Cornerstone Capital Group

Global Thematic Research

September 25, 2015

Flash Commentary: Corporate Governance

VW: A Case Study in Failed Governance


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The emerging allegations that Volkswagen installed "defeat devices" on its cars to evade emissions requirements highlights the importance of good corporate governance during periods of industry disruption. Such periods challenge companies to respond to emerging market trends without losing focus on longstanding and well-established social concerns and expectations. It seems clear that VW failed to do so.

We consider the automotive industry poised for disruption for the following reasons:

- The industry has been subject to long-running, growing and often conflicting social and environmental pressures;
- The boards and management teams, especially in the United States, have not always successfully navigated these challenges, as evidenced by recent bankruptcies and safety failures; and
- Emerging technologies offer potential solutions to many transportation challenges, offering new entrants opportunities to compete with or complement industry incumbents.

The markets have unfortunately become accustomed to shocks to the auto industry, but the emerging revelations about Volkswagen are different. Safety issues at Toyota (decelerators), GM (ignition switches and airbags), and Honda/Takata (airbags) were sins of omission—primarily, these were failures of safety and quality oversight from the board level down. Volkswagen's was a sin of commission—a deliberate decision to program each car sold to lie on emissions tests. The "defeat device" is not just a violation of the Clean Air Act; it is a deception of customers, dealers, employees and the public about the nature of the product being sold.

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No one outside the company yet knows who made this decision or why. A key question will be whether top management or board members actively approved or even directed the deception, or if they merely failed to prevent it. Moreover, because the company firmly denied the allegations for months after they surfaced, shareholders will want to know at what point board members or management became aware of the deception. As of this writing, rumors linking management to the decision are being reported by European news agencies, but no definitive evidence has yet emerged.

Even if top management had no specific knowledge of the decision, the incident suggests a culture and set of incentives within the company that enabled or encouraged cheating. Either way, the incident raises significant governance concerns.

A flawed analysis

In all likelihood, the company's engineers could not meet expectations for price, performance, and environmental compliance

One can infer that someone within the company studied the risks and benefits and concluded that installing the defeat device was the right business decision. The rationale may have been related to concerns about reduction in fuel efficiency and performance caused by the required pollution controls. In all likelihood, the company's engineers could not meet expectations for price, performance, and environmental compliance, and the defeat device was the chosen solution.

Although a full understanding of the decision-makers' thought process will await the outcome of outside investigations, any analysis that took place implicitly underestimated the likelihood and/or significance of detection.

Both U.S. and European regulatory systems rely heavily on company participation in safety and emissions testing. As The *New York Times* and others have reported, companies have sometimes used this as an opportunity to exaggerate test results. In this case, VW seems to have underestimated the likelihood that a non-governmental research organization would have the resources that government regulators lack to perform more detailed testing.

The company also apparently miscalculated the costs of exposure

The company also apparently miscalculated the costs of exposure. Perhaps VW did not consider how public and regulatory concern about corporate malfeasance in general and environmental compliance in particular has grown over the past several years. Indeed, the current EPA seems to be particularly aggressive in pursuing corporate malfeasance.

Risk analysis that excludes ethical analysis is inherently flawed from a business perspective

More importantly, we believe that this method of thinking—risk analysis that excludes ethical analysis—is inherently flawed from a business perspective. As we observe in our **Shareholder Alignment Frontier™** analysis, social and environmental issues evolve through a "lifecycle" as awareness of the issue grows and social norms emerge that demand attention from companies.

The business issue lifecycle

Business issues typically emerge via opinion leaders, then concern grows among the general public

In the emerging, or "pre-financial" phase of the issue lifecycle, public awareness and concern about the impact of corporate actions arise, first among opinion leaders and later among the general public. For example, concerns about air quality first emerged in California and elsewhere in the 1960s as industrial smog began to affect quality of life, leading to the grass-roots environmental movement.

Society then seeks a solution either explicitly (via government) or implicitly (via markets)

In the "transitional" phase, society seeks a solution to these issues either explicitly through government action or implicitly through market mechanisms. Air quality issues were first addressed in the United States through the Clean Air Act in 1970, as well as the executive order by the Nixon Administration to create the Environmental Protection Agency. The regulatory regime that sets expectations for company behavior has been evolving since then, most recently to address concerns about climate change.

Once expectations and norms are set, companies are expected to incorporate compliance into their practices

In the ultimate phase of this lifecycle, the "financial" phase, norms and expectations are firmly established, and companies are expected to operationalize these norms. However, it would be a mistake to treat these issues purely as operational issues. Rather, they are a culmination of a long societal process of seeking solutions to shared problems. Stakeholders may pay less attention in this phase of the issues lifecycle, not because the issue no longer matters, but because they expect companies to have the issue under control.

When regulations or similar social norms are viewed merely as unwelcome burdens, cheating can be seen as a legitimate solution

Companies that interpret regulations or similar social norms as unwelcome requirements, rather than a common responsibility, may create conditions where cheating is seen as a legitimate solution to business problems. But the negative results of discovery threaten the company's relationship with every stakeholder impacted by the issue, affecting the business in myriad ways that would be difficult to anticipate and avoid, as our **BRAVE Matrix™** analysis demonstrates (see Figures 1 and 2).

These concerns are particularly relevant in the VW case, because they reflect a more general concern about corporate honesty, which began to emerge in the early 2000s with the accounting scandals affecting Enron, WorldCom and others, and which gained momentum with the financial crisis. Over the last several years, companies caught up in crises that implicate corporate integrity—including BP, Massey Energy, GM, Tokyo Electric Power and others—have suffered widespread negative media attention, enduring harm to their reputations and long-term damage to shareholder value.

The full range of costs of the VW scandal could exceed the market value of the company

For VW, the results may be both tangible and intangible. EPA fines could reach $37,000 per car, although the figure may be much lower. If the total all-in global costs associated with this incident exceed $4,700 for each of the (at least) 11 million implicated cars, the costs would exceed the market value of the company (approximately $52 billion as of September 25). Potential costs may include not only regulatory fines, but also the costs of recalling each car, consumer lawsuits, criminal findings, and others. Additionally, the scandal will raise substantial questions about VW's future competitiveness in a rapidly changing industry.

VW's challenges reflect the enduring stresses on the US and European transportation industry. Conflicting social and environmental demands facing the automotive OEMs have grown steadily over the last decade and a half. These include:

- increasing pricing pressure conflicting with labor activism over wages and pensions;
- demands for greater comfort (often equated with larger vehicles) coupled with ever increasing demands for environmental responsibility; and
- tightening regulatory requirements for safety and emissions coupled with market demands for driving performance.

The current VW situation is only the latest, though perhaps the most troubling, in a continuing series of financial and engineering failures within the industry. In most cases, the companies' managers and engineers could not find the right balance among all of these expectations.

Transformative trends may tip the balance

Transformative trends do not necessarily play to the strengths of traditional auto companies

While the traditional transportation model remains under pressure, long-term technological and market trends that have transformative potential do not necessarily play to the strengths of traditional auto companies. These include ride-sharing, car-sharing, electric engines, and, phased in over a longer time horizon, autonomous vehicles. Both the internal combustion engine and the idea of individual car ownership seem vulnerable to disruption over the long term.

It is notable that the market leaders in the transformative trends are well-capitalized startups, including Tesla, Uber, and Zipcar (now a subsidiary of Avis), as well as a long list of lesser-known young firms. These opportunities have also attracted more established technology companies, including Google and possibly Apple. While leading automotive companies have begun to experiment with disruptive technologies and may maintain their leadership, barriers to entry appear to have fallen.

Where corporate governance comes in

The quality of a firm's corporate governance can help determine its ability to adapt to long-term market changes

In an operating environment at risk of disruption, the quality of a firm's corporate governance can help determine whether it will be well positioned to think strategically about long-term market changes. Boards of well-governed companies combine a diversity of skills and perspectives to ensure that business problems are well understood; to create proper incentives for management to focus on the right strategic challenges; and to allow management flexibility but insist upon accountability.

In the case of VW, the governance structure does not inspire confidence that these characteristics are in place. The company's equity is majority owned by the Piëch and Porsche families, with a German regional government and the Qatar Investment Authority's sovereign wealth fund holding large minority stakes. Public investors mostly own non-voting preferred shares. The board of directors is majority non-independent, and the company has seated several family members, including two nieces of the former Chairman, without providing substantial disclosure about their credentials.

VW's Board of Directors lacks independence and includes family members of majority owners with unclear qualifications

Like most German companies, VW includes labor representatives on the board. Unusually, the Board Chair is a labor representative, which could create a perceived conflict of interest regarding alignment with shareholders. The audit committee is not independent, and the company lacks a compensation committee. We note that the company had intended to elevate its CFO to be the Chair of the Board, although it is not clear whether the current crisis will affect this decision.

Proponents of combining family ownership and control of companies claim that such companies benefit from the long-term perspective of individuals who view themselves as stewards of the family heritage. However, such leadership may not be as well suited to manage through a crisis or a changing business environment. The EPA complaint states that "VW knew or should have known" about the defeat device. This means that at the very least, VW executives and board members failed to ask the right questions: initially about how engineers managed to balance performance, price, and environmental compliance; and eventually about discrepancies in test results. Shareholders may question whether board members have the independence and expertise to challenge management in this way.

An early test of the board's independence will be how it disposes of the pension and severance of the outgoing CEO, Martin Winterkorn. News reports indicate that he has earned $32 million in pension benefits and may be offered up to an additional $35 million in severance, at the board's discretion. The board can reduce this amount if they determine that he is responsible for the circumstances under which he is leaving. How they make this determination will provide a useful signal to shareholders about whether the board intends to become more active.

Prices of public companies mentioned in this report, as of 24 September close

Company	Symbol	Price (USD)	Company	Symbol	Price (USD)
Apple Inc	AAPL	115.00	Takata	TKTDY	21.86
Avis Budget Group	CAR	44.92	Tesla Motors Inc.	TSLA	263.12
BP plc	BP	30.38	Tokyo Electric Power	TKECY	6.50
General Motors Corp	GM	29.44	Toyota	TM	118.61
Google Inc.	GOOG	625.80	Volkswagen	VLKAY	$24.17
Honda Motor Corp	HMC	30.52			

Figure 1: BRAVE Matrix™ Questions about Volkswagen

Business Value Drivers	Demand Stakeholders	Supply Stakeholders	Contextual Stakeholders
Cost/cost reduction	What will it cost the company to make quality improvements or shift its product mix?	What is the cost of leadership transition, including, eventually, junior staff implicated in the scandal? How will the decline in share price impact the company's capital structure or ability to raise capital?	How much will recalls ultimately cost the company? How will EPA and other regulatory actions impact the bottom line?
Risk/risk reduction	What will the company pay related to potential customer and dealer lawsuits? Will this incident raise support for disruptive technologies (car sharing, electric cars, etc.)	How will management/board distraction affect the company? Are there more scandals waiting for detection?	What will be the impact of criminal charges against the company? How might this affect competitors? (e.g. strengthen market position or increase scrutiny on entire industry?)
Sales and pricing power	Will the company be able to sell diesel engines in the future? How will this impact access to the US market?	How will this impact motivation of employees?	What will be the impact of increased regulatory scrutiny in the future, especially with respect to the company's ability to bring products to market?

Source: Cornerstone Capital Group

Figure 2: BRAVE Matrix™ Questions about Volkswagen (continued)

Business Value Drivers	Demand Stakeholders	Supply Stakeholders	Contextual Stakeholders
Reputation/ brand equity	How will this affect the willingness of dealers to sell VW cars? How does this affect customer perception of VW engineering skill? How does this affect customer confidence in diesel technology?	How will disruptions in production of models impact company's relationship with suppliers?	How will this affect future media coverage? Will this encourage activists seeking additional failings?
Attractiveness as employer	Will future engineering talent have second thoughts about this company?	What pressures were placed on employees to become complicit in deception? How are they being addressed?	How will negative coverage affect recruiting?
Capacity for innovation	Will consumer have confidence in company claims about new technology? (e.g. new hybrid was unveiled as scandal was surfacing)	To what degree is the incident indicative of leadership culture? Is the company positioned for technological leadership?	How will this affect the company's ability to partner with other automotive or technology companies?

Source: Cornerstone Capital Group

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