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Volkswagen: System failure

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VW's culture has been blamed for fostering dysfunction but the company's politics may hinder change

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Industrial espionage. Prostitution and bribery. Cheating on environmental standards.

On the face of it, the three big scandals that roiled Volkswagen in 1993, 2005 and 2015 seem to have little in common. But current and former executives, board members and investors say the successive crises are united by one thing: the so-called VW system.

A historic and unique construct of Germany's postwar *Wirtschaftswunder* (economic miracle), the system is built on deep connections between management, workers and local politicians — a situation made even more complex by layers of family ownership. For unions and politicians, the system is crucial to protecting jobs at the country's industrial crown jewel. For investors and governance experts, however, it is responsible for fostering a dysfunctional corporate culture at VW — and denting its profitability.

"People are starting to question the whole VW system again . . . VW is among the most complicated and questionably governed companies," says Hans Hirt, a director at Hermes Equity Ownership Services, the UK activist investor. "In other cases, you have strong families. But here you also have state ownership and powerful employees. It is a very special mix."

VW's latest scandal intensified this week as the carmaker faces new allegations of cheating on emissions tests. US regulators are investigating whether it fitted a "defeat device" in 10,000 cars — including a Porsche model — and VW disclosed on Tuesday that it had understated the carbon dioxide levels on about 800,000 vehicles, including for the first time those with petrol engines. These findings come after the initial revelations that 11m diesel cars worldwide used defeat devices.

The latest allegations have intensified questions about whether cheating at VW was systematic. Many investors and current and former employees have concluded that the company needs a radical overhaul.

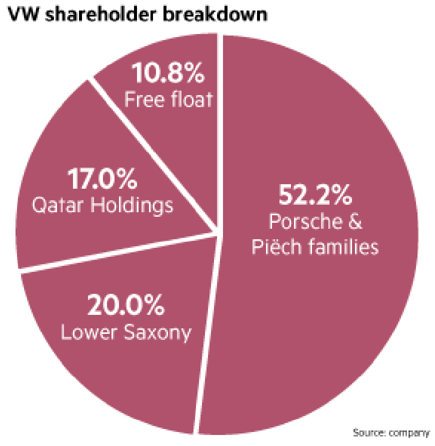
"The VW system needs a complete shake-up," says a former VW supervisory board member. "But do I think that will happen? No, I don't — and that's why I'm worried for the future."

Yngve Slyngstad, chief executive of Norway's $870bn oil fund, is pushing for a revamp. "We of course hope that this event can lead to some rethinking in the company about what would be a good governance model," he says.

VW has always been an odd beast. Founded by Hitler in 1936, it was rescued by the British army after the second world war and then privatised in 1960. But the local state government of Lower Saxony (and for a time the federal government) were given special ownership rights that gave it a blocking minority and supervisory board seats.

These days, VW is no longer just a state-controlled company. Following the 2005 scandal, the Porsche and Piëch families — and later Qatar — joined Lower Saxony as VW's dominant shareholders. At the same time, the carmaker's German employees are so influential that some critics say it resembles a co-operative.

Unlike US and UK companies, VW does not have a single board of directors. Instead, it has a supervisory board that is meant to hold management to account. But investors and governance experts say the emissions scandal shows that it lacks the independence and authority to do this.



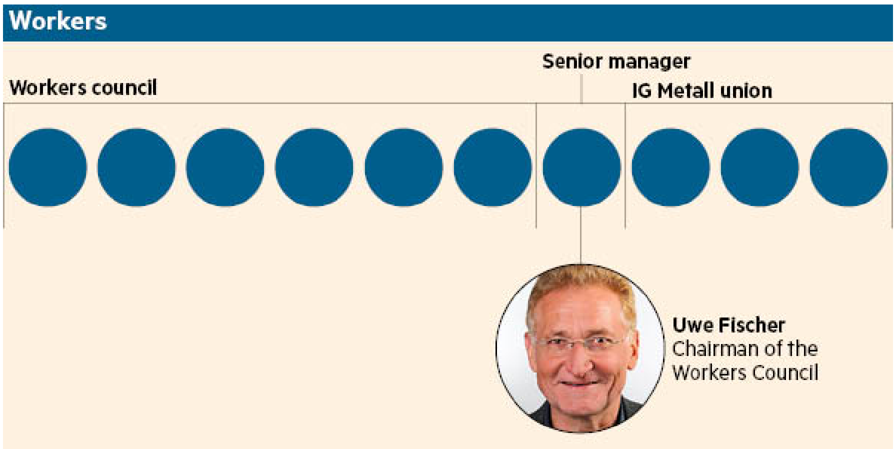
Under the German principle of co-determination, half of the board seats are reserved for workers. In VW's case, the head of the IG Metall union has long held a board seat and even served as interim chairman when the diesel scandal first broke in September. All of the employees' 10 seats are occupied by German workers.

On the shareholders' side of the board, the problem is one of independence. Four of the 10 are members of the Porsche and Piëch families; two each come from Lower Saxony and Qatar. The new chairman, Hans Dieter Pötsch, was until last month VW's finance director and is close to the two families.

That leaves only Annika Falkengren, chief executive of Swedish bank SEB, as an outsider — and one corporate governance expert disqualifies her since SEB is an adviser to Scania, the truckmaker that is one of VW's 12 brands.

In most German companies, the chairman would discuss sensitive matters with the shareholder side first, agreeing a common position before bringing it before the full board. At VW, particularly under former chairman Ferdinand Piëch, who was in charge from 2002 until this year, things worked in reverse. "Piëch would first talk to the works council and agree a position. Then he would bring it to the shareholder side," says a former director.

Sometimes, not even that happened. In 2005, Mr Piëch sided with the works council to ensure an IG Metall member was made head of personnel at VW against the wishes of his own chief executive and most shareholder directors.



This created an atmosphere where sensitive matters were resolved far from the boardroom and without management oversight. "The board was really just for show," says a former senior VW executive. "They lacked the ability to ask any deep technical questions — and you see that in the current scandal."

Under Mr Piëch, who was also chief executive from 1993-2002 and at the heart of the so-called Lopez scandal involving corporate spying in 1993, the principle of co-determination became something akin to co-management, with workers actively helping shape decisions. Together with the presence of Lower Saxony on the board, it meant job losses — particularly at VW's notoriously inefficient main factory next to its headquarters in Wolfsburg — were all but taboo. Critics saw a quid pro quo: Mr Piëch agreed to preserve jobs if the employee bloc worked with him on other initiatives.

One example of the close relationship between the former chairman and workers was when Gunnar Kilian, a spokesman for the works council, left to work in Mr Piëch's personal office, only to return to the works council a few years later as general secretary.

"It is hard to exaggerate what kind of atmosphere this created," says a former supervisory board member. "It was very difficult to do anything that hurt workers or Lower Saxony. But beyond that it just killed the board as a place of proper discussion."

Questions about competence

Current and former supervisory board members say they knew nothing of the emissions cheating and never discussed the rigged engine. “Matters of technical expertise were not for us,” says the former member. A current director expresses intense irritation at VW management’s failure to tell the board of the problem for two weeks in September, but says the supervisory board should not be blamed. “This scandal had nothing, not one iota, to do with the supervisory board,” the director says.

Others disagree. Christian Strenger, a German corporate governance expert, says: “The control system of the supervisory board appears to have been deficient.” He calls for half of VW’s 10 shareholder-appointed directors to be true outsiders. “ W hat is vital now is a substantial redress of the supervisory board. Required are seasoned personalities as convincing counterweights to the families, Lower Saxony and Qatar.”

Mr Hirt, the activist investor, is supportive of bringing fresh blood into the boardroom. “The supervisory board appoints the management. It is a little bit odd to say that it doesn’t have anything to do with the supervisory board.”

Many are wary of the new role of Mr Pötsch as chairman, despite his good reputation as finance director, as he was part of the management board throughout the entire period of the scandal. “I think Pötsch will be destroyed,” says one investor, adding that an outsider is needed to reform the board fully.

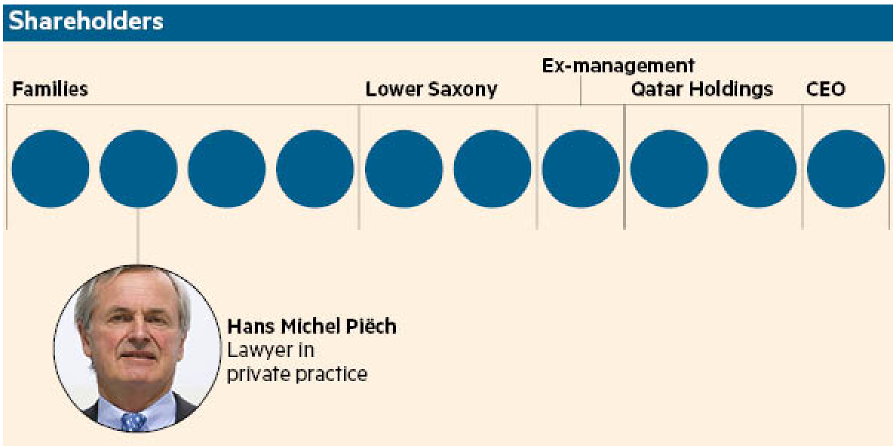
‘Pursuit of perfection’

Several attempts in the past decade to fundamentally change the way VW is run have foundered.

Following a scandal in 2005 when executives hired prostitutes and bought Viagra for members of the works council, the management tried to dismantle the system. They ended a 29-hour, four-day working week and Wolfgang Bernhard, a cost-cutter who was head of the VW brand, looked at closing some of the least profitable operations. But the system endured, as Mr Piëch installed the new head of personnel and then ousted the chief executive, leaving Mr Bernhard to resign.

A few years later, Wendelin Wiedeking, then chief executive of Porsche, which had become VW’s biggest shareholder, declared there should be “no sacred cows” at VW. Workers took this as code that jobs would be threatened, but when Porsche ran into financial problems in 2009 Mr Piëch pounced and VW bought the sports car maker.

Some are hopeful that the emissions scandal might force VW to change. For the first time in two decades, Mr Piëch has no formal leadership role at VW. And there is fresh blood both in the chairman’s role and in Matthias Müller, the former Porsche executive who was appointed chief executive after the emissions scandal claimed his predecessor, Martin Winterkorn.



Under Mr Winterkorn, VW became known — in the words of one former director — as a “dictatorship”. “There was no dissent allowed. Everyone was paranoid, and everyone was afraid of being told off from above,” the former board member says.

Mr Müller has pledged to change VW’s culture, but he is already facing questions over his own role in the scandal. US regulators say a Porsche model was potentially caught up in the affair, which could threaten his credibility as the person to clean up the company.

He says he wants to keep the best parts of the VW way of doing things including “the pursuit of perfection”. And he has helped install a long-planned new structure of the VW group under which its 12 brands are to be given more responsibility. “The key point is that group management will be decentralised to a greater extent in the future,” he said last month.

That is most crucial at its main VW brand, whose problems in the US lay behind the emissions scandal. The VW brand also has a new head, Herbert Diess, a former BMW executive, who inherits a slew of problems from weak profitability to poor sales in the US.

A senior VW executive says Mr Diess was shocked the first time he walked around the Wolfsburg factory. “He was just so upset, shaking his head. It looks so inefficient.”

VW makes about the same number of cars as Toyota — 10m in 2014 to 9m by the Japanese — but has almost double the number of workers — 593,000 to 344,000. Analysts pin the blame predominantly on VW's German factories and suggest change is difficult because both unions and Lower Saxony are resistant to job cuts. "Our role is to protect jobs," says a person close to Lower Saxony's ruling Social Democrats.

VW executives are also clear about what is possible and what is not. Mr Müller's pronouncements have been similar to those from Bernd Osterloh and Stephan Weil, respectively the head of the works council and minister-president of Lower Saxony. The trio recently toured the Wolfsburg factory in a display designed to reassure workers.

"We need a new culture, that much is true," says a senior manager. "But to change the VW system, to make the workers or Lower Saxony upset, I don't think we have the time or the energy for that. That is just the constraints you have to accept when running VW."

Troubles on the factory floor: scandals

The Lopez Affair (1993): Ferdinand Piëch, then the new chief executive at Volkswagen, unleashed one of the biggest fights in the car industry when he poached José Ignacio Lopez from General Motors in 1993. A torrent of insults, law suits and criminal investigations followed amid claims of espionage, stolen documents, and patent infringement. Mr Lopez had a reputation for squeezing money out of suppliers by scrapping long-term contracts and pushing down costs relentlessly. Mr Piëch wanted him to help lift VW out of its early 1990s torpor. The acrimony only ended when Mr Lopez was forced to leave the German carmaker.

Prostitute and bribery scandal (2005):
VW's cosy relationship with its works council lay at the heart of twin scandals that broke in 2005. Klaus Volkert, then head of the works council, was found guilty of breach of trust for illegally receiving a bonus of almost €2m from Peter Hartz, a VW management board member. A second aspect involved trips abroad for members of the works council involving prostitutes, shopping excursions for wives, and even Viagra paid for by VW. Mr Piëch, by then VW chairman, told a court the scandals were "irregularities" of which he had known nothing.

Emissions scandal (2015): The most serious scandal of the three broke in mid-September when US environmental regulators revealed VW had admitted cheating on emissions tests for diesel engines. In total, 11m cars worldwide were involved. Analysts estimate that law suits, fines, and recalls could cost VW up to $30bn. The carmaker has also revealed problems with the stated carbon dioxide levels of about 800,000 cars in Europe.

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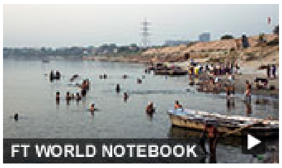

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