

Reputation for innovation lost

RIM and Kodak were once masters of all they surveyed; but not any more. As their fortunes have declined, so their reputations have plummeted. Disgruntled shareholders are now looking for people to blame

By Nir Kossovsky

“A reputation once broken may possibly be repaired,” observed Bishop Joseph Hall, “but the world will always keep their eyes on the spot where the crack was.” As the world focuses on the cracked reputation for innovation that is plaguing both Research In Motion (RIM) (NASDAQ:RIMM) and Eastman Kodak (NYSE:EK), the bigger question revolves around what really underpins that reputational value: patents or the culture for value creation that is evidenced by patents? As judged through the filter of Delaware’s 2006 *Stone v Ritter* case, the distinction is anything but philosophical.

Research In Motion

Buried among the headlines heralding the end of Europe as we know it during the first week of November 2011 was this eye catcher from Bloomberg: “RIM as ‘Wounded Puppy’ Trails Book Value With Faith Fading”. The chief investment officer of a New York fund explained: “They’ve been losing business, there’ve been operating technology problems. There isn’t a lot of customer loyalty anymore.” That day, the company’s market value dipped below book value for the first time in nine years.

It’s not as if RIM isn’t trying. The 2010 fiscal year was the second year in a row that

the Waterloo-based BlackBerry-maker headed the list of the top 100 corporations in Canada for research and development spending. RIM actually boosted its spending on research and development by 26% to US\$1.3 billion in 2010. That represented about 6.8% of its revenue.

But while the innovation process is well financed, it (the process itself) may not be well. Bloomberg quotes John Goldsmith, a money manager with Montrusco in Toronto, who says that the pricing collapse shows that RIM has lost its competitive advantage. “RIM was a market leader in terms of smartphones,” he said. “There are a lot of guys out there able to commercialize a product at a significantly lower cost.”

What about the patents? In addition to its organically grown patent portfolio, RIM has been actively acquiring them too. When the auction of the patent portfolio of Canada’s previous technology giant, Nortel, ended on 30th June 2011, the winning bid was an eye-popping US\$4.5 billion. Among the consortium of winning bidders, also comprising Apple, EMC, Ericsson, Microsoft and Sony, was RIM.

It’s not hyperbole to say that RIM started the handheld computing revolution. Set up in 1984 by Mike Lazaridis and his co-chief executive, James Balsillie, RIM produced its first BlackBerry in 1998. With a six-line display that let users send and receive basic email, the device changed business communications forever. By 2002, the BlackBerry had added voice and data capabilities and RIM stood virtually alone in the nascent smartphone industry.

A 2002 press release said it best: “RIM pioneered the market for enterprise wireless email in 1999 and has propelled adoption and innovation since that time. With over 14,000 organisations already using BlackBerry, RIM is now delivering the next

generation of wireless enterprise solutions with converged voice and data services. RIM has maintained its industry leadership with the only complete 2.5G wireless enterprise solution ready to address the needs of both users and IT departments.”

And therein lies the rub. RIM’s customer is the corporate IT department. There are rebels in the workforce who do not acknowledge the primacy of the corporate IT department.

By 2008, no less a figure than Barack Obama was musing about his BlackBerry addiction and whether he could break it upon entering the presidential security bubble. But the man who became US commander-in-chief was also a rebel-in-chief for knowledge workers. The US government did not issue the president a mobile device, so he got one for himself. Today, most workers do not want company-issued BlackBerrys – they want iPhones and the like.

Like many other companies, and governments, RIM missed the power shift from the corporate IT department to the individual worker. Amitabh Passi, who covers the smartphone sector for UBS, suggests that RIM has stumbled. “They need to introduce exciting products. They’re not there. They need to hit the time-to-market windows. They’re not there,” he says. “They need to rejuvenate and reenergize the brand. They’re not there. I think it’s partially a management issue. Partially it’s a culture issue. Partially it’s really getting a better sense of consumer psychology and what drives consumer decisions.”

In the setting of a cultural issue, can a well-funded innovation process that creates and buys many patents be “not there”? Yes, if you are willing to define innovation along the lines of the January 2008 *Report to the Secretary of Commerce by the Advisory Committee on Measuring Innovation in the 21st Century Economy*. The report defines innovation as “the design, invention, development and/or implementation of new or altered products, services, processes, systems, organisational structures or business models for the purpose of creating new value for customers, and financial returns for the firm”. Even here, patents are but an artifact of innovation; and their value is suspect if they do not create “new value for customers, and financial returns for the firm”.

The consequences of its broken innovation process – dare we say, reputation for innovation – are material. The *Financial Times* quoted Pierre Ferragu of

Table 1. Reputation is an epiphenomenon. There are six key business processes (intellectual properties) that seek to achieve specific reputationally relevant goals and underpin reputation value

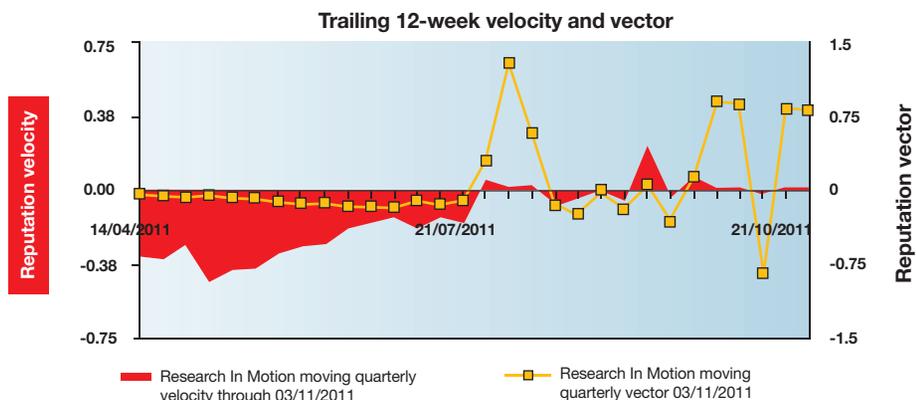
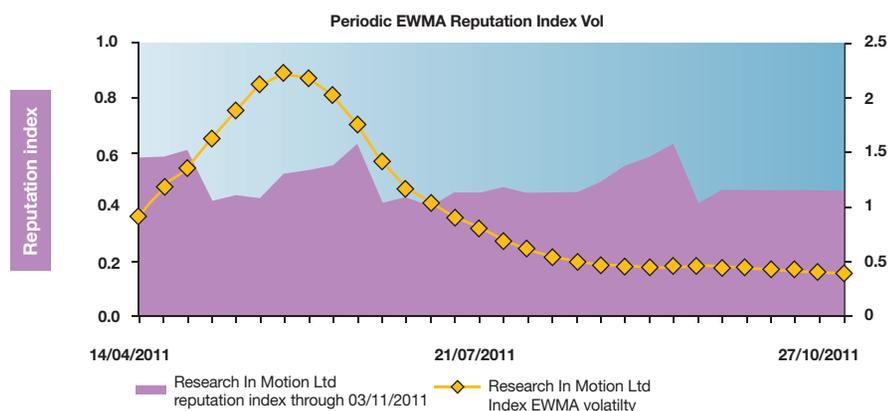
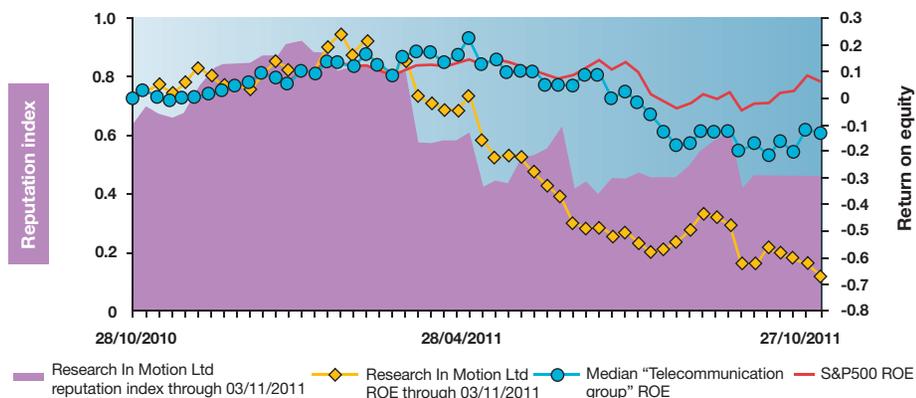
Process goal	Definitions
Create an ethical work environment	Ethics are the moral principles by which a company operates; integrity is the act of adhering to those moral principles. Ethics are an integral part of governance that combine with integrity to affect the reputation value of all other intangible assets. Additionally, ethics are the keystone intangible asset because they form the basis for trust and confidence.
Drive innovation	Innovation is the design, invention, development and/or implementation of new or altered products, services, processes, systems, organisational structures or business models for the purpose of creating new value for customers and financial returns for the firm.
Assure quality	Quality is: <ul style="list-style-type: none"> • The extent to which a product is free from defects or deficiencies. • The extent to which a service meets or exceeds the expectations of customers or clients. • The extent to which products and services conform to measurable and verifiable criteria.
Uphold safety	Safety is the state of being certain that a set of conditions will not accidentally cause adverse effects on the wellbeing of people or the environment.
Promote sustainability (aka corporate social responsibility)	Sustainability means making, using, offering for sale or selling products and services that meet the needs of the present without compromising the ability of future generations to meet their own needs.
Provide security (physical/and cyber threats)	Security is the degree of protection that a company offers against events undertaken by actors intentionally, criminally or maliciously, for purposes that adversely affect the firm. Because fear is the great disruptor of life and commerce, it is useful to think of security, the most ethereal of the intangible assets, as “absence of fear”.

Data source: *Mission: Intangible. Managing risk and reputation to create enterprise value* (IAFS, 2010)

Sanford Bernstein: “RIM is facing three major challenges. On its historic customer base, BlackBerry is a broken brand; RIM’s business with corporate clients is ex-growth and under attack; and RIM’s premium profitability is at risk.” In other words, BlackBerrys are not generally seen as being cool.

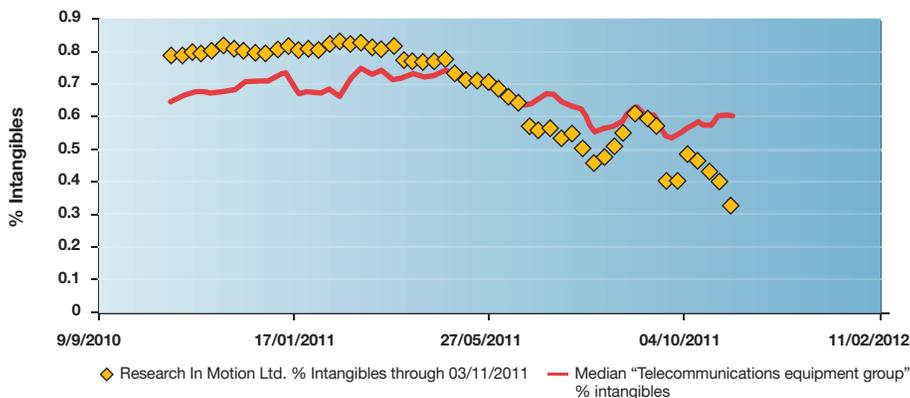
The numbers back Ferragu. The Steel City Re Corporate Reputation Index, the metrics that underpin the RepuStars Variety Corporate Reputation Index calculated by Dow Jones Indexes (DJI:REPUVAR), shows a loss of reputational value. Over the trailing 12 months, RIM’s reputation ranking dropped from the 63rd percentile to the

Figure 1. Quantitative reputational metrics profile of RIM. Top: superimposed plots of RIM's deteriorating reputational profile, its corresponding drop in return on equity and the benchmarks – the median return on equity among the median of the 70 peers in the telecommunications equipment sector, and those of the S&P500 Composite Equity Index. Over the trailing 12 months, RIM's reputational ranking dropped 17 percentile points and its equity underperformed the median of its benchmark by 53%. Middle: the exponentially weighted moving average of RIM's reputation, a volatility index, shows that the most recent metric is still very high at 40%. Bottom: two derivative metrics of velocity and vector are negative to flat in the case of the former and hyper-volatile in the case of the latter. Collectively, these are indicators that RIM's reputation – in its sector, most importantly for innovation – is evoking significant stakeholder uncertainty and fear



Data source: Steel City Re

Figure 2. A measure of the fraction of RIM's market capitalisation accounted for by its intangible assets. As of the close of markets on 3rd November, only 30% of RIM's value was intangible compared to the median of its peer group at 60%. For a firm whose reputational value in innovation once commanded extreme valuations, this is a clear sign of reputational value loss from multiple overlapping chronic factors: cultural, managerial and operational



Data source: Steel City Re

46th percentile, as measured relative to the 70 companies in the telecommunications equipment sector, and its most recent reputational metric volatility measure was 40% (Figure 1). Over the same time period, the company has financially underperformed the median of its sector by 53%. Last, while the market capitalisation was still greater than book value at the close of the markets on 3rd November, according to the Steel City Re criteria, the intangible asset fraction was drifting downwards toward 30%, while the median of the peer group was 60% (Figure 2).

RIM's reputation – in its sector, most importantly for innovation – is evoking significant stakeholder uncertainty and fear. For a firm whose reputational value in innovation once commanded extreme valuations, this is a clear sign of reputational value loss from multiple overlapping chronic factors: cultural, managerial and operational.

Eastman Kodak

About 200 miles east of RIM's headquarters is the home office of Eastman Kodak in Rochester, New York. The company, whose reputation for innovation is long gone, finds its patent portfolio in a three-way play between and among equity investors, creditors and third parties – with Eastman Kodak management on the passive end of this battle.

In 1973 Eastman Kodak held a seemingly impregnable position in the lucrative

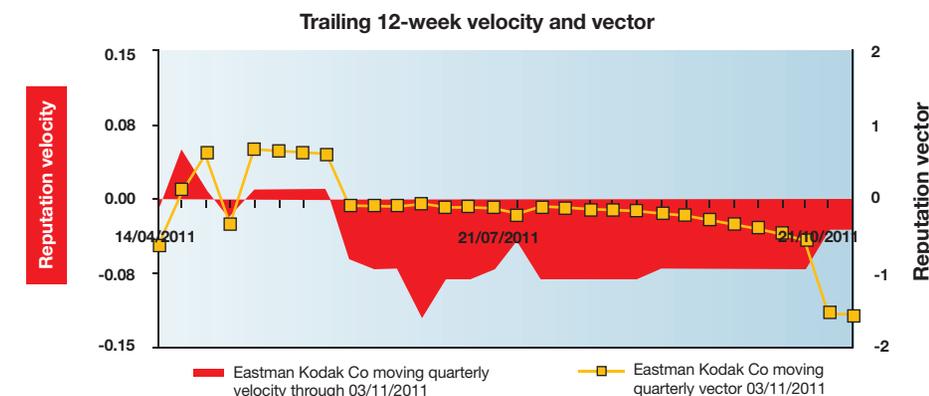
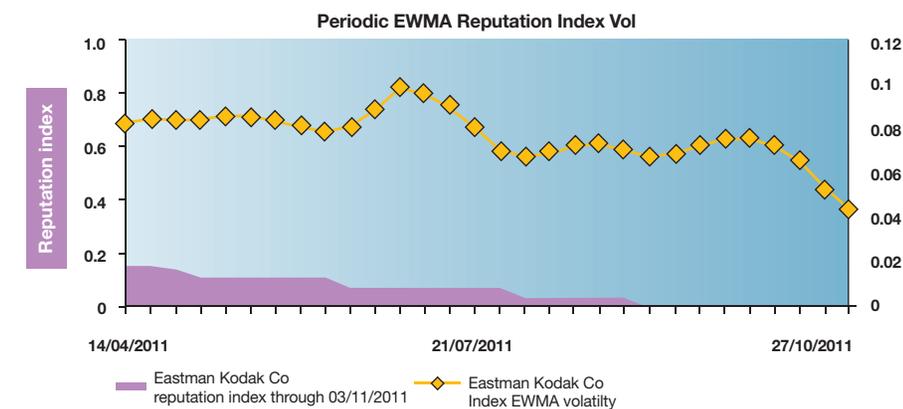
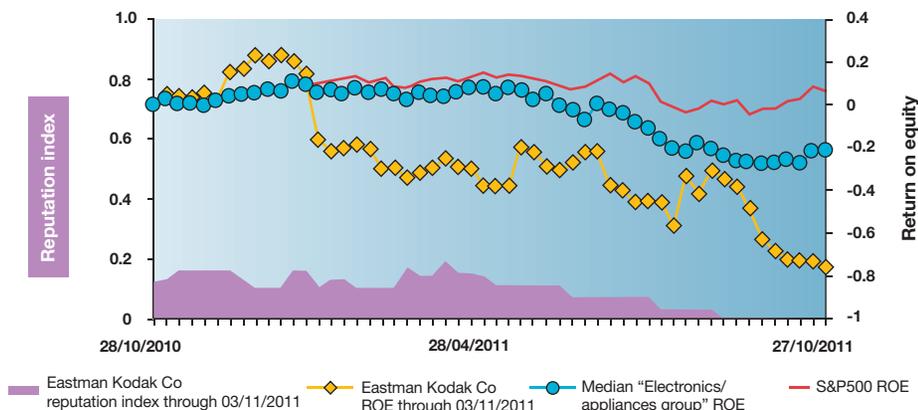
market for photo film and chemicals, enjoyed a reputation for innovation and astute marketing, and boasted a market value even greater than that of oil giant Exxon. Kodak shareholders had been favoured with an uninterrupted stream of dividends dating back to 1902. In 1930, the company was added to the Dow Jones Industrials Average index.

It was an innovator in the classic sense. Wholly owned laboratories staffed by scientist employees developed chemical-based technologies for many of the applications and sub-processes associated with films and photography. Its strength was in innovation and the patents arising, and so was the root cause of its fall.

The beginning of the end, many argue, is linked to a bruising patent battle – not the infringement suit against Apple Inc and RIM that found Kodak's patents to be invalid and whacked 15% off the company's market capitalisation this past July, but one that moved to culmination on 1st May 1989. It was on that day that, after more than a decade of bitter legal wrangling, the damages phase of the trial began in the huge patent fight between Eastman Kodak and the Polaroid Corporation. Polaroid was asking for more than US\$12 billion, which exceeded Kodak's net worth. Kodak insisted that, at most, it owed US\$150 million plus interest, which would have made the award less than US\$200 million.

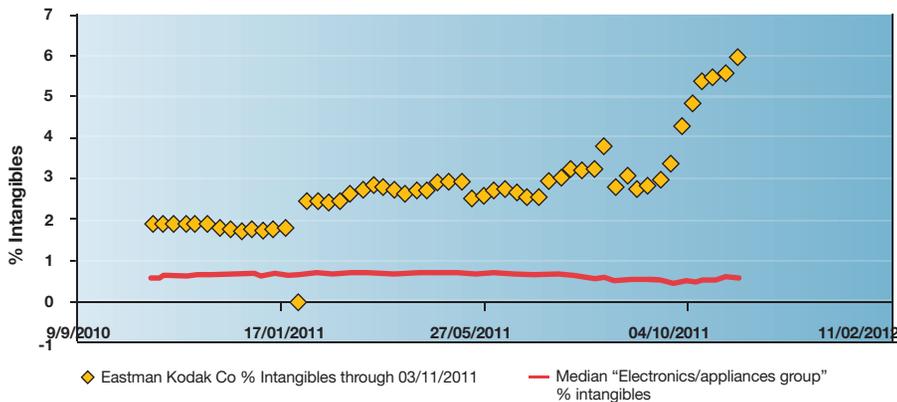
When the dust settled, the case had generated 104 stories in the *New York Times*

Figure 3. Quantitative reputational metrics profile of Eastman Kodak. Top: superimposed plots of Kodak's deteriorating reputational profile, its corresponding drop in return on equity and the benchmarks – the median return on equity among the median of the 29 peers in the electronics/appliances sector, and those of the S&P500 Composite Equity Index. Over the trailing 12 months, Kodak's reputational ranking dropped 12 percentile points and its equity underperformed the median of its benchmark by 54%. Middle: the exponentially weighted moving average of Kodak's reputation, a volatility index, shows that the most recent metric is moribund at 4%. Bottom: two derivative metrics of velocity and vector are negative. Collectively, these are indicators that Kodak's reputation – in its sector, most importantly for innovation – is dead



Data source: Steel City Re

Figure 4. A measure of the fraction of Kodak's market capitalisation accounted for by its intangible assets. As of the close of markets on 3rd November, 600% of Kodak's value was intangible compared to the median of its peer group at 56%. Equity investors, at any rate, are betting on a monetisation event around the patent portfolio.



Data source: Steel City Re

Inside Stone v Ritter

The Delaware Supreme Court's 2006 opinion adopting the concept of oversight liability is notable for many things, including:

- Its clarification that breach of the duty of oversight is a breach of the duty of loyalty.
- The affirmation that director oversight liability may be predicated on facts showing that either: "(a) the directors utterly failed to implement any reporting or information system or controls, or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."
- Its applicability to intangible assets.

Source: Reese, C et al, "Intangibles and the New Reality: Risk, Reputation and Value Creation", *Corporate Finance Review* 2011; 16(1): 20-32

and US\$873 million for Polaroid. It also knocked Kodak out of the rapidly growing sector for instant image-based gratification on the personal, and subsequently corporate, levels. It further forced the company to sell off its chemical subsidiary, Eastman Chemical, in 1994 to raise cash to support the company's aggressive search for new products. It was a game of catch-up with much more nimble competitors.

In 2004 Kodak was removed from the Dow Jones Industrials Average index. In December 2010 the company was removed from the Standard and Poor's 500 Composite Equity Index. In what might be described as a Hail Mary move, Kodak hinted in late August 2011 that its patent portfolio was on the block.

The media were amused. ZD Net greeted readers to Larry Dignan's 17th August blog, "Between the Lines", with the banner: "Welcome to the patent valuation bubble.' In this patent bizarro world, Kodak looks like a screaming buy and no-names like InterDigital get tech giants to drool. You can thank Google's Motorola Mobility purchase and the Nortel patent auction for this nonsense... Simply put, any company with a significant technology patent portfolio will be in play. The patent arms race is on and now the valuation for patents has been set at 'ridiculous.' Cash-rich companies have the go-ahead to gobble up portfolios that would have tanked stocks just a few years ago."

It didn't work. On 30th September 2011 Eastman Kodak hired law firm Jones Day for

advice as its stock dropped to an all-time low of US\$0.54 a share.

Now in the end game, the battle is once again over patents and innovation. As summarised succinctly by the *Financial Times*: "Investors handicapping the odds that Kodak can survive must solve three related unknowns. Will the portion of Kodak's patent portfolio that it has put on the block fetch a good price? Can it prevail in its patent fights with Apple and Research In Motion, now being heard by the International Trade Commission and elsewhere? And when will Kodak's newer businesses, which are fast-growing but not profitable, become cash generators?"

But it is not a battle over strategies. Rather, it is a battle between stakeholders. As reported by Bloomberg in late October: "Eastman Kodak Co.'s lenders sent a letter to the board of directors reminding the company of its fiduciary duty to sell its patent portfolio for fair market value." In case you are missing the punch line, the article explains that: "Kodak's board has been put on notice by lenders, who are saying 'If you destroy value, we will sue you,' said Amer Tiwana, an analyst at CRT Capital Group LLC in Stamford, Connecticut."

With the spectre of *Stone v Ritter* (see below) hovering over Eastman Kodak, the Steel City Re Corporate Reputation Index shows that over the trailing 12 months, its reputation ranking dropped from the 12th percentile to the 0th – yes, zero – percentile as measured relative to the 29 companies in the electronics/appliances

“ The duty of loyalty requires that directors and officers serve the interests of the corporation and its shareholders with undivided allegiance. Unlike for the duty of care, corporations are not permitted to indemnify officers and directors against personal liability for breaches of the duty of loyalty ”

sector, and its most recent reputational metric volatility measure was 4% (Figure 3). Over the same time period, just like RIM, Kodak financially underperformed the median of its sector by 53%. Last, the market capitalisation was greatly in excess of book value at the close of the markets on 3rd November according to the Steel City Re criteria. The intangible asset fraction was nearly 600%, while the median of the peer group was around 56% (Figure 4).

We've seen parts of this movie before. Eastman Kodak's reputation – in its sector, most importantly for innovation – is gone. For a company whose reputational value in innovation once commanded values placing it in the two greatest equity benchmarks, this is a clear sign of reputational value loss from multiple overlapping chronic factors: cultural, managerial and operational.

Making tangible how *Stone v Ritter* applies to intangibles

Two innovation-based companies – one severely wounded, the other moribund. The causes of their predicament are multifactorial and include cultural, managerial and operational elements. There is no fortuitous event that took everyone by surprise. In other words, these declines occurred in the setting of a fully functioning board of directors, an approved strategy and a compliant shareholder community.

A nonchalant interpretation is that the above comprise further evidence of Shumpeter's "creative destruction". These firms, both of which once had a stellar reputation and commanded the benefits arising therefrom, have fallen on hard times. As Nobel laureate Merton Miller once observed: "Above-normal profits always carry with them the seeds of their own decay."

On the other hand, shareholders find it

hard to be philosophical when they are losing money. Under longstanding precepts of corporate law, the business and affairs of a corporation are managed by its board of directors. The board has authority to appoint officers who assume day-to-day management functions under the direction of the board. Directors and officers, in turn, are bound by fiduciary duties to shareholders. These fiduciary duties generally entail affirmative, open-ended obligations to act in the best interests of the corporation and its shareholders so as to maximise shareholder value. By any measure, both RIM and Kodak are not maximising shareholder value.

Fiduciary duties can be viewed as falling within two categories: the duty of care and the duty of loyalty.

The duty of care requires that directors and officers exercise disinterested due care in decision making and act on an informed basis. When directors and officers satisfy due care requirements, their decisions are given deference under the business judgement rule. This means that courts will not second-guess the wisdom or the propriety of director and officer decisions, even if they turn out in retrospect to have been improvident. Further, corporations are permitted to indemnify officers and directors against personal liability for losses that the corporation incurs as a consequence of decisions made in breach of the duty of care.

The duty of loyalty requires that directors and officers serve the interests of the corporation and its shareholders with undivided allegiance. Unlike for the duty of care, corporations are not permitted to indemnify officers and directors against personal liability for breaches of the duty of loyalty.

In *Stone v Ritter* the Delaware Supreme

Action plan



Stone v Ritter relates to innovation, reputation and value:

- Innovation is a core business process that underpins reputation. Reputation, and its component drivers, should be discussed in formal corporate documents as an asset to be managed and value to be protected. Patents are evidence of activity; not necessarily evidence of innovation in the sense that innovation should create new value for customers and financial returns for the firm.
- Corporate decline may be an inevitable evolutionary process. Board-level controls and affirmative oversight of the innovation process may mitigate the inevitable disappointment that shareholders tend to express through litigation.
- Boards can help to immunise themselves against claims of breach of duty of loyalty.
- Demonstrate leadership and participate in appropriate reputationally relevant affinity groups where they can demonstrate publicly their oversight processes.
- Obtain third-party endorsements from iconic investors, rating agencies or insurers affirming the integrity of their oversight processes.

Court embraced the duty of oversight as law, with one important distinction. Breach of the duty of oversight is a breach of the duty of loyalty.

The court stated that director oversight liability may be predicated on facts showing that either: “(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.”

The implications of the *Stone v Ritter* opinion are significant and assume even greater importance in an economic climate where scrutiny of risk management functions has been greatly heightened. Notably, the duty of oversight requires ensuring the implementation and ongoing monitoring and adjustment of reporting and information systems and controls — precisely the types of tools that are part of a sound quantitative reputation management programme.

Severe consequences

Innovation failures are the result of a combination of cultural, managerial and operational events. This may be inevitable, or it may be the result of a breakdown somewhere along the continuum from culture to corporate brand to reputation; and the associated breakdown between operational execution and board-level governance.

When a broad range of stakeholders perceive failure, a firm’s once-stellar reputation for innovation may be permanently damaged, with a resulting impact on enterprise value. As discussed previously in this magazine, and as

evidenced by the cases presented, a damaged reputation has significant economic consequences. For their sake and the positive affirmation of conformance with their duty of loyalty, we can only hope that the directors at RIM and Kodak have in place (or put in place) oversight systems that give them visibility into their respective firms’ innovation processes. **iam**

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This series is inspired by the book, Mission: Intangible®, Managing risk and reputation to create enterprise value, published by Intangible Asset Finance Society (IAFS)