coalitions: The case of 2 Tunisian companies”*) compares the situation for the boards of two companies in Tunisia, particularly in relation to how changes in management and ownership have affected the board and its effectiveness. Importantly, board conflict is highlighted as potentially positive for the growth and development of a business whereas concerns are raised as to the presence of a passive board. In *“HalKa Resort, Board and CEO, Fight to (Hotel) Death”*, Wafa Khlif, Coral Ingley and Lofti Karoui explore the issues that arise in respect of the on-going health of an enterprise where a founding CEO continues to exert his influence over a board to the point that poor decisions lead to failure of the enterprise and ultimately that of the individual. It reveals much of interest given the insistence in the literature of the importance of separation between management and the board. The case written by Aylin Ataay (*“Complicated Ownership and Voting Structure in an International Partnership: Case of Turkcell”*) examines governance concerns where disputes between three partners, all represented on the board, escalate to the point that it is impossible for the board to function efficiently or effectively, and highlights issues for regulators and the corporate sector alike.

## FOREWORD

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In *“Opera Performance Company: Passion and Emotion as the Driver for Decision-making and Management Processes in a Not-For-Profit Performing Arts Company”*, Sally Rosenberg investigates the situation that exists in a small performing-arts company and proposes strategies for conflict resolution while in the *“Gome Electrical Appliances Holding Case”*, James Ang, Shi Li and Chaopeng Wu explore the situation where professional executives along with an American equity fund attempt to wrest control of a Chinese company from its disgraced (and imprisoned) founder. It refers to the role of criminal law in punishing poor governance of such companies and to the relationship between shareholders (investors) and the board.

A second category includes cases that examine governance mechanisms in a context of transition. Two of these cases deal with the situation where control is passed down through generations in the context of a family firm. Nicola Moscardiello in *“Governance Mechanisms and Generational Transitions in Family Firms: the case of De Matteis AgroAlimentare S.p.a.”*, discusses how well-designed governance structures and processes can assist a company through this potentially difficult phase and permit positive and constructive change to enable the business to not only survive it but become stronger. Cristina Bettinelli and Andrea Guilani impart a similar message in *“Living Without Regrets: How an Efficient Governance Wins the Succession Dilemma and the Economic Crisis”*, emphasising also the importance for successors to take the hard decisions that will allow the business to survive and increase value to shareholders. A third study (*“Formal and informal governance mechanisms behind successful family firms’ international expansions: the case of CMD S.p.a.”*), provided by Michele Pizzo, looks at the role of good governance systems in a family firm as a valuable resource that enables the firm to transition from a local to an international player. The study by Sasha Grebe entitled *“Building a communication platform: the use of a ‘Bricks and Mortar’ model of formal and informal communication in an organisation”*

## FOREWORD

discusses how a major international scandal forced leaders of AWB Ltd to restructure its governance in order to both survive and restore its reputation. Finally, in *Permo-Drive: Governance under Innovation*, Jerry Courvisanos and Angela Hipwell explore a situation where innovators fail to translate a good idea to market success.

A third category includes those that look at governance issues affecting the public sector, particularly in how decisions can impact on society. Stuart Strother in *“Public Sector Governance: the Case of Light Rail Expansion in the City of Angels”*, examines decision-making and its purpose in the context of the expansion of light rail in Los Angeles, asking how public leaders can identify and measure objectives and benefits for such a project. Frances Schwartzkopff, Peter Smith and Ljiljana Erakovic (*“Council Water Co: Changing the Charges for Water”*), describe the problems and options for a council-owned water company in setting charges for supply and waste-water removal in a New Zealand city, a case that highlights the conflict that can arise between a local authority with responsibility for management of this essential resource and those who feel a charging regime is distorted.

In a third case, *“Wrangling Along: Governance and Leadership Principles and Applications”*, Larry Ettner and Mark Ahn examine the application of governance principles to politicians and their activities, focusing particularly on how leaders in public life have a fundamental imperative to respect moral boundaries in reconciling their public role with their private interests. Finally, Geetanee Napal in *Ethical issues at the Independent Commission Against Corruption*, explores the problems involved in addressing ethical practices in a governmental commission.

Two other cases in this category explore the tensions that can arise between private and public interests. In *“The Emerging Oil Industry in Uganda: a Blessing or a Curse”*, Pamela Mbabazi uses the recent history of oil exploration and exploitation in her home country of Uganda to examine the problems that arise when Governments must reconcile social concerns, that may in

## FOREWORD

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themselves involve inherent conflicts, with private commercial gain: all within a context in which stakeholders feel ignored and where tradition suggests that all options on the table carry immense risk into the future. Finally, in *“Where Private Gain Leads to Social Cost, The Case of Natural Gas Fracking in Pennsylvania”*, Mark Heuer examines the problems and tensions that arise where a process promising much in terms of profitability for private enterprise runs up against a conflicted social message: resistance from those seeking protection for a fragile environment and those looking to such activity as an economic saviour.

A fourth category includes studies that analyse governance structures and strategic choice in terms of their roles in increasing value for those having stakes in the organisation. Frances Schwartzkopff, Ljiljana Erakovic and Srimaye Kudumula-Arora, in *“Design Company: the Art of Balancing Creativity and Control”*, explore the major issue facing the board: whether survival of the company requires fundamental changes to the operating and management structures and processes that have served it so well in the past. Huong Ha (*“Corporate Governance in NTUC FairPrice Co-operative Ltd, Singapore”*) takes us into the world of cooperatives to explore the particular governance issues that face those operating through such a structure, particularly in addressing needs of members in a broader way than just financial return. Finally, in *“On Defining a Strategy for Push-pull Allocation of Promotion Expenses”*, Dr Ehrman from Israel emphasises the importance of data analysis for those making governance-level decisions in corporations and other profit-driven organisations, and indicates how the selection of approach can affect the final calculation and, therefore, potentially the decision.

The final three case studies approach corporate governance from different angles. In *“The B & W Ventures LLC Case: Business Dispute Resolution using ADR”*, Peter Bowen uses a conflict simulation to take us through an alternative dispute resolution process as a means of resolving governance issues.

## FOREWORD

It is of particular importance for SMEs (that make up a very large proportion of business enterprises in many economies) as it addresses many of the issues likely to arise in this context. The second case (*The EU Labor Requirements for Turkey: What are the Implications for Corporate Governance?*” by Helen LaVan and Margaret Oppenheimer) explores the implications for Turkey and corporate governance within that country of rules set by an external body – the EU. With Turkey in negotiations at the time of writing to join the EU, this issue is likely to have major ramifications for Turkish businesses that are primarily SMEs. Finally, Ron Fisher in “*Developing a Business Governance Model by Aligning Systems and Practice: an Australian Case Study*”, proposes a Business Process Model (a BPM) be used as a framework by organisations to design governance structures that enable effective process-based decision-making.

As a final word, we would like to thank all those who submitted cases for this book. Their contributions are well written, thoughtful and challenging to all of us who research and teach into this important area of corporate governance. I would also like to thank those other individuals who have contributed to the compilation of this work, including reviewers, editors and publishers.

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## 1

## 1

## The Board of Directors' Dynamics: Conflicts and Coalitions: The Case of 2 Tunisian Companies

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*Abstract:* The aim of these case studies is to demonstrate that each board has its own dynamic, determined by the degree and level of interactions between board members with different profiles, points of view and opinions. These interactions may be sometimes value destructive, but may also generate new ideas and new perspectives enhancing the dynamics of the board, and improve the effectiveness of decision-making.

The case studies are used to explore some board's features affecting decision-making effectiveness especially, conflicts in board of directors, in the particular context of Tunisian small and medium enterprises (SMEs). These firms often share certain characteristics, such as the relatively small amounts of capital invested, the dominance of the family business, and the lack of a well-defined governance structure. But each has different dynamics and directors' roles that enhance the board's and company's effectiveness.

*Key words:* Board of directors, roles, dynamics, conflicts.

### Introduction

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According to Huse (2007), the effectiveness of boards and the creation of value are the results of interactions between diverse stakeholders (owners, managers, administrators and other actors). The interactions between different cognitive, psychological and social profiles, are supposed to lead to differences of views, ideas and opinions. These differences may affect various decisions of the board, and can be a source of conflict. The dynamics of the board is the outcome of these interactions. We suppose that each board has its own dynamic, determined by the degree and level of interactions between board members with different profiles, points of view

and opinions. Thus, these interactions may be sometimes value destructive, but may also generate new ideas and new perspectives enhancing the dynamics of the board and improve the effectiveness of decision-making. The case studies presented here are used to explore some board's features affecting decision-making effectiveness especially conflicts at board level in the particular context of Tunisian small and medium enterprises (SMEs). These firms often share certain characteristics, such as the relatively small amounts of capital invested, the dominance of the family business, and the lack of a well-defined governance structure.

Drawing on the results of interviews with the chairman and two other directors of each company, we analyze board features affecting decision making effectiveness. The first company is a computer and networking systems service, that we will call "Computers", in this study, and the second sells and maintains equipment such as wheel loaders, forklifts and compressors. The company will be called "*Equipments*".

## 1. Case Description

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As mentioned above, this chapter is a case study of two boards of Tunisian company, the first is *Equipments* and the second is *Computers*.

### a. The Case "*Equipments*"

*Equipments* is a company recently created as a subsidiary of a leading company in Tunisian market. This company has been selling loaders, forklifts, and compressors for international brands since 1926, and which will here be referred to as "Industrial Engine".

"Industrial Engine" was a foreign company bought by a Tunisian family-developing group in the eighties (called here "AB Group"). The group was founded in the end of the seventies by two brothers who used to work in the government. The group now owns about fifty companies operating in a variety of industry sectors, including banking, insurance, leasing, tourism, trade, industry, foods and health. By way of further diversification, and since the brands represented by "Industrial Engine" offered new categories of products with lower cost, "AB Group" decided to introduce these new products to the Tunisian market and to a neighboring market. In 2008, *Equipments* was created for this purpose, and for legal reasons, it has two branches: "*Equipments Tunisia*", for the local market and "*Equipments International*" for the neighboring market. However, the board of directors is almost the same for the two companies. *Equipments* has 7 shareholders and 6 directors, with "Industrial engine" holding 99% of the capital. The board includes "Industrial Engine's chairman and *Equipments*' chairman, a representative of a company of the group, one *Equipments*'

executive engineer and one family group representative, holding one share each. For the international branch of Industries there are 8 shareholders, all directors. “Industrial Engine” holds 62.5% of the shares, and the two founding brothers of the group have 18.75% each. The other directors are two sons of the founders, the chairmen of *Equipments* and “Industrial Engine” and a representative of another company of the group. Below (figure 1) is a diagrammatic representation of AB Group and its subsidiaries. Table 1 offers more details on the distribution of shares in both *Equipments Tunisia* and *Equipments International*.

Figure 1: AB GROUP AND ITS MEMBER COMPANIES

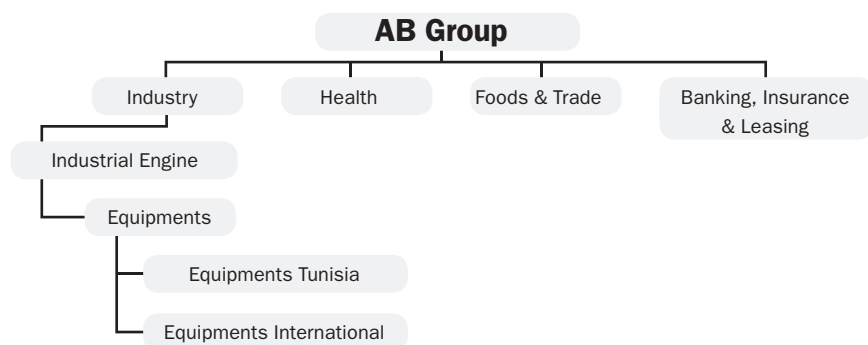


Table 1: The shareholding in ‘Equipments Tunisia’ and ‘Equipments International’

	Equipments Tunisia	Equipments International
Industrial Engine	99%	62.5%
Founding brother 1	0	18.75%
Founding brother 2	0	18.75%
Others	1%	0

The strategic objective for Equipments is to have a significant market share in Tunisian and neighbouring markets, an objective the directors of both subsidiaries believe attainable given that since its products are lower cost products produced by a worldwide leader under a new brand. So far, the results have been very satisfactory for the local market but almost disastrous in the neighbouring market for the two last years. That is the big issue in this case.

**b. The Case “Computers”**

*Computers* was found in 1987 by a Tunisian engineer in computers systems. He had the biggest private bank in Tunisia as a major client, a client

that needed full time assistance. As *Computers* was a small enterprise and would be completely dominated by the bank, a deal was made: the bank bought *Computers* and recruited the founder engineer as the information systems manager for the bank. In 1991, the bank recruited a new CEO to manage *Computers*. This CEO was a young engineer, freshly coming from the United States with a prestigious PHD in computer engineering. An agreement was made between the bank and the new CEO about a leveraged buy out. Now he holds 70% of the capital of *Computers* and is the chairman and general manager of the company. This transfer of ownership from the bank to the chairman has contributed to a concentration of the capital and decision making in the hands of this chairman. In 1995, *Computers* created a subsidiary to manage and market a big brand of data retrieval and storage units. There are seven capital shareholders but only four directors and 99% of the shares are held by the chairman, who is also the CEO, and almost the only decision maker in the company.

With a similar strategic approach as in *Equipments*, *Computers* is a leader in Tunisia in telecommunication networking equipment, services and trade. In addition, it is in a good position in neighbour markets (Algeria and Libya) and other African countries like Mauritania and Nigeria.

In emerging economies like Tunisia, the dominant form of business is the family business. This form evolves over time. For example, even though *Equipments* is a company owned by a family group, directors talk about the owners' desire to escape the family business concept, opening up the board to other non-family members who can bring their talent and expertise. However, "*Computers*" shows that traditional thinking can still dominate.

Family business or not, decision-making can always be problematic. In Tunisia, concepts of the board of directors and on its decision-making processes are also emerging. Through the two case studies below, we will discover some similarities and some differences in the board decision making. In these two cases, different motivations may drive directors, different kinds of discussion may take place and can pose different issues for the company. The decision making itself is a process which frequently encompasses discussions, frictions, crisis, conflicts and disagreements before an agreement is finally reached. It is interesting to see the effect of these discussions, frictions and conflicts across the two case studies and how they can enrich the decision making but also how they can also sometimes handicap the process.

### The Boards of Directors; Different Roles

According to agency theory, the main role of the board is to fight against the opportunism of the agent, generally perceived as someone with bounded rationality trying to maximize his personal utility. In this perspective, the company *Computers* perceives the role of the directors as being to “*call to order if there are any violations*” (according to a director in the board of this company. He adds that the most important thing is the respect of the law.)

The chairman of this company, the major shareholder with 99% of the capital, explains that the company *Computers* has been through different phases in its life cycle. By the 1990s, this company was a subsidiary of one of the most important banks in Tunisia. According to the directors, the board had been very dynamic and active. However, the transfer of ownership from the bank to the chairman in the twenty last years has concentrated capital and decision in the hands of one person: the chairman. This person perceives now the board of directors as a formal structure. The chairman goes to talk about two big periods: before (multiple shareholders) and now (single shareholder). He states that a board of directors cannot be effective when the capital is held by one person. The third director of *Computers* perceives his appropriate role as contributing to company strategic vision. However he does not hesitate to stress the power of his chairman: “*with his money, he can do whatever he wants*”. For him, there is a total correspondence between the major shareholder and the company. That makes the directors and the board completely redundant. This conclusion is confirmed by the fact that in making strategic decisions, the company calls for external expertise (and ignores the directors). Asking *Computers*’ chairman of the role played by the directors, he implied that they were here to “*fill the seats*”.

The perception of the role of directors is quite different in *Equipments*. It is no longer limited to the protection of shareholders, but involves cooperation of shareholders, directors and managers. From this perspective, *Equipments* proves that the interests are not contradictory but can be convergent.

This company has a different board structure: a chairman; directors with one share each and directors representing the major shareholders. The quality and frequency of board meetings are much higher in this case, which are considered necessary for the effectiveness of the board. In this case, directors perceive that the board is supposed to go beyond the monitoring role. One of them states that if “*I’m not sure of the importance of my giving role, I would not be here now*”.

In the *Computers* case, since the board is dominated by the main shareholder, we perceive a person acting to protect his own interests. Accordingly, the board is a formal structure. We also have been able to observe in *Computers* the passive attitude of the directors. They are spectators more than watchdogs.

In the *Equipments* case, we notice the presence of non-shareholder directors. They were hired for their expertise. They act as chief executive manager (chairman) and executive manager (director) and only have one share each. Since their interest is less personal enrichment and more contributory, we should expect more a cognitive contribution. Indeed, the main shareholders express some effectiveness expectations from these persons, especially in terms of strategy.

### 3. The Board of Directors; from Features to Dynamics

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#### a. The Director's Profile

A director's profile is a combination of attributes, expertise and characteristics. It may be divided into two types: a personal and cognitive profile. The first one focuses on the personal and behavioral features. The second one takes into account professional background, knowledge, technical skills and expertise, career, experience and social capital.

In *Computers*, the major shareholder's personality dominates the board and the company. The main theme in the chairman's interview was himself. He spent a long time talking about his personal career and his studies in the States. He celebrated his contributions to community life. Two directors supported his self-confidence, expressing their appreciation as to how he is running the company. They show lack of individual personality compared to whom they consider as their "boss". This "crossing out" attitude is probably not due to their educational/professional background, since one of them has a PhD degree in computer science from Michigan University and the other a bachelor's degree in commercial sciences from a good Tunisian University. They have also about fifteen years of professional experience each in this same company.

In *Equipments*, directors have high educational/professional profiles. They have all graduated from American and European universities and have different competences and knowledge. Even though the chairman and CEO is an ex-minister (well-educated with a large experience in management and leadership), he has adopted a democratic style in managing the board.

The group founders – and main *Equipments* shareholder (99%) – are aware that their children (even though very well educated) should be

supported by external competencies recruited for the boards of each one of their companies.

### **b. The Board's Diversity**

The board diversity is related to board composition and different profiles of directors working in the same boardroom. The diversity in the boardroom ensures a higher level of innovative ideas, more valuable experience and knowledge and skills to provide better board effectiveness.

The diversity is quite clear in *Equipments*. The board is composed of six different persons (a part from diverse curriculum and backgrounds): a government ex-executive, a woman, a young engineer graduated from a Canadian university and two family members (owners) and the ex-minister.

However *Computers'* board doesn't show any diversity; it is composed of four directors: the chairman (main shareholder), his wife (formal presence) and 2 of his managers. The chairman is aware of the lack of diversity and the absence of other directors' contribution. But, according to him, only ownership can legitimate the involvement in decision-making.

### **c. The Board's Power**

*Computers* is a good example of chairman's domination in the board. When asked about the contribution of directors in the board, the chairman claims clearly that "*I know the company better than anyone, and I decide, I have an absolute decision power. What is a director supposed to add to the company, it is just a legal appearance. Unless I lie to you?*" The two other directors are completely subject to this domination of the chairman. They act passively and seem to accept and even appreciate this domination. They look like they feel the lack of legitimacy that is related to ownership (as pointed out so many times by the chairman).

However, in *Equipments* the chairman is also a company employee. He is not able to dominate the owners, but in this case, nor do the owners. The directors of *Equipments* did not have any difficulty in talking about conflicts on the board. However, in *Computers'* directors avoid the word completely, and just use (prefer) discussion or debate instead.

## **4. The Board of Directors; Between Dynamics and Conflicts**

For both *Computers* and *Equipments*, board performance has not really been subject to scrutiny, particularly as both companies are doing well. When asked about the board performance, all the directors agreed that the board is doing well. For *Computers*, the chairman thinks that his board could do better if the capital was more open to other shareholders. For *Equipments*, the directors think that the board was fully invested by the

challenges facing the company. For them, the evidence is the work done over the last two years and the positive results compared to the forecast.

*Computers*, although revealing friendly ties and good personal relationships between directors, shows the chairman's domination operating as a kind of brake to different types of counsel, advice and interactions. The strategic outcomes are the result of the opinions of only one person. According to one of the directors, the company's actual performance is essentially a result of the good vision of the chairman. *Computers* does not really face major strategic challenges, and according to the chairman, the company is now living its *glory days* (i.e. his own entrenchment), and ready for a public offering.

Cognitive diversity in the boardroom enhances discussions and provides better solutions and decision making. Indeed, the more the board is heterogeneous, the higher is the amount and diversity of skills and ideas. And this gives more alternatives to the board for decision making or problem solving. In the case of *Equipments*, and as shown above, diversity is more apparent on the board as compared to *Computers*. The effects of this diversity are obvious. According to the chairman and directors, *Equipments* faced difficulties and challenges two years ago, when moving into a neighbouring country where market conditions carry considerable risk. Directors explained that during this period board meetings were very stormy, and they always end with a dispute, especially between the young engineer and one of the shareholders.

The board meetings of *Computers* are quieter. The directors denied the occurrence of conflicts in their boardroom, and they always talk about discussions or debates always ending with large consensus. Nevertheless, they secretly confess that when the bank was the main shareholder, the board meetings were thundery and very nervous, but much more fruitful. For them, these fights generated ideas and made *Computers* a leader in IT.

The conflict does not always mean disagreement or dispute; it can be derived from a comparison of different mental and cognitive patterns. In the context of the firm, conflicts may be of two kinds: affective or cognitive conflicts. A good strategy for conflict management is to minimize the emotional conflicts and maintain a moderate level of cognitive conflict, since they stimulate debate and learning and achieve a higher level of effectiveness (individual level, group level and organization level).

In *Equipments*, more than one director talked about the conflict existing between the engineer and one of the shareholders. The directors said that this conflict goes beyond the simple disagreement in ideas and vision to

some frictions during the board meetings. The engineer declared that *“personally, after every board meeting, I feel very bad, and angry, very angry”*. He is critical of the shareholder always trying to dictate his opinions, saying that *“the boss is always right, and when the boss is not right, he is right”*. The engineer considers it necessary to consider the opinion of other members of the board, not only that of a pretentious shareholder. He thinks that shareholders should give more freedom, a kind of leeway so that board members and managers can act and then be assessed. The engineer reproach to the shareholders not having a commercial vision, since they are more focused on banking and finance. He said: *“I’m the one living in the company day to day, so I better know it”*.

We can state that, in the case of *Equipments* these affective reactions (engineer- shareholders) improve the willingness of providing the board with real dynamic. Since there is visible competition between these two board members, they both take much more time to explain and expose their ideas and make efforts to give propositions and solutions. According to the engineer, the shareholders are in the board to show off and to express their dissatisfaction. As he said, they think that *“whatever we do, they will never be satisfied, and our efforts are never sufficient”*. All three directors interviewed in *Equipments* think the same thing and they criticize the shareholders for their ignorance of the difficulties the board members face every day and the difficulties of the sector in the local and neighbouring market. In *Equipments*, we can observe two challenging groups; the managers versus the shareholders. Between these two groups, there is a kind of competition - a kind of race to improve the situation of the company. They have to come up with the neighbour market implementation and the maximization of the market share. This is a real challenge.

**Questions:**

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- Is conflict really destructive in board of directors?
- Did the conflict affect the power relationship or is it power in the board that moderate conflict?
- How can conflict improve decision making in board of directors?
- Did conflict in board of directors confirm the agency theory principles, or is it an opening to other theoretical perspectives?





## 2

### **Halka Resort Board and CEO, Fight to (Hotel) Death!**

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*Abstract:* The aim of this case is to emphasize the paradoxical nature of the central and powerful position of the founding manager, but not the majority shareholder, and his strong influence on the board decision making in the context of a small business operating in the tourism industry. The case shows that if the founding manager's objective is no longer aligned with the enterprise's one, the former can manipulate the board to follow his own will. Friendship and family relationships can be used for that. Besides, the case proposes some key options for directors to protect the firm stakes from shareholders' own interests.

*Keywords:* Boards decision-making process, centrality of founding manager, role of friendship and family relationships, objectives alignment, SMEs, resorts.

#### 1. Introduction

The aim of this case is to emphasize the paradoxical nature of the central and powerful position of the founding manager and his strong influence on the board decision making in the context of a small business operating in the tourism industry. Due to the legitimacy acquired during his past experiences, both in term of competencies and social network, the founder as both Chairman of the board and CEO of the company, has developed close relationships with a majority of the directors sitting on the board. The case shows that this closeness may help the development of a new venture because of shared vision and values (social regulation) but may become a source of danger in a crisis situation for the corporate stake. The dominant position of the founding manager and more particularly his or her legitimacy may become a barrier to critical judgment in the board and a

weak evaluation of the risks, leading potentially to failure and bankruptcy. The case challenges current thinking in corporate governance by pointing that even if the interest of shareholders may be assumed to be aligned with those of the corporation, at a given point of time these interests may diverge leading to a misuse of corporate resources and ineffectiveness in the risks taken by the owners.

## 2. Tunisian context

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Tunisia is a small and independent country situated in the North Africa coast. It covers 155,360 square kilometers and is bordered by Algeria on the west, Libya on the south and the Mediterranean Sea on the north and east. In 2009, Tunisia had a population of 10.4 million.

Tunisian tourism receives 0.75% of the tourist flows worldwide (6.9 millions of tourists) and 2.5% of those visiting Mediterranean destinations. It represents one of the pillars of the national economy. In 2008, it contributed to 6% to national GDP<sup>1</sup> and 12% of current revenues. It represents 14% of exports of goods and services and employed 482,400 people (95,398 directly, more than 12% of the workforce). Tourism earnings amount to 3 billion Tunisian dinars (TND) which cover 60% of the deficit of the trade balance.

Government's investment in infrastructure has resulted in a steady and continuous increase in the number of hotels and lodging capacity. Back in the 1960s, tourism's infrastructure boasted a lowly 91 hotels with capacity of 2,498 rooms, half of which were located in the capital Tunis. By the end of 2008 the number increased to 836 hotels with capacity of 238,495 beds.<sup>2</sup>

Seaside tourism infrastructure continues to dominate existing lodging capacity, and to attract most tourism investment. Hotels are concentrated in three major seaside tourist zones: Nabeul-Hammamet, Sousse-Kairouan and Jerba- Zarzis, which in 2006 accounted for almost 59% of the total number of hotel beds in Tunisia and 64% of total bed nights (Fitch Ratings, 2007<sup>3</sup>).

The range of lodgings for tourists is limited with most hotels being of the resort type. The majority (67%) of beds are in the three- and four-star category while the market share for five-star hotels is growing, representing currently 11% of total hotel beds. Tunisian hotels are, for the most part, SMEs owned and managed by their owners. During the last decade, International hotel chains increased their stake in the industry and they are currently managing almost 33% of the total number of beds (2006).

1 GDP = 43,522.2 millions in 2009 (current US\$), (World Bank).

2 Office National du Tourisme Tunisien. [http://www.aft.nat.tn/fr/tourisme\\_indicateurs\\_tunisie.php](http://www.aft.nat.tn/fr/tourisme_indicateurs_tunisie.php)

3 [www.tustex.com/.../tourisme/tourisme\\_analysefich20071212.pdf](http://www.tustex.com/.../tourisme/tourisme_analysefich20071212.pdf)

### 3. Background of the Resort

Built in 1992, HalKa resort has a covered area of about 12,000 sq. m in set in grounds of some 3.46 hectares. The situation of the resort on the border of Hammamet (north east of Tunisia) permits its optimal exploitation. On one hand, it belongs to the traditional region of Hammamet, which connects to the city, its history and its medina; on the other, it is adjacent to the new tourist area, rich with its marina, the casino and all the facilities of Hammamet-Yasmine.

Mr. JK worked in the National Bank of Tourism Development (NBTD) for more than 25 years and has extensive knowledge of the Tunisian tourism sector and all its leading actors. He built a large international network (official and personal), especially with the main national Banks and international Tour Operators (TO)<sup>4</sup>. As projects VP of the NBTD, he led the construction of two large resorts (in two main tourist areas) and was also chairman of 3 hotels' boards.

In 1990, he decided to quit the Bank and take advantage of his strengths: 1- a large network (bank and tourism), 2- a real competency and some savings allowing him to start his own enterprise. He also made use of some environment opportunities: 1- government supports for “young”<sup>5</sup> entrepreneurs and 2- specific tax benefits for the area of “Hammamet south”. Since his savings set a limit for him to have a long-term loan and to be the main owner, he called on some of his friends and family for financial support. In 1990, the equity structure of the resort was as follows:

Afrinvest (investment fund)	49%
JK and close family (wife and 3 children)	23%
BIAT (Commercial Bank)	12%
AA (brother in law, doctor)	7%
AB (close friend, Tunisian TO)	9%
	100%

### 4. The Board Composition and Operation

The composition of the board follows HalKa's equity structure. The investment fund (Afrinvest) elects a director, as does the bank BIAT. Those two directors are still JK's friends because of the former relationship they

<sup>4</sup> “Tour operators are businesses that combine two or more travel services (e.g., transport, accommodation, meals, entertainment, sightseeing) and sell them through travel agencies or directly to final consumers as a single product (called a package tour) for a global price”. <http://stats.oecd.org/glossary/detail.asp?ID=2733>. The biggest Tour Operators (TO) active in Tunisia are Neckerman, and TUI. Those TO have consolidated in Europe and now lead a large portion of the incoming tourists to Tunisia.

<sup>5</sup> Not related to age but to the first enterprise.

had in several professional positions. The representative of Afrinvest is a 30-year friend (HK) and he actively persuaded Afrinvest to invest in HalKa. The tacit deal was for HalKa to achieve “the highest occupancy rate with the optimum price to reach 10% of Return On Equity per year”, and as HK said, “even though I believe that this is not possible on the long run, but I know JK’s management competencies and trust them”.

At the first board’s meeting, all directors agreed to nominate JK as chairman of the board and CEO of the resort. AA and AB were showing real excitement in taking part in the board deliberations.

Thus, “friends” were invited once a year to the boardroom ran by Mr JK. Although their field and competence differed (banker, doctor, tourism agent, investor), the directors had real similarities: age (50-55 years old), region (Sfax<sup>6</sup>), gender and education (university level). They were interested in sharing information regarding the resort’s activities but also in sharing moments and anecdotes (as old friends do). Once a year, the chairman and CEO Mr. JK prepared a note with some of the important events/fights of the year (mostly contracts with TO and struggles with government agencies to finish the habilitation of the bordering filthy river). Occasionally, directors provided some advice, taking advantage of their position outside the resort (banker, TO). But, since the implicit shared and unique goal was clear (making money with a brand new 3 stars resort), they rapidly scanned the financial statements, especially the bottom line. If everything seemed to achieve the “private” goal of each one of them, the meeting lasted less than one hour. The BIAT’s representative was the only one requesting details for some balance sheet lines or figures depicting the resort real life (number of claims, nature of the cancellations or reasons of hiring/firing people).

Quickly, the discussions turned to general trends of the markets and of the sector. They forgot about the resort and started talking politics sharing some “private” anecdotes on the “palace<sup>7</sup> or on politicians and public servants involved in corruption affaires. The meeting finished each time with a generous lunch and a comfortable room to rest and enjoy the resort’s facilities.

6 Most entrepreneurs come from this region. People in Tunisia still believe in regional values and traditions. The trust capital is enlarged if people come from the same region, especially Sfax and Jerba.

7 The “palace” is the presidential residence. 1990-1997 Ben Ali’s dictatorship is reinforced and people couldn’t participate to public debates. They just have the opportunity to share some private information since press and political opponents are under close control. The corruption is increasing and fighting it becomes a real danger.

### 5. The Resort: Presentation and figures (1992-1996)

HalKa resort is three-stars with 205 rooms (or 410 beds/149,240 nights) fully air-conditioned. In addition to traditional hotel facilities, the unit has several others: a multipurpose room that can host discos and large seminars for around 300 people, 3 committee rooms (40, 50 and 70), a beauty salon with sauna and steam room, a hairdressing salon, an indoor heated swimming pool with Jacuzzi and a swimming beach for children with water games, rapid river, etc., catering facilities by a private pool (for winter), a mini-forest for Tunisian parties, a Kid club with outdoor play and a Moorish café tent. In addition, the resort boasts dedicated facilities for a range of sports, including tennis, volleyball, football, basketball, handball, petanque, darts, rifle shooting and mini golf. In 1992, those facilities were quite rare for the area.

The resort was run by JK, although he hired a general manager to help him. He centralized all the decisions (managerial and strategic ones) and was close to all the 100 worker. JK also has offered to chair the regional federation<sup>8</sup> of the hotel industry. Thus, this position allowed him to enlarge his professional and personal networks. After 6 years, the resort had one of the highest occupancy rates (OR)<sup>9</sup> of the country despite its location back from the waterfront.<sup>10</sup> In addition, the GOP was at an average level of 34% of the total sales. Three key factors made this possible:

1. JK's network and profile. In Tunisia, business can be intensely enhanced by this cultural capacity of friendship in professional networking;
2. A new and modern resort. Built quickly with a lot of innovative advantages (even though easily imitable);
3. Some taxes and credit advantages over the first 5 years.

Table 1 shows the occupancy rates (OR) and the revenues from 1992 to 1996.

**Table 1. RESORT FIGURES**

	<b>1992<sup>1</sup></b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
<b>Nights spent</b>	64.733	108.729	105.336	93.671	97.751
<b>OR<sup>2</sup></b>	43,25%	72,65%	70,38%	62,59%	65,14%
<b>Revenues<sup>3</sup></b>	1 566	2 421	2 517	2 293	2 149

<sup>1</sup> Only 6 months, because the resorts started working in June 1992.

<sup>2</sup> The Tunisian average OR in 1990 was 54%, in 1995; 52.4% and in 2000, it was 55.8%.

<sup>3</sup> In Million dinars (1dinar = 0,728 US dollars, April 20, 2011).

<sup>8</sup> This institution brings together the actions of hoteliers and acts as a lobby to protect their shared interests.

<sup>9</sup> Number of sold nights/total number of bedsx364.

<sup>10</sup> It is a real handicap not to be in the waterfront for a hotel in this region.

## 6. The Crisis

In 1995, JK met the President of AFEST (French Association of Scientific Experts of Tourism). Quickly, they became friends and organized the annual congress of the association in the Hotel in 1996. Talking with the President about some strategic orientations of the hotel, JK expressed his will to buy some of Afrinvest shares as to become the majority shareholder. JK said: “even though I feel very independent and don’t have any problem with my directors, I need to express my majority and do what I want to do with the hotel without any kind of pressure”. He continues: “the problem is that I put all my savings in the shares and I don’t have any other income except the one I can have from the resort as salary and bonuses on profitability. So there is only one solution for me to realize my will: an exponential increase in profitability”.

The President advised JK to adopt the timeshare<sup>11</sup> resale and rental solution. Taking advantage of the lack of restrictive Tunisian legislation, this solution could transform a part of the hotel in a real chance to accumulate very quickly a huge amount of cash. In fact, without legislation, the timeshare gives the opportunity to sell all the apartments even before they are built. The resort could thus take advantage of this lag (6 months to one year) of treasury to invest and enhance its profitability. This solution implies the alignment of both objectives, those of the hotel (to maximize returns), and of JK (to become majority shareholder). Even though highly risky (because of this lack of legislation), the solution was very attractive.

JK didn’t encounter any problem in convincing the board of this “huge opportunity” for the hotel. He had several reasons:

- Timeshare is a new concept and offers a good deal for both Tunisians and foreign buyers;
- HalKa would be the first place in the area developing such a product;
- JK has already a good selling network;
- The cash flows would allow the hotel to extend the number of “traditional” rooms, so that by increasing the capacity (from 400 beds to 500 beds), it should increase easily (low marginal costs) and enhance the general profitability (ROI);

<sup>11</sup> A timeshare is a type of vacation property ownership in which the owner possesses a legal agreement with a resort that entitles him or her to vacation at the resort for a specific interval of time (commonly one week per year for a set number of years). A timeshare resale is simply a timeshare, which is being sold by the current owner well below retail resort pricing. <http://www.sellmytimesharenow.com/timeshares/index/content/buyerfaq/>

- The total investment doesn't threaten the solvency of the company and one of his bankers is willing to finance the project.
- All hotels built after 1995 include most or all of the facilities the hotel had as advantage, so the resort is not any different from its competitors.

JK believed that, in less than one year, he would be the majority shareholder of a very profitable hotel. He could organize his succession and put his daughter (PhD in management) in charge of the company.

But, as JK was to discover, reality has this tendency to sabotage dreams.

JK underestimated some environment facts. Several professionals (national and international) started to sell timeshare resorts in Tunisia. As the Tunisian legislation was loose, they oversold resorts and did not follow up customers who were often left with their bad purchases (resorts never built up, cheating on locations, low standard rooms, etc.). When the high-pressure sales tactics were taken into account, Timeshare quickly acquired a bad reputation in Tunisia.

JK spent a lot of time building up the project, neglecting the resort's daily management and ignoring the publicity around the timeshare scandals. Just when everything was clearly set and the company was ready to start the selling process in July 1997, the Tunisian parliament enacted legislation specifying the rights and duties of both contracting parties. Now, timeshare is one of the most heavily regulated forms of real estate in Tunisia.

With the new legislation, HalKa resort was compelled to abandon the timeshare project and the apartments never came out. Then at the end of 1997, Afrinvest partners fell out and decided to dissolve the fund. They distributed the shares in the fund and a new businessman (EAA) inherited the 49% of Afrinvest in HalKa's capital and became full member of the HalKa's board. The opposite of HK, he is not a friend of JK.

## 7. Board Decision: Fighting Process

This new board composition changed the whole tone of the meetings. The new businessman (EAA) wanted to debate all decision-making in management and strategy. Conflicts and voting/interest blocs began to emerge. JK lost his trusted position mainly because of his advocating of the timeshare proposal that was a complete failure. Besides, he was feeling the disillusionment and doubts of his brother in law AA and friends (AB and HK).

In this hostile context and because the board was in crisis, EAA proposed two possible scenarios to JK:

1. He could buy 2% of the shares (from any other shareholder, especially from the BIAT who wanted to sell) to become the majority shareholder and take the control of the enterprise (as CEO);
2. He could sell all his shares (formerly Afrinvest's ones), 49% of the total capital, at the implicit promised price (ROE of 10% by year).

This price was not negotiable.

Those alternatives left JK with a hard decision: remaining part of this board, but losing control (he would be just a shareholder), or buying all EAA's shares, becoming the majority shareholder and keeping the board's control.

The first option would make him face his own failures: managing, decision-making, losing the "oeuvre" of his life (his "4th child", as he used to call the resort). For him, this situation would destroy his self-confidence, his status (both family and professional) and the entire network he built up over more than 30 years. Moreover, this option would also deprive his children of the capital (enterprise) he (and his wife) had created over time. But still, this option remained the safe one regarding his financial position.

The second option was more psychologically (and emotionally) convenient for JK. He could prove his financial and human leadership to his family and friends. He had to rebuild the lost confidence and trust. Even though he didn't have the money to buy 49% of the capital, he could certainly show that his network was solid and he could borrow all the money he needed (perhaps with extreme conditions of reimbursement). He knew that objectively this would put him in a highly financial risky situation, implying probably a self-bankruptcy. He could lose everything and put his own family in a very bad situation.

The board was pressing for the first option. His friend (AB) and brother in law (AA), as well as his best friend (HK) assured JK that they would support directly (for AB and AA) and indirectly (for HK) his position as chairman. They also promised to work together as a bloc (convincing the BIAT bank also) to protect its interests against EAA. They were quite sure that this latter, not really competent in managing hotels, would abandon the idea of being CEO, and would start to sell progressively his shares. Of course, nothing was guaranteed.

The negotiations took more than a month. The board was sure that, under the second option and under financial pressure, JK would concentrate on his own objectives (maximizing return in a minimum time), neglecting the objectives of the resort. That would mean no quality, no maintenance investments, a pressure on all costs, no training for the workers, etc. But, in

this case, the board members knew that they would not be able to stop him as he would be a majority shareholder (with 72% of the capital).

JK chose the second option. He activated his bank network and could negotiate 3 different loans with 3 different banks. He mortgaged the family home and persuaded his friend HK to vouch for a share swap. At the mid of 1998, he was the majority shareholder with 72% of the capital of HalKa's resort, but he was completely over-indebted.

That was the end of the board's implication and the beginning of the end for the resort also. After 10 years of fighting with all the stakeholders (especially the bankers, the suppliers and the TOs), the hotel was a ruin and was sold for peanuts.

JK lost everything, the resort, capital, the family home, his friends and a big part of his self-confidence.

## Questions

1. To what extent relational links, that certainly played a key role in the growth and development of the hotel, have become a strong limitation on the board evaluation of risks and strategic options?
2. Referring to the theory of psychological ownership (Pierce et al. 2001), what are the key-corporate governance practices that may be set up to avoid the company collapse?
3. Building on the agency theory as reframed by Lan and Heracleous (2010), what are the key options for directors to protect the firm stakes from shareholders own interests?

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## 3

## Complicated Ownership and Voting Structure in an International Partnership: Case of Turkcell

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*Abstract:* This case analyzes a leading communications and technology firm, Turkcell, in Turkey. Recently this company has encountered serious corporate governance problems because of its complicated shareholding and voting structure as well as continuing disputes between three main international partners. This case will discuss the impact of the board of directors' composition on the control of the company, and the importance of independent board members in establishing effective and impartial governance practices.

*Keywords:* board of directors, independent board members, international partnerships.

### Mobile telecommunication sector in Turkey and key actors

The main private-sector involvement in telecom services in Turkey has been in mobile telephony. Turkey's mobile market has grown tremendously in the last two decades. Mobile-phone penetration overtook fixed-line penetration in 2001. There are currently three mobile-phone service providers. Türk Telekom launched an analogue NMT network in 1986. In 1993, two digital GSM 900 operators Turkcell and Telsim (now Vodafone), launched services in a revenue sharing agreement with Türk Telekom. This was converted into a 25-year license in 1998 with each company paying US\$ 500 million for the license. In addition, and under the terms of the license, they pay the Turkish Treasury a monthly ongoing fee equal to 15% of gross revenue. Turkcell, the market leader, is co-owned by Çukurova Group, the third largest industrial conglomerate in Turkey, Telia Sonera, Alfa Group and MV Holding. Telsim, the second-ranked operator, was owned by the Uzan family, one of Turkey's wealthiest (Minges, 2002). However, it was seized by the Turkish Government regulator (the Savings Deposit and

Insurance Fund (SDIF)) in the wake of the 2001 financial crisis in order to cover the debts of the failed Imarbank, which also belonged to the Uzan Group. In July 2004, the Turkish Government enacted a law allowing the SDIF to sell a majority stake in companies owned by the SDIF, including Telsim, to foreign companies. SDIF sold Telsim to British Vodafone in December 2005 for \$4.55 billion.

Turkcell and Telsim were joined in 2001 by İş-TIM (brand name Aria), owned by Telecom Italia Mobile (TIM) and a large Turkish bank, İş Bank and Aycell, Türk Telekom's mobile-telecoms service. Aria merged with Aycell in February 2004 when Aycell ran into financial difficulty. Following the merger, they introduced a totally new brand "Avea" on June 2004. Turkcell, which acquired a 25-year operating license in April 1998, holds pole position in Turkey's mobile telecoms market.

The state-controlled Türk Telekom (TT) owns the national fixed-line infrastructure and has about 18.5 million subscribers. TT also has a 40% stake in Avea. It also offers a range of Internet and data services, and owns infrastructure for cable TV services. Attempts to privatize TT in 1998, 2000 and 2001 were thwarted by legal challenges, and a lack of investor interest, partly because of the poor performance of telecoms stocks globally but also because of the inadequate management rights initially offered to investors. In November 2004, the Turkish Privatization Agency announced that 55% of Türk Telekom would be privatized through a "block sale". Türk Telekom's privatization process was completed on November 2005 and 55% shares of Türk Telekom were sold to Oger Telecoms Joint Venture Group for \$6.55 billion.

### Issues with ownership structure and management in Turkcell

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Turkcell is the leading communications and technology company in Turkey with a market share of 54% as of 2010 and a leading regional player, with market leadership in five of the nine countries in which it operates. Turkcell, that enjoys the status of being also the third largest GSM operator in Europe, has been listed on NYSE and ISE (Istanbul Stock Exchange) since 2000. The ownership structure of Turkcell is presented in Table 1 (below).

Turkcell's founding shareholders are Sonera Holding, formerly known as Telecom Finland Ltd. and currently owned by TeliaSonera, Çukurova Group and MV Holding. Çukurova Group controls the company despite holding only 13.81% of the share capital due to a complicated shareholding and voting structure. Çukurova Group agreed to sell its Turkcell Holding stake to TeliaSonera way back in 2005 but then withdrew from the agreement, selling a 13.22% stake to Alfa Group instead. TeliaSonera took legal action

against Çukurova Group and in August 2009 an arbitration panel ordered Çukurova Group to sell the shares to TeliaSonera. Çukurova Group is still fighting this order. The Altimo Group, owner of Alfa Telecom is also suing the Çukurova Group for Çukurova's remaining 13.81 % stake, claiming that it was collateral for loan on which the Çukurova Group has defaulted.

**Table 1. RESOR TURKCELL OWNERSHIP STRUCTURE**

Shareholders	Percentage of Direct Share Capital	Indirect ownership Percentage	Total consolidated ownership percentage of each partner
Sonera Holding B.V.	13.07		39.09
Çukurova Holding A.Ş.	0.05		13.81
M.V. Holding A. Ş. <sup>11</sup>	1.18		1.18
Bilka A. Ş.	0.01		0.001
Turkcell Holding A. Ş.	51.00		-
Alfa Telecom Turkey		13.22	13.22
Sonera Holding B.V.		24.02	-
Çukurova Group Co.s		13.76	-
Public Float	34.69		34.69

Source: Public Disclosure Platform ([www.kap.gov.tr](http://www.kap.gov.tr)), [www.turkcell.com.tr](http://www.turkcell.com.tr)

According to the Articles of Association of Turkcell, the board is comprised of 7 members elected by General Assembly and ordinary action of the Board shall be taken by affirmative votes of 5 directors upon the presence of more than 5 directors in the meetings. The composition of the board of directors of Turkcell is shown in Table 2. The role of independent members on the Board is crucial because of the presence of representatives of the partners. It should also be noted that the biggest partner of the company (TeliaSonera) with its stake of 37% couldn't control the Board even with the support of Alfa Telecom, Altimo Group.<sup>12</sup> These two partners voting together still could not achieve the majority required to carry or change important decisions at Board level. TeliaSonera had called several times for an increase in the number of board members to 9 and number of independent members to 3 in accordance with the recommendations of

11 Turkcell Holding controls 51% of Turkcell. Turkcell Holding is jointly owned by Sonera (47%) and Çukurova Telecom Holding (%53). On the other hand, Çukurova Group holds 51% of the stakes in Çukurova Telecom Holding whereas Altimo have a 49 percent of the shares of this Holding. We can say that Mr. Karamehmet, owner of Çukurova companies controls indirectly Turkcell via Turkcell Holding and Çukurova Telecom Holding.

12 It was declared that TeliaSonera and Altimo have agreed to combine their ownership interests by contributing their respective direct and indirect interests in Turkcell and MegaFon, into a new company. TeliaSonera and Altimo have also agreed to collaborate and align their efforts to resolve all ongoing legal disputes between each of them and Çukurova Group to make the establishment of the new company possible. Such collaboration is expected to result in a speedy resolution of the disputes.

Turkish Capital Market Board. It is expected that with these changes, the possibility of Çukurova Group controlling the company will be removed. TeliaSonera had put forward a formal request to the Board of Directors of Turkcell to add the possibility for Turkcell's shareholders to address the board composition at the upcoming annual shareholders' general assembly meeting in April 2011. This action had however been rejected by a board vote supported by Çukurova Group and the Chairman at the Board of Directors' meeting of March 23, 2011 and shareholders were invited to an ordinary Annual General Assembly Meeting with an agenda which does not include any item on changes in the composition of the board. Based on this board decision, TeliaSonera announced in March 24, 2011 that it will sue the Chairman of Turkcell, Colin J. Williams,<sup>13</sup> for failing to act independently or impartially.

Table 2. **COMPOSITION OF BOARD OF DIRECTORS OF TURKCELL**

	Position	Status
Colin J. Williams	Chairman	Independent member
Mehmet B. Ergin	Member	Çukurova Group representative
G. Nazlı Karamehmet Williams	Member	Çukurova Group representative
Oleg Malis	Member	Alfa Telecom, Altimo Group representative
Alexey Khudyakov	Member	Alfa Telecom, Altimo Group representative
Tero Erkki Kivisaari	Member	Sonera, TeliaSonera representative
Karin Eliasson	Member	Sonera, TeliaSonera representative

Source: Public Disclosure Platform ([www.kap.gov.tr](http://www.kap.gov.tr))

During the 2010 ordinary Annual General Assembly on April 21 2011, TeliaSonera proposed the addition of a new clause to the agenda pertaining to the removal of the Chairman, and the election of a new candidate. This was rejected by Government Commissioners under the provisions of Turkish Commercial Law Article 369 (items not appearing on a previously announced General Assembly agenda cannot be discussed). Consequently, the representative of Turkcell Holding, which holds a 51% stake in the Company, decided to abstain from voting on all agenda items. Turkcell Holding's representative noted that this rejection would violate the minority shareholder's rights, and therefore also abstained from voting on all agenda items. Sonera Holding which holds 13.07% direct shares in Turkcell and a 47.09% stake in Turkcell Holding voted against approval of the Balance

<sup>13</sup> He served as independent board member in Turkcell Board since 2004 and was appointed as the Chairman of the Board of Directors, as a successor of Mr. Karamehmet, owner of Çukurova Group and founding Chairman of Turkcell.

Sheet and Profit/Loss Statements for the 2010 fiscal year, against the release of the statutory auditors, and against their replacement, and against the Board of Directors' dividend distribution proposal. Because Turkish law requires each of the items on the agenda be approved by a simple majority of the shareholders, none of the items on the agenda, excluding the establishment of the presidency board and authorizing the presidency board for the signature of minutes of meeting, were approved.

After this debacle, and to prevent its investors making losses, the company decided to suspend temporarily trading of its shares on the Istanbul Stock Exchange (ISE). Turkcell was downgraded by Goldman Sachs Group due to its "slim chance for a sustainable turnaround" and the disputes among its shareholders.

The Board of Directors convened on April 27, 2011 to discuss the agenda items that were not approved at the Annual General Assembly of April 21, 2011. Three proposals were put to this meeting and all rejected, the proposals being for an Extraordinary General Assembly with one agenda item regarding the election of statutory auditors, for an Extraordinary General Assembly with the same agenda as on April 21, 2011 Annual General Assembly, and for an Extraordinary General Assembly to convene with the same agenda as the April 21, 2011 Annual General Assembly and add an agenda item regarding the removal of one or more members of the Board of Directors and the election of new ones put by TeliaSonera.

In an attempt to solve these outstanding disputes, Turkcell's statutory auditors invited the shareholders to an Extraordinary General Assembly to fulfill their statutory obligations under the Turkish Commercial Code, as no Board of Directors' decision can be taken on this matter. As per the statutory auditors' decision dated June 22, 2011, Turkcell's Extraordinary Annual General Assembly was held on August 11, 2011. This General Assembly was convened with the same agenda for the ordinary Assembly described above and with the same results: the Balance Sheet and Profit/Loss Statements for 2010 and the proposed 75% dividend distribution from 2010 profits were not approved. The entire Board of Directors and the statutory auditors were not released in respect of the Company's activities and operations for 2010, and the statutory auditors whose term had expired were not replaced.

Since then, two board members representing the Çukurova Group have filed lawsuits requesting the cancellation of the decision taken at the Extraordinary General Assembly not to release them from their activities and operations during the 2010 fiscal year. TeliaSonera claimed

that it has made several formal requests to the Board of Turkcell that the question of the board composition be addressed at the Shareholders' General Assemblies. Turkcell's chairman, Mr. Colin J. Williams (acting in concert with the Çukurova Group), has repeatedly blocked these requests at the Board, as well as at the annual general shareholders' assembly. Consequently, Teliasonera argues, Mr. Williams has clearly proven that he is not independent and impartial (in violation of the law), to protect his own and Çukurova's positions at the expense of a majority of the shareholders.<sup>14</sup>

Following the election of new statutory auditors at the August 11, 2011 General Annual Assembly meeting, a new general assembly meeting is scheduled for October 12, 2011 (a step taken by Turkcell's statutory auditors with the request of the Sonera Group). It is claimed that the assembly will resolve issues related to the corporate governance of the company as well as dealing with items from the 2010 fiscal year, including the payment of dividends. There will be additional items on the agenda, including "removing one or more than one of the members of the Board of Directors and election of new members in lieu of those removed; and determination of their remuneration". It should also be noted that the Çukurova Group has filed a lawsuit requesting the cancellation of Turkcell's statutory auditors' decision to hold Turkcell's Extraordinary General Assembly on October 12, 2011, as well as the announcement of the Extraordinary General Assembly and its agenda.

<sup>14</sup> Sonera and Altimo proposing jointly Sir Julian Horn Smith, former CEO of Vodafone as independent member.

## Questions:

- 1 How could the current deadlock at the Turkcell's Board of Directors be resolved?
- 2 Discuss the importance of the composition of board of directors, especially the role of independent members in international partnerships from the perspective of minority shareholders and small investors.
- 3 What are the governance difficulties and challenges faced by international companies involved in international partnerships operating in in developing countries?

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## 4

## **Opera Performance Company: Passion and Emotion as the Driver for Decision-making and Management Processes in a Not-For-Profit Performing Arts Company**

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*Abstract:* The arts sector is typified by passionate individuals who donate their time, skills and funds to the production of arts experiences for the broader community. An often unknowing audience has the opportunity to appreciate the talents of performers or static artists.. Larger arts organisations that are commercially successful have a history of significant funding from Government or generous benefaction that allowed them to build the foundations of a profit making enterprise. Most of the arts sector retains its visibility through the activities of small, not-for-profit organisations. Often these organisations that create the opportunities are under resourced and poorly structure. Opportunities that arise to move from NFP or volunteer status into profit making and commercially viable structures are missed as a result. The discussion that follows puts a small, opera company (OC) as the subject of study. The OC structure and management processes typify the NFP arts sector – a limited number of passionate individuals with informal or non-existent agreements around role, responsibility and function, yet with an organisational longevity that could not be sustained in the commercial sector. The attributes of NFP organisations in the arts sector are described and comparisons made with commercial organisations. Underlying the discussion is the theme that the introduction of commercial practices would prove advantageous in the NFP environment.

Defining characteristics of small, not-for-profit organisations globally include a passion for a narrow field of product or service delivery, under-skilled management layers and decision making techniques that are more emotionally bound than outcomes driven. Perhaps statements that are difficult to swallow but many examples of this contextual environment exist – from the health and alternative health sector to the political and environmental lobbying sector to the arts sector.

The organisation under study is a small opera performance company, based in a regional urban area. The demographics of the audience catchment include many rural businesses, which use the urban centre as a service hub, and a large population of tertiary students (25% of the urban centre population). With this audience there are two key factors that influence the ability of the opera company to remain viable as a not-for profit. The first is patrons' access to discretionary spending for ticket purchase and secondly a low awareness of the performing arts as a necessity for the cultural health of an urban centre.

Thus, the context for this business case is set – a small opera company, a management team of three and volunteers numbering between three and seven assisting with opera production, plus contracted 'employees' who use individual talents to perform on a specific date and then 'bank' the experience, along with the pay cheque, to be used in other subcontracted roles for other performance companies.

The challenges the opera company (OC) faces, in order to continually delight their customers (the audience) include:

- a. working with the diverse personalities and passionate amateurs for an outcome that is satisfying for the individuals at management level, performance level, technical support and customer to ensure that there is a 'best fit' model of management decision making
- b. the challenges that are inherent in an NPO with no defined leader, a very collaborative working style, but very singular drivers from the individual contributors and deadlines that are fixed i.e. performance dates
- c. the problem solving techniques, the conflict resolution pathways, the challenges when audience feedback, which in other industry sectors equates to the measures of outcomes is immediate, real time and very personal
- d. building longevity at management level in the NPO and with key partnerships in a project based, contracted, informal working environment

Let's view the organisational strategy as a starting point. Typically business success conforms to the start up pathway – undertake market research to prove or disprove the appetite for a potential product or service, use the research to define strategic goals and the tactics to reach or exceed the goals, organize a business structure to deliver the operations required to meet strategy, measure outcomes and adjust tactics and eventually extend the strategic goals to a more lofty target.

The not-for-profit sector, and the OC is no exception, often ignores the regular pathway due to the emotional investment in the desired outcomes. This emotional investment involves a key individual with a clear vision, and sufficient passion for that vision that entices or induces others to take the journey, will set strategy, assign structure based on collegial behaviour or familiarity and then expect the results to flow.

In the voluntary political sector, an election or closing dates for submissions to a proposed change in policy pose these same time-bound challenges, thus the characteristics across sectors can be considered comparable. How then does an organisation with a relatively informal structure, which is not deliberately designed to be so, make decisions that are likely to have a positive or constructive outcome?

The OC has no database of friends or followers, as such market research would involve significant cost. The perceived need for the product (the performance of an opera) is therefore measured on the willingness of the principal decision makers to take 100% of the risk of success or failure. The illustration of the decision making process follows, but requires some introduction of the three key decision makers.

Caroline (C) is a business woman, with a strong background in the highly competitive market sectors of construction and agri-business. She has a love of the arts and a drive for producing an exciting experience for the OC audience, but is firmly wedded to proven management practices.

Liam (L) is an internationally successful opera performer turned director and has deep and wide knowledge of opera from a performance viewpoint. He has a deeply embedded belief that a community and emerging operatic talent will suffer if not continuously supplied with artistic experiences.

Mario (M) is a brilliant musician with strength in teaching, rehearsal and performance from the perspective of a pianist, and répétiteur and chorus coach. His drivers are for excellence of performance and adherence to a perceived 'proper' opera performance, which closely aligns with the original performance at the time of first production.

As the opera performance is an annual event the planning needs to begin sufficiently early to ensure the critical success factors are addressed – music, costumes, rehearsal schedule, venue preparation, props, ticketing and marketing.

The first decision is the most difficult to make for this group – which opera to perform? Inputs to the decision are usually threefold – what else is being performed by the larger opera company based in a nearby city, what is the appetite of the regional audience, how many performers need to be contracted for the performance?

In a business setting the NPD process would help determine what a new product should be and the risks and benefits associated with that product development. Data, proof of concept, pilot tests and consumer feedback would help determine the price, the place and the packaging of the new offering.

In the OC the decision making involves C, L and M. The decision pathway is typically this: L suggests an opera, M agrees and then offers alternatives, C introduces the concept of audience appetite for common repertoire, L senses conflict and sits back, M diverts to other context-rich discussion of music. Some weeks later the decision making process re-ignites, driven by the requirement to inform venue organisers of the product that they can start to promote. C repeats that a decision must be made, M suggests obscure options, L suggests options that put him back in the performer role. Days go by – C insists that a decision be made and sets a time limit and reminds L and M that to remain financially viable there needs to be a selection that audiences will want to pay to see. L and M confer, a decision is made and most often the selection is one of the first tranche of suggestions, often the very first suggestion.

Then follow a range of subsidiary decisions – costumes, props, imagery for marketing, ticket pricing. These decisions are sometimes made in isolation by C who has become frustrated at the process and perceived difficulty of reaching consensus and therefore don't meet the needs of L and M. C's business background means that timely decision making keeps her in her comfort zone and she has residual discomfort that the delay in reaching the primary decision took time away from opportunities to carry out the downstream planning for the performance.

Added to this is the matter of volunteerism, common in NFP organisations – C gives her time and skill set to the OC for free and there is no profit share arrangement in place. L often performs in the opera productions as well as taking on the directorial responsibilities and is not sufficiently remunerated i.e. at market rates, for the work undertaken. M is employed fulltime elsewhere in the music industry and uses the OC contracted income to support his love of music. It allows him to make purchases that otherwise would be beyond his income level.

Thus decisions with downstream contractual obligations are made in an environment where individual drivers are not explicitly recognised nor factored into the process. Consideration of strategy is not a driver for these decisions, in fact strategy is an ad hoc arrangement more correctly labelled as a tactical response to fixed term project delivery.

The *ad hoc* nature of OC extends into the management structure. C and L are the financial underwriters of each project and the directors of the OC business entity. Thus they have legal and commercial liabilities that are specific to them. M is not a director of OC and therefore avoids these liabilities; his professional reputation is his 'at risk' contribution which is also one of the core skills utilised by OC. Defining leadership, where collaboration is a critical success factor in the delivery of the 'product', is another challenge although not unique to OC.

Stepping back into the broader context of NFP organisations we should reflect on the opening statement about passion and emotion. Examples abound where the passionate individual takes on the role of spokesperson, leader, decision maker, advocate, funder and sometimes martyr. This behaviour is most marked in NFP organisations that are involved in political lobbying – to wit environmental campaigners staging Parliamentary sit-ins, chaining themselves to trees, water cannoning whaling ships.

Other NFP organisations have the same characteristics, but such characteristics are not as visible to the public, perhaps due to the unwillingness of media groups to publicise issues involving lower levels of political conflict. Behind the board room doors the equally passionate and highly competitive behaviours exist – driven in part by the gap between NFP goals and ambitions and the limited pool of philanthropic or personal funds available.

Finding the recognised leader for OC has not yet been successful, despite 8 years of operation. It is difficult to imagine a profit-making organisation surviving that length of time without the structure and leadership to drive the vision. OC doesn't measure outcomes other than the financial bottom line and the willingness of festival organisers to continue the annual contracted arrangement for performance. It could be argued that in a highly collaborative setting, with no defined strategy there is little need for leadership.

However by creating the tools for measuring success in a values based manner, that is the net 'good' provided to the regional community or audience, leadership could add to the bottom line of OC. More streamlined decision making and action-based planning could lead to more frequent performances thereby increasing 'good' from arts delivery.

Leadership could provide the drive to create a financially sustainable business model and set longer term strategy for business growth, market growth or creation of new products. Recognition of competition in the market and the creation of viable tactics to counter this competition is also

a leadership responsibility – whether in the profit making or NFP sector. With clear leadership OC would become market leaders in the region and continue to work collaboratively with other arts organisations – a model that generates greater benefit from the funds provided by supporting sources, public and private.

Stakeholder analysis is done by OC on an ad hoc basis, leaving the organisation vulnerable, as without a formal or regular informal process to manage the competitive landscape the continued operation of OC is at risk from an unrecognised threat. Likewise opportunities are not actively sought but rather projects are undertaken as a response to annual or intermittent requests for provision of the OC product.

Competitive forces in the NFP sector parallel those in the profit making sector, and both are quite discrete from the government sector. NFP and profit making sectors have the challenge of positioning their products or services within a model, such as one of Porter's Generic Strategies, and to have the discipline to remain aligned to the selected strategic model. For OC the selection of a strategic direction has not been consciously undertaken and this failure leads to conflict amongst the decision makers.

In order to constructively resolve conflict, in the collaborative working environment OC needs to adopt a standard practice which is agreed by the decision makers. One suggested approach is the Interest-Based Relational approach. Accepting that the passion and personal interest in the success of the OC product as a given there needs to be a framework in place to resolve the differences between C, L and M's interests in OC. The IBR approach suggests five steps to problem solving:

- **Ensure good relationships as a first priority:** remaining respectful of other participants and their individual skills retains an environment where the need for emotional protection is minimised – people are more likely to share and create best fit solutions
- **Separate people from problems:** issues are debated at a rational level
- **Pay attention to the differing viewpoints:** understanding of the potentially conflicting stances is improved, listen first, talk second
- **Set out the facts:** agree and establish objective, observable elements that will have an impact on the decision, recognise that perception plays a strong part in 'fact' definition
- **Explore options together:** a third position may exist, remove the binary decision making i.e. yes or no that dissuades participants from creative problem solving.

OC using this technique might improve the decision making process for opera selection, remembering that the passion element would make the use of bullet points two, three and four more challenging. But could this technique be applied in the live performance arena, where feedback is immediate, real time and very personal?

A live performer places their personal integrity at risk each time he or she steps on stage. This applies to business executives or subject matter experts as they step out to present ideas or challenges to forum participants – each message must be presented in a credible, defensible manner. When an executive ‘bombs’ he or she can readily underpin their message with follow-on communication, or even step into the territory of policy or compliance to retrieve their performance.

For a musician there is no second chance, particularly where there is a paying audience. The industry maxim states ‘you are only as good as your last performance’: conflict resolution techniques cannot capture the time and attention of individual audience members as persuading them to ‘come to the table’ would necessitate the purchase of another ticket. There is also the role of the art critic – conflict with the critic’s perceived and personal KPIs (key performance indicators) for opera performance leads to poor reviews, potentially influencing the willingness of future audiences to pay for the product.

OC principals need to offset the potential impact on contracted performers through anticipation of positive and negative outcomes at individual level. Having contracted performers for the project, the need to understand the drivers and communication styles of the individuals helps shape arms length feedback that is nevertheless very personally directed.

For C and L this need to anticipate and provide pastoral care extends to managing M. Looking at the Myers Briggs Personality Types both L and M are INFP, despite being performers, whereas C is ENTJ. Conversations that predict positive or negative reaction to the product, and decisions on which tactics to use with contracted individuals when preparing them for live performance, are most successful when focussed on the intuitive understanding of how the audience response will affect those individuals. The sustainability of the OC product (three performances of a single opera on consecutive evenings) is 100% at risk should a contracted performer renege on their commitment to OC.

During rehearsals and performances the roles of C, L and M transform from decision makers into performers and human resource advisors, sometimes mixed with such operational technical roles as sound and

lighting. Typically C will take on the role of HR advisor, becoming the sounding board and complaints manager for contracted performers and the gatekeeper to L and M in relation to other issues. L becomes the performer/director (a role that equates to that of an Operations Manager in a more streamlined business with specific, tangible deliverables). M becomes the performer and coach, equating to a subject matter expert with a quality focus such as in a manufacturing environment. This duality creates new arenas for communication, problem solving and conflict resolution and, as with the original decision making process, OC has no explicit framework for constructive outcomes.

The questions should be posed and satisfactorily answered – why do they do it? What has kept OC alive for 8 years?

Sustainability of the OC organisation and the market is linked to two standard market forces – the uniqueness of the product and the rarity of the opportunity to purchase the product. Other similar organisations exist in the regional area, but have links to tertiary education institutions and therefore have a transient population of performers. OC has developed a following based on uniqueness, defined by the high standard of contracted performers, the high standard of the overall performance and fact that the management representation of OC through C has ensured that funding organisations and festival organisers can work with OC with relative ease.

A key stakeholder, with which an informal strategic alliance has been formed, is an independent post-tertiary Opera School. The willingness of OC to provide performance opportunities to the emerging operatic performers at national level is a unique offering. Other opera performance organisations offer very limited, competitive positions to such performers to understudy principal opera roles whereas OC gives these same individuals the opportunity to be the principal performer. In the New Zealand context, where OC operates, young performers by necessity move offshore to further their arts careers. OC provides the vehicle to add creditable performance experience to their CV, which improves the likelihood of being accepted into further employment or advanced tuition.

The OC offering is not equally valued by the Opera School and OC. OC places higher perceived value on the opportunity offered than the School does which has led to open breaches of the intent of the strategic alliance by the School in that students have been advised not to accept performance opportunities created by OC. The terms of the strategic alliance do not include an exit clause, due to its informal nature, and there is no mechanism for dissolution. The strategic alliance is not effective for either organisation and might be considered unworkable. However should

there be a change of decision makers at the School or OC the strategic alliance could be re-invigorated to the advantage of both organisations.

The rarity of the OC product offering is another success factor – not only from ensuring an audience appetite is not over catered but from the sustainability of the effort required of a very small group of owner operators and supporters. Balancing demand from the consumer (audience) with supply (C, L and M hours and at-risk funds) dictates some of the constraints in the informal business model and therefore keeps the rarity of the product as a constant. An annual production of an opera, requiring eight months of planning for three performances to break even, is not sustainable for a commercial operation. The advantage of the NFP structure and processes of decision making mean that actual costs are minimised.

This discussion clearly indicates that a lack of good business practice has hindered OC from pursuing growth opportunities. Similarly lack of formalised strategy and processes to deliver to that strategy has meant the organisation has not met its potential for improved income in its eight years of existence. However, the one key measure of success has been the reviews provided by arts critics which have been outstandingly high praise, published reports on the quality of the OC product.

By creating a strategic and business plan, supported by the reviews, OC would be able to demonstrate to potential corporate or arts sector funders that sufficient rigour exists in the organisation to meet funding criteria. This in turn would lessen some of the directors' liabilities.

Additionally a business plan that enables business growth would allow OC to pattern multiply the annual product into a touring performance in other urban centres. The demand exists as there are unmet requests from arts organisers in these centres; by geographically spreading the OC product the risk of over-saturation would be avoided.

By increasing the number of performances the income generated would offset expenditure and could allow reinvestment into asset replacement, for example electric pianos, lighting and sound equipment, which are currently funded from C and L's personal income.

To answer the challenges of why and what has kept OC in a financially liquid state for eight years we return to the defining characteristic of many not-for-profit organisations. Passion, which could be called the organisation's vision if it were formalised and shared equally, and internal drivers of the key decision makers – high quality contracted resources, a belief in the need for artistic performance and the opportunity for personal involvement in the high risk business of live performance.

## Questions for Business Case study

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1. What is a successful organisation structure for a not-for-profit in the arts sector?
2. Does an arts sector NFP share management practice characteristics with other sector NFPs?
3. How could OC organise itself to create recognised leadership?
4. What specialist skills are needed to improve the likelihood of business sustainability in an NFP?
5. Given the tension between collaborative and consultative working style and fixed deadlines how should an NFP best organise itself to deliver on time?
6. In a highly collaborative organisation how could decision making techniques be applied to produce successful outcomes?
7. Does a small NFP need a strategy? How could that translate into a structure where there are very limited resources (time, skills, funds)?
8. Is the IBR approach for conflict resolution valid for the NFP sector? Does it have more validity than in the profit making sector?
9. What is the most appropriate toolset for an NFP to use to understand personality types, individual drivers and why?
10. How do the strategic drivers of profit making, not-for-profit and government sectors differ? Which drivers does the NFP company in the business case display NFP?
11. In the NFP business model how important is stakeholder analysis and formalised strategic alliances? How do a profit making organisation and an NFP measure value when the monetary and 'net good' drivers do not equate?
12. What business model and business plan would ensure a sustainable NFP organisation with a greater rate of product delivery than OC? What resources would be required and what are the potential sources?





## 5

## The Gome Electrical Appliances Holding Case

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*Abstract:* This is a corporate governance case. It involves attempt by professional executives, in cooperation with a U.S private equity fund, to wrest control from a disgraced founder in a private enterprise. It is the first of possibly more governance motivated corporate control contests in China.

*Keywords:* Corporate governance; Controlling-rights contest; Private equity.

### Essential Facts:

On March 9th, 2011, the chairman of China's largest electrical appliance retail enterprise –Gome Electrical Appliances Holding Ltd (Gome) - Chen Xiao (Chen) resigned. In Gome's press release, it said "Mr Chen Xiao resigned from the chairman position for personal reasons. It is the shareholders' consensus decision to accept his resignation. The only regret is that he should have resigned sooner, as the company, the shareholders and the society suffered irreparable losses during his tenure." The question to be addressed in this case study is this: Was Chen responsible for destroying the company's value?

#### **Key antagonists:**

Huang Guangyu (Huang) was the founder and is the largest shareholder (with 33.98% shares) of Gome. He was ranked as China's richest person in 2004, 2005 and 2008, according to the Hurun's China Wealthiest Persons List.

Chen was the founder and chairman of Yongle Electrical Appliances Holding Ltd, which was acquired by Gome in 2006. Chen was then made Gome's CEO. His ownership in the company ranged from a high of 13.13% in 2006 to the current 1.51%. (See *Exhibit 3*)

### **The Chronology of Events:**

In July, 2006, when Gome acquired Yongle, this merger was positively received by the market (see adjusted stock market returns,<sup>15</sup> (CAR), in *Exhibit 2*).

After the merger, Huang, the chairman of the board at the time, persuaded Chen to become Gome's CEO by offering him a lucrative package that included a Maybach Manufaktur sports car, and a personal chef, etc. However, as Chen was not able to bring his former lieutenants at Yongle to the new position, he had a hard time rallying support for and implementing his strategy for Gome. In addition, Chen's vision for the company was in conflict with Huang's. The latter wanted an aggressive expansion via external growth while Chen preferred a steady growing company. Huang prevailed and made several acquisitions, most notably Dazhong Electrical Appliances (Dazhong) in 2007 and Sanlian Commerce Co. Ltd (Sanlian) in 2008. These acquisitions doubled Gome's sales but at the expense of profitability (*Exhibit 1*).

In early 2008, Gome was investigated by the Hong Kong Securities and Futures Commission for an illegal share buy-back plan that was detrimental to the minority shareholders' interests. There were signs that Chen was discouraged and had thoughts of withdrawing from the company. The signal was his steady sale of Gome shares, with his shareholding percentage decreased from 13.13% to 7.28% within two years (*Exhibit 3*).

Under Huang's management, Gome undertook an aggressive expansion policy for years, but in 2008 faces tight capital constraint and even risk of financial distress. The situation changed dramatically in November 2008, when Huang was charged and investigated for stock manipulation (adjusted stock CAR for November was -25%, *Exhibit 2*). This event changed Chen's initial plan to leave Gome and he accepted the chairmanship of the company on 18th January, 2009. The stock market reacted positively to the news that he was replacing the jail-bound Huang (CAR= +2%, *Exhibit 2*). Chen had a personal incentive to create value and to bail out the firm as he still had a sizable portion of his personal wealth tied up in it. Based on the share price at that time, his 7.28% ownership had a market value of 2 billion yuan. He re-negotiated with suppliers to get their support, introduced a private placement plan to bring in strategic investors, and claimed to put up his own assets and shares as collateral to secure bank loans. At this juncture, Bain Capital LLC (Bain) offered Gome HK\$1,804 million to participate in

<sup>15</sup> We use the market adjusted model in calculating the abnormal return. Market returns are calculated from the Hang Seng Index as Gome is Hong Kong listed.

Gome's convertible bond plan.<sup>16</sup> If Bain chose to exercise its rights under the convertible bonds, it would own 32.26% shares of Gome and become the largest shareholder; it would also be able to appoint 3 directors while Huang, after the increase in number of shares outstanding, would see his holding reduced to 30%. The news of Huang's incarceration was positively received by the market (a +4% CAR, *Exhibit 2*). However, after being sentenced to 14<sup>17</sup> years for a number of commercial crimes, Huang, in order to retain his control over Gome, voted against the proposal in the May 2010 shareholders' meeting,

In June 2010, Chen issued a press release<sup>18</sup> stating that "The board is unprecedented in its unanimity to take actions removing the largest shareholder. I believe the government will also support us, as no government would allow a criminal to play important roles in a listed company."<sup>19</sup> After this release, the deep split between Huang and Chen was now public. On August 4th 2010, Huang called for a shareholders' meeting to remove Chen from the chairman position on the basis of alleged mismanagement (citing as evidence the recent decline in Gome's operating performance). The next day, Gome filed a suit against Huang for his violation of directors' fiduciary responsibilities laid down by company law. On August 12th 2010, Gome's management declared<sup>20</sup> that the company's future is bright and the whole management team is unified. On August 23rd 2010, Gome released the 2010 semiannual report, with revenue and profit showed dramatic increase (see *Exhibit 1*). But on August 30th 2010, Huang gave Gome's board written notice that if his proposal to remove Chen from his position was not passed by the shareholders at the meeting, he would take steps to terminate the management and procurement contracts between the 372 Gome stores he personally owned and the publicly listed Gome Company.<sup>21</sup>

16 Gome's Hong Kong Stock Exchange (HKSE) public release on 26th, June 2009.

17 The Sentence of Beijing Second Intermediate People's Court 18th May, 2010.

18 Chen had interviews with journalists in Gome Shanghai office on 24th June, 2010. <http://tech.sina.com.cn/e/2010-10-18/15054758633.shtml>, accessed October 18, 2010.

19 "Hong Kong Listed Companies Constitution" prohibits any natural person who has convicted crimes being the company's director or senior management 5 years since the date of sentencing. However, Huang can still try to control Gome as the largest shareholder and through his representatives on the board.

20 August 12th, 2010, four vice presidents and Chief Financial Officer of Gome held a press conference and declared their unification.

21 Gome's Hong Kong Stock Exchange (HKSE) public release on 30th, August 2010

On September 1st 2010, Huang followed up with a proposal to implement a stock option incentive plan for Gome employees.<sup>22</sup> And on September 15th 2010, Huang released Gome's Five Year development plan and tried to gain Bain's support.<sup>23</sup>

On September 28th 2010, the shareholder meeting produced mixed proxy contest results. Shareholders voted against the proposal to remove Chen as chairman,<sup>24</sup> but also voted against and thus cancelled the private placement to Bain, enabling Huang to remain as the largest shareholder. Gome's share price outperformed the market index after the shareholder meeting (refer to *Exhibit 2*), as investors expected the battle between the two parties to now end and board would now focus on the company and its business activities.<sup>25</sup>

As *Exhibit 3* shows the company's ownership is made up of three roughly equal parts: Huang's founder shares, professional funds and Chen's, and other investors. Thus, the support of the other shareholders was pivotal to the contests. Chen may have committed strategic mistakes when he: a) acknowledged Huang's stranglehold on the firm through the firm's contracts with the 372 Gome stores he owned, which led some investors to conclude Huang was indispensable while Chen may not have been, and b) announced a slower store expansion strategy than that pursued by Huang, that added only 700 stores in 5 years as compared to the main competitor's (Suning) plan to add 3,000 stores in 10 years. Some Chinese investors could have seen the smaller planned growth as a sign of weakness, not realizing it was the over-aggressive expansion in sales without profit in the last few years that resulted in Gome's financial difficulties. Nevertheless, these factors shifted the support of the pivotal shareholders to Huang, and in December 2010, Huang successfully replaced two directors; one being his sister. Chen, anticipating his removal, had sold most of his holding, and was removed by the Huang controlled board on March 9, 2011. The market reaction was negative due to the greater uncertainty caused by the resignation.

22 Although Huang is in jail, media reported that he has a single office and room in jail as he paid extra fines. Besides, he can exercise his control over Gome through his wife, Du Juan. In the proposal, Huang promised that if the result of the shareholder meeting is favor of him, he will optimize and extend the original share option plan to benefit most Gome employees.

23 September 15th, 2010, Huang released "The public letter to Gome shareholders". [http://www.press-statement.com/archive\\_1.html](http://www.press-statement.com/archive_1.html), accessed September 15th, 2010.

24 Gome's Hong Kong Stock Exchange (HKSE) public release on 28th, September 2010.

25 Gome's Hong Kong Stock Exchange (HKSE) public release on 28th, September 2010 states that "the company's steady growth are in the best interests of shareholders, employees and other stakeholders. We will keep effective communication with all shareholders including Huang..." A number of major media also supported the above viewpoint, such as "Daily Economic News" 30th September, 2010.

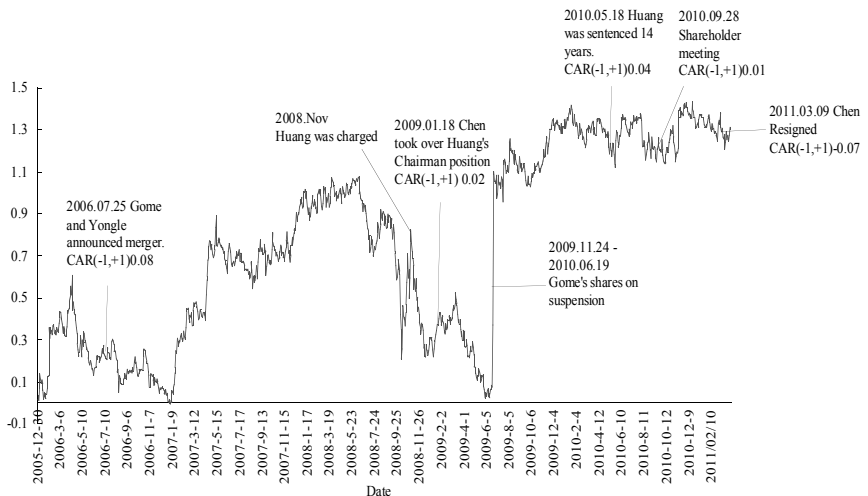
## Questions

1. Is Huang qualified to participate in the strategic decision making process and management of Gome as he has been convicted of commercial crime? Please provide debate from both ethical and rational viewpoints.
2. When the company's chairman and CEO have conflicting strategies, such as in the case, Huang held an aggressive expansion strategy while Chen insisted the conservative one, how could this conflict be resolved? What power distribution would lead directors to vote for one or the other? And what roles should shareholders play in this decision-making process?
3. Suppose you are Bain, how would you exercise control over Chen and Huang to minimize agency problem and maximize your return?
4. What role should the government and media play in this contest to protect shareholders' interests?

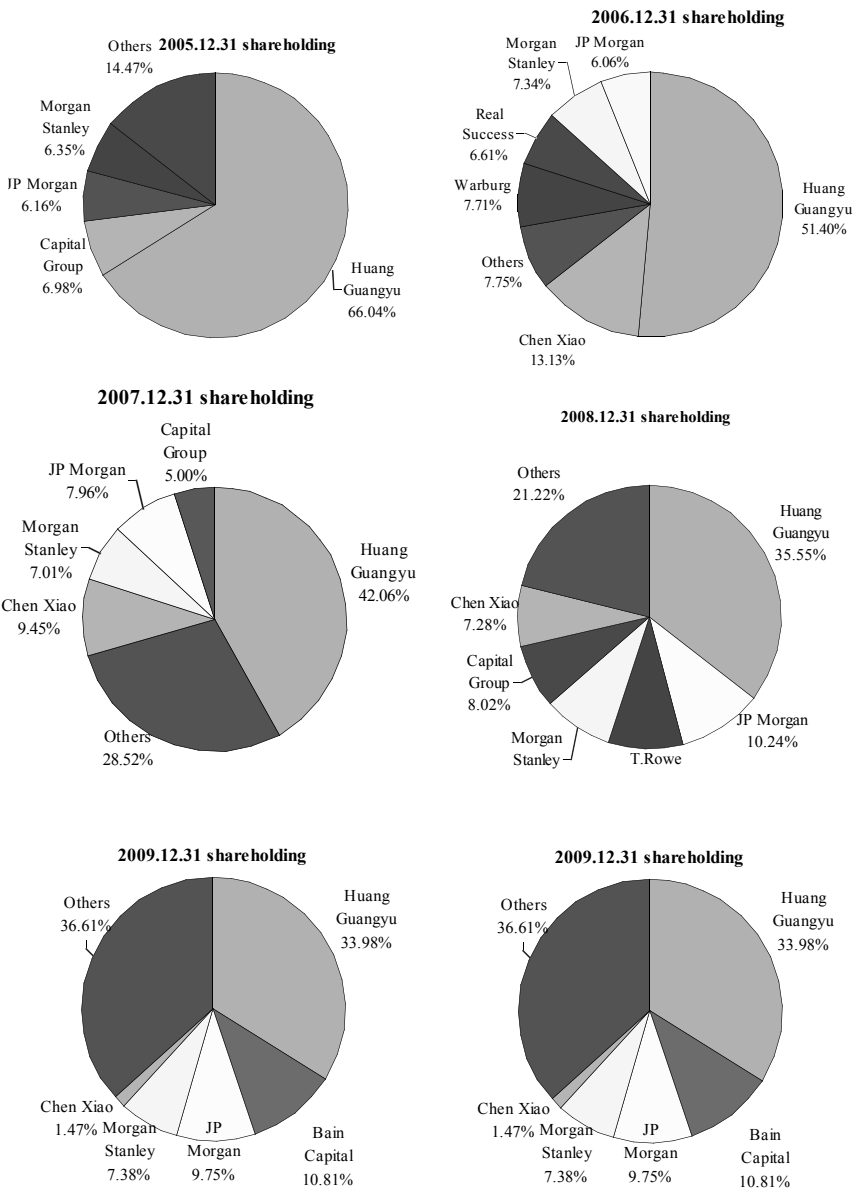
## Exhibit 1 GOME'S KEY FINANCIAL FIGURES FROM DECEMBER 12, 2005 TO JUNE 30, 2010

	Unit	6/3/2010	12/3/2009	12/3/2008	12/3/2007	12/3/2006	12/3/2005
Sales Revenue	Million Yuan	24,873.28	42,667.57	45,889.26	42,478.52	24,729.19	17,959.26
Total Asset	Million Yuan	33,613.80	35,763.18	27,495.10	29,837.49	21,176.23	9,367.89
Net Profit	Million Yuan	962.33	1,426.20	1,098.69	1,167.84	942.62	776.87
Net Asset	Million Yuan	12,113.57	11,802.47	8,700.04	10,392.67	5,240.39	1,871.29
Return on Asset	%	2.86%	3.99%	4.00%	3.91%	4.45%	8.29%
Return on Equity	%	7.94%	12.08%	12.63%	11.24%	17.99%	41.52%
Net Profit Rate	%	3.87%	3.34%	2.39%	2.75%	3.81%	4.33%
Debt to Asset	%	63.96%	67.00%	68.36%	65.36%	75.25%	80.02%

## Exhibit 2 CUMULATIVE ABNORMAL RETURN (DECEMBER 31, 2005 TO MARCH 30, 2011)



**Exhibit 3 GOME'S SHAREHOLDING STRUCTURE  
(DECEMBER 31, 2005 TO JUNE 30, 2010)**





## **Governance Mechanisms and Generational Transitions in Family Firms: The Case of *De Matteis AgroAlimentare S.p.a.***

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*Abstract:* Generational transition is a primary concern in family-owned SMEs. An in-depth analysis of corporate governance mechanisms able to support an effective and efficient succession planning represents, for this reason, an important research topic and contributes to increasing the understanding of such a fundamental business organizations. In fact, the family culture provides the basis for a competitive advantage, while specific governing bodies – such as family councils, assemblies and family meetings – ensures family firm stability and preserves family wealth.

By analyzing the case of an Italian business (*De Matteis AgroAlimentare S.p.a.*) we contribute in exploring the relation between governance mechanisms and successful generational transition in family controlled business. In fact, although the company has been recently involved in a generational transition process, it is characterized by an increasing turnover and by an extremely high innovation rate. These results testify the positive consequences associated to the appointments of the new board members and stimulate further analysis in order to shed light on the governance mechanisms adopted by the firm to take advantage of the succession process.

*Key Words:* Family Firms, Corporate Governance Mechanisms, Board of Directors, Generational Transition.

### Introduction

Generational transition is a primary concern in family-owned SMEs. Indeed, no recurring event in the life of family firms is more critical to survival than the transfer of power from the incumbent to the successor (Chua et al., 2003; Sharma et al., 1997). Empirical evidence shows that

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merely 30% of family businesses survive in the second generation, while fewer than 14% make it beyond the third generation (Morris *et al.*, 1997; Neubauer, Lank, 1998; Matthews *et al.*, 1999). For this reason, an in-depth analysis of corporate governance mechanisms able to support an effective and efficient succession planning represents an important research topic and contributes to increasing the understanding of such a fundamental business organizations.

However, the theoretical models usually developed to explore issues and solutions behind the CEO and directors turnover in large listed companies are not suitable to capture the complexity characterizing the generational transitions in family-run businesses (Phan *et al.*, 2005). In actual fact, the academic literature has stressed the role played by soft elements to guarantee family business longevity, focusing its attention on peculiar governance mechanisms able to boost these factors. The family culture – represented by habits, attitudes, beliefs, and values permeating family members – provides the basis for a competitive advantage (Campbell, 2007), while specific governing bodies – such as family councils, assemblies and family meetings – ensures family firm stability and preserves family wealth (Royer *et al.*, 2008; Aronoff *et al.*, 1998).

By analyzing the case of De Matteis AgroAlimentare S.p.a. we contribute in exploring the relation between governance mechanisms and successful generation transition in SMEs family firms. De Matteis AgroAlimentare S.p.a. is an Italian small family business specialized in the production of top quality pasta. It has been founded in 1993 and since that time it has been successfully managed by the “De Matteis” and “Grillo” families. Recently, the company has been involved in a generational transition process. In fact, in addition to the company Chairman De Matteis A. and to the executive director Grillo F. (senior members of the founder families), the Board of Directors is now made up of members of the second generation. The increasing turnover and the high innovation rate characterizing the company performance testify the positive consequences associated to the appointments of the new board members and stimulate further analysis in order to shed light on the governance mechanisms adopted by the firm to take advantage of the succession process.

### *Theoretical Framework*

Family businesses represent the prevalent form of enterprise and carry the weight of the wealth creation in most economies (Phan, 2005; Alcorn, 1982; Beckhard, Dyer, 1983). Although the generational transition can be considered a strategic theme in these firms, family business succession is still a “black box” for family business researchers, while succession

rates among family businesses remain extremely low (Morris et al, 1997; Neubauer, Lank, 1998; Matthews *et al.*, 1999; Campbell, 2007).

Several explanations exist for this pattern (Raskas, 1998). The lack of a proper strategic plan describing the basic business policies and, in particular, the lack of a succession plan offering details about the family members' participation in the business constitute important aspects of unsuccessful intergenerational businesses. Indeed, many family businesses put off the succession planning of their senior managers until the last minute, which leads to crises that sometimes can cause the death of the family business (Bowman, 1987; Sorenson, 1999; International Finance Corporation, 2008)<sup>27</sup>. Moreover, succession decisions are often driven by family's needs rather than by the actual requirements of the business (Goldberg, Woodridge, 1993; Firshkoff, 1994; Ifera, 2003). *Nepotism* – rather than the need for new competencies and skills - is often considered to be one the determinants of a succession process within a family business and, consequently, one of the reasons behind the failure of a successful succession process (Pollak, 1985; Gersick *et al.*, 1997).

In such a scenario, well functioning governance mechanisms can play a fundamental role in avoiding the failure of these firms (Tapiés, Fernandez, 2010). Indeed, on the one hand, in accordance to the resource-based view of the firm, formal and informal governing bodies – such as the board of directors, the advisory councils, the family councils, assemblies and family meetings – represent fundamental mechanisms useful to widespread the family culture (familiness)<sup>28</sup> (habits, attitudes, beliefs and values of the family) within the organization's boundaries (Barney, 1991; Alvarez, Busenits, 2001; Campbell, 2007; Sirmon et al., 2007). Familiness can be considered as source of competitive advantage by fostering goal congruence among family members and, consequently, boosting a shared will for the family to succeed, even at the expense of personal goals. On the other hand, corporate governance mechanisms perform several operating tasks that may contribute to prepare the family to the CEO succession by:

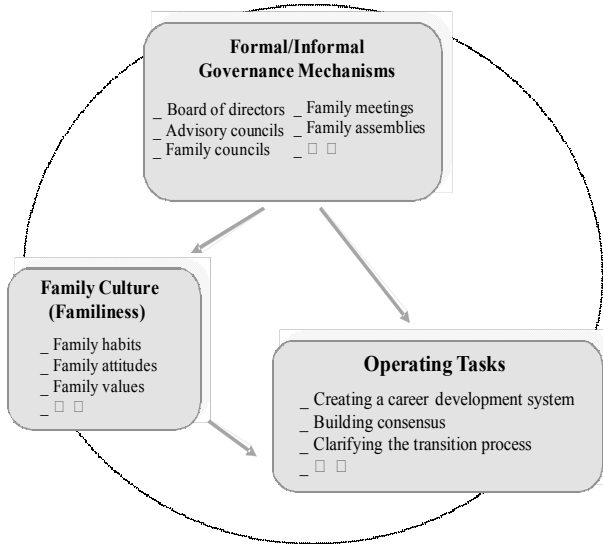
- creating career development systems in order to select the best possible candidate for the CEO position, regardless of whether this candidate is a family member or not;

27 The founders of a family business might ignore the necessity of a succession plan for a multitude of reasons: a) to create potential frictions among family members in case several potential CEOs are available within the family; b) because no current family member is deemed capable of replacing the current CEO; c) to avoid a discussion about the eventual loss of a family leader; d) because they refuse to admit that the company can survive without him/her. See Lansberg (1988), Neubauer, Lank (1998).

28 Familiness may be defined as interactions between the family members, family unit itself, individuals and the business that lead to positive synergies; this creates competitive advantages for the firm (Campbell, 2007). See also Habbershon et al. (2003).

- building consensus to assure the acceptance of the new CEO by the key stakeholders involved in the company; and
- clarifying the transition process by specifying the transition date and defining the levels of involvement in the firm activity of the former CEO after retirement<sup>29</sup>.

Figure 1. **THE ROLE OF GOVERNANCE MECHANISMS IN FAMILY BUSINESS SUCCESSION PLANS**



Source: Our elaboration.

Unfortunately, it is not possible to draw up a “one best way” or a universal model to manage a succession plan. In fact, as the academic literature has already stressed, a deep investigation on corporate governance issues associated to the different phases of a generational transition cannot neglect peculiarities in both organizational context and institutional environments (Corbetta, Salvato, 2004; Filatotchev, Wright, 2005). The board tasks and board composition, for example, appear to be significantly correlated to the generational phase of the firm. Indeed, the likelihood of having an outside director on the board has a convex generation trend, as the advice needs decrease from the first to the second generation and increase from the second to the third generation (Bammes et al., 2008). At the same time, the nature of the preferred successor (family or no-family member)

depends on the difficulty of transferring knowledge within a business and, in particular, on the relevance of general and technical industry-specific knowledge with respect to experiential family business-specific knowledge (Royer et al., 2008). Whenever industry-specific, general and technical knowledge become essential to reach a sustainable competitive advantage, the outside option (non-family member) has higher probability of being a successful choice; on the contrary, in case of high relevance of family business-specific experiential knowledge, the inside option (family member) should be preferred.

Figure 2. **THE CONTINGENCY MODEL OF FAMILY BUSINESS SUCCESSION**

	<b>LOW</b>	<b>HIGH</b>
Relevance of experiential family business-specific knowledge	Inside and outside option have same probability to be success promising	Outside option has higher probability of being success promising
	Inside option has higher probability of being success promising	Inside option is preferable only if family-specific knowledge are particularly relevant
	<b>HIGH</b>	

Source: Our adaptation from Royer et al. (2008), *Promoting family: a contingency model of family business succession*

In the next session an analysis of an Italian family firm (De Matteis AgroAlimentare S.p.a.) is developed. In fact, the De Matteis is a second generation family firm recently involved in a successful generational transition process. For this reason, an examination of the De Matteis governance systems might shed light on this topic and contribute to a better understanding of the relation between governance mechanisms and the effectiveness of succession plans.

### The Case of *De Matteis AgroAlimentare S.p.a.*

The *De Matteis AgroAlimentare S.p.a.* is an Italian family business founded in 1993 in Avellino (a town in the South of Italy) by the De Matteis and Grillo families. The company is specialized in the production of top quality pasta with the control of the entire production process, from the wheat to the finished product. Thanks to the quality of its products, the company has grown considerably over the years, becoming a firm leader in its sector. In fact, in addition to its own *Baronia* brand, the *De Matteis* also makes pasta for the private labels of some of the main Italian, English, German and American distributions chains. Nowadays, the production of the De Matteis is on average 950.000 tons per year, of which 70% is private label abroad. The company employs 105 people; its annual turnover is of about 80 million of euro, and the invested capital amounts to 102 million of euro.

Twenty years later the foundation of the *De Matteis*, the equity capital of the firm is still wholly held by the two founder families. Indeed, the 100% of the *De Matteis*' shares are owned by a *Holding Company* whose capital is equally shared by De Matteis family and Grillo family. Members of De Matteis and Grillo families also occupy all board's seats. Although the founders of the firm (represented by the Chairman De Matteis A., and by the executive director Grillo F.) still play an important role in the management of the firm, several positions are held by representatives of the second generation. De Matteis M. is the CEO of the board and sales manager; De Matteis A., Grillo M. and Grillo V. are directors and production manager, planning manager and communications manager respectively.

**Table 1. DE MATTEIS AGROALIMENTARE S.P.A. – BOARD OF DIRECTORS' COMPOSITION**

<b>Mr. De Matteis A.</b>	Chairman/Executive Director	Senior family member	50% of equity capital
<b>Dott. De Matteis M.</b>	Chief Executive Officer	family member (second generation)	0% of equity capital
<b>Dott. De Matteis A.</b>	Executive Director	family member (second generation)	0% of equity capital
<b>Dott. Grillo M.</b>	Chief Executive Director	family member (second generation)	0% of equity capital
<b>Dott. Grillo V.</b>	Executive Director	family member (second generation)	25% of equity capital
<b>Mr. Grillo F.</b>	Executive Director	Senior family member	25% of equity capital

Source: *De Matteis AgroAlimentare S.p.a. – Management Discussion & Analysis.*

The effectiveness and the efficiency of the strategic and operational choices undertaken by the company during these years (demonstrated by extremely positive profitability indexes) show how the firm has not been negatively affected by the succession process; on the contrary, the entrance of the second generation has boosted the operating profits and the financial positions of the *De Matteis*, opening new strategic options for the future.

By interviewing the CEO of the board, it has emerged that one of the reasons behind such a successful generational transition has to be found in the gradual handover of power and responsibility from the senior members of the family to the new generation, in order to reduce the potential for conflicts within the organizations and ease some of the main emotional problems associated to the succession process. The CEO also asserted that informal governing bodies – such as family councils or family meetings – were not important in driving the generational transition, while a fundamental role was played by the board of directors. Indeed, the board of directors has initially led the succession plan: monthly meetings have been arranged to assure to the offspring a “*training and development phase*” and, subsequently, a “*partnership phase*” with the senior members of the family. Then, the board has been strongly reconstituted to reflect its new leadership with the substantial transfer of control and responsibilities to the successors (*power transfer phase*). The graduality of the *De Matteis* generational transition process has allowed the family values (*familiness*) to be transmitted to the family firms, contributing to the continuity and success of the company over time.

The examination of the *De Matteis* case also highlights the absence of non-family members in the management of the succession process. However, the considerations presented during the brief review of the theoretical framework on generational transitions in family businesses point out that such a choice is consistent with the life-cycle phase of the firm and with the economical and institutional context in which it operates.

In fact, the level of *De Matteis* and *Grillo* families’ experience has obviously increased over the time. The second generation benefit from explicit and tacit knowledge acquired by the *De Matteis* company during the management of the senior members of the families. Consequently, complementary knowhow held by outside directors does not seem to be necessary in this phase of the *De Matteis* life. At the same time, the attention paid by the senior members of the families in transferring power

and responsibilities from the old to the new generation has alleviated potential conflicts within the organization and, so doing, has decreased the need for outside arbitration<sup>30</sup>.

The main characteristics of the industry in which the company operates also help to understand the governance systems of the *De Matteis*. Indeed, producing high quality pasta still requires artisan capabilities and traditional knowledge. For this reason, a competitive advantage is strongly associated to family business-specific knowledge, rather than to general and technical industry-specific factors. Then, a significant presence of family members in the governing bodies of the firm represents a strategic resource for the achievement of the company's targets, while the contribution of external advisors and independent directors are not significantly correlated to the firm value.

Figure 3. **THE CONTINGENCY MODEL OF FAMILY BUSINESS SUCCESSION – DE MATTEIS AGROALIMENTARE S.P.A.**

		Relevance of general and technical industry-specific knowledge	
		LOW	HIGH
Relevance of experimental family business-specific knowledge	LOW	Inside and outside option have same probability to be success promising	Outside option has higher probability of being success promising
	HIGH	Inside option has higher probability of being success promising  <b>De Matteis Agro Alimentare S.p.a.</b>	Inside option is preferable only if family-specific knowledge are particularly relevant

Source: Our adaptation from Royer et al. (2008), *Promoting family: a contingency model of family business succession*.

<sup>30</sup> As already stated in the previous paragraph, the above considerations are particularly true in case of a second-generational transition. In fact, in this case, a significant decrease in the need for complementary outside know-how from the first to the second generations is not likely to be compensated by the increased need for outside arbitration. On the contrary, from the second to the third generation a substantial increase in the need for outside arbitration takes place, which is not likely to be compensated by the further decreasing need for complementary outside know-how.

This case study highlights the fundamental role played by family firms' governance mechanisms in leading a successful generational transition. In particular, it sheds light on the importance of the board of directors either in transmitting the family values to the family firm, or to carry out operating tasks that contribute to prepare the family to the CEO succession. Moreover, it also stresses the impossibility to draw up a universal model to manage a succession plan, showing how the tasks and composition of the family firms' board are strongly influenced by contingent factors such as the organizational context and the institutional environment.

## Review Questions

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1. Can you explain why generational transition is a critical event in the life cycle of a family-owned SME?
2. What is the meaning of *familiness*? How formal and informal governance mechanisms can contribute to widespread *familiness* within a family-run business?
3. The theoretical framework developed in this chapter demonstrates that it is not possible to draw up a universal model to manage a succession plan. Can you explain this assertion? How variables such as “general industry-specific knowledge” and “family business-specific knowledge” influence the nature of the preferred successor (family or no-family member) in generational transition?
4. The case study analyzed in this chapter can be considered a successful one. Can you explain how the governance mechanisms adopted by the firm have contributed to reach this goal?

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## 7

## Living Without Regrets: How an Efficient Governance Wins the Succession Dilemma and the Economic Crisis

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*Abstract:* The G.ValotaS.p.A. case represents an interesting example of how an unforeseen event such as the founder's death fosters successful organizational change. Succession in a family firm from the first to a second generation is often considered as the most difficult since it directly involves the founder. This case shows how such a succession can instead be seen as an opportunity to improve corporate governance and create value for the company.

### Introduction

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G.ValotaS.p.A. is a medium-sized Italian family business founded in the 60s by Giulio Valota, a visionary entrepreneur who made the company a national market leader in the field of Polyethylene Films. The business today displays a high level of flexibility which is typical of family business and combines it with another significant competitive advantage: organizational innovation. Additionally, Valota values investments in new equipment and technology to constantly improve its products and gain a leading position in the Italian market.

When the founder Giulio Valota tragically died in 2008, the business was doing incredibly well: three years of sales growth and a set of new projects on the way. Even though Giulio Valota's daughter Francesca was already

<sup>31</sup> *ACKNOWLEDGEMENTS:* The authors are extremely grateful to Francesca Valota, Michele Pardini and Gianmaria Beni for their availability during the research and help in understanding the dynamics of this case study. The authors are also thankful to Professor Claudio Ghilardi for his support. This paper is the result of the shared research of both the authors. In terms of authorship, the "Introduction" and "Main Governance Issues" paragraphs can be attributed to Cristina Bettinelli, the "Valota S.p.A. Case" paragraph can be attributed to Andrea Giuliani.

involved in the management of the company as CEO, mainly involved in the purchasing and sales of raw materials, her father, besides having a representative role, was in charge of supervising the entire value chain process.

This case shows how Francesca Valota reacted to loss of her father and how she successfully took over the business. After the founder's sudden death, the personalities involved in governance of the firm changed significantly. Francesca's husband, a successful entrepreneur in a different business, was brought into the venture as the new CEO. Francesca assumed the role as President. She hired experienced people to manage operations and at the same time improve the governance system. She established a top management team and never gave up on her commitment and passion. The leadership model of the company, thanks to Francesca Valota's strategy, became less authoritarian and more group-oriented.

### **Main governance issues.**

Family businesses tend to become more complex as they expand and evolve from generation to generation.

As successive generations take charge of family businesses they can be confronted with issues that were never a part of their parents' experiences. These can include financial issues such as the 2009 global economic crisis, issues around the design and implementation of different leadership arrangements, and re-thinking the business model to survive and prosper.

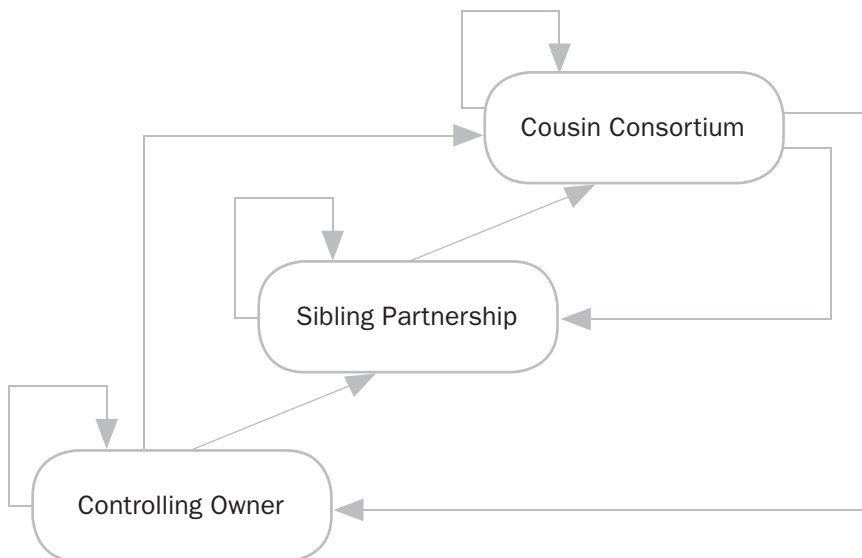
It is recognized that although succession and governance structures of family firms take various shapes that may change from generation to generation, some processes are common to every succession. In particular, in each family business transition someone from the new generation takes charge, and someone from the older generation gives up control. These processes are typically implemented through negotiation between the two generations. Issues to be resolved include the new leadership structure, the criteria that determine the selection of the successor and the steps that need to be followed to complete the process. This process is not as simple as it seems because the family firm's successions impact both the business (its structure, and its development) and the family.

In regards to the former element, the business, the choice of the future governance structure involves a variety of options that can be categorized as follows: one, "recycling" and reproduction of the previous structure (a founder leaves the business to one daughter or son); two, a more complex structure (ownership rights and management responsibilities are divided among a group), or three, a structure that is simpler than the previous one

(Gersick et al., 1997) (or recursive succession). These possible succession options are summarized within a framework (figure 1).

Figure 1. **NINE TYPES OF SUCCESSION**

*(Gerswick, et al. (1997) p. 203*



Among the nine possible types of succession reflected in this framework, three involve a change in leadership while maintaining the same ownership form, therefore being categorized as “recycling”. This happens, for example, when the incumbent passes the family business to one person who remains the controlling owner and becomes the new leader. Figure 1 indicates also three “progressive” succession types that involve a change in leadership while increasing the complexity of the ownership form. An example of such a situation would be where a family business evolves from being one run by a “controlling owner” to a “sibling partnership” structure. Three are “recursive” successions that imply a change in leadership while simplifying the ownership form. Examples are the cases where company passes from a sibling partnership to a controlling owner model.

The Valota case is an example of the first category: a situation where the successor passed on control to his daughter (albeit unintentionally) and where the previous governance structure remained essentially unaltered. It provides evidence that such succession can be successful, particularly where steps are taken by the new incumbent to foster change and innovation.

In regards to *the family*, no succession can be successfully implemented if family members are not considered. Successions play a crucial role in shaping people's lives, and are processes that affect and are affected by "the development and maturation of individuals as they move through life" (Lansberg, 1999, p.4). A number of deep psychological factors must be taken into consideration when analyzing the succession, such as the emotional and other links of family members to the business. As Lansberg (1999 p.5) notes, all successions are driven by a vision of the future, "that embraces the aspirations of both senior and junior generations as well as those of their forebears". This vision, which Lansberg calls "The Shared Dream" increases cohesion and helps carry out succession in an effective way. This case study tries to analyze some of the most relevant aspects that occurred during the transition in a family business called G.Valota S.p.A. With this case we try to show how the "Valota's dream" shared by Francesca, her father and later, her husband, has guided the strategic choices during and after the transition period. The story's protagonist is a woman, Francesca Valota, who takes charge of her father's business.

Women have traditionally played roles in family businesses that are closer to the family than to the business, including matriach, spouse, parent, and in-law. As a consequence, many daughters are socialized to believe that they are not suited to leadership roles (Galiano & Vinturella, 1995) or that their careers are restricted to certain sectors (Aldrich, 1989). This is not the case for Francesca Valota, who has shown her passion for the business since she was young and, as the case will show, has been able to challenge the cultural bias that existed. More generally, indications are that change is now occurring and women are increasingly involved in the business side of family businesses (Martinez Jimenez, 2009).

Once a father-daughter succession is accomplished, daughters can face a number of problems as they need to reconcile work and family tasks; and to prove their skills both to the rest of the family and to the shareholders (Vera & Dean, 2005). These challenges can be addressed if these successors leverage the numerous qualities they typically have. According to the existing literature, some of these qualities are: their loyalty to the firm and family, their thoughtfulness and attention for the needs of all the members, and their flexibility regarding roles and judgments (Salganicoff, 1990). Women generally tend to distinguish themselves also for their ability to multitask, the ability to manage disagreement, and the ability to follow intuition and instinct, rather than relying only on analysis and rationality (Francis, 1999; Rosenblatt, De Mik, Anderson, & Johnson, 1985). Finally,

women tend to be more attentive to relationships and to recognize their importance for the business success (Lansberg, 1992), which may be an advantage for a firm that is going through change such as Valota.

Recent literature suggests that the effectiveness of a succession process in family businesses is a function of the incumbent's propensity to step aside, the successor's desire to take over, agreement among family members to preserve family participation in the business, recognition of the roles of those involved and succession planning (Sharma, Chrisman, & Chua, 2003). In addition, it is important to success that consideration be had of all the strategic stakeholders' needs and perceptions. In particular, employees, managers, owners, clients and the economic community must be taken into account and managed (Sharma, Chrisman, & Chua, 2003).

However, it is not only the process of orderly succession itself that is important: researchers report that the ability of an organization to adapt to the changing competitive environment is also essential: Those companies who do not adapt "*seem destined to expire*" (March, 1995, p. 431). Miller (1991) suggests in his research that CEOs grow "stale in the saddle" when they enjoy a lengthy tenure; this is a common situation in family firms and in Valota, where ownership and management functions overlap and the family has stable leadership. However, even the most successful CEO and family business has to face the market competition and it can happen that "*fit with environment deteriorates so much and performance declines so precipitously that revolutionary change must occur. This change generally occurs after the ascendancy of new leaders.*" (Miller, 1991, p. 49).

As Ward (1987) points out, the development of management practices that reflect the different stages of the company's life is essential for success. Among these stages, succession (especially in the first-to-second generation's case) is probably the most important phase in which new management tools can be developed. Lansberg (1988) in his studies on succession seems to confirm this assumption. He states that difficulties around succession are not limited to the founder and the family; rather the transition imposes a wide variety of significant changes for the entire family firm system. Traditional patterns of influence are redistributed and long-standing management and ownership structures must give way to new structures (Handler, 1994).

Another important governance issue involves the strategic choices that the successor has to make once he/she is in charge of the business. The desire to carry on the family business tradition leads some successors to slavishly follow in their parents' footsteps and fail to introduce innovative

strategies. Having a conservative approach can be detrimental for a company especially during negative economic conjuncture periods such as the one that Valota was facing when the transition occurred. This case study shows the importance for the heirs to choose the most suitable strategy and leadership styles according to their attitudes and to the needs of the business *in their generation*, regardless of the needs of the business in their predecessor's generation (Dugan, Krone, LeCouvie, Pendergast, Kenyon-Rouvinez, & Schuman, 2008).

### The Valota S.p.A. Case

The problems for G.ValotaS.p.A. began in 2008 when the founder, Giulio, tragically passed away. Despite his remarkable age and the official transfer of the CEO position to his daughter Francesca several years previously, Giulio was far from retiring. He had a direct leadership style and was a truly visionary entrepreneur with a deep knowledge of his business and an enviable charisma. When he died, he was still intimately involved in the firm; Chairman of the Board and mentoring Francesca. Moreover, he maintained his ties with non-family managers, employees and key stakeholders till the very end: he died while on a business trip.

From an academic perspective, it might be said the business was suffering a persistent "*generational shadow*"<sup>32</sup> and Giulio Valota's control deeply influenced the firm's management, thus limiting the discretion of the successor. However, no one can deny his remarkable achievements. Thanks to Mr. Valota's passion, vision, experience and strong leadership, his small venture G.ValotaS.p.A, founded in 1964, rode the Italian boom and became a national market leader operating in the industry of blown PE films, employing more than 50 people and reaching revenues of around 30 million EUR in 2007.<sup>33</sup>

The PE films are largely produced for packaging purposes (key consumers of these products are the beverage, food and brick industries) and for the building of greenhouses in the agricultural sector. The raw material is mainly polyethylene, which is heated and mixed with chemical additives and paints. A new biodegradable line, introduced recently to meet the needs of a greener economy, uses cornstarch *instead of polyethylene*;

<sup>32</sup> For a better understanding of the concept, see Davis, P., & Harveston, P. (1999). In the Founder's Shadow: Conflict in the Family Firm. *Family Business Review*, Vol. XII, No. 4, 311-32

<sup>33</sup> The revenues of € 29.769.877 (Source: Valota S.p.A., annual report 2007) are equal to US\$ 40.198.265. The value has been determined using European Central Bank official exchange rate in date 30/09/2011 1 EUR = 1,3503 USD. Source: European Central Bank, available online at <<http://www.ecb.int/stats/exchange/eurofxref/html/eurofxref-graph-usd.en.html>>

however, the fast decay due to the weather agents limits *the potential for these products. The most important suppliers are therefore the petrochemical companies, and subsequently the chemical ones. The oligopolistic nature of the upstream market, compared to the fragmented and competitive arena in which Valota has to operate, determines a limited market power for the firm concerning procurement. For these reasons, the strategy for the firms in this industry necessarily involves a continuous effort in containing production costs and investing in R&D to improve product lines and thus achieve a price premium.*

During the *two-generation partnership phase*<sup>34</sup> long discussions and debates had already begun to take place between Francesca and her father. After having assumed her position as CEO, Francesca was determined to begin introducing changes she believed necessary if the business were to survive in a new competitive environment with harsh international competition and strict domestic policies.

The first big challenge Francesca faced was the transformation of the traditional 5 on 7 days production cycle used in the company into a continuous production cycle. She firmly believed this was essential in order to control the costs overrun (mainly due to production waste and electricity consumption to heat machinery). Giulio, reflecting a rooted traditional belief, believed the idea was not going to be accepted by the workforce. Their resistance to any concerted effort to introduce this policy would damage the company. Nevertheless, Francesca faced the situation with strong determination: despite the critics she decided to implement the new strategy and take responsibility for whatever happened.

Francesca Valota is not the kind of person to stand in her father's footsteps, nor one to act as leader from day one just because she is the boss' daughter. She started her career in the firm "from the ground floor"; over the years, Francesca constantly demonstrated reliability, talent and devotion to her father. She overcame many difficulties and in the end won her father's trust thanks to her "determination and commitment, everyday", as she proudly remarks. Of Giulio's three children, Francesca was the only daughter; nevertheless, she was also the only one with experience of the business and the will to pick up her father's legacy. Francesca's siblings never showed any interest in joining the family firm.

<sup>34</sup> The four stages of Family business succession: "apprenticeship", "career commitment", "two generation partnership" and "passing the baton" follow the design proposed in Jaffe, D. (2010). *Stewardship in your Family Enterprise*. Charleston, SC: Pioneer Imprints.

This determination is of additional interest given that according to Francesca, in the industry of blown PE films, it is rare to find women in leadership positions. Her claim is that this industry still demonstrates significant prejudice against women: *“it is not like the fashion industry, where nowadays there is no discrimination towards women. This is just a field in which women cannot usually work, you always expect to find a man in charge of the business”*. Francesca’s assertion resonates with the evidence of Vera & Dean (2005) that when suppliers or customers are likely to be men, they expect to have business relations with another man. Francesca had to overcome harsh discrimination from both inside and outside the family business; even her father, at the beginning, didn’t think entering the family business was the right choice for her because of her gender.

As we said, Francesca was Giulio’s only offspring seriously engaged in the company and therefore the *controlling owner structure* didn’t change with succession. Wisely, considering his age, Giulio secured the structure of the firm and the continuity of the business by transferring a major stake to Francesca and having her appointed CEO. After Francesca’s take over in 2006, her husband Michele, a member of the enterprising family Pardini, owner of the Italian group Pardini S.p.A.<sup>35</sup>, and a successful manager in this group of companies, joined Valota as director of sales. He therefore became another member of the top management team representing the family. In 2009 Michele became CEO, and Francesca assumed her father’s former position as President and Chairman of the Board. Today, despite different backgrounds and competences, the couple acts as a team, managing the complexities of their medium-sized business.

Even if organizational change started before the founder’s death, the real revolution was yet to come, and Giulio Valota’s demise marks a watershed between the past and the present of the firm. A new vision was introduced by Francesca and Michele towards the firm *“we want G. Valota S.p.A. to be LESS a FAMILY and MORE a BUSINESS”*. Under this diktat, major changes followed:

- The organizational chart was rewritten. A new CFO joined the company and the financial division restructured, including staffing reviews and changes. The General Manager was also replaced, mainly because of his disagreements with Francesca. A new manager responsible for the quality and the IT systems of the company was hired.

<sup>35</sup> Manifatture Norberto Pardini & figli S.p.A. Information on the business available on the company’s website: <[http://www.pardinispa.com/index\\_flash.php](http://www.pardinispa.com/index_flash.php)>

- The company changed the product mix and started seeking new markets and opportunities as a consequence of the negative economic conjuncture affecting sales in the domestic market.

The first impact of this revolutionary change was a shock: a dramatic fall in turnover was registered at the end of 2009, with major consequences on earnings: the good trend of the previous years turned into consistent losses. It is not easy to estimate how much of this loss is due to succession related-issues and how much is a function of negative economic sentiment affecting the entire world over this period; however, it is quite clear that they both played a part.

The new CFO nevertheless strenuously defends the implemented changes: *“A new leadership was necessary. The mindset of the old leadership and organization had reached their natural limits. We had to realign the firm with the industry competitive environment and the changes occurred in the market in the recent years”*. Michele Pardini agrees and adds more: *“The first generation could manage the firm in a simple way, but now the industry has changed: marketing, innovation, quality, social responsibility... the policy makers and the market nowadays pretend high standards from our business, and we have to deal with complexity successfully”*.

From a theoretical standpoint, regardless of competences and skills, a successor is seldom able to replace the founder-entrepreneur. For many of the functions that the founder used to perform or supervise, the change in leadership requires a different degree of institutionalization (Lansberg, 1988). The formalization of processes, budget and cost analysis, the use of IT systems and the hiring of new personnel at the executive and middle-management level are all instruments that allow the successor to act in a more conscious way and help the firm to recover from unease and decline in confidence that may accompany the transition. Miller, Steier & Le Breton-Miller (2003) warn about the high risks of failure connected to a *“rebellious attitude”* towards change, where everything must be new for the sake of it. The development of a coherent strategy is therefore always needed. The following steps taken (2010-2011) move in the direction of a conscious plan to put back costs on the right track:

- The firm started the development of a new budget system and instruments for costs analysis and management control. With the improved support of the new IT systems introduced by Francesca, the firm began to check duly important costs like electricity, which before were just estimated, and adopted a more scientific approach towards budget and reporting.

- Valota introduced and institutionalized specific practices of credit management, in order to achieve a better control over the cash flow and minimize the credit losses, which may undermine the financial stability of a SME especially during a negative economic conjuncture or a crisis.

Although it may restrain the senior managers' influence, the institutionalization of the practices is a crucial stage: developing trust relationships with peers and receiving support from the managers who should act as agents of change will help the successor through this delicate phase.

For Valota, and as shown in the following table, after the previous big losses, the fiscal year 2010 showed a small profit and an improvement in all the key indicators. Interesting projects are being carried out and the CFO team is still working hard on the new budget system. The comparative data also indicates that the demise of the founder marks a big point of discontinuity not only in the management of the company, but also in its financial results.<sup>36</sup>

**Table 1. VALOTA FINANCIAL PERFORMANCE: 2006-10**

	2006	2007	2008	2009	2010
REVENUES	€ 26.457.542	€ 29.769.877	€ 29.075.569	€ 21.103.074	€ 26.739.168
EBITDA	€ 1.176.788	€ 1.126.808	€ 1.198.355	€ 98.876	€ 925.278
EBT	€ 260.934	€ 57.933	€ 102.780	€ (763.761)	€ 112.915
EAT	€ 10.559	€ (107.253)	€ (106.272)	€ (831.981)	€ 15.452
ROI%	6.37	5.00	5.51	0.47	3.94
ROE%	0.45	(4.08)	(2.55)	(32.72)	0.60
FCF	€ 452.568	€ 398.341	€ 334.069	€ (3.55.531)	€ 494.938

However, some questions remain. First and foremost: will Valota be able to regain its financial stability? According to the CEO Michele Pardini, this is the biggest current challenge for the firm. If the firm can negotiate this difficulty, it will be on the right track. The CFO and his team have worked hard to ensure more stable cash flow for the company, but even more has to be done. A second key question is related to the succession process and the organizational changes that have occurred. Was this revolutionary change a necessary step to realign the company to the external environment, as the CFO has pointed out, or was it responsible, together with the economic crisis,

<sup>36</sup> EBITDA: Earnings Before Interest, Taxes, Depreciation and Amortization; EBT: Earnings Before Taxes; EAT: Earnings After Taxes (Net Income); ROI: Return on Investments (EBITDA / Assets); ROE: Return on Equity (EAT / Equity); FCF: Free Cash Flow.

for the costs overrun and the turnover fall that endangered the financial stability of G.ValotaS.p.A., as some theory (Miller, Steier, & Le Breton-Miller, 2003) claims? Only the company's future will help to find these answers.

**Questions to Consider:**

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What options are there for settling the question of succession in the context of a family business?

What are the main governance issues for a successor?

How can a successor be effective in her/his new role?

How does a second generation's governance of the firm differ from that of the founder?

How does or could the gender issue affect governance of the firm?

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## 8

## **Formal and Informal Governance Mechanisms behind Successful Family Firms' International Expansions: The Case of CMD S.p.a.**

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*Abstract:* Family-owned and managed firms face specific barriers to international expansion. For this reason, an examination of corporate governance mechanisms of family firms entering foreign markets represents a fundamental research topic. In particular, an analysis of the board of directors as a potential determinant of the international pathways taken by family businesses stresses the elements that make such a governing body an important strategic resource contributing to the international expansion.

We develop a case study by carrying out an analysis of an Italian small family firm (*CMD – Costruzioni Motori Diesel S.r.l.*). In fact, despite its familial nature, the *CMD* is characterized by an extremely high export propensity and represents a clear success case of an international expansion undertaken by a family firm. An in-depth examination of the attributes characterizing the *CMD* governing bodies certainly sheds light on the effectiveness of family-owned and managed corporate governance systems and on the role played by the board of directors in implementing successful internationalization strategies.

*Key Words:* Family Firms, Corporate Governance Mechanisms; Board of Directors, Internationalization Strategies.

### 1. Introduction

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Family-owned and managed firms face specific barriers to international expansion (Fernandez, Nieto, 2005; Graves, Thomas, 2004). Indeed, factors such as the resistance to change, the preference for direct control and the prevalence of self-financing sources usually characterize family-run businesses and prevent these organizations from carrying out effective internationalization strategies (Gallo, Garcia Pont, 1996; Romano et al., 2001; Fernandez, Nieto, 2006; Claver et al., 2009). In this scenario, an

examination of corporate governance mechanisms supporting family firms to enter foreign markets represents a fundamental research topic. In particular, an analysis of the board of directors as a potential determinant of the international pathways taken by family businesses stresses the elements that make such a governing body an important strategic resource contributing to the international expansion (Calabrò et al., 2009).

However, a research methodology mainly based on the conceptual framework of the agency theory (Jensen, Meckling, 1976) and on the examination of the so called “usual suspects” (CEO duality, board size, insider/outsider ratio, director’s shareholding) hardly fits with the familial nature of these organizations (Finkelstein, Mooney, 2003; Huse, 2009). Opening the “black box” and exploring the actual behaviour of board components through the lens of alternative theories (such as the resource based view of the firm) is absolutely necessary to detect elements fostering family firms’ international expansion (Huse, 2005; Erakovic, Overall, 2010). An analysis of “*board working style*” (organization of board meetings, board work) and “*board quality attributes*” (board knowledge, diversity and motivation to participate) – rather than of board composition features – might enhance understanding of the role played by the governing body and offer useful insights into formal and informal governance mechanisms lying behind a successful internationalisation strategy (Pugliese, Wenstøp, 2007).

We firstly present some theoretical assumptions and empirical evidence on the features of the board of directors that are deemed positively to affect the internationalisation strategies of family businesses. Then, an examination of an Italian small family firm (*CMD – Costruzioni Motori Diesel S.p.a*) is carried out to verify the assumptions derived from the literature. The *CMD* is an engineering firm specialized in the design and production of diesel and gasoline engines. Despite its familial nature, the *CMD* is characterized by an extremely high export propensity. Indeed, since its foundation in 1971, *CMD* has been exporting its products to Europe, India, Korea, Indonesia, China, America, Australia and New Zealand. *CMD* represents a clear success case of an international expansion undertaken by a family firm and an in-depth examination of *CMD* board of directors “working style” and “quality attributes” certainly contributes to shed light on family-owned and managed corporate governance effectiveness.

## 2. Theoretical Framework

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Owing to the globalization process, a firm’s ability to expand internationally is an essential indicator for its survival and growth. In fact, a high international commitment is a fundamental criterion not only

for large firms, but also for Small and Medium-Sized Enterprises (SMEs) (D'Souza, McDougall, 1989). However, notwithstanding the importance of a successful internationalisation strategy, entering in a foreign market still represents one of the biggest challenges for SMEs and, in particular, for small family-controlled businesses (FCBs) (Graves, Thomas, 2003; Thomas, Graves, 2005).

Several variables have been identified in an attempt to understand FCBs' difficulties in setting up and managing international pathways, and a lack of support by the board of directors has been often listed among these variables (Gallo, Garcia Pont, 1996; Calabrò et al., 2009). In fact, in accordance to the resource-based view of the firm, the board of directors could provide resources that are valuable, rare, inimitable and difficult to substitute. It represents not only an important monitoring mechanism, but also a fundamental tool which enables a firm to implement effective and efficient strategies and to exploit opportunities and face threats in the competitive environment (Barney, 1991; Alvarez, Busenits, 2001; Huse, 2007; Sirmon *et al.*, 2007).

For this reason, the board can be described as a firm internal source of competitive advantage that contributes to the international expansion of family businesses. In particular, if we adopt the view of an effective internationalisation process as a pattern of expansion (*sprints*) and consolidation (*pauses*)<sup>37</sup> (Mintzberg, Waters, 1990), directors' knowledge and expertise might play a fundamental role initially in boosting the international expansion of their firm and, subsequently, in consolidating the achieved results.

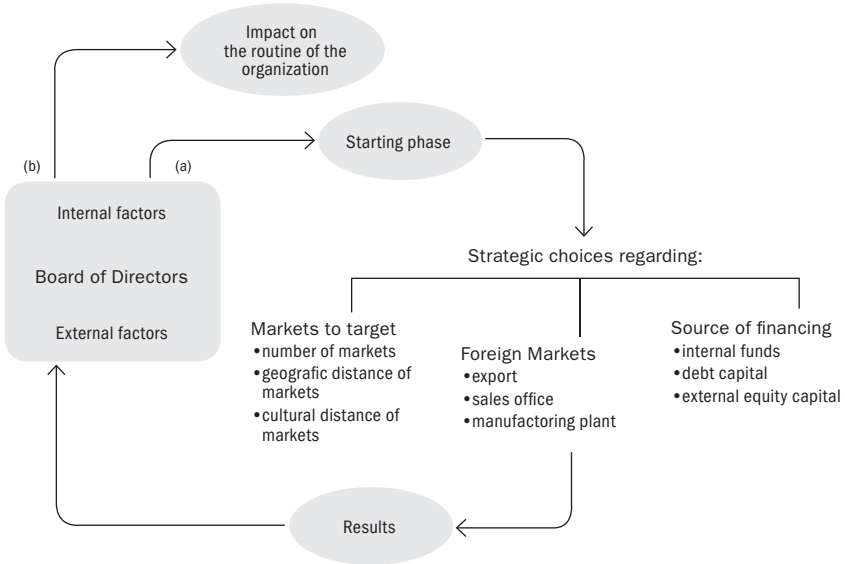
In other terms, board of directors of small FCBs can provide the extra resources to allow the FCB to seize the opportunities for a successful international strategy (Calabrò et al., 2009). Factors within and outside the boundaries of the organizations should be constantly monitored to implement choices concerning:

- a) the countries to target;
- b) the foreign markets entry mode (export, overseas sales offices of manufacturing plants);
- c) the level of resources to invest and the sources of the funds chosen to finance the investment planned.

37 This pattern of sprints and pauses suggest an inchworm analogy: an organization leads with some primary strategy, usually related to expansion then pauses to bring up lagging strategies [...] the result is an unsteady pattern of growth, but one that can generate a great deal of excitement and energy within an organization. Growth becomes the all-out sprint, a pause, the time to catch breath" Mintzberg, Waters, Tracking Strategy in an Entrepreneurial Firm, Family Business Review, 1990, 3(1), pag. 307.

Subsequently, the governing body should modify the routine of the organization in order to adapt the operating activities to the new competitive arena and to guarantee a sustainable competitive advantage.

**Figure 1 THE INVOLVEMENT OF THE BOARD OF DIRECTORS IN THE INTERNATIONALISATION PROCESS**



Source: Our adaptation from Caroli (2002), *The SMEs' internationalisation process: an explicative model*.

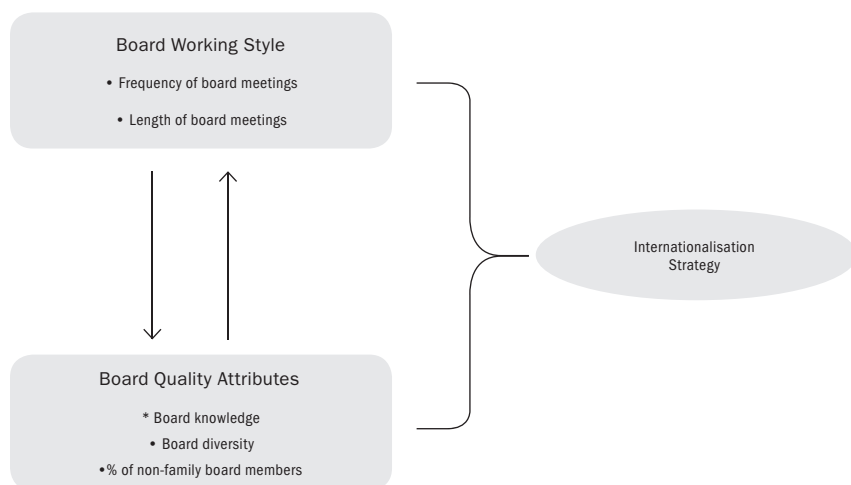
Indeed, some evidence already suggests a strong relationship between some features of the board of directors and the export propensity of FCBs.

In fact, an examination of the governance mechanisms of FCBs which operate only in the domestic market often highlights the existence of a board of directors whose purpose is limited to comply with legal requirements (approving the company's financials, dividends and other procedures that require board approval by law). Known as a "paper board", such a governing body usually meets about once or twice a year and its sessions often last for a very short period of time. In addition, the board is generally composed exclusively of family members who also act as managers and principal owners of the company (International Finance Corporation, 2008).

On the contrary, in the case of successful international FCBs, the board working style and quality attributes evolve and become more complex. In particular, the frequency and the length of the board meetings increase significantly. At the same time, the Board's knowledge about the activities

of the firm, its critical technology and its key weaknesses substantially increases, while directors show a great diversity in terms of industrial, functional and educational background (Pugliese, WenstØp, 2007). Non-family board members can also be considered a fundamental determinant of the international pathways taken by FCBs (Huse, 2007; Calabrò *et al.*, 2009). In fact, following the resource-based view, non-family board members represent a strategic resource for the firm, increasing knowledge and competencies represented on the board and giving to the governing body the opportunity to develop its advisory tasks (Bezemer *et al.*, 2007; Johnson *et al.*, 1996).

Figure 2 **BOARD'S FEATURES AFFECTING FIRMS INTERNATIONALIZATION PROCESS**



Source: Our adaptation from Pugliese, WenstØp (2007), Board members' contribution to strategic decision making in SMEs

In the next paragraph we test the theoretical assumptions outlined above through the medium of a case study involving CMD - Costruzioni Motori Diesel S.p.a. The board of directors of this Italian FCB characterized by an extremely high export propensity, is examined in order to assess the relationship between some board features and the effectiveness of the internationalisation strategies undertaken by small family-owned and managed firms.

### 3. The case of CMD: historical overview and analysis of the internationalisation strategies

The **CMD – Costruzioni Motori Diesel** (initially called FNM – **Fratelli Negri Macchine Diesel Sud**) is an Italian family business founded in Caserta (a town in the South of Italy) by the Negri brothers in 1971. The *FNM* core business was the design and development of innovative diesel engines for companies operating in the automotive industry. Thanks to the quality of its R&D activity, the *CMD* expanded very fast, increasing the range of its products and setting up extremely important partnerships with national and international automobiles manufacturers (such as the Italian *FIAT S.p.a.* and the Indian *Walchand-Nagar Industries Ltd*). In 1991, the R&D staff of the *FNM* was absorbed by the Newco *CMD*, and the second generation of the Negri family (the cousins Mariano Negri and Giorgio Negri) joined the company's founders, adding a new range of engineering services to the traditional production of automobile engines.

As of the present, the *CMD* is a dynamic engineering enterprise that offers a complete range of engineering services to the global transportation industry (marine, automotive and general aviations applications) in the design, prototyping and development of advanced gasoline and diesel engines. The *CMD* is also an internationally recognized leader in providing full engine integration and in-vehicle calibration services.

The *CMD* employs 98 people characterized by high levels of education (71.5% hold a bachelor or master degree) and a low average age (at 37). The *CMD* annual turnover is about €20 million and its total assets amount to €70 million. A breakdown of turnover by product shows that 19.5% of revenues come from sales of marine diesel engines, 1.5% from automobile engines and 79% through the provision of engine integration and in-vehicle calibration services.

A significant portion of the total sales is derived from exports. In fact, the *CMD* has always been characterized by a very strong international propensity, with a constant expansion over the last twenty years in sales offices around the world.

Figure 3 **CMD OVERSEAS SALES OFFICES**



(Source: CMD – Costruzioni Motori Diesel S.p.a. website).

- |                  |                 |         |                 |               |                      |
|------------------|-----------------|---------|-----------------|---------------|----------------------|
| • <b>America</b> | • <b>Europe</b> |         | • <b>Africa</b> | • <b>Asia</b> | • <b>Oceania</b>     |
| Argentina        | Cyprus          | Poland  | Morocco         | China         | Australia            |
| Greenland        | Coratia         | UK      | Tunisia         | India         | New                  |
| North America    | Denmark         | Romania |                 | Lebanon       | Caledonia            |
| USA              | Estonia         | Russia  |                 | Taiwan        | New Zealand          |
|                  | Finland         | Spain   |                 |               | Polynesia/<br>Tahiti |
|                  | FranceA         | Sweden  |                 |               |                      |
|                  | Greece          | Turkey  |                 |               |                      |
|                  | Latvia          | Ukraine |                 |               |                      |
|                  | Netherland      | Hungary |                 |               |                      |
|                  | Norway          |         |                 |               |                      |

More than 25% of total sales are realized in foreign markets with automobile engines in particular being widely sold outside the domestic market (85% of the sales).<sup>38</sup>

38 An indicator showing the strong international propensity of the company is also given by the high number of expos, organized all over the world, the CMD regularly participates (for example in Sydney, Helsinki, Dubai, Moscow, Ribex and Mumbai).

Table 1 **CMD BREAKDOWN OF SALES (Euro/000)**

	Domestic Sales		Foreign Sales		Total Sales	
		%		%		%
Marine Diesel Engines	2.145	55,0	1.755	45,0	3.900	19,5
Automobiles Engines	45	15,0	255	85,0	300	1,5
Engine Integrations	12.710	80,4	3.090	19,6	15.800	79,0
<b>Total Sales</b>	<b>14.900</b>	<b>74,5</b>	<b>5.100</b>	<b>25,5</b>	<b>20.000</b>	<b>100</b>

Source: CMD – Costruzioni Motori Diesel S.p.a. financial statement.

However, the export activity and the establishment of overseas offices do not reveal the whole story about the unique international strategic options undertaken by the CMD. In fact, in 2007 the company has started a partnership with an Italian engineering firm (*Fiat Powertrain S.p.a.*) to establish a manufacturing plant in China. With an investment of €1.4 million, the CMD has acquired the 34% of the equity capital of the Newco *Changsa Ximai Mechanical Construction CO. Ltd*, a company producing advanced electronic and mechanical components for automobiles and marine engines.

The purpose of this acquisition is twofold. On the one hand, it aims to exploit the advantages of low labour and raw material costs; moreover, it can also benefit of superior infrastructures. On the other hand, the choice to establish a manufacturing plant in China has also been driven by the idea that this was the most effective and efficient way to enter into this emerging market. In other terms, the acquisition of 34% equity interest in the Chinese Newco, far from being a simple way to reduce the operating costs, represents a long-term internationalisation strategy intended to deeply modify the organizational structure of the firm.

Notwithstanding the familial nature of the company, it is clear from the above description that the company displays an extremely high export propensity. An analysis of the firm's corporate governance system and, in particular, of the board of directors can help identify some determinants of such a successful international pathway. In fact, the board of the CMD displays some features consistent with those described by the academic literature as important variables affecting FCBs' international propensity, confirming the important role played by the governing body in the implementation of the internationalization strategies undertaken by the firms.

#### 4. An examination of the CMD's formal and informal governance mechanisms

The board of directors of the *CMD* is composed by four executive directors. Two members of the board (Dr. Mariano Negri and Mr. Giorgio Negri ) belong to the family that founded the company and together hold the 100% of the *CMD* equity capital. The Chairman (Professor Salvatore Antonio De Biasio ) and the fourth director (Dr. Mario Rosario Marsicano ) are non-family board members and do not possess any stock in *CMD*.

Table 2 **CMD BOARD OF DIRECTORS COMPOSITION**

<b>Prof. De Biasio S. A.</b>	Chairman/Executive Director	non-family member	0% of equity capital
<b>Dott. Negri M.</b>	Chief Executive Officer	family member	70% of equity capital
<b>Mr. Negri G.</b>	Executive Director	family member	30% of equity capital
<b>Dott. Marsicano M. R.</b>	Executive Director	non-family member	0% of equity capital

Source: *CMD – CMD – Costruzioni Motori Diesel S.p.a. Management Discussion & Analysis*.

An examination of the qualitative aspects and of the working style of the *CMD*'s Board through the lens of the resource-based view allows us to assess the fundamental role played by the governing body in the implementation of the successful internationalisation strategies undertaken by the company.<sup>39</sup>

First of all, the presence of non-family members sitting on the board not only enhances the monitoring activity of the governing body, but increases its competences and strengthens its networking functions. In fact, two non-family board members hold important positions in other firms and in the directive committees of domestic industrial associations, linking the organizations with its environment and securing the resources needed for survival. Moreover, the board members also represent different educational and cultural backgrounds (the Chairman is an applied physician, while the CEO Mariano Negri and the director Mario Rosario Marsicano hold degrees in economics), contributing their particular skills and expertise to the implementation of the company's strategic choices.

The working style of the board (given by the frequency and the length of the meetings) also displays some characteristics that are considered positively associated to the strategic involvement of the governing body. The board holds 6 formal meetings a year. In addition to these meetings, the directors routinely see each other once a week in informal

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The following information was the outcome of an interview held with the CEO Mariano Negri.

short meetings that offer a fundamental contribution to the strategic management of the firm. Although the informal meetings last no more than 30 minutes, their high frequency allows the directors to have an in-depth and up to the minute knowledge about the activities of the firm, letting them to carry out fundamental advisory tasks. Moreover, the high frequency of the board meetings can also be interpreted as an important indicator of a strong director's motivation to do a good job and to create a collaborative environment between him or her and the management of the firm. So doing, the board is not only the main actor promoting innovative international strategies, but also a fundamental player in the creation process of the new organizational routines useful to guarantee a sustainable competitive advantage.

This case study highlights the importance of family firms' governance mechanisms on the implementation of their internationalization strategy. In particular, it sheds light on the dynamics linking some board characteristics – frequency and length of its meetings, diversity and knowledge of its components – and the internationalization processes.

### Review Questions

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1. How do you define a family business? How do family-run businesses and large publicly listed companies differ in terms of corporate governance mechanisms?
2. What are the causes of the difficulties that family firms usually encounter in implementing successful internationalisation strategies?
3. According to the “resource-based view of the firm”, the board of directors is an internal source of competitive advantage that contributes to the international expansion of family businesses. Can you explain this assertion? How the “resource-based view” and the “agency perspective” differ with regards to the governance role assigned to the board of directors?
4. The case study analyzed in this chapter stresses the importance of a qualitative examination of family firms' governance mechanisms in order to appreciate their role in the implementation of an entity's strategies. What are the qualitative dimensions of the board of directors that need to be considered for a better understanding of the determinants of a successful internationalisation strategy?

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## 9

## **Building a Communication Platform: The use of a ‘Bricks and Mortar’ Model of Formal and Informal Communication in an Organisation**

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### *Abstract*

#### **Purpose**

The AWB Limited case study demonstrates the critical importance of an organisation’s leadership in the development of organisational culture, reputation management, crisis communication and change management.

#### **Design/Methodology**

As a case study, the crisis that engulfed the company AWB Limited was a very public and significant corporate scandal that provides a unique example of the role of a company’s leaders in responding to the challenges of a damaged corporate reputation and what is required to stem the damage and rebuild the standing of the organisation with key stakeholders.

#### **Findings**

The AWB scandal is a great example of a company initially mismanaging its crisis communication and reputation management strategies but also demonstrates what was required from the leaders of the company to fix that initial mistake as well as the underlying problems and causes of the problems that got the company into difficulty in the first place.

#### **Research**

The case study draws on the personal involvement of the author and the significant body of evidence presented to the Australian Government’s Royal Commission (The Cole Inquiry) into the dealings of the company, as well as its constitutional and governance reform process disclosed to shareholders.

#### **Practical implications**

The AWB case study provides a clear example of how to not respond to an emerging crisis and what is then required to get that strategy right.

### **Original value of the paper**

As the former Government Relations and then National Regulatory Affairs Manager for the company, the author can provide a practitioner's insight into the crucial role of the company's leaders in overcoming the significant negative impacts resulting from the corporate scandal.

*Keywords:* leadership, organisational culture, reputation management, crisis communication, change management, governance and reform.

### **Major Focus of the Case**

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It would be difficult to find anyone in Australia having even a passing interest in corporate governance issues who was not familiar with the kickback scandal involving AWB Limited ("AWB") wheat contracts with Iraq during the time of UN sanctions and the UN Oil-For-Food Programme. In Australian corporate history there have only a handful of companies that have been the subject of a Royal Commission. In Australian political history there have only been a few occasions when the Coalition partners of the Liberal Party and the rural National Party have split on an issue and voted en masse on opposite sides of the House of Representatives. The monopoly arrangements of Australia's 'single desk' bulk wheat export marketing arrangements in place since 1938 came to an end. AWB was the company responsible for these infamous achievements.

Yet the leaders at AWB were able to stave off precipitous legislative and regulatory action and undertake significant and genuine governance reform. The crisis created the necessary momentum for change as the leaders of the company responded to the political outrage and societal disquiet. This response was initially mishandled but with a new management team the company was able to effectively rebuild the reputation of the company, stabilize the value of the business and align the organisation with the external operating environment.

Within three years of the Royal Commission, and with over a dozen executives facing charges by the Australian Securities and Investments Commission (ASIC), the company obtained approval from the new wheat export regulator for an export license. This approval process included meeting the new 'fit and proper' test for companies and individuals seeking an export license. This was a significant hurdle for a discredited company. The 'fit and proper' test included an AFP National Police check on all executive officers.

## Introduction

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AWB was once a respected company, listed in the top 200 companies on the Australian Stock Exchange (“ASX”). The company was a legislated monopoly, controlling Australia’s overseas sales of around AU\$ 3.4 billion depending on the size of the crop and international market conditions. Australia is one of the world’s largest wheat exporters, accounting for over 15 percent of global wheat exports.

In January 1996, AWB’s share price was trading at a record high of \$6.41 but after the Volcker Inquiry on alleged corruption and fraud in the United Nations Oil-for-Food Programme in Iraq and the Cole Royal Commission in Australia, the share price fell to under \$2.38, all in less than 12 months. After 2008, the company was just one of many granted an export licence for wheat. AWB’s market share fell from a peak of about 70% of bulk wheat exports under the single desk monopoly arrangements to just 20% of wheat exports. During this time AWB not only faced the damaging impact of a shareholder class action but also class action in the United States, legal action against former employees, ongoing media criticism and an enormous campaign by other parties in the Australian grains industry to remove the monopoly arrangements.

The company initially tried to ride out the storm but in documents tendered to the Royal Commission, the company’s own external consultant lambasted the company for trying to dodge accountability and not doing enough; *“This whole list of facts reads to me like a one-sided effort to look as innocent as you can without actually lying. You are entitled to do that. It is a lawyerly thing to do. It might be the right thing to do if you think you are in legal trouble and need to argue your way out. Or it might be the right thing to do if you think you are being ethically criticised unfairly and are preparing to say you did nothing unethical and are the long-suffering, innocent victim of an unfair report from Volcker and unfair media coverage in Australia. It’s a terrible way to begin if you are seeking forgiveness for ethical misconduct that everyone pretty much knows wasn’t illegal ... It makes the reader want to find something illegal to get you for.”*

This initial response only inflamed the situation and did nothing to halt the political appetite for legislative reform to dismantle the long held monopoly position of the company. However, this initial mismanagement was a legacy of the old guard. Its failure triggered a change within the company and empowered the new leaders in the company to do things differently to better manage the crisis and prepare for the future. As a

result, the progressive leadership was able to halt precipitous legislative reform and the company encouraged an orderly transition over a number of harvests to allow time for the governance and commercial changes to take place within the company.

### What Changed

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Shortly after the fiasco of the initial apology, the CEO Andrew Lindberg resigned in early February 2006 and the Chairman of AWB Limited, Mr. Brendan Stewart, became Executive Chairman of the Company and appointed director Mr. Peter Polson as acting CEO. Mr. Stewart had earlier replaced the outgoing Chairman Trevor Flugge who was one of the central figures in the scandal.

After the failure of its initial response under the former CEO to adequately address the issue, the Board stated that it would take all necessary steps to protect AWB and to restore its reputation. It took the significant step in August 2006 of appointing a new CEO Gordon Davis, based on his proven strengths in cultural change and business restructuring and integration, abilities which the company stated were essential in a top executive and invaluable in developing the future strategy for AWB.

Mr. Davis developed a new senior management team, including former NAB executive Robert Hadler as head of corporate affairs. Shortly after then the author was recruited as Government Relations and Trade Advocacy Manager. This was reported by the senior Canberra political reporter Michelle Grattan as “AWB, back against the wall, has assembled an A-team to help it argue it has turned over a new leaf and should be given another chance” (SMH, 29/11/2006).

In addition to the Chairman Brendan Stewart, these reforms were strongly endorsed and supported by the ‘commercial or non-grower directors on the Board, namely Peter Polson, Tony Howarth, John Schmoll and Fred Grimwade but not by some of the grower directors who spoke out against the reforms and tried to return to the old ‘single desk’ and keep intact the company’s structures aligned with the old arrangements, such as the dual share ownership and the A-class grower shares.

In its response to the Royal Commission findings the company made it clear that under the new CEO it had embarked on a cultural change program to develop and commit to a set of values to guide employees in interactions with stakeholders and with each other. The company stated that “We will ensure that these values and behaviours will be integral in all of our people management processes – performance management, feedback, reward and recognition, recruitment, promotions and training.”

### What Had To Change

In December 2006 the government moved swiftly via the Wheat Marketing Amendment Bill 2006 to begin to dismantle the 'single desk', thereby altering the commercial operating environment for AWB. This was only a partial repeal of the 'single desk' but the old monopoly arrangements were on the way out and the company was under attack from both sides of the political fence. To use Kotter's analogy, the old platform was well and truly alight, the ships were on fire on the beach and there was no going back.

By that time, the company was fully aware of the damage that had been done and that the landscape had fundamentally and irrevocably shifted, with Chairman stating in a press conference that "Our reputation has been shattered by the events of the past year."

Making the transition even harder was that AWB had spent considerable time, money and effort in defending the single desk wheat marketing arrangements. As a result, it had developed both a culture of resistance to change and hostility to accusations of wrongdoing associated with not just the single desk but any and all commercial activities. The 'single desk' wheat marketing arrangements had also been designed and built to withstand any attempts by pro-competition advocates and other critics of the monopoly arrangements. However nobody could have predicted an impact of the magnitude of the UN 'oil-for-food' scandal and not even the legislative arrangements, with the vocal support of the Australian National Party and the double-entrenched provisions of the company's constitution, could delay the inevitable.

The new management team had to achieve an orderly transition that cushioned the commercial impact of the reform. This required some rapid to the damaged reputation of the company with key government, media, regulatory and financial stakeholders. The company was caught in the middle of the single desk defenders who wouldn't let the company move forward and the opponents who wouldn't let it go back (although the latter at least provided Kotter's burning platform for radical change). The only way was to move forward and to adapt but that would be no easy task.

### What Was Done to Change

In its initial response to the findings of the Volcker Inquiry, the company had continued to defend the indefensible but all that changed with the Royal Commission and the legislative changes supported across the political spectrum to dismantle the company's monopoly position.

Unlike its previous responses to the scandal, the statement drafted by the new management team and released by the new Chairman made it clear that the Board deeply regretted how the company had behaved and the damage to Australia's trade reputation. The inclusion of the term 'deep regret' had taken some time to get past legal and some of the old guard within the organisation.

The Chairman and the Board showed clear contrition by stating that the board ultimately accepted responsibility for what happened and that it was committed to making significant changes to make sure that it never happened again. This not only sent a clear signal to external stakeholders, it empowered the new CEO and management to make meaningful changes and provided a starting point for rebuilding the company's reputation.

The new CEO made it clear that the world was changing and that the company needed to not only adapt but to be involved in developing that new direction if it was to have any hope of salvaging anything from the wreckage. The progressive leadership inside the company was able to stabilize the situation and ameliorate the commercial impact by quickly repairing the reputation and thereby the influence of the company with key stakeholders such as government. This would entail a clear reversal of what Commissioner Cole and others had described as an obstructionist and dismissive initial response to the mounting evidence of wrongdoing inside the company.

The clear direction from the new CEO was that the wheat marketing arrangements were a matter for the government and that the monopoly of the single desk wheat marketing system was a 'gift of government.' In this way, he began to alter the culture of the organisation and to prepare for significant governance and organisational change. The CEO also made practical but important symbolic gestures such as refusing to refer to the Royal Commission as the 'Cole Inquiry' in recognition that such a reference de-emphasised the seriousness of the situation. In addition, such the inappropriate personalisation of the term suggested that an individual rather than government was conducting the investigation.

The success of the reformers within the company and in key constituencies in portraying the opponents of internal change as being out of step with the changing external environment allowed them to breach the supposedly impenetrable defenses of the defensively aligned monopoly wheat marketing arrangements and corporate structure of the company. AWB management made it clear to growers that governance reform was required to align with regulatory reform. If agri-political activists

continued to use AWB as a platform to defend the old Single Desk then the company's competitors would gain a competitive advantage by ensuring that the company was lumbered with the convoluted artifices of a 'single desk' in what was to become an open competitive market.

### The Results of Change

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Within three years the same company that had been the subject of a Royal Commission had been approved by the new wheat export regulator for an export license, which included the new 'fit and proper' test for companies and individuals seeking an export license. It may not have been fully welcomed back into the fold and the loss of the monopoly wheat marketing arrangements had meant that the company had a fundamentally different business model to the one that it enjoyed prior to the scandal.

### Governance Reform

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The proposed restructure covered both the commercial arrangements and fundamental governance reform to align with the anticipated regulatory reforms. Under the proposed constitutional changes, the dual share ownership structure would be removed and there would be no more grower control of the company's board. The company would be required to remain a grain marketer and there would be 10 per cent shareholding limit and the removal of class distinction between investors.

Both of these were subsequently addressed when shareholders voted to accept the take-over offer in 2010 from the Canadian company Agrium but in 2007 and 2008 the company was faced a split Board, with grower directors actively campaigning against governance reform. In response the pro-reform management made public that a majority of AWB directors elected by both A-class and B-class shareholders supported the proposed amendments, but four directors elected by A-class shareholders did not.

At the AGM in February 2008, the 'A-class' or grower shareholders of AWB failed to support a resolution to scrap the dual-class share structure. Although approximately 63% of A-class shareholders voted in favour of the resolution and when A-class and B-class shareholders voted together, the resolution gained support from about 88%, the constitution required 75% support of the A-class shareholders to succeed. The fathers of the AWB constitution and the architects of the single desk had made it almost impossible to reform the governance arrangements and the dual class share class arrangements were set up so as to be impervious to change from within.

The meeting resumed on September 3 and that day the company announced that in a second vote 77 per cent of votes cast by 'A class' shareholders were in favour of the reform resolution proposed by the majority of the Board and therefore the yes vote had exceeded the 75 per cent threshold of A-class shareholders in the AWB Constitution required to implement governance reform.

### Regulatory Compliance

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The new wheat marketing arrangements included the continuous monitoring of exporters and the requirement for exporters to inform the regulator of a 'notifiable matter' in line with ASIC's continuous disclosure requirements. The 'fit and proper' test included an AFP National Police check on all executive officers, while the application forms of the regulator Wheat Exports Australia ("WEA") required significant details on policies and procedures as well as any special conditions that the regulator seeks to impose. The specific conditions for meeting the 'fit and proper' test as set out in the regulation include offences anywhere in the world relating to dishonest conduct, the conduct of business, breaches of the Corporations Act 2001 or the Competition and Consumer Act 2010.

The company was able to rebuild a level of trust with key regulators. An indicator of the effectiveness of the new approach is that in 2008 the company was able to work with Austrade and the Department of Foreign Affairs and Trade ("DFAT") on the resolution of outstanding commercial debts with the Government of Iraq. AWB was able to resolve this dispute at a meeting with a delegation from the Grains Board of Iraq facilitated by Austrade in their offices in Amman, Jordan.

Under the clear and strong direction of its leaders, the company had embarked on a self-help program of removing the constitutional artifices within the company of the old 'single desk' at the same time as the government set about dismantling the legislative and regulatory structures of the monopoly, thereby not only preparing the company for the new arrangements but ensuring that it could have a say in what that new external operating environment would look like for the company. Through genuine governance reform and reputation management the company rehabilitated itself to the extent that it could play a role in the public policy development and legislative processes.

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### Discussion Questions

Once the scandal broke, how could the company have better managed its response?

Does organisational change require a 'burning platform'?

Is it better to apologise up front and early?

How important is corporate culture to reputation?

Should AWB have followed the advice of the external consultant?

Did the lawyers over 'legalise' the company's response and how should leaders balance this advice?

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### Key Leadership Lessons

This reputational as opposed to the financial turn-around was possible because of the actions taken by the Board and the CEO.

How a company is perceived by its constituencies is the result of how an organisation sees itself and how an entity is perceived based on what a company stands for.

Public apologies and demonstrations of genuine contrition are critical for effective crisis and reputation management.

AWB initially tried to obfuscate on genuine reform and to try and 'manage' through the initial crisis.

A burning platform is unfortunately often required for genuine reform.

When the game changes, so must the play book.

## Suggested Reading for Further Insights

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## 10

**Permo-Drive: Governance under Innovation***Jerry Courvisanos & Angela Hipwell*

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*Abstract:* Permo-Drive Technologies Limited is a small public company, based on the north-east coast of Australia, that made the first functional Regenerative Drive System (RDS) for motor vehicles. The RDS technology captures energy expended in braking the vehicle, and then applying this energy to assist moving the vehicle when required from stoppages and on steep inclines. Permo-Drive created this intelligent hybrid hydraulic system for vehicles leading to savings in fuel and therefore reductions in carbon emissions and other pollutants. RDS is a significant ecologically sustainable technology which as at 2011 has become a mainstream ecological technology to the extent that the Toyota Prius model has been promoted with three energy sources; petrol, electricity and regenerative drive.

In *The Weekend Australian Magazine* on the 5th July 2003, an article on Permo-Drive called “Oily Rages to Riches”, lauded the innovation in this technology and predicted an exciting future with the US Army at that time keen to retrofit all its trucks with the RDS technology. As of 2011, Permo-Drive is still struggling to make a mark in the business world, having gone through many trials of survival related to plethora of governance issues including legal (patents and bankruptcy), management, marketing, financial, regional development, and public innovation support. What went wrong? This is the question that this study aims to explain, using a specific technology commercialisation of innovation model set up by V.K. Jolly in the book *Commercializing New Technologies: Getting from mind to market* (1997).

From a two-man private innovation company, Permo-Drive went on to be a small private company with a large shareholding list of many “mums and dads” who bought into the idea with \$3 million of shares at shopping malls, clubs and schools on the north coast of NSW. Then, Permo-Drive

morphed into a broad-based public stock company with an international management team. The road to realising a commercial return on this innovation has been very bumpy with an uncertain end; a process that has also had significant implications for governance of the company. More than anything, it reveals just how tenuous and uncertain the innovation process can be.

## 1. Introduction

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Permo-Drive Technologies Limited (called “Permo-Drive” for short) is a small innovative public company, based on the north-east coast of Australia, that went from early massive entrepreneurial promise to a tenuous existence, having failed to succeed in commercialising its innovation. Governance under innovation failed. This is its story.

In the late 1990s, Permo-Drive was the first in the world to develop an ecologically sustainable scientific invention first developed in the 1940s, into a useful practical innovation called Regenerative Drive System (RDS). The company incubated and then developed the innovation so that it could be retrofitted onto any existing motor vehicle. However, the commercialisation process failed at this stage. This case study aims to explain why.

In the book *Commercializing New Technologies: Getting from mind to market*, V.K. Jolly provides a framework to show how technology commercialisation is carried out (Jolly, 1997). The framework as depicted in Appendix A consists of five key sub-process “stages” and four mobilisation resource “bridges” between each stage. Notice two crucial differences between the Jolly framework and the standard linear commercialisation process framework from basic research, applied research, development and then marketing. The Jolly framework is complex with feedback and lock-in, which means that with lack of mobilisation, an innovation gets locked into spinning around the same stage or even slipping backwards for redraft. Also the Jolly framework is overlapping, indicating that organisations can be working on aspects of two stages that are linked as if by a Venn diagram. The nine activities in the Jolly framework aim to take technical advantage and market insight through to successful commercialisation. In short, this framework identifies how entrepreneurs need to have the capacity, or to complement their capacity by engaging others, to bring forward the innovation from “mind to market” (Jolly, 1997, p. xix).

This case study first attempts to find the connections between the ideals put forward by Jolly in order to “successfully” commercialise a new technology and the complicated reality faced by Permo-Drive’s inventors

Mick Perry and Allan Rush in developing the first functional RDS for motor vehicles. This complicated reality is something they both ignored or could not foresee, and for this reason they are “inventors” and not “innovators”.

The second overarching feature reflected in this case study is the issue of governance in innovation which unfolded in a disorganised manner leading to further difficulties for the inventors, managers and consequently the shareholders. In meeting contractual obligations for production, Permo-Drive signed up Dana Corporation in the USA, providing Dana with exclusive access to all intellectual property on the innovation. Dana then filed in the USA for Chapter 11 bankruptcy which led to the sale of Dana’s core units, including the RDS technology to a rival competitor – the huge German based company Bosch. At the time, Permo-Drive protested to the sale stating this “violates public policy by eliminating competition to develop technology in this arena.” (CorpGreen, 2011)

This case highlights the blind faith that Rush and Perry had in their ability to commercialise their innovation and the problems in corporate governance of the “principal-agent model” as outlined in Marnet (2008). Maintaining traditional “down-home country values” with implied personal obligations to their shareholders, Rush and Perry assumed that the interests of their agents were aligned with those of their own, supported by Corporate Governance Conventions and the legal system. Further to this issue are underlying patterns of behaviour in the exploitation of an opportunity that raise issues of corporate governance. Are there checks in place to assist and protect companies such as Permo-Drive in commercialising innovations?

Permo-Drive as a public company left Rush and Perry behind, reinvented itself and is still “in business” as the case study is being written. However, the company faces competition from other manufacturers of similar DRS which are being fitted to new vehicles like the Toyota Prius, as well as retrofitting. No longer does Permo-Drive have a unique opportunity, nor does it have its two founding inventors. From this case study, lessons can be drawn on managing innovative opportunities in respect to the “successful” commercial implementation, in conjunction with a lack of comprehensive corporate governance that can befall such new enterprises.

## Case Report

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There is a distinct difference in the mindset of the inventor to that of the entrepreneur. The inventor is creating or developing new product or process “ideas”, but as Jolly (1997, p. 5) states “...ideas come cheap, there are so many generated all the time, all clamoring for attention...”; whereas, “...an entrepreneur [is] a person who habitually creates and innovates to build something of recognised value around perceived opportunities” (Frederick and Kurakto, 2010, p 40). Figure 1-1 (in Appendix A) from Jolly (1997, p. 4) is the commercialisation process framework that is adopted to analyse the issues raised in this case study. The Permo-Drive story unfolds through the first six activities of the Jolly framework as presented below. Permo-Drive have not been able to negotiate the last three activities (labelled numbers 7, 8 and 9) due to the failures referred to in the introduction.

### *Imagining*

The two founders (Allan Rush and Mick Perry) took the approach of identifying a PITA (“pain in the arse”) product. Indeed their research was characterised by the primary goal of solving the problem of whether it was possible to save and use for fuel saving purposes the massive energy generated and dissipated where a fast-moving truck braked.

According to the entrepreneurial principles set out by Frederick and Kuratko (2010, p. 163), the initial “creative thinking process” by truck driver Perry is almost an exemplar. The imagining period extended over seven years during the 1990s whilst Perry spent his time as a truckie “... pushing big rigs up and down the Pacific Highway between Brisbane and Sydney” (Safe, 2003, p. 26). Further, Perry consulted with mechanic Rush who approached the problem from “...the driver and mechanic’s point of view” (Safe, 2003, p. 26). Together they accumulated knowledge and formulated various versions until they developed a prototype that could be taken through the commercialisation process for evaluation and (hopefully) implementation. To begin this path, the two had “academics” document the details, clarifying the prototype was theoretically feasible. They were confident that their design was feasible. The feedback from the academics served as “proof of principle”, alluding to the potential of the product to be technically able to save braking energy and use this stored energy for future motion.

With their practical experience to draw on, the founders were also convinced of its market potential. This “aha” reinforced the drive and desire to move forward and commence the commercialisation process, a process described by Jolly (1997, p. 48), as a wilful act, involving a “techno-

market' combination. Here this dual insight of technology and market was in place. Having an appreciation for the dilemma of existing vehicles with no RDS, Rush and Perry set about designing a "bolt on" system which meant the RDS could be retrofitted on any truck. "Well, we're going to make this work the way we want it to, says Perry" (Safe, 2003, p. 27), and so the experimentation process through prototyping commenced. The "cross-pollination" of ideas with local electrician Colin Kerr saw the first unit – although still much too big – achieve "...20 percent fuel savings straight away" (Safe, 2003, p. 27).

Rush and Perry demonstrated all the 'typical' entrepreneurial characteristics at this imagining stage; being motivated, "aggressive and determined" along with a high degree of risk bearing activity. "He doesn't see problems - only solutions." (Safe, 2003, p. 27) Overall, they displayed a positive attitude to the innovation, with the "can do" approach. "Jeez, you've got to have a lot of tenacity for this stuff" said Perry (Safe, 2003, p. 26). The formal creativity techniques such as brainstorming and a strong insight into the market served as a spring board, along with the capacity to engineer and the flexibility for informal "skunkworks" methodology over time.

"The basic technology to do it was already out there with pumps, accumulators and electronics...Combine the three and it could work" (Safe, 2003, p. 26) was Perry's view at the imagining stage. The product appeared to evolve as a synthesis of these three components, ultimately creating a practical system with the potential to change the truck market. Perry had the technical ability and understanding, as well as being able to identify the need in the marketplace. The idea itself was aligned with the notion of "technological breakthrough" and with the probability of market opportunity (Jolly, 1997, p. 3). To this extent governance was ad hoc in this stage. The role of Perry in eliciting support from Rush, Kerr and "academics" was the perfect, if simple process that adequately met the need to negotiate this first stage of the commercialisation process. There was no corporation and no complex business issues to negotiate. Such ad hoc behaviour can not serve well in more commercially complex stages of commercialisation.

### ***Mobilising Interest and Endorsement***

To "cross the bridge" between imagining and incubation requires the mobilising of commercial interest and business endorsement. Clearly the ad hoc strategic planning undertaken by Perry and Rush during the imagining stage lacked foresight, particularly in relation to securing investors and funds to support the further development of the product

through the more complex incubating and demonstrating stages. They chose to “climb over” each financial hurdle as it arose. As a result, the Permo-Drive RDS concept “spun” around the imagining stage for seven years, at the crucial time when the two inventors were well ahead of anyone else in practical application of the scientific idea.

Rush and Perry were convinced of the commercial value of their product but used only their own financial resources in these early stages of development. This is poor governance for innovation. Only an entrepreneurial business plan as detailed in Frederick and Kuratko (2010) would enable an innovator to argue effectively for interest in the commercial success of the product (outside the small coterie of the innovator’s close allies), and for endorsement by supporting funds (outside the small amounts available from the innovator’s “own funds”).

Jolly suggests the incentive for investors as being market potential verses technical merit (Jolly, 1997, p. 6). According to Max Bosotti, the corporate managing director hired by Perry and Rush to market the technology, the RDS product exemplified both of these qualities. Optimistically, Bosotti was brought into the firm for his perceived ability to sell the technology to the world. (Safe, 2003, p. 26) However, Bosotti was unable to put a value on the “triple breakthrough” technology. Struggling to get the support of venture capitalists and government, in 1999 a lack of capital led the newly formed corporation to convince the locals of Ballina, NSW, as to the value of being a shareholder. Perry and Rush were known as hard working locals and a functioning prototype served to dispel any scepticism and entice the “mums and dads” to invest. As Jolly (1997, p. 6) notes: “Some stakeholders place greater importance on ideas’ technical merit, while others are more attracted to their market potential.” Similarly Permo-Drive brought in business development expert Greg Beaver to assist. Beaver relied on the potential shareholders’ “perception” of technical merit and market potential to entice \$1 million from one asset manager and small amounts from Saturday morning Ballina shoppers (Safe, 2003, p. 27). This enabled Permo-Drive to be floated as a corporation, with the first set of board members installed. Garnering interest from the US Army provided the other mobilising element. Thus, this bridge was also negotiated in an ad hoc manner, but now as a corporation real governance was required to successfully commercialise the invention.

### ***Incubating***

The incubating stage began for the new corporation with a signing of an R&D agreement in early 2003. Under this agreement, the US Army would commence an evaluation of the retro-fitted RDS device with a

view to installation in its complete fleet of Family of Medium Tactical Vehicles (FMTV). This testing process, led by the US Army, amended the initial research to improve the capabilities of the technology by 35 per cent acceleration as well as proving its energy savings. Jolly (1997, p. 90) identifies this phase as the shift from crossing a functional threshold to multi-environmental demonstration, where the technology is tested under real world conditions. It is possible at this point to identify the transition of an innovation from “science” to “technology”.

Another component of the incubating stage is the patenting of the innovation. As Jolly states: “In science, the credit goes to the man who convinces the world, not to the man from whom the idea first came” (Jolly, 1997, p. 58). The patent protects the entrepreneur’s plans along with the assumptions of any the competitors’ potential to copy or match. The issue being: When to patent? In order for the Perry and Rush, to protect their intellectual property and actualise their investment through returns from such property (e.g. royalties on license), the innovation needs to be patented. Clearly the two did not see this as a significant strategy to protect their investment and the interest of the shareholders. As the Landline TV program in November 2003 noted, at the height of expectations with the US Army deal and with the value of the shares grown ten-fold, the issue of patenting became crucial. However the company had no funds for the expensive patenting process, so the two investors were contacted with an urgent request to place \$10,000 into the bank account by 5pm on a Friday to ensure the patent was certified (ABC, 2003). This highlighted not only the excitement of returns, but also the chaotic governance process at work. The exciting potential just got them through at this stage.

As the company became corporatised, both Rush and Perry moved on from their original roles as the founders and drivers of Permo-Drive. Although they retained shares in the company, Perry states that “[t]he challenge for him was making the technology work not refining it. He was already involved in another innovation...” (Safe, 2003, p. 27). Like many inventors, Perry highlights the driving motivation as finding a solution to a problem. The point of recognition is the validation of the solution. The complexity involved in commercialising the idea and the role of governance in this process does not provide the same ‘sexy’ appeal but is instead a rather tedious process which could be better managed by others. The issue in corporate governance as indicated in the Permo-Drive story at this incubating stage is that, in the process of gaining recognition, the important building blocks for further success may not be well planned, and the ad hoc process in place can undermine long-term success.

### ***Mobilising Resources for Demonstrating***

Jolly (1997) explains that mobilising resources for the demonstrating stage is very difficult. The demonstrating stage is where the product gets endlessly tested, retested and modified to meet strict technical, environmental, health, and safety regulations. This needs much expensive trialling and is the most costly stage of commercialisation. By late 2003, Permo-Drive had entered this stage, but lacked necessary funding to carry it through. As noted above, just funding the application for a patent was difficult. Despite the interest of the US Army, two problems emerged that caused difficulty in mobilising resources. One was the long and very time consuming stringent tests required by the Army in evaluating the product, this delays any quick returns for investors, and raised some uncertainty (despite all the media “puff pieces” in 2003 to try and gain investor support). The other was the need to secure a partner in the USA to manufacture, if and when the US Army placed an order for retrofitting more than 246,000 trucks. There was no way the small Ballina company could gear up quickly with the size of capital equipment needed for investment to produce that many units of the product.

As far as the researchers can identify, there is no evidence of an entrepreneurial business plan or even some basic proposal with specific direction for Permo-Drive when it was attempting to enter the demonstrating stage in late 2003. Equally, communication with potential shareholders was predominantly limited to the media, through articles and radio publicity. This is a governance problem that can be attributed to the perspective of the founders, who were technical problem solvers but not commercialising problem solvers. Still, the central Permo-Drive actors Allan Rush and Greg Beaver who appeared in the ABC Landline program in November 2003, looked for other explanations for their inability to secure resources for demonstrating. In the transcript, Greg Beaver blames the venture capitalist in Australia for unwillingness to invest in regional and rural Australia. Beaver goes on to say:

*But to try to get physical money was very, very hard. We actually went out to venture capitalists, we went out to financial institutions, we went to standard lending banks to see if we could do something and we were too far away from them. Basically they needed to see us have customers, have a manufacturing base before they were willing to put money in. They thought the idea was good, everybody thought the idea had potential, but no-one was willing to back it with any sort of dollars.*

How did Permo-Drive gain the funding? As noted before, at the floating of the company Greg Beaver took a year off to raise money across Ballina and the North Coast. This included selling small bundles of shares at shopping centres, golf clubs and community clubs. This secured \$5 million. For the demonstrating stage, Beaver also managed to gain \$1 million from the non-Australian Deutsche Bank as well as some money through a few local, state and federal government grants.

### ***Demonstrating***

With the prototype in place, and Rush and Perry now only loosely identified with Permo-Drive, it was now necessary that the product have relevance to the market. At this point assessments are made on the attributes of the product, evaluating the hypothetical need for demand in fabricating a “good design”. The actual design that often emerges from this is one that addresses the critical variable of market price, which establishes the target customer and the market segment. “We knew if we went to a manufacturer and said, ‘We’ve got his great idea, but you’ve got to redesign your truck’ we wouldn’t have a show in hell.” (Safe, 2003, p. 27) The bolt-on configuration developed gave the RDS product manufacturing process appeal for a US multi-national company such as Dana Corporation with large manufacturing facilities.

Permo-Drive formed a strategic alliance with Dana Corporation to build the device for the US Army in America. This could be considered a major turning point as the arrangement saw Dana Corporation producing the product in the Detroit, USA on behalf of Permo-Drive.

*Dana Corp. of Toledo, Ohio, and Permo-Drive Technologies Ltd., an Australian firm with North American operations in Ann Arbor, Michigan, have an exclusive licensing agreement for the design, development, and supply of the Permo-Drive Regenerative Drive System (RDS) for use in the U.S. Army’s Family of Medium Tactical Vehicles. The Army will introduce a hybrid drive system into its FMTVs as soon as 2006. (BNET, 2004)*

At this stage Dana was considered to be a reputable company with a large market share in the manufacture of axles, drive-shafts, off-highway transmissions, sealing and thermal-management products, and service parts. This alliance seemed to be a viable strategic manoeuvre for Permo-Drive. Reflecting on how personal behaviour should be guided by principles of good corporate governance, it should be possible to suggest the “hand over” to Dana implicitly incorporated obligations on its part should the venture fail. In addition, it also raises issues of how a company

in the situation of Permo-Drive that invested so much, could realistically withdraw from the arrangement if things start to go awry. Marnet (2008, p. 102) in a review of the literature notes that: “Escalation of commitment has been investigated as ‘entrapment’.” For Permo-Drive there was the dilemma of “too much invested to quit” and “throwing good money after bad” (Marnet, 2008, p. 102). The company had gotten this far and Dana was seen as the means of realising its investment in demonstrating and eventually full blown manufacture. Despite this alliance, however, the deal appeared to have no performance measures or verification to compliance of any contracts between Permo-Drive and Dana. It did not help that both were waiting for the US Army demonstrating stage to lead to clear orders for manufacture.

### ***Mobilising Market Constituents***

Mobilising the market constituents relies heavily on the cohesion between the agents to see the innovation through to the marketplace. Unlike entrepreneur-inventor Thomas Edison, who took his innovation of the burning filament through to commercialisation with the development of the Electric Light Company (Jehl, 1937, p. 169), Rush and Perry backed away from the formal business and handed over corporate governance to the new board and executive of Permo-Drive. Similarly, this is the point at which this example deviates from the textbook formula provided by Jolly (1997), raising issues in regards to corporate governance and the overall management of the company.

Corporate governance literature identifies the central problem of separation of ownership and control in the modern corporation. To connect these separate entities, Marnet (2008, p. 13) refers to the large body of research on agency theory and its influence on governance to maintain that an agent’s behaviour is determined by the “contract” between him/her and the principal. Such a “contract” can involve a trade-off between ethics and profits. Under such a model, shareholders, directors and the executive (CEO etc.) each bear varying degrees of risk. Whereas in the earlier stages this was a problem between Perry and Rush as the ad hoc controllers of the innovative enterprise and shareholders who were coming into the company via streets, malls and clubs; at the stage of mobilising market support, the problem was different when it came to Dana. In an alliance situation, a contracted manufacturer such as Dana rarely bears the same risk as the owners of the intellectual property. The executive of Permo-Drive as controllers saw Dana as the means of entry into the US market place but the shareholders were increasingly being distanced by

the decisions occurring in far-off USA, a long way away from sleepy little Ballina. This is where it goes very wrong.

Where did things go wrong?

*In corporate governance, the conflicts of interest of greatest concern are those between executive management (the insiders) and all parties who have a stake in the firm (the outsiders). These outsiders include shareholders and other providers of capital, but also employees, customers, suppliers, and other stakeholders. (Marnet, 2008, p. 14)*

The unforeseen circumstance (to Permo-Drive) of Dana Corporation filing for Chapter 11 Bankruptcy protection proved to be the first step in the decline of Permo-Drive. “Dana...filed for bankruptcy in March 2006 amid pressure from big car makers to sell parts at lower prices. Dana employs about 35,000 people in 26 countries.” (The Age, 2007) As part of the Chapter 11 proceedings, Dana sold its Intelligent Hydraulic Drive business (the division which held and managed the Permo-Drive licence) to the giant German automotive parts company, Bosch Rexroth. This led to issues around the ownership of intellectual property (IP). Dana claimed compensation from Permo-Drive for RDS hardware and components that they claimed were provided by Dana as part of the Army’s FMTV evaluation project. Permo-Drive countered with its own compensation claim in the US bankruptcy court for damages incurred due to Dana’s breach of contract (Permo-Drive Technologies, 2006, p. 11). The interests of the original founders and the organisation funding the demonstrating stage also clearly came into conflict. As John Thompson, then Managing Director of Permo-Drive, stated in private communication on 13 May 2008:

*The results of demonstration are owned, at least in part, by the funding body. They are free to make use of this to advertise the results in the general marketplace, which allows competitors to come in at the tender stage and bid for any resulting sales. (Thompson, 2008)*

Following changes in the board in 2006 that were led by Chairman Garry Davis (the second set of directors installed) and after incurring huge financial losses, Permo-Drive seemed optimistic again in 2007. Evidence of this persistent optimism can be seen in the 2007 Annual Report:

*The events surrounding the bankruptcy protection measures of Permo-Drive’s North American licensee, Dana Corporation, are now behind us. Negotiations are in progress to resolve our claim*

*for breach of contract and related matters regarding ownership of IP. We expect a favourable and realistic outcome to be concluded shortly. The Company has altered its primary commercialisation strategy from that of licensing its Intellectual Property to Tier 1 automotive companies, to one of direct supply to users on a Collaborative Manufacturing basis. Supporting strategies are to continue our relationship with the U.S. Army and licence production for this and other niche regional opportunities. (p. 4)*

However, what resulted were expensive court proceedings without a favourable conclusion for Permo-Drive. Disappointingly, the long time-lag in the commercialisation process, in conjunction with the IP issues, left the global market wide open to competitors. Dana's financial complications led to the takeover of the company and the prospect of successful competitors entering the market, utilising Permo-Drive's knowhow.

*Earlier this month, Dana and Bosch Rexroth announced plans to form a 50-50 joint venture to co-develop and manufacture advanced drive transmissions for the off-highway market...the planned joint venture company is expected to operate in Arco, Italy. Dana and Bosch Rexroth will contribute staff, intellectual property, and capital to the new joint-venture company, which will engineer, manufacture, and market hydro-mechanical variable powersplit transmission systems (HVT) for the global off-highway markets. (Official Journal of the European Union, 2011)*

This situation is in contradistinction to the earlier stages of commercialisation when Permo-Drive did not appear to have any competition. At that stage the big automotive companies had not been able to manipulate the technology to their advantage, and no similar product was available.

### Governance issues

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Governance issues arise during Permo-Drive's attempts at commercialisation when it lacked necessary internal and external mechanisms to ensure proper processes that would achieve "production supported sales" (Thompson, 2008). Early on in an effort to maintain ongoing funding requirements, Rush and Perry sought assistance from both government and venture capitalists. Being based in a small regional town in Australia, these two unknown inventors attempted to use the media to "drum up" enthusiasm for the invention. Perry expressed their frustration of the venture capitalists, suggesting: "There is no such thing –

it's bullshit." (Safe, 2003, p. 27) Their personal appeals to venture capitalists failed as the perceived risk compared to return on investment was too great, and the potential was not seen by investors in the same light as it was by the inventors. This is the point with which a strategic plan would have been valuable. The inventors identified their lack of interest in the business detail as not in their areas of expertise.

Once the venture attracted interest from the US Army, the Australian Government appeared to endorse the potential project. "Mr. Macfarlane [then Minister for Industry, Tourism and Resources] said Permo-Drive had benefited from Federal Government support, including a \$920,000 AusIndustry R&D Start grant in 2000. 'This is the perfect example of how well-targeted government assistance can reap major benefits,' he said" (Anderson and Macfarlane, 2003). By this stage, the two inventors had sold off most of their equity and Permo-Drive could not afford the demonstrating stage with the US Army. A second team of directors "drove" Permo-Drive into the IP jungle of Dana.

Following the complications from Dana's Chapter 11 bankruptcy, the Australian Government accordingly withdrew its support. As Permo-Drive noted:

*The action of the Federal Government in withdrawing the Commercial Ready Grant scheme as a cost saving measure in this year's Federal Budget had a significant effect...the opportunity to claim up to \$5 million in Government assistance under the program." (Permo-Drive, 2008)*

Once the financial complications became public, the venture lacked shareholder appeal. "These, and more, factors may hide an impending corporate disaster from the eyes of the actors nearest to the events, as well as from the eyes of interested parties until after the facts become public knowledge." (Marnet, 2008, p. 9) By this time Rush and Perry no longer had control over the production of the innovation or over the IP. As the business began to fail there was very little mention of the "mum and dad" investors who backed the scheme from the start, and were the original risk bearers.

A third set of directors came into Permo-Drive in August 2008 after the company was voluntarily wound-up on the 12th June 2008 (Permo-Drive, 2008). The new Chairman (Trevor Dunn) announced a financial restructuring of the company and gained (again) the nominal support of the local members of parliaments – both state and federal. The press release goes on to criticise the previous management team for poor governance:

*We intend to run a lean and focused company dedicated to ensuring the success of the RDS, Trevor Dunn said. Gone are the days of champagne lunches or expensive hotels and hire cars for company executives and we have also secured a better lease of 10,000 sq m of space which will allow us plenty of room for expansion. (Dunn, 2008)*

Despite this third wave of optimism, the researchers have been able to track only minimal evidence of activity by Permo-Drive since this press release. a puzzling “Welcome back after such a long time in the wilderness” notice placed on the Permo-Drive website on 11th March 2010, described as the “first report of the new Management” installed back in August 2008 (Permo-Drive, 2010). A few days later on 30th March 2010, a local newspaper article appeared reporting tests of RDS by Toll/Ipec on its “demanding” Northern River’s delivery route with the data yet to be analysed (Weekes, 2010). No further information on a static website, nor any further press releases or puff pieces in newspapers can be found. Phone calls to the company phone number went unanswered.

## Conclusion

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What could have initially been considered a significant innovative opportunity by the Permo-Drive founders in the mid-1990s, both in terms of vehicle efficiency and ecological sustainability, fell over due to persistent problems in getting the innovation to market. By late 2011, Permo-Drive is nowhere to be seen, yet the RDS technology it had attempted to champion has now been brought to the market by the major automotive producers. Adopting the Jolly commercialisation framework offers an analytical window into the difficulty of bringing “mind to market”, and the governance issues that this entails. The stages from Imagining to Demonstrating were loosely followed by Permo-Drive; however the inventors, uninterested in the day to day running of the business, left the company in the hands of so-called professional business people and a somewhat insecure and arguably unfavourable agreement to produce the innovation in the USA. A few times during this saga governments sought kudos from being associated with the company by publicly promising meagre support funding. At a time of crisis both for the company and the economy, Permo-Drive failed and governments withdrew their support, leaving the company floundering. This was an unenviable predicament for the local small shareholders who came on board with optimism a decade ago.

Permo-Drive demonstrates that without a formal entrepreneurial business plan and a clear coherent strategy to mobilise resources and sales, any innovation however sound, can flounder. Such strategic behaviour is the crucial governance issue under innovation. Technological solution is not enough. Strong internal systems of action and learning, together with effective external mechanisms of engagement, are necessary. Trust that the idea is enough to succeed is evidence of weak governance by the principals, and ignores the varied and “unexpected” roles of agents who have not the same attachment to the innovation. The path to commercialisation is fraught with disaster and without strong governance, shareholders question the value placed on their support. Securing funding, intellectual property, contracts, and production facilities all tested Permo-Drive’s weak governance and were the source of its failure to commercialisation. As one of Permo-Drive Managing Directors said in a private communication:

*It follows that if there is not a viable plan to fund the cost and time (considerable and years respectively) to bridge the gap between prototype and production capacity then the innovation is not viable. (Thompson, 2008)*

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## Review Questions

### Question One:

Why are Rush and Perry classified as inventors and not innovators? Use the Jolly technology commercialisation framework to explain the weak governance of these two inventors in the context of Permo-Drive.

### Question Two:

Corporate Governance has fallen by the wayside in the development of this product. What governance issues should Rush and Perry have considered prior to, and in the formation of, the company PermoDrive Technologies Limited? Reflect on the reliance of the small shareholders and the risk to both the founders and shareholders. What was the role of Bosotti in this regard?

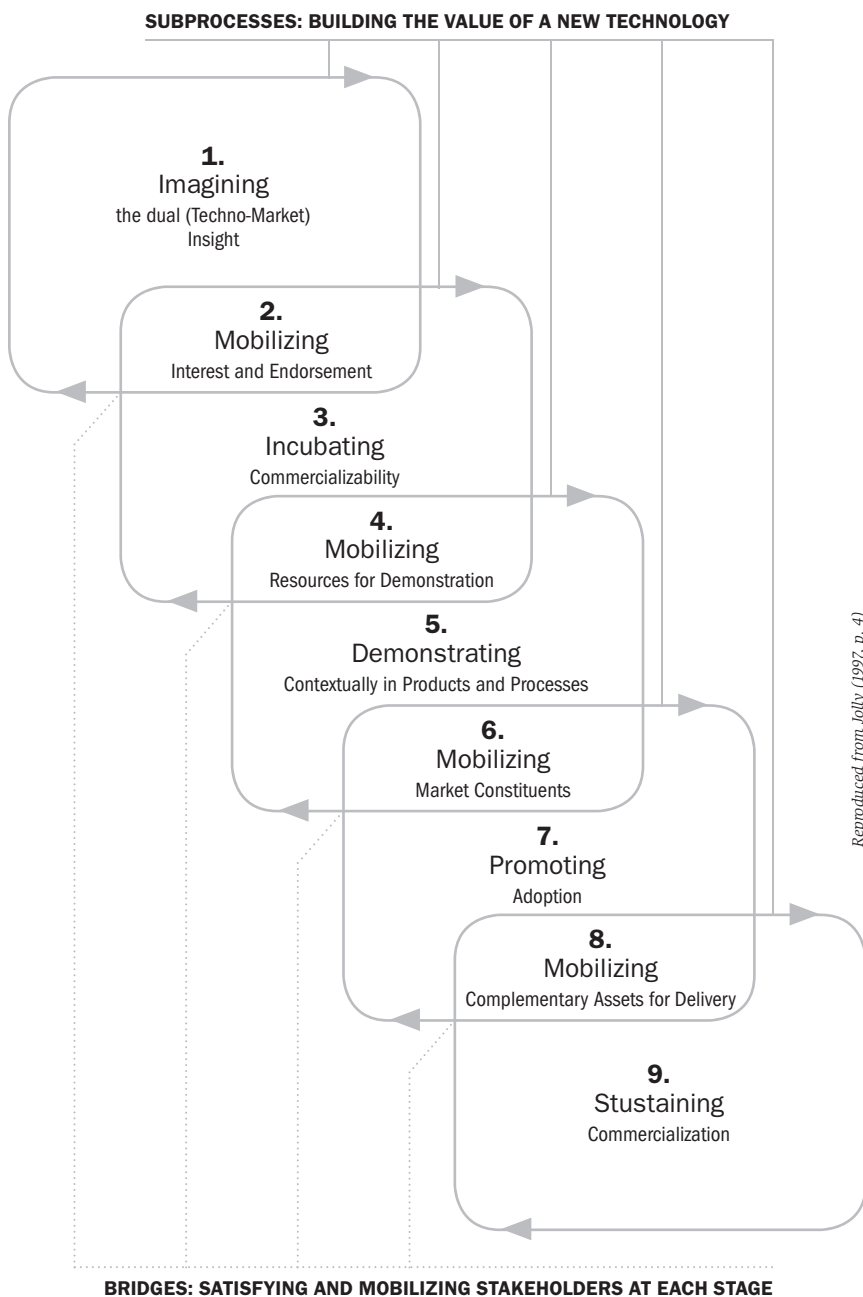
### Question Three:

Discuss the impact and outcomes of contractual arrangements by Permo-Drive with Dana Corporation in relation to corporate governance? Consider copyright concerns and the eventual sale of Dana to Bosch.

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Figure 1. **THE PROCESS OF TECHNOLOGY COMMERCIALIZATION**





## 11

## Public Sector Governance: The Case of Light Rail Expansion in the City of Angels

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*Abstract:* Decision-making in the public sector differs significantly from the private sector. Whereas the profit motive lends much clarity to private sector decisions, public leaders have numerous, sometimes contradictory criteria for governance decisions. Should public leaders intentionally target specific stakeholder groups to receive the benefits of a large public project? This article describes a recent case of light rail expansion in Los Angeles then offers a number of decision criteria which are relevant to the situation of public project selection.

*Keywords:* public sector, light rail, economic development, stakeholders.

### 1. Introduction

Decision-making in the public sector differs significantly from the private sector. The theory of the firm suggests private companies exist to maximize profits. While private firms are kept viable by producing goods and services that society finds useful, company managers nonetheless make decisions primarily based on increasing the wealth of the company's owners, rather than on increasing the welfare of society. In the public sector, no such profit motive exists, so public leaders follow different guidelines, such as using public resources the most economically, efficiently or equitably, to improve the overall welfare of society.

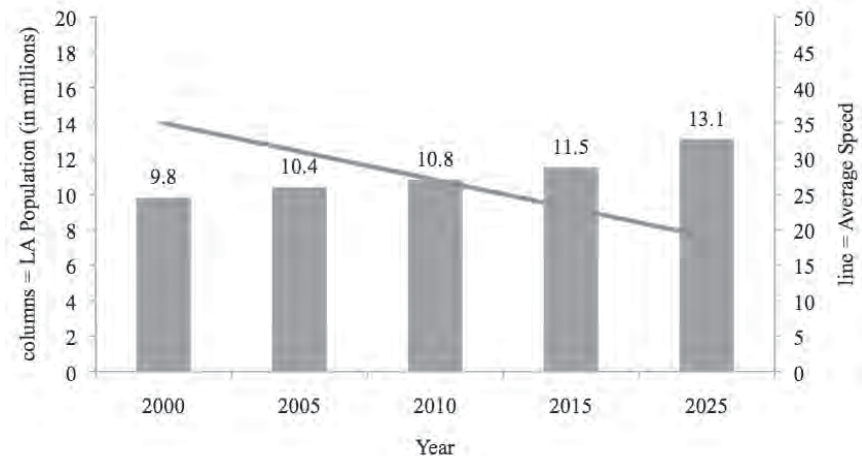
Government officials initiate public projects hoping members of society will derive benefits from the project that outweigh the costs of the project. Some projects provide direct social benefits such as schools, libraries and hospitals; while other projects such as bridges, ports and industrial parks are designed to encourage economic growth that might increase welfare for future generations. Because governments face the classic economic

problem of resource scarcity, officials face the dilemma of having to choose how to allocate scarce resources among numerous competing projects. Additionally, different stakeholder groups may benefit unequally from a public project. How should leaders decide who gets these benefits? This article describes a recent case of light rail expansion in Los Angeles, and describes a number of decision criteria which are relevant to the situation of governance in the public sector.

## 2. Gridlock in the City of Angels

Freeways in the Los Angeles metropolitan area are legendary for their gridlock. A journey from the east side of L.A. County to the west side can take from 90 minutes up to 3 hours, depending on traffic. L.A. is one of the most important shipping and transportation hubs in the country, and as illustrated in Figure 1, as the population continues to grow, the freeway system becomes increasingly inefficient. Over the next 15 years, reduced freeway speeds are a great threat to efficient business in L.A.

Figure 1: **POPULATION GROWTH AND AVERAGE HIGHWAY SPEED IN LOS ANGELES**



(Source: LACMTA, 2001).

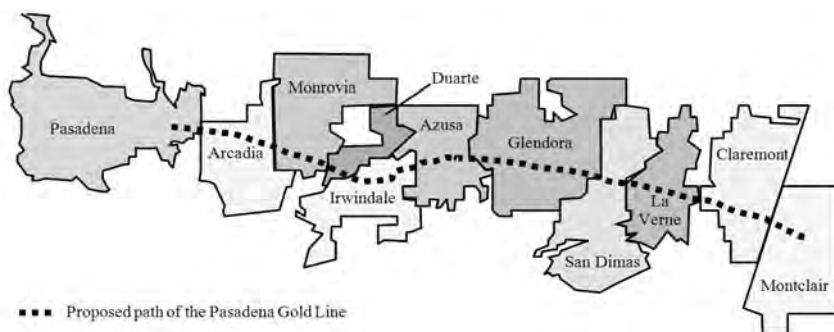
## 3. Where to Next?

An obvious solution to reduce the congestion on L.A. freeways is to move commuters out of their automobiles and onto the public transportation system, especially light rail. Unfortunately the relatively young light rail network only covers a small portion of the metropolitan area. Many

projects have been proposed to expand the light rail system. This case study focuses on the two projects likely to be built next. The first proposal is to extend the Pasadena Gold Line to the rapidly developing communities in the east while the second proposal is to build a new Expo Line from downtown L.A. to Santa Monica in the west. The maps in Figures 2 and 3 show both proposed routes.

The existing Gold Line connects the city of Pasadena with downtown L.A. According to Guccione (2006) ridership on this 14-mile route is 6.3 million per year. The proposed extension will connect to cities such as Arcadia, San Dimas and Claremont. There are many low income and middle income families in these cities who would benefit from this project. Additionally, the City of Hope hospital is directly on the route, and there are at least four major colleges and universities along the route including Azusa Pacific University, Citrus College and the Claremont Colleges. The extension will also benefit those living in the rapidly developing Riverside and San Bernardino counties where, Guccione (2006) notes, over 150,000 building permits were issued in recent years. The estimated costs of the Gold Line extension include financial costs of approximately \$1,276 million in construction and \$10 million in annual operating expenses.

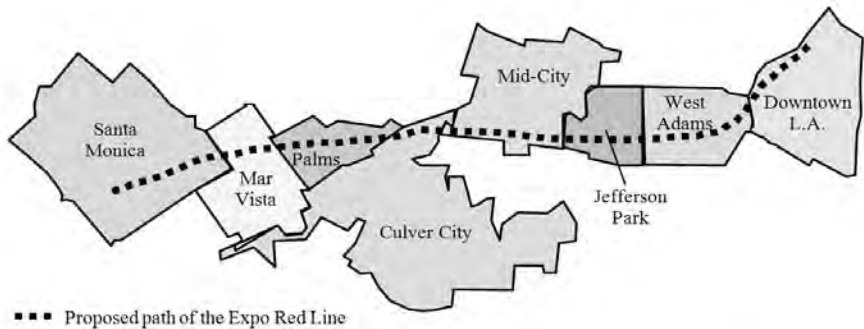
Figure 2: **PROPOSED PASADENA GOLD LINE LIGHT RAIL EXPANSION**



The Expo Red Line, named after Exposition Park, is planned to run from downtown L.A. through Culver City, on to the terminal at Santa Monica. This “Subway to the Sea” will relieve some of the worst freeway gridlock in L.A., which is important due to the area’s proximity to the Port of Los Angeles. The route will also connect numerous community amenities including four major museums, the University of Southern California and Santa Monica beach. Guccione (2006) estimates the estimated costs of the Expo Red Line extension to include financial costs of approximately \$2,461 million in construction, \$10 million in annual operating expenses, higher

local sales taxes, and environmental risks associated with tunneling through hazardous methane gas pockets, which previously resulted in explosions, such as in 1989 when a Ross clothing store was destroyed by an explosion (Ramos and Braun, 1989).

Figure 2: **PROPOSED RED EXPO LINE LIGHT RAIL EXPANSION**



Estimating costs of a large public project are difficult, and nearly always underestimated, but estimating benefits is even more challenging. Nonetheless, both Gold Line and Expo Red Line extension advocates boast the following benefits (with accounting that is speculative at best): fare revenue, federal funding, relieved congestion on key freeways, improved air quality due to reduced automobile emissions, cost savings to passengers as compared to driving an automobile, time savings to passengers and reduced maintenance on freeways.

#### 4. Theories of Project Selection

A number of theories provide insight into governance in the public sector. Resource theory, for example, illustrates a policymaker's dilemma of choosing between multiple worthwhile projects. According to Miller, "Whenever you engage in any activity using any resource, even time, you are *trading off* the use of that resource for one or more alternative uses" (2005, p. 14). Should public leaders intentionally target specific stakeholder groups with the benefits of the project? In this section I describe general theories of income distribution and project selection. Next, theories favoring projects benefiting the poor are presented and contrasted with theories arguing in favor of investing in projects benefiting those with higher incomes or even private firms.

Layard and Glaister suggest a project should be selected, "If the benefits exceed those of the next best alternative course of action," (2003, p.1)

meaning the most *economical* projects should be selected. When two or more projects compete for public funds, the project with the greatest return relative to the investment should be selected. According to this ROI view, projects should be selected where the public resources are used most *efficiently*. Alternately, others such as Rawls (1963) argue that public funds should be used most equitably, that is, the poor should be looked after with public resources.

It is useful to consider the relative prosperity of various stakeholders including individuals of various income levels, and even private firms. Ideally, a public project should benefit members of society of all income classes, but this is impractical. For example, a school lunch program benefits lower income families with children, but provides no direct benefit to a higher income individual who has no children.

Pareto (1906) suggested society is improved when some of its members improve their lives and no one else is made worse off. This sounds reasonable and fair, but may not be feasible because someone ultimately bears the cost of a project. In the case of L.A. light rail expansion, *Pareto efficiency* might be achieved if residents near the light rail stations gain access, while other L.A. residents do not bear any cost associated with constructing or maintaining the new light rail lines. This might be possible if local leaders can secure funding from other governments such as state or federal.

The *Kaldor-Hicks* compensation criterion (1939) intends to balance the “who pays?” dilemma suggesting a public project should go forward so long as those who gain from the project compensate those who lose from the project. To expand L.A.’s light rail network will require the acquisition of additional land parcels, mainly for station construction. Government agents will offer cash payments to these property owners, but if they cannot agree on a price the agents may use eminent domain, or the threat of it, to secure the parcels. When eminent domain is used, citizens losing their land and homes rarely feel fairly compensated. While the Kaldor-Hicks compensation criteria espouses fairness, payment to the losers rarely compensates adequately for what they’ve lost especially where both political cycles and politician’s memories are short.

Another way to think of the costs and benefits of projects is to consider the theory of *the optimum distribution of income*, a state achieved when one dollar has equal value, regardless of whose it is. In real life, however this is not practical because \$1 is valued differently by different people. To a poor man suffering hunger, \$1 can purchase a sandwich satisfying one of

his most basic needs; while, to a rich man, an additional \$1 provides very little additional satisfaction. It seems unlikely that any society will achieve the optimum distribution of income, fulfilling the axiom, “You will always have the poor with you.”

Layard and Glaister offer a compromise, “If income is not optimally distributed most economists would argue that it should be redistributed by cash transfers rather than through the choice of projects” (2003, p. 2). In other words, when policy makers implement new projects, they should build in the costs of compensating the losers. In Azusa, California, for example, a real estate developer building upscale homes donated a portion of the land to the city for parks, a school, and a light rail station on the Gold Line route. Interestingly the compromise *sometimes* happens when a project benefits those with higher incomes; that is, the poor are compensated, but it is *extremely rare* when a project benefits the poor that those with higher incomes are compensated.

Observing that individuals have different preferences, Arrow (1970) concludes it is impossible for society to agree on how these preferences should be ranked. Indeed, in the U.S. today, healthcare and defense are much higher priorities than infrastructure development such as light rail. In light of resource scarcity, it seems Arrow’s *impossibility theorem* is true. We simply do not have enough resources to implement every worthwhile project, so they must be ranked and selected according to some criteria, such as favouring the poor, or favouring those with higher incomes.

Rawls (1963) argues public projects should favour the poor. *Rawlsian justice* suggests each policy, program, and project should be evaluated from the perspective of “the most miserable person in society.” In other words, since the poor are suffering, justice dictates they deserve greater help.

Similarly, Jevon’s (1866) theory of *diminishing marginal utility* suggests money in the hands of the rich provides less utility than the same money would provide to the poor. From the perspective of choosing how to implement public projects then, this theory argues that projects should benefit the poor, more than the rich. If the distribution of income in an economy is not optimum, the economy is thought of as distorted. Market prices in such an economy will not reflect true costs. A project should therefore be analyzed not only according to its narrow financial benefits and costs, but also according to its more broad *economic* benefits and costs.

According to the criteria established by the H.M. Treasury, “Each monetary cost and benefit should be weighted according to the relative prosperity of those receiving the benefit or bearing the cost” (2003, p. 92). In other words, given a choice between a project benefiting the poor and a

project benefiting the rich, it is most ethical to choose the project benefiting the poor because their relative prosperity is already low.

However, if we used the same criteria to compare the poor to the poor of a previous generation, we might conclude that the standard of living that we label “poverty” today might have been considered “prosperity” just one generation earlier. Certainly in the U.S., and even in developing nations, the poor today enjoy many conveniences an average household in the 1950s would not have enjoyed. In the case of light rail in L.A., however, a vast network of streetcars existed in the 1950s but has since been dismantled when L.A. embraced the automobile lifestyle.

Porter’s (2000) *clustering theory of economic development* is relevant here. He argues that rather than investing in short-term projects, governments (and firms) should focus on long-term strategic planning to increase the competitive advantages of an economy and invest in projects directly tied to economic development such as airports, wharfs, business incubators, and technology park developments. Porter’s ideas are feasible, yet policymakers taking a position favouring long-term economic growth over serving the poor open themselves up to much criticism which can negatively impact their future job prospects, especially if they are publicly elected.

The general idea of favouring the poor when it comes to public policy and the specific idea of redistributing income is attractive on moral grounds, but these ideas are often impractical. The *classical economic theories* first articulated by Adam Smith (1776) and David Ricardo (1817) suggest government intervention in an economy creates inefficiency, while market competition results in economic growth benefiting all members of society. On a practical level, policymakers subscribing to free market ideals might eschew public projects altogether, preferring to leave money in private hands rather than collect it in taxes. If forced to choose, however, free marketeers would certainly favor infrastructure projects such as light rail over projects that simply provide services, such as health clinics or nutrition programs.

In the context of local government, Peterson (1981) argues, in what has been dubbed the *city limits theory*, the limited resources available to governments prevent them from addressing all the needs of their locality. Tax revenue is never sufficient to pay for all of the services demanded by the citizenry. Because of these “city limits,” government leaders must choose which of the numerous distributional, allocational and redistributive policies and programs to implement. They are also limited by what funds they can secure. City leaders in Azusa want to construct light rail stations, but also modernize the library. Neither project will be realized unless

the city leaders procure grants from the federal government. Peterson notes, “The luxury of redistribution which was once possible is becoming increasingly difficult to sustain” (1981, p. 106). If Peterson is right, public officials are likely to implement programs favoring projects that develop a region’s economic base rather than redistributing income from the rich to the poor.

*Economic base theory* suggests economic growth occurs when a region’s export activities grow, as Maki and Lichty note, “A leading measure of the size and viability of a local economic base is the value of its exports” (2003, p. 103). The multiplier effect is the most essential component of the economic base model. The export of goods starts a chain reaction where money is both reinvested in the means of production and paid to local workers through wages. Thus, investment in an economy’s most productive elements (i.e. entrepreneurs and firms that increase exports) results in wealth creation for the rich and wage generation for the poor, benefiting all income classes.

Tiebout’s (1956) *pure theory of local expenditure* notes individuals are mobile and people “vote with their feet” choosing a location for work or residence that offers the “basket” of public amenities best matching their preferences. In other words, a person who disagrees with the policies, programs, or projects implemented by government officials is free to move to another location. Parents buying homes in better school districts are fulfilling Tiebout’s theory. But moving is not practical for everyone, especially in L.A. County where the housing bubble prevented “median income” single families from being able to afford “median” priced single family homes. The recent popping of the bubble has made matters worse with millions of single families losing their homes through foreclosures. Millions more are “underwater,” meaning they owe their bank more than their home is worth, preventing them from being able to sell their home to move somewhere else.

In the U.S. since the 1980s, the idea that society will be better off when the whole economy grows has been quite influential, especially since the days of “Reaganomics,” which were characterized by cuts in taxes and government spending so that society’s resources would not be redistributed inefficiently by government bureaucrats, but the resources would instead “trickle-down” from business owners to individuals. The practical value of this theoretical position is that policymakers can again focus on long-term economic development, rather than meeting the temporal and disparate needs of the citizenry.

If Arrow's (1970) *impossibility theorem* is true, then it seems reasonable to invest scarce resources in policies, programs, and projects that are directly tied to economic growth, such as light rail expansion. On the other hand, if Knight's (1921) *theory of risk and uncertainty* is true we might be better off consuming our resources now while the benefit is certain, rather than postpone our consumption into the uncertain future. Recent experiences in the U.S. banking system bear this out—banks received public funds but sat on them rather than invest the funds into productive uses.

Those with shorter time preferences may indeed prefer to enjoy the benefits of a project today rather than wait, but we must also consider the intergenerational dimensions of resource use. Those who argue that projects should favor the poor, i.e. the H.M. Treasury, typically claim to be taking the moral high road by showing compassion on today's poor. A less popular view, yet perhaps equally valid is that investing in future economic growth, rather than present consumption, demonstrates compassion for future generations.

## 5. Conclusion

When faced with a choice between two worthwhile projects, public officials should select the project that provides the greatest benefit to society. In light of imperfect information, public officials in the U.S. typically attempt to answer Potts' (2002) question, "Who gets what?" by following Simon's (1957) "bounded rationality" decision-making model. That is, they make the most rational decision they can make based on the limited information they possess.

The L.A. light rail expansion case illustrates that public projects can be selected to benefit different stakeholder groups. According to a more detailed cost-benefit analysis (see Strother, 2011) the net benefits of the Pasadena Gold Line exceed the net benefits of the Expo Red Line. However, a welfare weights analysis indicates the Expo Red Line extension will benefit a larger number of citizens, and many more lower income individuals (see Strother, 2011).

Additionally, future demographic changes should influence decisions. The land adjacent to the Expo Red Line route is already built out and has little, if any, room for additional development, while the east side of the metropolitan area continues to experience new construction. If both projects were already functional today, we might expect equal ridership, but as population growth continues in the east, the Gold Line should draw more riders.

In the case of LA light rail, public leaders decided to build the Expo Red Line first. They threw their weight behind the project and secured significant federal funding to begin construction in 2006. The entire project should be completed by 2015 at a cost of nearly \$3 billion. At the time there were no plans to fund the Gold Line so the project was shelved. However, Gold Line advocates eventually secured additional funding and in 2010 construction on the project began.

It is certainly feasible in practice to ensure that public projects benefit different income classes. Since we can target different income groups with our projects, the greater question then becomes, “Which projects should be funded?” The theory of marginal utility is a logical and compassionate argument to invest in projects directly benefiting the poor. Unfortunately there is a trade-off where the wealthy (i.e. taxpayers) are required to bear the costs, while the poor enjoy the benefits. But if all other things are equal we should choose the project with the greatest benefit to society.

### Discussion Questions

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1. What are the key differences in governance decision criteria between public and private sectors?
2. Which of the theories mentioned in the article are most relevant to provide guidance for public administrators in the case of L.A. light rail expansion?
3. If you were a public official, would you choose to expand the Red Line or the Gold Line? What theoretical or empirical evidence supports your decision?
4. What criteria are used to evaluate the job performance of corporate managers and public administrators? Who evaluates them? How would this affect their job performance?

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## 12

**Council Water Co.:  
Changing the Charges for Water<sup>40</sup>**

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*Abstract:* This case considers broader governance issues in a public sector company. It focuses on the relationships between a city council's water company, Council Water Co., and its stakeholders. The case opens a discussion around the issue of new water charges that the Council Water Co.'s management team proposed to the board. The board of Council Water Co. needs to discuss alternative ways of charging customers and decide which proposal to present to the City Council. More than half of the Council's area is rural, and the city's leaders try to attract new businesses and residential developments. Furthermore, some of New Zealand's poorest neighbourhoods are located in this Council district. The question about the fairest way to charge customers continues to hang over Council Water Co. and over the board. The board has to ensure that charges are kept as low as possible, to make them affordable, and yet high enough that Council Water Co. has sufficient funds for future investments.

*Key Words:* public sector governance, multiple stakeholders, water utility company, stakeholder analysis.

### Introduction

Andrew Wilson looked at the report on the desk in front of him and frowned. Wilson, an established businessman, was chairman of the board for Council Water Co<sup>41</sup>. He had just read management's proposals on alternative ways of charging customers and needed to decide which to recommend by the time he spoke, in a few days, before the Manukau City

<sup>40</sup> This case was written with the cooperation of Council Water Co.'s Senior Executive Team. All data contained in the case are based on field research and public sources. The case is not intended to be used as illustration of either effective or ineffective handling of a managerial situation. The authors would like to acknowledge the financial support of The University of Auckland Business Case Centre.

<sup>41</sup> For confidentiality purpose, the name of the real case study company is disguised. Thereafter, it will be referred to as Council Water Co.

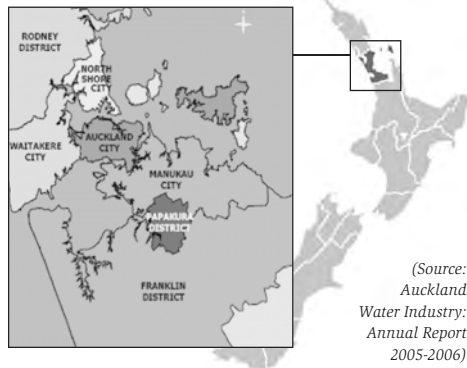
Council. Although Wilson's board ran Council Water Co., the City Council owned the company, and the local government retained the power to set customer fees. The Council needed to levy new ones by July 2008, when the new fiscal year started.

Council Water Co.'s management team, newly plucked from the private sector, advocated changing the fee structure so that charges were tied to the volume of sewage generated: the more a household produced, the more it paid. Introducing so-called volumetric charging or user fees, which some businesses already paid, would, however, mean big price hikes for large families, who already had tight budgets because of an economic downturn. Council Water Co. had estimated that if fees were to reflect usage, residents would have to pay 24 percent more while small businesses would pay 30 percent less.<sup>42</sup>

Even in the best of times, the option would not be popular, at least not among families. Worse yet, Council Water Co. had recently been through a maelstrom and did not need another public lashing, thought Wilson, who began serving as chairman in 2006. That was the year the City Council stopped funding sewage operations through property taxes and established the wastewater charges, billing customers quarterly. The politicians had made the change to clarify the cost and encourage conservation. Small households and small businesses complained loudly, saying they unfairly paid the same as larger families and firms. In fact, Audits had found that some companies produced far less wastewater than estimated, leading not only to protests but also to lower revenue than forecasted. As a result, the City Council had been forced to raise prices in July 2007. It also demanded Council Water Co. suggests alternatives to the fee structure. Wilson did not want to see a repeat of the previous turmoil.

### Background

Council Water Co. was the third largest retailer of water and wastewater services in the country, after utilities owned by the cities of Auckland and Christchurch. Headquartered in a lawn-fronted, glass building in a heavily developed area of the city, Council Water Co. employed 83 people and hired contractors to



(Source:  
Auckland  
Water Industry:  
Annual Report  
2005-2006)

42 Manukau City Council, *Annual Draft Plan 08/09*, Chapter 2: Wastewater Charges

install, monitor and maintain the water and sewage pipes that served the city's urban areas. Rural residents and businesses relied mostly on septic tanks.

The Manukau was home to more than 360,000 people, who generated about 63 percent of Council The Manukau was home to more than 360,000 people, who generated about 63 percent of Council Water Co.'s wastewater revenues. About 21,000 companies operated out of 7,000 industrial and commercial sites, and small businesses made up 28 percent of Council Water Co.'s wastewater revenue. Large firms comprised 6.3 percent. The remainder of sales came from schools, community groups and rural customers.<sup>43</sup>

In the fiscal year ending June 30, 2007, Council Water Co. had sales of \$84.6 million and a net loss of \$6.56 million. Assets, including cash and equivalents as well as property, plants and equipment, totalled \$971.9 million. The company was formed a year earlier, in July 2006, after the City Council decided to separate water and sewage from other local government-provided services. As part of the change, Council Water Co. purchased the operations, including pipes, pumps and other assets, for \$962.3 billion, from the Council. To pay for the acquisition, Council Water Co. issued shares worth \$433 million, which the City Council held, and borrowed another \$529 million from the Council.

### **Infrastructure**

Manukau itself was a young city, established in 1965. It was one of four cities and three districts that made up the metropolitan Auckland region. The others were the cities of North Shore, Waitakere, and Auckland, the districts of Papakura and Rodney, and part of Franklin District. Manukau contributed about eight percent of New Zealand's gross domestic product, and was expected to continue to be a driving force behind the Auckland region's growth.

Experts predicted that Manukau's population would grow by 52 percent, to 526,656, by 2031 compared with an anticipated rise of 41 percent for greater Auckland<sup>44</sup>. That growth would help put Manukau on track to become New Zealand's second largest city in less than 10 years, after Auckland City.

More than half of Manukau's 55,387 hectares were rural, and the city's political and business leaders worked hard to attract new businesses and residential developments by setting aside land for higher density commercial and residential areas and constructing amenities. The city had allocated 1,700 hectares to establish New Zealand's largest planned town and contributed \$8.6 million toward the construction of a \$12 million

43 Manukau City Council, *Annual Draft Plan 08/09*, Chapter 2: Wastewater Charges

44 Auckland Regional Council, *Auckland RLTS Development of Final Report*, May 2009, WP 2010/22

sports facility. City leaders were proud of having some of the metropolitan area's lowest property taxes and services charges, and they wanted to maintain Manukau's reputation as an inexpensive place to do business, both to retain jobs and attract more development.

With the city's residents producing about 32 million cubic metres of wastewater annually, Council Water Co. had almost 2,200 kilometres of water mains and more than 1,800 kilometres of sewer lines<sup>45</sup>. Council Water Co. pumped most its wastewater to wholesale treatment provider Watercare Services Ltd. Watercare was jointly owned by Manukau, the cities of Auckland, North Shore, and Waitakere, and the districts of Papakura and Rodney.

Watercare provided most of the metropolitan region's water and wastewater treatment, and payments to the wholesaler constituted Council Water Co.'s single biggest expense. Recently, Watercare had proposed a price increase of 17.5 percent for the fiscal year starting July 1, 2008. Wilson, and the management at Council Water Co., expected to be able to limit the impact and had recommended that the City Council increase its charges by 3.5 percent to account for the higher Watercare costs. All the proposals that Wilson was reviewing incorporated the increase.

## OVERVIEW OF THE AUCKLAND REGION (June 2006)

	Auckland City	Manukau City	North Shore City	Waitakere City	Rodney District	Papakura District	Franklin District
Population to June 2006	430,700	339,400	215,300	194,700	91,500	43,900	58,500
2026 Population estimate	559,700	459,000	269,500	269,250	128,000	79,700	86,000
Total Rating Properties	181,559	100,767	83,684	65,276	41,696	15,739	25,918
Residential properties	156,598	90,566	75,665	55,656	26,760	12,781	11,248
Business properties	23,012	5,494	7,175	2,711	1,454	1,090	1,126
Rural properties	873	3,462	719	5,767	12,926	1,868	13,544
Other properties	1,076	1,245	125	1,142	556	0	0
Area (ha)	65,553	55,139	12,976	36,700	247,500	11,826	219,000
Area within MUL (ha)	16,519 (25%)	14,541 (26%)	10,769 (83%)	8,208 (22%)	4,850 (2%)	2,539 (21%)	0
Beaches/Lagoons (no.)	17	15	27	19	14	0	5
Estimated stream length (km)	108	154	230	960	4,400	40	3,000

(Source: Auckland Water Industry: Annual Report 2005-2006)

45 Auckland City Council, Auckland Water Industry report, 2006

### **Pressure To Keep Prices Low**

Yet the pressure to limit government expenditures and thereby property taxes and charges stemmed not only from a desire to attract and retain business: some of New Zealand's poorest neighbourhoods were located in the southwest corner of Manukau City. Forty-four percent of Manukau residents earned \$25,000 a year or less, and 23 percent of the adult population had left high school before getting any qualifications.

In 2001, roughly half of its urban areas ranked either nine or 10 on a deprivation scale used by health and statistics experts. Ten was "most deprived," one the least. The scale incorporated the number of people receiving public assistance, unemployment rates, the percentage of households living below the poverty level, access to cars and telephones, education levels, and the percentage of single-parent families.<sup>46</sup> "We have a customer base which, from a demographics point of view, we don't have high affordability," Chief Executive Officer Ivan Mauger said, "The tension for us is great to keep our prices low."

Under the existing fee structure that Wilson was reviewing, residents paid a yearly, fixed charge of \$350 per household while community organizations such as churches and schools paid \$710 and businesses paid \$1,040. The price difference reflected the larger pipes typically needed for commercial and industrial areas, which cost more both to purchase and to install, as well as higher pumping capacity to handle peak outflows of waste.

Organizations and businesses that produced more than 400 cubic meters of wastewater also paid \$2.60 for each cubic meter over that amount. A small number of companies in Manukau generated large amounts of sewage and therefore negotiated directly with Watercare for treatment. To cover the cost of just transporting their waste to Watercare, Council Water Co. charged the firms a fixed fee of \$1,040 and \$1.25 per cubic meter of sewage.

Council Water Co. decided in 2006 that it could no longer afford to refund customers with leaks that led to higher charges. The company told members of the Greater East Tamaki Business Association in September 2006 that management had made the decision because the company still had to pay for the water itself. More frequent, quarterly billing would ensure early identification of leaks, Mauger said, trying to ease association members' worries that they would be saddled with big, unexpected bills.

### **The Options**

In the report on Wilson's desk, Council Water Co.'s management had laid out various ways that the City Council could change the fee structure

<sup>46</sup> Statistics New Zealand, *Census of Population and Dwellings*, 2001

and how that would affect charges. The most fundamental changes would be the adoption of volumetric charging for households, similar to those already paid by businesses, and the elimination of the de facto subsidy that households were getting because businesses overpaid. The report laid out the consequences of eliminating the subsidy over both four years and 10 years.

Were they to adopt volumetric charging, as management had recommended, and eliminate the subsidy over four years, the family of four could expect its annual sewage bill to climb on average 40 percent, to \$490 in July 2011 from \$350 in July 2007. Were they to eliminate the subsidy in four years but not impose volumetric charges on residential customers, the family would pay \$448 in 2011, or 28 percent more. In either case, small businesses using 100 cubic meters of water annually would see a 54 percent fall in their bills, to \$475 from \$1,040.

Alternatively, the Council could also opt to maintain the existing fee structure and incorporate only a 3.5 percent increase to reflect higher costs, management said in its proposals. A family of four would then pay \$389 in July 2008, with the price increasing roughly in tandem with inflation. Businesses would pay \$1,156, plus \$2.89 for each cubic meter of waste over 400 cubic meters.

“There is no rational basis for small businesses to be subsidising the rest of the community to the extent that is occurring,” said Michael Barnett, the chief executive of the Auckland Chamber of Commerce, in a letter to the City Council supporting the shift to volumetric charging. “The small business sector is the engine room of Manukau’s economy and generates a large proportion of the wealth and employment opportunities in the city.”

## **A HISTORY OF THE WATER INDUSTRY IN AUCKLAND**

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1866 Auckland obtained its first piped public water supply from springs in the Auckland Domain

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1877 Public supply transferred to Western Springs

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1910 Completion of the first concrete Waitakere Dam

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1914 Orakei sewerage scheme opened

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1941 North Shore, which previously sourced water from Lake Pupuke, is now connected to the Auckland City bulk supply

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1960 Mangere Wastewater Treatment Plant commissioned ending discharge of untreated sewage at Orakei

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1962 Rosedale Wastewater Treatment Plant commissioned on North Shore

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- 1965 Bulk water supply responsibilities shifted to the Auckland Regional Authority
- 
- 1980 Mangere Wastewater Treatment Plant expanded to meet population increase
- 
- 1991 Resource Management Act (RMA) introduced
- 
- 1992 Watercare - established as independent regional wholesaler, now owned by TLAs
- 
- 1997 Metrowater – established as an independent company, owned by Auckland City
- 
- 1997 United Water – awarded a thirty year management contract by Papakura District Council to provide water and wastewater services
- 
- 2001 RMA network consent applications lodged with ARC
- 
- 2002 Waikato Water Treatment Plant commissioned
- 
- 2003 Mangere Wastewater Treatment Plant upgrade completed to meet increased environmental standards
- 
- 2004 Publication of the first region-wide comparative performance review
- 
- 2004 North Shore Rosedale Wastewater Treatment Plant Stage IV upgrade completed
- 
- 2004 Publication of the Auckland Water Management Plan a region-wide approach to managing reticulated water resources
- 
- 2004 ARC's Proposed Auckland Regional Plan: Air, Land and Water submission decisions notified and appeals lodged
- 
- 2005 Three Waters Vision published in June for the integrated management of water supply, wastewater and stormwater services in the Auckland region
- 
- 2006 Browns Bay wastewater sewer enhancement and tunnel storage project completed to prevent sewer overflows to the North Shore City East Coast Bays during heavy rainfalls
- 
- 2006 Metrowater, Auckland City Council and Watercare completed and applied learnings from a comprehensive Integrated Catchment Study (ICS) towards optimising \$800 million worth of investments
- 
- 2006 The Auckland Water Group was formed in June
- 

*(Source: Auckland Water Industry: Annual Report 2005-2006)*

## **Businesses Protest**

The City Council called on management to come up with the options after homeowners and businesses bitterly protested the sewer charges shortly after they were first introduced in July 2006 and again when the fees were raised a year later, in 2007.

Under the first set of charges, introduced in July 2006, each household was required to pay a fixed, annual fee of \$320, while community groups paid \$650 and businesses paid \$950. Community groups and businesses also paid \$2.38 per cubic meter if they disposed of more than 400 cubic meters of wastewater. The City Council set the fees according to their staff recommendations, and the board and management of Council Water Co. were not involved.

Clint Smith, a building consultant, was so angry that he tried repeatedly to get the water and wastewater connections to one of his commercial properties terminated. The owner of Building Solutions used a building next to his headquarters only for storage and did not think he should have to pay for water and sewer services, so he asked Council Water Co. to stop providing them. What he got was a letter from a debt collector saying he owed \$1,129, including \$200 of interest, the businessman told the *Eastern Courier*, a local newspaper, in August 2007. Council Water Co. had maintained that laws required buildings to be connected.<sup>47</sup>

“The hardest part of having a council as a shareholder, the one thing that they hold onto, Manukau City, was the setting of the tariff,” Wilson said, “Pricing becomes almost what we were judged on, with someone else setting the pricing.”

The City Council was then forced to raise the charges after businesses did not produce as much sewage as forecast, and actual revenue for the fiscal year ending June 30, 2007, fell more than 10 percent short of the budget. Sewer revenues reached \$42.03 million, compared with a forecast of \$46.94 million. Water sales rose slightly more than expected, to \$33 million, compared with a forecast of \$32.1 million.

Customers complained that the City Council had promised that turning Council Water Co. into an independent company would lead to greater efficiencies, not higher prices. Residents organized under the banner of the grassroots organization Water Pressure Group and began visiting city councillors and potential candidates in the upcoming mayoral race. Business associations launched a coordinated lobbying effort on behalf

<sup>47</sup> *Eastern Courier*, *Firm gets \$1129 bill for no water*, 16 August 2007, <http://www.stuff.co.nz/auckland/local-news/eastern-courier/42192>

of their members while individual companies went to the local media to publicize their cases.

Leonard's Superior Smallgoods, which employed 80 people to make bacon, ham and sausages, considered moving out of Manukau after its wastewater bill climbed exponentially. In an interview with the New Zealand Herald in June 2007, the award-winning sausage maker said its July 2006 bill soared to \$245,585, from \$2,366 in July 2005. Although the company negotiated with Council Water Co. to bring the year's fee down to \$45,000, the charge was scheduled to rise to \$88,825 in July 2007.<sup>48</sup>

"We might have to move out of Manukau because this is a volume-related business with a skinny profit margin," Doug Leonard, a company director, told the newspaper. "We can't increase our prices to the supermarkets and customers."

Greater East Tamaki Business Association hastily scheduled meetings with government officials, including Manukau City Chief Executive Officer Leigh Auton, to get explanations about price surges of as much as 150 percent that some of its 600-plus members experienced. The group urged its members to contact Council Water Co. individually as well, and provided them with a form letter. Keen to put an end to businesses overpaying, the group also became part of a working group that the City Council hastily organized to re-examine the fee structure.

### **Manukau Defends Fees**

Mauger, Council Water Co.'s CEO, and Janine Smith, the manager of customer services, met in September 2006 with the association's members to address their concerns, and urged those with problems to call them directly. The executives also asked that their staff "not be subject to either written or spoken abuse."

In a subsequent November 2006 appearance before the association, Manukau City CEO defended the charges, saying that 65 percent of Manukau's 2,850 small businesses actually paid less.<sup>49</sup> Almost half of those remaining faced price increases were less than \$200 a year, Auton said. Only 18 companies had increases of more than \$500, with the largest increase amounting to \$11 a week, he said.

### **Unexpected Shortfall**

Yet even as top executives at Manukau went out into the community to justify the new fees, management was beginning to see that the charges were not generating the level of revenue they had forecast and around

<sup>48</sup> New Zealand Herald, *Sausage makers in a stew over water bill*, 7 June 2007

<sup>49</sup> as recorded in minutes published Dec. 6

which they had built their annual budget. The unexpected revenue shortfall that triggered the 2007 price hikes came, in fact, as a shock to the board and management of Council Water Co. Customers' complaints that they were paying too much for too little had prompted the company to conduct audits of some firms' wastewater disposal, but officials did not expect large discrepancies. Unlike water use, sewage was not metered because the solids in the mix made volumes difficult to measure. Instead, treatment providers estimated the amount of waste produced based on the amount of water used, and varied the percentages according to customer type. For example, residential customers disposed of roughly 75 percent of water used.

Council Water Co.'s audits found, however, that in some cases the volume of wastewater was as low as 40 percent of water use. The assumptions about usage on which Council Water Co. had projected waste flows and incoming revenue were "wrong," Wilson said. "Each time they would do one of these audits, they'd realize it was wrong, and my revenue was going down and down and down, and the viability of the company was wrong," Wilson said. "Looking back now, if we directors had been able to examine the assumptions further, we might not have set the tariffs wrong."

The shortfall added to worries that Wilson and the board had about Council Water Co.'s profitability. The utility already was expected to lose money for several years, because it had had to pay the City Council a high price when it purchased the water and sewer infrastructure to become an independent company. Council Water Co. would have to make annual allocations for the cost of the assets "forever," Wilson said. Depreciation totalled \$19.8 million, or 22 percent of operating costs, in the fiscal year ending June 30, 2007, the second largest expense after payments to Watercare. Employee expenses amounted to \$4.8 million (see Exhibit 5).

While the company would pay fewer or no taxes – because the depreciation lowered its taxable income– Council Water Co. would not report a profit for some time. "I know that's a good tax shelter but it's a hell of a thing to have to charge to the profit and loss account and have to explain to the public how we made losses, because of it being such a high value," Wilson said.

### **Volumetric Charges Divide Residents**

Meanwhile, homeowners organized under the banner of the Water Pressure Group and sought to prevent the adoption of volumetric charges, which they feared would lead to higher prices that large households especially could not afford. In September 2007, Annie King, spokeswoman for the Council Water Co. Pressure Group, joined the mayoral race with a

pledge to convert Council Water Co. back to a city department, funded by property taxes, if she won.<sup>50</sup>

Residents had been fighting against so-called user charges from more than a decade. Public opposition to the charges led the City Council to abandon a 1997 plan to turn the water and sewer operations into a local-authority trading enterprise.<sup>51</sup> Again, in 1999, the City Council considered switching to user charges and even sought High Court clarification on whether it could impose them without first incorporating its water and wastewater operations. Public opposition again buried the plan.

Some of that opposition was eroded, however, by the City Council switching to quarterly sewage charges in 2006 and smaller households were assessed the same fee as large ones. People's Choice, another homeowners' group, collected signatures from almost 2,000 residents who said they backed some form of volumetric charging; they argued that a flat, fixed fee penalized those who conserved and those who used little water.<sup>52</sup>

"There are many elderly people on fixed incomes who are being charged three or four times the water they bring into their homes to get rid of it," Dick Quax, a Manukau City Councillor who supported user charges, said in a May 2008 press release. "Where is the fairness in that? There is no fairness in a pricing regime which forces low users of water to subsidize high users." Quax chided Manukau Mayor Len Brown for favouring a fixed rate for residents.

### **Experts Support User Fees**

Experts, including the New Zealand Water and Wastes Association, generally supported user charges, largely because they encouraged conservation. The industry group, whose members include local government owned companies such as Council Water Co., and consultancies, estimated that installing meters cut water usage by as much as two-thirds and, with that reduction, wastewater disposal. The average daily per capital water use in areas that imposed volumetric charges was about 200 litres, compared with more than 700 litres in some authorities that did not adopt the fee structure, the association said.

Decreased water use and lower disposal rates enabled governments to postpone costly infrastructure expansions, the association said, citing the experience of one local government. It imposed metering at a cost of \$9.7 million and subsequently was able to delay investing \$75 million on water supplies for 10 to 12 years and postpone investing another \$30 million to \$40 million in sewage treatment by up to eight years.

50 New Zealand Herald, *Eleven vie to fill void left by Sir Barry*, 6 September 2007

51 New Zealand Herald, 28 December 1999

52 <http://talkbackmanukau.blogspot.com/2008/05/manukau-not-listening.html>

New Zealand's 73 territorial local authorities allocated nearly 30 percent of their budgets to providing drinking water, removing and treating wastewater, and managing storm water. Only 11 of the authorities metered water use and charged according to the volume used. Eight more had some metering, and yet another authority required meters in homes but did not charge according to use. An analysis of the 73 authorities' long-term community plans showed they expected to spend a combined \$22 billion in the decade to 2017 on water, sewage and storm water infrastructure. "There is currently no unified strategy to address the affordability issues inherent in a figure such as this," the Association said.<sup>53</sup>

"Local governments should move toward volumetric charges", an independent, government-backed inquiry said in an August 2007 report. The recommendation, one of a number of funding proposals made by the Local Government Rates Inquiry, said cities and other local municipalities needed to manage demand better, to reduce the needed amount of tax-funded infrastructure investments.<sup>54</sup> The report also said local governments should seek alternative ways of funding operations and investments, because residents increasingly were unable to afford the steady rise in property taxes that the governments were imposing.

"Applying volumetric charging to wastewater is more difficult but not impossible, and should develop equitable policies based on the volume of water used," the inquiry recommended. "Depending on the cost structure, these user charges would comprise a mixture of an access charge and a volumetric charge."

### **Between a Rock and Hard Place**

Wilson weighed the options. At risk was not only another public controversy but the support of the City Council. Their backing was critical to Council Water Co.'s success. Wilson had also served as chairman of the city of Auckland's water company (as well as being the managing partner of global accounting firm KPMG's Auckland office) and had seen first-hand what havoc a divided board could cause. "Auckland City thought they'd lost control in establishing Metrowater," Wilson recalled. That led to division among the city's councillors over support for the utility, with some "saying, 'This is a complete waste of time, this thing shouldn't exist, and we want to take it back in.'" Wilson did not want that to happen to Council Water Co.

The fee problem, Wilson thought, was a dark spot in Council Water Co.'s otherwise successful transformation into an independent business, a process that he had steered. Council Water Co. had been a unit of the local

<sup>53</sup> New Zealand Water and Wastes Association, *Briefing to Incoming Ministers*, November 2008

<sup>54</sup> [http://www.dia.govt.nz/Pubforms.nsf/URL/RatesInquiryFullReport.pdf/\\$file/RatesInquiryFullReport.pdf](http://www.dia.govt.nz/Pubforms.nsf/URL/RatesInquiryFullReport.pdf/$file/RatesInquiryFullReport.pdf)

government until the council voted in 2005 to make it a separate, non-profit company, with a new management team and an independent board of directors. None of members were affiliated with, employed by, or a member of the City Council. Instead, a headhunting firm had identified each of them because of their expertise in various areas, including governance, engineering, negotiation and finance. The City Council hoped the changes would draw private-sector employees to the public enterprise and lead to more efficient operations. And under Wilson, Council Water Co. had achieved most of those goals, reporting a smaller loss than budgeted after just one year in operation and despite the unexpected revenue shortfall.

Yet the question about the fairest way to charge customers continued to hang over Council Water Co. and over Wilson. The council-mandated review found that residential customers, many of whom lived in poverty, did not pay enough to cover their share of the cost of operating the sewer system. Meanwhile, businesses, also struggling amid the world economic slowdown, were overpaying. Wilson needed to figure out which of the options that lay in front of him best resolved those inequities.

The chairman also had to ensure that charges were kept as low as possible, to make them affordable, and yet high enough that Council Water Co. had sufficient funds for future investments. The company would soon need to sink some money into new pipes and pumps to meet more stringent pollution regulations. Wilson, who was responsible for Council Water Co.'s long-term financial health, read the funding alternatives again, trying to imagine the consequences.

**Questions:**

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1. To whom are Council Water Co.'s efficiency gains accruing?
2. Who are the major stakeholders in this case? What is their relative importance? What is their formal, economic and political power?
3. Given the financial structure of Council Water Co., can the company afford for its customers to make significant reductions in consumption?
4. Should the charging regime be the same for residential and commercial users?
5. Should Council Water Co. employ the marketing approach in analysing its stakeholders?
6. Should Council Water Co. invite its stakeholders to participate in governance decisions? Is such participation appropriate given the status of Council Water Co.?

	2008	2007
<b>Income</b>	\$000	\$000
Water and wastewater charges	81,163	75,043
Other revenue	6,718	9,386
Other gains	75	168
Total income	87,956	84,597
<b>Expenditure</b>		
Employee benefits expenses	5,654	4,769
Depreciation and amortisation	19,874	20,459
Other expenses	55,144	55,968
Finance costs	9,288	9,956
Total operating expenditure	89,960	91,152
Operating (profit/ loss) before tax	(2,004)	(6,555)
Taxation	-	-
(Profit/ Loss) after tax	(6,555)	(6,555)

(Source: Council Water Co. 2008 Annual Report)

	2008	2007
<b>Asset</b>		
Current assets		
Cash and cash equivalents	6,299	155
Trade and other receivables	17,402	16,908
Forestry assets intended for sale	–	36
Total current assets	23,701	17,098
Non-current assets		
Property, plant and equipment	946,700	951,865
Intangible assets	1,407	1,664
Forestry assets	1,355	1,295
Total non-current assets	949,462	954,824
Total assets	973,163	971,922
Represented by:		
Liabilities		
Current Liabilities		
Trade and other payables	9,001	12,065
Employee benefit liabilities	754	400
Borrowings	463,076	457,473
GST payable	455	103
Total current liabilities	473,286	470,041
Non-current liabilities		
Employee benefit liabilities	–	–
Borrowings	75,000	75,000
Deferred tax liability	–	–
Taxation	–	–
Total non-current liabilities	75,000	75,000
Total liabilities	548,286	545,041
Equity		
Share Capital	433,436	433,436
Accumulated Loss	(8,559)	(6,555)
Total equity	424,877	426,881
Total equity and liabilities	973,163	971,922

(Source: Council Water Co. 2008 Annual Report)

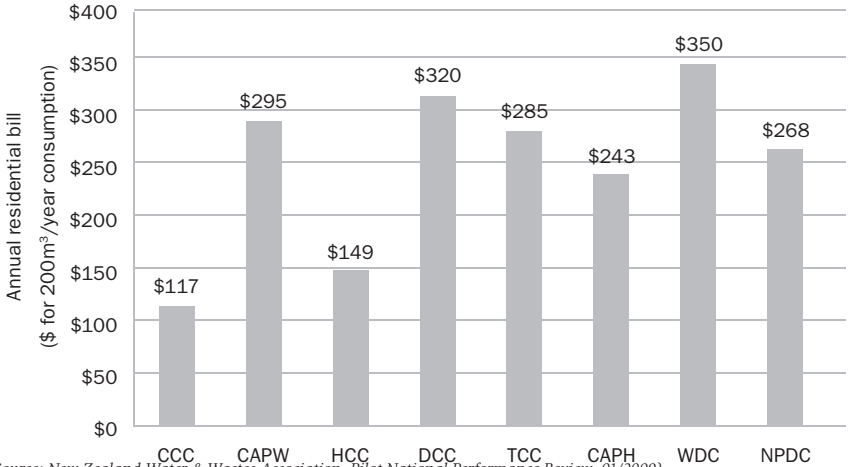
**Exhibit 8: WATERCARE SERVICES LIMITED**

Owned by the city and district councils of Auckland, Manukau, Waitakere, North Shore, Papakura and Rodney, Watercare is the bulk water and wastewater service provider for the greater Auckland area. Drawing water from 12 sources, Watercare treats it to A-grade quality and supplies it to six LNOs; they in turn retail it to more than 1.2 million consumers.

Watercare also operates a regional wastewater network. It receives wastewater from Metrowater, Council Water Co., Waitakere City Council and United Water and treats it at the Mangere Wastewater Treatment Plant.

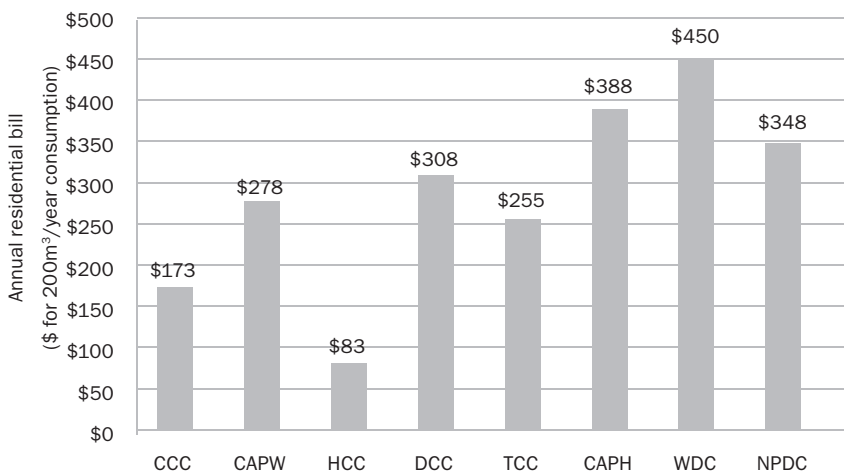
Watercare's annual turnover in 2007/08 was \$167 million and assets were valued at more than \$2 billion. In the same period, Watercare supplied more than 136 billion litres of A-grade drinking water and treated 114 billion litres of wastewater from the region.

*(Source: Auckland Water Industry: Annual Report 2008-2009)*



(Source: New Zealand Water & Wastes Association, Pilot National Performance Review, 01/2009)

- CCC** Christchurch City Council: \$0.311271/\$1,000 of capital value.  
(Ave. cap. Value \$377,000)
- CAPW** Capacity-Wellington:  
Minimum \$112.50 + capital value x 0.00042356  
(Ave.cap. value: \$431,000). (OR elective metering \$1.58per m<sup>3</sup>)
- HCC** Hamilton City Council: Charge based on property value
- DCC** Dunedin City Council: Uniform Annual Charge
- TCC** Tauranga City Council: User charge: \$25 fixed + \$1.3 per m<sup>3</sup>
- CAPH** Tauranga City Council: User charge:  
First 100 m<sup>3</sup> = \$1.38 per m<sup>3</sup>; additionalm<sup>3</sup> = \$1.05 per m<sup>3</sup>
- WDC** Whangarei District Council:  
User charge: \$25.50 fixed + \$1.62 per m<sup>3</sup>
- NPDC** New Plymouth District Council: Uniform Annual Charge



(Source: New Zealand Water & Wastes Association, Pilot National Performance Review, 01/2009)

**CCC** Christchurch City Council: \$0.458623/\$1,000 of capital value.  
(Ave. cap. value: \$377,000)

**CAPW** Capacity-Wellington:  
Minimum \$112.5 + capital value x 0.00038314  
(Ave. cap. value: \$431,000)

**HCC** Hamilton City Council: Based on average property value

**DCC** Dunedin City Council: Uniform Annual Charge

**TCC** Tauranga City Council: Uniform Annual Charge

**CAPH** Tauranga City Council: Uniform Annual Charge

**WDC** Whangarei District Council: Uniform Annual Charge

**NPDC** New Plymouth District Council:  
Pro-rata based on pans. (Most residential customers pay for 1 or 2 pans at \$348 per year.)



## 13

## Wrangling Along: Governance and Leadership Principles and Applications

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*Abstract:* Representative Charles B. Rangel (Rangel) was censured by the House of Representatives for “violation of the Code of Official Conduct, or of a law, rule, regulation, or other standard of conduct applicable to the performance of official duties or the discharge of official responsibilities by a Member, officer, or employee of the House of Representatives” (June 17, 2010 Statement of Alleged Violation), see Rule 19(f), Rules of the Committee of Official Conduct, as determined by the House Investigative Subcommittee.

Only 23 Congresspersons have faced censure by the U.S. House of Representatives. Rangel has served in Congress since 1971, representing the Harlem district in New York City, was a founder of the Congressional Black Caucus, and became the first and only black Chairman of the powerful Ways and Means Committee. A respected civil rights advocate, legislator, and Korean War veteran, Rangel’s fall from grace tragically illustrates the principles of governance and leadership.

This case presents principles of governance and leadership that should be incorporated into individual and group decision-making. These principles reflect the imperative that decision makers must respect moral boundaries that are important for both leaders and followers.

As required by Article 6, members of Congress are bound by oath to affirm their support of the US Constitution. Representatives, delegates, and the resident commissioner all take the oath of office on the first day of the new Congress, immediately after the House has elected its Speaker. The Speaker of the House administers the oath of office as follows:

*“I, (name of Member), do solemnly swear (or affirm) that I will support and defend the Constitution of the United States against all enemies, foreign and domestic; that I will bear true faith and allegiance to the same; that I take this*

*obligation freely, without any mental reservation or purpose of evasion; and that I will well and faithfully discharge the duties of the office on which I am about to enter. So help me God.”*

This case explores the question: How did Rangel violate the solemn oath of office, and why?

**Institutions/Persons:** United States House of Representatives, Committee on Standards of Official Conduct, Charles B. Rangel

**Geography:** United States of America

**Key Words:** leadership, governance, values-based leadership, principles

## Introduction

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Charles (Charlie) B. Rangel (Rangel), Democratic congressman from New York, was censured by the House of Representatives (House) on December 2, 2010 by a vote of 333 to 79. Rangel became the twenty-third member of the House ever to be censured for violating its ethics rules. This was a remarkable action taken by a Democratic majority in the House, and this case will apply a framework of leadership values (Ahn & Ettner, in press) and governance principles (Ettner, 2006) in evaluating Rangel’s exercise (or lack thereof) of these fundamental understandings.

## Background

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Rangel represents the Fifteenth Congressional District (District) in New York, primarily composed of the Harlem area in Manhattan. He has represented the District for 40 years, since his initial election in 1971 after defeating the legendary Adam Clayton Powell, Jr. (Powell). Rangel defeated Powell primarily campaigning on ethics violations that occurred during Powell’s incumbency. Subsequently, Rangel has become known for his swashbuckling style and has legislated effectively in advancing civil rights and championing disadvantaged members of society. Although ethics charges were pending during his 2010 reelection campaign, Rangel easily defeated his opponent. He rose to the heights of the House, by being elected Chairman of the powerful House Ways and Means Committee (stepping aside during the ethics inquiry), and is a founding member of the Congressional Black Caucus (1971), serving as its chairman. Rangel fought during the Korean War, and received numerous citations for bravery (the Bronze Star) and service. He graduated with a Bachelors degree from New York University (1957) and a law degree from St. John’s School of Law (1960).

### **Ethics Charges and Violations**

Rangel was investigated for a series of ethical violations, including:

1. Improper use of Congressional letterhead for Rangel Center fund raising

2. Renting Harlem (rent controlled) apartments at below-market rates
3. Evading taxes on Dominican villa rental income
4. Failure to report assets and income

*Improper use of Congressional letterhead and Rangel Center fund raising*

The central and underlying issue was Rangel's direct use of Congressional resources for solicitation of funds for the Charles B. Rangel Center for Public Policy at the City College of New York, from organizations and individuals who had business before the Ways and Means Committee, including notables such as Donald Trump and AIG.

Rangel was found in violation (two counts) of soliciting funds and donations to the Rangel Center from those who had business before the House Ways and Means Committee. In addition, he faced four counts for improper use of Congressional letterhead and other House resources for the solicitations.

*Renting Harlem (rent controlled) apartments at below-market rates*

Rangel rented four rent-stabilized apartments in the Lenox Terrace complex in Harlem, which was regulated by the city of New York's set of laws requiring the apartment be utilized for residential tenants; Rangel paid \$3,894 per month versus the market rate of \$8,125 per month, and utilized one unit for a campaign office. The Lenox complex owners supported Rangel's reelection campaigns through donations.

Rangel was found in violation (one count) for use of one of the apartments as an office, when he had Congressional dealings with the landlord.

*Taxes on Dominican villa rental income*

Rangel owned a three-bedroom villa in Punta Cana, Dominican Republic. In September 2008 his attorney Lanny Davis reported that Rangel failed to report \$75,000 of rental income for at least three years for rental income received. Subsequently, Rangel immediately paid the past taxes of \$10,800. During this time Rangel was responsible for the United States tax code as Chairman of the House Ways and Means Committee.

Rangel was found in violation (one count) for failing to pay taxes on his Dominican villa.

**Unreported assets and income**

For transparency purposes, Members of Congress are required to file financial disclosure forms. In September 2008 Rangel acknowledged he failed to report the sale of his Washington D.C. residence, as well as substantive differences (undervaluing) in the value of a property in Florida and investment fund reporting. In July 2009 Rangel refiled his 2007 report, with adjustments to an unreported \$500,000 of undisclosed assets, thus

doubling his net worth. In addition, he failed to pay property taxes on two New Jersey properties.

**Rangel was found in violation (one count) for incomplete and inaccurate financial disclosure statements.**

**Rangel was found in violation (two counts) of the House rules.**

### Analysis

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**On [date] the Speaker of the House read to him the following:**

*“In the matter of Rep. Charles B. Rangel of New York. Resolved, that Rep. Charles B. Rangel of New York be censured; Rep. Charles B. Rangel forthwith present himself in the well of the House for the pronouncement of censure; Rep. Charles B. Rangel be censured with the public reading of this resolution by the speaker; and Rep. Rangel pay restitution to the appropriate taxing authorities or the U.S. Treasury for any unpaid estimated taxes outlined in Exhibit 066 (evidence concerning taxes) on income received from his property in the Dominican Republic and provide proof of payment to the (ethics) committee” (Richard, 2010).*

Rangel remained defiant after the formal censure. He continued to deny wrongdoing, and noted that his violations were a matter of poor record keeping and administrative housekeeping. “I know in my heart I am not going to be judged by this Congress. I’ll be judged by my life in its entirety” (Kocieniewski, 2010). “History will show that a different standard has been utilized in this case, where I did not curse out the Speaker, I did not try to have sex with interns,” referring to past censure cases. “I am at rest with myself, and I am convinced that when history has been written that people will recognize that the vote for censure was a very, very, very, political vote”. (Kocieniewski, 2010).

In contrast, Representative Zoe Lofgren, Democrat from California and Chairman of the Ethics Committee noted, “Rangel violated the public trust” (B34NZ, 2010).

#### *Governance Principles Application*

*Independence (for the governing body to function, it must be independent of influence).*

Rangel displayed enormous influence during his years of House service. How difficult is it to judge a senior member of House leadership by its membership? How critical is it to the Committee on Standards of Official Conduct to be independent and be constituted of equal Democratic and Republican members?

*Transparency (the centerpiece of transparency is disclosure. Disclosure*

*'casts the light of day' on governing and informs others of known and unknown information).*

The role of the Committee on Standards is to investigate in a nonpartisan manner the alleged complaints and actions. The June 17, 2010 Statement of Alleged Violation, Committee investigative public hearing, and House floor debate were all within the public domain. How important is transparency to the legitimacy of the pending matter and institution?

*Creative Tension (implies a culture of mutual trust and value between two groups or individuals that there are two separate and distinct roles in governing).*

The roles of the Committee are separate and distinct from those of the House in adjudicating the Rangel investigation. Rangel alleged the matter was 'political' and not based upon fairness to him. Is it essential for the House to have confidence in the Committee determining the ultimate outcome?

*Trust (shared belief of governing organizations that collaboration and reciprocity generate a positive climate of group dynamics and decision-making).*

Institutional legitimacy requires that those being governed have confidence in leaders who are appointed or elected to act on their behalf. Does the practice of appointing equal numbers of Democrats and Republicans to the Committee serve to encourage trust among the House membership and public?

*Results (effective and sustainable outcomes that are necessary for ongoing obligations to constituents).*

The full House voted to censure Rangel, and found him guilty of 11 violations. How important was it to conclude this matter in 2010 before the House changed to Republican leadership? Would further questions of fairness be raised by Rangel and his supporters if it was delayed until 2011?

*Oversight (the supervisory role necessary for monitoring and controlling governing behavior).*

How important is it to the House and its responsibility to its constituents to have an independent nonpartisan committee to investigate and adjudicate House members?

*Accountability (holding officials responsible and liable for acts).*

Rangel was found guilty of 11 violations and censured by the full House of Representatives. How critical was this to the legitimacy of the House and to holding elected representatives liable for violations?

*Integrity (ethics and moral courage are rewarded and deviations are not tolerated).*

Rangel represents through his comments after the censure vote that he was not afforded proper representation, and cited the unfairness of the process. Should Rangel have been forced to resign from the House, as some note he showed very little contrition despite the censure vote?

*Leadership (officials lead and direct organizations in the collective achievement of organizational goals).*

For 40 years Rangel has been an advocate for minorities and the disenfranchised. How adversely has this affected his ability to lead within the House and be supported by those he represents?

*Values Based Leadership (VBL) Application*

VBL requires leaders demonstrate values that ensure follower engagement. Leaders are responsible “to make those within their sphere of influence valuable” (Ettner, 2011) Valuable personally as well as to their respective organization. The dilemma in the Wrangling Along case is how to ensure to society that those leaders, who are responsible for its well being, reflect the values (and perhaps the ideals) of the governed. This case also reveals human frailty and the heavy responsibility in the exercise of leadership. Is Charles Rangel right in positing that his life and contribution will not be measured by Congressional ‘mortals’ in a vote for censure? Or are his colleagues who believe he violated House rules eleven times correct in asserting that he “violated the public trust”?

*Integrity (steadfast adherence to a strict moral or ethical code).*

Was Rangel fairly judged by his colleagues? Do Rangel’s actions as reflected in the 11 counts denote a complete lack of integrity? Does society believe that political actors such as Rangel are required to exhibit integrity? If integrity is important, why was Rangel reelected in the face of pending ethics charges?

*Good Judgment (tempered by flexibility and situational awareness, significantly influences performance).*

Did Rangel exercise good judgment in his dealings with the ethics committee? Why didn’t Rangel seek a negotiated settlement with the committee, and not face a vote of censure? Why did he fail to report his villa income? In his financial disclosure findings, did he exercise sound judgment? As Chairman of the Ways and Means Committee, how could he oversee the nation’s tax policy and not file his personal taxes?

*Leading by Example (collective actions, desired and general deportment of leaders).*

Congressmen and women are elected to represent their constituencies. Is it fair for those they represent to expect elected officials to act as role

models for others? Politicians have historically not been held in high esteem. Should they be seen as persons who should exhibit characteristics and traits greater than the common person?

*Decision-Making (steadfast adherence and support of decisions that follow the chain of command, unless requested actions are immoral, illegal, or unethical).*

Rangel requested the use of Congressional letterhead, and those within his chain of command carried out his request. Did his staff have an ethical responsibility to deny Rangel's request? Renting four rent-stabilized apartments in Lenox Terrace complex and utilizing one for campaign purposes was clearly a violation of New York City statutes. Why did the landlord not report the violations?

*Trust (relationship of reliance between leaders and followers).*

Rangel was found guilty of 11 violations. Should those who elected him for his 20th term have trust in his decision-making ability and integrity? Should those staff members who still work for him trust his judgment and actions?

*Justice/Fairness (justice is considered the rules and norms governing how outcomes are distilled, produce distributive decisions, and how people are treated).*

The vote by the ethics committee was 9-1 for censure. Was Rangel treated fairly in the deliberations or as he stated, "the vote for censure was very, very, very, political vote"? As a founding member of the Congressional Black Caucus should have Rangel been afforded greater discretion?

*Humility (lack of arrogance, capacity to listen carefully, and egolessness).*

Rangel made strong statements concerning the fairness of the proceedings as well as the eventual censure outcome. "I know in my heart I am not going to be judged by this Congress. I'll be judged by my life in its entirety." Does being found guilty by one's colleagues requires greater deference to their judgments, and does Rangel's statements show due respect for the decision?

*Sense of Urgency (to instill a sense of action orientation to achieve results).*

Rangel exercised enormous influence as one of the three most senior members in Congress, founding member of the Congressional Black Caucus, and Chairman of the Ways and Means Committee. Should his actions be measured by the benefits he brought to the disadvantaged he championed (whether he broke the rules or not) or by taking actions that benefited those underserved? Is it better to get results even if they rely on unethical acts?

## Conclusion

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The Wrangling Along case explores the crucial application of governance and VBL principles, as well as their application to the exercise of contemporary leadership. Charlie Rangel has had a storied personal and political career of over forty years. He brought truth, justice, and courage to the forefront in combating injustice for those that couldn't defend themselves. But where did he go wrong? Did the power of being a Congressman for forty years cause ethical and moral decline? Or do we expect too much from our elected leaders? The eight VBL values and the nine governance principles bring to light how Rangel lost understanding of the principles and values of governance and leadership. Values Based Leadership has foundational values and governance principles that transcend time, and within their application they form a basis of reflection and action for contemporary leaders. Critical governance questions need addressing. Do governance principles constrain individual and leader behavior and performance? Do governance principles rely on both cultural understanding and compliance adherence? How do governance principles across sectors differ in business, not-for-profit, and public organizations in their application? Do governance principles apply universally across cultures?

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## 14

## Ethical issues at the Independent Commission Against Corruption

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### Background

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In Mauritius, the Prevention of Corruption Act 2002 provides for the prevention and punishment of corruption and fraud offences and for the establishment of the national institution that has the task of investigating cases of corruption. The Independent Commission against Corruption (ICAC) became operational in June 2002. Of its main functions, the ICAC is expected to educate the public, foster public support against corruption, investigate any act of corruption and consider any allegation that an act of corruption has been committed. The Commission is to advise and assist any public body on ways and means in which acts of corruption may be eliminated. In order to be credible and effective, the ICAC needs the unanimous support of the political class and the trust of the people. The concern of Mauritian citizens however is the fact that key institutions are headed by political nominees. How impartial is an institution where chief officers are appointed politically? Does the loyalty of these individuals go to their profession or to the people who appoint them that is, the members of the National Assembly?

### Facts

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The Independent Commission Against Corruption (ICAC) experienced many internal problems of an ethical nature in the early years of its establishment. In December 2003, the Commissioner faced accusations of unjustly dismissing the director of investigations. The Commissioner was accused of conspiracy as there were allegations that he exercised pressure on a police officer to unjustly incriminate the former director of investigations/fraud investigator. There were also allegations that the commissioner gave instructions to the Parliamentary Committee not to

give a hearing to the fraud investigator. The written press reported that this act constituted a clear case of power abuse.

In 2004 serious allegations of money-laundering and irregular transactions were made against the ICAC commissioner. While the commissioner was accused of some transactions at an exaggerated cost without calling for tenders, there were allegations that one of the deputy commissioners failed to declare interest in a specific case where he intervened to stop two suspects from being arrested. The deputy commissioner acted in his capacity of Solicitor of Advance Engineering Ltd., a company that had benefited from funds embezzled from the Mauritius Commercial Bank<sup>55</sup>.

According to the Prevention of Corruption Act 2002, it is up to the Appointments Committee further to the recommendations of the Parliamentary Committee to take action if there is evidence of misconduct on the part of the commissioner/deputy commissioners of the ICAC. The Appointments Committee is composed of three members: the Prime Minister, the President and the Leader of the Opposition. It is the prerogative of the President to convene the committee when the need arises. In spite of the allegations made against the commissioner and deputy commissioner, no action followed. This absence of action on the part of the authorities, followed by regular updates on crises facing the ICAC in the press led to the perception that the institution had lost its credibility.

Following the above-mentioned allegations, the ICAC commissioner issued an official communiqué on 20 April 2004 on behalf of the commission pointing out that the allegations made were being investigated and that the commissioners would take appropriate action in due time: “The ICAC deplores the fact that it is the object of campaigns in the media that systematically denigrate the commission and aim at destabilizing it. This is a cause for rejoicing among all those involved in corruption”.

The ethical questions arising from the above include the following:

1. Should the ICAC commissioner have answered in his own name rather than issue a communiqué on behalf of the commission?
2. Was it ethical for the commissioner to issue a communiqué considering that he was the subject of the allegations?
3. Were there grounds to justify the dismissal of the former director of investigations?

<sup>55</sup> A case of embezzlement publicised in 2003.

4. If not, does the commissioner have the right to terminate his employment?
5. Why was the former director of investigations denied a hearing?
6. Do the above allegations not put in question the integrity of the commissioner and that of the deputy commissioner?
7. Could the above constitute a “war” between a dismissed employee and his former superior?
8. Is it ethical for the deputy commissioner to intervene as Solicitor of Advance Engineering Ltd., a company that had benefited from the funds embezzled from the Mauritius Commercial Bank?
9. Does the fact that the deputy commissioner failed to declare interest not amount to a punishable offence?
10. Should the Parliamentary Committee and Appointments Committee not be accountable to the public?

If we refer to main facts as described above, the acts of both Commissioner and Deputy Commissioner are questionable. On the one hand the employment of the former fraud investigator was terminated and on the other, we have no evidence that the latter committed any specific form of misconduct to justify his dismissal. Bearing in mind that power abuse

is culturally accepted in Mauritius as in many countries of the Third-World, does this mean that the authorities, namely the Parliamentary Committee and the Appointments Committee, condone the actions of the ICAC officials since no action followed the disclosure of the above acts? Assuming the press reported factual information, there was a perception that the Independent Commission Against Corruption had lost the trust of the people.

Is it acceptable for a key representative of the ICAC not to declare interest while intervening as solicitor of a company involved in a major case of embezzlement? Unlike the trend in developed countries where pressure groups have a tendency to fight for justice, civil society reacts differently in Mauritius. The media being quite weak, political nominees such as those heading the ICAC feel strong in the position that they occupy.

Does the fact that power abuse on the part of individuals in such positions of responsibility is regarded as culturally acceptable in the developing world exempt the commissioners/deputy commissioners from their duty?



## 15

## The Emerging Oil Industry in Uganda; A Blessing or a Curse?<sup>56</sup>

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*Abstract:* This paper introduces the main governance issues surrounding the emerging oil industry in Western Uganda. I provide an overview of the current issues, including relevant parties involved and potential issues, followed by a summary of key findings. It is important to note, however, that due to the infancy of the oil industry in my country, little to no academic literature is available on the subject. Also, the little information provided by the Government of Uganda and the involved oil firms has severely limited the level of public knowledge on the topic; thus it is very difficult to gauge the public temperature on this issue. Additionally, much of the information for this paper has been obtained from a limited number of sources, due largely to the limited writing on the issue, as well as the general secrecy of the industry. For a thorough, well-researched discussion on the issues of the Ugandan oil industry, International Alert's "Harnessing Oil for Development in Uganda" is a comprehensive document.

### Introduction

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For nearly a decade foreign exploratory firms have been attempting to discover and map further oil deposits in western Uganda. In 2008 it became clear that Uganda was sitting on one of the largest on-shore oil deposits to be found in decades (Pagnamenta 2009). Following the discovery, the country enjoyed a period of optimism, as it was believed that oil could become the key to national development. However, two years have passed since Uganda's President Yoweri Museveni announced the find and still oil has yet to be exported. This briefing paper provides a summary on the

<sup>56</sup> Note that the situation in relation to the oil industry in Uganda is changing rapidly. This case study was written in a 2010 context. Although this context has now changed, the governance issues remain highly relevant.

current situation of the oil industry in Uganda, and tries to highlight the nature and extent of lack of accountability of the different stakeholders often known as the corporate governance challenge. Given the negative relationship between oil and development witnessed across the African continent, one could arguably say that the discovery of oil in Uganda is a curse and will hinder, rather than help, the growth of the country. The paradoxical resource curse has negatively influenced many nations across the globe, and has a real potential to influence Uganda as our nation moves forward to develop its oil fields unless among other things, best practices in corporate governance are adopted and implemented.

Oil blocks have been demarcated and lie along the Albertine Rift Valley that separates Uganda from the Democratic Republic of the Congo. According to International Alert 2009 the government of Uganda split up the oil deposits into nine exploratory blocks, with further divisions within some of the blocks. While projections of the quantity of oil range depending on the source, most estimates suggest a range of approximately 1-2 billion barrels of oil, up from 300 million projected in 2006 (International Alert; 2009 p. 22-23). If this figure is in fact correct, Uganda, once able to maximize the full potential of the industry, could become one of Africa's largest oil producers and subsequently one of the world's top 50 oil exporters. (Reuters, 2010). At this time, oil profits cannot be accurately estimated. This is due, in large part, to dramatic fluctuations in oil prices over the past two years, notably during the global economic crisis. However, International Alert speculates that Uganda could double, or possibly even triple, total export revenues from oil. (International Alert, 2009 p. 23-24).

Much of the promise of the oil industry has yet to be realized in Uganda. The question on many Ugandan's minds today is whether this discovery is a blessing or a curse? Commercial drilling has not yet commenced and it appears as though it will be a couple of years before Uganda will begin to benefit from its recent oil windfall. This briefing paper tries to highlight some of the key issues and tensions surrounding the oil industry in Uganda today. I begin by outlining the key actors, discussing their positions and their current policies towards oil in Uganda. I follow this with an assessment of Oil for Development and the potential for the resource curse, where I make specific note of the problems faced by several other African oil nations. I then summarize the potential environmental consequences of the oil industry in the very fragile western Ugandan ecosystem. Finally, I conclude this briefing by summarizing the key issues that surround the emerging oil industry in Uganda and suggest the way forwards.

## FACTS AND FIGURES:

- It is estimated that between 1-2 billion barrels of oil lie in the Albertine Rift Valley
- Uganda's export earnings are expected to double (from USD \$2billion to USD \$4billion) or even triple once the industry is fully functioning.
- There are nine oil exploration areas, otherwise known as blocks. Five of these have been licensed to international firms, yet only 30% of the licensed territory has been mapped.

## Key Actors and their Positions

As one of the sovereign authorities in the Albertine Rift Valley, the Ugandan Government is, undoubtedly, the primary actor in the nation's oil industry.<sup>57</sup> From licensing companies to developing national policies, the government of Uganda is the most influential and crucial actor. With this power, however, comes a level of great responsibility. It is us, the people of Uganda, and indeed the outside world outside that will judge the government's performance on handling this controversial oil resource. Strategic decision making should consider the impact on society and not just the shareholders. All stakeholders must be consulted and their needs taken into consideration when designing the policies that will direct the growth of this sector.

## NORWAY'S INVOLVEMENT

Norway and Uganda, who have been partnered since 1995 through the Norad Oil for Development program, have renewed their partnership this past year after their goal to find oil was reached. Oil for Development in Uganda was the initiative formalized between them March 10, 2010 and focuses on Resource Management, Revenue Management and Environmental Management. Together, Norway and Uganda have been creating institutions using resource-sharing practices to strengthen and improve management practices of the oil and gas sector in Uganda.<sup>58</sup>

Although the government is the primary actor, some other critical actors require introduction. Tullow Oil of the United Kingdom, Heritage Oil Ltd. and Dominion Petroleum are the major oil firms involved in Western

<sup>57</sup> By Government of Uganda here I mean the National Resistance Movement Organisation (NRMO) Government of President Yoweri Museveni which is currently holding political power in Uganda.

<sup>58</sup> Note that the situation in relation to the oil industry in Uganda is changing rapidly. This case study was written in a 2010 context. Although this context has now changed, the governance issues remain highly relevant.

Uganda.<sup>59</sup> Each has a significant share of various oil blocks, and each has negotiated agreements with the government to extract oil in the near future. Secondary actors include both domestic and international lobby groups, notably Platform, as well as international partners, namely the Government of Norway, the World Bank, and the International Monetary Fund. Other states, particularly the Democratic Republic of the Congo, and to a lesser extent, Kenya, also play a role in this issue.

As mentioned above, Tullow Oil and Dominion Petroleum hold the largest stakes in Uganda's emerging oil industry. Dominion holds 100% of the stake of Block 4 while Tullow Oil has stakes in half of Blocks 1 and 3A amounting to 4,285 and 1,991 square km respectively (Op Cit, *International Alert*, p. 26). It also owns 100% of Block 2 covering 4,675 square km and has been trying to sell a stake of its interests. Tullow has sunk more than 20 wells to date.

#### The Guessing Game

- To date much of the information on the oil industry and the contracts awarded to firms have been kept secret from the general public
- This secrecy has kept many Ugandan's, including MP's from oil rich regions, guessing as to what is really going on.
- As long as the government keeps the industry a secret they will continue to face pressure across the board, escalating tensions between the government and NGO/lobby groups as well as local community leaders.

Heritage (HOIL.L) owns half of blocks 1 and 3A - Italian firm Eni SpA (ENI.MI) agreed last year to buy the interests from Heritage for \$1.35 billion but later opted out of the deal. Tullow has exercised its pre-emption right over Heritage's sale to Eni and is awaiting government approval.

Tower Resources and Global Petroleum own block 5, covering 6,040 square km. The companies drilled the first well in May/June 2009, but did not find any oil.

While contracts were negotiated as early as 2008, none of these contracts have been publicly released by the government, and of the information provided, most has come from lobby groups (*International Alert 2010*).

It is important to note that France's Total (TOTF.PA) and supposedly China National Offshore Oil Corporation, CNOOC, (0883.HK) have entered into a partnership with UK's Tullow Oil (TLW.L) to jointly operate exploration

<sup>59</sup> Note that Heritage Oil agreed to sell their assets in Uganda to Italian firm ENI, only for the deal to fall apart at the last moment. PLATFORM(2010). Uganda's Contracts – A Bad Deal Made Worse. Platform.

areas in western Uganda. Russia's LUKOIL (LKOH.MM) has also expressed interest in investing in Uganda - a delegation from the company met Uganda's President Yoweri Museveni in Feb. 2010 to discuss their plans.

**The Government Position:** When President Yoweri Museveni elatedly announced Uganda's vast oil find, he declared that the profits generated from the industry would be used to develop the nation. (Afrol NEWS, 2009). In the same announcement, President Museveni revealed how the search for oil in Uganda began shortly after he took office, more than two decades ago. The government's policies towards oil although still very unclear, appear to centre on making Uganda self-sustainable in oil (Afrol News 2009 & International Alert, 2009). For many years, Uganda has relied on oil imports from Kenya, which makes the nation vulnerable not only to world prices but as well to the stability of Kenya. In 2009 national protests and rioting in Kenya created an oil shortage in Uganda, which not only drove the price of oil upwards, it also made the task of exploration more risky.

With the goal of self-sustainability in mind, here is a short list of government preferences:

- Construction of an oil refinery in Uganda;
- Avoid shipping unrefined oil to neighbouring Kenya or Tanzania;
- Fulfill the demand of the domestic market before exporting oil;
- Acquire investment of up to USD \$8billion to be able to fully develop the oil industry and to invest in oil shipment.

**Oil Firms' Positions:** For this section, I try to summarise the general positions of the major oil companies. Most of their positions regarding general oil policy in Uganda are similar and/or overlap. Specific company policies have been difficult to discover at this time due to the sensitivity of the issue (International Alert 2009 p. 29-32). Below is an overview of these positions:

- Oil companies prefer to extract and ship the oil, rather than wait to refine in Uganda
- They believe that the best potential shipping methods are via rail to Kenya or a combination of rail/ferry through Tanzania. However, to ship through Kenya appears to be the preferred option
- There is a strong desire to export Ugandan oil to the international market where profits can be maximized
- There seems to be very little discussion of the domestic market at this time, perhaps due to their strong desire to export oil to the international market
- They all want to begin commercial drilling as soon as possible

### **Non-Governmental Organizations:**

Due to the complexities and controversy of oil extraction, many interests groups have put pressure on the government and oil firms in regards to a variety of issues (International Alert, 2009 p. 29-32).

- Many are lobbying for greater access to information. Much of the information on the oil industry has been kept within inner circles of President Museveni's NRM government, as well as within the oil companies themselves
- They are demanding thorough environmental assessments, and want environmental protection policies put into place
- Platform, one of the leading lobby groups on oil in Uganda, has repeatedly hammered the government and oil firms for not disclosing what they claim should be public information, such as the costs of oil exploration, reports of environmental incidents, as well as the agreements signed between the two parties. Platform has, on numerous occasions, accused both parties of neglecting the local environment as well as local populations

### **Local Community Leaders:<sup>60</sup>**

Similar to the interests of the NGO/lobbying community, local community leaders feel as though they have largely been left out of the oil industry. Their marginalization throughout negotiations could lead to increasing hostility towards the current government. Largely, MPs from the oil rich regions have also been left out of the process, demonstrating a lack of transparency on behalf of the government.

Oil can be found all through the western region of Uganda and, as such, there are many different communities with different ethnic backgrounds and different opinions. While all groups have varying positions with regard to oil, their general sentiments can be echoed by these common points:

- They want to be involved in the negotiation process
- They want to financially benefit from the oil industry rather than see all of the profits leave the region (some groups have demanded that 50% of the profits be transferred to them)
- They want to be protected in the event of an environmental hazard– They want to maintain control over their land. Many Ugandans and non-nationals have attempted to purchase lands throughout the oil rich Albertine Rift Valley, and some have even done so illegally.

<sup>60</sup> For a detailed discussion of varying local community interests see International Alert, Chapter 4 'Local Level Conflict Risks'.

Local community leaders in Western Uganda want to be reassured that the land their communities occupy will remain in their hands.

- They believe the government should not only share oil wealth with them but should also invest in these regions, many of which appear to have been neglected through recent resource distribution
- Local community leaders believe they should receive a substantial share of the labour employment resulting from the industry

#### AFRICAN EXAMPLES OF THE RESOURCE CURSE

- **Angola,**  
*Result:* a nearly three decade long civil war and is one of the least developed nations in Africa today.
  - **The DRC,**  
*Result:* consistent turbulence throughout the nation and a central government that is ineffective outside of Kinshasa.
  - **Sierra Leone,**  
*Result:* one of the most brutal and deadly revolutions of western Africa, lasting nearly a decade.
- There are many other examples of failure, and only one example of success, Botswana.

If the government continues to ignore the wishes of local communities it would be reasonable to assume that tensions between the communities and the NRMO government will escalate. By ignoring the desires of local communities, the government could be creating a disconnect between itself and the people, which is often associated with resistance movements in other oil rich African states (*to be discussed further in later sections*).

#### **Relations with the D.R.C.**

Uganda and the Democratic Republic of the Congo have recently enjoyed improved relations. The Eastern DRC, notably the regions bordering Uganda, remains a hotbed of instability, and many Congolese continue to seek refuge in Uganda. As illustrated in Figure 1.1, the majority of the oil deposits found in Western Uganda lie along the border with the DRC. Due primarily to instability in the region, the DRC is well behind Uganda in mapping/exploring and extracting oil in the Albertine Rift Valley. However, the government of the DRC is well aware of the deposits and of the developments occurring on the Ugandan side of the border. Even though relations have improved since the late 1990's, (*when Uganda invaded the eastern DRC*) the two governments have not been able to establish and maintain a formal

agreement on the oil industry.<sup>61</sup> If the Ugandan government moves ahead with its industry plans without an agreement with the DRC, it can be expected that relations between the two nations will decline once again. If Uganda begins to extract oil from deposits that span in both territories, this could jeopardize a fragile relationship with its neighbour to the west. The Great Lakes Region is widely known for its unprecedented instability, and worsened relations between DRC and Uganda could potentially lead to instability in the region.

Each party involved in the oil industry has different policies and different preferences. If the Ugandan government is committed to avoiding the problems often associated with oil extraction in Africa, it should take heed of the positions of all the other interested parties.

### **Oil Fuels Development?**

In five years time Uganda could become one of Africa's largest oil producers. From an economy largely dependent on agriculture and the domestic market, Uganda's transition to one of the top 50 global oil exporters presents an exciting opportunity for the nation. By 2015 Uganda's export revenue could jump from USD \$2billion to \$4 billion or higher. The amount of foreign direct investment is set to skyrocket as everyone positions themselves to grab a piece of the lucrative pie. The potential optimism from the industry has been echoed through many public announcements made by President Museveni. Uganda is now coming to crucial crossroads, and the next five years will determine whether Uganda can become the first African nation to utilize oil to promote peace, prosperity and national development. This opportunity presents an exciting, yet daunting challenge for the government, the people of Uganda, and for the international community. If things go wrong and the oil industry is mismanaged, the outcomes could irreparably damage the nation and the entire great lakes region, which is enjoying its greatest level of peace since the colonial era.

### **Resource Curse Theory:**

The resource curse, developed by renowned economist Paul Collier (2003), has crippled many African nations since their independence. Cases like Angola, Sudan, the DRC, Gabon, Equatorial Guinea, Sierra Leone, Liberia, and several others, have endured the hardships brought on by the presence of highly sought after raw materials, notably oil and precious gemstones. To date, there have been few resource related success stories. Most experiences are similar to those of Angola and Nigeria, both

61 After convening in Arusha, Tanzania, Uganda and the DRC signed a deal, however, days later, military skirmishes between the parties in the Lake Albert region re-escalated tensions, and limited the legitimacy of the deal signed.

See Kathung, Joseph. "The Curse of Oil in the Great Lakes Region". Paper Published at the University of Lubumbashi, DRC. 2009.

of which have endured equally devastating effects from the presence of crude oil.

The resource curse occurs when nations rely on the sale of their raw materials (often one resource specifically) to the world market in order to fill national coffers.<sup>62</sup> In the short run, nations receive an influx of foreign direct investment, and increased capital due to the sale of this commodity on the world market. However, due to the dramatic increase in capital, governments often ignore other essential institutions (such as those that pay most tax), and essential industries (such as those fuelling the economy before the discovery of the precious material). The decreasing quality of national institutions combined with the increasing reliance on the sale of a single commodity creates a dangerous cycle, one often resulting in conflict. Governments no longer have to rely on the people to provide income and can rely on the world commodity market instead. As such, governments begin to ignore the demands of the public, and in doing so create a divide between the people and their leaders. This can lead to “Dutch Disease” which further complicates the problem. Dutch Disease (Paul Collier 2003), occurs when the economic growth caused by resource extraction results in an over-inflated currency. Due to an inflated currency, goods, such as agriculture, textiles, or other manufactured products, are no longer competitive in the international market. These industries subsequently collapse. Consequently, the poor are no longer able to afford basic goods because of the over inflated value of the national currency. The resulting effects of Dutch Disease are high unemployment, high poverty, underdeveloped industries, and, in general, underdevelopment. The resource curse and the Dutch Disease overwhelmingly affect the nation’s poor and neglected citizens, and often instigate resistance in the form of civil conflict, guerrilla movements, or other various means of rebellion. For nearly 30 years UNITA, Angola’s most prolific resistance movement, relied on the government’s negligent policies (because they remained wealthy due to oil) to fill its ranks with motivated fighters.

### **Applying the Resource Curse Theory to Uganda**

Aside from a select few middle-Eastern nations, there are few international success stories when it comes to using oil for development. There has yet to be any African nation able to use oil to achieve development, while there have been many who have fallen further and further behind due to its presence. As mentioned earlier, Uganda has the challenging yet exciting

62 For a more detailed explanation of the resource curse see, Collier, Paul and Anke Hoeffler (2005) ‘Resource Rents, Governance and Conflict’, *The Journal of Conflict Resolution*, 49:4 (Primary Commodities and Civil War), 625-633 and Auty, Richard (2007) ‘Natural Resources, Capital Accumulation and the Resource Curse’, *Ecological Economics*, 61, 627-634, Also see International Alert, p. 16-17.

opportunity to become a success story. However, this will not come easily, and, as reinforced by the International Financial Institutions, The Ugandan Government has a lot of work to do to ensure it does not encounter the same problems of its continental neighbours.

Approximately 90% of Ugandans are employed in the agricultural sector and to date this sector makes up a vast proportion of Uganda's international trade revenue. With the looming development of the oil industry and the forthcoming surge in foreign direct investment (FDI), the agriculture sector could be in for a very rough ride. Uganda has already received increased international attention, including recent visits from the Iranian President Ahamadinajad and South African head of state, President Jacob Zuma; all eager to invest in the emerging industry. The inflow of FDI could mark the beginning of the resource curse in Uganda or the beginning of improved infrastructure and services across the country. If the resource curse occurs in Uganda, the number of unemployed will sky rocket, the level of investment in national infrastructure will decline (except for oil related infrastructure), and national as well as district level institutions will decline dramatically. If these conditions, often associated with the resource curse occur, it could be predicted that resistance and opposition would mount throughout the public. Thus, before the commercial extraction of oil begins the government needs to ensure it has the capacity to prevent the resource curse, a task that will require time and significant support. The government will need to ensure that Dutch Disease does not occur, and that the national currency does not become inflated.

As mentioned, times are exciting for Uganda. The government has been presented with a challenge no other African nation has been able to overcome. If successful, Uganda could become one of Africa's next great success stories, following in the footsteps of Botswana which has successfully utilized the diamond industry to promote development. It is likely that within five years from now we will have a better understanding of just where Uganda and its oil industry are heading. Whether or not the resource curse kicks in will depend on the policies developed by the government over the next coming months and years.

## WHAT PEOPLE ARE SAYING:

*'I wonder what will happen later. The more we are ignorant about the operations of the oil companies and the related effects, [...] the more it is to their advantage; they have their own environment officers who cannot talk ill of their operations'.*

(KII – Hoima District)

*'The companies are aware of the environmental issues, but they are keeping it to themselves [...] They need to work with us; we are gazetted public officials responsible for environmental issues [...] There are bigshots involved and so the oil companies feel they are beyond us'.*

(KII – Hoima District)

*'When you go down there (the rift valley), you find that they (the oil company) are having a lot of challenges with industrial waste disposal, but the district seems to be ignorant about this [...] There is what are called mud waters, which precedes the oil [...] They are having problems with disposing it and yet it is very toxic to the community; once poured on the grass, it dries up immediately. Yet this is the beginning of exploration'.*

(KII – Hoima District)

*'The method of disposal of some of the wastes they generated was not good, although they explained that they would dilute those chemicals using other chemicals to avoid having adverse effects on the local people'.*

(KII – Kanungu District)

(All quotes taken from International Alert local interviews)

## Environmental Concerns

Concern at the local level for potentially devastating environmental disasters brought on by oil is increasing, especially in light of the recent Gulf of Mexico oil spill. This raises major issues with regard to the power of government over these oil companies if indeed it cannot exert its authority over the transnational corporations circling the country waiting for the opportunity to extract oil and compel them to observe corporate social responsibility. The vast majority of peasant Ugandans who live in oil rich regions live off the land using the natural resources to contribute to their livelihoods (Okumu, Wafula; 2010). If waste is not managed properly and if there are any oil leaks, many Ugandans' livelihoods will be put in jeopardy. Western Uganda is a region known for its lush agriculture, its fertile lands, its water resources (including great lakes Albert and Edward), its bountiful wildlife (finally approaching the numbers that existed before the Amin era), its national parks (Queen Elizabeth, Kibale,

Bwindi, Murchison Falls, etc.) and its growing natural tourism industry. The ecosystems that exist operate in delicate balance, and the arrival of big oil poses many threats to its sustainability, especially if a spill were to occur. A key issue the government needs to address before commercial oil drilling begins is how to minimize environmental damage in this fragile region (International Alert 2009 p.27-28). If the water table becomes contaminated, inhabitants, including animal and marine wildlife, will become vulnerable. If waste is not properly managed, it too could result in soils that are infertile and unable to support livestock. When polled by International Alert, many communities expressed concerns about not having enough information about the plans for environmental management (International Alert, 2009 p.45-50). As people are depending on their environment to meet their needs, the potential contamination of this land is a chief concern. If the people in this region can no longer use the environment to provide for themselves, they will most likely encounter difficulties in sustaining themselves. The government, has yet to make a public statement around environmental sustainability in this regard and needs to provide greater assurance that the concerns of those who live in the area are being addressed. In Nigeria, a nation riddled with oil related problems, resistance movements, such as MEND, have emerged due in large part to the environmental effects of the poorly managed oil industry. The government of Uganda should look to situations unfolding in continental neighbours and learn from their mistakes.

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Key findings from this case study:

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- Uganda is sitting on the largest untapped on-shore oil reserves in Africa and the potential for large scale economic development is very real
- While discovered many years ago, the government has taken its time before opening up the industry to commercial development
- Much of the information regarding the industry has been kept secret from the general public, and much of the discontent emanating from the public is due to this secrecy
- There are several key actors involved, with the most important being the government, the oil companies, and the local communities, with NGO's and international partners playing a subsidiary role
- Local communities have varying demands, yet they largely focus on the desire to be involved in the decisions about the oil industry and the negotiation process. Simply put, they do not want to remain out of the picture as they feel they have been to date.
- Relations with the DRC could be threatened if a resource sharing agreement is not signed before commercial drilling begins
- While the oil industry presents an exciting opportunity for Uganda, it also presents a daunting challenge that its neighbours have fallen victim to, the resource curse
- Western Uganda has a very fragile ecosystem. The presence of the oil industry alone could disrupt the lives of many animal species. If a spill were to occur, the region would be gravely damaged and the people would not be able to support themselves through local natural resources.

### Direction for the future:

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This briefing outlined the key issues at play in the Ugandan oil industry. The summary of key findings (as discussed above) presents a brief, yet accurate detail of the report at large. There are other issues that need to be explored for future reports, primarily public perception and attitudes towards the industry. Some of the other key questions that need to be answered include; What theoretical construct for Corporate Governance best identifies the dilemmas faced by the Uganda government? What would be the best way of approaching decisions? And can the demands of the various stakeholders be dealt with? These are pertinent questions that any further research needs to address. However, much of the information on the oil industry in Uganda is limited to external sources such as international institutions, as well as government documents that were leaked by interested organizations. In compiling this report, I had to rely on a few key sources, which limited the scope of the research, and prevented conclusive answers to pertinent questions. Much of the confusion surrounding the oil industry and subsequent issues has been sustained by the governments' limited willingness to release important information pertinent to a report of this nature. If, and when, greater information is released, a follow up to this brief will be conducted.

### Questions For Consideration:

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1. What theoretical construct for Corporate Governance best identifies and explains the dilemmas faced by government in such a situation as described in this case study?
2. What would be the best way for the Ugandan Government and society to approach decisions on oil extraction in Uganda?
3. How should the Ugandan Government deal with the demands of the various stakeholders?

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## 16

## Where Private Gain Leads to Social Cost: The Case of Natural Gas Fracking in Central Pennsylvania

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*Abstract:* The discovery of trillions of cubic feet of natural gas in the Marcellus Shale Region in the eastern United States, including central Pennsylvania, and the development of hydraulic fracturing (fracking) techniques to extract the natural gas, has created a politically fractious governance conflict involving private economic gain at the expense of environmental and social degradation. The fragile ecosystem of the Marcellus Shale region underlies an economically depressed area, thus underscoring the apparent stark tradeoff between shorter-term, concrete economic gain versus longer-term, less obvious threats to ecosystem sustainability.

For the citizens of central Pennsylvania, preserving the natural environment for future generations has a special meaning. The Susquehanna River flows through the heart of central Pennsylvania, from its source in upstate New York through Pennsylvania into the Chesapeake Bay. Dozens of tributaries fed by mountain streams, surrounded by lush forests, offer a vast ecosystem for humans and the natural environment.

In addition to the lush forests, the Susquehanna River Valley also included rich deposits of coal. More recently, estimates of trillions of cubic feet of natural gas beneath the Marcellus Shale region (<http://www.dep.state.pa.us>, 2011), stretching from West Virginia through Pennsylvania to upstate New York, has further attracted attention to the natural resource wealth of the Susquehanna River Valley. This has ushered in a third epoch encounter of governance conflict involving private acquisition of wealth versus social and environmental cost. In the 19th century, forests along the Susquehanna River were clear-cut by firms that then continued a westward quest, leaving behind soil erosion in the Susquehanna which, ironically,

provided transport of the logs south to the Chesapeake Bay. Subsequently, coal mining became a dominant industry in central Pennsylvania from which long-abandoned mines continue draining acid into the streams and rivers of the basin. The Pennsylvania Department of Environmental Protection estimates the total cost to clean up the acid mine drainage at \$15 billion (Susquehanna River Basin Commission 2010 Report, 2010). Thus, to many citizens of the Susquehanna Valley, the prospect of natural gas fracking creating a third degradation of the natural environment has led to a growing public activism.

### What is Natural Gas Fracking?

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Extracting natural gas from the Marcellus Shale formation requires horizontal drilling and a process known as ‘hydraulic fracturing’ [fracking] that uses far greater amounts of water than traditional natural gas exploration. Drillers pump large amounts of water mixed with sand and other proppants into the shale formation under high pressure to fracture the shale around the well, which allows the natural gas to flow freely. Once the hydraulic fracturing process is completed, the used water, often referred to as “frac fluid” must be treated to remove chemicals and minerals. (<http://www.dep.state.pa.us>, 2011).

A Vanity Fair article by Christopher Bateman notes that “while hydraulic fracturing has been in use for decades to increase production when a well starts to run dry, its use in unconventional types of drilling, such as shale gas, is relatively new... It is an energy- and resource-intensive process, with every shale-gas well that is fracked requiring between three and eight million gallons of water” (*Bateman, 2010*).

### What Is Sustainability Governance?

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The sustainability of the Susquehanna River Valley ecosystem lies at the heart of the conflict between stakeholders favoring the use of “fracking” in drilling for natural gas and NGO groups concerned about the responsible use of natural resources in the region. While corporate governance, in the Anglo-American tradition, involves managers acting as agents in order to control and protect the private property of its shareholders, ecosystem governance involves managing dynamic relationships between humanity and the natural environment in order to preserve “the commons” for future generations (Heuer, 2011). Ecologists suggest that individual organizations should not view themselves as becoming sustainable so much as contributing to a large system in which sustainability may or may not be achieved (Jennings and Zandbergen, 1995, p. 1025). Consistent with that

governance philosophy, numerous coalitions formed in the Susquehanna River Valley in response to soil erosion from agriculture, pollution of streams and tributaries flowing into the Susquehanna River from acid mine drainage, and ecological impacts on fish and other wildlife. One example is The Susquehanna River Heartland Coalition, comprised of a diverse network of concerned citizens, academics, local businesspeople, farmers, and sports enthusiasts. Generally speaking then, the Heartland Coalition serves as an informal hub for a decentralized network of people who value the Susquehanna River for different reasons but all of whom are joined by a passion for its beauty and concern for its wellbeing. With the rapid increase of natural gas fracking and a concern that a third wave of outside economic interests might create another environmental disaster for the next generation to deal with, the Heartland Coalition, along with other coalitions such as the Responsible Drilling Alliance ([www.responsibledrillingalliance.org](http://www.responsibledrillingalliance.org)), the Riverfront Coalition, and Organizations United for the Environment ([www.ouenews.org](http://www.ouenews.org)), have become active advocates for resisting the spread of the drilling.

Groups supporting natural gas fracking have also become active, including the Marcellus Shale Coalition, which has as its stated purpose “the responsible development of natural gas from the Marcellus Shale geological formation and the enhancement of the region’s economy that can be realized from this clean-burning, Pennsylvania-based energy source in an environmentally sound manner” (<http://marcellusshalecoalition.org>, 2011).

The legitimacy of the opposing governance approaches involves not only economic and ecological perspectives, but also conflicting social and political positions. With unemployment remaining chronically high throughout central Pennsylvania (although lower than the current national average), job creation has become a major factor in legitimizing opposing viewpoints. Both sides agree that natural-gas development has produced new jobs for laborers at well sites, truck drivers to haul equipment and waste water, and even engineers and accountants (Maher, 2011). While the Marcellus Shale Coalition claims 72,000 jobs were created last year by using data based on new hires, rather than using conventional new job figures in order to achieve optimistic results, the Pennsylvania Department of Labor estimates 13,000 jobs were created last year in industries related directly and indirectly to natural gas. The Keystone Research Center, which receives funding from foundations and labor unions, cites 6,649 jobs created last year, while emphasizing emphatically that the impact of the industry on the Pennsylvania economy is overstated (Maher, 2011).

From a social perspective, the national profile developed around Dimock, Pennsylvania, serves as a symbol of painful social externalities caused by fracking, as up to 8,000 gallons of Halliburton-manufactured fracking fluid leaked from faulty pipes, seeping into wetlands and causing damage environmental damage. Cabot Oil and Gas was fined \$360,000 by the Pennsylvania Department of Environmental Protection for contaminating Dimock's groundwater. Moreover, Dimock is now notorious as the town where one woman's water well spontaneously combusted (Bateman, 2010). More commonly, residents in small towns routinely complain about the influx of out-of-state workers and the convoys of large trucks hauling away wastewater, all of which overburdens rural roads and other infrastructure.

From a political perspective, three U.S. Members of Congress from Pennsylvania (two Democrats and one Republican) recently urged President Obama to expand Marcellus Shale drilling in the U.S. as a way to promote energy independence. The three argued that shale gas recovery "does not pollute our Nation's water supply" and implored President Obama not to pursue further environmental regulation of the industry (www.politicspa.com, 2011). Under a 2005 law passed by the U.S. Congress, natural gas fracking was exempted from major federal environmental laws such as the Clean Air Act, Clean Water Act, and the Safe Drinking Water Act, thus limiting federal oversight. However, in July 2011, President Obama's Environmental Protection Agency (EPA) released proposed regulations to address air quality issues resulting from natural gas fracking (www.epa.gov, 2011).

At the state level, legislative and regulatory action has been limited. The natural gas industry contributed more than \$7 million to Pennsylvania candidates and Political Action Committees from 2000 through the end of 2010, with current Pennsylvania Governor Tom Corbett accepting more than \$640 thousand from the natural gas industry during the last half of 2010 during his election campaign. Pennsylvania remains the only state among the top 15 natural gas producing states not to impose a severance tax on the industry (<http://watchdog.org>,2010), with Governor Corbett on record as continuing his opposition during his term as Governor.

**So what are the political governance implications of this industry support?**

Josh McNeil of Conservation Voters of Pennsylvania summed it up as follows:

*"We know that natural gas drilling is a serious threat to the safety of our air and our drinking water, but it's becoming clear that the gas industry checkbooks pose an equally dangerous threat to our democracy. When our Governor and our legislative leaders ignore the overwhelming*

public support for a fair tax on gas drillers, how can they ask us to believe that six-figure contributions aren't playing a part in their decisions?" (www.conservationpa.org, 2010).

### Discussion Questions

1. Discuss the apparent tradeoff between jobs created through natural gas fracking versus protecting the ecosystem in central Pennsylvania. What are the issues involved? Does it have to be a tradeoff?
2. Identify the stakeholders involved in natural gas fracking. Discuss which stakeholders have the most, and the least, legitimacy, power, and rights. What determines legitimacy, power, and rights? Is Mother Nature a stakeholder?
3. Much of the fracking occurs on private property. Do landowners have the right to permit fracking on their property without consulting other stakeholders? Why or why not?
4. What are the responsibilities of the various stakeholders in maintaining and nurturing the ecosystem of central Pennsylvania?

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## Design Co.: The Art of Balancing Creativity and Control<sup>63</sup>

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*Abstract:* This case opens a discussion about governance in a professional service firm. Design Co. is organised as a private company with 32 shareholders. The company has a board with seven internal directors who control 84 percent of shares. Only their shares come with voting rights. The board members who actually run Design Co. have sterling reputations as designers and even visionaries but only the broadest understanding of management and finance. The practice's unique creative and collaborative culture has contributed to the winning of prestigious projects and numerous awards, but how Design Co. is going to tackle the really big questions: surviving the recession, deciding whether to expand internationally, and, ultimately, ensuring the practice's long-term existence. The case focuses on the major, controversial issue that seven directors-owners-architects need to resolve: Whether the company needs an outsider, not an architect like themselves, with greater strategic, financial and management experience to serve either as general manager or part-owner and board member?

*Key Words:* professional service firm, corporate governance, board composition, leadership, board-management relationship.

### Introduction

Lance Ellwood silently ran through his arguments for why Design Co.<sup>64</sup> should co-sponsor Auckland's 2009 spring architectural film festival. Ellwood and the rest of the board of New Zealand's biggest architectural practice had gathered for their regular, informal Monday morning meeting.

<sup>63</sup> This case was written with the cooperation of Design Co.'s Board of Directors. All data contained in the case are based on field research and public sources. The case is not intended to be used as illustration of either effective or ineffective handling of a managerial situation. The authors would like to acknowledge the financial support of The University of Auckland Business Case Centre.

<sup>64</sup> For confidentiality purposes, the name of the real case study company is disguised. Thereafter, it will be referred to as Design Co.

The seven architects were “going ‘round the table,” as they called it, taking turns giving their opinions in a bid to build consensus on the event, which the firm had sponsored previously. There would be no vote. Soon it was Ellwood’s turn to comment.

As he waited, Ellwood, who also was managing director, mused that the discussion might offer him an opening to resume talks on a related, albeit more controversial, subject: whether Design Co. needed an outsider, not an architect like himself, with greater strategic, financial and management experience to serve either as general manager or part-owner and board member. Ellwood and the six other directors had considered the question before, most recently a year ago, but a rising tide of projects had allowed them to sidestep the issue. Then the recession hit.

The architects who ran Design Co. had sterling reputations as designers and even visionaries but Ellwood had to admit that only the broadest understanding of management and finance, and the lack of expertise sometimes showed itself even in relatively simple issues like the festival. Sponsoring the event would cost money but would also generate goodwill and publicity. Which course was better? The board’s inability to agree quickly reflected members’ uncertainty, and Ellwood knew he would not be able to swiftly get them to reach a solution. He wondered how Design Co. was going to tackle the really big issues: surviving the recession, deciding whether to expand internationally, and, ultimately, ensuring the practice’s long-term existence.

Still, bringing in an outsider could disrupt the consensus-based approach that the board had used for years to make decisions. A culture of collaboration and agreement permeated Design Co. and gave both directors and staff members a sense of responsibility, independence, and freedom. That had fostered creativity, winning the practice prestigious projects, numerous awards and success in attracting among the best clients and employees (see Exhibit 1). In fact, some directors and employees were already worried that Design Co. had gone “corporate” enough, and that to push it further would erode the practice’s unique creative culture.

## Background

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Design Co. was incorporated in November 1989, when its predecessor, Design Group Ltd., merged with two small architectural practices. Design Group Ltd.’s owners orchestrated the consolidation of the three firms; they wanted younger architects to reinvigorate Design Group Ltd. and to ensure its survival after their retirement.

The practice grew slowly until the mid-2000s, when demand for its services and the size of projects began to skyrocket. In five years, Design Co. nearly tripled in size, so that by March 2009, the firm employed 209 people. There were 189 people in the practice's Auckland office and another 20 in Wellington and Christchurch.

As the Design Co.'s popularity grew, directors were able to choose projects and selected the health, education, civic, and commercial sectors. They typically declined requests to design facilities such as prisons. Periodically, Design Co. also did work in other areas such as luxury homes and mixed-use developments, and employed urban and interior designers and landscape architects.

Maintaining Design Co.'s large staff numbers now required it to have several big projects underway simultaneously. However, the profit margin on large contracts could be slim, and clients occasionally stalled on paying until buildings were well along. The Directors did not like to push, and before the recession, the practice could handle the erratic cash flow. But a slowdown in new projects and the progression of existing ones to less profitable stages were making it imperative that Design Co. operate more efficiently, select profitable projects, and ensure clients paid on time.

The recession – and its impact – was the first item on the agenda for Design Co.'s annual general meeting. At the winter meeting, Design Co. forecast net income slumping 45% for the fiscal year that would end March 31, 2010.

### International Aspirations

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In addition to the Auckland headquarters, Design Co. also had small offices in Wellington and Christchurch, and was looking to expand both within and beyond New Zealand.

Ellwood imagined offices in Brisbane and Jakarta, from which Design Co. could reach into all of Australia and Southeast Asia, possibly specializing in schools and other educational facilities. The company had expertise and knowledge not found elsewhere in the region, and Ellwood considered the practice to be among the best globally.

Design Co.'s size, and that of the projects it took on, already made it one of the largest architectural firms not just in New Zealand but in Australasia. Among recent projects was a new office building for Insurance Australia Group's New Zealand subsidiary. Opened in Auckland in June, the building met New Zealand's toughest environmental requirements and would house more the 700 IAG employees. Design Co. also entered joint ventures with other architectural firms, serving as a partner on New Zealand projects.

## Creative Interrogation

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Design Co. approached projects with a commitment to both innovation and sustainability and a belief that what people needed from a building varied and changed. As a result, design had to be functional, flexible and forward-thinking as well as cutting-edge. To achieve those ends, directors wanted to help clients in a consistent, thorough manner to identify and sort through their multiple needs and to anticipate future ones - and then to design a suitable building. This led to what Design Co. called “creative interrogation.”

The processes of making observations and analyzing needs, drawing and modeling options, and experimenting with new materials and technologies characterized the approach. So, too, did a steady flow of discussion and debate both with clients and among employees; talk stimulated curiosity and creativity. As a result, directors wanted Design Co. to be organized in a way that encouraged interaction and spurred employees to independently pursue ideas that interested them. So the practice had evolved a structure with “loose boundaries,” as one of the directors characterized it.

In addition to the seven director-architects, Design Co. employed four practice directors, 12 associate directors (all architects), and more than 150 specialists. These employees were divided among the seven studios that each director (the board members) led. At any given time, each studio was comprised of between 20 and 25 people, including often a project architect, a project secretary, possibly a head of projects, and a few other key people.

Yet the majority of employees were not tied to a specific studio. Instead, they moved around as projects changed and demands arose elsewhere in the practice, dispersing to work on other assignments after a contract was completed. The loose boundaries also applied to the various roles the directors held: architect, board member, manager, and business owner.

The setup allowed directors and employees to get to know one another more personally, so they could build on strengths and offset weaknesses. People generally knew who to go to for information and were encouraged to ask if they did not. Directors routinely made themselves available. This included Richard McGhee. Now in his 80s, the former director and Design Co. founder was officially retired but still worked as a consultant. It was to him that employees often went, and the depth of his knowledge was legendary among staff.

The arrangement gave directors considerable scheduling leeway, so they and employees could give lectures, attend school, or pursue hobbies or

other interests. The system also helped prevent employees from getting lost in what otherwise would have been a large practice. Most importantly, the ebb and flow of people allowed ideas to circulate and cross-pollinate, leading to new solutions to the unique challenges that each project presented. Spontaneous exchanges in particular fostered new ideas and helped drive Design Co.'s creative culture. Conversation was, in short, Design Co.'s lifeblood.

### Conversation Stoppers

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Still, the “loose” organizational structure had drawbacks. Tensions sometimes arose as activity levels varied, with some studios under the gun to meet deadline while others relaxed after finishing a project. In addition, as Design Co. had grown, it was harder to depend on conversation to pass along knowledge and experience.

When Design Co. was smaller, employees worked more closely together on fewer projects. When architects and specialists received information, they quickly passed it along, either spontaneously or when they spotted similar situations or problems. But to keep pace with demand, Design Co. – and the space it occupied – had grown, widening the virtual and real distances between employees. Experience, information, even simple tips fell through the gaps, and mistakes were made, costing Design Co. and its clients time and money.

In one instance, a studio working on an Auckland University of Technology building installed doors that were difficult to identify as an entry way. An audit team, which was identifying problems that people with disabilities might face, caught the problem and relayed it to Design Co. Still the practice installed the doors two more times, because people changed jobs and the information was not passed on.

In response, Design Co. created a database of information into which employees could tap, and called the project to better manage the firm's collective knowledge the “AUT Book of Knowledge.” The project was only a partial success, limited by uneven commitment among directors and by the culture of depending on conversation to find out information. In fact, some employees thought the database would only become relevant once McGhee, a veritable architectural encyclopedia, stopped coming to the office.

To stimulate information flow, the company had recently moved. Design Co. headquarters had been located in a multi-story site in downtown Auckland, but moved in June to a 1960s office and warehouse complex in Parnell, a funky in-town suburb.

Initially, the board disagreed on the need to move, with some directors hesitant about the cost and disruption. Those who wanted it had had to lobby hard to build consensus, arguing that, after Design Co. renovated the building, staff members would be on the same floor. That would generate more interaction; Design Co.'s future, they said, rested on its ability to retain and nurture the discussions and debates that spurred creativity.

### Management and Governance

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In addition to around 150 architects and design specialists, Design Co. employed more than 50 people in management and administrative positions. In addition to Ellwood, top management staff included Peter Maxwell, the finance manager; Alison Thomson, the technical and design manager; Dean Saunders, head of marketing; and Amrita Patel, human resources manager. Andrew Bradley, a senior associate architect, represented employees at board meetings.

While the board expected management to take initiative and lead, its primary function was to support the directors in their roles as architect, board member, business owner, and studio head. In addition to the informal Monday meetings, the board met with staff every other week and held formal meetings on a quarterly basis. The board conducted their own director reviews and held annual retreats to set strategy. To save money, they had held their 2009 retreat at the office.

Board members considered the informal Monday meetings to be the most critical. They updated each other on how projects were progressing, what contracts they were trying to land, new materials and methods other architects were using, and how employees, particularly the younger architects, were doing. Every other Monday, up-and-coming practice directors were invited.

At the Monday meetings, the board also worked through issues such as the move and the festival, turning over the questions again and again to reach an agreement. Some members had been friends for years and considered it ungracious to argue too hard to convince others of their views. Those who were not long-time friends shared a mutual respect stemming from an appreciation of each other's knowledge of architecture, experience, and record of success.

Still, the board members had strong personalities and opinions - practicing a creative art such as architecture demanded it - and conversations could get raucous as disagreements arose. Some members even stood and banged on the table to make their points. Often, too, the architects would pursue tangents or entirely new topics. Arnold, the chairman, would intervene,

putting members back on track and then calling for the board to go around the table.

At this particular meeting, even as Ellwood was weighing whether to broach the subject of an outsider, Arnold was beginning to pull the other board members back to the subject of the festival from the various tangents onto which they had strayed. “Had I missed this opportunity?”, wondered Ellwood. He sighed. After four years, he was growing tired of being managing director. His architectural responsibilities were growing. At the same time, he knew his meticulousness sometimes irritated others, and that some in management wanted greater independence, responsibility, and influence.

#### History of Design Co.

Design Co. did not always have a managing director. For six years, board members shared responsibility for running the company. But several were in their late 50s and looking toward retirement, and in 1995 McGhee and Stephen Syddall, another founder, did retire, although McGhee continued to serve as a consultant. McGhee and Syddall’s departure prompted remaining directors to seek outside advice on how to organize and run the growing company.

After a nine-month review, the board opted for the first time to appoint a managing director. The first would be Leonard Arnold, whose firm was one of the two that merged with Design Group Ltd. in 1989. The directors also agreed to pay themselves salaries that varied with the value and number of projects they brought in.

Arnold found, however, that trying to balance the responsibilities of a managing director with the needs of his architectural clients was pushing him “close to burnout.” Too often, he found himself unable to perform the management function properly, and after five years he stepped down from the position. Besides, he felt that his strength lay in building and sustaining client relations.

As his replacement, the directors appointed John Billing, whose firm also had merged with Design Group Ltd. in 1989. Billing had the fewest projects going at the time of his appointment, and the board therefore reasoned he would have the most time to manage. Four years later, though, Billing left Design Co. to set up his own firm. Tumult followed as staff questioned not only whether the practice had just lost its competitive edge but whether Design Co. could even survive without Billing.

John Billing was not a rainmaker: he did not bring in the most projects. But he emphasized innovation, creativity, and daring, and employees considered

him to be on the cutting edge of architectural design. His mentoring of young architects had made him popular in the practice, and his charm and accessibility led to wide public exposure for Design Co. Some people even thought, “Design Co. was him,” Arnold recalled. Fears that the economy was flagging exacerbated the worry.

The board sought to boost morale by appointing a couple of up-and-coming architects as directors and highlighting awards won by other architects. Now, five years later, it was clear that the concerns about Design Co.’s future were not fully justified. Business had flourished, staff numbers had soared, and the awards continued to flow in. Unfortunately, though, now the recession was again forcing the board to consider how Design Co. should be managed and for whose benefit. Ellwood debated with himself as to whether to break into the conversations going on around the table.

### Too Many Hats?

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Design Co.’s looseness sometimes befuddled management and perplexed particularly those who had not worked in a creative industry before. The traditional corporations from which they came had rigid hierarchies, well articulated goals and strategies, established operational procedures and methods for measuring progress, and transparent incentive schemes. Boards focused strategy and CEO performance. Members did not get involved in mundane questions like what photocopier to buy; nor did management seek their input. The firms channeled knowledge so that it resided with the company, not the individual.

While Design Co.’s board valued their Monday meetings, managers thought the gatherings often served more as an opportunity to swap stories about golf and the weekend. When directors did focus on issues, their resolution could take far longer than needed, months even, as the seven slowly arrived at a consensus. Management thought the company needed to be more nimble, particularly during the tougher economic times, and on occasion felt compelled to circumvent the board. In those instances, they took ideas directly to individual board members and let the architects believe they originated the plan.

Another frustration was the multiple roles that the directors had. Staff members were not always certain what role a director was playing when he asked a question or made a suggestion or comment. Not knowing this made it difficult to answer questions. Plus, there sometimes seemed to be a conflict of interest. What was good for the company was not always good for the individual director - and vice versa. If an architect asked about a project, was he interested in the design itself? The project’s financial

contribution to Design Co.? The impact it would have on his annual bonus?

Recently, the board began discussing whether to reward some employees by giving them more shares, because the strained budget would not allow for anything else. Design Co.'s 32 shareholders owned 2 million shares total. Holdings ranged from 3,000 and 4,000 shares, which the practice had issued to management, to the 240,380 shares that each of the seven directors held. If someone quit Design Co., they had to sell their stake back to the company. Seven directors together controlled 84 percent of shares. Only their stock came with voting rights.

Shareholders were entitled to a pro-rata proportion of after-tax profits, paid out at the end of the year as bonuses. Design Co. also began paying its owners dividends in 2007, when shareholders received \$505,509. A year later, Design Co. returned to its owners \$2.22 million in profits. In the first six months of 2009, Design Co. paid its shareholders dividends totaling \$603,911.

But in considering the proposal to award more shares to employees, the board could not agree on how to do it: whether to issue more shares, which would dilute everyone's holdings; give up some of their own shares, diluting only their holdings; issue additional shares without voting rights; or whether to redistribute the shares held by non-board members, thus preserving their stakes. For months they had been stuck. Meanwhile, the risk of losing talented employees grew.

The absence of a single leader articulating a single vision for Design Co. also led to the sense among some employees that no one was in charge. Each studio diligently worked on its own projects while the company as a whole floated like a rudderless ship at the mercy of the prevailing economic conditions. While some employees and managers felt that uncertainty was an essential ingredient to stimulating a culture of creativity, others found it unsettling, particularly in the downturn.

In recent years, the board had taken a couple of measures to address the concerns. Under Ellwood's tenure, the board had worked for months on a strategic plan, identifying expansion in both New Zealand and Asia as a key goal. The board also had hired a private consulting company to review operations and Design Co.'s governance structure and recommend changes to ensure that the company would meet its strategic goals.

Among the recommendations were that Design Co. hire a dedicated, professional general manager - not a board member whose education was in architecture - to run the company, and that Design Co. appoint a similarly independent director to the board. The consulting company also suggested that the board adopt a company charter, a board work plan and a directors' code of practice, to clarify roles and plans.

So far, the board had taken little action on either the strategic plan or the recommendations. Would the recession act as a catalyst or serve as a reason for further inaction, wondered Ellwood.

## Recession

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The national statistics agency had just reported that the New Zealand economy had contracted for the fifth consecutive quarter. While the construction component of gross domestic product had risen for the first time in the five quarters, the increase resulted mostly from government investment in roads and bridges. Non-residential construction actually dropped 1.4 percent while residential building fell 0.8 percent.

New figures showed that investment in non-residential buildings was not paying off. The country's Property Council New Zealand had just reported that total returns fell 0.8 percent for the 12 months ending March 31. The Council compiled the index with global real estate consultancy Investment Property Databank. A measure of the industry's health, the index took into account the income return and market value of 327 properties, but excluded debt.

The economy might pick up in the coming quarters, but the gains would probably be slight and the environment would likely continue to be "difficult" for businesses, the New Zealand Institute of Economic Research warned. "Profitability is likely to remain a challenge given subdued demand and reduced pricing power," it said. "Cost-reduction strategies may be required for some time yet."

Design Co. was feeling the pressure. As the economy contracted, Design Co. expected net fees to drop by one-third, to \$14.54 million from \$21.42 million. In an earlier, five-year forecast, the practice anticipated fees of nearly \$22 million. The company expected profit of \$1.84 million, compared with \$3.36 million a year earlier.

Both directors and managers acutely felt the need to bring in more clients, tighten operations, and improve cash flow. They were also trying to cut costs, prompting the discussion about the film festival. Rumors had begun to fly, however, that Design Co. might fire some people, a move that would go against the very grain of the company's culture of conversation and camaraderie. Ellwood knew something had to be done

## Questions:

1. What are the major issues in the governance of professional service firms?
2. What are the roles that the board plays in Design Co.? Are the directors' roles and responsibilities clearly articulated?
3. Does the board in Design Co., as a governing body, provide much value to the firm?  
Are the seven directors effective board members?
4. Should Design Co. include independent directors on the board?  
If yes, why does this firm need independent directors? Why is the board reluctant to appoint independent directors? What kinds of independent directors should be selected?
5. Should Design Co. move more toward a corporate model of governance?

**Exhibit 1. GARNERING AWARDS AND INFLUENCE**

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The kind of professional and personal freedom that Design Co. allowed, and the high-profile buildings that it designed, had helped Design Co. build a reputation as a great place to work and landed it numerous awards.

Design Co. designs punctuated Auckland's skyline: the Civic Theatre, an iconic 1920s cinema saved from demolition and converted by Design Co. into a contemporary theater; Town Hall, transformed into a performance venue while still retaining its 1911 Edwardian elegance; and the ultra-modern Vodafone building in the city's central business district.

Design Co. had won numerous honors over the years from the New Zealand Institute of Architects and the Property Council New Zealand, the country's premier industry groups. Among the award-winning designs was that of Te Papa, the country's national museum in Wellington. The design helped establish the firm's reputation and thrust its architects into the public eye.

In 2008, Design Co.'s design for the Sylvia Park, a \$225 million retail area in southeast Auckland, won it two awards from the International Council of Shopping Centers. That same year, the practice won a New Zealand Institute of Architects award for its design of Wellington Zoo's new amphitheatre. In 2006, its design for Vodafone V. Nue's headquarters in downtown Auckland won it the Rider Hunt Supreme Award, the highest honor that the Property Council New Zealand bestowed.

Design Co. was perhaps best known for its design of Te Papa (see Exhibit 3). Opened in 1998, the \$136 million museum won Design Co. the New Zealand Institute of Architects' Northern Regional Award for architecture/community and culture, and the DuPont Antron Design Award. McGhee, one of the project's key architects, won the New Zealand Institute of Architects' Gold Medal in 2008, in recognition of more than 50 years of outstanding work.

Recently, Design Co. had been selected to redesign the 47,000-seat Eden Park stadium for the 2011 Rugby World Cup, a prestigious \$240.5 million project that involved all aspects of the practice, from architecture and interior design to urban design and landscaping.

Design Co. board members also were active both in industry circles and beyond. Most recently Leonard Arnold, Design Co.'s chairman, had been selected by the government to head up a national taskforce looking at how to more densely develop New Zealand's cities. Arnold, a director since 1989 and chairman since 2000, also served as the Institute's president and as chairman of Construction Information Ltd. which provided specification systems and software to the construction industry

### Exhibit 2. MUSEUM OF NEW ZEALAND TE PAPA, WELLINGTON



Source: Wellington City Council (2008) *Over 15 Million Visit National Museum*. Available from: [http://www.wellingtonnz.com/media/wellington\\_tourism\\_stories/over\\_15\\_million\\_visit\\_national\\_museum](http://www.wellingtonnz.com/media/wellington_tourism_stories/over_15_million_visit_national_museum)

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## 18

## Corporate Governance in NTUC FairPrice Co-operative Ltd, Singapore

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*Abstract:* The Singaporean Cooperative, FairPrice has sought to address issues of governance through a series of codes and policies. A cooperative differs from a small limited company in that it focuses on the needs of its members in a broader sense than just financial return. Governance therefore involves policies that reach beyond the business itself into its social and environmental context. FairPrice uses a series of codes and policies that addresses the needs and expectations of the wider community and a variety of stakeholders. This case examines some of those codes and policies in terms of their purpose and effectiveness.

### Co-operative Sector

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The International Co-operative Alliance (2010) defines a co-operative as an autonomous association of members who voluntarily establish a jointly-owned business entity to meet their shared socio-economic needs. The co-operative sector is considered one of the important sectors contributing to national and international social and economic development and stabilisation. The total turnover of the top 300 co-operatives reached USD\$1.1 trillion in 2008, and there are over one billion members of worldwide co-operatives in 2011 (International Co-operative Alliance, 2011; Singapore National Co-operative Federation Limited, 2009a).

In Singapore, a co-operative is a legal business entity in which shares are held by the general public. This is different to a private limited company in which shares are held by less than 50 people and not available to the general public. A co-operative also differs from a private limited or a public listed company in terms of its social mission, i.e. meeting the needs of members and fostering mutual and self-help via different programs, products and services while maintaining business excellence

(Singapore National Co-operative Federation, 2011). Co-operatives are crucial to the economic growth of Singapore for the following reasons: (i) they improve the well-being of ordinary people and meet the needs of their members and the community by supplying them with goods and services at affordable prices and acceptable quality, (ii) their main objectives are to serve members, and not to maximise profits at the expense of their members, and (iii) they have either helped workers upgrade their skills or created new jobs for people (Singapore National Co-operative Federation Limited, 2009b; Tan, 2003). The International Co-operative Alliance (2011) estimates that about 1.6 million of Singaporean residents are members of at least one co-operative. NTUC FairPrice is one of the co-operative societies which has achieved significant success and become one of the well-known and trusted home brands in Singapore.

### Background of NTUC FairPrice Co-operative Ltd (NTUC FairPrice)

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NTUC FairPrice was established in 1973 and registered under the Co-operative Societies Act (Cap. 62) in Singapore. Currently, NTUC FairPrice has 36 founder members, 34 institutional members and many individual members (NTUC FairPrice, 2009a). These groups of members have provided capital to NTUC FairPrice to assist in achieving its goals. In a co-operative entity, members are also customers. Thus, NTUC FairPrice is obliged to be transparent and accountable to all of its stakeholders (Soo, 2011).

From one shop at the time of establishment, NTUC FairPrice is now the second largest retailer and the largest supermarket chain with S\$2.2 billion turnover, more than 6,000 staff, and a network of 230 outlets of supermarkets and convenience stores in Singapore (AsiaOne, 2009; NTUC FairPrice, 2009b, 2010). NTUC FairPrice owns and operates a Fresh Food Distribution Centre and a warehousing and distribution company (NTUC FairPrice, 2009a, 2010). It has also recently expanded its business model by introducing convenient stores in mini-marts at petrol stations (Lee, 2007).

As a co-operative, the vision of NTUC is to be the leading world-class retailer with a social conscience. Its mission is to meet the needs of its members and to serve the community. It seeks to be the best place to shop and work, and the best corporate citizen (NTUC FairPrice, 2009a).

NTUC FairPrice focuses on quality of products and services, ensures food safety and embraces technology to improve productivity and to assist farmers in adopting good practice in farming (Chua, 2007). It has sought to build a trusting relationship with all stakeholders. These business strategies help it gain competitive advantage over other retailers. In contrast

to some business entities, the success of NTUC FairPrice is measured by the positive impact which it makes on customers, members and the society via affordable prices and acceptable quality of products and services, a strong commitment to social contribution and environmental protection.

NTUC FairPrice has also expanded its business to other countries in Asia. It has opened many hypermarkets in different locations in China, such as Shaoxing and Zhejiang. It has worked with many well-known business partners, such as L'Oreal, ExxonMobil, etc., and also is involved in a joint venture with DBS Private Equity, New Hope Group, Silver Tie and Taiwan's Apex Group (Lee, 2007; GS1 Singapore, 2008).

#### Corporate Governance

Co-operative corporate governance emphasises the important role of the independent directors in providing objective judgment on the performance of the Management of a company and scrutinizing its operating issues, such as business strategy, financial performance, human and capital resources, appointment of key executives, setting standards of conduct, etc. (Donaldson, 2003). In addition to observing the requirements of legislation, regulations and guidelines laid down by relevant authorities and industries, NTUC FairPrice has formulated its own three sets of code of practice, namely, Code of Corporate Governance, Code of Conduct for Buyers and Employee Code of Conduct. It should be noted that these codes are only for internal circulation and the details of their implementation are not widely available to the public. Only brief information on these codes is provided on request by NTUC FairPrice's Corporate Communications Department.

#### **NTUC FairPrice's Code of Corporate Governance**

As a co-operative society, NTUC FairPrice operates differently from both private and listed companies, and it is not mandated to comply with the Code of Corporate Governance 2005, enacted by the Monetary Authority of Singapore (MAS). Actually, companies are not required to comply with this Code because it only serves as a guideline. Nevertheless, the Singapore Exchange Listing Rules require listed companies in Singapore to disclose their corporate governance practices and any practices deviant from the rules in their annual reports. The Singapore Exchange Listing Rules are not applicable to NTUC FairPrice as it is not a listed company. However, NTUC FairPrice must act in accordance with the Co-operative Societies Act (Cap. 62) and Singapore Financial Reporting Standards.

NTUC FairPrice has a Board of Directors (the Board) and a team of management staff (the Management) whose membership is independent

from the Board. According to the company, the promotion of corporate transparency, integrity and accountability at all levels of the organisation is led by the Board and assisted by the Management.

NTUC has worked with different stakeholders to develop its own standards. Its internal Code of Corporate Governance provides the governance principles and practices to ensure transparency and accountability (Soo, 2011). This code also clarifies the responsibility of the Board and the Management. Three key areas are the main foci of NTUC FairPrice's principles and practices of governance. They are "(i) Strategic Directions of the Co-operative, (ii) the Co-operative's Board Operating Standards and, (iii) the Co-operative's Management" (Soo, 2011). The first section covers the corporate vision, mission and business strategies. The second section consists of the Board Operating Standards which provides the guidelines on the constitution, functions and responsibility of the Board, the role of the Chairman's, the composition of different Board Committees. It also includes Terms of Reference, frequency and procedures of the Board meetings as well as confidentiality clause (Soo, 2011). The third section of the Code of Corporate Governance of NTUC FairPrice stipulates the responsibility of the Management, how the Management is delegated with authority, how annual and financial reports should be prepared, how the Internal Control system regarding financial, operational, compliance controls, investment appraisal, contractual and legal risk reporting and risk management should be maintained (Soo, 2011). The Code also stipulates how NTUC FairPrice should comply with the Co-operative Societies Act (Cap 62) and its By-laws.

#### **NTUC FairPrice's Code of Conduct for Buyers**

NTUC FairPrice has created and adopted the FairPrice's Code of Conduct for Buyers, providing guidance to its procurement staff on how to manage and communicate with suppliers to ensure the high degree of transparency (Soo, 2011). All staff involved in purchasing activities are expected to adhere to this code.

#### **NTUC FairPrice's Employee Code of Conduct**

NTUC FairPrice operates in a unionized environment, and seeks to maintain a good labour-management relationship (Chua, 2007). In order to achieve its mission of being the best place to work, NTUC FairPrice takes care of the welfare and well-being of its employees by providing health insurance, a conducive working environment and opportunities for career development. Flexible work arrangements at NTUC FairPrice are in response to the call for greater work flexibility by the union and the government. It has also set its own Employee Code of Conduct which governs the activities

of all the Co-operative's employees. All employees can access this code via its intranet (Soo, 2011). Occupational safety and health is also a major focus at NTUC FairPrice, especially at the distribution centre due to its cold working environment (Chua, 2007).

### **NTUC FairPrice's Board Role and Responsibilities**

Currently, the Board of Directors of NTUC includes a Chairman, a Deputy Chairman and 12 members. All board members are prominent business leaders in the private sector and/or senior executives of public agencies or industry associations in Singapore, such as the Singapore Institute of Directors, the Corporate Governance Council, the OECD Asian Network on Corporate Governance for State Owned Enterprises, the Health Sciences Authority, the Lien Centre for Social Innovation and the Agri-Food and Veterinary Authority (AVA) (NTUC FairPrice, 2010). Collectively, the members of the Board have vast experience and expertise in banking, accounting, insurance, investment, legal, and risk management.

The function of the Board is to make sure that NTUC FairPrice implements sound corporate governance practices, and complies with pertinent laws and regulations. The Board members are independent from the management team, and thus they can objectively and independently make judgement and decisions (NTUC FairPrice, 2010). More specifically, the Board oversees the activities of NTUC FairPrice's Management (including ensuring that professionalism is practised by all levels in the organisation in order to enhance its reputation) and provides direction to the co-operative to operate and achieve its objectives.

### **NTUC FairPrice's Chairman and Chief Executive Officer (CEO)**

The management team comprises the CEO, the Chief Finance Officer and 14 directors and deputy Directors. They are in charge of different business functions, such as Hypermarket, Convenience Stores, Food Safety and Quality, Supply Chain, etc. Under the leadership of the Board, the management team is responsible for the daily operation of the co-operative. The management team also takes care of the preparation and presentation of the financial statements that must comply with the Co-operative Societies Act (Cap. 62) and Singapore Financial Reporting Standards (NTUC FairPrice, 2010). The separation in responsibilities of the Board and the management team allow a balance in power and authority of these two groups of senior executives and facilitates greater accountability and independent decision making.

Mr. Ng Ser Miang and Mr. Tan Kian Chew are the current Chairman and the Group Chief Executive Officer (CEO) of NTUC Fair Price, respectively.

The Chairman steers the Board toward maintaining higher standards of corporate governance and making sound decisions. The Chairman and the Board play the role of legislative executives, whereas the CEO, the most senior executive in the management team, is the key executive personnel, assuming full responsibility for NTUC FairPrice's overall operations (NTUC Income, 2010). The management team, leading by the CEO, are responsible for designing, implementing and improving internal control mechanisms which can ensure financial statements are not misleading. They also make accounting estimates that are acceptable by the Board and the members (NTUC FairPrice, 2010). Nevertheless, it is not clear to what extent the performance of the Chairman and the Group CEO are scrutinized.

### **NTUC FairPrice's Board Committees**

Six Board Committees provide assistance to the Board. These Board Committees are the Audit, Establishment, Risk, Finance and Real Estate, Study Grant and Business Development Committees (NTUC FairPrice, 2010). These committees are authorised to oversee the operations and business affairs of NTUC FairPrice. The composition and the key responsibilities of each board committee are clearly defined in NTUC FairPrice's own Code of Corporate Governance. All chairpersons and members of these Board Committees are the members of the Board of Directors. However, the members of these Board Committees are not the members of the management team.

### **NTUC FairPrice's Financial and Operations Reporting**

Annual Reports with full financial reports and the reports by the directors and independent auditors are available on NTUC FairPrice's website. Such reports include financial information, similar to a financial report of a listed company, which is necessary for its members to evaluate its performance. However, details about how these reports are prepared are not available to the public, although the Independent Auditors' Report stated that the management team was responsible for preparation of the financial statements in accordance with the respective act and standards. Also information about the number of meetings of the Board and the Management, and the remuneration of the Board members and senior executives is not included in its annual reports. Only the reports of the Directors in NTUC FairPrice's annual reports indicate the Directors' interests in shares and debentures.

### **Corporate Social Responsibility (CSR)**

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CSR practice at NTUC FairPrice can be categorised into three groups, namely (i) support and promotion of community projects, (ii) promotion of

environmental sustainability, and (iii) working with relevant authorities to develop standards applicable to the industry.

Firstly, NTUC FairPrice has launched many CSR programs to build trust with both internal and external customers and enhance its reputation as the best corporate citizen. Some of these programs are its Used Textbook project, Million Dollar Food Voucher scheme for the poor, Study grants for children of low income parents, Heartstrings Buys fund-raising drive for the Community Chest, and Everyday Low Price scheme. The purpose of the recent “Breadwinners – We Care, U Care” campaign, another initiative by NTUC FairPrice, is to raise S\$1 million which will be used to provide financial assistance to 130,000 recipients (NTUC FairPrice, 2010; Soh, 2011). Senior citizens will get special discounts and offers on every Tuesday of the week, and customers can get special prices for NTUC FairPrice housebrand products even during the current 2011 economic volatility sparked by the high inflation rate in Singapore.

Secondly, NTUC FairPrice actively promotes environment protection for sustainability. It is one of the founding members of the Singapore Compact for CSR, a national society supporting the United Nations Global Compact (NTUC FairPrice, 2010). It has introduced the “Love Nature” reusable bags, and participated in the “Bring Your Own Bag Day” to encourage customers to reduce the number of plastic bags used when shopping at its outlets every Wednesday (Chua, 2007).<sup>65</sup> Otherwise, customers have to pay S\$0.1 for each plastic bag taken on these days. Some other environmental initiatives are the FairPrice Green Lifestyle campaign and the establishment of the Green Committee (2007) to enhance the public awareness of green issues (NTUC FairPrice, 2010). An eco-friendly supermarket equipped with energy-saving equipment and lights was also opened by NTUC FairPrice in 2009.

NTUC FairPrice has also co-developed the Technical Reference on Cold Chain Management together with the Angri-Food and Veterinary Authority (AVA) and the Standards, Productivity and Innovation Board (SPRING) of Singapore (Chua, 2007). The Director of Corporate Communications Department of NTUC FairPrice mentioned that “we are in the process of developing platforms to communicate our corporate social responsibility policies and actions to our stakeholders. This should be ready by the end of this year” (Soo, 2011, para 7).

<sup>65</sup> Singaporean customers are not very environmentally conscious. This is very different from people in other countries, such as Japan, Scandinavian countries, Australia, etc., who are happy to participate in programs aiming to protect the environment. Thus, these programs are “breakthroughs” for Singapore.

## Achievements

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Sound business strategies, good corporate governance with clear financial reporting channels and a strong sense of social responsibility has enabled NTUC FairPrice to improve its financial performance, i.e. a two-fold increase in profit from S\$6.3 million in 2009 to S\$130.3 million in 2010. Members received dividend of 5% and a special dividend of 1% in 2010, and customers and members also receive benefits through discounts or rebates (Kumar, 2008 and, 2008b; NTUC FairPrice, 2010; Boujelbene and Nabila, 2011).

NTUC FairPrice has received many national and international awards from 1989 until now. For example, it was recognised for its improvements in consumer choices, satisfaction and service and obtained the top award in the Efficient Consumer response (ERC) Asia Pacific Annual Award in 2007 (GS1 Singapore, 2008). NTUC FairPrice was in the top ten of the Superbrand list in Singapore, voted by consumers in 2009 (Yeo, 2009). NTUC was also voted by consumers in the 2009 survey by Reader's Digest as Trusted Brand (Platinum category) for Supermarket Chain category in Singapore (NTUC FairPrice, 2010). Good CSR practice enabled NTUC FairPrice to be crown the Best Community Developer and obtained the Singapore Compact CSR Award in 2010 (Singapore Compact, 2010).

## Conclusion

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NTUC FairPrice has done well in terms of financial performance and relations with members, customers and the community. Apart from compliance with government legislation and regulations, it also set its own codes and standards to guide its strategies and operations. In this case, regulatory and self-regulatory approaches have been employed by NTUC to govern its operation and the behaviour of its senior executives and staff members. NTUC FairPrice also has a Board of Directors who scrutinise the activities of the management team. There is a certain level of independence in terms of membership composition of the Board and the management team as none of the members of the Board of Directors is a member of the management team. However, more evidence of separation of responsibility of the Chairman and the Group CEO, and mechanisms used to manage the relationship among stakeholders and to control business strategies and corporate performance is required in order for NTUC FairPrice to achieve good corporate governance.

Evidence proves that NTUC FairPrice can achieve financial objectives and at the same time can be social conscious. Clear corporate structure,

mission and vision helps NTUC FairPrice to build and maintain trust of members and customers, and to go beyond what other business entities do, i.e. to serve the community and protect the interests of its members. Being good corporate citizen is a strategic and long-standing advantage over competitors. Practising good corporate governance does not deter firms from making profit, but on the contrary, it helps firms sustain and grow their businesses as customers and investors would support them.

Yet, only limited information about corporate governance of NTUC FairPrice is open to the public, although some general information about its corporate governance can be obtained from the Corporate Communications Department upon request. Thus, NTUC FairPrice should make more information about its corporate governance, internal control mechanisms and executive compensation available to the public.

## Review Questions

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1. How does a cooperative differ from other types of business structure?
2. What are the requirements for good corporate governance in co-operatives according to the OECD?
3. How do the mission, vision and operations of a co-operative affect its principles and practice of good corporate governance?
4. What are the key corporate governance lessons from NTUC FairPrice?
5. What issues NTUC FairPrice needs to pay the most urgent attention in order to achieve good corporate governance?
6. What information is required for a robust structure for corporate governance in this case?
7. What impact does the social environment have on corporate governance of NTUC FairPrice?
8. What are other factors that would increase confidence in the robustness of the corporate governance structure for NTUC FairPrice?

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## 19

## On Defining a Strategy for Push/Pull Allocation of Promotion Expenses

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*Abstract:* This case addresses 2 distinct styles of governance in terms of problem solving. One approach can be defined as: "data driven." The decision maker has to find supporting data for his/her line of reasoning, and they use data analysis as the basis of their decision. Alternative governance dictates that data analysis is merely the first step. One must be able to interpret the data and read between the lines to identify what really is behind the numbers. In other words, the decision cannot be merely be "data-driven" to support his solution. He must use data interpretation to justify his decision. These 2 approaches are presented below. The reader will determine which style is appropriate for which type of problems.

### Introduction

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In the field of new product introduction, it is quite typical for the manufacturer to approach the retailer to request shelf space to put the new product on the market. However, there is a major stumbling block here. It is well known that most retailers are reluctant to introduce new products to their store. Their logic is very straightforward: Since their current merchandise in the store is moving, why substitute an unknown entity which may not sell at all, and remove current merchandise in the store which is selling and is a proven success?

In the literature, one finds two basic strategic approaches regarding promotion tactics to overcome the retailer's reluctance to carry a new product. One is called the Push Strategy and one is called the Pull Strategy. The push strategy calls for using the sales force, trade promotion and direct contact with the retailer to offer them significant incentives to carry the new product. These incentives include paying the retailer's promotional expense, paying for in-store promotion, offering coupons and price discounts, such as 2 for 1 and so on. On the other hand, the pull

strategy calls for heavy expenditures directed to the consumer, not the retailer. This can include advertising, direct marketing, and consumer promotion to induce final consumers to buy the product. The consumer, in turn, will ask the retailer for the product. This new demand for the product will encourage the retailer to carry the product in his store, since consumers are asking for the product. (Kotler and Armstrong, p. 418).will pull the product through the channels (ibid, page 418).

In terms of justification of promotion expenditure, one can use the profit motive as the firm's ultimate goal. Since Profits are defined as Revenues minus Costs; increased sales and demand for the product will increase profits by increasing total revenues earned and lowering the incurred cost of production.

With respect of promotional expense, our objective is the following: Net Profits should be increased, i.e., Increase incremental revenues that are generated by the promotion effort minus the incremental cost of the promotional effort. Clearly, if the cost of promotion is greater than incremental revenues earned by promotion, then the promotion effort must stop, because our firm is losing money as a result of this promotion.

### The ABC Corporation

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The ABC Corporation has just invented a new method for filtering tap water. Most competing firms sell a pitcher with a filter to purify the water. The ABC Corporation offered a superior alternative. Instead of using a large pitcher with a filter inside, which is what Brita and PUR use, ABC invested a filtration device that is hooked up directly on the faucet. This is more efficient and easier to use than the large pitcher. Furthermore, there is no need to constantly refill the pitcher of filtered water. The problem facing the ABC Corporation is, what is the most cost effective way to disseminate this information of the new filtration device to the general public?

Harold, the Chairman of the Marketing Department, hired a consultant to come with forecasts of sales and revenues for 10 different scenarios, using different levels of push and pull expenditures for the promotional effort. The consultant provided data that is presented in Table 1 below . Clearly, Scenario 5 offered the highest incremental sales revenues minus the promotional costs.

### **Conflict between Chairman of the Marketing Department and Board of Directors**

When Harold presented his decision regarding the promotion budget and how it should be allocated between push and pull strategies

(Scenario 5), The Board of Directors and had some serious misgivings. Their claim was that Harold was simply using numbers to define the best solution. No effort was made to interpret the numbers and see what they really mean. Furthermore, there is a tremendous gap in the forecast data given by the consultant. Consider the following: We have 3 variables Push Strategy, Pull Strategy and the Feature Price. We also have which is given in units, a formula how to predict earned revenues: The consultant evaluated or total number of possible scenarios , if we are given only 10 scenarios out of a possible number of 18, or 10The Board of Directors read the following quote from Dr. Diane Ratchford, Research Professor at New York University. This statement was given at the commencement exercise for Graduates from Johns Hopkins University in Baltimore, Maryland. "Our Research Activity today is crippled by data analysts who assume that it is their responsibility to dictate policy based on their data analysis. Indeed, data analysis is important, but interpretation of the data is more important. This responsibility should not be dependent on what the data analysts dictate. For example, the data analysts measure the probability of getting a job for those who major in Math and Sciences is significantly higher than those who major in Liberal Arts." The data analysts conclude that the motto, "No Student shall be left behind" should be a wake up call for increased efforts, expenditure and focus on Mathematics and the Sciences. However, we still have gifted students who can write beautiful poetry, or introduce new ideas in Philosophy or focus their talents on Physical Education. Are we obligated to abandon these students because they are not gifted in Mathematics and the Sciences? We cannot and should use the results of data analysis with respect to successful employment to provide for us data interpretation on how money should be spent in Education. The Chairman of the Board offered a very different interpretation of the data given in Table 1.

### **Data Interpretation by the Chairman of the Board.**

Instead of looking at the revenue minus cost column, let us rank all 10 scenarios by the key variable.

The dependent variable or "KEY" variable which we want to maximize is Incremental Sales Generated by the Promotional Effort, minus the corresponding Promotional Expense. In Table 1, we provide a new set of rank-order data based on this key variable. Scenario Number 5 has the highest revenue minus promotion expense. The problem facing the decision maker is, how can we make up for the 44% missing data that our consultant neglected to give us?

**Table 1: FORECAST OF INCREMENTAL SALES REVENUE GENERATED BY DIFFERENT PROMOTIONAL STRATEGIES**

Scenario	PUSH strategy (in Millions of Dollars)	PULL strategy (in Millions of Dollars)	Feature Price (Generate 70% of Sales)	Incremental Revenues minus Promotion Expenses	
1	5.2	5.4	34.99	1.81	Rank = 1 = Lowest
2	5.2	5.4	34.99	2.17	Rank = 2
3	5.2	5.4	29.99	2.43	Rank = 3
4	9.1	11.1	34.99	15.20	Rank = 4
5	9.1	11.1	29.99	20.85	Rank = 9 = BEST
6	9.1	11.1	29.99	18.07	Rank = 7
7	9.1	15.0	34.99	15.65	Rank = 5
8	13.0	15.0	34.999	17.43	Rank = 6
9	13.0	11.1	29.99	20.44	Rank = 8
Data are taken from the Harvard Case; Number 9-500-024				"The Brita Products Case"	Ranks are based on Best Incremental Revenues

Our solution for the “Missing Scenarios” is to use the technique known as: Conjoint Analysis (See Green and Wind, “New Way to Measure Consumer Judgments”, Harvard Business Review, July, 1975.). Using Conjoint Analysis, we simply average the rank orders in the last column on the right for ALL levels for each attribute. The average rank for each level is known as “Part Worth.”

Let us take for example: the “Push” strategy for the first 3 scenarios, which is 5.2. In the last column right of Table 1, we find that there are 3 different rankings for this same Push expenditure of 5.2. The ranking numbers are 1 and 2 and 3 (the first 3 scenarios). Add the different ranks and divide by the frequency to get the average of 1 and 2 and 3, which is  $2 (1+2+3)/3 = 2$ . We enter the number 2 in the first three rows for Column 2 of Table 2, the Push Strategy. We compute part worth for all pull and push expenditures as well as the two price levels. The Part Worth numbers will be inserted in Scenario 1 to assist the reader in computation for Part Worth scores. The term “Utility” is simply the sum of all part worth scores for EACH scenario. Thus, for Scenario 1, the Utility Score is 7.6, which is  $2+2+3.6$ . In Table 2 we have the Part Worth and Utility Scores for all 18

scenarios. The BEST scenario has the highest utility or the greatest sum of all part worth scores for that scenario. The best scenario is number 17.

**Table 2: UTILITY SCORES FOR ALL SCENARIOS; DERIVED BY THE SUM OF PART WORTHS (PW) FROM PUSH AND PULL**

Scenario	Push		Pull		Feature Price		UTILITY SCORE = SUM OF ALL PART WORTH SCORES	Feature Price		UTILITY SCORE = SUM OF ALL PART WORTH SCORES
1	$5.20(1+2+3)/3=2;$ PW=2		$5.4(1+2+3)/3=2;$ PW=2		$34.99(1+2+4+5+6)/5=3.6$ PW=3.6		$(2+2+3.6) = 7.60$	$34.99(1+2+4+5+6)/5=3.6$ PW=3.6		$(2+2+3.6) = 7.60$
2	5.20	PW=2	11.1	PW=7.75	34.99	PW=3.6	13.35	34.99	PW=3.6	13.35
3	5.20	PW=2	15.0	PW=6	34.99	PW=3.6	11.60	34.99	PW=3.6	11.60
4	9.10	PW=6.75	5.4	PW=2	34.99	PW=3.6	12.35	34.99	PW=3.6	12.35
5	9.10	PW=6.75	11.1	PW=7.75	34.99	PW=3.6	18.10	34.99	PW=3.6	18.10
6	9.10	PW=6.75	15.0	PW=6	34.99	PW=3.6	16.35	34.99	PW=3.6	16.35
7	13	PW=7.3	5.4	PW=2	34.99	PW=3.6	12.90	34.99	PW=3.6	12.90
8	13	PW=7.3	11.1	PW=7.75	34.99	PW=3.6	18.65	34.99	PW=3.6	18.65
9	13	PW=7.3	15.0	PW=6	34.99	PW=3.6	16.90	34.99	PW=3.6	16.90
10	5.20	PW=2	5.4	PW=2	29.99	PW=7.4	11.40	29.99	PW=7.4	11.40
11	5.20	PW=2	11.1	PW=7.75	29.99	PW=7.4	17.15	29.99	PW=7.4	17.15
12	5.20	PW=2	15.0	PW=6	29.99	PW=7.4	15.40	29.99	PW=7.4	15.40
13	9.10	PW=6.75	5.4	PW=2	29.99	PW=7.4	16.15	29.99	PW=7.4	16.15
14	9.10	PW=6.75	11.1	PW=7.75	29.99	PW=7.4	21.90	29.99	PW=7.4	21.90
15	9.10	PW=6.75	15.0	PW=6	29.99	PW=7.4	20.15	29.99	PW=7.4	20.15
16	13	PW=7.3	5.4	PW=2	29.99	PW=7.4	16.70	29.99	PW=7.4	16.70
17 Total "Promotion Cost: 24.1	13	PW=7.3	11.1	PW=7.75	29.99	PW=7.4	22.45 Highest Utility Score!	29.99	PW=7.4	22.45 Highest Utility Score!
18	13	PW=7.3	15.0	PW=6	29.99	PW=7.4	20.70	29.99	PW=7.4	20.70

### Data Interpretation

We see that Scenario number 17 has the highest utility score: 22.45, which indicates that we should spend 11.1 on Pull and 13 on Push. The Board of Directors claim that Table 2 represents the Best Data Interpretation. Each of the 10 scenarios provided by Harold's consultant was evaluated by a whole new measurement: What is the utility that or net gain that each variable and at each level is provided for the ABCcorporation in terms of the Profit Motive. This interpretation of the data is far more useful and has more validity than simply looking for profits in Table 1 which is what our data analyst gave us.

### Conflict Resolution

At this point, the reader is asked to resolve the conflict between Harold and the Board of Directors. Here is a quote from the Principles of Marketing text 13th edition, by Kotler and Armstrong:

The authors state the following: "One of the **Hardest Marketing Decisions facing a company is how much to spend on promotion.**" Thus, this problem in promotion is defined by the 2 most prominent authors in the Marketing field as the most difficult one to solve!

Recall, Risk Prone means the decision maker feels a risk that is analyzed and deemed worthwhile should be taken; Risk Averse means no risk is worthwhile because it will fail; Risk Neutral would mean that the decision maker should use probability measure to estimate the chances of success before making a decision. It is the hope of the author that the reader will see the merit of both approaches to decision rules and data interpretation seems to offer more than mere data analysis.

### Suggested aspects for the instructor to explore:

1. Push strategies are usually much cheaper to implement. It is a finite amount: Pay for the Retailer's advertising budget. A pull strategy can involve heavy advertising expense. You need the "repetition" effect (you must repeat the message several times such that the consumer will remember the message) in advertising to make the advertising worthwhile. Therefore, the Push strategy may be more appealing to the manufacturer of a new product. For instance, , when Fisher Price introduced their riding toy, they used the Push strategy.

2. The Data interpretation approach is more effective but it will cost more. Is the firm willing to pay more??

3. Risk Averse Decision Makers would select the less expensive way to go. The problem is that if you are in business, you have to be willing to assume some risk. The decision maker who is truly risk averse has no business being in business! He should go into teaching instead!

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### Acknowledgement

Please note that Professor John Deighton, the author of the Brita Case was contacted by this author and requested permission to expand the Brita Case and use it as an illustration on defining optimality for Combining Push and Pull Strategies.. Professor Deighton's response was, "Go for it!".

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### Review Questions:

1. Which tactic is more effective: Push or Pull?
2. What about combining the 2 strategies: Should the expenditure be equal for both?
3. Is one tactic more costly than the other to be effective?
4. What impact does the very low feature price have on defining the optimal combination?
5. What about different decision "styles" of decision makers? Some are risk prone and some are risk neutral and some are risk averse?
6. How does one incorporate the willingness to take risk?

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## 20

**The B & W Ventures LLC<sup>66</sup> Case:  
Business Dispute Resolution using ADR**

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## Preface and Synopsis

This case derives from the inexorable fact that there are disputes and conflicts in virtually every type of business today, emanating from many places, including general management failure, market strategy failure, failure of synergy among parts of a business, failure of effective human resources management and the increasing ethical/legal failures of businesses. How disputes and conflicts are resolved within a business or among businesses (or for that matter with the regulatory environment) are a good index of competent, efficient, effective, collaborative management (or the alternative).

Lively competition among businesses is certainly the princely part of conflict. But negative conflict simply diminishes profits, and ADR is the most effective methodology for its resolution.

B & W Ventures, LLC, is a fictitious company that is really a mixture of many companies in several business areas. The players are probably recognizable to most who have studied or been involved in business and/or the ADR processes. The original version of the B & W case has been used for several years for ADR simulations in an undergraduate course called “Resolution of Business Disputes” at Daniels College of Business, The University of Denver. It is structured so the students receive the new facts, which essentially become empirical, at the beginning of each ADR sequence. Students are divided into teams and assigned to complete negotiations, then a mediation and finally a full arbitration hearing. Grading is done using Graduate Assistants with a series of grade sheets which were designed for each sequence.

<sup>66</sup> LLC is short for “Limited Liability Company” which is an American legal organizational structure that combines the advantages of a corporation and partnership.

The course has thus been well-liked by students, as it focuses on a management area that is seldom considered in business school curricula; it is also designed as an experiential learning environment with the simulations.

The author has the combination of a 30 plus year career as general partner/CEO of an investment business, an arbitration and mediation practice, a number of years as a legislator and for many years a professor of business management and the ADR areas of business law.

## Introduction

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A company called B & W Ventures, LLC, is in the commercial property management business, and manages many apartment complexes, a few home-owner associations (HOA) and a couple of small shopping centers. It also generally represents owners of the properties which it manages when there are disputes with tenants or other entities (including disputes with HOAs which are proximate to the properties which they manage).

The company is an old line family company and has been in existence for nearly 80 years. Its two founders are no longer around but their grandchildren, Henry and George, manage and partly own the company. Henry is 41 and George is 36; George became Managing Director shortly before his father died, angering his older cousin Henry.

Because of the LLC structure of the company, Henry and George each own a 15% interest, the balance is owned mostly by their mothers and sisters, and several friends of the founders, none of whom, except for attending board meetings, spend any time at the company. Both Henry and George have college degrees, and though Henry is relatively introverted and married, George tends to be a bit wild as a bachelor, and his spending habits (such as flying around in a Porsche 959) are considered excessive by Henry. But they mostly work well together, partly because they wisely separated their management tasks to fit their respective personalities.

The company has been relatively profitable for its owners but it has continuing conflicts of varying sorts, some of which have related to poor management decisions and some relating to disputes which derive from a poor economy. Because the company has had to reduce staff slightly, some employees are unhappy because of the potential uncertainty of their futures. In addition there have been attempts by workers and various related people to end the authoritarian rule of George and Henry, and allow other workers within the company to have a say on policy, strategy and operating decisions.

The gross income in 2008 was US \$4,542,000; its net to shareholders<sup>67</sup> was \$450,342. In 2009 its gross was \$3,356,000; net to shareholders was a mere \$46,000, which angered the older members of the owning families.

B & W, LLC owns some of the properties which it manages, and in 2010 it mortgaged several properties, and used most of the funds to physically improve those company assets. The balance was given to the owners as a special distribution, which moderated the diminished 2009 income from operations.

Because their type of business tends to foster disputes, Henry and George recently hired Hank Friedman, a well known lawyer with an MBA degree, as vice-president to negotiate future conflicts as well as represent the company in preparation of legal documents, allowing both George and Henry to simply manage the company rather than deal with various parties in the disputes.

### Conflict Resolution Part 1: Negotiations

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#### **Additional Facts for the Negotiations:**

Dave Peterson worked for B & W for nearly 5 years as the property manager for several of the apartment complexes. His salary in 2009 was \$70,000. He had done a reasonably competent job, but because of a tenant dispute which he improperly negotiated (as far as B & W was concerned), it had cost significant money to the owner of one of the managed complexes and as a result, B & W lost the contract with the owner to manage it. It was a large complex and the loss of the management contract had a notable impact on the income to B & W in 2009.

Henry (who by agreement with George was head of HRM) was furious with Peterson and fired him the following Monday, telling him to clean out his desk and get out of the office in a half-hour. Payday had been the prior Friday, so Henry told Peterson he was paid to date and there would be no severance pay, bonus, nor would he write a letter of reference to a future employer.

Peterson left as instructed, but a few days later threatened to sue B & W, as he thought that he had vacation pay coming and he knew that bonuses for the prior year for staff, including himself, had already been determined. He hired a lawyer, John Lawful, Esq., who suggested that rather than going to court or pursuing arbitration (a dispute resolution process provided for in the employment contract), Peterson first consider entering into negotiations with B & W. Lawful agreed to take the case based on receiving 40 % of any recovery by Peterson. Since that was less

<sup>67</sup> officially "members" in the LLC statutes

onerous than going right to arbitration, Peterson agreed to commence resolution of the conflict with negotiation.

Though Henry and George were not excited at the prospect of seeing Peterson again, at the strong recommendation of their in-house counsel, Hank Friedman, they agreed to enter into negotiations.

The date for the parties to negotiate was set for the following month, however as that date approached, each side had additional ethical, legal and personal problems to deal with:

(1) Henry had to deal with his mother, Maud. She was certainly overbearing, but had an ownership interest in the company, so he had to listen to her. (George thought she was a lunatic.) Maud disliked Peterson from the day he was employed and blamed him for the loss of the large management contract and thus the diminished income to the company. She had been critical of Henry for not firing Peterson long ago, as she considered Peterson a trouble-maker, and threatened to attend the negotiating session where she could make her thoughts known to all.

(2) Because Peterson had an undergraduate degree in business ethics plus an MBA from a respected university, at B & W he made business decisions based on the ethical as well as the economic impacts of his decisions. He had thus taken the side of the tenant in the earlier dispute, providing monetary recovery, because he believed the tenant had been severely wronged. His decision was based on what he thought was ethically right. (The tenant later wrote a glowing letter of thanks to Peterson, which Peterson knew could become a fabulous letter of recommendation.) But Peterson also disregarded the fact that he was employed by B & W (and was therefore its agent) which, by his and the property management contracts, automatically meant he was expected to represent the owner's interests in the tenant dispute.

(3) Peterson had another problem: just before he was fired from B & W, he had entered into a specific performance agreement to purchase a house, agreeing to pay 15% down using his 2009 bonus, the balance payable from a first mortgage. Because he had a good salary and an exemplary credit rating, he had not thought of making the purchase contingent on receiving a satisfactory mortgage loan. Now without a job, he knew he might not qualify for a mortgage.

(4) B & W had another problem: the owner of another large apartment complex contacted George and said that if Peterson was not reinstated, they would not renew their property management contract with B & W and would contract with whatever company Peterson went to.

(5) Since B & W planned to replace Peterson, they immediately advertised for a property manager and Henry (and later George) interviewed an excellent candidate they both wanted to hire. But she said she would not go to work for B & W for less than \$90,000, which was significantly more than they were paying Peterson. George (the bachelor) suspected that salary might be negotiable and since she was a “sweet young thing” he had made a date to take her out for a drink and try to “soften” up her salary requirement.<sup>68</sup>

(6) In the interim, at Lawful’s suggestion, Peterson filed a complaint with the state real estate commission, claiming that because of the tenant-favored resolution of the dispute, there were “irregularities” in the accounting for that property. The irregularities, according to Peterson, derived from false categorization by B & W of payments to the tenant. The real estate commission launched an investigation into the matter, and threatened to hold a hearing with George, Peterson and the B & W accountant, to determine the validity of the claim.

That greatly frightened George, as he had had to deal with earlier complaints which were on file at the real estate commission and his broker’s license might again be in jeopardy. (By law, any company in the real estate or property management businesses must have a managing broker, and that had been George.)

(7) Henry’s mother Maud had somehow found out that Peterson was dating the company bookkeeper, and charged that Peterson had entered into this relationship to get private accounting information that would enable him to take over the company. She therefore instructed Henry to file a lawsuit for fraud and theft of company secrets, charging (among other things) violation of the federal Economic Espionage Act, against Peterson and the B & W bookkeeper.

(8) Mother Maud may have been a good sleuth, but she also couldn’t keep a secret: Peterson shortly found out about the lawsuit instruction to Henry. The trouble was he had just asked the bookkeeper to marry him and she had accepted. And in contemplation of their forthcoming marriage, she had moved in with Peterson.

*[Instruction to negotiation students: identify, evaluate and write down EACH of the main and underlying relevant issues before you start negotiations, so all are negotiated and the resulting agreement includes an agreement on the major issues as well as all underlying issues.]*

<sup>68</sup> This is potentially a violation of the Fraudulent Inducement Act which is law in many states in the United States.

## Conflict Resolution Part 2: Third Party *Mediation*

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The initial *negotiations* with Peterson and B & W went well, but as they continued the lawyers began posturing and the result was the parties could not reach a satisfactory agreement. Everyone realized that formal negotiations were fine for negotiating a transaction, but were probably insufficient to resolve a dispute of this magnitude. One particular hang-up was the bonus which Peterson thought he was due for 2009, but which B & W considered not due because of the considerable loss to its income from the cancellation of the management contract by the apartment owner. B & W felt that the cancellation was directly due to improper handling of the negotiations with the disgruntled tenant by Peterson, and the resulting cost to the apartment owner.

And there were several other factors which disrupted the negotiations:

(1) Mother Maud had walked in on them and had given everyone a piece of her mind, disrupting any chance of cooperation or synergy among the negotiators.

(2) George and Henry had so many other issues that they tended to arrive at the negotiating sessions unprepared. The economy had a continuing impact on the profitability of B & W, and George and Henry kept fielding complaints from other property owners that Peterson's recent replacement simply did not have the competence which Peterson had. And throughout the negotiations, George and Henry continued to blame Peterson for the start of their problems, and therefore remained adamant that he would get nothing from them. In fact they felt Peterson owed them money.

(2) Peterson also became uncompromising: he needed the money he thought was owed him. He knew that his specific performance contract to purchase the house meant that if he didn't close the transaction, the seller could sue him and collect on the \$20,000 promissory note he'd submitted with the purchase contract. However Peterson had a worse problem: his transaction was about to fail because the frustrated seller had found a back-up (second) buyer, after Peterson kept extending the closing date of the contract. That was pejorative as Peterson and his fiancée, with the earlier agreement of the seller, had moved into the house, in contemplation of completing the purchase.

(3) The good news was Peterson had, in the interim, received a job offer from a competitor (thanks partly to the great letter of recommendation from the formerly disgruntled tenant), at a hugely higher salary than he had received at B & W, but though the pay was more, he suspected his potential

new boss would be an aggressive authoritarian, and he was reluctant to accept the offer. But at least it helped his BATNA<sup>69</sup>.

(4) During the negotiations, Peterson and Lawful, Esq. decided to go ahead and file the lawsuit against B & W for wrongful termination, requesting \$1,500,000 in damages, thinking that would give them some leverage. There was a preliminary hearing on the lawsuit, and much to Lawful's distress, the judge instructed the parties to mediate the dispute before he would set a trial date. So the value of the lawsuit instantly became moot.

It was therefore decided by everyone that they should employ an outside third party mediator to help break the negotiating impasse. It was agreed, following normal protocol, that the mediator would be paid equally by each side.

A well known employment mediator named Mike Mediatro was employed and a date the following month was set for Mediatro to mediate the dispute. However in the interim, several additional things occurred making an agreement via the mediation more difficult.

(1) Mother Maud had become gravely ill and because of considerable medical expenses, decided she needed to sell her interest in B & W to pay for them. George and Henry responded that they didn't have the money and she should talk to the other family shareholders. That unfortunately went nowhere. Maud became desperate and in spite of her dislike of Peterson she privately approached him to buy her interest. Peterson agreed, contingent upon receiving enough money from resolution of the wrongful termination dispute and lawsuit with George and Henry (for which funds would mostly come from the company liability insurance carrier). Peterson, of course, also knew that would give him a sufficient position in the company to force at least George and maybe Henry out as well. As a back up, Peterson immediately approached Lawful about a joint venture, where Lawful would loan him the money and be both a silent partner and house counsel if he (Peterson) was able to take over the company.

(2) There was a "smoking-gun" e-mail which Peterson found in the B & W system which he printed and gave to Lawful (George and Henry had forgotten to cut off Peterson's e-mail account), which showed the 2009 (payable in 2010) bonus to Peterson was actually \$50,000. Peterson also found that a cheque had actually been written to him for that amount, but had been placed in a locked filing cabinet because of the earlier conflict with the tenant and building owner.

<sup>69</sup> BATNA = Best Alternative to a Negotiated Agreement, which is part of the "lingo" used for alternative dispute resolution.

(3) George and Henry were now at each other's throats much of the time. With the sour economy and their divergent personalities and management styles, they seldom could agree on anything. Net income to the company continued to decline with all of the current problems, and George (as managing director) was seriously considering dumping the company into Chapter 11 of the Federal Bankruptcy Code, if solutions to their problems or a buyer for the whole company couldn't be found.

(4) Notwithstanding Maud's illness, Henry was fed up with her, as she kept interfering with the operation of the company. But the real problem was her continuing need to get dividends (which didn't exist) from her interest in the company. She thus pushed Henry to personally give her money to pay her medical bills.

(5) George wrecked his Porsche 959, and discovered he had forgotten to pay the insurance premium on the car, so its value (a cool half-million dollars) was his personal loss. However since he had financed it, he still had to make the large on-going payments which meant he had limited funds available for other needs.

So the mediation started with many significant problems on both sides.

*[For the mediation students and Mediatro: (1)there are many additional components to the overall dispute which must be mediated, so Mediatro should start by creating a list of the dispute components to be mediated, then methodically try to reach agreement on each component which will ultimately create a general agreement among the parties. (2) Remember that in a mediation, Mediatro has no decision-making authority. His job is strictly to bring the parties together to reach an agreement. (3) If an agreement is reached, Mediatro should write the agreement for signature by all parties. (4) Protocol is Mediatro is equally paid by the disputing parties.]*

### Conflict Resolution Part 3 : Arbitration

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George and Henry have miraculously kept the company together. The mediation with Peterson was successful, although quite expensive, and Peterson is now mostly out of the picture, except that his advice to the tenants of the apartment building (described below) exacerbated the intensity of the forthcoming dispute with them. Fortunately a collector bought George's wrecked Porsche 959 for enough to permit him to pay off the loan on the car. He's now driving a VW Passat wagon which he dislikes, but which is the only car his insurance agent was willing to insure. Mother Maud passed away and she will be missed by (almost) all. Her last will and testament divided her shares in B & W equally between George and Henry giving them better control of the company. So things are improving.

George and Henry have decided that one of the apartments owned by B&W needs a new outside facade, roof, refurbished parking lot and landscaping. So they set about getting bids, later awarding a contract to *Perfect Construction Company*, owned by Jimmy Calhoun, a well known local contractor. It was decided that George would be the representative of B & W for this project.

*Perfect Construction* (and George as well) paid little attention to the fact that the apartment building was still fully occupied when construction started. The tenants in the apartment building (many of whom were retired) were suddenly dealing with the construction dust, noise, inaccessibility, etc. While employed by B & W, Peterson had alerted the tenants of the planned refurbishment, but since his departure no one knew when the project was to start and what was to be offered to the tenants, so they were very annoyed when work suddenly started. And *Perfect* did start work on the site immediately after the contract was signed, storing all sorts of building supplies and equipment around the apartment, tearing up the old parking lot and getting with the action to complete the project before winter.

Unfortunately *Perfect* also paid no attention to the fact that there was a fancy condominium complex next door. It was in such a hurry to get started that it partially blocked the driveway into the condo complex with a crane to be used to remove the siding on the apartment building; it also dropped some construction supplies on the condo complex property ruining some elegant landscaping. *Perfect* also created considerable noise when they began taking down the siding on the apartment as well as causing much dust around the area. In addition, *Perfect* permitted workers to park anywhere, including in an outlying parking lot which was owned by the condo complex, and, according to several residents, generally made living in the condo complex rather unpleasant. *Perfect* also wrecked a fence between the two properties, unknowing that it was on the condo property and had been built by the condo association, not B & W.

Notwithstanding that the leases and all construction contracts had arbitration clauses in them, the tenants filed the first law suit. The condo association followed, later joining the tenants as third party plaintiffs, and requested class action status. Total requested damages from the joint lawsuits: \$30,000,000 in damages, plus a cease and desist order to be served on *Perfect*, a restraining order on B & W, and a requirement that B & W relocate all tenants and pay rent for the new residences for however long they needed for the construction, or if a permanent move (at the choice of the tenants), rent for a period of 5 years.

The tenants hired Douglas Apartus, Esq. to represent them. The condo association HOA hired John Condoman, Esq. to represent them. *Perfect* and B & W immediately hired a lawyer by the name of Peter Constroman, Esq., to represent them.

The matter initially went to the district court which ruled as follows:

(1) The court had no jurisdiction on the tenant leases or contracts with *Perfect* because all had arbitration clauses in them and, based on the state law against intertwining,<sup>70</sup> the lawsuits initially had to go to arbitration and be ruled on by an arbitration panel formed by the American Arbitration Association (AAA).

(2) Based on the violation of several municipal ordinances, including nuisance, noise, the tort of property destruction and illegally blocking an access to a residence, *Perfect* was required by the court to cease construction until it could continue without violating any ordinances. It was also determined that *Perfect* had not obtained the required building permits, so it was fined \$25,000 and required to clean up the area surrounding the site within 10 days. The local planning department was instructed by the judge to provide continuous monitoring of the site to ensure compliance with the laws by *Perfect*. The judge finally ruled that if *Perfect* was late cleaning up the area, it would pay a per diem (daily charge) of \$10,000.

(3) The judge, in consultation with the AAA, suggested that a local expert on construction disputes chair the arbitration panel. His name was Jack Arbitraneous, MBA, Ph. D. Arbitraneous was readily agreed to by all parties. It was then decided that because of Arbitraneous reputation, there was really no need for the considerable expense of a full 3 person panel: Arbitraneous would be the sole arbitrator.

Arbitraneous scheduled the arbitration hearing five weeks after the court ruling and reserved one of the conference rooms at a major local bank. All parties agreed that they could prepare for the arbitration hearing, exchange exhibit documents and present expert witness lists to Arbitraneous by that date.

It was decided that since there were so many parties, there would be joinder of several entities: (1) George, B & W, Calhoun and *Perfect* would be joined and Constroman, Esq. would represent them; (2) Tenants and Condo owners would be joined, and Mr. Gustopher Gustibus, a condo owner, would be their personal representative, with primary legal counsel by Apartus, Esq. , with Condoman, Esq. added to the legal team if needed.

<sup>70</sup> Intertwining is a term in American law which states that if there is an arbitration clause in a contract or other document, even if it is not for the entire dispute, a court of law will not rule on areas not subject to arbitration until there is an arbitral decision on the parts of the agreement which are to be arbitrated. Additionally, a court will not overturn any prior related arbitral decision.

(3) Peterson was subpoenaed by Apartus and will be a key witness.

These conditions were agreed to in writing by all parties.

*For arbitration students:*

*The arbitration hearing operates as a civil trial to a judge (no jury). What is different about an arbitration from a mediation, is the arbitrator alone rules, and the ruling of an arbitrator cannot be overturned by any court in the United States, barring fraud or bias of the arbitrator.*

*The hearing starts with the arbitrator introducing himself and requesting introductions of all parties and their lawyers. The arbitrator generally then elucidates rules and procedures of his “court”, and how he or she will manage the hearing. This often includes a discussion of how the arbitrator will apply (or not apply) the “rules of evidence”.*

*The trial then starts:*

- (1) The attorney for each of the parties will present an opening statement (starting with the tenant/condo owners as petitioner/plaintiffs), showing why his or her case is undeniable.*
- (2) Each party and each witness will be examined by their lawyer and then cross examined the opposing lawyer.*
- (3) Generally each lawyer is allowed a redirect (so each lawyer gets 2 chances to question a witness).*
- (4) At the end of the trial, the lawyers for each party will present closing arguments, also with redirects if desired.*
- (5) The hearing is closed and the arbitrator, in this case Arbitraneous, rules. The ruling must be written, generally in a standardized court-ruling format. Remember there are many issues which must be separated and ruled on.*

## General Governance Questions For this Case

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1. Would policies which separate the duties of George and Henry make the management of B & W more efficient and effective? If so, give some examples.
2. What administrative policies would help a multi-family multi-generation company, as B & W, avoid the internal and external conflicts described in this case?
3. What are 2-3 human resource management (HRM) policies which would create an effective relationship between governing family members and non-family employees? How about for employed younger family members who are not managers? Would your answer change the relationship between B & W and Peterson?
4. How should employment contracts for non-family employees be structured in a family company? How about for younger family members who are not managers? Would your answer change the relationship between B & W and Peterson?
5. Are there unusual or unique features which employment contracts among governing family members (George and Henry) and the LLC should contain? Should they be different from those for unrelated (hired-hand) corporate executives? If so, how?
6. What company policies for ethical/socially responsible behavior should be established for governing family members? Should the policies differ for hired-hand executives, non-executive family employees and non-family employees? If so, how?
7. How might a policy to require the traditional alternative dispute resolution (ADR) sequence be effectively instituted in a small company? Would it be different in a small family company? If so, how?
8. What might a good administrative policy be for negotiation and management of contracts with outside vendors and professionals, for a small or family company such as B & W? How would your answer affect B & W's management of the Perfect Construction contract in this case?
9. What are 2-3 of the key administrative differences between managing a small service company as B & W, and a larger private or public company?





## 21

## The EU Labour Requirements for Turkey: What are the Implications for Corporate Governance?

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*Abstract:* Turkey is currently a candidate for accession into the European Union. This membership would bring with it numerous implications for corporate governance, and for the relatively large labor force, which is 24th in size in the world. World Bank standards for corporate governance and EU membership standards with respect to labor force criteria are described. Taking a case example of one of the most prominent sectors in Turkey, the textile industry, the case raises corporate governance issues that will have to be addressed, not only in the textile sector, but also throughout the labor force.

*Key Terms:* Turkey, Corporate Governance, EU Membership, Textile Industry, Labour Force, European Employment Strategy.

### 1. Introduction

Corporate governance has been defined, “broadly as the exercise of power over corporate entities so as to increase the value provided to the organization’s various stakeholders, as well as making those stakeholders accountable for acting responsibly with regard to the protection, generation, and distribution of wealth invested in the firm.”<sup>71</sup> The EU requirements have the potential to exercise power over corporations in that they may affect: 1) how stakeholders interact with corporations and therefore decision-making processes, and 2) the outcome of corporate processes with respect to competing priorities of stakeholders.

71 Corporate Governance: An International Review retrieved on April 7, 2011 from [http://onlinelibrary.wiley.com/journal/10.1111/\(ISSN\)1467-8683/homepage/ProductInformation.html](http://onlinelibrary.wiley.com/journal/10.1111/(ISSN)1467-8683/homepage/ProductInformation.html)

Another approach in defining corporate governance is taken by the International Finance Corporation of the World Bank Group<sup>72</sup>. The IFC emphasizes five principles of corporate governance:

- The rights and equitable treatment of shareholders, including communicating accessible and understandable information.
- The interests of other stakeholders, including legal and other obligations.
- The role and responsibilities of the board, including providing a range of skills and understanding to meet the needs of the business.
- Integrity and ethical behavior, including developing a code of conduct.
- Disclosure and transparency, including public information about the responsibilities of the board and accurate and timely information for investors.

As the discussion questions at the end of this case will make clear, EU labor requirements may have implications for the implementation of each of these principles.

Turkey is a rapidly growing and emerging market that lies at the cross roads of the East and the West. The Bosphorus, which divides Europe from Asia, runs through Turkey's most populous city, Istanbul, which is located at the northwest corner of the country. Turkey is currently a candidate for accession into the European Union. With a population of 79 million and a relatively high birth rate, it has the potential of being the most populous country of any in Europe.

Applying for and obtaining membership in the European Union is an intensive and lengthy process. This has been especially true for Turkey. Admission to the EU for Turkey continues to be controversial both within the EU and within Turkey. Nonetheless, the process is continuing and Turkey is making progress in a number of criteria for admission.<sup>73</sup> This case examines EU requirements that are concerned with the labor force and labor market policies and raises questions concerning the implications for corporate governance in Turkey. A hypothetical firm in the textile industry is used as an example to illustrate the possible changes in governance and strategy that may be necessitated or encouraged by meeting EU labor requirements.

72 <http://www.oecd.org/dataoecd/32/18/31557724.pdf>

73 For a complete description of the process of EU membership for Turkey, see Morelli, V. (2010). *European Union Enlargement: A Status Report on Turkey's Accession Negotiations*. Washington, DC: Library of Congress.

This case focuses on workers as stakeholders. The *acquis communautaire* describes the regulations and criteria for EU admission, including three chapters that deal directly with labor issues. The implementation of these requirements and related labor laws has the potential to change the relative power of workers as stakeholders and therefore their influence on corporate decisions, as well as the distribution of gains in value among stakeholders.

The case begins with background information on the EU labor requirements, the Turkish economy and labor markets, and the textile industry. Questions are then raised concerning corporate governance and strategy for a textile firm in Turkey, focusing on the implications for the firm's labor supply, human resource policies and strategies. Through this process, the reader comes to appreciate how Turkey's potential movement towards meeting EU labor requirements may change the economic relationship between organizations in the textile industry and workers and therefore corporate governance and strategy in Turkey. This is true for all industries, not just for the textile industry.

## 2. The EU Labour Requirements and Labour Laws

Three chapters of the *acquis communautaire* deal directly with labor issues.

- Chapter 2, Freedom of Movement for Workers. This specifies that citizens of the EU have the right to work in other Member States and must be subject to the same working conditions and social and tax advantages as are nationals.
- Chapter 19, Social Policy and Employment. There are minimum standards set by the EU concerning such issues as labor law, equality, work health and safety, anti-discrimination and equal opportunities for men and women. The goal here is to support employment policies that bring about greater social inclusion.
- Chapter 26, Education and Culture. This sets up the goal of cooperation and convergence on education and training policies and discusses expectations concerning the financial management of programs. However, "The areas of education, training, youth and culture are primarily the competence of the Member States."<sup>74</sup>

Member States are also subject to the treaties of the EU, legislation and case law. There are three major overall objectives of the European Employment Strategy (EES): full employment; quality and productivity at work; and cohesion and an inclusive labor market. Here are some examples of priorities

<sup>74</sup> [http://ec.europa.eu/enlargement/enlargement\\_process/accesion\\_process/how\\_does\\_a\\_country\\_join\\_the\\_eu/negotiations\\_croatia\\_turkey/index\\_en.htm](http://ec.europa.eu/enlargement/enlargement_process/accesion_process/how_does_a_country_join_the_eu/negotiations_croatia_turkey/index_en.htm) describes these and the other chapters of the *acquis*.

and initiatives that would need to be in place in Turkey to achieve these goals.<sup>75</sup>

- Increase the employment to population ratio. The Lisbon strategy sets a target of 70% overall and 60% for women.
- Greater labor market flexibility. Turkey has already made it easier for firms to hire part-time workers and fixed-contract workers. The EES however, also requires that such workers are not treated less favorably than full-time and permanent workers with respect to employment conditions. However, opening up part-time work is expected to facilitate greater employment of women.
- Promote “a skilled, trained and adaptable work force.” This in turn requires investment in education and training, for the large number of young people in Turkey as well as for adults, and other active labor market policies.
- Prevent sex discrimination and promote gender equality in the labor market.
- Provide legal rights and protection for workers. At the same time that labor market flexibility is needed, it is necessary to have Employment Protection Laws (EPLs) that provide such safeguards as maximum hours, minimum annual leave, safety and health requirements, and rights when business ownership is transferred or a business becomes insolvent.
- Establish the right for workers to organize in order to “create the conditions for a free and genuine bipartite as well as tripartite social dialogue at all levels.” This requires, among other things that workers and their representatives have access to appropriate information and be involved in consultation with firms on such issues as the firm’s economic situation and decisions that are likely to result in major changes in employment and work organization.<sup>76</sup>
- Apply all laws and policies, regulation and taxes to the informal sector, which would move to eliminate or at least drastically reduce the informal sector. In addition to extending rights to workers in this sector, this would allow the government to collect more revenue from taxes or to lower the tax burden on the current formal sector.

75 For a full description of these issues see Erol Taymaz and Sule Ozler, “Labor Market Policies and EU Accession: Problems and Prospects for Turkey,” in Bernard M. Hoekman and Subidey Togan, eds., *Turkey: Economic Reform and Accession to the European Union*, Washington, D.C.: The World Bank, 2005, pp.231 -240.

76 For a complete discussion of the implications for unions in Turkey, see Kaan Agartan, “Turkey’s accession to the European Union and the Turkish Labor Movement,” *European Journal of Turkish Studies*, 11/2010.

### 3. The Turkish Economy and Labour Markets

The reader's attention is turned to Table 1, which describes economic, education and labor force characteristics of Turkey. The gross domestic product in 2010 was (US) \$729.1 billion. The gross domestic product per capita was \$12,300, which ranks Turkey 92nd in the world.

The literacy rate is 81% for females and 96% for males. Ninety-four percent of females attain primary education and 96% of males do so. Seventy percent of females and 77% of males attain secondary school education. Tertiary school attainment is 34% for females and 43% for males.

The total labor force is 24,700,000, which is 24th in size relative to other labor forces in the world. Approximately 1.2 million Turks work abroad. The annual average wage for males is 20,441 Turkish Lira. For females, this wage is 5,352 Turkish Lira. This corresponds to (US) \$12,843 and \$3,362 respectively. This large gender gap can be attributable in part to occupational segregation, with women being employed in less skilled occupations. One could compare these wages to those in the EU (in Euros): EU 27 - 13.38, EU16 - 13.99, Turkey - 3.10. The male and female labor force participation rates in Turkey are 74% and 26% respectively.

Most workplace establishments are small, with 1,047,921 establishments having only between one and nine employees. On the other end of the spectrum, only 199 establishments have over 1000 employees.

Thirty percent of employees are in the agricultural sector, 25% are in the industrial sector and 45% are in the services sector. Major industries include oil and gas, telecommunications, tourism and agriculture.

Unemployment in 2010 was 12.4%, which is down from the 2009 figure of 14.1%. On a country basis, Turkey ranks 131/200 countries in terms of high unemployment rates. Youth unemployment is 18.1%. Unemployment rates by education are 23.6% for females completing tertiary education and 8.6% for males similarly educated. Unemployment rates for females competing secondary education are 39.1% and 24.1% for males. A very high proportion, 43%, work in the informal economy. This fact could distort all percentages, including inter-country comparisons.

Strikes are relatively rare. In 2008, there were only 15 strikes and in 2009, there were 34. The number of person/days lost to strikes was 145,725 and 209,913 respectively. There was one lockout in 2008 and none in 2009.

**Table 1: ECONOMIC, EDUCATION AND LABOUR FORCE CHARACTERISTICS**

<b>Statistic</b>	<b>Number</b>	<b>Comment</b>
Gross Domestic Product <sup>7</sup>	\$729.1 billion	(2010 est.)
Gross Domestic Product Per Capita <sup>8</sup>	\$12,300	(2010 est.) Rank of 92 in world.
Literacy <sup>9</sup>	Female 81%, Male 96%	
Education <sup>10</sup>	Education level attained: Primary School 94% Female, 96% Male Secondary School 70% Female, 77% Male Tertiary School 34% Female, 43% Male	
Total Labour Force <sup>11</sup>	24.73 million	Country comparison to the world: 24. About 1.2 Million Turks Work Abroad (2010 Est.).
Average Wages <sup>12</sup>	Annual: Male 20,441 Turkish Lira Female 5,352 Turkish Lira	
Mean Gross Hourly Earnings in Euros <sup>13</sup>	EU 27 13.38 EU 16 13.99 Turkey 3.10	
Labour Force Participation Rate by Gender <sup>14</sup>	Male 74%, Female 26%	
Number Of Establishments by Size <sup>15</sup>	Size of the establishment 1-9 1,047,921 10-49 145,757 50-99 12,451 100-499 9,352 500-999 628 1000 Plus 199 1,216,308	
Labour Force Participation Rate by Sector <sup>16</sup>	Agriculture: 29.5% Industry: 24.7% Services: 45.8%	(2005)
Labour Force by Sector <sup>17</sup>	Major industries: oil and gas, telecommunications, tourism, agriculture, the production of automobiles and electronics, construction, clothing and textile production, the production of petroleum, iron and steel, and mining.	
Unemployment Rate <sup>18</sup>	12.4% (2010 Est.) 14.1% (2009 Est.)	Underemployment 4% In 2008 Country Unemployment Comparison To The World: 131
Unemployment Rate; Youth (15-24) <sup>19</sup>	18.1%	
Unemployment by Education <sup>20</sup>	Female, Tertiary 23.6% Male, Tertiary 8.6% Female, Secondary 39.1% Male, Secondary 24.1%	
Informal Employment Rate <sup>21</sup>	43%	
Strikes <sup>22</sup>	2008: Public 1, Private 14 Number of Workers 5,040 Number of Days Not Worked 145,725 2009: Public 0, Private 34 Number of Workers 3,101 Number of Days Not Worked 209,913	
Lockouts <sup>23</sup>	2008: 1 Number Of Workers 1,256 Number Of Work Days Not Worked 16,328 2009: 0	

- 7 <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2004rank.html?countryName=Turkey&countryCode=tu&regionCode=me&rank=92#tu>
- 8 <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2004rank.html?countryName=Turkey&countryCode=tu&regionCode=me&rank=92#tu>
- 9 [http://www3.weforum.org/docs/WEF\\_GenderGap\\_Report\\_2010.pdf](http://www3.weforum.org/docs/WEF_GenderGap_Report_2010.pdf)
- 10 [http://www3.weforum.org/docs/WEF\\_GenderGap\\_Report\\_2010.pdf](http://www3.weforum.org/docs/WEF_GenderGap_Report_2010.pdf)
- 11 <https://www.cia.gov/library/publications/the-world-factbook/geos/tu.html>
- 12 [http://www3.weforum.org/docs/WEF\\_GenderGap\\_Report\\_2010.pdf](http://www3.weforum.org/docs/WEF_GenderGap_Report_2010.pdf)
- 13 [http://epp.eurostat.ec.europa.eu/cache/ITY\\_OFFPUB/KS-SF-10-003/EN/KS-SF-10-003-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-SF-10-003/EN/KS-SF-10-003-EN.PDF)
- 14 [http://www3.weforum.org/docs/WEF\\_GenderGap\\_Report\\_2010.pdf](http://www3.weforum.org/docs/WEF_GenderGap_Report_2010.pdf)
- 15 <http://www.csgeb.gov.tr> Labour Statistics 2009 Ministry of Labour and Social Security Republic of Turkey, p. 28
- 16 <https://www.cia.gov/library/publications/the-world-factbook/geos/tu.html>
- 17 [http://www.prospects.ac.uk/turkey\\_job\\_market.htm](http://www.prospects.ac.uk/turkey_job_market.htm)
- 18 <https://www.cia.gov/library/publications/the-world-factbook/geos/tu.html>
- 19 <http://www.tradingeconomics.com/turkey/unemployment-with-tertiary-education-percent-of-total-unemployment-wb-data.html>
- 20 <http://www.tradingeconomics.com/turkey/unemployment-with-tertiary-education-percent-of-total-unemployment-wb-data.html>
- 21 <http://www.todayszaman.com/news-207373-105-two-thirds-of-textile-employees-unregistered-in-turkey.html>
- 22 <http://www.csgeb.gov.tr/csgebPortal/ShowProperty/WLP%20Repository/csgeb/dosyalar/istatistikler/grev>
- 23 <http://www.csgeb.gov.tr/csgebPortal/ShowProperty/WLP%20Repository/csgeb/dosyalar/istatistikler/lokavt>

#### 4. The Textile Industry in Turkey

The Istanbul Textile and Apparel Exporter Association (ITKIB), a trade association, lists the following advantages of the Turkish textile industry:

- “Richness in basic raw materials, ranking seventh in the world in annual cotton production and production of synthetic and artificial fibres.
- Geographic proximity to main markets, especially in Europe.
- Short logistics due to geographic proximity.
- Qualified and well-educated labour force.
- Liberal trade policies.
- Well developed textile-finishing industry.
- Importance given to quality, environment and human health, sensitivity to working conditions of employees.
- Customs union agreement with the European Union and free trade agreements with many other countries.”

Although this list is written by a trade association that is trying to promote Turkish exports, many of these advantages are real and have helped sustain the sector. Other characteristics of the industry that should be considered fall under the following headings: the number and size of establishments, the importance of both exports and imports in the national economy, the value-adding strategy pursued by many companies in the sector and the creation of strategic alliances with universities and government entities.

The textile sector in Turkey involves the manufacture of textile products and wearing apparel (that forms the focus for this case). Closely related, but not included, is the manufacture of leather and related products.<sup>77</sup>

##### **Number of Establishments**

There are a large number of establishments. However, most are small in terms of number of employees, and many are family enterprises. The table below illustrates the size of the manufacturing establishments in the textile products and wearing apparel sectors and the distribution of employment in those establishments. The number of compulsory insured persons is a rough estimate of the total employment in the sector.

1 General Secretariat of ITKIB [http://www.itkib.org.tr/english/about/sectors/textile/textile\\_info.pdf](http://www.itkib.org.tr/english/about/sectors/textile/textile_info.pdf) April 19, 2011.

**Table 2: NUMBER OF ESTABLISHMENTS AND EMPLOYEES: TEXTILE PRODUCTS AND WEARING APPAREL<sup>78</sup>**

Size of the establishment (number of employees)	Number of workplace establishments in textile products	Number of workplace establishments in wearing apparel	Number of compulsory insured individual textile products	Number of compulsory insured persons in wearing apparel
1-3	6,292	13,693	10,696	23,449
4-6	2,212	4,546	10,666	21,910
7-9	1,177	2,411	9,333	19,068
10-19	1,604	2,577	22,064	35,237
20-29	758	1,181	18,275	28,587
30-49	851	1,181	33,177	45,357
50-99	574	631	40,829	44,475
100-499	655	495	126,641	96,988
500-999	63	36	42,766	24,487
1000 Plus	11	13	16,991	18,558
Total	14,197	26,764	331,438	258,118

\*This table excludes manufacturing of leather products.

The average number of workers in each of Turkey's 40,961 textile companies is 16. As noted above, family businesses are very dominant in Turkey. The SGK (Social Security Institution) data reports that the sector, along with the construction and leather manufacturing sectors, leads the list of sectors with the lowest salary paid to its workers. The average daily payment per worker stands at TL 30 (Turkish Lira, about \$20 US or 13.4 Euro) in the textile industry.

Wages in the textile sector are low for a variety of reasons. The sector consists of jobs that tend to be low skilled, home-based and held by women, who might be employed only part time. For example, in a survey of women workers in Istanbul's garment industry, 50% are age 25 or under; 74% have only primary school education or illiterate; 46% are married, meaning they are not the sole support of their family. Further, 75% of these women work in other than large-scale factories, such as small workshops and home-based production. These establishments would tend to have lower wages.<sup>79</sup>

Additionally, it has been estimated that two-thirds of all employees in the textile industry work in the informal sector, meaning that they would not

<sup>78</sup> <http://www.csgb.gov.tr> Labour Statistics 2009 Ministry of Labour and Social Security Republic of Turkey.

<sup>79</sup> Dedeoglu, Saniye. "Visible Hands—Invisible Women: Garment Production in Turkey." *Feminist Economics* 16(4), October 2010, 1-32.

be counted in the number of employed individuals in the sector because they are not covered by social security.<sup>80</sup> Additionally, they are difficult to monitor with respect to compliance with requirements for EU membership.

An employer association has been conducting activities under the name Turkish Textile Employers' Association (Tütsis) since February 13, 1962.<sup>81</sup> It transformed itself into a Turkey-wide organization one year after its founding by textile industrialists. They serve members by providing mutual support including support in collective bargaining.

The Confederation of Turkish Trade Unions (TÜRK-İŞ) is one of four major national trade union associations in Turkey.<sup>82</sup> It was created in 1952 and is the oldest of the four centers, having been the only trade union organization to survive the 1980 military coup. TÜRK-İŞ claims a membership of 1.75 million, and is affiliated with the International Trade Union Confederation, and the European Trade Union Confederation. It is also a member of the Trade Union Advisory Committee to the OECD.

There are 11 trade unions in the textile sector in 2009, the same number in 2008. Strikes in the textile industry are relatively rare. In 2008, there was one strike, involving seven workplaces and 209 workers. For a given workplace, the average participation rate of the workers striking was 73.59% and resulted in 26, 125 workdays lost. The comparable statistics for 2009 are one strike, one establishment, 603 workers, participation rate of .5% and 162 work days lost.<sup>83</sup>

### Exports and Imports

Since 1996, Turkey and the EU have had a Customs Union agreement to promote trade.<sup>84</sup> The textile industry in Turkey is now a driving force in the Turkish export industry. Turkey is a very large exporter of textiles to the European Union. It has a very large textile production capacity, one of the largest in the EU and fourth largest in the world. Its share in the country's GDP is around 10.7% and the share of total employment is 10.9% (Cukul, 2008).<sup>85</sup> There are about 40,000 manufacturing companies and 1.9 million employees in the Turkish textile sector. Textile exports reached \$5.4 billion US dollars in 2009.<sup>86</sup>

80 [http://www.todayszaman.com/newsDetail\\_getNewsById.action;jsessionid=C7343327A95B8BB8225D4B159212E5C9?newsId=207373](http://www.todayszaman.com/newsDetail_getNewsById.action;jsessionid=C7343327A95B8BB8225D4B159212E5C9?newsId=207373) (14 April 2010).

81 [http://www.tekstilisveren.org.tr/english/index\\_e.asp](http://www.tekstilisveren.org.tr/english/index_e.asp)

82 Agartan, K. (2010). Turkey's Accession to the European Union and the Turkish Labor Movement. *European Journal of Turkish Studies. Social Sciences on Contemporary Turkey*(11).

83 Labour Statistics 2009. Retrieved from [http://www.csgb.gov.tr/csgbPortal/ShowProperty/WLP%20Repository/csgb/dosyalar/istatistikler/calisma\\_hayati\\_2009](http://www.csgb.gov.tr/csgbPortal/ShowProperty/WLP%20Repository/csgb/dosyalar/istatistikler/calisma_hayati_2009)

84 <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/turkey/>

85 Çukul, D., & Candan, C. (2007). An Example for a Branding Program and Its Effects on Turkish Textile Industry.

Retrieved from [http://bildiri.anadolu.edu.tr/papers/bildirimakale/125\\_272157.doc](http://bildiri.anadolu.edu.tr/papers/bildirimakale/125_272157.doc).

86 [www.itkib.org.tr/english/about/sectors/textile/textile\\_info.pdf](http://www.itkib.org.tr/english/about/sectors/textile/textile_info.pdf)

The textiles and clothing sector employs around one-fifth of Turkey's industrial labor, accounting for 21.5% of total industrial output. From 2003 onwards, the share of textiles and clothing in export revenue began to fall as exports of other industrial products such as motor vehicles began to increase. In 2007, the share of textiles and clothing in export revenue was 20.9%, whereas motor vehicles accounted for 15.8% (compared with 10% in 2002). In 2008 the shares in export revenue were 17.4% (textiles and clothing) and 13.6% (motor vehicles), declining to 11.3% and 11.6%, respectively, in 2009.<sup>87</sup>

There are 7,500 textile manufacturers solely producing for export. Forty-nine percent of Turkish textile exports go to EU countries. The next important group of countries to which Turkey exports is former USSR countries. Turkey ranks sixth in clothing exports and third in home textile exports in the world.<sup>88</sup> Major exports in clothing & textiles accounted for 18.8% of total exports in 2009.

### **Sector Strategy: Producing High Value-Added Products and Selling Them at Reasonable Prices**

The current strategic goal for the industry, as marketed by the trade association, is to produce high value added, original and high quality products and sell them at "reasonable" prices. Turkey is developing experience in fabric design and presents designs in fashion shows in various markets. These designs, developed by textile industrialists, are trademarked and patent protected, providing protection to the process of providing high-value added products. Manufacturers in the apparel industry in Turkey promote their products through many fairs. At the time of the writing of this case, there were upcoming apparel fairs in promoting women's wear, men's wear, kids' wear, and fashion accessories brands. To quote from an Internet website "Istanbul has become the new center of this sector due to the fact that it has very close contacts between Europe and Asia". Moreover, there seems to be the tendency towards a niche in upscale/designer apparel.<sup>89</sup>

### **Strategic Alliances**

The Turkish government has also formulated partnerships among university, industry, and government entities and is giving attention to the importance of R and D in a variety of industries. There are alliances with

<sup>87</sup> <http://globaleledge.msu.edu/countries/turkey/tradestats/>

<sup>88</sup> Agartan, K. (2010). Turkey's Accession to the European Union and the Turkish Labor Movement. *European Journal of Turkish Studies. Social Sciences on Contemporary Turkey*(11).

<sup>89</sup> <http://www.biztradeshows.com/turkey/turkey-tradeshows.mp?industry=apparel-fashion>

universities offering degrees in textile engineering, including Ege University and Istanbul Technical University.<sup>90</sup>

## 5. Implications for Governance and Labour Strategies:

### Discussion Points & Questions

These questions should be considered from the point of view of a firm. This firm is a medium size textile manufacturer in the formal sector. It currently has between 100 and 125 workers, including several skilled workers in fabric design, but most workers are currently unskilled or semi-skilled. About 35% of the workforce is women. Our turnover rate for all skills is quite high. Most of our workers are in a union, but the union has not been very powerful. The firm is an active member of the trade association. The Board of Directors and top management have agreed on a strategic goal that is consistent with that of the trade association: to produce high value added, original and high quality products and sell them at reasonable prices. The firm defines “reasonable” prices as competitive prices for high quality goods. The company is developing experience in fabric design and plans to export these in various markets.

### **Disclosure and Transparency and Interests of Labour as a Stakeholder Employment Protection Laws**

1. The European Employment Strategy includes various Employment Protection Laws (EPLs), and in general, increases the rights and the effective voice of workers as stakeholders in a firm.
  - a) What does creating “the conditions for a free and genuine bipartite as well as tripartite social dialogue at all levels” mean for the company?
  - b) What does this imply about governance and labor strategies for the firm? For example, will the firm have to treat its labor force differently and/or negotiate with labor differently? Will it be expected to communicate with labor differently? Will it be expected to provide more information?
  - c) How will this affect the firm’s decision-making processes? How might this affect decisions concerning hiring, training and turnover?

### **Role of Unions**

2. Unions have not been strong in Turkey. Becoming a member of the EU may affect the ability of workers to unionize, making it more difficult or less difficult. (For example, might Turkish unions be able to increase their dialogue and alliances with European unions and receive support and guidance?)

<sup>90</sup> <http://www.ege.edu.tr/index.php?lid=1&SayfaID=181&cat=details> and

<http://www.itu.edu.tr/en/?academic/faculties-and-institutes>

- a) On balance, what do you think would happen to the power of unions in Turkey?
- b) What does this imply about governance and strategy for the firm? For example, will firms have to treat labor differently and/or negotiate with labor differently if unions become stronger (or weaker)?

### **Integrity and Ethical Behavior and Interests of Labor as a Stakeholder** **“Low Road” vs. “High Road”**

3. It has been said that a company (and a country) can choose a “low road” or a “high road” to increasing employment, productivity and growth. The “low road” involves low wages and low costs, but low productivity. The “high road” involves high wages and large investments in human capital, but high productivity and low turnover rates.
- a) Which “road” does the EU try to take? How?
  - b) What strategies can make the firm benefit from being pushed in this direction?
  - c) How does this “road” fit in with the current industry and firm strategy to produce high quality and high value-added products at reasonable prices?

### **Employment Flexibility**

4. Although there is a greater emphasis on employee rights and Employment Protection Laws (EPLs) under the European Employment Strategy, there is also a greater emphasis on employment flexibility. For example, it is now easier to hire people part-time and with fixed-term contracts (as opposed to full-time, permanent positions.)
- a) What are the advantages and disadvantages of hiring more people in this way?
  - b) Could there be an effect on the collective voice of workers as stakeholders if the firm moves toward greater part-time and fixed-term contracts? Why?
  - c) Are there ethical issues that should be considered as the firm makes this decision?

### **Other Ethical Issues**

5. What other ethical issues should the firm keep in mind as it adjusts our labor strategies in response to movement into the EU? For example, given the EU emphasis on increasing female employment and anti-discrimination policies, and the large proportion of women in the textile industry, are there ethical considerations with respect to female employees that the Board of Directors should consider.

### **Role and Responsibilities of the Board**

6. The Board of Directors should have appropriate skills to deal with business issues and to question management.

- a) What are the implications of EU labor requirements or EU membership on the composition of the board?
- b) What skills and background become more important?

### **Rights and Equitable Treatment of Shareholders and Interests of the Shareholders**

7. Taking all these factors into consideration:

- a) How might following the EU labor guidelines change the relative power of shareholders relative to other stakeholders?
- b) How would joining the EU raise costs for the firm or make it more difficult to run or less profitable for shareholders?
- c) What strategies would you suggest the firm undertake to minimize these problems?
- d) How would joining the EU provide opportunities for the firm to increase profits for shareholders?
- e) What strategies would you suggest that would maximize the gains from these opportunities?

### Questions for Further Discussion

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#### **Interests of Labor as a Stakeholder**

##### ***Labor Mobility***

1. If Turkey becomes a full member of the EU, there would be a free flow of labor between Turkey and other EU nations.
  - a) What are the implications for mobility of workers?
  - b) What are the implications for wages in the textile industry?
  - c) What are the implications for how our firm must treat labor and negotiate with labor?
  - d) Should this change the firm's policies concerning human capital investment in its workers? Why might it be more likely to invest in training our workers? Why might it be less likely to do so? What do you think the firm should do?

##### ***Employment of Women***

2. An important objective of the EU is to increase the employment rate for women, especially urban women. A related goal is to promote gender equality with respect to employment and wages.

- a) If policies are put in place (and enforced) to support these objectives (for example, making it easier to hire part-time workers, and anti-discrimination laws), what opportunities might this create for the firm?
- b) What challenges or costs might this create?
- c) What do you think the firm should do to make movement in this direction prove to be a net gain for the firm? Are there any policies or programs the firm could initiate to recruit or retain women workers? Should it try these? Why or why not?

### **Interests of the Government as a Stakeholder and Other Stakeholders**

3. Although EU regulations and strategies may increase costs for firms, it also places responsibilities on central governments to improve employment and productivity.
  - a) What government policies should the firm (or the trade association) lobby for that would help this firm make the transition into the EU more profitable?
  - b) What government policies should the firm (or the trade association) lobby for that would help achieve the current industry strategy to produce high quality and high value-added products at reasonable prices?
  - c) More generally, what kind of relationship should the firm pursue with the national government? What about the local government? What factors work in the firm's favor when lobbying with the government at both levels?
  - d) What can a trade association do to help the company interact with various stakeholders such as suppliers and companies that buy from it? How might being a member of the EU make this more likely?

### **Interests of Shareholders as a Stakeholder**

4. The EU looks at the implementation of the laws—not just the laws on the books.
  - a) What does this mean for the informal sector?
  - b) What are the implications for shareholder profits in this formal sector firm?



## 22

## Developing a Business Governance Model by Aligning Systems and Practice: An Australian Case Study

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*Abstract:* The case presents a business governance model developed through Business Process Management (BPM) that sets BPM decision-making, along with roles and responsibilities. Using a qualitative content analysis approach, together with in-depth interviews, a BPM governance model is proposed in a government owned corporation (GOC) operating in Australia. The research shows how BPM practice can be aligned and integrated with the corporate governance and management systems in the organisation. Although prior research has identified the importance of governance and capabilities, there has been little progress on how to deploy BPM Governance in an organisation.

*Key Words:* Business Process Management Governance Model, Business Process Management, Roles, Responsibilities.

### 1 Background

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Business Process Management (BPM) continues to receive significant attention as a business practice, providing organisations with a means of increasing competitiveness and sustainability in times of market uncertainty, increasing globalisation and constantly changing business conditions. BPM is a management discipline that requires organisations to shift to process-centric thinking, and to reduce their reliance on traditional territorial and functional structures. BPM is not a new discipline in business management. Some argue that BPM has its roots in the early work of Taylor (1911), while the concepts and principles embodied in BPM have received increasing attention over the past fifteen years. The business process reengineering (BPR) work of Hammer and Champy (1993) was synonymous with the rebirth of the interest in process management. However, the aftermath of many forays into BPR

came with issues. Most notably, for many organisations BPR projects were synonymous with staff cuts and budget overruns. Following this, Davenport (1993) took a more moderate view suggesting a less aggressive approach and the adoption of continual business process improvement and innovation (BPI). Over the next 10 years or so, other management practices such as total quality management (TQM), business excellence models such as EFQM, ABEF, MBNQA, standards such as ISO 9000 and even legislation such as Sarbanes Oxley<sup>91</sup> in the United States took on an increasing process management focus (Evans, 1996).

Different researchers have investigated BPM over the last years (e.g. Hammer and Champy 1993; Evans 1996; Hammer 2001; Davenport, 2005; Hung, 2006). The core problem was that companies reengineered too narrowly without a holistic and aligned view (Neilson and Couto, 2003). Companies should consider adopting new forms of BPM Governance to enable process orientation. This would require the empowerment of Business Process Owners, process orientated decision-making models, appropriate reward systems and supportive organisational structures. In support of this statement, Spanyi (2003) stated that setting BPM governing principles would enable firms to make tough strategic choices and engage the entire organisation in the more effective execution of strategies. From the research cited above it appears that the construct of BPM Governance is important in enabling the successful deployment of BPM across an organisation.

Despite research identifying the importance of governance, along with associated capabilities, there has been little progress in answering the question as to how the abovementioned capabilities can be effectively deployed across an organisation (Neilson and Couto, 2003). This two-stage qualitative case study proposes a BPM Governance Model that sets BPM decision-making, along with roles and responsibilities in a government owned corporation (GOC) operating in Australia. Decision making is around business processes and how they are managed.

## 2 Governance

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### 2.1 Corporate Governance

Definitions of Corporate Governance generally refer to the processes by which organisations are directed, controlled and held to account. Corporate Governance is driven by Directors and senior management in

<sup>91</sup> The Sarbanes Oxley Act 2002 was passed in response to a number of major corporate and accounting scandals that shook public confidence in the US securities markets. The Act covers issues such as auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure.

an organisation, and encompasses performance and the improvement in stakeholder relations. As Parkinson and Baker (2005) argue, there are two important elements of enterprise governance authority, accountability, stewardship, leadership, direction and control within the organisation (McPhee, 2008). It is the responsibility of top-level management to assess and manage the risks to which the business is exposed. Corporate Governance sets the principles for sound business practices, which in turn lead to greater accountability, integrity, efficiency, transparency and sustainability that reinforce stakeholder confidence (Mardjono, 2005). Failure to integrate good governance into an organisation's strategy, structure and operations could result in unrest as was seen in the collapse of high-profile organisations like Enron and MCI. An effectively deployed corporate governance framework involving conformance and performance in an organisation increases business, these being conformance and performance. Clear decision making structures and roles and responsibilities should be assigned to achieve both of these elements (Parkinson and Baker 2005).

Dyer and Singh (1998) argue that effective governance is achieved by both formal and informal means. Many effective alliances use multiple governance mechanisms, often starting with formal processes then developing informal systems over a period of time. In this way contracts may underpin trust-based systems of governance as such systems develop (Dyer and Singh, 1998). The existence of trust as a sole means of governance was discussed by Cook et al (2005), who argued against the popular view that trust is a societal variable, suggesting that it is neither sufficient nor necessary for cooperation and social order. Instead, trust exists at the interpersonal rather than societal level. Cook et al (2005), further argued that trust relations are not necessary for effective governance. Instead, effective governance creates a secure environment which in turn makes people feel safe enough to take risks, a necessary condition for trust. (Cook et al, 2005). Trust may also exist as an important factor in inter-organisational governance in the context of BPO outsourcing (Greenberg et al, 2008).

Coexistence of formal and informal systems of governance was also supported by Puranam and Vanneste (2009, p. 25) who discussed the relationships between trust and formal governance, suggesting that trust and governance may coexist over time. A similar argument was made by Enderwick (2009) who proposed three modes of governance, based around a formal contracting mode, together with modes based on a calculative trust-based relationship and relationship-based trust. In summary, the

research suggests that trust is not a proxy for formal governance systems. At best it may complement or enhance formal systems as discussed above.

## **2.2 Business process management governance**

BPM governance typically encompasses the same aspects as the more traditional corporate and IT governance, but with a focus on process. Effective BPM governance suggests that the authority to examine, challenge, and change work methods should be delegated to cross-functional teams in a business process-centric organisation (DeToro and McCabe, 1997). The team approach builds on Hammer and Champy's (1993) suggestion that decision-making should fall to workers not managers where business process design and re-engineering are concerned. Delegating control of work methods to workers results in the following advantages: 1) reduced process delays; 2) lower overheads and fixed costs; 3) more timely response to customers; and 4) workers are empowered to create value for the customer

Functional managers can make their own process management decisions as the processes reside within their functions, while processes that run across functional boundaries require some ownership, often labelled as business process ownership. What is often found in organisations is that business process ownership is assigned to functional managers, typically the role that has most interest, for the process to perform effectively. This might be a successful solution as long as the functional manager has the capability required to manage the process from an end-to-end perspective and has a sound understanding of process values and beliefs required to do so. Ultimately, discussion about process management refers to processes that span across functions and create and deliver value to customers.

## **2.3 BPM roles and responsibilities**

Hammer (2004) stated that the issue with BPM is that it requires new managerial responsibilities in an organisation. Actors, often called business process owners, have to take responsibility for cross-functional processes, in facing the major challenge of managing relationships with functional managers in order to negotiate the best overall process outcome. Furthermore, Hung (2006) proposed that every employee, not only managers, has responsibility for supervising and controlling their work. Hung (2006) argued that stronger leadership from top management towards managing core processes, while providing more authority to employees to manage their work, tends to achieve better performance overall. Jeston (2008) stated that managers should be supported in order to move to a new management model where BPM becomes part of their role. There may be requirements for guidelines, training and

coaching on how to use the practice and additional resources may also be necessary. Management needs to be seen as leaders and role models. As research suggests, the roles of business process owners and process improvement officers should be formalised and made visible. Business process ownership is the domain of managers, and managers should be appointed to each critical business process (Flint and Gerard, 2005).

#### **2.4 Organisational responses to BPM governance issues**

Organisations are adopting new forms of process governance that are appropriate to a new process orientation. However, there is no set approach to implementing BPM Governance, and/or set structure and design, as confirmed by Neilson and Couto (2003). Their research found that a key consideration in the design of BPM Governance is the extent to which business process ownership can be deployed, and how the tension between functional and process management is facilitated and managed. The approach of deploying BPM starts with the identification of the key processes of an organisation and the assignment of business process owners (DeToro and McCabe, 1997).

Recent studies (e.g. Hammer, 2001; Morello and Blecher, 2005; Melenovski, 2006; Olding, 2007) have further explored the different BPM related roles and organisational designs and reporting structures, to assist an organisation in building capability and deploying BPM related activities more effectively. Studies cited identified that what determines how an organisation approaches structure and staffing depends greatly on operating philosophy, maturity and culture (Melenovski, 2006). While recent studies describe BPM roles and responsibilities, along with an associated decision making framework, it appears that there are few that focus on how roles and responsibilities are deployed and operationalised using a BPM Governance Design Model or equivalent framework.

### 3 Research Design

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#### **3.1 The organisation**

The organisation that provides the context for the study is one of Australia's largest national transport providers that operates in a complex and dynamic business environment. Services provided include passenger services, freight services, infrastructure services and network access provision. The organisation has annual revenue in excess of \$A3 billion and manages assets of \$A10 billion. Operating for almost 150 years, the organisation is among the nation's longest running service enterprises. It is a Government Owned Corporation (GOC) directed by a Board of Directors

that is accountable to two shareholding state government ministers, the Treasurer and the Minister for Transport. In recent times the organisation has expanded its operation across state borders and has acquired a number of subsidiaries as part of an expanding business portfolio.

### **3.2 Progression of BPM in the organisation**

Within the organisation the assumption was made that a successful enterprise-wide implementation of BPM practices would require the same commitment and top-down support as other management practices (e.g. Finance). It was speculated that the main reason for ad-hoc uptake and implementation of BPM practice in the past was that BPM governance elements were not integrated effectively into the organisation's Governance and Management Framework. This study will investigate the BPM governance areas of BPM decision-making roles and responsibilities in order to design an approach to assist the organisation with its BPM journey.

### **3.3 Research design**

The research uses qualitative data obtained by means of document analysis and interviews. Content analysis is the approach used to analyse organisational documents in the first stage of the research (Creswell, 2003). The outputs of the content analysis stage are then used to inform the second stage of the research, which is a series of in-depth interviews. Given the positioning of the research within a single organisation, together with its explanatory nature and a focus on contemporary events, the research has been undertaken as a case study (Yin, 2003).

### **3.4 Data collection and analysis**

An initial BPM governance survey was conducted to establish the current state of BPM decision-making, together with BPM roles and responsibilities. The survey indicated that: 1) BPM standards were used in an ad-hoc manner across the organisation's businesses; 2) BPM decision-making roles and responsibilities (i.e. business process ownership) were applied mainly as part of process change projects driven by technology; and 3) BPM practice leadership was empowered through support given by senior management. Following the initial survey, data for the content analysis phase were obtained from the governance management document repository and other business document libraries that contained relevant references to BPM decision-making and BPM roles and responsibilities within the organisation. The documents were structured into the following: a) key governance management documentation (accountability and decision making structure); b) project business cases; and c) position descriptions.

For the purpose of the study three governance documents were selected, two transformational documents and two operational documents. These documents were reviewed along with nine position descriptions that covered the three categories and the different line management levels to provide further depth to the study. The results of the content analysis stage were used to assist in developing an interview guideline for the next stage of the study. The key findings are shown at Table 1, below:

Table 1

<b>CONTENT ANALYSIS BY CATEGORIES</b>
<p><b><i>Findings made in Governance</i></b></p> <ol style="list-style-type: none"> <li>1. Practice Leaders responsible for setting principles and standards to define management practices/guide line managers. Practices identified could be assigned to two types: Function or Process.</li> <li>2. Only two Practice Leaders were assigned to organisation-wide processes, all others were assigned to functions</li> <li>3. Practice Leaders were accountable and made decisions on necessary principles and standards for the organisation to execute the particular practice. Executive managers of the different business areas were accountable to translate the standards and specifications into work instructions and procedures as part of their business management systems.</li> <li>4. The position description reflects a Practice Leader role, which includes BPM practice decision-making, development of principles and standards. The current Management System does not include a Practice Leader for BPM.</li> </ol>
<p><b><i>Findings made in Transformation</i></b></p> <ol style="list-style-type: none"> <li>1. The project manager of a process change project was responsible for the design of the process.</li> <li>2. Decision-making on the process change was made by a steering committee including representatives from different areas of the business including some practice leaders.</li> <li>3. A business process owner was not identified as a participant or outcome of the project. The ongoing process performance management of the deployed process has not been assigned to a particular role.</li> </ol>
<p><b><i>Findings made in Operations</i></b></p> <ol style="list-style-type: none"> <li>1. Practice Leader principles and standards were translated into the specific work instructions and procedure on an operational level. Practice Leader's PD included monitoring and providing the process performance of the Supply Chain. The governing and corporate role of Practice Leaders links with the deployment of the practice at an operational level in the organisation.</li> <li>2. Work instructions and procedures clearly defined the roles and responsibilities of the process subject matter expert and indicated the decisions needing to be made during the execution of the process. Position descriptions of the subject matter experts defines what is required to execute the process effectively, however, does not describe the role or responsibilities in applying particular steps to find more effective ways to execute the process.</li> </ol>

The next stage involved in-depth interviews with 14 individuals. Interviewees were selected after considering extant literature around the

deployment and operationalisation of roles and responsibilities, current organisational design, accountability, and reporting structure, roles and responsibilities. Interviews were conducted around the themes identified at the content analysis stage of governance, transformation and operations. Interviews were transcribed and analysed using a constant comparison approach (Strauss & Corbin, 1990) to ensure credibility of categories of description. Data gathered from the questions relating to “General BPM” and “BPI” provided the researcher with insight into the organisations current position on BPM and BPI along with the different views and perspectives interview participants held. Data were further categorised as work within “core” (c), “support” (s) or “governing” (g) business areas to enable a comparative analysis to be made. Major themes emerging from the data are detailed in Table 2, opposite.

The interview findings were interpreted and used to inform the development of the BPM Governance Design Model and BPM Governance Model shown at Figures 1 and 2, below.

**4 BPM governance design model**

The purpose of the BPM Governance Design Model (Figure 1) was to provide a high level context for the elements to be considered by an organisation when establishing a BPM Governance Model. The elements were drawn from the findings made in this study and include: 1) organisational environment (owner/stakeholders, market, regulation and legislation, culture); 2) organisational design principles; 3) organisational structure (organisational reporting structure, BPM reporting structure); 4) results of investigation (content analysis findings - governance documentation, interview findings - interviewees); 5) BPM governance model success factors; and 6) the organisation’s BPM definitions.

Figure 1



Table 2

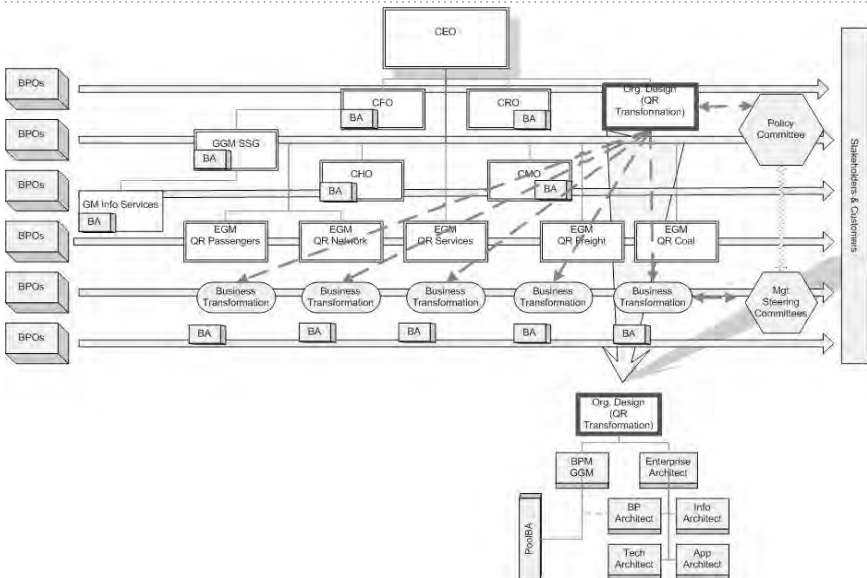
THEME	AREA
Processes not managed in the area due to a perceived lack of managerial capability to manage them	c, s, g
Inability to list critical processes. Focus on function rather than the processes needed to lead, deploy and monitor the practice successfully	g
Some processes not defined - though carried out by content experts process execution and knowledge required to do so is not captured	c, s
Teams perceived to lack the role and responsibility to manage the organisation's process architecture repository.	c, s
Practice processes defined and documented but delivery processes executed on an <i>ad hoc</i> basis	g
Links between processes/measures and organisational objectives is not clear – impacts are unclear due to lack of clarity of relationships between processes and outcomes	c
Most identifiable trigger for BPI across the organisation is customer satisfaction. Safety improvement trigger is associated with compliance rather than performance improvement or customer satisfaction.	c, s, g
BPI efforts are conducted in an <i>ad hoc</i> manner. Current approaches, structures and capabilities not consistent with enterprise-wide organisational objective.	c, s, g
Unstructured BPI approaches used to improve processes across organisation resulting in perceptions that organisation is reacting to business improvement (e.g. use of lag indicators)	c, s, g
Customised continuous improvement should be used. However, newer employees (e.g. 0–6 years) favour unstructured approaches while long-term employees (e.g. > 6 years) favour methods such as Six Sigma and Lean.	c, s, g
Limited understanding of the different BPI methods in terms of strengths and weaknesses and which was the most appropriate to use in particular circumstances. Choices were often made by “gut feel”.	c, s, g
Even structured BPI methods (i.e. Six Sigma) were applied ad-hoc and seen as non-successful. This confirms that an ad-hoc approach to BPI is unsuccessful even when using best practice methods (i.e. Six Sigma and Lean).	c, s, g

The BPM Governance Design Model identified key macro elements that are important in developing a BPM Governance Model. Development of the BPM Governance Model from the BPM Governance Design Model is described in the next section.

### 4.1 Modelling BPM roles and responsibilities

The BPM Governance Model (Figure 2) was designed using the key elements defined in the BPM Governance Design Model (Figure 1). First, an understanding of the organisational environment was gained and the organisational design principles were taken into the consideration. The proposed model ensured that the organisation’s risk exposure, due to ineffective and inefficient business process management, was reduced. Furthermore, the model provided the necessary consistency across the organisation to reduce duplication of effort, misalignment of business process change projects and lack of capability in managing process changes. Adherence to the model increased the capability of the organisation in BPM and facilitated progression to the next level of maturity. It was found that the BPM decision-making and reporting structure was not dissimilar to other management practices in the organisation. Second, the organisational structure did lend itself well to the integration of BPM roles and responsibilities and only minor changes were needed to integrate the BPM Governance Model effectively. The research findings of the study proposed including BPM roles and responsibilities within the current Organisational Transformation Office while expanding its purpose. The integration of some BPM decision-making, together with roles and responsibilities, into the Organisational Transformation Office provided a more robust design and improved strategy deployment approach across the organisation.

Figure 2



## 4.2 Implementing the BPM governance model

The deployment of the model enabled a government owned organisation to make effective process based decisions. Findings of this study required the organisation to undertake some corporate governance changes, some organisational restructures, and the assignment of visible and clearly defined roles management. Without these changes the organisation would not be in a position to further build capability in BPM and progress its journey. The following realignment of roles and responsibilities showed how BPM roles could interact and work together at different levels of management in the organisation (Jeston and Nelis, 2008), with responsibilities and decision-making mechanisms relating to functional and process

Operationalising the BPM Governance Model was assigned to the BPM general manager who is located in the Organisational Design Office (i.e. Transformation Office). The Organisational Design Office's (ODO) purpose is to facilitate and design the organisation and to define and prioritise the portfolio of programs and projects to achieve the deployment of initiatives and operationalise the design that will meet objectives and strategies of the enterprise. A major function of the ODO is to report directly to the Policy Committee of the organisation that includes all senior executive managers with a close link to the Board of Directors. The ODO should work closely with the Business's Transformation Offices and Steering Committees across the organisation to ensure programs and projects are deployed successfully following management principles, common standard approaches where appropriate and relevant to achieve effective implementations. The roles within the Organisational Design Office are assigned to highly skilled design professionals with a close relationship to Practice Leaders of the different practices with the purpose to facilitate the future enterprise design. In addition, feedback and advice is to be provided to Policy Committee on business initiative alignment and prioritisation. The Organisational Design Office further provides the ongoing coordination and performance management of the portfolio of initiatives for the organisation from a central point. Strong relationships are required with key stakeholders like the Board and Senior Executive Management, individual Businesses Transformation Offices and key management committees. Practice Leaders are to manage their communities of practice across the organisation and monitor capability and performance.

## Discussion

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Data from the content analysis stage provides insights to the current corporate governance and management framework, and its lack of relationship to BPM Governance. Building on the content analysis, a series of interviews provide insights into the current views and interpretations of BPM decision-making and BPM roles and responsibilities. Both phases of the research assist in creating and clarifying the case and setting some of the Organisation's BPM definitions. The definitions are further used in the design of the BPM Governance Model, and provide direction in operationalising the model.

Overall, it is found that BPM roles that work "in" and "on" a process are defined, however, they are not visible. Staff members are not assigned BPM roles as part of a workforce or succession plan and managed accordingly. The career paths of those in BPM roles that work "on" a process are to be developed and the performance managed to ensure further capability is built. It is recognised that all staff on all levels of management in the organisation have roles to play in BPM.

The BPM governance model includes the BPM roles required at different levels of management as part of the organisational structure, which the authors argue will ensure effective deployment of business process thinking in the organisation. Roles and responsibilities are integrated into the organisations' governance decision-making framework, which in turn ensures that process thinking is included in the operationalisation of strategies. The integration of BPM roles and responsibilities into the governance management system of the organisation ensures sustainability of the practice and business improvement efforts.

For the findings of this research to be effectively implemented the organisation's senior management team should endorse the BPM Governance Model as part of the governance and management framework, and deploy it as an enterprise-wide practice. Successful deployment will involve embedding the following enablers into management systems across the organisation: 1) a corporate ownership function; 2) assigning the role of practice leadership; 3) adopting principles and standards, 4) identifying relationships and dependencies; and 5) assignment of BPM Roles.

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## Conclusion

Organisations worldwide are rethinking and changing the way they are operating, as the pressures to improve performance seem to increase continuously. BPM has been seen as a practice that enables organisations to improve performance continuously > However, results often fall short of expectations. In response to this issue, research has investigated BPM practice in order to build the knowledge base further, and assist organisations in managing process performance more effectively. However, despite active research in BPM decision-making, and roles and responsibilities, limited information exists on how organisations can design their governance framework to allow effective process-based decisions. This case study has specifically explored and addressed the twin issues of BPM and governance, contributing to academic literature and practice.

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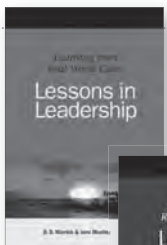
## Questions

1. Has the organisation defined its key BPM roles and responsibilities and decision making process as part of the BPM Governance structure?
2. Is the BPM Governance regime integrated into the overall corporate governance regime of the organisation to ensure the effectiveness of any process changes (Scale: from major business transformation to continued improvement) in the organisation.
3. How effective are the Business Improvement Initiatives in the organisation? Is there confusion around BPM Roles & Responsibilities and Decision making that might impact on the ineffective delivery of Business Process Improvement initiatives?
4. Are the organisation's functional managers making Business Process Change decisions without considering the impact on the service delivery process of the organisation?

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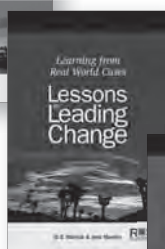
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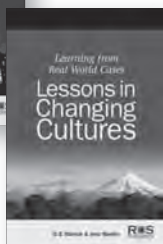
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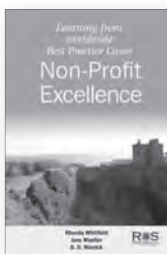
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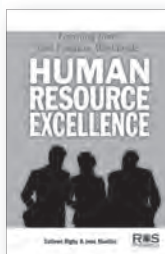
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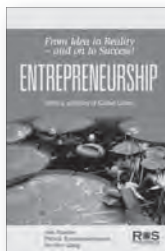
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