



Corporate Governance

In the Video Games Industry

“Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals....the aim is to align as nearly as possible the interests of individuals, corporations, and society” Sir Adrian Cadbury (1999)

Mark Loughlin Bo0343538

4/8/2011

Table of Contents

Introduction.....	3
The development of Corporate Governance Today	3
The Video Games Industry	5
Case Company.....	5
Corporate Governance Models	6
Agency Theory	6
Stakeholder Theory	7
Shareholder Value Approach	8
Conclusion	9
References.....	11
Bibliography	12

Introduction

In this coursework I will be looking at Corporate Governance today and how it came to be today, within an industry I will also assess how corporate governance theories can be applied to a situation that has occurred and what can be learnt from this.

The development of Corporate Governance Today

Within UK corporate governance the key aspects are that a single board are collectively responsible for the success of the company. There are 4 points that are key to governing an organisation in a checks and balances exercise;

- The roles of Chief Executive and Chairman are separated
- There is a balance in Executive and independent non-Executive directors
- The organisation has strong, independent audit and remuneration committees
- There is an annual revaluation by the board of its performance

There is an emphasis on objectivity within directors and the interests of the organisation, there should also be a transparency on appointments awarded by the organisation and remunerations made by the organisation. Shareholders have effective rights from a legal standpoint within the governing of an organisation. This 'Code of best practice' is not a legal requirement but is rather a guidance on how to do things within the organisation, which is why it is given a 'Comply or Explain' requirement for listing meaning that if an organisation does not follow the UK Corporate Governance Code, they must explain as to why they see fit to do something else. "The Code is not a rigid set of rules. It consists of principles (main and supporting) and provisions. The Listing Rules require companies to apply the Main Principles and report to shareholders on how they have done so." (FRC June 2010)

The origin of the 'Code' stems from a number of reports commissioned looking into good corporate governance, one of these is the Cadbury Report chaired by Sir Adrian Cadbury. The committee for this report was founded after the UK Company Polly Peck went into insolvency after years of falsifying financial reports, this committee was initially limited to preventing financial fraud but when the cases of BCCI and Robert Maxwell occurred the remit of the committee was extended to Corporate Governance in general. The Cadbury report when finished covered financial, auditing and corporate governance matters, whilst also making the following basic recommendations;

- the CEO and Chairman of companies should be separated
- boards should have at least three non-executive directors, two of whom should have no financial or personal ties to executives
- each board should have an audit committee composed of non-executive directors

In 1994 the principles of the code were given the comply or explain status meaning that companies need not comply with the principles, but had to explain to the London Stock Exchange why not if they did not. This was also due to recommendations made by Adrian Cadbury stating that listed companies should make a statement in their reports about their compliance with the Code and give reason for any areas of non-compliance.

Another committee was set up as a study group into executive compensation which was chaired by then Chairman of Marks & Spencer Sir Richard Greenbury. This Greenbury report finalised in 1995 and recommended some further changes to the principles existing in the Cadbury Report;

- each board should have a remuneration committee composed without executive directors, but possibly the chairman
- directors should have long term performance related pay, which should be disclosed in the company accounts and contracts renewable each year

Under Granbury's recommendation that progress should be reviewed in 3 years, in 1998 Sir Ronald Hampel chaired a third committee that suggested that the Cadbury and Greenbury reports be consolidated into a 'Combined Code' to which would form the bases to what the UK Code on Corporate Governance is today.



Throughout the following years there have also been several other reports whose recommendations have made it into revisions of the Combined Code (2003, 2006, 2008 and 2010). These reports were The Turnbull Report, The Myners Report, The Higgs Report and The Smith Report, with several of these reports having been updated in later years. As well as updating the UK Corporate Governance code in 2010 they introduced the UK Stewardship Code 2010 which is a set of principles or guidelines released in 2010 by the Financial Reporting Council directed at investors who hold voting rights in UK companies. Its principal aim is to make shareholders, who manage other people's money, be active and engage in corporate governance in the interests of their beneficiaries.

Institutional investors should:

- Publicly disclose their policy on how they will discharge their stewardship responsibilities.
- Have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.
- Monitor their investee companies.
- Establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.

- Be willing to act collectively with other investors where appropriate.
- Have a clear policy on voting and disclosure of voting activity.
- Report periodically on their stewardship and voting activities.

(FRC, July 2010)

The Video Games Industry

The Video Games Industry is an industry that today finds itself bringing in more revenue than Hollywood or music, in some years the industry revenues beat that of DVD's and CD's combined. It's a fast moving industry that finds itself competing against all forms of entertainment or as Nintendo's President Satoru Iwata would say any form of entertainment that takes time from consumers is a competitor. The structure of the way games are brought to consumers is through authorised publishers publishing games created by developers, but these publishers are also developers themselves, often finding themselves merging with other organisations (Activision merging with Vivendi Games to create Activision Blizzard) or purchasing up control rights within small or medium sized developers to bring them under the brand of the publisher (ZeniMax Media Inc acquired Machinegames Sweden in November 2010 and Tango Gameworks in October 2010). But also in cases with larger publishers acquisitions can be a short lived thing for example EA Games bought Australian studio Pandemic Studios in October 2007, a successful studio founded in 1998, in November 2009 EA Games closed the studio. In October 2006 EA Games acquired DICE fully and closed their Canadian offices hours after the acquisition leaving DICE Sweden the only studio still operating today.

The idea behind using this industry is with such mergers, acquisitions, partnerships and agreements corporate governance needs to be at the core of the organisation to avoid any scandal. If someone stood to profit from a certain activity what measures is there in place to avoid manipulation. With instances that go on it should be important to understand the corporate governance controls or issues that are involved. Although there have not been huge corporate governance scandals to happen within this industry the theories can still be applied to how situations are managed and how the organisations conduct their business.

Case Company

The case Company that I have chosen is Activision Blizzard, they are one of the largest publishers within the video games industry and with Activision's recent merger with Vivendi Games (holding company of Blizzard Entertainment and Sierra Entertainment) to form Activision Blizzard Inc they now own some of the largest properties within the industry including Guitar Hero, Tony Hawk, Call of Duty, Diablo, Starcraft and World of Warcraft, as well as holding agreements to produce games based upon Hasbro's Transformers and Marvels Spiderman and other movie to game rights including James Bond 007. Headquartered in Santa Monica, California, Activision Blizzard, Inc. is a worldwide pure-play online and console game publisher with leading market positions across all categories of the rapidly growing interactive entertainment software industry. "Activision Blizzard maintains operations in the U.S., Canada, the United Kingdom, France, Germany, Ireland, Italy, Sweden, Spain, Norway, Denmark, the Netherlands, Romania, Australia, Chile, India, Japan, China, the region of Taiwan and South Korea." (Activision Blizzards Investor website)

Within the last 1 and a half years Activision are at the forefront of a very public legal case against two of its former studio heads. Jason West and Vince Zampella were the two studio heads at

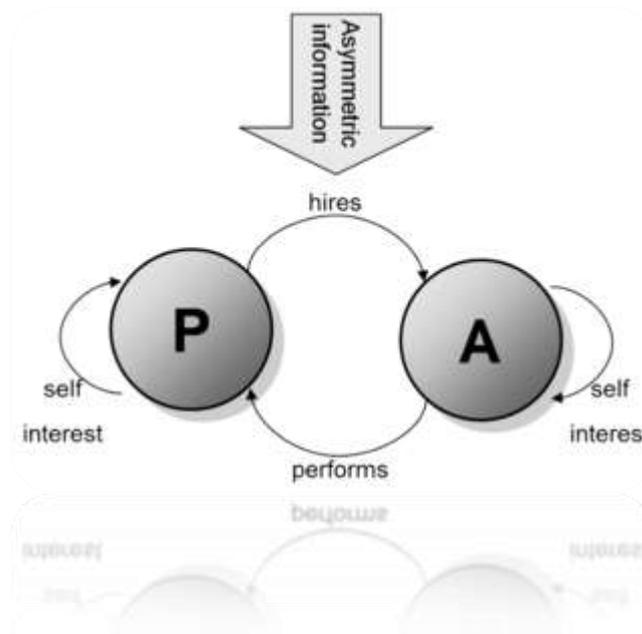
Infinity Ward a subsidiary of Activision, this studio created the Call of Duty franchise for Activision and throughout the years they took shared responsibility to producing the annual sequels with other subsidiary Treyarch who recently produced Call of Duty: Black Ops. Shortly after Infinity Ward had wrapped up development of Modern Warfare 2 and had it published in shops West and Zampella were fired by Activision, this was brought into light by amendments to its annual report with the Securities and Exchange Commission to include a notice that two top members of the studio were being fired. The filing read, "The Company [Activision] is concluding an internal human resources inquiry into breaches of contract and insubordination by two senior employees at Infinity Ward. This matter is expected to involve the departure of key personnel and litigation. At present, the Company does not expect this matter to have a material impact on the Company." In among the court cases law suits and counter suits, there was an original complaint that while West and Zampella had 2 years remaining on their current contracts with Activision, and that EA Games, through talent agency Creative Artists, dispatched a private jet to carry them to a secret meeting at the home of CEO of EA Games John Riccitiello during August 2009, according to Activision's complaint. West and Zampella are also counter suing Activision to the tune of \$36 million which they claim was part of unpaid bonuses being withheld by the firm. They went on to sign with EA Games after termination at Activision and formed Respawn Entertainment, subsequently hiring 40 employees away from Activision.

Recently the case has picked up again over a 'Memorandum of Understanding' that West and Zampella are claiming that Activision fraudulently got them to sign to protect its interest in consummating its merger with Vivendi Games. The recent filing in this legal case also alleges that Activision "began secret development of Modern Warfare and Call of Duty games and related products" behind the backs of its creators, a violation of West and Zampella's contract with the publisher dubbed the "Memorandum of Understanding". Now, West and Zampella say they were lied to by Activision, that they were fraudulently induced into signing that contract. The former Infinity Ward heads say Activision CEO Bobby Kotick assured them it was "impossible for you guys to get fired," allegedly saying "You're in the big leagues now". (Kotaku.com Legal Coverage)

Corporate Governance Models

Agency Theory

Agency Theory is a hypothesis concerning the relationship between a principal and an agent of the principal. An agency relationship arises whenever one or more individuals, called principals, hire



one or more other individuals, called agents, to perform a prescribed service and then delegate decision making authority to the agents. The primary agency relationships in business are those between shareholders and managers and between debtors and shareholders. These relationships are not necessarily easy going. Agency theory is in relation with so-called agency disagreements, or conflicts of interest between agents and principals.

In the case company the Agency Theory can be applied when identifying Activision Blizzard as the Principles and West and Zampella as the Agents. As identified throughout the case documents against West and Zampella they wanted creative control of the Call of Duty brand, with all decisions regarding the franchise to be directly influenced by them. This is a significant reason as to why they entered into the memorandum of understanding with Activision. Though it is unclear as to who caused the disagreement between the principles and the agents, was it the acclaimed fraud by West and Zampella, or was it the incited breach of fiduciary duty by West and Zampella in secret meetings with a competitor or the unwillingness to work with other studios also working on the Call of Duty brand, and intentionally sabotaging marketing campaigns by them. One of the claims in the countersuit by Activision is that West and Zampella released marketing videos for the next game in the series, Call of Duty: Modern Warfare 2, the same day as a partner studio released marketing videos for downloadable content for the current game in the series, Call of Duty: World at War, with the intent to "Crush and destroy with our video" (Text message sent by West to fellow Infinity Ward employee on the situation, text messages submitted in court filings)

Stakeholder Theory

Stakeholder theory has been articulated in a various ways, but in each of these stakeholders represents a broader population for corporate responsibility than shareholders. One very broad definition of a stakeholder is any group or individual which can affect or is affected by an organisation, including suppliers, customers, stockholders, employees, the media, political action groups, communities, and governments. Stakeholder theory suggests that the purpose of a business is to create as much value as possible for stakeholders. In order to succeed and be sustainable over time, executives must keep the interests of customers, suppliers, employees, communities and shareholders aligned and going in the same direction.

Within Activision Blizzard, the termination of the contracts based upon the evidence submitted showing their meetings at competitors, email evidence of the Infinity Ward duo talking about photocopying Activision documents and smuggling them out of their offices and what Activision describes in their court documents "executives almost obsessed by jealousy of other developers and the thought that another Activision game or studio might share their spotlight". Applying stakeholder theory Bobby Kotick and other Activision execs acted in the best interest of them all as a whole, for remaining staff at other studios being affected by these underhanded tactics it gave a greater comfort in their job security. It is still unclear on all the activities that have went on as the court case has yet to be determined by a judge, from what I have read it would be safe to assume that if Activision's claims are indeed factual West and Zampella were acting wholly on a self interest basis trying to cease control of a brand which they had created but Activision held the rights to. This was not an approach to business that held all stakeholder interests at best, within the memorandum of understanding they claim that they were to control all interest of the Call of Duty brand as well as establishing a new brand of game that was to also be controlled by West and Zampella at Infinity Ward.

At Nintendo they have been going about their business in an industry expansion strategy, they call it the 'Blue Ocean Strategy' this could be in reference to a book in the same name by W.Chan Kim and Renée Mauborgne. This strategy is aiming at bringing the industry to a much wider audience, and they started to execute this strategy with the hardware called 'Wii' and 'Nintendo DS'. This audience expansion could be viewed as a stakeholder theory approach to business, by strengthening the organisations position within the industry they create stronger job security, they help support the infrastructure of the local areas in which they operate and they create additional income for local governments to their facilities. These being 3 of many stakeholders they would have associated with their business.

Shareholder Value Approach

Shareholder Value Approach on the other hand when compared to Stakeholder Theory is where the organisation wholly concentrates on enhancing shareholder wealth. According to this view, a firm's only purpose is to serve the needs and interests of the company's owners, being those who hold shares in the organisation. According to shareholder theorists such as the Nobel winning economist Milton Friedman, managers should only focus on serving the interests of the firm's shareholders. "Responsibility is to conduct the business in accordance with their [shareholder's] desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom." (Friedman, 1970) Shareholder Value is all about enriching those who invest in your organisation, while someone is invested in your business you should do your duty in making sure that the value of their investment only rises throughout the period so when they do sell their share they have done so for a greater price than when they bought them.

As previously stated it was clear that West and Zampella had an issue with working with other studios within the Activision Publishing umbrella, namely co-developer of the Call of Duty brand Treyarch Studios. If Activision did not reign in the behaviour of the Infinity Ward execs, this could have harmed the shareholder wealth with disillusion within the market about the quality of the series and what to purchase. West and Zampella even "refused to sign standard exit documents representing that they had returned all Activision property, including computer code, and would honour the confidentiality obligations that they have to Activision" as stated within court documents, this even shows the fact that these execs did not have the best interests of the shareholders and could still potentially harm Activision's value with their knowledge of the organisation and key information.

Using Nintendo as an example again and their 'Blue Ocean Strategy' it can also be viewed as enhancing their shareholder wealth. Before they took this approach their previous generation of business was based upon the successful Gameboy series but also a lacklustre Gamecube home console strategy. Without a strong console business Nintendo lagged in sales and revenue, but upon the releases of the DS series and the Wii, their revenues rose to a degree they were able to increase investment into research and design, at its highest point it was 3 times as much or more as their lowest research investment in years prior (Nintendo Financial Statements). By having such a good financial position within the industry their share prices rose dramatically and have maintained a level above that during the "Gamecube" era, thus improving shareholder value.

References

- Crowe Horwath – *The Changing Landscape of Risk Management* 2008 [PDF document] accessible at: http://folio.crowehorwath.com/files/PDF/RISK8018_CFOResearch.pdf accessed 3-4-11
- Financial Reporting Council – *The UK Corporate Governance Code* June 2010 [PDF Report] accessible at: http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf accessed 31-3-11
- Financial Reporting Council – *The UK Stewardship Code* July 2010 [PDF Report] accessible at: <http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf> accessed 31-3-11
- Kotaku – *Call of Duty: Legal Warfare* Brian Crecente, Brian Ashcraft, Luke Plunkett et al [web news articles] accessible at: <http://kotaku.com/#!callofdutylegalwarfare> accessed 1-4-11
- New York Times - *The Social Responsibility of Business is to Increase its Profits* Milton Friedman 1970 [newspaper article]
- Nintendo [Financial Statements] accessible at: www.nintendo.co.jp
- Superior Court of the State of California *Activision Publishing Inc Vs. Jason West et al* [court documents]

Bibliography

- Activision Blizzard Inc [website] accessible at: <http://www.activision.com> accessed 2-4-11
- EDGE - *Zampella, West Accuse Activision Of Fraud* Nathan Brown [web news article] accessible at <http://www.next-gen.biz/news/zampella-west-accuse-activision-of-fraud> accessed 1-4-11
- Electronic Arts Inc [website] accessible at: www.ea.com accessed 1-4-11
- Financial Reporting Council [website] accessible at: <http://www.frc.org.uk> accessed 1-4-11
- Game Informer - *Infinity Ward Vs Activision* Phil Kollar [web news article] accessible at: <http://www.gameinformer.com/b/news/archive/2010/03/01/news-what-s-going-down-at-infinity-ward.aspx> accessed 29-3-11
- Games Thirst - *Activision vs Former Infinity Ward Devs West And Zampella Case Takes New Direction* Dean Kent [web news article] accessible at: <http://www.gamesthirst.com/2011/04/04/activision-vs-former-infinity-ward-devs-west-and-zampella-case-takes-new-direction/> accessed 30-3-11
- Gamespot UK - *Top Infinity Ward devs fired for 'insubordination,' lawsuits 'expected'* Tor Thorsen [web news article] accessible at: <http://uk.gamespot.com/news/6252657.html> accessed 29-3-11
- Gamespy - *Activision Pulls Electronic Arts into Lawsuit Against Former Infinity Ward Bosses* Mike Sharkey [web news article] accessible at: <http://uk.gamespy.com/articles/114/1141486p1.html> accessed 2-4-11
- Gamespy - *Objection! #1: Activision v. West & Zampella* Eric Neigher [web news article] accessible at: <http://uk.gamespy.com/articles/108/1083587p1.html> accessed 30-3-11
- Journal of Business Law November 1992 – *Board Performance and Cadbury on corporate governance* Vanessa Finch [accessed online] accessible at: <https://login.westlaw.co.uk/maf/wluk/app/document?src=toce&docguid=IC3C3FF70E72111DA9D198AF4F85CA028&crumb-action=append&context=5> accessed 1-4-11 [Pages 581 – 595]
- Joystiq - *Activision claims EA and former IW execs schemed to 'inflict serious harm on the company'* Christopher Grant [web news article] accessible at: <http://www.joystiq.com/2010/12/21/activision-claims-ea-and-former-iw-execs-schemed-to-inflict-ser/#continued> accessed 30-3-11
- Metro - *Activision says Infinity Ward leads 'obsessed by jealousy'* [web news article] accessible at: <http://www.metro.co.uk/tech/games/851224-activision-says-infinity-ward-leads-obsessed-by-jealousy> accessed 31-3-11
- Nintendo – *Corporate Social Responsibility Report 2010* [web based report] accessible at: <http://www.nintendo.co.jp/csr/en/index.html> accessed 4-4-11
- Pinsent Masons out-law.com [website] accessible at: <http://www.out-law.com> accessed 1-4-11
- University of Connecticut Department of Economics RePEc IDEAS [website] accessible at: <http://ideas.repec.org/> accessed 2-4-11
- VG24/7 - *Activision seeking \$400 million in damages from West, Zampella, and EA as Black Ops exceeds \$1 billion in sales* Stephany Nunneley [web news article] accessible at: <http://www.vg247.com/2010/12/22/activision-seeking-400-million-in-damages-from-west-zampella-and-ea-as-black-ops-exceeds-1-billion-in-sales/> accessed 30-3-11

- VG24/7 - *West and Zampella add charges of fraud to suit against Activision* Stephany Nunneley [web news article] accessible at: <http://www.vg247.com/2011/04/02/west-and-zampella-add-charges-of-fraud-to-suit-against-activision/> accessed 30-3-11