People matters

Accounting for culture in mergers and acquisitions

Baker & McKenzie

The FUTURE OF WORK series
Business Transformations Report

People matters

The missing link

For the past 20 years, the number of mergers and acquisitions worldwide has been rising as companies find them a fast, easy way to expand into new markets, obtain new products, access new customers, realize synergies and acquire new talent and technology. M&A activity took a steep dive during the global economic crisis, but has rebounded in the past few years, bringing deal teams back to the table.

Yet study after study shows that these transactions have a failure rate of 50 to 85 percent, depending on which research you rely on. A recent study by KPMG found that 83 percent of mergers failed to boost shareholder value while another study by McKinsey & Company determined that 61 percent of acquisitions did not earn a sufficient return on the company's investment.

Whether a company is pursuing a merger or acquisition to increase revenue growth, gain market share, boost productivity or reduce costs, the research is showing these deals often don't meet their objectives. Not only do many of these transactions fail to meet financial goals, but they can also lead to loss of key talent, customer attrition, systems integration problems, negative publicity and loss of credibility with shareholders after a series of transactions fail to achieve their projected benefits.

"As many acquirers discover to their and their stockholders' dismay, the ability to buy may have nothing at all to do with the capacity to own," wrote McKinsey consultants Clay Deutsch and Andy West in their 2010 report on M&A trends.

Business analysts have identified a host of reasons for these failures, from negotiation mistakes and unrealistic expectations to lack of planning and CEO egos. But the two obstacles that come up again and again are differences in organizational culture and difficulties with human capital integration. In other words, people.

"It's extremely important to not just go out into the marketplace with lots of cash but to pay attention to what you're buying from an HR perspective," says Christine O'Brien, an employment partner based in Baker & McKenzie's London office. "One of the most important parts of these deals is the people part and that's the one that's often left behind."

Leaving the people part until after the transaction closes can undermine the very purpose of the deal: to acquire new talent, an increasing driver of many mergers and acquisitions. By not taking into account the cultural differences between the two organizations early in the process, companies risk employees walking out the door because they don't like the new environment, such as a management style that may be more bureaucratic or regimented than they're used to. They may also be discouraged by changes to their compensation structures, benefit packages or perks they enjoyed under their previous employer.

"Human capital is critical for the success or failure of a business," says Guenther Heckelmann, an employment partner based in Baker & McKenzie's Frankfurt office. "If you don't get the key people at the acquired company on board, there is a high likelihood that you will not achieve your goals. But if they are on board, it's much more likely that the transaction will be successful."

Short-term tools like non-compete agreements and stay-on bonuses may provide temporary relief in preventing employees from leaving. Over the long-term, however, these short-term tools are of little value because once the timeframes provided by these tools run out, people will still leave if the culture doesn't fit them.

Five questions to ask yourself before an acquisition

1. Do you have sufficient management capacity to take on the integration process or are you already stretching to run the business?

2. Have you thoroughly assessed the culture of your target acquisition and is it compatible with your company's culture?

3. Is the deal in line with your corporate strategy?

4. Is the deal priced so you can afford to pour adequate resources into the integration and still have a return on investment that passes the hurdle rate?

5. Is the acquisition, along with all the associated costs and risks, a better choice than all other alternatives?

Source: Forbes magazine

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Guenther Heckelmann
Employment Partner
Baker & McKenzie

Are we compatible?

Deal activity is largely driven by a company's business development team, along with senior management and the legal department. Once they select a target and determine the business case looks promising, they will often move straight into due diligence, bringing in the lawyers, accountants and bankers to start working on the deal terms. The focus is often on market considerations, financial calculations and cost-savings opportunities without much input from HR consultants or labor and employment legal advisors.

As the deal gains momentum, assessing issues like the organizational culture of the target, labor relations, and how the workforces will be integrated are often not part of the equation, leading to compatibility problems later that erode the deal value. In a 2010 McKinsey study on M&A opportunities and challenges, 92 percent of the business executives surveyed said their past mergers would have "substantially benefited from greater cultural understanding prior to the merger." The mistake that many companies make is failing to look at the people issues early with enough depth to make better informed decisions.

"You don't start assessing culture after you have decided to do the deal, you need to do it at the front end during origination," said Paula Larson, chief human resources officer at Newell Rubbermaid, during a business transformations panel discussion at Baker & McKenzie's Global Employer Forum.

So what is organizational culture and how do you assess it? Culture is more than a code of conduct or mission statement. It boils down to "the way we do things around here," Paula Larson says. That encompasses everything from management styles and how organizational systems are set up to the company's sense of time, such as whether meetings start on time, how quickly decisions are made and how fast implementation happens.

Culture is also reflected in whether the workforce is union or non-union and what types of employment policies a company has in place, such as equal opportunity or anti-harassment policies and procedures—and whether they enforce them. It may be apparent from reward strategies, such as the balance between individual or team achievement, and the approach to issuing equity-related benefits. Even the smallest things such as a company's dress code and whether employees can bring their dogs to work can be important.

"These things matter because they matter to the employees that you are relying on to deliver the acquisition's value," says Monica Kurnatowska, an employment partner based in Baker & McKenzie's London office. "How will they integrate into your organization? And will they still feel engaged and motivated in an environment that because of its size, may become more rule bound?"

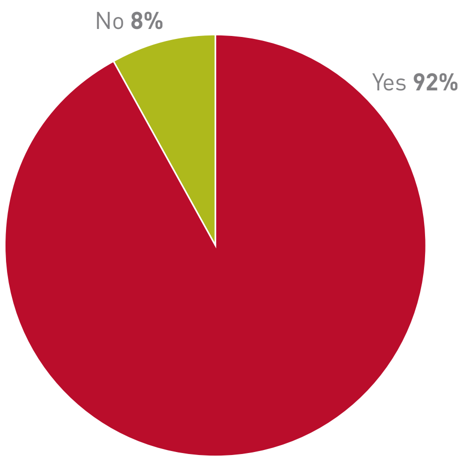
The purpose of paying attention to the softer, squishier issues like organizational culture and factoring them into the decision of whether to proceed with a transaction is to determine your compatibility level and identify where the gaps are. It will provide a better idea of the challenges you will face during the integration process and whether those differences are surmountable.

"It's understanding if their culture can coexist within your organization," said Dan Meade, vice president of total rewards at Hewlett-Packard, during a business transformations panel discussion at Baker & McKenzie's Global Employer Forum. "Particularly if you're considering acquiring an entrepreneurial shop or think tank, you may not want to impose your culture. You may want to maintain the freedom of thought to get the real value out of that transaction."

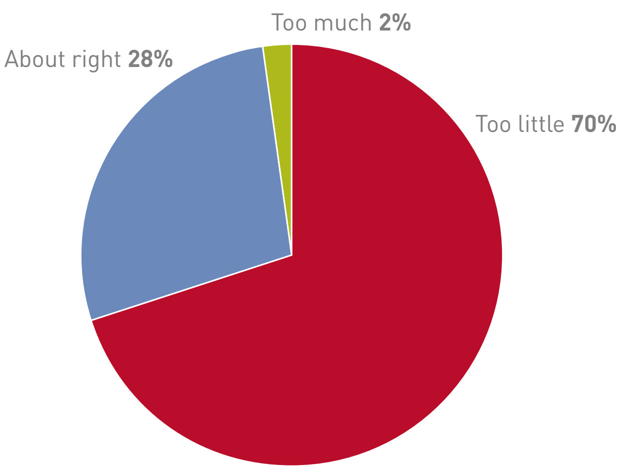
> "Some companies have walked away from deals because they realized the cultural compatibility was so poor that it would have been a money pit."
>
> **Paula Larson**
> Chief Human Resources Officer
> Newell Rubbermaid

Need for more attention to culture

Would your past mergers have substantially benefited from greater cultural understanding prior to the merger?



In your experience, how much effort is typically focused on culture during integrations?



Source: 2010 McKinsey & Company Report: Perspectives on Merger Integration

Hurdles to success

When developing an integration plan that accounts for issues like culture and human resources, it's important to be aware of key factors that could keep you from reaching your deal objectives. Knowing what the most common stumbling blocks are can increase your chances of success by allowing you to plan and problem-solve from the outset.

Buy in: Having buy in from the target's leadership is crucial to making sure the integration goes smoothly and assuring business continuity after the transaction closes. To determine their level of buy in, start by assessing the leadership's motivation for doing the deal. Are they selling for a quick payout? Do they have a vision for how the company can transform into a larger operation? Do they plan to stay? Do they want to move on to another opportunity? Knowing what their intentions are can help you take appropriate action.

Talent retention: Losing key talent is one of the biggest reasons for deal failure. When looking at a target, it's important to assess who the key talent is, how specialized the workforce is, what opportunities they have outside the organization and how easily they could leave for another position. In some cases, the key talent will be senior executives or sales managers who hold the important customer relationships. In certain industries, such as life sciences or technology, key talent could include research and development team members. Those individuals may also be positively incentivized to leave by rich payouts under change in control agreements. A thorough assessment of the target's workforce will help you determine who you want to focus on retaining and what the barriers may be. That will guide you in developing strategies to help you do so, such as using retention benefits, earn-outs and non-compete agreements, as well as the softer side of engaging with the employee, offering reassurance if you can and sharing your vision for the business.

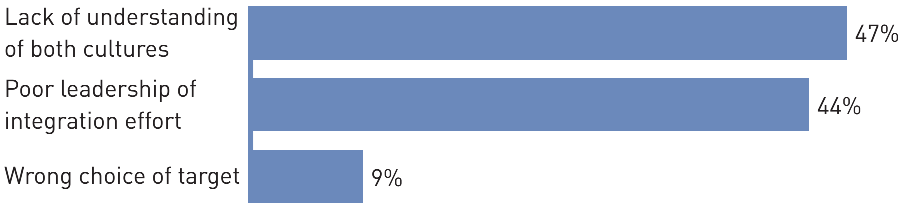
Deal heat: One of the biggest obstacles to proper integration planning is when the leadership gets their minds set on doing a certain deal. It's easy to get caught up in the deal-making frenzy and assume that everything will be in order with minimal investigation. Even when issues are brought to the leadership's attention, they think, "That's fine, we'll fix that later." But later they discover the problem can't be fixed or it's too expensive. Having a formal process for accessing a target's culture and focusing on post-acquisition integration planning during due diligence can really help keep deal heat from taking over.

Unions and works councils: Labor relations is an area often overlooked during M&A due diligence. Failing to take these issues into account can lead to major delays and even bigger headaches. In the early stages of deal consideration, it's important to assess what the target's relationship is with its unions and works councils and how that compares to how you relate to yours. Or maybe you don't have a unionized workforce and need to be educated on the types of requirements that entails, such as consultation with the works council at various stages of the acquisition. Buyers who are unaware of the strict consultation rules in Europe, for example, often underestimate how long it can take to close the deal because of various agreements they are required to reach with the local works councils.

Cost cutting: Another area where companies run into trouble is trying to achieve cost savings too soon after the deal closes. In their rush to capitalize on potential synergies within the merged organization, they may try to implement major layoffs or cut employee benefits in ways that may not be legal under local labor laws or meets fierce resistance from the union or works council. This problem often arises when the business development team has created a business plan that assumes a certain cost savings within the first year without consulting HR or outside legal advisors to determine whether the plan is realistic from a labor and employment perspective. "Many companies don't take time to plan for synergies and rush into it, which is a recipe for failure, particularly in Europe where unions and works councils can be very strong and make your life miserable," Frankfurt Employment Partner Guenther Heckelmann says. "Companies that try to achieve cost saving quickly without doing the proper planning are less likely to achieve what they want or to do so in a way that creates long-term damage to labor relations."

Cultural and leadership issues

When cultural differences create difficulties in a merger, what is to blame?



Source: 2010 McKinsey & Company Report: Perspectives on Merger Integration

Recommendations

Companies that are willing to spend the additional time and effort addressing organizational cultural disparities and thinking about how they will integrate employees prior to and during due diligence are more likely to achieve the types of growth and efficiencies they are seeking through mergers and acquisitions. With some forethought and planning, there are ways to avoid costly mistakes and retain the talent and other assets that made the target so attractive in the first place. Here are some recommendations to help you better achieve your deal objectives.

Involve your HR and labor and employment advisors early in the process.

Your level of employment due diligence will depend on whether you are looking for red flag issues or something more in depth, your budget versus deal value, the nature and size of the workforce and to what extent the deal value rests on the people. The more successful multinational companies have recognized the benefits of using HR and labor and employment advisors at the beginning of the process to assess cultural issues and plan for workforce integration. To evaluate cultural compatibility, these companies often hire HR consultants to interview senior executives to understand their business drivers, walk through the facilities to get a sense of how the company operates and take note of everything from the dress code to management's attitude toward the workforce. On the legal side, these companies use their employment counsel to assess the labor relations implications and develop a post-acquisition integration plan that accounts for workforce issues like how they will retain key talent, what they want the employee terms and conditions to be, where they want to locate employees and whether they will need to downsize the workforce. Developing this plan during due diligence helps identify major employment issues early, develop strategies to overcome them and determine whether your business plan and timeframes are realistic given the requirements and restrictions of local labor laws. In some cases, this exercise could make you realize the transaction isn't worth doing because it would be too difficult to overcome cultural differences or integrate the workforce.

Create a cross-disciplinary integration team during the due diligence phase.

One of the biggest problems in deal making is the disconnect between the acquisition and the integration. The best approach, depending on the size and geographic scope of the deal, is to create a cross-functional integration team at the outset comprised of experts from various specialties—such as human resources, legal, tax, finance, IT, real estate and operations—so they are working together to consider all of the issues. A best practice, for example, is to create a corporate development team that includes HR integration experts. "They should be involved at the earliest stages of deal planning to help the business people think about the people strategy," said Fred Green, a former senior attorney of employment law at Microsoft who is now in-house at Walmart, during a business transformations panel discussion at Baker & McKenzie's Global Employer Forum.

Talk to each other.

The reason having a multidisciplinary team is important is because so many integration issues are interrelated. To avoid having subject matter experts developing plans that might not be workable in the context of another, the various experts need to be consulting with each other. If, for example, the tax advisors have developed a scheme that involves transferring employees to another jurisdiction or the real estate advisors plan to terminate a lease on a major facility, they should be conferring with HR and employment counsel to determine how it would affect plans for integrating the workforce.

Have a dedicated integration manager.

An effective way to make sure that important issues don't fall through the cracks and that the subject matter experts are talking to each other is to select a dedicated integration manager. The integration manager would be responsible for bringing all of the work streams together and serving as the project manager and troubleshooter who leads the buyer and target through the entire integration process. The deal leader isn't necessarily going to be the best integration manager, as they are often preoccupied with the details of the transaction, so it's a good idea to select someone else with the time and bandwidth to focus their attention on the integration process. The integration manager could be someone from business development, human resources or operations who is a good informal leader. "This is a great stretch assignment for key talent, especially if they haven't had cross-functional experience," HR Expert Paula Larson says.

Tread lightly on the issue of redundancies.

One of workers' greatest fears after the announcement of a merger or acquisition is losing their jobs. Often it is the case that workforce integrations will involve downsizing employees on certain teams or in certain locations because of redundancies within the merged workforce. At the early stages of deal planning, it's typically not appropriate to tell employees about plans to downsize until you have worked out the details on timing and who will be impacted, as well as consulted with the works council if that's a requirement. In cases where you can make assurances to the workforce about the security of their jobs, be sure to do so to minimize unnecessary anxiety and disruption. It's important not to make promises you can't keep, so in the end it's about striking the right balance.

> "HR integration managers should be involved at the earliest stages of deal planning to help the business people think about the people's strategy."

Fred Green
Former Senior Attorney of Employment Law
Microsoft

Critical factors for post-acquisition integration success

1 Management commitment

2 Dedicated integration manager

3 Cross functional participation (HR, legal, payroll, benefits, tax, finance, treasury, facilities, IT, etc.)

4 Support and resources

5 Focused plan

Communicate with employees early.

Studies have shown that mergers and acquisitions cause great anxiety among employees in both the buyer and target organizations, leading to a 25 percent drop in productivity during the transition. More and more, companies are calling on their legal counsel to advise them on how to minimize disruptions and move through the integration phase as quickly as possible. "People become unsure, insecure and they don't know what's happening," London Employment Partner Christine O'Brien says. "The rumor mill starts running fast." A major component of reassuring workers is communication. As soon as the buyer can, given the constraints of confidentiality, it should start making the employees in the target organization feel comfortable with the acquisition. Companies often do this through all-staff Town Hall meetings, webcasts and roadshows that include presentations by senior business leaders from the buyer and the target organizations explaining the reasons for the acquisition, a brief history of the buyer, growth projections for the merged organization and significant dates and targets. When planning these communications, it's important to consider how the target has traditionally communicated with its workforce and adapt accordingly. It's also critical to factor in consultation with works councils in places like Europe. In most cases, the Town Hall would trigger the requirement to start consulting with the works council and it's important not to share information with the workforce that you haven't discussed yet with the works council.

Continue the conversation.

Often you won't have worked out all the details of the integration by the first Town Hall meeting, so it's important to tell employees what you do know, what you don't know, and when you will let them know, and continue the conversation through email updates and additional staff meetings. In Europe, where it may be mandatory to consult with works councils at various stages of the deal planning, these conversations could be legally required. Even if there is no legal requirement to consult at an early stage, it can be helpful to your long-term relationship with the unions or works council to do so. In the rest of the world, it's up to you to develop a communications plan that will keep employees informed and feeling comfortable. It can be helpful to use outside council to draft your scripts for Town Hall meetings and employee updates together with your communications department. It's also important to have senior leadership involved in the communication because it demonstrates their commitment to the workforce. "You can't just hold a Town Hall and think the job is done," London Employment Partner Monica Kurnatowska says. "The most important communication is often the one-to-one discussions between the employees and their managers, so it's worth paying attention to the junior managers to ensure they feel equipped to handle those conversations positively." In all of your employee communications, it's crucial to make sure your words match your actions, as key talent often stays on to see how the integration plays out before deciding to leave because of what they perceive as misleading information and broken promises.

Make sure your non-compete agreements are enforceable.

Since talent retention is a major concern in mergers and acquisitions, it's important to review whether the senior executives at the target company have post-termination clauses in their employment contracts that prevent them from competing with the company for a certain number of years upon leaving. Employee contracts may include non-compete agreements, but if they are poorly drafted, they are unenforceable. If these agreements are not up to standards, it's advisable to revise them as part of their incentive packages, the terms of which will vary depending on whether the buyer wants the company founder or senior executives of the target to stay on after the deal closes. It's also important to note that certain jurisdictions, such as Russia, do not recognize non-competes at all, whereas others like France and Germany may extract a high price for enforcement. In those cases, your other retention strategies are even more important.

Beware the entrepreneur.

In deals where a large multinational is acquiring a smaller entrepreneurial business, be ready for challenges because the cultures, based on size alone, are probably much different. Entrepreneurs who stay on after the acquisition often find they don't have the same level of autonomy, that decisions move more slowly and that there are more restrictions on what they can and cannot do, even at the world's most innovative multinationals. When integrating entrepreneurs into the workforce, it's already at high risk of failing, and if they are also the sellers and receiving substantial deal consideration, they have less financial incentive to stay. That's why it's important to be honest with them about your company's culture at the deal stage, so that everyone understands the issues and challenges. You also want to take precautions in case the relationship does not work out, such as negotiating retention packages and having them sign non-compete agreements.

Dig deeper in emerging markets.

When legal counsel is reviewing employment policies and procedures in emerging markets, they often find that the target company's HR policies and protocols don't have the same level of sophistication or documentation as those in developing markets. These companies may lack important things like anti-harassment or equal opportunities policies, in which case it's important to question them further on how much employment litigation they've had in recent years and what types of claims and grievances employees have filed to get a clear picture of how well they manage their workforce. If you notice they also lack protections like anti-bribery policies and systems and controls for monitoring things like the expense accounts of senior sales managers, it's a good idea to consult with legal counsel who specialize in conducting "integrity due diligence" to investigate senior management and determine whether the company is sustained by a high level of corruption.

Set the stage for a smooth handoff.

Once the integration team is ready to hand off the new workforce to the regular HR team to manage, it's important that the integration team fully brief the HR department on the history of the deal and any special arrangements that have been negotiated with the leaders of the target company. Because the integration team has the institutional knowledge of these types of conditions and all the pertinent documentation, this can help avoid disputes and misunderstandings that arise years after the deal has closed and the integration team has disbanded. Without a strong handoff, much of their knowledge will be lost in the shuffle. It's also a good idea for the HR team of the acquiring company to connect with the target organization's HR team early in the process and sustain that relationship well beyond the acquisition because they will be a good resource for knowing which employee issues may become major obstacles in the future.

How do you know your deal was a success?

1. Financial results
2. Synergies realized
3. Employee engagement and low attrition
4. Customer measurement
5. Execution against project plan
6. Strength of relationships
7. Market perception

The way forward

Business consultant Peter Drucker, widely considered the "man who invented management," once said, "culture eats strategy for breakfast." It's an adage often repeated by leaders at some of the world's largest multinationals, including Ford Motor Company and Merck, acknowledging that even the best sales tactics, tax schemes or expansion plans will fail if the company culture doesn't support them. In a speech to MBA students at Harvard Business School, Former IBM CEO Louis Gerstner, who is credited with saving the tech giant from bankruptcy in the 1990s, admitted, "The thing I have learned at IBM is that culture is everything."

The impact that culture has on a company's ability to deliver results is something that more and more executives are beginning to recognize, particularly in light of research showing that failing to account for differences in organization culture is one of the biggest reasons for deal failure. As companies continue to pursue mergers and acquisitions to keep pace with the global nature of today's business, it's more important than ever that they assess these issues early and tap the right HR and legal advisors to help them determine the best path towards workforce integration. The time to do so is not after the target has been formally selected and vetted, but during the initial consideration. Companies that invest upfront time and energy in post-acquisition planning and consider people a major factor in that equation are much more likely to achieve their business objectives and pave the way for executing their corporate strategy towards a stronger economic future.

Ten tips for avoiding employment pitfalls in M&A deals

1 **CONDUCT** a thorough due diligence that includes a review of change in control agreements, restrictive covenants and employment-related IP provisions.

2 **INVOLVE** HR, employment, benefit and equities lawyers in the deal negotiations. Don't assume that these issues will simply "fall into place later."

3 **AVOID** the fait accompli in press announcements.

4 **ANALYZE** and prepare for how employees will transfer, such as automatic transfer vs. termination and hire jurisdiction vs. assumption of contracts.

5 **REVIEW** the underlying benefit plans and build in time for benefit transfers.

6 **PLAN** workforce integration carefully. Watch out for "early transfers" of employees and co-employment risks, changes in reporting structures, benefits, email addresses, etc.

7 **UNDERSTAND** the limitations on redundancies and the specific protections related to business transfers.

8 **CONSIDER** whether to harmonize employment terms and conditions, and potential limitations on the ability to change, consent requirements and possible severance obligations.

9 **DETERMINE** whether there are any immigration issues, such as visas, work permits and sponsorship that may need to be transferred or re-applied for.

10 **ASSESS** the limitations of non-compete agreements, which are not enforceable in certain jurisdictions, and consider alternatives.

CULTURE

Innovation is fundamentally social.

Malcolm Gladwell
Author

If you do not manage culture, it manages you.

Edgar Schein
MIT business professor

Culture is everything.

Louis Gerstner
Former CEO of IBM

To win in the marketplace, you must first win in the workplace.

Doug Conant
Former CEO of Campbell's Soup

No company can win over the long run without employees who believe in the mission.

Jack Welch
Former CEO of GE

Culture eats strategy for breakfast.

Peter Drucker
Business consultant

Small groups of people can have a really huge impact.

Larry Page
Co-founder of Google

The Future of Work Series

The Future of Work is a series of client reports based on panel discussions at our Global Employer Forum, a two-day thought leadership conference we first hosted in September 2013. During the forum, nearly 70 clients, academics and consultants gather with our employment partners to discuss pressing workplace topics like talent shortages, data privacy, global mobility assignments, globalization of unions and managing the employment aspects of M&A deals.

Rather than the traditional "how to" legal format of most law firm conferences, the Global Employer Forum features panel discussions of in-house counsel and senior-level executives from some of the world's largest multinational organizations who discuss their personal experiences addressing these challenges and the solutions they have found to overcome them.

Based on the hottest topics arising out of those panel discussions, we create these reports to share the current trends on these issues, insights from members of major multinational organizations, academia and government agencies on how they are navigating these trends, and the legal expertise of our lawyers who are on the front lines advising clients on the shifting employment landscape. We hope you find these reports helpful in meeting the new challenges of managing a modern workforce.

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About Baker & McKenzie's Employment Law Practice

Our Global Employment Practice includes more than 500 locally qualified practitioners in 47 countries. We have more lawyers with mastery of the subtle intricacies of labor, employment, immigration and benefits issues in more jurisdictions around the world than any other leading law firm. Chambers Global 2014 ranks both our Global Employment and Global Immigration practices as Tier 1. Baker & McKenzie is recognized by PLC Which lawyer? Labour and Employee Benefits Super League 2012, as the top global law firm with our Global Employment practice ranked in 25 countries, and we are among the 10 firms US general counsel list most often as "go-to" advisors on employment matters.

If you have any questions about this report or would like to know more about the Global Employment Practice, contact:

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