Chapter 14

The Story of a Tortoise: How Toyota Fell from the Top Spot[36]

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Abstract

In 2008, Toyota Motors achieved its goal of becoming the No. 1 carmaker on earth.Despite its ascension to the top spot, problems with electronic and physical systems of its cars morphed into a disease in early 2010. In three separate events, Toyota had to recall a total of 11 million vehicles. Toyota lost $21 billion of its market capitalization in a single week in January 2010, and was slapped with an unprecedented penalty of three fines totalling $48.8 million. For the first half of 2011, Toyota fell to third place, with GM and Volkswagen first and second, respectively.

This case explains how the failure of Toyota's corporate governance – especially its board structure – contributed to its fall from the No. 1 spot. Although the problem of sudden unintended acceleration syndrome was reported back in 1999, it took Toyota CEOs and its entire insider-dominated board more than 10 years to acknowledge its existence, let alone initiate any corrective measures. Despite swift governance reforms to include Anglo-American features of corporate boards in the mid-1990s in Japan, Toyota CEOs always dismissed the idea of appointing outside, independent directors. Although Toyota cut down the board size from 58 in 2003 to 29 in 2010, all the members were executives and insiders, and none independent. There were no dissenting voices that could raise the alarm that Toyota was going through a crisis, and that decisive and drastic measures were needed to control this crisis. The case calls to question whether all insider board members at Toyota performed their duty of oversight and discharged their statutory role in the execution of appropriate internal control.

36 During the first author's sabbatical in the winter of 2010 at the ESSEC Business School in Paris, Toyota's accelerator pedal recall became a focus of mainstream media in France. Business journals made Toyota the lead topic. The author's interest was piqued and the result is this case. I am grateful to colleagues at the Department of Management, ESSEC Business School, especially Carole Donada, for their encouragement for the completion of this case.

Introduction

In 2008, Toyota Motors (Toyota) achieved its goal of becoming the No. 1 carmaker on earth.[i] Until then, General Motors (GM) had been the market leader in the global automobile industry for 77 consecutive years from 1931 through 2007. That same year, the financial crisis severely hit the auto industry. In the US, for example, automobile sales declined 18 percent, from 16.1 million units in 2007 to 13.2 million units in 2008.[ii] The credit crisis, coupled with an already declining market share, customer perceptions about poor quality, redundant product offerings, and huge legacy costs pushed GM into bankruptcy court protection. In comparison, Toyota reported a \$4.8 billion loss during the first quarter of 2009, the largest quarterly loss in the company's 72-year history.[iii] Although Toyota's setback was quite in line with its global competitors, what was to follow in the months to come was not at all in line with the company's previously exceptional record. Revelations of Toyota's quality control problems over the years were so disturbing that many found it difficult to reconcile this with the firm's historic stellar reputation for quality production methods. Such callous disregard of persistent quality problems on the part of the world's largest automaker was neatly summed up by the New York Times:

> As Toyota returned to the black in late 2009, its reputation for safety and quality were battered by a series of recalls. The issue of unintended acceleration would lead the company through a bruising gantlet of government investigators, lawsuits from crash victims and one of the heaviest fines ever imposed on a car manufacturer in the United States. [iv]

Resultantly, the number one sales position that Toyota achieved with a struggle stretching over 71 years was lost within two years to GM. Moreover, Toyota faced a risk for significant loss of brand equity and market share. This fall in Toyota's fortune was attributed to its obsession with growth; to its departure from age-old traditions and values; and, finally, to a broader failing of its board in the control and reversal of this battered situation. The following paragraphs chronicle the role of Toyota's board in its rise and fall during 1995-2010, a period marked by a record number of recalls and an unprecedented penalty of three fines totalling \$48.8 million.

Although a number of reasons, such as an overly ambitious growth goal for global market leadership, failure of crisis management, failure of internal communications, and failure to comply with US government regulations have been attributed to Toyota's problems leading to its fall, the failure of Toyota's corporate governance has hardly been mentioned, either in the academic literature or in the business press, as a contributor to this crisis. Briefly, it is the examination of Toyota's governance failure, or more specifically the failure of its board, to which this case is dedicated. In order to bring this failure into perspective, a brief history of Toyota is presented first.

A Brief History

The history of Toyota can conveniently be divided into three uneven time periods: 1937-1956, 1957-1994, and 1995-2010. The first two periods represent its founding followed, with the exception of a few hiccups, by ever-increasing growth based on a "fastidiously tended" reputation for quality and reliability. In contrast to the first two periods, the last was plagued by a systemic and widespread scandal. A series of recalls involving faulty floor mats and balky gas pedals sullied Toyota's reputation for quality and customer loyalty, the long-term impact of which is still not fully known. The last stage spanned approximately 15 years.

The origins of Toyota Motors can be traced back to 1902 when Sakichi Toyoda invented a loom that stopped automatically if a thread snapped. This reduced defects and raised yields of usable fabric. His son, Kiichiro Toyoda, founded Toyota Motors in 1937. Kiichiro applied his father's system of designing processes to stop automati¬cally and call attention to problems. Kiichiro also designed a system that provided different processes with only the kinds and quantities of items needed, when they were needed, which came to be known later as the famous "just-in-time" (JIT) inventory. Toyota also benefitted from the Second Sino-Japanese war in 1937, when the Japanese government authorized it, along with Nissan and Isuzu, to produce automobiles in order to break the dominance of large US automakers.[v] Toyota's operations also grew significantly following the outbreak of World War II. However, because of the recession following the War, Toyota nearly went out of business in 1950. It survived the recession and made a comeback largely due to an increased demand for cars during the Korean War in 1950. Since this recovery, Toyota never lost money until the recession of 2008.

Toyota set up its first foreign headquarters in Hollywood in 1957 to sell its imported cars produced in Japan. However, its cars were selling dismally in the US due to design and manufacturing problems. This is when Toyota began to design and produce cars specifically for the US market. From 1965 onwards, Toyota's sales were nearly doubling each year. By 1971, Toyota was selling over 300,000 vehicles per year.[vi] After years of experimentation, Toyota perfected its production system by the 1970s.

The fabled Toyota Production System (TPS) – a standardized process to encourage and facilitate unique and creative employee contributions to its unified goals and objectives[vii] – guided and supported Toyota's steady rise since its founding. The resultant tradition came to be known as the Toyota Way. The Toyota Way, which is more of a mind-set than a collection of management tools,[viii] lowered costs, improved brand quality, and gave Toyota an enduring competitive advantage, and allowed it to grow faster than its rivals in the US and other markets.

Toyota made major inroads into the North American market when oil prices spiked in 1973 and again in 1979. The demand for better fuel efficiency and increased safety standards, as mandated by the US federal regulation, led to an unprecedented demand for smaller, lighter, and more efficient cars. Small car makers like Toyota were particularly well positioned to meet this new demand. In the 1980s, Toyota started to build manufacturing plants in the US. In 1984, the first Toyota Corolla was built in the US at the New United Motor Manufacturing (NUMMI) facility in Fremont, California – a joint venture with GM.[ix] GM wanted to learn lean production from Toyota, and Toyota wanted to gain its first manufacturing base in the US, work directly with American workers, and invest in the local communities, hence the joint venture. Toyota achieved a revolution in NUMMI, in that it proved that lean production could be successfully replicated in manufacturing facilities in the US. In 1986, Toyota established its first wholly-owned subsidiary in Georgetown, Kentucky. This is Toyota's largest manufacturing facility outside Japan. Under the leadership of three non-family presidents – Hiroshi Okuda from 1995 to 1999, Fujio Cho from 1999 to 2005, and Katsuaki Watanabe from 2005 to 2009 – Toyota achieved a record of growth no other automaker had ever witnessed. In less than 70 years Toyota had become a $100 billion corporation. This feat was topped by the fact that between 2001 and 2008 Toyota doubled its size – the most staggering growth for a carmaker the world had ever seen. And finally in 2008, with over 300,000 employees and 53 production facilities in 26 countries,[x] Toyota replaced GM as the world's largest auto manufacturer. See *Table 1*.

Table 1: **ANNUAL PRODUCTION VOLUME OF VEHICLES BY GM AND TOYOTA** [xliii]

Year	GM	Toyota
2001	7,582,561	6,054,968
2002	8,325,835	6,626,387
2003	8,185,997	6,240,526
2004**	8,066,536	6,814,554
2005	9,097,855	7,338,314
2006	8,965,305	8,036,010
2007	9,349,818	8,534,690
2008	8,282,803	9,237,780
2009	6,459,053	7,234,439
2010	8,476,192	8,557,351

** Toyota overtook Ford and became the No. 2 auto manufacturer in the world. It took Toyota only three years to beat GM and emerge as the No. 1 in 2008.

Corporate Governance in Toyota

Historically, a life-time employment contract, and a resultant employee-centered stakeholder model – as opposed to a stockholder-centered 'Anglo-American' model – approximated the governance of large corporations in Japan. [xi] Boards in Japan were composed almost entirely of inside members. Senior managers, who were career employees of the corporation, would achieve board membership as they moved up the corporate ladder. This composition created a foundation of trust in these managerial board members, which was based on a 'lifetime' involvement in and commitment to the company.[xii] In such boards, there was a low degree of separation between the management and monitoring functions.[xiii] Concomitant with Japan's post-war growth, insider-dominated boards prospered until the mid-1990s. These insider directors however owed "fiduciary duties of care and loyalty to the corporation and shareholders" under Japanese law.[xiv]

Couched in this brief historical snapshot of corporate governance, Toyota's key focus was always on its people, and its CEOs were committed to upholding job security of their employees. In 1998, Moody's Investors Services downgraded the Toyota bond rating because of its commitment to lifetime employment, but Toyota had never budged.[xv] Senior managers, who were career employees of the corporation and moved up the corporate ladder, ultimately achieved board membership. This composition created

58 board members, or almost five times those of GM's.[xx] This number came down to 30 in 2007[xxi] and 29 in 2010,[xxii] and all of the members were executives and insiders,[xxiii] and none of them independent. Moreover, the directors – all men – lacked in diversity.[xxiv] The directors held different titles, which indicated "fine gradations of a presumed hierarchical order of authority, responsibility and seniority."[xxv] Quoting Toyota's Form 6-K filed with the Securities and Exchange Commission, from June 29, 2007, presented the following rationale for having a board composed entirely of its own executives:

> With respect to our system regarding directors, we believe that it is important to elect individuals that comprehend and engage in Toyota's strengths, including commitment to manufacturing, with an emphasis on frontline operations and problem solving based on the actual situation on the site (genchi genbutsu). Toyota will consider the appointment of outside directors should there be suitable individuals.[xxvi]

Although the lack of an outside perspective was particularly striking in the case of Toyota's board, Toyota set up an International Advisory Board of ten experts as a surrogate for outside directors in 1996. The disciplinary role of this advisory board was questionable.[xxvii] Toyota CEOs always dismissed the idea of appointing outsiders on the board, in that it was doing perfectly well without such outside members.[xxviii] For Toyota, its insider board members could share knowledge and information acquired on the shop floor, thus facilitating incremental, "step-by-step" innovation. Over decades, Toyota built its reputation and market share in tiny increments, which could be best captured by the Japanese word jojo, meaning "slowly, gradually, and steadily."[xxix] Therefore, an insider-packed board was perfectly in keeping with Toyota's growth philosophy and attendant success.

The Biggest Recall in Automotive History

Despite Toyota's ascension to the top spot, problems with electronic and physical systems of its cars morphed into a disease in early 2010, and caused a hailstorm of recalls and bad publicity. At least 34 deaths were attributed to problems related to unintended acceleration and brake failure in Toyota and Lexus vehicles,[xxx] and death tolls linked to these defects might reach 100 or more.[xxxi] In three separate events, a total of 11 million Toyota and Lexus vehicles were recalled, by far the most extensive recall in automobile history. The timeline for all the recalls that spanned slightly more than three years is presented in *Table 2*. Toyota attracted intense scrutiny, rebuke, and public outcry. Its failure to notify the US Department of Transportation (DOT) of the problems made its closely guarded values very questionable. The obvious outcomes were a sense of betrayal among loyal customers and fear and mistrust among potential buyers about the safety of Toyota vehicles. It would be difficult to predict exactly how the future would unfold for Toyota. The outcome of the pending class action lawsuits aside, Toyota lost $21 billion of its market capitalization in a single week in January 2010.[xxxii] It was slapped with an unprecedented penalty of three fines totalling $48.8 million. For the first half of 2011, Toyota had fallen to the third place, with GM and Volkswagen first and second, respectively.[xxxiii] The timeline for the recall of Toyota vehicles is also given in *Table 2*.

Table 2: **TOYOTA RECALL TIMELINE: SOME KEY DATES** [xliv]

Date	Reason for Recall
September 2007	Toyota issued a Lexus recall to fasten floor mats to car floors to avoid acceleration problems.
August 28, 2009	Uncontrolled acceleration crash of a Lexus killed four people near San Diego, California, including an off-duty highway patrol officer.
September 14, 2009	Preliminary reports indicate that a Lexus, on loan from a Lexus dealership, may have had the wrong floor mats installed, interfering with the gas pedal.
September 29, 2009	Toyota issued a safety advisory on floor mats for approximately 4.2 million Lexus and Toyota vehicles, adding that it was recalling the floor mats.
October 02, 2009	Newly appointed Toyota CEO Akio Toyoda publicly apologized for the deaths in California, and to every customer affected by the recall.
October 25, 2009	An investigation by local authorities and the National Highway Traffic Safety Administration (NHTSA) revealed that a set of rubber floor mats designed for the Lexus RX 400 SUV had been placed over the top of the ES 350's stock carpeted floor mats and that the accelerator pedal had become jammed against them, causing the car to accelerate out of control.
October 30, 2009	Toyota began sending letters to owners notifying them of an unspecified upcoming recall to fix the unintended acceleration issue. In the letters Toyota claimed that "no defect exists."
November 16, 2009	Japanese media reports claimed Toyota had made a deal with NHTSA over a recall. Toyota denied any agreement had been reached, but the company admitted it had already set aside $5.6 billion to deal with the issue.
November 25, 2009	Toyota dealers were instructed to remove the gas pedal and shorten it so it could not interfere with the floor mats.
December 26, 2009	A Toyota Avalon crashed into a lake in Texas after accelerating out of control. All four occupants died. Floor mats were found in the trunk of the car.
January 11, 2011	Toyota announced its brake override software fix will be made global by 2011.
January 21, 2010	Toyota recalled another 2.3 million Toyota-brand vehicles because of a problem with the gas pedal.
January 23, 2010	Agence France Press reported that Toyota might recall 2 million vehicles in Europe for the same problem.
January 26, 2010	Toyota announced it was immediately halting the sale of all models affected by the January 21 pedal recall, and that it will shut down assembly lines for those models at five North American plants for one week beginning February 1 to assess and coordinate activities.
February 1, 2010	Toyota announced a plan to fix sticky gas pedals and the part was shipped to dealers.
February 5, 2010	The Toyota president apologized at a news conference.
February 23, 2010	Congressional investigative hearings of Toyota began.
May 18, 2010	Toyota paid a $16.4 million fine to settle regulatory charges that it was too slow to issue a recall for the acceleration problem.
July 2010	Toyota recalled 280,000 cars for engine problems.
December 2010	The Motor Vehicle Safety Act stalled on the House floor.

Since 1995 onward, following the change of leadership from the Toyoda family to outsiders, Toyota's orientation took a different turn. Hiroshi Okuda, appointed in 1995 as Toyota's first non-family president, pushed for excessive growth, which he continued with until he was removed from the presidency in 1999. His two successors – Fujio Cho and Katsuaki Watanabe – followed in his footsteps. Overly obsessed with the lucrative US market, these three CEOs changed Toyota profoundly in terms of size and geographical dispersion of operations. As a result, Toyota developed a chronic pattern of reacting slowly to safety concerns, and was even failing to notify customers or the DOT of known defects in its previously sold vehicles. This failure also demonstrated a marked departure from its commitment to uncompromising quality and nearly perfect reliability of its vehicles.

Beginning with the 1990s, the pace of internationalization grew rapidly, as the Japanese government made foreign direct investment (FDI) a key priority to revitalize its sluggish economy. As a result, Toyota became increasingly internationalized with overseas production facilities and operations. In order to accomplish such explosive growth, cost cutting took on a new dimension, taking the TPS to extreme levels. Various programs aimed at drastic cost cutting resulted in savings of more than $10 billion from global operating costs over the period 2000–2005.[xxxiv] Under pressure, Toyota suppliers were also cutting corners in the design of parts. Toyota's existing infrastructure and resources could barely support this accelerated speed of growth, with the result that quality simply became unsustainable, and was clearly slipping. "The parable of Toyota is that the tortoise became the hare."[xxxv] Toyota moved away from its famed Toyota Way, with which its senior executives in overseas operations had little or no experience. An MIT operations expert, Steven Spear, having trained in Toyota factories, said, "the Toyota Way – in which knowledge accumulated by élite cadres of engineers and assembly workers over many years is shared across the company – got diluted by the demands of production."[xxxvi] Contrary to its vaunted commitment to lifetime employment, Toyota started to rapidly increase the number of temporary workers in 2004,[xxxvii] and was replacing seniority-based pay with ability-based pay.[xxxviii] Although an overzealous pursuit of growth had plunged Toyota into a disaster of immense proportions, there was no dissention in the board to voice that Toyota was going to through a crisis, and that decisive and drastic measures were needed to control the crisis.

Failure of Governance

Toyota's directors never paid serious attention to the events leading to the recall of 11 million vehicles and a hefty $48.8 million penalty, although these outcomes were largely grounded in their own board structure. The problem of sudden unintended acceleration syndrome was reported in some Lexus and Toyota models even back in 1999,[xxxix] but it took Toyota CEOs – and by extension its board members – more than 10 years to acknowledge its existence, let alone initiate any definitive corrective measures. By all accounts, Toyota's board felt that these events were minor hiccups and would go away on their own.[xl] However, the legal precedent from the Daiwa Bank case brought into question, once again, whether the directors of Toyota performed their duty of oversight and discharged their statutory role in the execution of appropriate internal control. As the chronology of Toyota's recalls would suggest (see *Table 2*), Toyota's board did not.

Both life-time employment and promotion from within led to acute inbreeding in Toyota. Managers were climbing the corporate ladder on the coattails of their seniors who were sitting – or would be sitting – on the board soon. This rigid system of hierarchy made it difficult to pass bad news up the hieratical ladder. This, in turn, made it difficult to respond to crises, such as recalls and harsh press publicity. Any attempt to short-circuit the hierarchy would be deemed as an act of disloyalty and a violation of Toyota's internal harmony and consensual corporate culture. [xli] If Toyota's board had included outside members with diverse backgrounds and orientations, its response to the crisis could be different. Such outside directors might pursue effective information and reporting systems to exercise their oversight function more effectively,[xlii] and Toyota would still be in the number one position in the latter half of 2011.

Discussion Questions

1. What distinctive attributes of Toyota's governance aided its success?
2. What distinctive attributes of Toyota's governance structure may have contributed to its quality problems?
3. What distinctive attributes of Toyota's management may have contributed to its quality problems?
4. What external factors may have contributed to Toyota's quality problems?
5. What are the differences between a stakeholder-centred board and a stockholder-centred board?
6. Why were stakeholder-centered boards in Japan incorporating features of the Anglo-American boards from the mid-1990s?
7. Discuss the pros and cons of insider-dominated and outsider-dominated boards.
8. Can an informal outside advisory board perform as effectively as formal outside directors? Why or why not?
9. Are outsider-dominated boards better-equipped to handle a crisis and why?
10. Did Toyota's board members perform their duty of oversight during its recall crisis?
11. Did Toyota's board members perform their statutory role in the execution of appropriate control during its recall crisis?

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