

# CHAPTER 11

## MAJOR CORPORATE GOVERNANCE FAILURES

### CHAPTER OUTLINE

- ◆ Bank of Credit and Commerce International (UK)
- ◆ Maxwell Communications (UK)
- ◆ Enron (US)
- ◆ WorldCom (US)
- ◆ Andersen Worldwide (US)
- ◆ Vivendi (France)
- ◆ Satyam Computer Services Ltd. (India)
- ◆ Harshad Mehta Scam
- ◆ Kingfisher Airlines
- ◆ Common Governance Problems in Corporate Failures

Corporate scams or scandals arise with the disclosure of misdeeds by trusted executives of large public corporations. Such misdeeds typically involve complex methods for misusing or misdirecting funds, overstating revenues, understating expenses, overstating the value of corporate assets or underreporting the existence of liabilities, sometimes with the cooperation of officials in other corporations or affiliates. This chapter presents the major corporate collapses arising out of the scams in different parts of the globe. The issues of corporate governance involved in the debacles are also discussed to highlight the need for reform in the governance of companies.

### Bank of Credit and Commerce International (UK) 1991

Bank of Credit and Commerce International (BCCI) was a major international bank founded in 1972 by Agha Hassan Abedi, a Pakistani financier. The BCCI was incorporated in Luxembourg with head offices in Karachi and London. The bank primarily focused on serving Muslim and third-world clients. The quadrupling of oil prices in 1973-74 led to huge deposits by Arab oil producers. As a result BCCI expanded rapidly in the 1970s. BCCI also acquired parallel banks through acquisitions. BCCI entered the African markets in 1979, and Asia in the early 1980s. BCCI was among the first foreign banks awarded a license to operate in the Chinese Special Economic Zone of Shenzhen. By 1980, BCCI was reported to have assets of over \$4 billion with over 150 branches in 46 countries. BCCI expanded rapidly and by 1991 it had 420 offices around the world and a presence in 70 countries.

### Forced Closure of the Bank

Although BCCI's published results showed ever-rising profits, by the late 1970s the bank was suffering an alarming level of bad debts due to reckless lending. BCCI came under the scrutiny of numerous financial regulators and intelligence agencies in the 1980s due to concerns that it was poorly regulated. Reality was not reflected in BCCI's accounts because the losses were concealed

in a Cayman Islands subsidiary, a bank within a bank known internally as 'the dustbin', safe from regulatory scrutiny. As the losses mounted Abedi resorted to more and more desperate ways of keeping the bank afloat. He tried 'proprietary trading', but the results were further huge losses. The bank only kept going by fraudulent accounting and massive misappropriations of depositors' funds. Desperately in need of new sources of deposits and revenue, from the early 1980s BCCI's Panama branch acted as money-launderer for Latin America's drug barons. Subsequent investigations and the inquiry report in June 1991 for BCCI by Price Waterhouse at the behest of Bank of England code named 'Sandstorm Report' revealed that BCCI was involved in massive money laundering and other financial crimes, and illegally gained controlling interest in a major American bank. The report indicated massive manipulation of non-performing loans, fictitious transactions and charges, unrecorded deposit liabilities, fictitious profits and concealment of losses.

Uncovering of BCCI's fraud and illegal operations in the 1991 probe led to a massive regulatory battle in 1991. Eventually on July 5, 1991 customs and bank regulators in seven countries moved quickly to seize and take over the bank's branches in the UK, US, France, Spain, Switzerland, Luxembourg and the Cayman Islands. BCCI's assets were ultimately liquidated, and a pool was established to reimburse depositors who had lost their funds when the bank shut down.

The BCCI scandal was the biggest bank fraud in history. Its closure left 150,000 depositors around the world scrambling to recover lost money. The biggest loser of all was Abedi's backer, the Sheikh of Abu Dhabi. Eventually small depositors recovered 75 per cent of their claims, leaving a final loss by depositors of around \$2 billion. Abedi was indicted in the US but he died in 1995 before facing the trial.

Although it is difficult to sum up the causes of the BCCI scandal despite various investigations and reports since 1991, the primary reasons leading to losses to bank stakeholders particularly the small depositors were:

- (i) Lax Corporate Governance
- (ii) Manipulation by bank officers with their own personal agendas
- (iii) General fraud
- (iv) Failure of fundamental risk management structures
- (v) Untenable loans and acquisition strategies
- (vi) Poor treasury and record-keeping practices
- (vii) Complex structure of BCCI leading to numerous regulatory violations and legal liabilities.

## Flaws in Corporate Governance

- (1) **Poor Risk Management** - The flaw in operations of BCCI had been that it made large loans to companies and individuals without properly securing them. The loans represented massive concentrations of credit risk, but were often not properly documented or monitored. When these loans went bad, the bank had no legal recourse, and was forced to absorb the losses. This strategy, which ran counter to common sense and all principles of good lending, racked up huge losses for BCCI. It covered up this problem by taking in new deposits and not recording those straight forwardly on its books. The bank created a matrix of false accounts that hid the losses for years.
- (2) **Non-existent Board of Directors** - The Board of Directors of BCCI was virtually non-existent as the company (the bank) was managed by its founder Abedi and the CEO Naqvi. 248 managers and general managers of the bank at different locations were reporting directly to them. They had developed an intricate international web of financial institutions and shell companies to escape regulations and indulge in dubious lending, fraudulent record-keeping

and money laundering. Certain senior bank executives manipulated gaps in the bank's risk management structure.

- (3) **Lack of Regulatory Supervision** - BCCI was structured in such a way that no single country had overall regulatory supervision over it. Its two holding companies were based in Luxembourg and the Cayman Islands— two jurisdictions where banking regulation was notoriously weak. It was also not regulated by a country that had a central bank. Investigators in the U.S. and the UK revealed that BCCI had been “set up deliberately to avoid centralized regulatory review, and operated extensively in bank secrecy jurisdictions. Its affairs were extraordinarily complex. Its officers were sophisticated international bankers whose apparent objective was to keep their affairs secret, to commit fraud on a massive scale, and to avoid detection.” Weak fragmented regulation obscured transparency in the activities of BCCI with the bank indulging in money laundering and funneling illegal money to disreputable clients such as dictators, insurgents, arms dealers and terrorist groups.
- (4) **Ineffective Audit System** - BCCI had an unusual annual auditing system. While Price Waterhouse was the accountants for BCCI Overseas, Ernst & Young audited BCCI and BCCI Holdings (London and Luxembourg). Other companies (such as KIFCO and ICIC) were audited by neither. There was a need for independent and unified regulation and auditing of complex financial conglomerates. In 1990, a Price Waterhouse audit of BCCI revealed an unaccountable loss of hundreds of millions of dollars. The bank approached Sheikh Zayed, who made good the loss in exchange for an increased shareholding of 78 per cent. The audit also revealed numerous irregularities. The audit also confirmed that BCCI secretly (and illegally) owned First American. Despite these problems, Price Waterhouse signed BCCI's 1989 annual report in the interest of the bank survival.

### Maxwell Communications Corporation and Mirror Group Newspaper (UK) 1991

Maxwell Communications Corporation was a leading British media company. It was listed on the London Stock Exchange and was a constituent of the FTSE 100 Index. The company was established in 1964 as the British Printing Corporation. In 1967 it acquired a majority stake in Haymarket Group. In July 1981 Robert Maxwell launched a dawn raid on the company acquiring a stake of 29 per cent. In 1982 he secured full control over the company and changed the name of the Company to British Printing & Communications Corporation and to Maxwell Communications Corporation in October 1987. The company acquired Macmillan Publishers, a large US publisher, in 1988 and Science Research Associates and the Official Airline Guide later that year.

By the end of the 1980s the Maxwell Empire, comprising more than 400 companies was loosely organized into three clusters. The two publicly listed companies: *the Mirror Group*, which published the Daily Record, the Sunday Mail and Racing Times, as well as the Mirror newspapers; *Maxwell Communication*, the flagship company which controlled such concerns as Macmillan books, the Official Airline Guides and P.F. Collier encyclopedias; and the *Robert Maxwell Group* which was privately held and owned 100 per cent by the family whose operations included the Oxford United Football Club and publications like the European, as well as stakes in newspapers in Israel, Hungary and Kenya. All the three holding companies were also directly and indirectly linked to dozens of other family-controlled enterprises.

### Debacle of Maxwell

In November 1991, chairman of the group companies Robert Maxwell, 68, was found drowned floating beside his luxury yacht near the Canary Islands. In a matter of weeks of the mysterious death of Maxwell, the global empire of publishing and other businesses collapsed amidst scandal about shocking financial maneuvers. Investigations revealed that Maxwell's group companies owed

£2.8 billion to its bankers. Maxwell's untimely death triggered a flood of instability with banks frantically calling in their massive loans. His two young sons Kevin and Ian struggled to hold the empire together, but were unable to prevent its collapse. Furthermore, the most famous UK pension scandal of all time came to light when £530 million hole in the pension funds of 16,000 employees of Mirror Group Newspapers was discovered. The thousands of employees of the Mirror Group had paid into pension funds totalling many millions of pounds, which Maxwell had 'borrowed' in a desperate attempt to prop up the ailing Maxwell Communication.

The Company went into administration following the death of Robert Maxwell. Its properties were sold to various media companies. The London based Maxwell Communication Corporation- parent of the giant U.S. book publisher Macmillan also filed the Chapter 11 bankruptcy petition in New York, in part, because bulk of its revenue and operating profit was generated in the United States. The Maxwell case was one of the most important transnational insolvencies of modern times. The empire of Maxwell was an unusual one with its true "seat" in London, where it was administered and nearly all of its financial affairs (especially loans and the grant of security) were managed, but its principal assets were in the United States in the form of various large operating companies. This ambiguous structure gave rise to a double-headed proceeding: an administration in the United Kingdom and a Chapter 11 bankruptcy in the United States.

### Reasons of the Debacle

- (1) **Acquisitions through Heavy Debts.** Maxwell was in deep debts following large acquisitions. The borrowings were personal as well on company accounts. The company borrowed \$3 billion in 1988 to buy the US publishers Macmillan and Official Airlines Guide. In fact, Maxwell wanted to buy everything from American book publishers to British soccer teams to Israeli and German newspapers. He piled debt upon debt by pledging the assets of the companies under his control. It was discovered later that Maxwell had pledged the same assets as collateral for various loans.
- (2) **Financial Difficulties and Diversion of Funds.** By the end of the 1980s the Maxwell empire, comprising more than 400 companies, was experiencing acute financial difficulties and was only kept afloat by shifting funds around his maze of inter-locking private companies, misappropriating pensioners' funds, and relentless deal-making. Months before Maxwell vanished from his yacht, there was a growing fear that he was having trouble meeting his repayment schedule. With the American and European economies starting to sour, Maxwell was faced with declining cash flow and debilitating debt payments. Despite his eroding financial condition, however, he was able to pass annual audits by leading European accountants Coopers & Lybrand Deloitte. That enabled Maxwell to add on more debt in March 1991 when he purchased the Daily News from the Tribune Co. by assuming as much as \$35 million in obligations. In 1991, desperate for money, Maxwell sold Pergamon and floated Mirror Group Newspapers as a public company. But it was too late.
- (3) **Uncertainties following the Death of Maxwell.** The stock of Maxwell Communication plunged to \$2.18 on 5 November 1991, (the day Maxwell disappeared) from a high of \$4.28 a share in April 1991, and further dropped to \$0.63. The decline in stock value was of special concern to Maxwell's creditors, since most of the family's 68 per cent stake in the company was pledged as collateral for loans. The untimely death of Maxwell triggered a wave of uncertainty amongst the lenders and creditors which ultimately led to the collapse of the empire of Robert Maxwell based around Maxwell Communications Corporation.

## Aftermath

- (1) It emerged that, without adequate prior authorisation, Maxwell had used hundreds of millions of pounds from his companies' pension funds to shore up the shares of his Group and to save his companies from bankruptcy.
- (2) The scandal sent shockwaves through the occupational pension market as employees confidence crashed. Eventually, the pension funds were replenished with money from investment banks Shearson Lehman and Goldman Sachs, as well as the British government. This replenishment was limited. The rest of the £100 million was waived. Maxwell's theft of pension funds was, therefore, partly repaid from public funds. The result was that, in general, pensioners received about 50 per cent of their company pension entitlement.
- (3) The son of Maxwell, Kevin was declared bankrupt with debts of £400 million. In 1995 Maxwell's sons Kevin and Ian and two other former directors went on trial for conspiracy to defraud, but were unanimously acquitted by the jury.

## Flaws in Corporate Governance

- (1) **Domineering CEO** - Maxwell was a physically imposing and domineering individual who ran his companies as his personal fiefdom, acting as both chairman and chief executive. He had a complete control over the companies of his empire. Maxwell personally controlled movement of funds around his empire consisting of web of hundreds of companies. Ethical and professional standards be it governance of company or governance of pension funds were relegated to the background for commercial advantages and empire building.
- (2) **Ineffective Board** - The non-executive directors on the Maxwell Communication board, all reputed persons, did little in discharging their responsibilities. Unrestricted movement of funds across group companies, pledging shares of a company to raise funds for another company, excessive borrowings took place under the nose of the board. It appeared that the board was helpless in the face of larger than life personality of Robert Maxwell.
- (3) **Lack of Transparency** - Assets of the company and pension assets which belong to the employees were mixed. There was hardly any transparency of the financial activities of Maxwell. The shareholders as well as the creditors were unaware of the corporate structure and web of hundreds of interlocking companies woven together by the tycoon. Maxwell had incorporated family trusts in Liechtenstein, where tax laws and disclosure rules are virtually non-existent. It was later learnt that even Maxwell family members were not aware of the companies and trusts managed single-handedly by Robert Maxwell.
- (4) **Flaws in the Audit** - To make the matters worse the auditors of the company failed to pick up the transfers Maxwell was making from the Mirror Group pension scheme, even though they were in a position to do so. The Institute of Chartered Accountants in England & Wales (ICAEW) asked the Joint Disciplinary Scheme (JDS) to investigate 35 complaints against the Maxwell auditors, Coopers & Lybrand (now part of PricewaterhouseCoopers), and 24 complaints against four individual partners, in relation to Mirror Group of Newspapers and other Maxwell companies for the period 1988 to 1991. The panel found lack of objectivity in dealing with Mr. Maxwell and his companies. The audit firm also admitted 59 errors of judgment.

## Enron (2001)

The Enron scandal is one of the largest in the US corporate history. It was revealed in October 2001.