In Practice

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Advice for Effective Board Mergers

The board may be least effective post-deal, at the very time when its oversight may be most important.

By Johanne Bouchard and Ken Smith

SambaTech has just acquired HipGen (names disguised). The deal closed with the premise that four longtime members of HipGen's board, including its CEO, would join SambaTech's six-member board.

The two CEOs know each other from the negotiations. The chair of SambaTech knows one of the four HipGen board members from prior business. Otherwise, the members of SambaTech don't know these new directors, except through their CVs.

The first board meeting is held shortly after the deal is closed. The board has an intense agenda, with a number of important decisions to make, including approval of the new combined operating budget and initiating the oversight of post-deal implementation.

So 10 high achievers are gathering for the first time to make important decisions that directly affect each other's former companies and the future of the merged entity. Many of them don't know each other. There is no assurance that the new directors are aligned with the merger, let alone the implementation plans and associated budget and staff cuts. The SambaTech onboarding program is planned but hasn't happened yet. The board composition and roles have changed significantly. The board climate will be tentative at best, but possibly hostile. The board dynamics are anybody's guess. What could possibly go wrong?

This is not an uncommon situation. According to a study by Kevin W. McLaughlin and Chinmoy Ghosh of the University of Connecticut, among the mergers of Fortune 500 companies, about one-third of target directors are retained. While in most cases attention is paid to the integration of the companies, there is seldom much done to ensure the effective integration of the boards.

As a result, the board may be least effective at the very time when its oversight may be most important. Directors are well aware of the high failure rates of mergers, often blamed on poor post-deal implementation. It is usually in this period that the value promised in the deal proposal is actually created (or not), and that the success (or failure) of the deal is thereby determined for shareholders.

Notwithstanding the board's own integration

challenges, it is difficult enough for directors to play an effective oversight role in post-deal implementation. Most directors will have limited visibility into the combined assets and post-deal implementation activities. This is further encumbered when some of the most knowledgeable directors of the acquired company are lost upon the close of the deal, either because the board was not structured to accommodate them or because they chose not to stay on.

Furthermore, when some of the directors of the acquired company are retained, integration of the new board is often left to chance. At best, directors will be a bit starry-eyed—relieved to be through the intense period of deal oversight, most likely meeting each other for the first time, possibly undertaking unfamiliar committee roles, and having to agree on a new or altered strategy. At worst, the post-deal board can be dysfunctional, perhaps due to lingering resentments from the deal process, a less than ideal board composition due to poor fit of skills or personalities, or simply a lack of attention to the post-deal integration of the boards.

Representative Scenarios

The challenges and solutions for the merged board vary based on the nature of the transaction. Here we consider four representative transaction scenarios:

Scenario 1 The merger of similarly sized, healthy, public companies, with the goal being to create a differentiated new enterprise with superior competitive positioning. It is a "friendly" deal in that both companies share the vision and agree on the goal of the merger. The larger of the two is designated as the buyer and the smaller as the target (e.g., mergers of competitors in an industry that is consolidating).

Scenario 2 A public company acquires a smaller, healthy, private company. The goal of the buyer is to add a new competitive capability or product range. This is most likely one of a series of acquisitions. The acquired company intends to accelerate growth with the additional capital and market scope of the buyer. For the founding shareholders, this capital is also part of their exit strategy. Such deals are common in the high-tech sector.

Scenario 3 A public company acquires a smaller, healthy, public company. Similar to Scenario 2, the goal of the buyer is to add a new competitive capability or product range. The target was competitive in its own right and had not been seeking a buyer. The premium paid, however, ultimately convinced the board of the value of merger (e.g., an acquisition that began with an unsolicited or "hostile" takeover offer).

Scenario 4 A public company acquires a troubled company, public or private. The goal of the buyer is to add a new competitive capability or product range, and to turn around the performance of the target. The acquired company may or may not have been seeking a buyer but certainly needs help to get back on track (e.g., a target company that has become subscale and/or is in the vicinity of bankruptcy).

For each factor—board composition, roles and dynamics, and post-deal oversight imperatives—Scenario 1 is treated as the general case and then the differences for the other scenarios are noted.

Board Composition

Among the various studies of post-deal boards, there are some interesting findings on board composition. Among large mergers 34 percent of inside directors and 29 percent of outside directors of the target are retained, according to McLaughlin and Ghosh's study.

In addition, some 83 percent of directors are retained from the bidder. The boards are often enlarged, and some bidder directors are dismissed to accommodate the addition of target directors.

Not surprisingly, fewer directors are retained from (proportionately) smaller targets.

The reasons for retention vary. Local regulators sometimes impose retention of local board seats; for example, the retention of Canadian board seats was a condition of Canada's approval of the sale of Nexen Energy to Chinese oil giant CNOOC. Board seats may be a matter of a merger negotiation to protect the interests of the target company, or may be included at the insistence of major block holders. Finally, it may be of recognized value to the company to retain the best directors from both boards and to have directors with knowledge of both enterprises at the new board table.

For public companies, these initial appointments are ultimately open to replacement by shareholder election, but the board composition upon deal close is as negotiated and/or committed in the merger documents approved by the respective boards, shareholders, and regulators, as required.

The governance committee of the acquiring company, in consultation with the governance committee of the target and with both chairs and CEOs, should plan these appointments in advance of deal close to get the best board possible for the post-deal organization. Appointments should be based on a matrix of skills, modified to include skills and experience relevant to successful post-deal implementation. ***Can you tell us about that participation?***

The knowledge and experience of directors from both boards should be mapped against the following:

- Acquirer's industry or sector knowledge/experience.

- Target's industry or sector knowledge/experience, if different.
- Knowledge of the geographies of the combined operations.
- Familiarity with the business and organizational issues of the acquirer.
- Familiarity with the business and organizational issues of the target.
- Existing strategic alliances of the target or the acquirer currently involving board representation.
- Anticipated strategic challenges.
- M&A integration experience/expertise.
- The standard functional expertise required for key oversight responsibilities (i.e., strategy and risk) and committees (i.e., audit, nominating and governance, and compensation).
- Relevant leadership and governance experience.
- Diversity—this is an opportune time to consider objectives for experience, gender, and race.
- Independence.

The existing skills matrix of the buyer would be a place to start. In any case, this mapping will inform the choice of the directors from among the two boards. Any knowledge or skill gaps for which new directors should be recruited would also be exposed.

Finally, the preferences of directors and the potential for conflict or chemistry between directors will be a factor. Some directors, especially on the target side, will want to take the opportunity to exit the board. The two board chairs may reach an understanding of the post-merger board structure, informed by discussions with the members of their respective boards.

Alternatively, the governance committee or a third party can conduct interviews to complete the skills matrix, determine director preferences, consider the potential dynamics, and make a recommendation. In either case, the proposed board composition would ideally be part of the merger proposal put to shareholders and regulators for approval.

Differences Between Scenarios

All of the aforementioned applies in concept to board selection considerations in all scenarios, but implementation will vary among the scenarios.

In Scenario 1, the buyer should make room for several target directors, including independent directors. In some cases, the entire boards of both enterprises are retained, but this typically results in too large a board with many redundant skills. Best practice is to determine what skills and experiences are most needed from both companies, and to create room through a combination of director retirements and some limited expansion of the board.

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In Scenarios 2, 3, and 4, it is likely that fewer seats would be made available for the target directors on the buyer's board, say, three or fewer. More seats, however, may have been negotiated or may be required by regulators, as noted earlier.

In Scenario 2, the founder is often retained for his or her institutional memory and employee following, company morale, and corporate culture. The entrepreneurial founder, however, is seldom effective as a (non-CEO) manager within the larger enterprise, so a non-executive board position should be considered.

In Scenario 3, there is an added consideration of support for the deal—directors who have fought the deal to the end are less likely to agree to join or to be constructive in their oversight if they did join. In Scenario 4, one must carefully examine the competence of director candidates from the target and their complicity in the downfall of the company.

Roles and Dynamics

Approaching deal close or soon after, the board should: meet, get educated on the combined company and the key opportunities and challenges in the merger, establish committee roles, and begin to develop the relationships they will need with management and with each other to be effective. The appointments to board committees should also consider the knowledge of both the bidder and target organizations, as well as other factors in the board skills matrix. Onboarding sessions for the new members should be scheduled as soon as possible.

Whether the board composition changes as a result of the merger or acquisition, the board will benefit from holding a special session (or sometimes multiple sessions) to regroup and align before going into the first official board meeting. This session should be designed to:

- Introduce directors to each other and explore their respective backgrounds, including any new directors and those from the buyer and the target company's board.
- Meet the new leadership team and ensure that the executives meet their board members.
- "Level set" on the strategy, the goal of the merger, and the key components of value.
- Transfer knowledge, with a focus on matters most relevant to the deal. This may include discussions with key customers and/or business partners.
- Establish the chair's role.
- Last, but most important, begin to function as an effective board; that is, es-

tablish a board culture and dynamic that will draw from the skills and experience of all directors and reach well-considered decisions for the company.

It is often beneficial for such a session to be facilitated by a skilled third party that can ensure all voices are heard, that issues (stated and unstated) are tabled and addressed, and that any required follow-up is noted and agreed to. The social issues of personalities, board culture, and group dynamics are critically important, but difficult to see clearly from the inside. Holding one or more such sessions immediately post-closing can be extremely valuable. While this is a busy time for directors, with the pressures of finalizing the deal and launching post-deal implementation, early investment in board dynamics can result in better board effectiveness and save time in the future.

A similar session should be considered after the first few official board meetings, no later than at the end of the first year, to evaluate how the board has functioned. This session can be informed by a board effectiveness assessment that is conducted and analyzed in advance.

Differences in Scenarios

The challenges in board dynamics vary significantly between scenarios.

In Scenario 1, it is likely that the board has been enlarged and/or a significant number of new directors have joined the buyer's board, most from the target's board. The merger is a big project for the newly combined company, and the board will have an intense agenda with many decisions to make on organization and implementation issues.

The chair and CEO must be ready to effectively give an impartial voice to the new members—there cannot be a sense of "us" and "them" on the board. Though all board members may have indicated their support, it would be wrong to assume:

- That there are no misgivings, regrets, or reservations about the deal.
- That all feel comfortable with the chair and CEO's ability to effectively lead the larger board and the new company.
- That no one feels individually threatened with respect to their domain expertise.
- That there is mutual respect and complementary personalities.

Care in board composition and committee assignments can help. Nevertheless, the work to merge the boards, including the pre-meeting sessions, is critical to success in this scenario.

In Scenarios 2, 3, and 4, there are typically only three or fewer directors to integrate. As a result, the integration process may resemble any well-executed introduction of new directors to the buyer's board, but with the following exceptions:

- The former directors of the buyer need to show respect for the acquired company and value the new directors.
- If the former CEO of the target becomes a director (especially in Scenario 2, in which the CEO is the founder), the transition to a non-executive director is often a huge challenge. The former leader may not be effective or even constructive in letting go; other directors may harbor jealousy or question motives; the large holdings of the former leader (in a stock deal) and possible contingency arrangements may create a conflict or perceived conflict of interest.
- The transition of the acquired company to new management requires careful and sensitive oversight.

Again, care must be taken with the "soft" issues. Special board sessions to ensure such issues are brought to light and discussed may be critical to the ongoing effectiveness of the board. Even when no new directors are added (which is often the case in Scenario 4), the board will benefit from a session to regroup and align on some of the "hard" and "soft" issues to be tackled post-deal. Many boards surprise themselves with what they didn't know about each other—skills, experiences, aspirations, biases, etc.—until they put these things on the table in the context of a big challenge such as an acquisition.

Post-Deal Oversight Imperatives

It is usually helpful for the post-deal period to be separated into two broad phases: transition and value creation.

The purpose of the transition phase is to get to a functioning combined structure as quickly as possible. Directors have an oversight role in each of

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three key components of the transition phase:

- **Definition of the new (interim) organization structure and staffing:** Directors should be satisfied that the new structure is aligned with the deal logic and deploys the best talent from both organizations in key positions.
- **Joint (detailed) planning of the implementation of the deal logic:** Directors should review the adequacy of the plan, and be satisfied that management identified metrics and milestones of implementation that will be reported to the board.
- **Communications with all stakeholders:** Directors should be satisfied that all key stakeholders have been considered and that the communications plan supports the value in the deal and the reputation of the new company.

Following the transition phase, director oversight of post-deal implementation should continue until all aspects of the plan are implemented. Directors should focus on three key aspects:

- **Alignment with the deal logic:** Directors should track the metrics and milestones associated with deal implementation and satisfy themselves that post-deal cost reduction and revenue development are aligned with the deal logic, ambitious, well managed, and adequately resourced. Directors need to take the long view on shared value, encouraging transactions and post-deal actions that will create the most value as opposed to those that will create the most "sizzle."
- **Integration of organizations and corporate cultures:** Directors should be satisfied that the desired merged culture is defined and that culture change is being managed, not left to chance. The choices for organization structure and culture should be aligned with the overall strategy and facilitate the deal logic.
- **Project management of post-deal implementation:** As noted earlier, there should be reportable metrics and milestones relating to the post-deal plan. Post-deal implementation completion audits are a good practice and should be reported to the board. Such an audit is comprised of a brief report on each item/source of value identified in the deal proposal: Was it completed, and if not, why not? Did it get the expected results, and if not, why not? What are the lessons for the next deal?

The organization structure and culture should be aligned with the overall strategy and facilitate the deal logic.

Differences Between Scenarios

The above post-deal oversight priorities apply to all scenarios. The main differences between deals will be in the extent of integration required and the time it takes to complete the implementation of the deal logic.

For example, in the acquisition of a new product line or capability in Scenario 2 or 3, it may not be necessary or advisable to fully integrate the companies. It is often preferable to integrate only what is necessary to achieve the product-market synergies and to otherwise retain the culture of the acquired firm. In such deals it should take less time to complete the deal logic.

In the case of Scenario 4, it may be necessary to compress the post-deal time frame to "stop the bleeding."

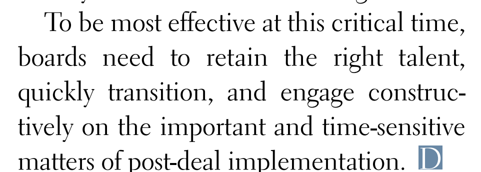
In all cases, directors need visibility on progress and issues and the board needs to be functioning at its best during this challenging, high-stakes period for the new company.

Success Breeds M&A

The development of an effective post-merger board is an important governance issue for any company active in M&A. First, M&A activity is again on the rise. Global industry restructuring continues to raise the bar on what constitutes competitive scale and scope. Technology advances continue to facilitate new business models while making others obsolete. These forces and others are driving industries to restructure, and most successful companies are active in M&A.

Second, there is a greater concern for good governance of M&A now than in previous M&A cycles. The many well-documented governance failures, from Enron to the financial crisis, have put greater focus on the role of the board in strategy in general. In particular, the high failure rates of M&A in previous cycles, as measured by shareholder returns, have directors paying more attention to M&A activity and their role in ensuring success.

To be most effective at this critical time, boards need to retain the right talent, quickly transition, and engage constructively on the important and time-sensitive matters of post-deal implementation.



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