Corporate Governance at Martha Stewart Living Omnimedia: Not “A Good Thing”

Case Synopsis

The case opens with Martha Stewart’s 2005 release from prison following her conviction for obstructing an insider-trading investigation of her 2001 sale of personal stock. The scandal dealt a crippling blow to the powerful Martha Stewart brand and drove results at her namesake company, Martha Stewart Living Omnimedia (MSO), deep into the red. But as owner of more than 90 percent of MSO’s voting shares, Stewart continued to control the company throughout the scandal.

The company faced significant external challenges, including changing consumer preferences and mounting competition in all of its markets. Ad rates were under pressure as advertisers began fragmenting spending across multiple platforms, including the Internet and social media, where MSO was weak. New competitors were luring readers from MSO’s flagship publication, Martha Stewart Living. And in its second biggest business, merchandising, retailing juggernauts such as Walmart and Target were crushing MSO’s most important sales channel, Kmart. Internal challenges loomed even larger, with numerous failures of governance while the company attempted a turnaround.

Appropriate Uses

The case is intended to be used by MBA and executive students. It can be used in courses or modules dealing with corporate governance or turnarounds. This teaching note contains approaches for both uses.

Learning Objectives

After reading and analyzing the case as a governance case, students will be able to:
- Identify how control of shareholder voting rights by a founding executive can undermine corporate governance
- Describe the importance of independent directors and board committees
- Understand how company bylaws affect corporate governance

After reading and analyzing the case as a turnaround case, students will be able to:

- Recognize and respond to early signs of stagnation
- Identify and avoid management actions that can make a crisis worse
- Describe how weaknesses in executive leadership can help push a company into crisis and foster a culture that actively prevents strategic revitalization

**Supplemental Materials**

Because many students, especially those from outside the United States, may not be familiar with Martha Stewart, it is suggested that you use her interview with Matt Lauer of the *Today* show to introduce her at the start of class. This interview covers her prison stint and gives a bit of her life history. The video may be seen at: http://www.youtube.com/watch?v=HIOnrf2xtXk.

**Assignment Questions**

The following questions can be assigned to students to help them prepare for class discussion of governance issues in the case:

1. In what ways did Stewart’s control of shareholder voting rights disrupt the functioning of the board? How did her control of the board interfere with directors’ carrying out their fiduciary duties?
2. What changes in the makeup of the board would have improved governance?
3. How might changes in corporate bylaws have improved governance?
4. What situations might have been improved or avoided through better risk management?

The following questions can be assigned to students to help them prepare for class discussion of turnaround issues in the case:

1. What are the advantages and disadvantages of having one person serve as both a company’s dominant brand and its controlling shareholder?
2. In what ways did MSO fail to respond to competitive trends and changes in consumer preferences? Why?
3. What might management have done to stabilize revenue and reassure investors after Stewart’s legal troubles surfaced?
4. What were the internal and external symptoms of trouble in the years following Stewart’s 2005 return to the company?

**Case Analysis**

**TEACHING AS A GOVERNANCE CASE**

*In what ways did Martha Stewart’s control of the company impair its ability to respond to external challenges?*

The combination of Stewart’s personality, leadership style, and voting control turned the CEO suite at MSO into a revolving door. Her presence was stifling to any outside directors or executives who tried to foster accountability. When independent directors opposed big increases in her pay and perks, Stewart ousted them and replaced them with allies, including her personal hairdresser.

Stewart’s confidant and personal advisor, Charles Koppelman, played an important executive role at the company for several years—a role for which he was essentially unqualified. He described his primary goal during this time as preserving the company for Stewart.

In addition, Stewart showed little interest in ensuring sound strategic or succession planning or developing a short- and long-term strategic vision for the company.

*What changes in the makeup of the board would have improved governance?*

When Rick Boyko was appointed to the board, his independence should have been more carefully vetted. The New York Stock Exchange required companies to “broadly consider all relevant facts and circumstances” when determining the independence of a director, including “charitable and financial relationships, among others.”¹ At the time, Boyko was employed at Virginia Commonwealth University, to which MSO had made charitable contributions. MSO directors, citing bylaws giving directors the right to determine independence “based on all the facts and circumstances,” declared him independent and assigned him to the compensation committee.

Naming Fekkai as a director breached a general principle that independent directors should have no other connection to the company, be free of conflicts of interest, and exhibit “business sense, sound judgment, (and) wealth of experience.”² However, MSO determined that Fekkai met the more specific standards for independence as defined in its corporate governance guidelines. Among other prohibitions, its rules barred designating as “independent” any directors who were present or recent employees, who had recently received more than $120,000 in compensation from the company, or who had been employed by a company that recently made or received payments of more than $1 million from the company. Directors whose immediate family members met any of the criteria also were barred from being classified as “independent.”

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² Steven Rogers, “Technical Note: Boards of Directors,” Case #7-104-003 (Kellogg School of Management, 2004).
In what ways did Stewart’s control of the board result in poor compensation practices?

The board had little latitude to structure executive compensation as an incentive to improving corporate performance. Stewart’s compensation continued to rise despite declines in the company’s stock and financial performance.

In what other ways was Stewart’s compensation package inconsistent with sound compensation-planning principles?

Stewart’s perks violated the principles of sound compensation planning. She received $2-million-and-up annual payments for use of “intangible assets” such as her image and her estate, $612,249 for private security services, $49,440 for a weekend driver, a $100,000 “non-accountable expense allowance,” and a salary for a personal trainer.

Stewart received millions of dollars’ worth of stock options—a management incentive that should not have been necessary. As the company’s largest shareholder, she should already have had adequate incentive to raise its stock price.

What key performance indicators did executives and directors fail to monitor at critical times in the company’s history? What might have been done to ensure greater vigilance?

Competitors gained market share in MSO’s publishing and merchandising businesses during Stewart’s legal troubles and continued to dominate media markets for younger consumers in the years that followed. Periodic board review of competitors’ strategies and relative market share could have helped management anticipate and head off such setbacks.

MSO failed to recover during the economic expansion of 2005 and 2006, trailing its competitors and posting losses both years. Even in 2007, when the economy peaked, the company barely edged into the black.

Continuing losses in Internet advertising and e-commerce should have signaled that MSO’s repeated, incremental restructurings and relaunchings of the website were a flawed approach that left the company hopelessly behind by decade’s end. An early strategic e-commerce alliance might have positioned MSO to grow in e-commerce and reduce its dependency on publishing.

Bloated costs wiped out MSO’s profit quarter after quarter, reflecting management’s lack of accountability. Board oversight of operations might have helped identify effective ways to stanch the bleeding.

Management lost momentum in revitalizing the Martha Stewart brand and blurred its identity with a flurry of extensions into questionable lines, from liquid cleaners to pet-waste bags. Board focus on long-term strategic planning might have positioned the company to capitalize on the millennial generation’s renewed interest in handcrafted, homemade goods.

What questionable business decisions might have been prevented if an effective board of independent directors had been in place and if MSO had been held accountable to shareholders?

The board’s 2011 decision to put the company up for sale might have received closer consideration, instead of being dismissed out-of-hand because of Stewart’s baseless assumptions about the company’s value.
Directors might have blocked the ill-advised 2011 decision by Stewart and chief operating officer Lisa Gersh to sign a merchandising agreement with J. C. Penney, which clearly conflicted with a similar pact signed in 2007 with Macy’s.

The board could have prevented the CEO suite from becoming a revolving door, chewing up five CEOs in ten years, and engaged in succession planning to support continuity in leadership.

The board could have aligned CEO selection with the demands of changing markets, recruiting an executive with merchandising experience rather than a series of CEOs from the media industry.

**How might changes in corporate bylaws have improved governance?**

A shareholder coalition might have been formed to sue for control of voting rights. A new code of governance could have been added to the company’s bylaws, ensuring more equitable distribution of voting rights among shareholders.

**What other steps could have been taken to improve governance?**

The board should have been charged with aligning executive compensation with long-term goals. Directors should have strived to balance short-term risk-taking with sustainable long-term growth. To that end, executive perks should have been eliminated, and compensation decisions and their underlying rationale should have been communicated clearly to shareholders.

**How might the board have provided better strategic direction for the company?**

Directors should have overseen management’s development of a one-year, five-year, and ten-year strategic vision. A high priority should have been given to strategy at board meetings. Directors also should have ensured that management was tracking key performance indicators to stay abreast of changes in the company’s markets, market share, and performance. The company’s long-term vision and strategy should have been discussed frequently and communicated to shareholders.

**What situations might have been improved or avoided through better risk management?**

Directors should have been well trained in risk management. An advisory board could have been set up to provide outside advice and oversight. The board also should have formed a risk-management committee that had responsibility to review key business sectors regularly and ensure diversification to protect the business. All of these risk-management measures should have been communicated clearly to shareholders.

**What steps should have been taken to improve communication with shareholders?**

In addition to holding the annual shareholder meeting, management should have held regular calls with analysts and investors and reported regularly to the board. The board should have overseen the establishment of a communication plan to keep investors informed.

**Could the board have nurtured a more positive corporate culture?**

Directors could have met regularly with executives to gather information about employee attitudes, morale, and levels of engagement. The board also might have overseen establishment of a “whistle-blower hotline” to give employees a way to inform directors of problems without
risking retaliation. The board might also have overseen development of an incentive plan to reward employees for fostering new ideas and to encourage bottom-up communication.

TEACHING AS A TURNAROUND CASE

Which of the common external causes of a company’s decline were evident in the situation of Martha Stewart Living Omnimedia in the years following its 1999 IPO?

Technological change was driving a shift in editorial how-to content from print media to the web. At the same time, new, lower-cost competitors were invading MSO’s merchandising and publishing markets. Consumer preferences were shifting away from Stewart’s glossy print magazines and traditional stand-and-stir cooking-show format toward shorter online content and lively reality TV–style cook-offs. In merchandising, larger, stronger competitors were crushing MSO’s most important sales outlet, Kmart.

In what ways was the company’s strategy ill-suited to the changing marketplace?

MSO’s “omnimedia” strategy rested on selling multimedia ad packages across its publishing, broadcast, and Internet platforms at a time when the trend was toward a fragmentation of advertising dollars among numerous disparate media, including social media. MSO made several failed attempts to profit on e-commerce without developing or acquiring the necessary technology and marketing expertise.

Which of the common internal causes of a company’s decline impaired MSO’s ability to respond to fundamental shifts in markets and technology?

Fundamentally, management failed to take responsibility for the firm’s performance. Stewart lacked financial expertise and accountability to shareholders. As her company posted continuing losses, she continued to drain cash from the company to cover her compensation and severance costs for the string of CEOs she drove away.

The company recruited CEOs whose backgrounds in the media industry left them ill-equipped to grow the most promising segment of the business—merchandising. Repeated changes in direction showed that the management team was not capable of leading the company. Management veered from moving merchandise online to launching unprofitable new broadcasting and entertainment ventures to introducing a flurry of new product-licensing agreements that diluted the brand.

Did the company’s ownership structure contribute to its decline?

Control of more than 90 percent of the voting shares of the company by one person whose image and lifestyle were also the basis for its dominant brand eliminated the checks and balances designed to ensure effective management and governance.

In what phase of the organizational distress curve was MSO in 2001?

Regardless of the cause or nature of a distressed company’s struggles, it invariably finds itself somewhere on the curve in Figure TN1, which demonstrates how companies slide down a slippery slope through five phases: the blinded, inaction, faulty action, crisis, and dissolution phases. A company that is unable to fix its problems in one phase eventually falls to the next one, with less time to repair the damage and greater effort required to do so.
In the *blinded phase*, management is blind to serious problems in the company. If nothing is fixed, the company probably slides to the *inaction phase*, in which management knows there is a problem but it does not (or cannot) fix it. The most frequent next phase is the *faulty action* phase, in which management finally takes action but fails to resolve the problem and sometimes makes things worse.

Without course correction, the company usually progresses into the *crisis* phase, in which it bleeds cash and loses customers, suppliers, and good employees. The performance slope shows that once a company reaches this phase, things get worse faster and faster.

The final phase is *dissolution*. If the company’s problems are not fixed correctly along the way, the company will legally dissolve, whether by bankruptcy, liquidation, or other similar processes.

In 2001 MSO was in the first, or blinded, stage of the distress curve. Revenues were stagnating, but management did not recognize the crisis. Ratings for its flagship TV show were faltering and the company was losing market share in merchandising, while its primary retail-sales outlet, Kmart, entered bankruptcy and closed six hundred stores. Shrinking profit margins reflected softening demand among advertisers and consumers and continuing losses on the company’s website.

Falling share prices reflected growing concern in the marketplace, but management did little to address it. Leadership overlooked fundamental market shifts toward e-commerce and the migration of young consumers to online communities and short how-to content.
In what phase was the company by 2005?

The company had entered the inaction phase, as management let the company stagnate and post losses during an economic expansion. Competitors were stealing market share in publishing and broadcasting. Both print magazines (such as Real Simple) and websites (such as TheKnot.com) were overtaking MSO’s offerings. Reality TV chefs were supplanting traditional cooking shows such as Stewart’s. The company was bleeding cash, wiping out 80 percent of its reserves in a single year.

The company continued to say the same things about strategy without executing—promising to find new retail outlets to replace Kmart, drive the website into the black, and sell more ad pages in Martha Stewart Living.

In what phase of the organizational distress curve was the company in 2008?

By 2008 MSO had skidded into the faulty action phase. The company’s problems had mounted to the point that management was spurred to action, starting several unprofitable new TV shows and diluting the brand by extending into far-flung product lines, from cleaning fluid to pet-poop bags. Many of the moves were ill-conceived, however.

Stewart’s preoccupation with perks and her oversized paycheck were a continuing sign of her complacency and irresponsibility. A poorly conceived merchandising agreement with J.C. Penney plunged the company into an embarrassing court battle with Macy’s, eventually forcing MSO to scale back the Penney deal.

Management engaged in across-the-board downsizing, resulting in a shrunken company that bore an eerie resemblance to the MSO of 1990. Although online advertising accounted for nearly one-fifth of publishing revenue by 2012, the company was still dependent on that troubled business.

Where was the company in 2011?

MSO had entered the crisis phase. Management retained an investment bank to consider its alternatives, but Stewart rejected its findings because she considered the price too low. The company was seen as obviously distressed. The few analysts still watching it regarded it as a potential takeover target.

The company’s fifth CEO was fired after seven months in the job. The CEO position remained open amid uncertainty over the J.C. Penney litigation and its history as a revolving door.

What kinds of analysis might have been used to detect the warning signs of the company’s impending demise?

A management analysis would have shown that Stewart was not delegating responsibility or responding to changes in the marketplace. She clashed with a series of CEOs and directors, ousting those who disagreed with her. A management analysis also would have highlighted the risks of recruiting a series of CEOs from the media industry when the company’s greatest growth potential was elsewhere, in merchandising.
A trend analysis would have shown that MSO significantly underperformed during the economic expansion of 2005 and 2006, posting a loss both years and barely edging into the black in 2007 as the economy was peaking.

Industry analysis would have shown that MSO had failed to keep pace with changes in both retailing and e-commerce; that continuing investments in daytime TV were ill-advised; that stagnation in print media signaled the need for a strategic overhaul; and that repeated failures to develop products that appealed to younger consumers signaled the need for new approaches or leadership.

**Epilogue**

MSO threw Wall Street another curve in late 2013. The CEO slot had been vacant for eight months when the announcement came: After saying it would tap an executive with merchandising experience, MSO reached into an industry that could hardly have been farther afield—scrap metal.

Daniel Dienst was known for financial restructurings and turnarounds in a cyclical, commodity-based industry that collected scrap metal and sold it as raw material to steelmakers. The website of the $9 billion company he had most recently run, Sims Metal Management Ltd., featured a large photo of giant claws hovering over piles of crushed, rusted metal—a stark contrast to the artichoke turnovers and tiny pine-tree reindeer displayed on MarthaStewart.com. The immediate response was derision: “Martha Stewart’s company is hoping a new CEO will rescue it from the junkyard,” the *New York Post* declared.3

Dienst, 48, was a former banker and lawyer who had represented creditors in steel bankruptcy cases. In 2004 he became CEO of a company that emerged from Chapter 11, Metal Management Inc., where he was credited with “a remarkable turnaround.”4 When Australia-based Sims Metal acquired Metal Management four years later, Dienst took over as CEO of the combined company, which became the world’s biggest scrap metal and electronics recycler, operating hundreds of scrap yards worldwide. He retired from Sims in June 2013 and joined MSO’s board two months later.

MSO directors elevated Dienst to CEO after just eight weeks, citing in a joint statement the “fresh perspective” he brought. In the same statement, Martha Stewart praised Dienst’s “strong operating and financial discipline and a clear track record of creating significant value for shareholders,”5 adding that she expected him to expand the brand and extend it into international markets.

In the statement, Dienst called himself “a fan of Martha Stewart, the person and the brand.” Indeed, under his leadership, Sims Metal had showed an interest in design unusual in its industry, hiring one of New York City’s top architects in 2011 to design a new recycling transfer station in Brooklyn.6

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Dienst soon made it clear that his focus at MSO would be on redesigning the balance sheet. The company had continued to bleed cash, posting an $8.7 million loss for the first nine months of 2013, on a 20 percent drop in revenue. He told a reporter he took the job “to provide some basic leadership . . . and make some of the tough, but obvious decisions that should have been made long ago.” Analysts speculated that Dienst would get the company in shape for sale. He moved quickly, laying off about 14 percent of MSO’s staff, or seventy employees.

The stock surged 18 percent on the news—to just under $4 a share. MSO’s total market capitalization stood at a shrunken $218.8 million, down more than 87 percent since its 1999 New York Stock Exchange debut.

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