Research Thesis – PhD in Management

MACQUARIE GRADUATE SCHOOL OF MANAGEMENT

CAVEAT EMPTOR: THE ACCOUNTABILITIES AND REQUIRED ACTIONS OF DIRECTORS IN SECURING VALUE WHEN MERGING OR ACQUIRING COMPANIES

OR LONG TITLE:

CAN A SET OF GOVERNANCE 'RIGHT PRACTICES' BE DISTILLED FROM LITERATURE AND THE VIEWS OF PRACTICING BOARD DIRECTORS REGARDING THE ACCOUNTABILITIES AND ACTIONS NECESSARY TO ACHIEVE RESPONSIBLE VALUE MANAGEMENT FOR SHAREHOLDERS DURING MERGERS AND ACQUISITIONS?

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Dedication and acknowledgments

This PhD represents the capstone of my experience in M&A transactions, which has always been my 'first love' in terms of management consulting engagements.

This PhD was, however, not entirely self-motivated.

I owe a huge debt to my mother, Marion Blomson, who initially instigated this idea, encouraged me to explore it and then gently but persistently nudged me to complete it when I could otherwise have stalled. Her proof-reading skills also made a difference in keeping me moving gradually towards my goal.

In greater and different measure, this work would not have been possible without the love and support of my exceptional wife Glynda, who has been unfailingly selfless and uncomplaining in allowing me to pursue this dream. The time and space to tackle this PhD would never have been possible without her generosity of spirit in giving me the latitude to pursue this goal over a protracted time.
I hope one day to be able to repay her in equal measure.

My children too have been patient and undemanding in supporting this endeavour and I hope that my commitment will inspire them to follow their dreams and to strive for excellence in their chosen fields.

The insights captured in the research in Chapter 6 came from busy non-executive directors who unfortunately cannot be named and who generously made themselves available to be interviewed and who provided years of condensed wisdom in the space of each interview. Additionally, chapters in the PhD have benefitted from the reviews of friends and associates including practising solicitors and barristers, current and lapsed academics and ex CEOs who were prepared to provide review inputs.

Lastly, my grateful thanks go to Professor Tyrone Carlin, an exceptional academic who despite the massive professional demands of his day job, made the time to provide the necessary direction and input in his own inimitable style – with articulate and always thought-provoking feedback. He has demonstrated consistently an enviable grasp of the subject and the ability to demand the necessary academic integrity in my work, whilst understanding that the approach adopted was at times a little more commercial and pragmatic than perhaps the norm.
Any shortcomings in this PhD are due to my oversights, not his advice.

Abstract

Mergers and acquisitions (M&A) are critical mechanisms for corporate growth and potentially for increased shareholder returns. The reality, however, often does not live up to the promise, as is borne out by empirical data on the high incidence rates of M&A under-performance.

At present in Australia, directors and executive management, particularly of the acquiring company, have considerable latitude to put at-risk shareholder value via M&A without any meaningful pre-event restraints or post-event sanctions (and with the benefit of the Business Judgment Rule defence).

The old adage *caveat emptor* ('let the buyer beware') still holds true for buyers, but when it comes to ensuring that shareholders' interests and capital are properly protected, there is little clarity on what are the acceptable 'checks and balances', key activities and behaviours of the directors of the acquiring company, that represent responsible standards of conduct. The initial question to be considered is whether there is a discernible set of 'right practices' that provide a reference set of benchmarks for non-executive directors to know whether they are exercising the necessary care, diligence and skill in selecting and overseeing transactions. Looking from the 'outside in', the corollary is 'How do shareholders in the acquiring company have some visibility and assurance that their executive management team and board are exercising (or have exercised) sufficient due diligence (in the broadest sense of the word)?'

The challenge thus arises as to how to describe the 'right practice' stewardship that should be exercised by 'reasonable directors' of the acquiring entity to manage the risks and performance of transactions – before, during and after acquisition. This thesis focuses on identifying and describing 'right governance' i.e. the required level and mix of actions and responsibilities of directors of the acquiring company, necessary for protecting the interests of their shareholders.

To carry out this research, and to shed light on these gaps in knowledge and required practices, the extant commercial, governance and legal literature relating to M&A practice has been studied; and has been juxtaposed with the opinions and experiences of a cross-section of non-executive directors and Chairmen, emerging from targeted interviews ('grounded research'). From these gaps has arisen an emergent theory regarding 'right practice'.

The emergent theory points to six key themes that those directors interviewed believe make a difference to deal performance: (1) the Board's degree of strategic thinking (*'Clear strategy upfront');* (2) planning and preparation (*'Early preparation and planning'*); (3) the extent of board members' cultural due-diligence ('*Proper understanding of culture*'); (4) robust business-case scrutiny and investment assessment ('*Rigorous testing of the investment business case and funding strategy*'); (5) their focus on tracking the delivery of the targeted benefits ('*Effective monitoring post transaction*'); and (6) the quality of their mutual challenge and critical debate ('*Well-chaired board with constructive challenge*').

These emergent board-level themes have been compared to the extant literature to examine whether similar learnings and congruent practices have been articulated or whether there are key gaps or contradictions between the emergent theory and the extant literature. In most cases there is

alignment, although the interviewed directors' views have crystallised what in the literature could best be described as 'un-consolidated ideas' based on 'an extrapolation of managerial practices', as the body of documented knowledge is generally not targeted at board members.

This process of comparison has indicated that these initial findings have merit and should be regarded as an emergent theory. Whilst still not a guarantee for success, these themes – once subjected to further testing and validation for relevance and impact – could help to crystallise standard board practices in a way that better meets M&A transaction demands and more effectively serves shareholder expectations in the 21^{st} century.

1. Introduction and outline of thesis structure

"Would you tell me, please, which way I ought to go from here?"

"That depends a good deal on where you want to get to."

[Source: Lewis Carroll, *Alice in Wonderland*, 1865]

"Begin at the beginning," the King said, very gravely, "and go on till you come to the end: then stop."

[Source: Lewis Carroll, *Alice in Wonderland*, 1865]

Key points

1) Mergers and acquisitions (M&A) are the lifeblood of corporate growth – ideally, a source of industry efficiency and rationalisation and a driver of economic competiveness.
2) Chapter 2 sets the scene and provides an orientation for the reader by exploring the track record of M&A results, which are generally poor. It shares some of the research, pointing to indifferent or adverse results and hypothesising why these results have occurred.
3) Chapter 3 then surveys the extant literature and discovers that whilst M&A activity is often complex with many moving parts, it is generally not unchartered territory – there is a readily accessible, plentiful supply of learning and documented practices as well as professional skills and advice available to management.
4) Despite what would appear to be abundant literature on the topic of M&A, the key question to be explored is whether the body of knowledge is sufficiently targeted at board practices i.e. directly relevant and able to guide directors to carry out their duties in an M&A process. This is explored in Chapter 3. As a consequence of the knowledge gaps that appear out of that review process, Chapter 4 posits the focusing question and sub-questions for the research will need to be, before describing the Research Approach in Chapter 5.
5) Putting aside what has been gained from exploring the extant literature, Chapter 6 analyses the results and considers what a sample of experienced executive and non-executive directors believe makes a real difference to board performance over the M&A lifecycle.
6) From this research, potential gaps and disconnects are explored between the extant literature and the experience of directors in what could be called 'right practice', so as to better describe the 'un-codified' body of practice that experienced directors would generally advocate as the sound M&A practices they should follow.
7) The process commences in this chapter, Chapter 1, by describing the journey of discovery in the chapters that follow.

1.1 Thesis structure

This introductory section, **Chapter 1** sets the scene for the research that follows. It outlines the general lay of the land and some of the exciting high points in the terrain at a high level. More importantly, this introductory chapter flags what will be dealt with where in this thesis. It also briefly describes the motivations of the author in examining the topic under consideration.

Chapter 2, Context for M&A Governance, outlines why M&A is so important to corporations and the economy and why there is a problem worthy of further investigation. It sets out some of the nomenclature and theory around M&A in order to achieve a consistency of understanding around the topic and attempts to quantify the size of the 'value dilution' or destruction problem. This chapter, therefore, aims to help readers to orientate themselves in the topic.

This is an important chapter to provide level-setting context for the less informed reader; but even for a practicing non-executive director, who would possibly claim to be well familiar with M&A, it is important to plant the seed that possibly directors are not as well-equipped for the task as they ought to be or that there could be significant variability of understanding around what could be considered to be 'right practice' by directors.

This chapter does not yet zero in on a specific topic or focusing question for the thesis – that it not its intention. The rationale for the thesis topic selected emerges from Chapter 3, the Literature Review.

Chapter 3, Literature Review, is an exploration of the body of published knowledge with regards to the duties and activities of the directors of the acquirer. This exploration investigates the extent to which board directors would be able, in effect, to 'self-educate' about their responsibilities during M&A transactions, through access to relevant literature. Essentially, the litmus test for the literature review would be: 'Is the literature sufficiently complete and relevant ('on topic') for an interested director to be able to inform themselves adequately as to their responsibilities and required activities during M&A?'

This chapter searches through commercial, legal and corporate governance writings and research for clues and guidance regarding directors' duties during M&A. This chapter develops a sense that there is a problem to be studied, refines a sense of what that problem might be (on the basis of appeals to the strengths, weaknesses, gaps and silences in the existing literature), and develops a justification for the focus on the chosen area.

The literature review aims to identify potential 'whitespace' (i.e. gaps in knowledge), disconnects in content, misalignments or contradictory advice which would create uncertainty in the minds of directors as to what they ought to do during transactions. One would expect that congruency and clarity between these three dimensions is important to encourage reasonably consistent activities, informed and effective actions by directors.

The literature review explores the extent to which current researchers, practitioners[1] and theorists, have isolated what it is that boards ought to do during transactions.

The literature review explores the role that boards of directors, particularly the chair and non-executive directors, ought to play in the process. It will show that there is a wealth of commercial literature available on sound M&A practices: M&A case studies and analysis, a wide variety of practitioners' guides and technical textbooks. It will also become apparent that the literature focuses almost exclusively on the necessary actions of practitioners (and to a much lesser degree, of executives) during transactions. Any activities by the board are at best only implicitly referenced.

Chapter 3 examines three interlocking aspects in the literature to see what clues and learnings these provide to directors as to what they should do during transactions:

- *Commercial writings on M&A and transaction management* – how professional practitioners describe the key tasks and 'mechanisms' necessary for ensuring, securing and extracting value from acquisitions.
- *Governance writings and practices* – to chart the landscape of requirements on how boards should operate and organise their functions; and codes of practice for boards of directors, especially if or where these pertain to the conducting of transactions.
- *Legislative requirements*, interpretations and common law precedent – to examine what level or standard of care the law requires with regards M&A activities by acquirers, particularly the duty of care of directors as described in the *Corporations Act 2001* (s. 180) and the response/interpretation by Common Law in Australia.

The chapter then considers whether the above-documented commercial, governance and/or legal dimensions are useful or deficient in providing guidance to Directors regarding sensible practices and accountabilities during M&A. Arising from the literature review, the focusing questions for the PhD can now be more precisely articulated and framed.

Chapter 4 draws together the primary conclusions from the literature review, and then crystallises and articulates the 'Research question and objectives'. In essence it argues that the gaps in chronicled M&A governance requires a specific focusing question to be examined with non-executive Directors.

Chapter 5 addresses the qualitative research approach and Grounded Theory methodology selected in interviewing a sample of directors to elicit their opinions and descriptions of 'right practice'. It sets out the process to be followed in gathering and interrogating the evidence drawn upon for the purposes of attempting to shed light on answers to the research questions – and justifies the applicability of the selected process. In doing so, there is a discussion of the pros and cons of a variety of some alternative methodological approaches before an outline of the rationale for selecting the preferred option as being optimal in the circumstances.

[1] Practitioners include a wide spectrum of those involved in M&A practice, whether in-house strategy and deal advisory teams (incl. finance executives and corporate counsel roles), external M&A strategy practitioners, investment bankers and deal architects, management consultants and legal advisory firms.

Having picked carefully through the extant literature for clues and guidance, it is now time to seek the expertise of a sample of directors who are interviewed to ascertain their perspectives.

Chapter 6 covers ‘Results and Analysis’ by detailing the outcomes of the field research undertaken through the interviews of non-executive directors. This chapter involves ‘taking the temperature’ of directors’ stated views in relation to their responsibilities – via a set of essentially exploratory questions. These are nonetheless important as a temperature check – especially given the prognostications of a large volume of literature explored in Chapter 3.

Therefore Chapter 6 examines whether, in board practice, there is a clear set of essential commercial practices and accepted governance arrangements that the ‘acquiring Directors’ claim to adopt typically or turn to for guidance. From this has flowed an Emergent Theory via the use of a Grounded Research approach which allows the data to speak for itself, unclouded by the opinions of the researcher. Through this process, a set of six key themes emerges that describe what directors generally do (or more correctly, believe they ought to do).

Key non-executive director interviews indicated clear views about the need for a clear M&A strategy upfront; the importance of early preparation and planning; proper understanding of the target company’s culture and degree of cultural and strategic fit as part of the due diligence; rigorous testing of the investment business case and funding strategy; the need for regular control points post transaction; and the importance of having a well-chaired board where constructive challenge is nurtured.

Thus the second part of this Chapter 6 interrogates the differences (and similarities) between the prognostications of the extant literature and the views expressed by the directors in the research sample. It considers whether this reveals any patterns which could cause concern or are worthy of further investigation. This second part relates to gaps or incongruities which might exist (e.g. areas evident from the interviews but not within the extant literature) – and the consequences of this for the existing literature – and of course for practice.

Finally **Chapter 7** covers ‘Conclusions and Emergence of a New Theory’. This last chapter summarises the conclusions drawn from interviews and literature on the implications for directors of the acquirer based on their access to published sources of knowledge about transaction management. From this consideration arises an emergent theory that describes what directors ought to do to, from a governance perspective, to improve the likelihood of success of transactions.

The journey therefore will take the reader through: the broad theory and practice of M&A (answering the questions ‘Why is this important issue and what typically goes wrong?’); the literature to see what guidance can be found as to ‘right practice’ for directors of the acquirer; an articulation of the focusing questions and the research approach selected; and then into the minds of experienced non-executive directors who describe the key things they pay attention to and how they believe directors should act in carrying out their responsibilities.

1.2 Summarising the focus of the research study

The short thesis title is: '*Caveat Emptor* (buyer beware): The accountabilities and required actions of directors in securing value when merging or acquiring companies.' The choice of topic, and the thinking behind its selection, will be gradually explained and expanded across Chapters 2, 3 and 4.

As denoted by the words 'acquiring companies', the study approaches M&A 'governance' activities from the perspective of the shareholders in the acquiring company.

The alternative long title provides some clarity: **'Can a set of Merger and Acquisition governance 'right practices' be distilled from literature and the views of practicing board directors with regards the accountabilities and actions necessary as acquirers to achieve responsible value management for their shareholders during mergers and acquisitions?'**

The shorthand for 'mergers or acquisitions', 'M&A', should denote a 'combining' of two or more companies in a transaction as a result of which there is a legally recognised transfer of control in exchange for value. The definition of 'M&A' is expanded on below. The study does therefore not include alliances or joint ventures for example, which are other types of corporate 'combinations'.

The reference to 'M&A governance right practices' signals that the intention is to ascertain which practices by boards (and more particularly non-executive directors) in pre-deal and post-deal stages are followed and advocated as important to improve value protection and creation. These insights will be sought via a review of documented and accepted ('proven') commercial practices on the one hand, and via direct interviews with a sample set of seasoned directors on the other. As will be expanded on in due course, namely in Chapter 5, the interviews achieved exposure to a select group of directors sitting on the boards of major Australian enterprises; and followed a semi-structured approach to understand their views on 'right practice'. The study is qualitative rather than normative in nature i.e. it does not seek to prove empirically which activities tend to make the most difference. In following a Grounded Theory approach, and in order to generate an Emergent Theory, all prior experience and judgments have been suspended to allow the data to speak for itself.

As indicated, the thesis focuses on the actions or omissions of directors, particularly non-executives of the acquiring company during significant transactions particularly acquisitions (i.e. not joint ventures or other forms of inter-organisational collaboration or combination).

Although it is not explicitly stated elsewhere, generally the duties and actions explored are those of non-executive directors of listed public companies, rather than of private companies or state-owned enterprises.

Whilst the research topic will be gradually crystallised and revealed in the chapters that follow, the intention is to explore M&A transaction governance matters with a view to understanding what directors ought to do. The resulting research could potentially be read from two perspectives: from that of board members wanting to know what to do, or what to do better; and from that of investors wishing to know what they should expect directors to be doing.

Put differently, this study should provide a crystallisation of research and practical experience – achieved in part through a 'gaps analysis': gaps in the literature, gaps in the research based body of knowledge, analysis of relevant M&A results pointing to performance gaps; gaps between the directors' views themselves; and gaps between theory and practice.

It was hoped that documented and proven commercial practices will be sufficiently clear from literature research to provide clear and consistent guidance to directors, but where such guidance was lacking, the anticipation was that any gaps will be addressed via the opinions of seasoned directors, so as to form the foundation for effective transaction governance by a board. Whilst guidance was sought from a mix of proven and reasonably contemporary literature sources, the interviewed directors' views should represent a 'state of the art' analysis of what practices should be followed. Through the process of comparison, it was hoped that a congruent, clear and convergent set of views, from literature and interviews, will be chronicled, so as to provide guidance as to what 'right practices' should be adopted, practically and sensibly, by boards to protect and deliver shareholder value from a transaction.

1.3 Establishing a lexicon for base understanding – defining terms

Before we start looking in depth into transaction success and failure rates, it is appropriate to define our terms i.e. what we mean by 'mergers and acquisitions'. Investopedia's short form definition is:

> "A general term used to refer to the consolidation of companies. A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed."[2]

A longer-form definition from the *Financial Times*' lexicon is:

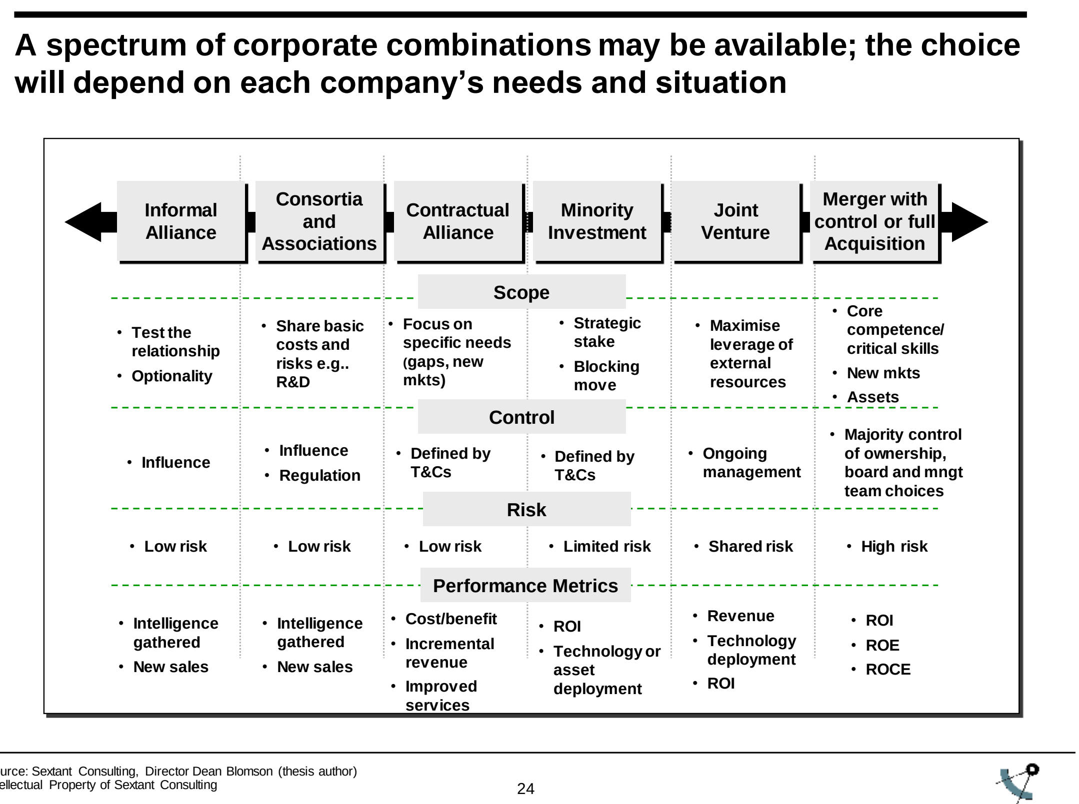
> "M&A is a common short term for mergers and acquisitions, grouping the two concepts as a single area of interest. Whether some combinations are structured as a merger or acquisition depends not only on the underlying business transaction, but also on other legal, taxation and psychological implications. An acquisition may or may not lead to a merger, from a strategic and investment banking point of view the two concepts require a similar expertise and process. M&A activity contributes to the consolidation or rationalisation in a particular sector or industry but may be subject to antitrust concerns."[3]

The comment "An acquisition may or may not lead to a merger" is a reference to the nature of the consolidation or integration activity that the new management team may decide to undertake i.e. having acquired the target enterprise, management may decide to combine, or not to combine, certain assets like factories or call centres or product lines, or to consolidate or leave independent back office operations, or to move to common systems, platforms, processes, etc.

[2] http://www.investopedia.com/terms/m/mergersandacquisitions.asp
[3] http://lexicon.ft.com/Term?term=mergers-and-acquisitions

The thesis title indicates a focus on mergers and acquisitions which are one variant of a broader spectrum of ‘corporate combinations’, ranging from profit-sharing alliances through joint ventures to complete control buyouts. Risks and consequently returns are usually more amplified to the right-hand side of the spectrum, as indicated in Figure 1, as these combinations not only include an exchange of value but also a ceding of control and are largely irreversible.

<u>Figure 1: Spectrum of corporate combinations</u>



Source: Sextant Consulting, Director Dean Blomson (thesis author)

For the purposes of this thesis, the reader should interpret ‘M&A’ to mean acquisitive transactions (or capital commitments) at the far right of the spectrum – and usually larger, more significant acquisitions at that. In other words, the focus is on transactions where there is a change in control, not mergers where control (in theory anyway) may be shared.

Additionally, there is no such thing as a ‘standard transaction’ as there are many variables that come into play which cause each merger or acquisition to be unique, such as: company size and composition, business model (how the company makes money) and operating model (how the company organises itself – process, systems, structures). In addition, a range of other factors can and do vary widely from deal to deal including: market dynamics, transaction / deal structure, competitive responses and market reaction to bids, etc. In practical terms therefore there is no such thing as a ‘one-size-fits-all’ approach to undertaking a transaction across all of its phases.

What are the bookends that define the starting point and the ending point of a typical transaction process?

The thesis explores board involvement across all the different stages of the full M&A lifecycle – not just the deal stage. These stages may be called the 'four Ts':

1) Targeting (including development of the M&A intent and strategy)
2) The Transaction (the deal)
3) The post deal phase of Transition (or first 100–180 days); and beyond that to
4) The Transformation of the combined enterprise.

A transaction is not over when the deal is done. Practice shows that the real work for the executive team is only just beginning at this point. Thus it is important to see how:

- the board's support and involvement may vary across these stages of the lifecycle
- board members perceive their roles and involvements to be different at each major stage.

It often takes three, four or more years to be able to say with justification whether a major acquisition was successful or not, as will be seen in Chapter 2 which deals with some longitudinal studies. It is important not to underestimate the importance of understanding how boards ought to be involved and what the key focus should be across these four stages.

This research focuses on the board's involvement in deals that proceed through to completion, rather than on those transactions that the board determines not to proceed with. Some views have, however, been documented as to when and how an effective board should determine to say 'no'.

Lastly, in various sections of the thesis, reference is made to 'value loss'. This is a shorthand, umbrella term that could be used interchangeably in the literature with words commonly used like 'value destruction', 'value erosion' or 'value seepage'. In essence, all of these terms denote the costs – direct or indirect – of deals that underperform in some shape or form.

1.4 Aims and objectives in selecting the thesis topic

In commencing this journey it will soon become apparent to the reader that significant literature points to the fact that acquisition transactions are frequently 'losing events' for the shareholders of acquiring companies, due to 'value destruction'.

According to Bain, "a commonly accepted benchmark of a successful merger is one that generates an *excess return* of 10 per cent or more… Seventy per cent of all deals fail to meet even this modest target." (Harding and Rovit 2004)

Failed deals result in significant impacts on shareholders and staff. It is in no one's interests – neither the shareholders of the acquirer, or the board and executive management, or the wider market – for there to be such a high incidence of these disappointing events. Disgruntled shareholders would be entitled to ask themselves: how could the board have allowed this to happen on their watch? What were they doing or thinking? Or what were they not doing or not thinking?

Given that M&A is a critical mechanism to accelerate the growth of enterprises, this research will attempt to uncover and clarify what the directors of acquisitive boards believe they ought to do, practically speaking, in exercising effective stewardship over transactions. This aspect of governance goes to the heart of shareholder value creation and directorial duties.

Without pre-determining the outcome of this journey, the key motivations in undertaking this thesis were to:

5) Improve the level of successful outcomes from transaction activities for shareholders who generally deserve better from their directors and management.
6) Raise the levels of awareness and debate about what boards of directors can and ought to do during transactions.
7) Catalyse action amongst boards of directors primarily; but also to do the same for executive management, M&A practitioners and specialist advisers, industry and regulatory bodies (legislators and the legal community) specialising in takeovers and company law.
8) By so doing, improve safeguards for the investing public, whether via improved transparency or legal recourse.

As an end-product, the thesis should provide a set of observations and high-level recommendations for consideration by boards themselves so as to start to 'lift the performance bar' and to protect their shareholders, first and foremost, from unnecessary value destruction; and themselves from disgrace and embarrassment and more particularly from culpability.

It is also hoped that 'involved and interested' authorities[4] will benefit, through a better understanding of what needs to be done in pragmatic terms to help to address any key gaps or deficiencies in common, current M&A practices and remedies.

Therefore, by exploring this topic, this thesis aims to generate an emergent theory using a Grounded Theory research approach about what boards (and particularly non-executive directors) ought to do that will make a difference to more successful outcomes. Whilst this research will of course not result in a codified recipe or formulaic approach for boards to adopt, it does aim to present a clear, or clearer set of actions, activities and behaviours for boards to consider following.

The emergence of a set of views or nascent theory should not only advance the art and science of 'director practice' and governance, but may hopefully contribute to greater awareness and action by corporates, regulators and other influential bodies.

[4] Regulators and financial markets' authorities, industry lobby groups, professional associations, and possibly legislators.

2. Context for governance of mergers and acquisitions

“It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

[Source: Warren Buffet, Letter to shareholders, 1989]

“Rule No. 1: never lose money; rule No. 2: don't forget rule No. 1"

[Source: *The Tao of Warren Buffett*, 2007]

“Theorem 1 says that whichever projects the firm ends up selecting (optimally) will turn out to have been valued optimistically, on average.”

[Source: Compte, O., Prediction errors and the winner’s curse, ENPC[5] working paper, September 2004]

Key points

1) M&A is the lifeblood of corporate growth; ideally, a source of industry efficiency and rationalisation, and a driver of economic competiveness.

2) The track record of M&A results is, however, generally poor – and there is good deal of research pointing to indifferent or adverse results and hypothesising why these results may have occurred.

3) Whilst M&A activity is often complex with many moving parts, it is generally not unchartered territory – there is a readily accessible, plentiful supply of learnings, and documented practices as well as professional skills and advice available to boards and management.

4) Directors and management have a duty of care to their shareholders – and having access to advice and experience they should be able to ‘get it right’ far more often.

5) Thus there are two questions to be asked and answered: firstly, why this is the case and whether the causes of failure can be traced back to things directors did or didn’t do; and secondly whether there ought to be practical, effective steps that directors – executive and non-executive – ought to adopt that should lower the risk of value destruction and improve the chances of value creation.

The preceding chapter, Chapter 1, was intended as ‘an aid to navigation’ in outlining the structure of this PhD research document by describing which topics are located where and describing how it would peel away the ‘layers of the onion’. Chapter 1 also outlined the broad intent in looking more closely at the topic of ‘M&A governance’ and in doing so set the scene for this chapter, which

[5] ENPC: École Nationale des Ponts et Chaussées.

expands on why there should be concern about the track record of mergers and acquisitions and potentially directors' governance of these.

Chapter 3, therefore, develops a sense of the scale of the M&A value dilution phenomenon and informs the reader about some of the terminology associated with M&A practices.

We now turn our attention to understanding why the broad topic relating to the governance of M&A is particularly relevant.

Acquisitions remain common occurrences despite widely reported evidence that the majority are unsuccessful (e.g., Datta, Narayanan & Pinches 1992; Haleblian, Devers et al. 2009; Jensen & Ruback 1983; Sirower 1997). This suggests a sizable disconnect between the expectations that motivate management and board to undertake acquisitions and the apparent challenges in delivering and realising value post-transaction. These challenges will be unpacked and considered in this chapter as they form the important context for trying to assess what directors can do to 'improve the odds' of value protection or value creation.

There are many well-documented case studies that help to contextualise the relevance of M&A governance – and why boards should be particularly vigilant. Section 2.1 presents a powerful illustration of the problem.

2.1 Typifying the problem with an example

One particular undocumented case study amply illustrates the failures of M&A processes. To improve its rigour and consistency when undertaking transactions, a major Australian enterprise called in external assistance to help with the design of an end-to-end M&A process and capability 'compendium'. The resulting compendium (called an 'M&A toolkit'), described M&A processes, tools and templates, checklists and structural arrangements including roles and responsibilities.

The 'M&A toolkit' concept had been initiated by a concerned senior executive. The client was a blue-chip household name on the ASX – and was a 'serial acquirer' at this point, which coincided with the peak of the 'dotcom' boom in 2002. The sponsoring executive intended to achieve greater efficiency and consistency in M&A activities, as well as to safeguard the enterprise against reckless behaviours, as there was evidence that transactions were being pursued in a somewhat random way.

Subsequently, the same enterprise made a scale-defining acquisition at the height of the dotcom boom. The acquisition, for several billion dollars US, was reported widely in the press. The executive team of the acquirer brought additional outside expertise after the deal was concluded, to provide an independent view of the sources (and quantum) of value in the deal and potential risks to these value sources. The review team found that the financial models used internally and by the advising investment bankers had poorly-documented and fundamentally flawed assumptions and suffered from significant over-optimism; and did not recognise the observable realities on the ground regarding internet infrastructural capacity build-out and pricing implications.

The acquisition came at a huge cost: not only had the board and executive considerably overpaid against a more objective, realistic view of the sources of value, but they had bought at the peak of the market. The new owner's share price took a pounding and massive write-downs followed over a period of months and years; and ultimately the business ignominiously exited one of the acquisitions. The investment bank kept its fees and management and directors kept their jobs, at least immediately after the aftermath. The chairman and a few key directors' subsequently resigned, over a period of two to three years, but there was never any explicit connections made in market communications as to their involvements in the value dilution that had taken place.

How could the leadership of this respected enterprise have got it so wrong? After all this was a sector they knew well (at least in Australia); they had their top executives working on this and had two of the best big brand investment banks and legal firms on their team. And why was it that the executives only commenced stress testing the synergies and value sources after they had formally committed to the transaction? Why initiate and conduct an independent strategic/commercial due diligence at that point, when this was not a hostile takeover?

In this case, the deal advisers had played a significant role in not doing their homework well and potentially in unduly promoting the deal, although that would be impossible to prove. If one dug deeper, however, it was apparent that management and the board viewed this as a 'strategic deal' i.e. a deal that had to be done to support their offshore growth aspirations. Too often, a 'strategic deal' is one where the business case cannot provide clear evidence of why to proceed; the 'strategic' moniker becomes a smokescreen in the absence of tangible benefits that can be argued for or against.

If this were an isolated example of a board's failure to exercise proper stewardship over a transaction then it could be dismissed as an interesting but not widespread occurrence. Sadly research indicates that this is an all-too-frequent event.

2.2 Understanding the size and impact of the M&A value erosion problem – the 'burning platform'

The first question to be addressed is: Is M&A governance a problem worthy of study? The second question is: Why should we care?

As to the first question, there are a range of studies using different methodologies that examine the impacts of acquisition activities on M&A success rates. The popular headlines, broadly speaking, are that three-quarters of mergers and acquisitions do not perform well (relative to earning their cost of capital). If one digs beneath the headline surface, however, there are other patterns to the results, which indicate that the failure (or under-performance) rates are not as clear-cut as they may first appear.

Research from a variety of commercial sources indicates that many transactions underperform in some shape or form – often dramatically so. There have been a number of studies into this phenomenon.

KPMG studied the success rate of the 700 most expensive international deals from 1996–98[6]. Examining *shareholder returns* one year after deal announcement against the overall trend in the relevant industry segment, they found that 83 per cent of mergers failed to unlock value for the shareholders of the acquirer.

Two of the most commonly quoted statistics comes from a 1998 study by Mark Sirower in the US indicating that:

1) 77 per cent of acquisitions do not earn or exceed their cost of capital.
2) On average the acquirer's stock trailed the S&P 500 by 8.6 per cent one year after the deal announcement. (Sirower 2000)

Significant literature has pointed to acquisition transactions as frequently being losing events for the shareholders of acquiring companies due to value destruction. According to Bain and Company (Harding) at pg. 6, for example "A commonly accepted benchmark of a successful merger is one that generates an *excess return* of 10 per cent or more… Seventy per cent of all deals fail to meet even this modest target."

According to Richard Dobbs, Bill Huyett, and Tim Koller (Dobbs et al. 2010):

> "Acquisitions are both an important source of growth for companies and an important element of a dynamic economy. Acquisitions that put companies in the hands of better owners or managers or that reduce excess capacity typically create substantial value both for the economy as a whole and for investors."

Dobbs et al. continue:

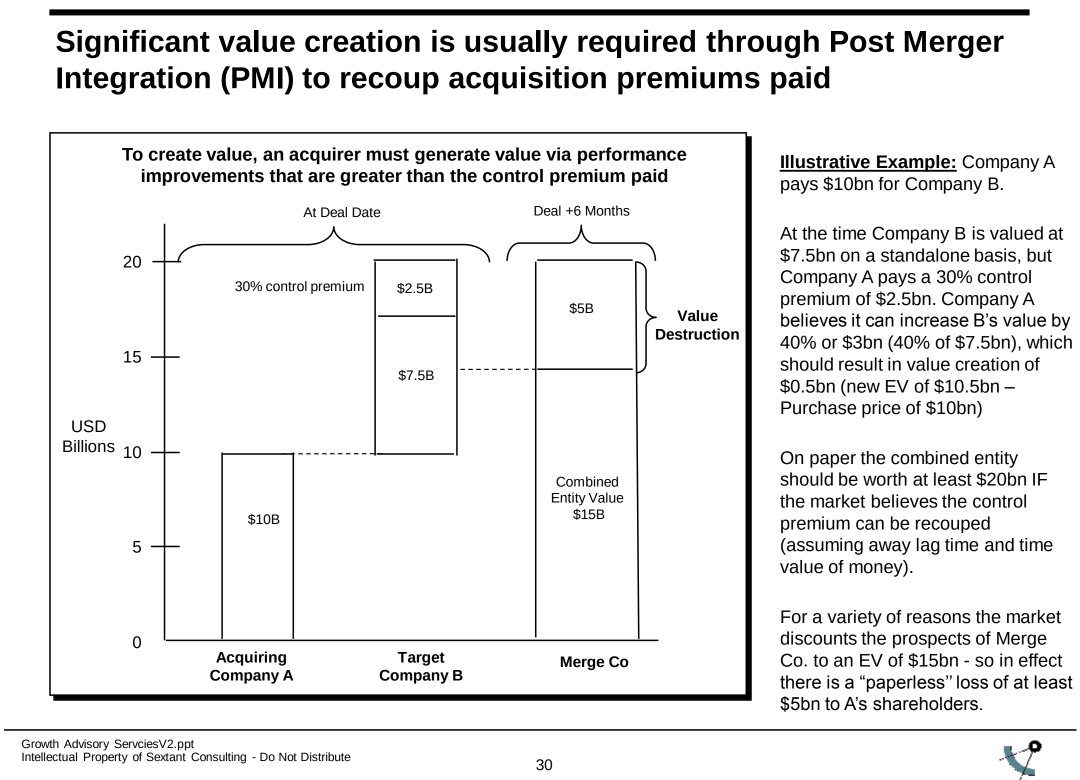
> "You can see this effect in the increased combined cash flows of the many companies involved in acquisitions. But although they create value overall, the distribution of that value tends to be lopsided, accruing primarily to the selling companies' shareholders. In fact, most empirical research shows that just half of the acquiring companies create value for their own shareholders."
>
> "The conservation-of-value principle is an excellent reality check for executives who want to make sure their acquisitions create value for their shareholders. The principle reminds us that acquisitions create value when the cash flows of the combined companies are greater than they would otherwise have been. Some of that value will accrue to the acquirer's shareholders if it doesn't pay too much for the acquisition."(Dobbs et al. 2010)

Figure 2 outlines how the value transfer and value dilution process operates. Assume Company A is worth $10 billion and buys Company B for $10 billion – a transaction that includes a 30 per cent premium over B's market value of $7.5 billion. Let's say that Company A expects to increase the

[6] "Unlocking Shareholder Value: The Keys to Success", *KPMG M&A Global Research Report*, Nov. 1999; cited also in http://www.riskworld.com/PressRel/1999/PR99a214.htm

value of Company B by 40 per cent through various operating improvements, so the value of Company B to Company A is $10.5 billion (40 per cent improvement on $7.5 billion is $3 billion). Subtracting the purchase price of $10 billion from $10.5 billion should provide $500 million of value creation for Company A's shareholders – **in theory.**

Figure 2: Value transfer and value dilution processes



Source: Sextant Consulting, Director Dean Blomson (thesis author)

As Dobbs et al. have claimed,

> "...when the stand-alone value of the target equals the market value, the acquirer creates value for its shareholders only when the value of improvements is greater than the premium paid. With this in mind, it is easy to see why most of the value creation from acquisitions goes to the sellers' shareholders: if a company pays a 30 per cent premium, it must increase the target's value by at least 30 per cent to create any value." (Dobbs et al 2010)

Additionally, previous research tells us that "Acquiring-firm shareholders on average earn about 4 per cent in hostile takeovers and roughly zero in mergers, although these returns seem to have declined from past levels." (Jensen 1987).

Predicting performance from takeovers – whether by scrip, cash or a combination – is not straightforward. There are a range of potential success drivers including from management skills and behaviours, target attractiveness and competitive responses. In addition, structural issues also play a role. For example:

> "Horizontal mergers (where cash or debt is the form of payment) within declining industries will tend to create value because they facilitate exit: the cash or debt payments to shareholders of the target firm cause resources to leave the industry directly. Mergers outside the industry are more likely to have low or even negative returns because managers are likely to know less about managing such firms." (Jensen 1987)

The second question, to be addressed as a corollary, is: 'Why should we care?' Put more gently, the real question is: 'How much of an economic impact are M&A failures in Australia? Is this really a significant economic issue for local shareholders?'

McKinsey[7] indicates that: "Empirical studies examining the reaction of capital markets to M&A announcements find that the value-weighted average deal lowers the acquirer's stock price between 1 and 3 per cent"[8]. Stock price impacts can amount to a paper loss (if the shareholders don't 'vote with their feet' by selling their shares and thus monetising the loss) or may be an unrealised temporary opportunity cost, especially if the stock recovers. What cannot be recovered are write-downs, or of course acquirers that end up going insolvent because of their failed acquisitions.

There is reasonably accurate, regularly published data available on announced and completed large public company deals in particular, provided by Thomson Reuters. Forming a view on the potential of each transaction for value creation versus value dilution, before the transaction takes place, is a different exercise entirely.

According to Thomson Reuters:

> "Ending five consecutive years of M&A growth, the volume of worldwide mergers and acquisitions totalled US$2.9 trillion in announced deals during 2008, a decrease of 29.6 per cent from 2007 totals and the lowest level for annual deal activity since 2005… Highlighting the difficult deal-making environment was a spike in the number of withdrawn M&A transactions, which hit an all-time record in 2008. There were 1194 worldwide M&A transactions that were cancelled during the year, the highest level since 2000."

Table 1 overleaf indicates deal activity during 2008.

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[7] McKinsey "*Valuation: Measuring and Managing the Value of Companies*", by Tim Koller, Marc Goedhart and David Wessels, 4th Ed at pg. 439

[8] McKinsey quote research by SB Moeller, FP Schlingemann and RM Stulz, "Do Shareholders of Acquiring Firms Gain from Acquisitions?" (*NBER working paper no. W9523*, Ohio State University, 2003)

Table 1: Announced and completed M&A deals in Australia for 2008 (source: Thomson Reuters)[9]

Announced

Period 1/1/2008 – 31/12/2008		Prior period 1/1/2007 – 31/12/2007		Percentage Change in Value
Val US$ million	**No. Deals**	**Val US$ million**	**No. Deals**	
104,287.3	1,852	136,457.3	2,389	2,389

Completed

Period 1/1/2008 – 31/12/2008		Prior period 1/1/2007 – 31/12/2007		Percentage Change in Value
Val US$ million	**No. Deals**	**Val US$ million**	**No. Deals**	
96,151.3	1,386	154,003.7	1,734	–37.6

Notes:

9) Total value of completed M&A activity in 2008 was US$96 billion in Australia – and excluded the value of announced deals (US$104 billion for that year) – the completed section of Table 1 includes deals that were completed in the current year and announced in the same year or in previous years.

10) Australia had several mega deals that were completed from 2007, such as Coles/Wesfarmers (US$15.7 billion), Alinta / Babcock & Brown (US$11 billion), Crown spinoff (US$8.6 billion), Cemex's acquisition of Rinker for AU$17 billion etc.

11) Additionally, in 2008 we had a number of other massive deals completed: St George Bank / Westpac Banking Corp (US$17.9 billion); Origin Energy – Coal Steam Gas Assets / ConocoPhillips (US$7.9 billion); Zinifex / Oxiana (US$3.8 billion).

Having close to US$100 billion of deals completed in 2008 – a turbulent year by any measure – indicates the existence of a significant marketplace. Not surprisingly, with the value and volume of deals made every year, there is a need to manage this marketplace and its key protagonists, carefully. Hence the mandates of ASIC (The Australian Securities and Investments Commission[10]), ASX (the Australian Securities Exchange[11]), ACCC (the Australian Competition

[9] Thomson Reuters Fourth Quarter 2008 Financial Advisors Mergers & Acquisitions Review at pg. 3
[10] ASIC – http://www.asic.gov.au/asic/asic.nsf
[11] ASX – http://www.asx.com.au/

and Consumer Commission[12]) and the FIRB (Foreign Investment Review Board[13]) to provide deal review and oversight mechanisms.

Fast-forward to 2013 and according to Clayton Utz's 2014 M&A Deal Trends and Developments report, "….public M&A activity in the Australian market plunge to levels not seen for a decade. There were only 21 announced deals with transaction values over $50 million. This is a 49% decrease from 2012 and a 64% decrease from 2011. This level of activity has not been seen since 2002." [14]

Clayton Utz identify uncertainty as the main reason for the lack of activity: "…uncertainty about the Australian economy, as it suffered the impact of the downturn in the resources sector; uncertainty about global markets as the US contemplated scaling back quantitative easing; and uncertainty about the political environment with the leadership instability of the Labor Government and the 9 month long election campaign. All of these uncertainties meant confidence in Australian boardrooms was low and the appetite for risk in terms of acquisitions was minimal. We also saw greatly reduced appetite for acquisitions from offshore investors, due to many of the same factors, as well as their own local issues, such as the leadership transition in China.

The low number of deals in 2013 is only part of the story. Average deal value in 2013 was $658 million, slightly up on 2012, but given the small number of deals, the total value of M&A activity fell dramatically. At $13.80 billion, it was 30% lower than 2012 and 73% lower than 2011."

	2010	2011	2012	2013
Total deal value	$63.72bn	$52.21bn	$19.25bn	$13.83bn
Average deal size	$1355.68m	$900.1m	$506.52m	$658.54m

Source: Clayton Utz 2014

Given the inevitable swings and roundabouts in M&A activity, the real question to be asked, however, is not 'How active is the M&A marketplace?' but 'How effective it is at creating value?' In other words, given the quantum of completed deal value, are the net contributions to the shareholders of the acquiring companies on balance, superior to 'standalone', organic growth returns?

To have any reliable understanding of the effectiveness or otherwise of each transaction, so as to prove convincingly where or why a deal was value creating or destroying, would be a massively complex task. Conclusions commonly found in literature and practitioner studies point to the need to have the following data points to develop a more reliable view of value creation potential:

- value of control premium paid per deal
- purchase price in excess of net asset value (NAV)

[12] ACCC – http://www.accc.gov.au/content/index.phtml/itemId/142
[13] FIRB – http://www.firb.gov.au/content/default.asp
[14] https://www.claytonutz.com/docs/REAL_DEAL_2014_Edition.pdf

- where purchase price was paid wholly or largely in stock, what the underlying NAV per share of the purchaser was
- value of warranties subsequently disputed
- value of goodwill per deal residing on company balance sheets
- level of write-offs incurred per transaction in year one, year two
- share price of the acquirer relative to its peer group at key periods before the transaction and then 12 months and 24 months after completion date
- the combined market cap[15] of the merged entity post deal relative to that of the two contributing entities, at key points pre-deal and post-deal via longitudinal studies
- amounts paid to advisers (lawyers, accountants, investment bankers, consultants)
- new entity establishment costs (once-offs), restructuring costs and redundancy payments and integration specific costs, versus
- actual synergies created (once-off and enduring), impacting on P&L and balance sheet
- the value of 'dis-synergies' such as lost customers, lost opportunities, management distraction, etc.

The above data points, if available, would enable an analyst to understand net value created post-deal (synergies achieved are always a murky issue), relative to purchase price and other deal costs, post deal implementation costs, once-off costs, non-financial versus accounting costs, etc. These are important factors to determine the true economic cost of, or value created by, each specific transaction; but to obtain this data for one company, let alone many, is a non-trivial exercise and well beyond the scope and focus of this PhD.

Aside from the direct losses associated with over-paying for a company relative to the value at stake, practitioner-oriented studies point to various kinds of other direct and hidden costs that cause direct loss for shareholders, such as:

- financial duress through over-gearing the balance sheet (especially at a time when debt becomes expensive)
- reputational damage
- reduced total shareholder returns (via dividend duress and market cap shrinkage)
- loss of momentum on other internal operational improvements needed in the business
- opportunity costs on organic growth opportunities
- distracting and over-stretching managerial and other resources.

[15] 'Market cap' is the current trading value of all company stocks/equity i.e. the total number of issued shares multiplied by current share price.

Australia has not been short of large value destroying transactions over the period 2008 to 2013. CSR, Suncorp, Babcock and Brown, QBE and Newcrest Mining were a few acquirers who did not adequately heed the words '*caveat emptor'* ('buyer beware'). These are described briefly below:

CSR purchase of Viridian

In just one transaction in 2008, namely the $1.2 billion Viridian glass acquisition by CSR, CSR has had to make two write-downs: AU$100 million in 2008 and another AU$250 million write-down in 2009.[16] Those write-downs equate to approximately 25 per cent of the original investment cost.

Suncorp acquisition of Promina

In another example, by early February 2009, the share market value of Suncorp was AU$7.2 billion. "That value means the bank has destroyed all the $7.9 billion it paid for Promina…."[17]. Or as the *Sydney Morning Herald* newspaper put it, on 6 February 2009[18], (the outgoing CEO who had just resigned) "Mr Mulcahy declined to take responsibility for Suncorp's dismal share price performance – it has fallen more than two-thirds from its peak. "I wouldn't think I have any regrets," he said.

"He believed the $7.9 billion acquisition of the insurer Promina in 2007 would one day prove its worth to shareholders. Yesterday Suncorp's market capitalisation was about $7 billion."

Babcock and Brown purchase of Alinta Gas

The *Australian Financial Review* reported on 18 August 2008 that, in relation to the Babcock and Brown Power purchase of Alinta Gas, "BBP said it would take a $410 million impairment charge associated with the Western Australian power utility Alinta Ltd, acquired by B&B and associated funds last year." [19]

The cited examples above are a sample of publicly documented M&A transactions that have under-performed. The consequences of ill-conceived or poorly executed mergers are potentially vast in terms of impacts on shareholders, stock-market confidence and employees. Shareholders in particular face real value diminution by incumbent management whether from ignorance, hubris, complacency, incompetence or recklessness.

QBE – multiple acquisitions

QBE, a serial acquirer has made 135 acquisitions in the past 30 years to expand to 48 countries and approximately 44 acquisitions valued at AU$7.61 billion since Frank O'Halloran became CEO in January 1998.

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[16] http://www.theaustralian.com.au/business/opinion/csrs-glacial-pace-to-demerger-250m-viridian-writedown/story-e6frg9io-1225791508475
[17] http://www.crikey.com.au/2009/02/05/suncorp-battens-down-the-hatches/
[18] http://www.smh.com.au/business/profit-slump-bad-debts-suncorp-in-the-shadows-20090205-7yyu.html
[19] http://news.smh.com.au/business/bb-power-book-writedowns-worth-452m-20080818-3xac.html

Nonetheless, as Australia's largest insurer by market value, QBE posted a 37 per cent fall in net income for the half year (i.e. in the six months) ended June 30 2013, which dropped to AU$477 million, as premiums fell in North America and it set aside more capital for unresolved claims. In the prior full year ending 31 December 2012, net income fell 45 per cent to AU$704 million for the 12 months, citing it as "one of the worst years on record for catastrophe events".

This culminated in Frank O'Halloran stepping down in 2013 as chief executive officer of QBE after overseeing a 13-year strategy of expanding through acquisitions, which faltered as a run of global catastrophes increased compensation payouts.

Whilst lauded for its acquisitions, those in the know have pointed to a vastly expanded global empire as making it far harder to develop a consistent approach to underwriting; and at the same time, its falling net income margins were reflecting a failure to generate efficiencies, caused by inability to integrate and streamline multiple acquisitions, which were in many cases treated more as bolt-ons.

Newcrest and Lihir Gold

Another cautionary tale belongs to Newcrest Mining:

> "The worst performer this year of Australia's 50 biggest publicly traded companies, has lost more than AU$20 billion in market value since Robinson became CEO in July 2011. The company has struggled as gold plunged from a record and it missed output targets."[20]

Newcrest, which is Australia's largest gold producer, named a new chief executive officer and new chairman in a boardroom cleanout after a AU$6.2 billion ($5.9 billion) write-down triggered a ASIC regulatory probe.

The outgoing chair and the CEO who was previously Newcrest's chief financial officer, "…had faced dissent from shareholders over the AU$9.7 billion acquisition of Lihir Gold Ltd. in 2010". According to an investment analyst: "It's a step in the right direction... There are so many things that need to change in this business, it's just one piece of the puzzle."

The same analyst asserted that "Newcrest has pretty much been on a downward path, coincidence or not, ever since that acquisition. The biggest mistake all managers make is capital allocation, and that's been true of Newcrest."

As at the end of December 2013, the market cap was AU$5.8 billion, less than the AU$9.7 billion it paid to acquire Lihir Gold Ltd. in 2010.

In addition to the acquisition, which threw up operational and production issues in its target, Lihir Gold, there has been a rapidly softening gold price. A related woe related to the timing and management of its announcement of its write-down, which became the subject of a disclosure inquiry by the Australian Securities and Investments Commission. Several major investment banks

[20] http://www.bloomberg.com/news/2013-10-08/newcrest-to-replace-ceo-chairman-after-writedowns-and-inquiry.html

had cut their ratings on Newcrest in the three days before its statement, prompting concern from ASIC. Newcrest has said an internal review found no evidence of any selective briefings.

Another analyst indicated that: “It’s a tightening up of corporate governance that we would be seeking.”

As the new chair put it: “In view of volatile market conditions, the board will continue to ensure the corporate strategy, asset portfolio, operating strategy and balance sheet remain appropriate, assessing all options to enhance shareholder value.”

The above examples represent losses in value reflected in a few high profile transactions featured in commercial literature. To provide further context into the financial consequences of M&A, attention now turns briefly to empirical research into the impacts of deal factors (deal structuring etc.). Note: qualitative and quantitative studies into the causes of poor performance are examined in greater depth in Chapter 3.

Quantifying the impacts of deal related factors affecting M&A performance

Evidence points to the value dilution effects growing as deal sizes have been increasing:

> “Acquiring-firm shareholders lost 12 cents around acquisition announcements per dollar spent on acquisitions for a total loss of $240 billion from 1998 through 2001, whereas they lost $7 billion in all of the 1980s, or 1.6 cents per dollar spent. The 1998 to 2001 aggregate dollar loss of acquiring-firm shareholders is so large because of a small number of acquisitions with negative synergy gains by firms with extremely high valuations. Without these acquisitions, the wealth of acquiring-firm shareholders would have increased. Firms that make these acquisitions with large dollar losses perform poorly afterward.” (Moeller, Schlingemann et al. 2005)
>
> “We find that from 1991 to 2001 (the 1990s), acquiring firms' shareholders lost an aggregate $216 billion, or more than 50 times the $4 billion they lost from 1980 to 1990 (the 1980s), yet firms spent just 6 times as much on acquisitions in the later period. We measure the dollar loss of acquiring-firm shareholders as the change in the acquiring firm's capitalization over the 3 days surrounding economically significant acquisition announcements (defined as transactions exceeding 1 per cent of the market value of the assets of the acquirer), which we call the acquisition dollar return, and sum these losses to get the aggregate loss.” (Moeller, Schlingemann et al. 2005).

Few observers of M&A activity would argue that the typical acquisition amounts to a planned as well as unplanned transfer of value to shareholders of the target company. There are a number of causal factors underlying the phenomenon being observed in value loss:

Firstly, the <u>form of the transaction payment</u> may play a role.

In most cases where a cash purchase is involved, the control premium or premium to valuation which goes to the target shareholders may typically range from 15–25 per cent and even higher in some deals[21] over the stock's pre-announcement market price (Gell 2008). This is in effect a value creation dividend going to the target's shareholders. Those shareholders that take the cash are able to walk away 'scot free'. If the merged company then subsequently underperforms, there is in effect a further unplanned value transfer from buyer to seller if it was a cash-based purchase (in whole or in part).

If, however, the acquisition takes the form of 100 per cent scrip, then the target's shareholders could suffer alongside the seller's shareholders if the post-merger value delivery does not take place according to plan. Those shareholders that opted to take the purchase price in scrip (in whole or in part) are in effect saddled with an underperforming asset.

Secondly, there is recognition of the effects of the 'control premium' paid.

Control premiums are often a significant 'value hole' over and above the estimated enterprise value (which could be based on an earnings multiple or the net asset or 'book' value). To the extent that the underlying value estimate is accurate, a control premium is often a planned transfer of value to the shareholders of the target company. The nature of control premiums was explained in Section 2.2 (Table 2).

The typical control premium paid means that the acquirer starts the post-deal value extraction and delivery task already considerably in the red. To reel in this opening deficit, arguably the executive directors and management need to be commensurately more creative, effective or assertive than the acquired or 'outgoing' management in operating the business; or should have significant access to synergies in the form of cost reduction and/or revenue enhancement and/or balance sheet performance; or they should have a significantly better access to other new opportunities for driving value creation, because of their improved scale.

Thirdly, short-term value is reduced by market perceptions (usually scepticism) about whether the acquirer will succeed in extracting the targeted value.

As a consequence of pressures on the P&L to deliver superior EBITDA[22] returns from the combined entity, market cap or enterprise value is also usually under significant pressure post deal. McKinsey[23] (Koller 2005) indicate that: "Empirical studies examining the reaction of capital markets to M&A announcements find that the value-weighted average deal lowers the acquirer's stock price between 1 and 3 per cent"[24].

McKinsey's research drew on a sample of 506 US and European transactions greater than $500 million between January 1996 and September 1998. Their "…analysis found that for half the deals

[21] *BCG* May 2008, "Return of The Strategist – Creating Value with M&A in Downturns" at pg. 18
[22] P&L refers to the Profit and Loss or Income Statement of the business; EBITDA is Earnings Before Tax Depreciation and Amortisation
[23] McKinsey at pg. 439
[24] McKinsey quote research by SB Moeller, FP Schlingemann and RM Stulz, "*Do Shareholders of Acquiring Firms Gain from Acquisitions?*" (*NBER working paper no. W9523*, Ohio State University, 2003)

with a statistically significant reaction in the capital markets[25], the acquirer's share price decreases in the 10-day window around the announcement of the transaction."[26]

Fourthly, <u>longer-term value creation, measured in terms of profits and cash flow, is deficient.</u>

Share performance following the transaction typically fared no better. This was not a short-term impact: a study by Mark Mitchell and Erik Stafford found that acquirers under-performed comparable companies by 5 per cent during the three years following the acquisitions.[27] Their study into the before and after deal stock price impacts corresponds with Sirower's estimates of the acquirer's stock trailing the S&P 500 by 8.6 per cent a year after the deal announcement.

In a comprehensive analysis Martynova and Renneboog found that:

> "Accounting studies examine the combined operating gains of takeovers. …14 out of 26 studies report a post-merger decline in the operating returns of merged firms (e.g. Ravenscraft and Scherer, 1987 D.J. Ravenscraft and F.M. Scherer, Mergers, *Sell-offs and Economic Efficiency*, The Brookings Institution, Washington, DC (1987), 7 papers show insignificant changes in profitability (e.g. Linn and Switzer, 2001), and 5 papers provide evidence of a significantly positive increase (e.g. Carline et al., 2002)." (Martynova 2008)

Martynova and Renneboog further found that:

> "The picture is even more blurred when post-merger corporate growth is investigated. Cosh et al. (1980) report a systematic improvement in the post-merger assets growth rate of UK companies that participated in M&As over the period 1967–69. For the period covering the third takeover wave, Mueller (1980) presents evidence of a significant decline in the growth rate of US merged companies. However, this conclusion is not upheld for the fourth takeover wave, as Ghosh (2001) finds no statistically significant changes in the growth rate of US merged companies in the 1980s. Similarly, analyses of Japanese and European M&A's reveal no significant changes in post-merger growth rates."

Martynova and Renneboog again:

> "Generally, studies showing a decline in post-merger profitability employ earnings-based measures, while studies showing merger gains are based on cash flow performance measures (Ravenscraft and Scherer, 1987) and employ both measures and demonstrate that the difference in benchmarks is responsible for these conflicting conclusions." (Martynova 2008)

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[25] 276 deals out of 506 had statistically significant positive or negative reactions of the buyer's share price. McKinsey, "*Valuation*", ibid at pg. 439

[26] McKinsey at pg. 439

[27] McKinsey, "*Valuation*", ibid at pg. 439 quoting the study by ML Mitchell and E. Stafford, "Managerial Decisions and Long-Term Stock Price Performance", *Journal of Business*, 73, (200): 287–329

Martynova and Renneboog then explore whether other factors may play a part in driving performance:

1) Gaining monopoly power: various studies have examined whether takeovers are associated with an increase in the monopoly power of the acquiring firm. Mueller (1985) states that the market share of the combined firm substantially decreases after the merger compared to a non-merging control group. This decrease is substantial for both vertical and horizontal mergers. In contrast, Gugler et al. (2003) interpret their findings of increasing profits and decreasing sales as evidence of market power expansion subsequent to the takeover. They show that this result is primarily driven by related horizontal takeovers.
2) Vertical versus horizontal acquisitions[28] and degree of relatedness: the evidence is inconclusive. Martynova and Renneboog considered nine studies which factored in the degree of relatedness of the merging firms' businesses and whether this was associated with post-merger profitability. "There seems to be no significant difference between the post-merger profitability of related and unrelated acquisitions, of takeovers with a focus strategy and diversifying mergers, of horizontal and vertical takeovers, and of takeovers that aim at product expansion and those that do not." (Martynova 2008)
3) The means of payment: this factor appears to be a good indicator of the post-merger performance. Martynova and Renneboog found that "Most studies show that the operating performance of all-equity acquisitions is significantly worse than of bids consisting of cash (see e.g. Ghosh (2001) for the US and Carline et al., for the UK (2002))". (Martynova 2008)

In summary, "The contrast between the large takeover returns to target firms and the frequently negligible returns to bidding firms is striking." (Martynova 2008)

Whatever the answer arising from each study area, the choice of methodology and yardsticks for measurement are crucial.

The type of study and benchmarks used into M&A value creation will impact the study results

As Nadolska and Barkema put it:

> "Measuring the success of acquisitions is difficult because there is such a diversity of motives behind them, from realizing economies of scale, to increasing scope and learning, to entering markets quickly, to pre-empting competitors. Success measurement is further complicated by a lack of data and by the difficulty of isolating post-merger performance from what might be considered the normal functioning of a firm." (Barkema 2013)

Measures used by researchers to evaluate M&A performance include: abnormal stock returns; accounting figures, perceptual measures, profitability of the specific acquisition, using cumulative

[28] Vertical (i.e. acquisitions of companies that are upstream or downstream of the acquirer) versus horizontal acquisitions (i.e. those of similar companies in related positions along the value chain)

abnormal returns, long term rate of return on assets deviations from those of competitors. (Barkema 2013)

The reliability and usefulness of studies into M&A are affected by several key factors: time-period used, the performance metrics selected for benchmarking; and sample size, to name but three.

Firstly, as regards timeframes used, the two most common ways of assessing deal success are event-based studies and longitudinal studies.

Event based studies examine the tracking of individual events pre and post-deal (relative to an industry peer group. This study type tests the shareholder value returns of the acquirer typically 12 months after the deal announcement versus the returns enjoyed by a peer group. The difference is called the *excess return*. Mark Sirower's study, cited earlier, is a case in point.

Longitudinal studies compare the performance of acquirers over a period of time using different filters or levels of activities i.e. by volume or value of deal-making activity. This type of study involves repeated observations of the same variables over long periods of time – often many decades and is sometimes used to explore the assertion that "practice makes perfect''. The McKinsey's research cited above is an example of a longitudinal study.

One ought to recognise, however, that the 'event based study' methodology focuses on a relatively narrow subset of all deals, namely only publicly traded acquirers and deals that are easy to research. This means there is an inherent bias towards significant transactions (usually greater than US$1 billion) and that are material to the acquirer (typically at least 10 per cent of their share capital).

Therefore results from event-based studies need to be balanced with data from smaller transactions: especially as large deals are inherently harder to implement and often because companies undertaking major transactions are operating in tougher strategic circumstances. Therefore it is quite possible that studies predicated on large deals are more likely to be pessimistic or lead to skewed results.

Secondly, the benchmarks selected to assess takeover impacts and performance also have an important impact.

In a detailed review of the extensive academic literature for corporate control, Marina Martynova and Luc Renneboog found that:

> "Event studies analysing short-term shareholder wealth effects constitute the dominant approach since the 1970s. The approach hinges on the assumption that an M&A announcement brings new information to the market, such that investors' expectations about the firm's prospects are updated and reflected in the share prices. An abnormal return equals the difference between the realized returns and an expected (benchmark) return, which would be generated in case the takeover bid would not have taken place. The most common benchmarks are estimated using asset pricing models such as the market model, or the Fama–French three-factor model." (Martynova 2008)

> "A similar event study approach is applied to assess the long-term shareholder wealth effects of M&As, but has several shortcomings. First, over longer periods it is more difficult to isolate the takeover effect, as meanwhile many other strategic and operational decisions or changes in the financial policy may have arisen. Second, the benchmark performance often suffers from measurement or statistical problems (Barber and Lyon, 1997). Third, most methods rely on the assumption of financial market efficiency, which predicts that the effect of mergers should be fully incorporated in the announcement returns and not in the long-term abnormal returns. This implies that, when a significant negative or positive long-term wealth effect occurs, the market corrects its initially inefficient predictions (the short-term wealth effects)." (Martynova 2008)

Thirdly, the sample makeup and the timeframes used for longitudinal studies into post-merger performance are also critical.

Carline, Linn and Yadav[29] suggest that:

> "Another fundamental measurement issue involves the uncertainty about the actual time it takes after the corporate merger has become effective for the operating performance change to fully materialize. The choice of the length of before-and-after time periods for evaluation therefore has important implications for the interpretation of the estimated change in operating performance accompanying a corporate merger. Clearly, using shorter before-and-after periods will guarantee a larger sample than that based upon longer pre- and post-merger data requirements. However, a shorter pre-merger period may not provide an operating performance benchmark that is sufficiently representative, and a shorter post-merger period may not capture the full consequences of the corporate merger." (Carline, Linn et al. 2009)

They go on to say that:

> "The relation between corporate governance and managerial choices, and consequently fundamental value and operating performance changes, is a topic of continuing interest (e.g., Gompers et al. 2003; Cremers & Nair 2005; Core et al. 2006). An important and open question in this regard is how corporate governance profiles of acquiring firms directly influence operating performance outcomes of merger decisions." (Carline, Linn et al. 2009)

As regards the second methodology – namely comparing performance of acquirers with different levels of activities i.e. by volume or value of deal-making activity – this looks at a company's acquisition track record in terms of its ability to earn excess returns on capital i.e. total shareholder return (TSR) which comprises dividend stream and capital appreciation.

McKinsey[30] used the TSR approach in its study called *Trading the Corporate Portfolio*, (2001) which measured abnormal returns to 200 companies between 1990 and 2000. Again, the results were consistent with other studies.

[29] *Journal of Banking & Finance*. Volume 33, Issue 10, October 2009, pages 1829–1841

McKinsey[31] makes the point, however, that although the investment community discounts the *average* deal, many deals do create value for the acquirer. The corollary question then arises, namely: ‘Which kinds of deals are more likely to perform well and in what circumstances?’ This is addressed further below.

2.3 Should M&A value dilution be inevitable from transactions?

Undertaking significant transactions is one of the largest and most complex decisions a board may have to make. Much emphasis is placed on the general governance duties of boards, relating in effect to monitoring the implementation of strategy, compliance and risk controls and disclosures, and financial and non-financial performance of the business. Yet given the large ‘bets’ that boards are able to place when making an acquisition there are relatively few checks and balances and procedural compliances required.

Relative to M&A, new capital raising events via prospectuses are generally well-choreographed events where the requirements and processes are clearly prescribed. Acquisitions do not benefit from the same level of systematised approach as capital raisings, nor can they, as they are usually once off, non-standard events. But solely for this reason, that transactions are *ad hoc* occurrences and bring such risk associated with them, it makes it all the more remarkable that relatively little attention is given to building in some practical safeguards for shareholders to protect them from culpable behaviour of directors and to improve the chances of M&A success.

A fundamental question to be considered – which is only obliquely addressed in the literature – is whether value destruction from deals should be a ‘high probability’ consequence or whether there are practical things that directors can and should do to reduce deal failure. What is explored in Chapter 3 is whether academic and commercial researchers have examined and documented the actions and practices that executive and non-executive directors (NEDs) should adopt, that will improve the chances of deal success. Chapter 3 endeavours to answer the question as to whether there is a clear and relevant body of knowledge that provides guidance to directors of the acquiring entity.

2.4 Some key pointers about deal dynamics and M&A definitional matters

The number of variables pertaining to each deal is quite significant and the mix and relative importance of these will vary considerably across deals. M&A is essentially an ‘open systems’ event – in that the range of external factors that impact deal success could be potentially large. A transaction cannot be viewed as a closed system.

‘Externalities’ to a transaction could include: how competitors respond in any deal; how hedge funds react; responses by the investment community, customers, bankers, suppliers, ACCC etc. These responses will differ from deal to deal and could have a profound impact on value creation or loss. Scientifically isolating the causal factors for success and their correlations is well-nigh impossible. Differences between internal factors too are numerous and extensive: such as the

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[30] Jay Brandimarte, William Fallon and Robert McNish, “Trading the Corporate Portfolio”, *McKinsey on Finance*, autumn 2001

[31] McKinsey, “*Valuation*”, ibid at pg. 439

underlying deal rationale, the operating model constructs of each entity, leadership and culture, etc.

It is also important to recognise that each board has its own dynamic; and whilst one can differentiate possibly between experienced and inexperienced directors, skilled NEDs and less skilled NEDs, how each board performs during transactions may be determined as much by individual composition as by board team performance and contribution.

Of necessity therefore, the focus for the research will be qualitative rather than normative or predictive i.e. it will attempt to describe what right practice for M&A governance appears to be, based on literature and interviews. It is not intended to take the next step for example by postulating that if one wants to achieve better outcomes for shareholders, then following certain norms or behaviours or options is to be recommended ('on the balance of probabilities').

It is certainly not intended to develop or prove a predictive theory i.e. that by doing x, y or z, successful M&A results will arise.

Other limiting factors, such as the research methodologies used and sample composition, are addressed as they are raised in subsequent chapters, particularly in Chapter 5.

2.5 Factors that are out of scope

Having described what the thesis will cover it is worth also clarifying what it will not address. Primary amongst these are:

1) What executive management (as opposed to non-executive directors) ought to do during M&A is not a direct focus, although, as will be evident in Chapter 3 covering the Commercial Literature, management's tasks (the do's and don'ts for management) do provide a context for what the board may need to pay attention to
2) The responsibilities and actions of the directors of the target company are not a focus of this study
3) 'Deal dynamics' including (a) the nature of the deal, for example whether a vertical or horizontal acquisition or unrelated diversification; (b) its locale i.e. whether an offshore, cross-border expansion or domestic transaction; and (c) the type of deal mechanisms selected e.g. friendly versus hostile takeover; schemes of arrangement versus more traditional takeover mechanisms.

How these various differences and variables may impact a board's actions has not been explored. Whilst it is felt that these dimensions may bring some unique characteristics to bear, these are by and large nuances in a broader theme of board actions.

2.6 Conclusions on Chapter 2

This chapter has outlined the general landscape for mergers and acquisitions by defining key terms and constructs and has provided some examples (more empirical evidence follows later on) on the nature of the problem relating to 'calamitous' acquisitions. It has also described the general nature of the problem and the extent of poor performance that has been measured previously. In doing so the section has covered the types of studies that examine M&A performance, and has indicated some of the challenges in obtaining effecting and insightful results into the post-deal performance of acquirers.

Chapter 2 set the foundation for the research that follows, by asserting that there is a general problem around value destruction that is worthy of further exploration.

Chapter 3 intends to explore this problem further by reviewing the extant literature and identifying aspects of the M&A value loss that warrant further study. A more thorough consideration of the existing literature will identify gaps in knowledge, and will help to refine the focusing questions for the primary research that follows. Therefore the principal aim is to establish whether there is a 'hole' in the body of knowledge regarding directors' duties during transactions, and set up a baseline for further investigation.

Having outlined the context for this study, the literature review that follows in the next chapter will describe the journey of discovery undertaken into the chosen topic; and set the scene for how the focusing question was arrived at and framed.

3. Literature review

“….as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns -- the ones we don't know we don't know."

[ex US Defense Secretary Donald Rumsfeld (2002)]

"There are two ways of constructing a software design; one way is to make it so simple that there are obviously no deficiencies, and the other way is to make it so complicated that there are no obvious deficiencies. The first method is far more difficult."

[CAR Hoare (1980)]

Key points

1) To understand what sources of guidance directors can turn to, this section explores in some detail three separate but potentially inter-connecting dimensions: Commercial M&A practice literature; Governance practice literature; and Legal writings.
2) The intention of the Literature review was (a) to understand what pointers these three sources provide as to actions, activities and the roles of boards of directors during M&A; and (b) whether the existing literature is adequately clear and comprehensive on the focusing question of the research.
3) These dimensions can be regarded as the three intersecting points of a triangle which, if correctly ‘triangulated’, ought to provide clear context and guidance for directors’ M&A actions.
4) The **Commercial literature** provides a fairly rich vein of advice on what management and advisers ought to do by way of pre-deal and post-deal activities; however there is little investigation of the underlying behavioural aspects of management (and even less so, by boards of directors) that impede or support deal outcomes.
5) There is also virtually no explicit advice (and little implicit guidance) in the commercial literature that defines the required activities of directors in regard to M&A or transactions.
6) **Governance literature** tends to be more general around key board activities and codes of practice and does not address directors’ responsibilities during M&A in any direct way; nor is there reliable guidance as to where the demarcation line may be between directors’ responsibilities and those of management during acquisitions.
7) **Legal literature** and case law (judicial precedent) deals reasonably well with directors’ duties in general terms – although one could debate whether these duties are onerous enough and the protections for shareholders are adequate; but there is a dearth of specific literature and precedent dealing specifically with the actions and accountabilities of the acquiring directors during M&A.

8) These three sources of literature form what could be called the "theoretical-ought" i.e. what theory or literature tells one that directors ought to do to ensure value creation from M&A.

9) In summary, when one looks at the three points of the triangle and the convergence of commercial, governance and legal literature, there is little guidance for boards in relation to transaction specifically about:

   a. **What** they ought to do that is different to what management does, so as to create and secure value from deals

   b. **Where** their accountabilities and duties start and end

   c. **How** the board should exercise its judgment and authority

   d. **When and in what** circumstances from a legal perspective would directors' actions or omissions in M&A be likely to incur civil or criminal liability.

10) There is thus a strong underlying need to clarify and address the considerable 'white space' identified at the convergence points of these three literature elements, if boards are to have a far clearer view of what they ought to do during acquisitions to exercise effective stewardship.

11) It therefore appears that the improved triangulation of the three determinants of directors' actions, accountabilities and duties during M&A will be an important step to delivering better value-creation results to shareholders, on a far more consistent basis.

The preceding chapter defined key terms, described the case for change or burning platform (unacceptably high instances of value loss from transactions) and outlined the intent behind this thesis and its broad focus. Chapter 2 set the foundation for asserting that there is a general problem relating to 'value loss or seepage' that is worthy of further exploration.

Having concluded Chapter 2 with some assessment of the size of the M&A value dilution issue facing both industry and directors, it is appropriate to develop a more detailed understanding via research into what typically drives success and failure of major transactions. This consideration of success factors leads to addressing the 'so what?' question i.e. if there are a set of factors at play that directors ought to be alert to, that are knowable and to some degree predictable, what is it that literature indicates they should be doing to pre-empt or respond to these factors? This chapter therefore reviews the extant literature. It aims to:

1) assess the causes of success or failure behind merger and acquisition activities to discover where or how these could be pre-empted by directors
2) uncover how well the literature provides guidance to boards on good M&A governance practices
3) identify where the documented learnings and practices may help non-executive directors of the acquirer to understand what is reasonably required of them.

The intent is therefore to investigate what light is shed by the body of research literature on why value destruction in transactions appears to be the 'rule rather than the exception' – and what actions may help to reverse these instances by management but more specifically by the board of directors.

It is in this chapter therefore that the case will be made as to whether a significant gap exists in the body of knowledge regarding what boards and board members ought to do to support responsible oversight of M&A.

3.1 Objectives of the literature review

Chapter 3 intends to explore further the problem of value loss from transactions and identify aspects that warrant further study. A more thorough consideration of the existing literature will identify gaps in knowledge in chronicled M&A governance, and should give context to the nature of fresh research required to be undertaken with non-executive directors. The subsequent chapter, **Chapter 4,** will draw together the primary conclusions from the literature review, and then crystallise and articulate the 'Research question and objectives'.

This literature review examines academic and commercial research material relating to directors' duties and activities – particularly those of the acquiring entity – during transactions. The intent is to establish whether there is a noteworthy gap in the body of knowledge regarding directors' duties for oversight of M&A transactions, and to set up a baseline for further investigation. To achieve this aim, the literature review in Chapter 3 below is structured along the following lines:

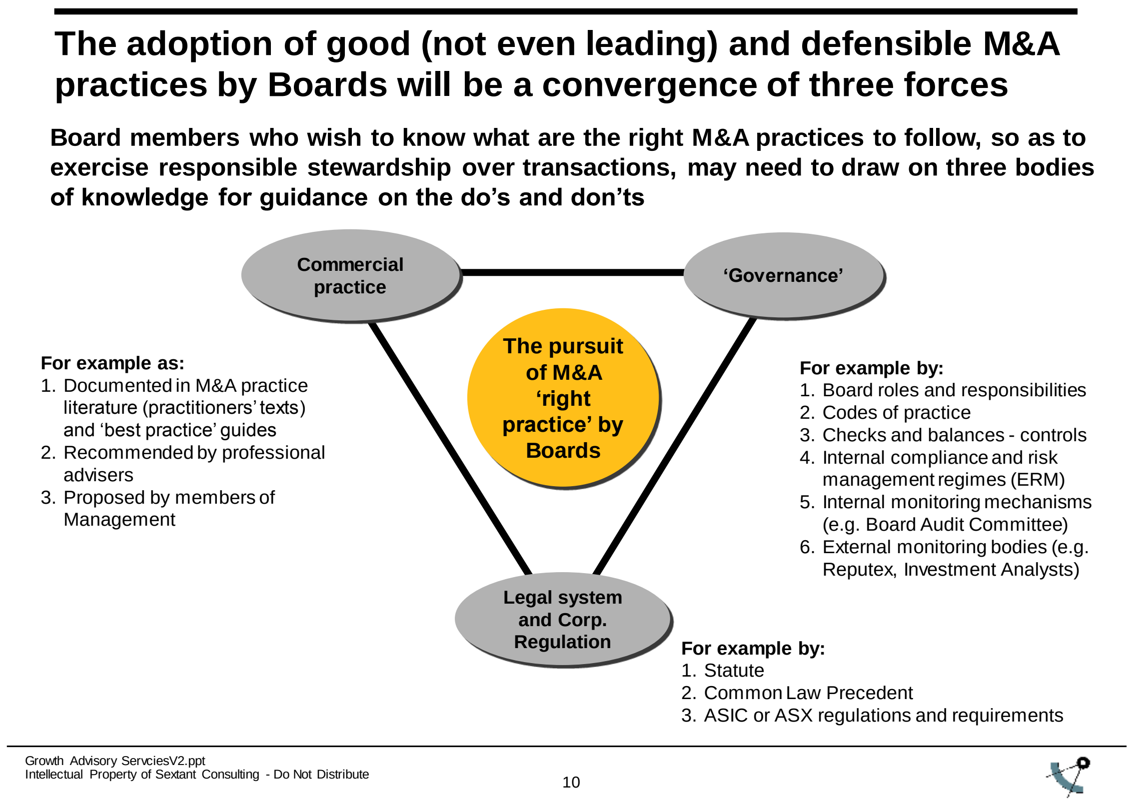
1) Business and commercial practices applicable to directors during the M&A lifecycle
2) General governance requirements for boards of directors, but more specifically how they provide guidance and exercise control during transactions
3) Their legal duties generally, but more specifically during transactions.

The literature review considers each of these three elements on a 'standalone' basis, and also reviews the interplay **between** these three factors from a systemic perspective. Seeing these three elements as interacting upon each other is important – especially the implications of the first two forces (i.e. accepted commercial practices and governance standards and practices) upon the legal or regulatory systems. Generally speaking, the law is usually a response by the courts or by legislators to the norms already prevailing in society.

In a PhD thesis that explored the role and duties of non-executive directors (Lipman 2008), Lipman suggested the following: common law precedent and legislation "identify **why** independent directors should act in the best interests of the company and its stakeholders." Corporate governance and "associated regulation helps define **how** independent directors are to fulfil the requirements of their roles"; and practitioner literature "shows **what** independent directors are expected to do".

Shown schematically, the 'triangulation' of these interacting forces appears as shown in Figure 3.

Figure 3: Triangulation of factors influencing clarity of directors' duties during M&A



Source: Dean Blomson (thesis author)

Another way of describing these three elements, which need to be well-aligned and complementary, is as the three legs of a 'M&A governance stool'; upon it rests how a board should provide the necessary stewardship over M&A so as to ensure that management protects or delivers value to its shareholders via transactions.

The literature review therefore sets out to explore three related questions:

1) Are there good, accepted **commercial practices** (not even leading practices) that most M&A practitioners would adopt and would expect reasonable acquirers to follow? Do these practices apply to board members or give adequate guidance to them? Is there persuasive evidence (anecdotal or empirical) that the adoption of these practices improves successful value creation outcomes and/or reduces the risk of value erosion or destruction?

2) What does the literature on **corporate governance** tell us about how boards should carry out their stewardship duties generally and specifically when it comes to creating and/or protecting shareholder value during acquisitions? Would these pointers or directives provide adequate clarity to non-executive directors as to what they ought to do or ought not to do during transactions in terms of carrying out their stewardship accountabilities?

3) From a **legal perspective**, are directors' accountabilities clear and how have legislators and the courts in Australia approached failures to act appropriately by directors or office holders during

mergers and acquisitions? What test or tests for negligence or gross negligence has the legal system applied and when has the law interceded, if at all?

If these three elements can be triangulated, the expectation is that it should be possible to distil a set of reasonably clear implications for directors. Conversely, if that guidance cannot be distilled or is unclear or inconclusive, the resultant 'white space' should provide context or fertile ground for further research.

In either event, of clear or unclear guidance, it is hoped that the literature will provide a baseline against which directors' own views on their accountabilities and what they believe they ought to do during transactions, can be compared and contrasted.

We commence with commercial literature that addresses causes of success and failure and the required business practices by directors to address these factors.

3.2 Literature regarding accepted commercial M&A practices

In Chapter 2, rates of M&A success and failures were considered and various studies into measuring these were discussed. That chapter considered empirical and anecdotal evidence about M&A failure rates, in effect answering the question: is M&A underperformance a significant issue? The chapter considered academic evidence as to the extent of the value loss problem. As a result of value destruction, catalogued in a litany of well-publicised but also relatively less known acquisitions, significant literature has consistently pointed to acquisition transactions as frequently being losing events for the shareholders of acquiring companies.

Having considered the propensity for under-performance of deals, the question that arises next is: What does the commercial literature tell us about the causes of success and failure? In considering the research evidence available, the intent is to see whether a set of ingredients can be distilled pointing to what it is that management and boards could and should do to prevent value erosion.

Attention will next focus on what the commercial literature has identified as key actions or activities that are likely to improve the deal success. The body of research knowledge will be examined for explicit advice on what directors should do to monitor or govern these factors as necessary actions of boards in exercising effective transaction stewardship.

In which circumstances are deals more likely to produce positive results?

Does the statistical evidence raised in Chapter 2 mean that all acquisitions are doomed? The short answer is that on the contrary, there is considerable evidence that serial acquirers and disciplined players, where M&A is a practised competency, enjoy considerably higher success rates. Additionally, those businesses which start with small transactions, to test and learn, are far more likely to succeed than those that go for large, periodic 'make or break' deals which are to some degree rolls of the dice.

In other words, those companies that have developed M&A as part of their corporate DNA and deliberately treat it as a part of their competitive capabilities, and work on becoming 'match fit', are more likely to beat the odds. The hypothesis and supporting evidence is that disciplined acquirers are far more likely to produce shareholder wealth creation from M&A activities than periodic or ‘amateur’ players.

The Boston Consulting Group (BCG) has researched and reported extensively on the causes of success and failure in M&A. BCG[32] explored the stock market performance and financial results of more than 700 large public, listed companies in the US, over a 10-year period ending in 2002. Companies were grouped by the extent of their M&A activities. BCG found that by looking at performance over an extended period, rather than stock market prices in the medium term (pre or post acquisitions), there was strong evidence that highly active acquirers had enjoyed on average better total shareholder returns than less active acquirers or companies that relied more on organic growth.

BCG then explored controllable variables as well as extraneous variables that tended to separate the high performers from the laggards (relatively speaking). BCG used the phrase ‘practice makes perfect’ to describe this developed M&A skill in a subsequent study.[33] Whilst not explicitly stated, it is likely that serial acquirers are following a deliberate policy that the board at some point would have mandated or endorsed or embraced.

Researchers have identified a range of other factors, aside from frequency and practice, which appear to influence M&A results:

1) ***Corporate governance profile***: Carline et al. found that “…corporate governance profiles of acquiring firms have an economically and statistically significant impact on operating performance changes following mergers. We observe that operating performance effects are curvilinear to directors’ aggregate stockholding, with the alignment threshold sooner breached the less dispersed are intra-board ownership stakes. Furthermore, operating performance outcomes suffer under the influence of larger corporate boards, but benefit from more concentrated outside block-holdings.” (Jensen 1976; Carline, Linn et al. 2009)
2) ***Managerial quality***: “We find that operating performance effects are adversely affected by a mismatch of managerial quality. The larger is the Q-ratio[34] (as a proxy for managerial quality) for the acquiring firm relative to the firm being acquired, the smaller is the change in operating performance.” (Carline, Linn et al. 2009)
3) ***Availability of cash to growth opportunities*** and relative size of acquisition target: “Operating performance outcomes are also worse when the acquiring firm has greater excess cash in combination with fewer growth opportunities compared with the firm being acquired; when the size of the firm being acquired is large relative to the acquiring firm”. (Carline, Linn et al. 2009)

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[32] “*Growing Through Acquisitions – The Successful Value Creation Record of Acquisitive Growth Strategies*”, May 2004
http://www.bcg.com/impact_expertise/publications/files/Growing_Through_Acquisitions_rpt.pdf
[33] BCG May 2008, “*Return of The Strategist*” at pg. 19
[34] QRATIO: Valuation ratio (size relative to book value of total assets) before merger adjusted for median industry value [Datastream]

4) ***The sales or purchasing process i.e. hostile or friendly or via auction***: Whether the bid is friendly or is contested appears to have an impact: "…the post-announcement CAARs[35] are characterized by significant differences induced by the attitude towards the bid (hostile versus friendly), the means of payment, the legal environment of bidder or target, the bid type (tender offer or friendly mergers), etc.

Target shareholders in successful but initially hostile M&As are offered higher premiums than those in friendly M&As. When a hostile bid is made, the target share price immediately incorporates the expectation that opposition to the bid may lead to upward revisions of the offer price. Servaes (1991) demonstrated that hostile bids trigger a CAAR of almost 32 per cent, whereas the wealth effects amount to only 22 per cent for friendly bids. Likewise, Franks and Mayer, 1996[36] find post-announcement CAARs of almost 30 per cent for hostile UK bids versus 18 per cent for friendly ones." (Martynova 2008)

Returns are also skewed when a tender bid process is conducted: "When (Schwert, 1996) and (Franks and Harris, 1989), partition the sample of takeovers into tender offers and mergers, they find that target shareholders earn substantially higher premiums in tender offers. Accordingly, as the means of payment in mergers is usually equity whereas cash bids prevail in tender offers, they also find that all-cash bids are more profitable for target shareholders than are all-equity ones. However, even within each takeover type subsample (mergers, friendly acquisitions, and tender offers), (Franks et al., 1991), (Andrade et al., 2001) and (Goergen and Renneboog, 2004) show evidence that all-equity bids trigger lower target returns than all-cash bids." (Martynova 2008)

5) ***Deal size and targets' debt levels.*** In a 2008 research report, BCG found that other factors also influenced post-deal performance:

- Deal size counts against acquirers: deals worth more than US$1 billion destroy more than twice as much value as deals less than US$1 billion, a reflection of the complexity of the integration tasks[37].
- Healthy targets matter, as measured by lower debt levels to assets (leverage). Successful value creating acquisitions involved targets with lower leverage ratios than unsuccessful acquisitions (on average leverage of 47 per cent versus 61 per cent for value destroying targets).[38]

6) ***Acquirer's health and performance trajectory.*** McKinsey has found evidence that strong, operationally effective operators and acquirers tend to be more successful. For those acquirers whose earnings and stock prices grew at a rate above industry average for three years before

[35] Cumulative average abnormal returns (CAARs) on the announcement day and the subsequent day.
[36] J. Franks and C. Mayer, Hostile takeovers and the correction of managerial failure, J. Finan. Econ. 40 (1996), pp. 163–181
[37] BCG May 2008, "Return of The Strategist – Creating Value with M&A in Downturns" at pg. 18
[38] BCG May 2008, "Return of The Strategist – Creating Value with M&A in Downturns" http://www.bcg.com/impact_expertise/publications/files/MA_Return_of_the_Strategist__May_08.pdf at pg. 18

they made their acquisition, the empirical evidence was that they earned statistically significant positive returns on announcement.[39]

These factors relate broadly to management's capabilities and performance (i.e. experience, skills and discipline) rather than any specific M&A process or other deal management mechanisms.

7) ***Level of contestability** is an* extraneous factor that tends to impact the prospects of value creation:

   - Negatively if it drives up the quantum or value of (control) premium paid. Research, unsurprisingly, has found that acquirers who paid high premiums earned negative returns on announcement.[40] (although BCG claim that a higher premium to valuation is not necessarily an impediment to deal success)[41].
   - Positively when bids are uncontested i.e. being the sole bidder, helps. Several studies have found that acquirer stock returns are negatively correlated to the number of bidders. Unsurprisingly, c*eteris paribus*, the greater the number of bidders, the higher the deal price.

8) ***Timing the market'*** is another key factor that would appear to affect post transaction performance. In a 2008 research paper[42], and as a sequel to an earlier research paper in 2003[43], BCG investigated more than 5100 *divestiture deals* (from 1992–2007) and found that 'downturn deals' (i.e. in an economy experiencing less than 3 per cent GDP growth), are "twice as likely to produce long-term returns in excess of 50 per cent and, on average, create 14.5 per cent more value for shareholders of the acquirer" (at pp. 7/8). BCG go on to say that "This additional value is not generated solely from 'buying low and selling high' but from acquirers unlocking hidden fundamental value through operational improvements".

   BCG's findings are supported by a range of studies that "…demonstrate that the total announcement wealth effects of M&As occurring in periods outside the surging takeover waves are always significantly lower than the gains earned during upward moving takeover waves. Both studies also reveal that the highest combined M&A gains are realized at the beginning of takeover waves." (Martynova 2008).

9) ***Target's health and performance trajectory.*** BCG further found that where acquirers purchased targets that had weak profitability but otherwise good financial fundamentals (i.e. relatively low levels of debt to assets), the performance also improved significantly. BCG found that in successful downturn mergers, the difference in profitability between acquirer and

[39] McKinsey, "*Valuation*", ibid at pg. 439 quoting research by R Morck, A Shleifer, and R Vishny, "Do Managerial Objectives Drive Bad Acquisitions?", *Journal of Finance*, 45 (1990): 31–48
[40] McKinsey, "*Valuation*", ibid at pg. 440, quoting ML Sirower, "*The Synergy Trap*", 1997
[41] BCG May 2008, "Return of The Strategist" at pg. 18
[42] BCG May 2008, "Return of The Strategist – Creating Value with M&A in Downturns" http://www.bcg.com/impact_expertise/publications/files/MA_Return_of_the_Strategist__May_08.pdf
[43] BCG July 2003, *"Winning Through Mergers in Lean Times – The Hidden Power of Mergers and Acquisitions in Periods of Below-Average Economic Growth"* http://www.bcg.com/impact_expertise/publications/files/Winning_Through_Mergers_Lean_Times_Jun2003.pdf

target was five times greater than the difference between acquirer and target in successful upturn mergers.[44] This spread of profitability allows focused and efficient acquirers to drive productivity improvements necessary to reverse the target's poor profitability and focus on cash flow and margin improvements.

The 'hard evidence' is that two years after deal announcement, successful weak economy acquirers had increased free cash flow returns (CFROI – cash flow return on investment) more than three times that of the strong economy acquirers (1.3 per cent versus 0.4 per cent) and achieved average profitability of 10.4 per cent versus 7.8 per cent for successful upturn acquirers.[45]

The challenges of proving correlation between factors and performance

Understanding that there could be proven causal links between factors and M&A performance is useful; but proving correlation, as evidence of what causes the greatest impacts, is the major impediment.

Notwithstanding a rich variety of research mostly into single source factors, in "Taking Stock of What We Know About Mergers and Acquisitions: A Review and Research Agenda", , Haleblian el al. note that :

> "In sum, although there are many influences on acquisition decisions and outcomes, we still have yet to clearly determine the relative importance of each of these factors. Moreover, there is much to learn regarding under what conditions particular factors have greater effects than others. Although there is merit in continuing to search for factors that drive acquisition activity, or lead to superior performance, we argue that it is also important to more deeply assess the relative merits of established factors and to more clearly understand their relative effects on acquisition decisions and outcomes." (Haleblian, Devers et al. 2009)

In summary, one could argue that management teams demonstrate skill and care where they:

1) are able to get the timing of the acquisition right relative to overall market performance or by finding a target whose performance has slipped relative to its peer group
2) are disciplined in setting a cap or ceiling for their offer price
3) can identify value that others do not see or are not interested in.

But this tells us little about the required actions of the boards themselves.

<u>The use of indices to predict governance performance</u>

There are a range of indices available that attempt to measure the efficiency of corporate governance. These range from 6 or 7 factors to 50 or more elements, clustered into practices, covering aspects such as: board size, board accountability, corporate social responsibility,

[44] BCG May 2008, "Return of The Strategist – Creating Value with M&A in Downturns" at pg. 16
[45] BCG, ibid, at pg. 18.

executive and director remuneration, financial disclosure (transparency and information disclosure) and internal controls, takeover controls and ownership base (e.g. no staggered board and no poison pill), progressive practices, ownership, director education and shareholder rights. The efficacy of these mechanisms as predictors of governance performance has been explored in a wide range of studies.

As Brown et al. state

> "As exemplified previously, the trouble with the construction of governance indices is that the methods employed are largely arbitrary, being hampered by the fact that we do not have an agreed theory of corporate governance to guide variable construction or to indicate which aspects should receive greater weighting. So it is hardly surprising that Bhagat et al. (2008) find no consistent relation between a variety of governance indices (identified from prior research and proprietary data) and firm performance. Similar findings are reported by Daines et al. (2010), who note that the most commonly cited proprietary indices have virtually no predictive power. They also note that there is surprisingly little cross-sectional correlation among the proprietary indices, suggesting either the indices are measuring different corporate governance constructs or there is a high degree of measurement error (i.e. the scores are unreliable) in the rating process." (Brown 2011)

Research indicates a whole range of factors at play that may affect operating performance after the transaction, including managerial quality, relative sizes and the purchase/sales process adopted. There is, however, no direct or even oblique reference to actions or activities by the board members for how the transaction is executed. The question as to what board members ought to do, or not to do, appears to be unanswered.

Having considered what can cause a lift in post-acquisition returns – and by implication how much of this relates to executives' skills and directors' competence – it is worth considering what actions or inactions can reduce M&A success.

What are the causes of value loss from unsuccessful transactions?

What does the literature tell us about where value-loss occurs post deal? As a result of value destruction, not only from well-publicised but also relatively less-known acquisitions, significant literature referenced earlier has consistently pointed to acquisition transactions as being losing events for the shareholders of acquiring companies.

A number of key underlying pathologies have been identified in commercial literature, foremost amongst these being a clash of operating models, failures in due diligence (especially in over-estimating the potential synergies) and overlooking cultural / integration issues.

These factors are explored first, in no particular order of priority, before looking at others.

The first factor is flawed merger intent or lack of clarity on the merger or acquisition rationale. As a case in point, in a 2008 newspaper article[46] John Reed, who masterminded the mega merger of Citigroup with Travelers Group in 1998 for US$166 billion, was quoted as saying that "It was unclear whether the company's model or its management deserved the greater share of blame for its problems". "The specific merger transaction clearly has to be seen to have been a mistake," Mr Reed said. "The stockholders have not benefited, the employees certainly have not benefited and I don't think our customers have benefitted because our franchises are weaker than they have been."

At the time the merger was hailed as "ushering in a new era by creating a one-stop shop for consumers and corporate customers" that could cross-sell banking and insurance and brokerage products over one platform. Citigroup, however, has underperformed the S&P 500 by more than 30 per cent over that time according to the *Financial Times*. Reed told the FT that "It was difficult to untwist the knot of mistakes and responsibilities between flawed vision and managerial errors".

Whilst there were doubtless many factors at play, the adoption of a potentially flawed operating model (as an integrated financial services provider) was pivotal in undermining the success of the M&A.

The second factor is a clash of operating models. In Bain's 2002 survey of 250 global executives involved in M&A, 85 per cent of respondents identified the importance of avoiding what was coined "the General Mills-Pillsbury trap. The General Mills-Pillsbury trap refers to the disconnects in the operating models of the merging entities that impact integration synergies (so-called because of the 2001 deal where General Mills acquired Pillsbury, with what on paper looked like a winning set of synergies, only to discover that their different sales force models presented significant integration obstacles). Respondents asserted that integration efforts must be "highly focused on where the value is in the merger".[47]

Third is what could be called a 'conspiracy of optimism' regarding synergies. As regards the 'over-optimism of synergies', the same Bain & Co. study examined the reasons why deals break down, and found that "…with the benefit of hindsight, two thirds of executives realized they had over-estimated the synergies available from the deal. Half discovered the target had been dressed up for sale. Half believed that their due diligence process had failed to highlight critical issues in the deal.[48]" Two thirds (67 per cent) similarly had ignored integration and implementation challenges. The conspiracy of optimism is a phenomenon that is applied to major capital commitments. As noted in a 2010 research paper by the International Centre for Complex Project Management:

> "The 'Conspiracy of Optimism' is a term used in areas as diverse as economics, environmental change and complex project management. Essentially, it describes a situation where a number of stakeholders, each with their own priorities and unique worldviews, tacitly ignore the reality of a situation in order to gain approval to proceed with a venture no-one would sanction if the true outcome were known. When both planners and promoters, either knowingly or otherwise, determine to optimistically

[46] The *Financial Times*, 4 April 2008.
[47] Bain & Co, *Mastering the Merger*, 2004, by David Harding and Sam Rovit at pg. 96
[48] Bain & Co, *Mastering the Merger*, 2004, by David Harding and Sam Rovit at pg. 62

misrepresent, a CoO exists."(Management 2010). (Note: 'CoO' denotes a chief operating officer).

The fourth factor is lack of adequate preparation and homework. The findings of a 2007 study by the Hay Group further emphasise the disappointing results that tend to arise from transactions and the recognition by CEOs that too often they did not do their homework properly. The Hay Group results arose from a European study they commissioned with La Sorbonne in 2007 via interviews with 200 senior European business leaders who have experienced a major merger or acquisition during the past three years. They supplemented this with desk research into the 100 largest M&As to take place in Europe over the same period.

Additionally, and as part of the Hay research, La Sorbonne conducted qualitative and quantitative research amongst 300 global employees of merging organisations. Their findings in a paper titled *"Dangerous Liaisons*"[49] indicated that a mere 9 per cent of business leaders told Hay Group that their M&A experience had been fully successful. The corollary is that a staggering 91 per cent i.e. more than nine in every ten corporate M&A transactions, had failed to fully deliver the objectives which drove the deals in the first place, according to business leaders. Close to three quarters (78 per cent) of deals studied were yet to generate significant new value.

Note: this should not automatically imply the deals were failures – it simply indicates that the CEOs' expectations, realistic or otherwise, were not met. No hard evidence is offered of particular metrics indicating which targets most deals failed to meet.

Fifth is the inadequate focus on commercial or business due diligence, relative to financial due diligence. As regards failures in due diligence (especially in over-estimating the potential synergies), interestingly, the evidence from the Hay research also indicated that the focus in preparing for transactions still centres on financial due diligence rather than strategic due diligence, which usually also includes assessing the goodness of fit between the two corporate cultures.

Financial due diligence generally aims to ensure there are no major undiscovered 'holes' in the company's financial position and that historic reports, the current financial position and future projections can be understood, confirmed and correlated. Essentially, due diligence is the validation of financial statements and a company's position. The primary aim is for the acquirer to have the information they need to assess financial risk accurately. The financial due diligence essentially addresses 'what is', not 'what could be'. For many companies a financial and legal due diligence is the *de minimis* position before proceeding with a transaction.

To assess the potential impact on performance that an acquisition offers, requires *strategic or commercial due diligence*. In essence this is the validation of the 'investment thesis' that better deal operators formulate at the Targeting stage; and then finesse and test during due diligence. The investment thesis, as the name suggests, is the working (or going-in) set of hypothesises as to where and how the acquirer is likely to generate the most significant quantum of benefits from the target.

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[49] http://www.haygroup.com/downloads/ww/Dangerous_liaisons_lo_res_R.pdf

Essentially, strategic or commercial due diligence stress tests in a data-driven, factual way, the 'informed guesses' about how the target will support the growth trajectory of the acquirer; where the combined enterprise will make money (sustainable shareholder returns), or potentially lose money and whether and where there are likely synergies (the 1 + 1 = 3 effect). Depending on the hypotheses as to where the largest potential value could exist, this could involve assessing the target company's product range and distribution arrangements; or its inventories; or its assets such as manufacturing facilities and processes; or its staff complement in various duplicated functions; what are known as overhead arrangements such as its head office components and various supporting processes and management systems, etc.

A commercial due diligence is carried out using publically available data and intelligence gathering by the acquirer where a hostile takeover is involved; and greater evaluation of disclosure materials provided by the target when an auction-based or friendly takeover process is being followed and a data room is set up by the target.

As Gerald Adolph and Justin Pettit put it in *Making the Most of M&A*:

> "A traditional due diligence exercise, defined narrowly, is intended to validate, verify, and 'stress test' the financial and legal aspects of the business case. But as business cases become more robust, due diligence should become more comprehensive. *Strategic* due diligence seeks to answer two questions: First, is it reasonable to conclude that the deal will produce an enduring, attractive economic return? Second, can we validate that the participating companies have the skills necessary to deliver on that promise?" (Pettit 2009)

The sixth factor is a closely related issue of <u>not properly understanding the cultural differences</u> between the entities or managing these cultures effectively. As regards cultural misalignments, the authors of 2007 joint study by the Hay Group and the Sorbonne (Dion et al. 2007) indicate that a bias towards financial due diligence is a significant blind spot as so much corporate value tends to be wrapped up in intangible factors which a financial assessment tends to overlook. The Hay researchers explored the role of culture and how poorly this tends to be managed in terms of post-deal integration and organisational realignment.

Since management often nominates cultural issues as a key eroder of value, the question begs answering: how many management teams undertake a targeted culture benchmarking exercise as part of their due diligence? No evidence has been unearthed into this question: either as to how many companies undertake cultural audits pre-transaction or what the potential impacts and benefits of such an audit are in preventing or anticipating cultural misalignments.

Taken together – the Bain work into poor due diligence and over-estimating synergies and the Hay report about not paying enough attention to strategic and cultural fit – the research indicates that many management teams still lack thoroughness and discipline in assessing acquisitions. Looking beyond the apparent failure by management teams to attend to these critical tasks, the question needs to be asked whether, in the main, boards are alert to the risks of limited due diligence and vigilant as to whether their management teams also see this as crucial.

Based on the identified sources of value destruction, commercial literature was further reviewed in order to see whether there is any explicit consideration of what boards should do to anticipate or prevent these factors. Potential stewardship actions could include ensuring that: management has adequately investigated the fit between operating models; or that cultural integration issues have been thoroughly assessed and considered; or that management have done everything they reasonably can to quantify and evaluate potential synergies. It was somewhat surprising, therefore, to discover that there is no explicit consideration of these activities in commercial literature as being a crucial part of board stewardship or how to exercise the appropriate levels of scrutiny over these activities by management.

What other factors may be the underlying causes of value loss?

Other factors impacting M&A results

The first, perhaps surprising, evidence from research is that post-merger performance is adversely affected by a ***mismatch in the calibre of the leadership teams*** of the two entities.

Carline et al. (2009) explored a number of variables for completed, domestic UK mergers over the period 1985–1994 (both companies needed to have a 5-year accounting history before the merger event and the merged entity for must have end-of-year financial records for 5 years after the deal). Two hypotheses in particular related to relative managerial quality and relative excess cash positions.

Carline et al. reported results:

> "…showing that post-merger operating performance changes are strongly determined by other characteristics of merging firms and the nature of the underlying deals. We find that operating performance effects are adversely affected by a mismatch of managerial quality. The larger is the Q-ratio[50] (as a proxy for managerial quality) for the acquiring firm relative to the firm being acquired, the smaller is the change in operating performance." (Carline, Linn et al. 2009)

Carline et al. hypothesised that "If operating improvements come primarily from better management teams taking control of firms that have been managed poorly, then we would expect the coefficient on RELQRATIO[51] to be positive (consistent with, in particular, Lang et al., 1989)." They found, however, that the coefficient was negative, suggesting there could be two potential explanations for the negative correlation: (1) it "…could be consistent with the hypothesis that operating performance changes are adversely affected by a mismatch of managerial quality because poorly managed firms are difficult to assimilate into well-managed firms"; and (2) "Alternatively, the result could be consistent with the view that acquiring managers are inflicted with hubris (Roll 1986) associated with the belief that they can turn around poorly performing firms when the chance of this occurring is small."

[50] Valuation ratio (size relative to book value of total assets) before merger adjusted for median industry value [*Datastream*] Carline, N. F., S. C. Linn and P. K. Yadav (2009). "Operating performance changes associated with corporate mergers and the role of corporate governance." *Journal of Banking & Finance* 33(10): 1829-1841.
[51] "The variable RELQRATIO is the ratio of the acquiring firm's value for QRATIO to that of the firm being acquired, and is intended to reflect the relative differences in managerial quality between the two firms." Ibid.

The second, again somewhat surprising, finding is that ***when capital reserve size and opportunity sets are inversely related***, post-merger performance also suffers.

> "Operating performance outcomes are also worse when the acquiring firm has greater excess cash in combination with fewer growth opportunities compared with the firm being acquired; when the size of the firm being acquired is large relative to the acquiring firm; and when the method of payment is common stock only. A larger absolute difference in leverage ratios between merging firms, however, has a positive impact on operating performance effects." (Carline, Linn et al. 2009)

The greater the cash reserves of the acquirer, the more likely the M&A will produce inferior results:

> "Acquisitions are among the largest and most readily observable forms of corporate investment. These investments also tend to intensify the inherent conflicts of interest between managers and shareholders in large public corporations (Berle and Means (1933) and Jensen and Meckling (1976)). As a result, academic researchers have extensively studied merger and acquisition activity. It is also well recognized that managers do not always make shareholder value-maximizing acquisitions; sometimes they extract private benefits at the expense of shareholders. Jensen's (1986) free cash flow hypothesis argues that managers realize large personal gains from empire building and predicts that firms with abundant cash flows but few profitable investment opportunities are more likely to make value-destroying acquisitions than to return the excess cash flows to shareholders. Lang, Stulz, and Walkling (1991) test this hypothesis and report supportive evidence. Morck, Shleifer, and Vishny (1990) identify several types of acquisitions (including diversifying acquisitions and acquisitions of high growth targets) that can yield substantial benefits to managers, while at the same time hurting shareholders" (Masulis, Wang et al. 2007)

This would imply that the acquirer needs to form a realistic view of its own likely working capital requirements after it executes the transaction and, as best it can pre-deal, the current assets' position of the target company. It also implies the need to foster a mindset of capital effectiveness with suitable controls otherwise excess cash could be squandered on limited opportunities. As boards are the custodians of shareholder capital, this requirement goes to the heart of board accountabilities.

Carline et al. conclude that "In spite of the sample median change in operating performance being significantly in excess of zero, we conclude that the potential for managerial shortcomings are real and depend importantly on corporate governance." (Carline, Linn et al. 2009)

These first two factors: ***mismatch in the calibre of the leadership teams*** and ***the cash reserves of the acquirer*** could certainly to some degree be attributed to a board that has done its work well in appointing the executive team and in approving and monitoring the enterprise's capital policies; but this alone does not prove some causal link between good governance and M&A performance.

Larger boards can impede progress:

> "In the general spirit of, in particular, Yermack (1996), we find that larger boards overseeing the acquiring firms can be an impediment to efficient operating strategy. In addition, we present evidence consistent with outside block-holders in acquiring firms playing an important monitoring role (broadly consistent with, especially,)." (Carline, Linn et al. 2009)

Anti-takeover provisions in the acquiring firm are linked to lower bidder returns:

> "Using a sample of 3333 completed acquisitions during the period between 1990 and 2003, we find strong support for the ATP[52] value destruction hypothesis. More specifically, acquisition announcements made by firms with more ATPs in place generate lower abnormal bidder returns than those made by firms with fewer ATPs, and the difference is significant both statistically and economically. This result holds for all the corporate governance indices or subsets of ATPs we consider and is robust to controlling for an array of other key corporate governance mechanisms, including product market competition, leverage, CEO equity incentives, institutional ownership, and board of director characteristics." (Masulis, Wang et al. 2007).

Perhaps unsurprisingly, therefore, those acquiring companies with anti-takeover arrangements in place tend to generate lower excess returns, possibly caused by a greater sense of confidence or complacency that they won't turn from hunter to hunted.

"The negative effect of ATPs on bidder returns can also be attributed to CEO quality in that bad CEOs can adopt takeover defenses for entrenchment purposes and make bad acquisitions." (Masulis, Wang et al. 2007).

The aforementioned studies have considered the more quantifiable and tangible or 'harder' factors such as a lack of strategic or operating model alignment, poor due diligence, lack of effective value extraction post deal, relative imbalances in managerial capabilities and capital reserves etc. The focus now turns to considering the impacts of 'softer factors' like leadership behaviours. The reason for undertaking this exploration is two-fold: one to understand what key behavioural factors may impact deal success or failure; and two, whether these are factors that the board needs to be alert to and can help mitigate against through more effective stewardship.

3.3 The impacts of management's motivation and compensation arrangements

In considering the impacts of softer factors on performance, the focus should first turn to management's motivations and behaviours. Much as many researchers may want to separate out causal factors to isolate managerial attitudes and mistaken beliefs, this is well-nigh impossible.

There is no proven nexus between management's motivation – self-serving or otherwise – and merger performance.

[52] Anti-takeover provisions

Personal interest

Personal interest touches on Agency Theory, which is explored in greater detail in Section 3.3.6 below. Understanding and then managing the personal interests of management and aligning these to the objectives of a board, is a topic all of its own. Finding a nexus between management's personal motivations and merger performance is even less straightforward.

> "Broadly speaking, there are two primary motives for corporate mergers. The first of these arises from expected synergies or efficiency-enhancing reasons, with the principal motive being to create value (see, e.g., Weston et al., 2004 J. Weston, M. Mitchell and J. Mulherin, Takeovers, Restructuring, and Corporate Governance, fourth ed., Pearson/Prentice-Hall, Upper Saddle River, NJ (2004). Weston et al. (2004, Chapter 6)). The incentives that induce such behavior are not uniquely specified under this hypothesis, but one argument is that the incentives allow managers to share in the value created. The second motive arises from acquiring firm managers pursuing their own interests. The personal interests of managers can manifest themselves in several forms, such as empire building, growth in asset size, and real asset diversification. Corporate mergers motivated by managers' self-interests do not necessarily create value, and may even destroy value if these choices waste assets. Corporate mergers driven by the former motive should be associated with superior operating performance effects relative to those influenced by the latter motive." (Carline, Linn et al. 2009)

Executive compensation

Research into executive compensation has considered how that may affect M&A decisions and post-deal performance. Providing executive share ownership programmes does not necessarily translate into prudent executive behaviour via vested interest.

Harford and Li have observed that:

> "…acquisition decisions may be the most significant corporate resource allocation decisions that managers make and the potential wealth destruction to firm shareholders is large, as Moeller, Schlingemann, and Stulz (2005) document. Thus, it is important to understand managers' incentives in corporate takeovers because of their impact on both shareholders' wealth and the organisation of assets in the economy. Further, by increasing the size of the firm and changing its scope of operations, acquisitions provide a natural opportunity for the CEO and the board to restructure his compensation. For instance, the increased size and complexity of the integrated firm could lead the CEO to argue for more pay and for pay that is less sensitive to performance for the first few years of the acquisition, or it could result in the board arguing for more sensitivity to ensure efficient integration." (Harford and Li 2007)

Harford and Li continue:

> "A large literature argues that many acquisitions destroy value for the acquirer (see, for example, Loughran and Vijh (1997) and Moeller, Schlingemann, and Stulz (2004)). While shareholders might assume that their CEOs' large portfolios of stock and options provide the necessary incentives to discourage them from making bad acquisitions, our results

> show how this intuition could be wrong in the presence of dynamic compensation changes following acquisitions. In many cases, the value of the flow of new grants after an acquisition can swamp any incentive effect provided by the CEO's pre-acquisition portfolio." (Harford and Li 2007)

Therefore one would expect that wise boards properly consider the substance and value of incentive schemes under different scenarios and thoroughly investigate how this is likely to colour or influence executive decisions regarding organic growth versus growth through mergers. There is a considerable body of knowledge regarding the constructing and operating of executive compensation schemes that all board remuneration sub-committees would have access to.

There is evidence that management's motivation and actions in pursuing M&As generally speaking are at odds with shareholders' interests – and that incentive issues are at the heart of this behavioural misalignment.

A low going-in value of the acquirer's stock options for example has a significant impact only if value is created:

> "We find that bidding firm CEOs are richly rewarded for growth through acquisitions with substantial new stock and option grants. In fact, large grants to CEOs of poorly performing firms offset the negative effect of poor merged firm stock performance on their pre-acquisition portfolio of own-firm stock and options. Consequently, CEO's pay and wealth are completely insensitive to poor post-acquisition performance, but CEO's wealth remains sensitive to good post-acquisition performance. Bidding firms with stronger boards retain the sensitivity of their CEOs' compensation to poor performance following the acquisition." (Harford and Li 2007)

Acquisitions are also more likely to strengthen a CEO's 'at risk' compensation arrangements than other forms of capital expenditure:

> "Our results bring into question the efficacy of existing equity portfolio incentives in the face of continuous flows of large new grants, and show that the strength of a firm's board affects the degree to which the new grants counter the incentives of the CEO's existing portfolio. We compare our findings for CEO pay changes following acquisitions to those following large capital expenditures. We find that compensation changes around major capital expenditures are much smaller and more sensitive to performance than those following acquisitions. These findings suggest that the board and the CEO treat internal investment and acquisitions differently and that the incentives to undertake each differ as well. They also add to the growing evidence of fundamental differences between internal and external investment (see Andrade and Stafford (2004), for example). We suggest that the uncertainty and information environment surrounding an acquisition allow the CEO more leeway in arguing for downside protection with a partially captured board. Further, an acquisition provides a natural point for compensation renegotiation and increase, while a large capital expenditure does not. Finally, unlike capital expenditures, acquisitions tend to follow a period of superior performance, when the CEO has a stronger hand to bargain with the board." (Harford and Li 2007).

Astute observers would be able to discern a potential set of implications from this research for board members, but it could not be considered to be anything other than an extrapolation.

Hubris, arrogance or inflated self-belief

Linking self-serving motivation to hubris on the part of management is hard to prove.

> "Acquiring firm managers may also pursue corporate mergers because of mistaken, inflated estimates of the operating performance benefits (see, e.g., and Malmendier and Tate, 2008). However, as with the merger motive concerned with managers' pursuit of personal interests, if scarce resources are used up in effecting the corporate merger without any consequent return for their use, then operating performance will also suffer in such instances. As such, and because it is almost impossible to define and measure hubris, we do not attempt to differentiate between the managerial self-interest and the hubris explanations for corporate mergers." (Jensen 1976)

Hubris is anecdotally associated with M&A failure; but whatever the underlying causes for its occurrence, identifying and linking it to manifested value losses arising from M&A is well-nigh impossible, not least because its displays would happen behind closed doors and sometimes in the most subtle ways. Should that causal link and its correlations ever be proven, and translated into a practical assessment framework, board monitoring would change dramatically.

Inflated self-belief may still be understandable when going into a deal, but the extent of this post deal is also noteworthy. KPMG[53] asked the managers of acquiring companies to rate their own acquisitions. Eighty two per cent of those interviewed, however, believed their acquisitions were successful, which is a remarkable inversion of results and reality. As Donald C Spitzer, the US national partner in charge of the Global Financial Strategies practice of KPMG LLP noted:

> "More than 8 in 10 deals fail to enhance shareholder value because of poor planning or execution or both, yet, by contrast, most of the executives interviewed (82 per cent) believed their deals were successful… This is an extraordinary finding…."

What factors drive M&A success?

The various examples above of research into the causes of M&A failure tend to imply that prudent steps could mitigate these value destruction risks. Shareholder value diminution need not be an automatic consequence. If the causes of value losses are well described, what does the commercial literature tell us about the factors that tend to drive deal success?

There are four broad, recurring themes across a variety of sources: strategic thinking and deliberate action in targeting and decision-making (incl. whether to proceed or walk away and where and what to integrate); proper planning and program management for value extraction; transformational leadership; and communication effectiveness.

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[53] Unlocking Shareholder Value: The Keys to Success", *KPMG M&A Global Research Report*, Nov. 1999; cited also in http://www.riskworld.com/PressRel/1999/PR99a214.htm

Bain & Co.[54] argue that there are four critical decisions that are key to deal success:

1) How you pick your targets. This relies on using what is called by strategists and Private Equity players an 'investment thesis' which was discussed earlier i.e. an operating hypothesis/es about how and where you will make money from the combined entity and specifically how the target will support the growth ambitions of the acquirer.
2) Deciding which deals to close or conclude. This means applying one's mind objectively and dispassionately to assessing specific potential sources of shareholder value – an activity which needs to be undertaken in a targeted, focused and factual way – with an unequivocal and unemotional view of the criteria and circumstances in which management and the board ought to walk away.
3) Determining where, when and how you really intend to integrate. Since every merger has a different driving rationale, management needs to recognise that a full integration is not always required. Given the investment thesis, some aspects of the business model may need to be merged well ahead of others. There is no 'one size fits all' approach to integration and there needs to be a careful prioritisation of which tasks are most urgent, as part of a consideration of how extensively to integrate and how best to go about that.
4) What to do when the deal goes off track. This is the corollary of point # 1 above, in that a clear investment thesis will focus the due diligence team on the big questions and enables the executive team to have a clear deal walk-away point.

McKinsey, Bain, Booz and other M&A professional consulting companies believe that value dilution is not inevitable; and espouse that management should follow a few clear rules and undertake relatively simple preventative actions to make a difference to deal success. Reviews of business literature espoused by various management consulting firms (including Bain, BCG, McKinsey, KPMG and PwC) suggest the following actions by management typically provide a positive impact:

- ***Pre-deal factors include:*** the clarity of the deal rationale; ensuring the executive team focuses on the big questions; prioritising and planning early; and knowing 'when to hold and when to fold'.
- ***Post-deal factors include*****:** the calibre of *executive leadership* and appointing and preparing executives to lead the change effort; *change management* via the assessment and proactive management of the stresses associated with the "human side of change"; *value management* by building confidence in the level and timing of benefits and the plans for the accelerated realisation of those benefits; *communication management* by seeking input from and sharing information with all stakeholder groups; and *program management* through ensuring that all activities are planned, scoped and coordinated.

Bain & Co. in the same 2002 survey of 250 global executives involved in M&A, indicated the top two reasons for success cited by executives as being: "cultural integration addressed early on and actively (83 per cent of executives cited this factor as important or very important); and best

[54] Bain & Co, "*Mastering the Merger"*, 2004, by David Harding and Sam Rovit, pg. 8

people selected to lead combined entity, irrespective of which company they come from."[55] (81 per cent cited it).

In close descending order behind these top two factors, Bain's research also identified: 'integration focused on value'; 'leaders communicated extensively'; 'measures of success established and tracked'; 'plan in place before deal closed'; 'approach tailored to the deal's strategic rationale'; 'new management team chosen before deal announced'; 'majority of employees focused on base business'; and 'speed valued above perfection'.

Whilst business literature is not short of providing good M&A practice and advice, no one has been precisely able to say how much of a difference the adoption of these practices typically makes. KPMG, however, have possibly got closest to a reliable answer. Although somewhat dated now this research has not been superseded yet.

In global research by KPMG International (KPMG Nov. 1999), interviews with executives identified a combination of six 'keys' – three hard keys and three soft keys – that were necessary for a deal to succeed, according to Donald Spitzer, a US national partner with KPMG.

The three hard keys were pre-deal business activities that had a tangible impact on the ability to deliver financial benefits: synergy evaluation (business fit); integration planning; and due diligence.

The three soft keys were human resources issues that must be examined even before a deal is announced namely: management team selection; cultural issues; and communications with employees, shareholders and vendors.

The research showed that companies which put a priority on: ***Synergy evaluation*** were 28 per cent more likely to be successful in improving value to shareholders; ***Integration planning*** were 13 per cent more likely to enhance shareholder value; and ***Due diligence*** were 6 per cent more likely to improve the value to shareholders.

"The research shows due diligence to be the most critical issue on balance, and must encompass a wide set of activities, such as management assessments, risk reviews and operational reviews. Companies were 15 per cent less likely to improve shareholder value if their due diligence emphasized finance or legal issues, to the detriment of other areas," said Spitzer.

Regarding the hard factors, management theory is clear on the importance of integration and synergy delivery planning to start early, for two reasons: firstly, the time value of money, as any delays in the first 100 day's plan will push the ROI further out; and secondly, the activity of planning before the final deal is struck brings an important reality check to what it will take and cost to deliver post-deal results.

This is not only an important sanity check for the post-deal planning stage, but by commencing this activity early, has the added benefit of estimating the transaction cost more accurately before negotiations are completed.

[55]I Bain & Co, *Mastering the Merger*, 2004, by David Harding and Sam Rovit, pg. 96

In terms of soft keys (the people issues), companies that placed priority on:

- Management team selection, in order to reduce organisational uncertainty, were 26 per cent more likely to improve value to shareholders.
- Addressing cultural issues were 26 per cent more likely to succeed in adding value for shareholders. Those that handled these issues early in the pre-deal process had a better success rate than those who left cultural issues until the post-deal period.
- Communications were 13 per cent more likely to enhance shareholder value. Poor communications with employees posed a greater risk to a deal, relative to poor communications with shareholders, suppliers or customers.

KPMG also flagged the early involvement of integration planners with "industry-specific experience and the cultural know-how" in order to make cross-border deals work.

This research – generated from management interviews – is important and valuable to the right audience, but is not targeted at board responsibilities or actions.

Summarising deal success drivers

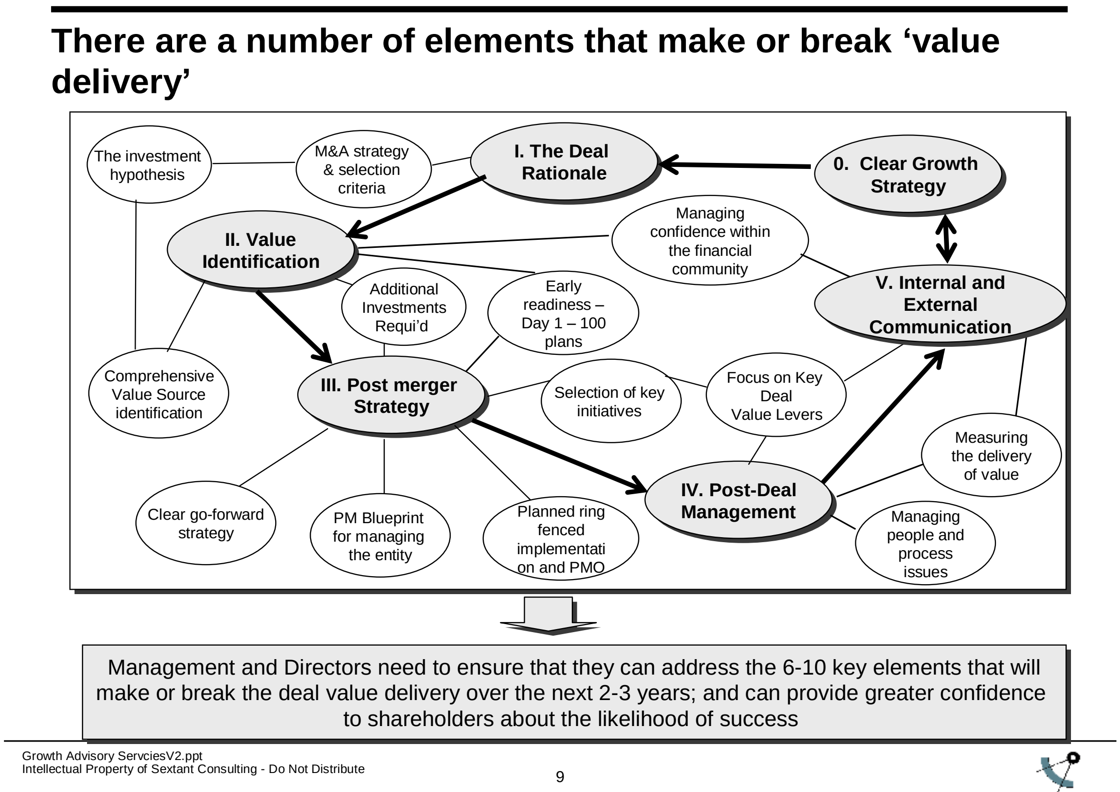
There is further extensive commercial writing on the critical ingredients of merger success, such *Making the Most of M&A* by Gerald Adolph and Justin Pettit of Booz & Co[56] (2009). Various deal success factors, distilled from a range of sources, can be summarised as follows:

1) **Clear growth strategy**: which provides the alignment and commitment mechanism between and board and management as to why, where and how fast to growth via acquisition and should also provide the set of screening criteria for evaluating targets;
2) **The deal rationale**: which includes the questions of strategic fit and having a well-considered investment thesis i.e. why should we be interested in buying this specific company and how do we think we can make money from the deal and how much?
3) **Value identification**: carrying out a thorough but focused due diligence with a commercial or strategic focus that rigorously tests the draft investment thesis and identifies significant risks to value;
4) **Post-merger strategy and planning**: undertaking adequate and early post-deal planning and preparation;
5) **Post-deal value management, including leadership**: executing the post-merger plans promptly and tackling the hard leadership decisions head on;
6) **Internal and external communication**: communicating effectively and managing expectations and reporting unambiguously on value delivery.

Diagrammatically, the six key factors and sub-elements may be represented as shown in Figure 4.

[56] http://www.strategy-business.com/resiliencereport/resilience/rr00071?pg=all

Figure 4: Deal success drivers



Source: Dean Blomson (thesis author)

In cases where these value drivers are not properly managed by the leadership of the acquiring business, typically there are a number of underlying pathologies that could be occurring to cause the value loss. Expanding on each of the six main value drivers:

Proposition 1: Growth strategy could be an issue where:

- The logic of why and where to grow is confused.
- The contribution that a target should make is unclear or contradictory providing screening criteria that cause ambiguity.

Proposition 2: The Deal Rationale could be an issue where:

- The M&A purpose or endeavour as a whole was ill-conceived or not properly thought-through: possibly ambition, 'irrational exuberance', greed, arrogance or ignorance may play a part.
- There was no proper investment thesis i.e. the acquirer did not have a clear, well-understood and agreed view as to how it was going to generate superior returns from the to-be combined entity.

Proposition 3: Value Identification could be an issue when:

- The value arguably was not there in the first place and/or the acquirer has overpaid i.e. there has not been an adequate, independent and rigorous validation of the sources of value. This could occur for a variety of reasons including: deal haste or deal fever; "target myopia" ("this deal has to happen"); 'spruiking' by the deal advisers; negotiation fatigue and inevitable convergence between negotiating parties.
- Risks and assumptions have not been fully tested or objectively assessed.

Proposition 4: Post-Merger Strategy could be an issue because:

- All the focus was on getting the deal across the line, not the post-transaction planning, because of:
    - Complacency: "We understand how to run a business – this is simply an operational task of integrating it."
    - Deal distractions or a belief that integration planning can be attended to in due course: "We can start this preparation in earnest once the designated management team has been appointed and we have the keys for the door."
- Strategy and integration plans were unclear: there is often a flawed assumption that the deal rationale was clear in the first place and that everyone has the same view of the CEO's integration vision and blueprint (if one exists) for the combined organisation.

Proposition 5: Post-deal Value Management could be an issue if:

- Value extraction was not properly managed: the rigours of programme management, staff expectations' management, and key risks' management were not in evidence.
- Integration skills and expertise were deficient or resource commitment was inadequate; the organisation may incorrectly believe it has good general or IT project management skills and that these can be applied to post-merger integration.

Proposition 6: Internal and External Communication could be an issue if:

- Mismanagement of market expectations has occurred, whether through a general lack of clear communication to the institutional investors as to the deal purpose and rationale; no great interest in providing transparency; or no compelling and continuous story on where and how the anticipated deal value is being delivered.
- Management has delayed or avoided making the hard decisions:
    - Desiring to be all-inclusive and democratic: "We should only start planning once the integrated management team is in place."
    - Preferring not to act without all the facts or rather adopting a 'wait and see' attitude.

Board members would need to be highly aware of these value drivers – at a minimum to be alert to what management ought to be doing or avoiding – but identifying and understanding these deal value drivers does not necessarily clarify for directors how they should be conducting themselves in relation to these factors – or what other activities they should be attending to provide oversight of management who are executing the deal or the integration.

Conclusions on some of the missing links in the commercial literature

How useful is the practical guidance gathered from commercial literature likely to be for boards to understand their responsibilities and where are some of the potential gaps?

Firstly, the focus in the literature is overwhelmingly directed towards management. Non-executive directors as a genre of transaction participants are generally not dealt with and the body of knowledge is not targeted towards them explicitly. As a constituency supposedly with an important stewardship role to play in M&A, board members are by and large overlooked as a participant group in commercial research.

Secondly, if we stand back and look at what the business literature covers, it is overwhelmingly about the hard factors such as 'the what' and 'the how' i.e. what management ought to focus on and how to go about it. The emphasis is heavily skewed towards processes and activities or actions. There is only, at best, an implicit reference to executives' skill-sets to attend to the 'the what' and 'the how' and limited exploration of their behavioural traits – either as individuals or in terms of their collective dynamics when it comes to mergers.

As in many matters, it is easier to deal with 'outward form' than 'underlying substance'. In the case of the commercial writings on M&A, the body of work by practitioners is sizeable, credible and beneficial for those wanting to know what activities to focus on and broadly how i.e. what to do and what not to do.

As represented diagrammatically in Figure 5, business literature does an excellent job of addressing the more tangible, outward manifestations of an M&A capability, but it undertakes limited exploration of other more intangible dimensions like directors' skills, knowledge and experience. Additionally, one would surmise that intangibles such as critical thinking skills and commercial nous may be important attributes to bring to bear on a transaction by executive and non-executive board members, but these factors do not get real airplay in the mainstream commercial literature.

This is not to say the literature ignores the importance of having the right skill-sets; or refutes the importance of a management team actively thinking through deal value or strategic fit, for example. Clearly, respected practitioners such as Bain or BCG would tend to emphasise those activities – these matters are canvassed but again for the benefit of management, not boards dealing with M&A activities.

Thirdly, and unsurprisingly, there is no 'how to do it' toolkit available for managing these softer factors or intangibles. It is understandably far easier for practitioners to focus on tangibles and assistance to management that they can touch and see such as toolkits and checklists that are practical and effective – and can be directed at 'doing things'.

Fourthly, there is inadequate exploration of where and how boards can help management and themselves to guard against irrational decision-making. Whilst there is a growing body of knowledge emerging around 'rational decision-making' by executives – through researchers and popular authors such as Daniel Kahneman (2010) – such writings are targeted at general management audiences and are not targeted specifically to board processes and/or M&A.

Despite this emergent body of literature, at the behavioural level, the commercial literature does not adequately explore what could be termed the ‘seven deadly sins’ of deal-makers: management naivety or unbridled optimism; hubris (arrogance or pride); complacency; undue haste; greed; deal myopia and deal fever.

Aside from the well-recognised phenomenon of deal fever, these underlying ‘behavioural’ pathologies have not been directly explored by academics to ascertain their impacts; the extent of their effects on value dilution can only be anecdotally rather than empirically assessed. More particularly for the purposes of this thesis, there is no substantive exploration or guidance on how the board needs to help management to safeguard themselves against the ‘seven deadly sins’.

Therefore it is a notable omission in commercial literature that there is limited analysis of how directors behave, individually and collectively, particularly in relation to major capital commitments like acquisitions; how they approach transactions could have significant impacts on decision-making and therefore transaction outcomes.

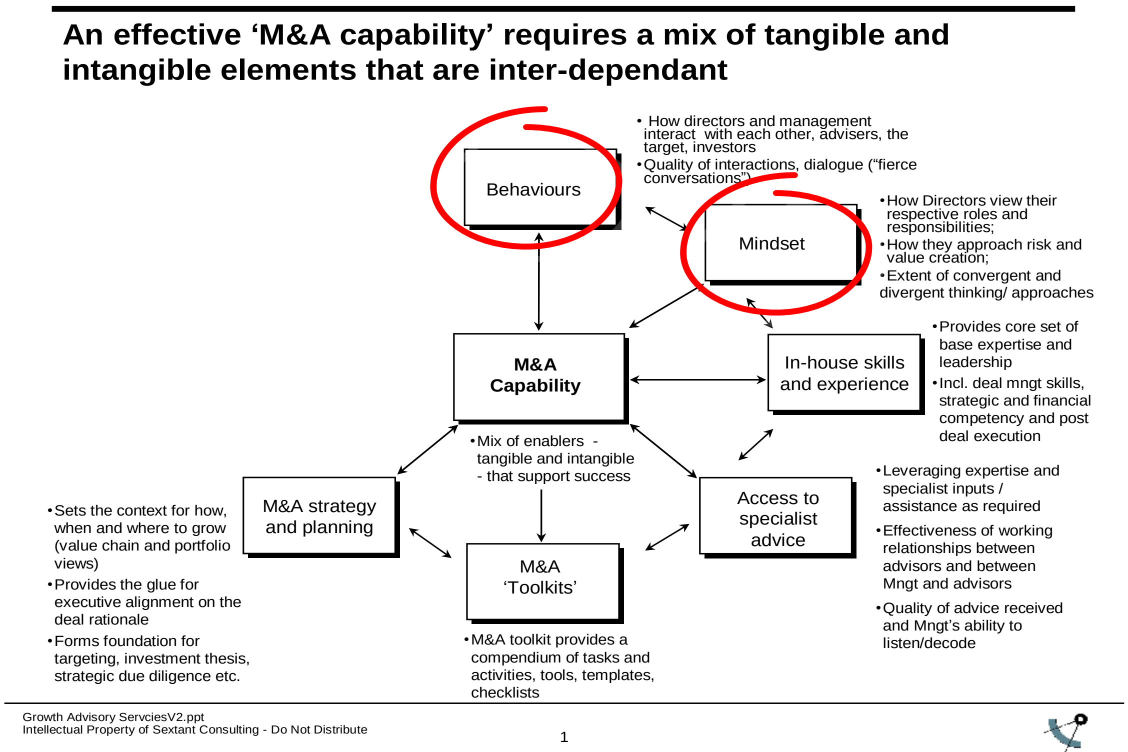
The behavioural aspects of board dynamics are considered again in Section 3.4.5.

As regards <u>mindset</u>**,** there is no research evidence into how non-executive directors should approach the transaction lifecycle or the kind of things they should do or think about that make a sizeable difference to M&A outcomes. At a more pragmatic level, there are no research-backed guides to help directors to debate and question merger or acquisition logic; or to challenge management in their strategic thinking. Probing questioning and critical thinking are important mental and behavioural antidotes to the seven deadly transaction sins described above, but how many board members possess or are taught these traits? Additionally there are no widely-published or readily accessible evidence-based or fact-based compendia available advising non-executive directors regarding what questions to ask about major transactions.

How important are these behavioural traits to deal success and value delivery? There is a growing vein of management literature on decision-making and particularly sub-topics like bias and decision-making in the face of uncertainty. Researchers have not yet definitively addressed the question of boards’ behaviours in relation to merger or acquisition decisions; although various elements of decision-making have been recently explored by researchers. These aspects include bias and myopia (‘distortions and deceptions’) in decision-making by Dan P. Lovallo and Olivier Sibony (Sibony 2006); lack of process rigour, by Bill Huyett and Tim Koller (Koller 2011), ‘System 1’ (instinctive / unconscious) and ‘System 2’ (deliberate and rational) thinking by Daniel Kahneman (Schrage 2003); and use of behavioural economics, again Dan P. Lovallo and Olivier Sibony (Sibony 2010).

The essence of the commercial literature elements explored so far are summarised in Figure 5, which indicates the various components of what could be portrayed as an ‘M&A capability’ set. This is based on what the commercial literature review has indicated, either directly or by implication. Certainly some of the strategy consulting firms reference what could be termed as developing a ‘M&A DNA’ or building a ‘M&A factory’ capability in undertaking transactions on a more regular and predictable basis. None of the literature reviewed, however, represents the M&A capability as it is depicted below. The boxes that are circled in red represent the clear gaps apparent in the commercial literature reviewed relating to mindsets and behaviours.

Figure 5: Understanding the various factors comprising an M&A capability set



Source: Dean Blomson (thesis author)

Lastly, another apparent gap in the commercial literature reviewed relates to accountabilities and roles of directors and management and how these are delineated.

Determining decision-making rights and delineating the boundaries

It is important to point out that the commercial literature reviewed does not particularly differentiate between the actions of executive management and those of non-executives or the board, regarding transaction management or practices. Explicitly the literature tends to focus on what management ought to do. There is no commercial commentary, yet unearthed, that has indicated where or how the two groups (board and management) ought to delineate their respective activities and responsibilities at the boundaries; or work together effectively and cohesively with what could be termed a 'constructive tension' in executing successful transactions.

There is a lengthy list of activities that management ought to pay attention to, that has been flagged in commercial literature and especially in practitioners' guides: from developing M&A strategy to capability building via M&A approaches and securing deal management skills; to targeting activities, business case development, due diligence activities of various kinds, development of funding strategy, development of integration blueprints and plans etc.

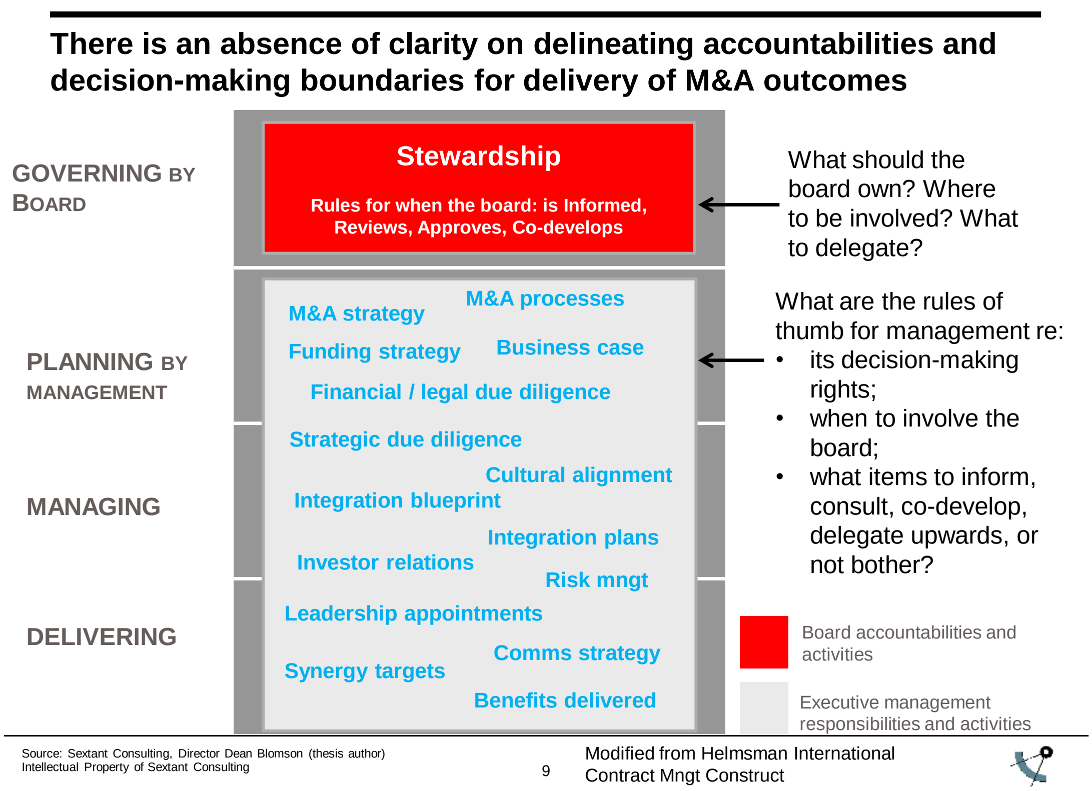
Depending on their reserved powers and prerogatives, generally speaking boards will review and approve strategy, policies, risk management and assurance regimes, major investments and track strategy implementation. Management is usually tasked with preparing these items: preparatory activities such as developing M&A plans, processes, securing skilled people, executing strategy and reporting on performance.

For non-executive directors it can be a bewildering question as to which of the various M&A activities they should be involved in and what degree of involvement is to be expected. For example, on which of these activities should they merely be kept informed or on which should they be consulted? Which of these items or activities should they review and approve? Or where should they co-develop their responses with management? And finally, where should the board develop and directly control these items itself?

Whilst to some degree these are matters for the determination of each board, literature unfortunately does not provide even directional or generic guidance on the answers to these questions.

Typical topics or activities that need to be evaluated and designated as items for the board or for management, jointly or separately to deal with, are depicted in Figure 6.

Figure 6: Delineating the decision-making boundaries



Source: Sextant Consulting, Director Dean Blomson (thesis author)

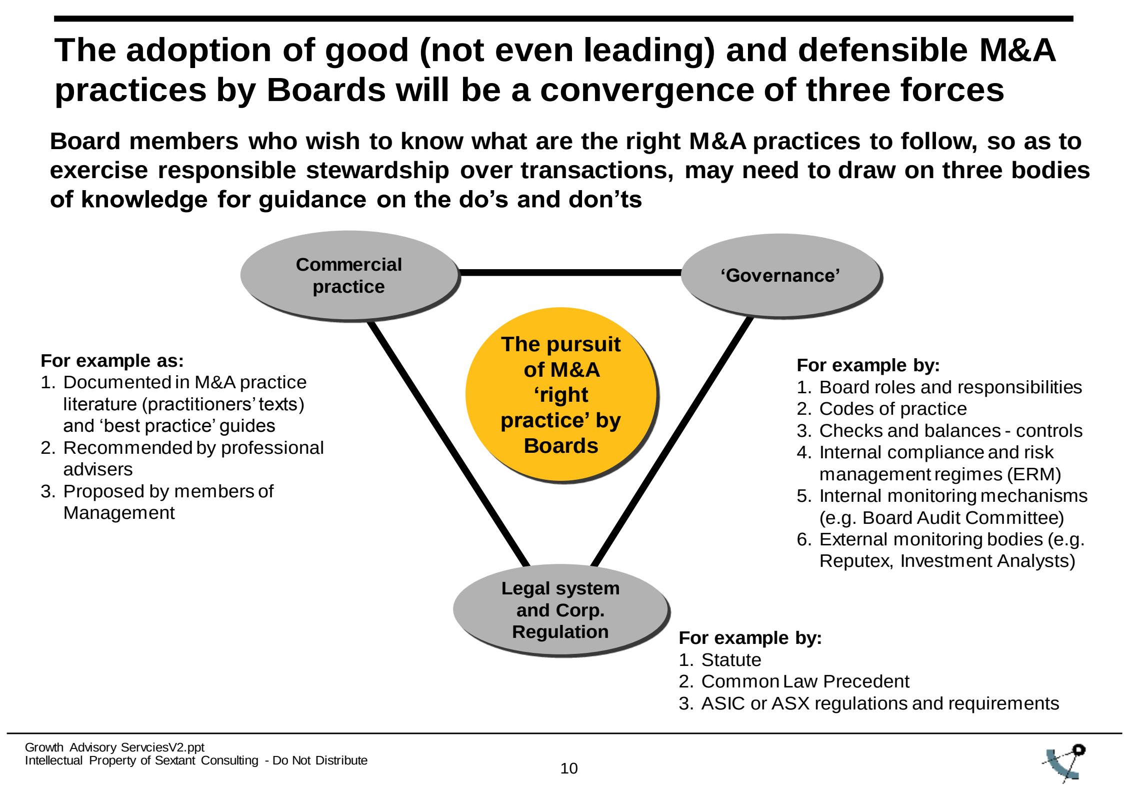
Whether corporate governance literature does a better job of exploring boundary management will be shortly considered.

At best it can be said that the commercial literature explicitly requires management to carry out the recommended tasks; and implicitly assumes that the board will have some degree of oversight or participation; but what that level ought to be or how to determine it, is not addressed. Certainly there are no explicit distinctions made and no clear delineation of duties. Nor is there is any mention of what boards specifically ought to do to assist the process and 'keep management honest' via checks and balances, interrogation of the recommendations and plans, etc.

Any director looking for well-researched commercial advice and guidelines on 'what I need to do in a pending merger' is likely to come away empty-handed: the best he or she could do is to extrapolate what management ought to do as a set of pointers to then ask management periodically "Have you done this?" Thus there appears to be a significant gap in this first realm of commercial literature regarding 'M&A right governance'.

This completes the analysis of the available commercial literature, the first of the three corners or elements of the M&A capability triangle. The second dimension, the Governance literature, is explored next.

Figure 7: Triangulation of factors influencing clarity of directors' duties during M&A



Source: Dean Blomson (thesis author)

Corporate governance: introduction, definition and current interpretations

This section of Chapter 3 initially addresses how governance is defined and proceeds to unpack the concept by examining the elements of governance and the dual, and often contradictory, roles of boards in both protecting value and creating value.

It examines current theory regarding corporate governance to understand how well or otherwise it explains the earlier identified value destruction phenomena.

This section of the literature review is intended to move beyond an exploration of how boards should go about their general governance roles and duties, to focus specifically on boards' oversight of M&A, by examining what the literature tells us should be their *modus operandi* in assessing and prosecuting transactions. This review aims to move beyond pure academic research in order to identify whether there is a vein of credible and useful research writings that help to describe, define and direct how directors ought to exercise 'deal stewardship' – that in effect could be chronicled as a guide to 'right' conduct i.e. not necessarily best or leading practice but right practice. The test is whether there is body of knowledge available that could therefore act as a 'guide to the perplexed' director about his or her governance duties during M&A.

The flip side of the test is whether, hypothetically, a 'reasonable directors' test could be applied to a director accused of misconduct or negligence during a transaction, by referencing a credible body of knowledge on right practice? In essence, if such a set of learnings or guidance can be distilled, it will serve as a baseline to test with experienced, practicing directors, to ensure that theory and practice are well-aligned on the important M&A governance do's and don'ts.

Firstly, how is governance defined?

How is 'corporate governance' defined?

'Corporate governance' has unfortunately become a clichéd and overworked term since it sprang into prominence in the early 1990s. For some it is an approximate synonym for control; for others it is mostly about structure and composition of the board; for others it is about board processes or systems; and for others it means everything from how decisions are made to who bears the consequences. Over time, governance has also moved into management parlance – as a result, if both parties are involved in governance, who has the accountability for stewardship of a company's affairs?

Gauged by most measures, the volume of literature on corporate governance ('CG') is vast. To illustrate, in August 2014, a general Google search returned 24.3 million results; and Google Scholar returned about 1.4 million hits using 'corporate governance' as keywords.

A wide range of disciplines have contributed to the already vast, and still fast growing, body of literature on CG, from legal, to accounting and finance, to behavioural economics and statistics. The question to be considered, however, is how much of this body of knowledge explains what directors ought to do during acquisitions or mergers or would provide guidance to boards on their duties and preferred or recommended practices.

Corporate governance is about the governance of incorporated enterprises or corporations – which, whilst it is a statement of the obvious, should serve to remind us that CG should determine the system by which companies are directed and controlled.

The Cadbury Committee (Cadbury Report, 1992, para. 2.5) explained it as follows:

> "Corporate governance is the system by which companies are directed and controlled'. The Committee elaborated on the roles of the board, the shareholders and the auditor: 'Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place (para. 2.5) …The role of the auditors is to provide the shareholders with an external and objective check on the directors' financial statements (para. 2.7)*"*.

The Australian Government's Corporations and Markets Advisory Committee (CAMAC, 2010) issued a report in April 2010, 'Guidance for Directors', which implicitly supports the Cadbury Committee's view. Subsequently, the CAMAC report quotes (at p. 17) the HIH Royal Commission report, *The Failure of HIH Insurance (2003) Volume 1, pp. 101–102,* as follows:

> "At its broadest, the governance of corporate entities comprehends the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations."

Based on this view, CG would appear to be confined to matters that are, or ought to be, within the control of the board on behalf of the shareholders. For that reason CG guidelines tend to focus on matters which shareholders and the board can decide upon and implement.

As Brown *et al.* state in *Accounting and Finance*:

> "Because of its breadth, research in CG is characterised by the lack of a unifying theory. The lack of theory is evident in the nature of the questions asked, how they are framed, the core ideas and the reasoning processes that underpin hypotheses, how models are specified, how the dependent and explanatory variables are defined and measured, which estimators are used and how tests are applied, and the manner in which conclusions are reached. This state of affairs is an inevitable reflection of the range of perspectives academics have taken when thinking about CG matters." (Brown 2011)

According to the OECD (2004), in the preamble (pg. 11) to its *Principles of Corporate Governance,* corporate governance is ultimately the responsibility of the board, which:

> "…involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." (OECD 2004)

The Australian Stock Exchange defines 'corporate governance' as:

> "…the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled within corporations. It encompasses the mechanisms by which companies, and those in control, are held to account." [57] (Council 2014)

Finance literature, as described by Shleifer and Vishny (1997, p. 737) takes a narrower but nonetheless practical approach in offering the following definition: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." (Brown 2011)

For the purposes of this thesis and the literature review, **'corporate governance' (or simply 'governance') will be taken to mean the system by which a board of directors provides or agrees and approves company direction and policy with executive management and exercises oversight of the enterprise's affairs and performance, on behalf (and for the benefit) of its shareholders.** 'System' encompasses processes, policies, review and control mechanisms, structures and roles.

With a working definition of governance in mind, it is appropriate to unpack the construct and examine some key elements that go to the nature of a board's involvement in value protection and value creation.

What are the key elements of corporate governance?

As indicated by the 'M&A capability 'triangulation' diagram (Figure 3), governance could include a number of dimensions:

1) How boards organise themselves to carry out their duties i.e. structures, roles and responsibilities
2) How they delineate their accountabilities from those of management
3) The codes of practice and *modus operandi* they adopt
4) Their involvement in direction setting by jointly defining or agreeing on corporate priorities and outcomes i.e. their 'strategic stewardship'
5) The checks and balances they put in place or the oversight and control mechanisms they adopt, including but not limited to:
    a) The development of policies and agreement on standards
    b) Internal compliance, assurance and enterprise risk management regimes (ERM systems)
    c) Internal monitoring mechanisms (e.g. via Board Audit Committees)
6) How external stakeholder management is to be conducted, including communications with key shareholders especially institutional investors, investment analysts, and major suppliers and customers

[57] Justice Owen in the HIH Royal Commission, The Failure of HIH Insurance Volume 1: A Corporate Collapse and Its Lessons, Commonwealth of Australia, April 2003 at page xxxiv.

7) Compliance with various voluntary and compulsory codes of conduct including key disclosure requirements around key legal duties and 'license to operate' matters involving regulatory authorities and various monitoring bodies.

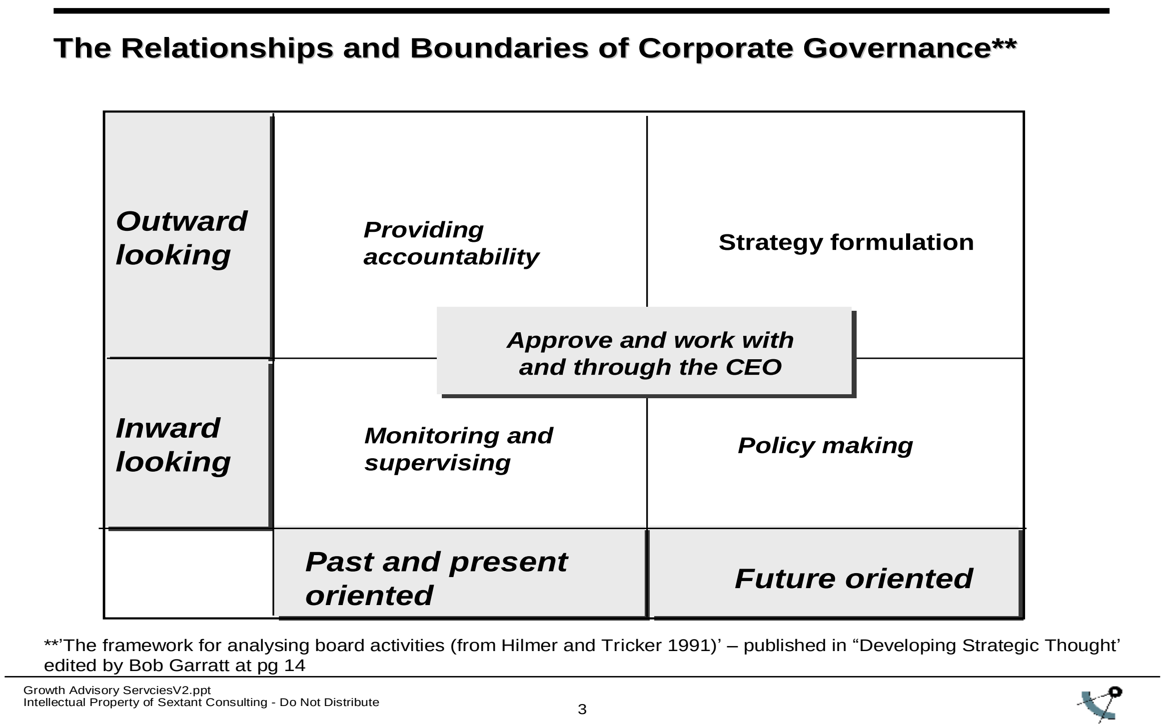
It is fair to say that governance is an evolving field of study and partly as a consequence, definitions and interpretations as to what constitutes good governance vary widely. Henry Bosch, arguably the father of the 'modern form' of corporate governance in Australia, defined 'governance' as "the system by which companies…are controlled. It involves the members (shareholders) as well as the directors and management, with the relationships between these groups being of fundamental importance" (Bosch 2002).

This definition has, however, been construed by some as a fairly narrow view for two reasons: (1) it ignores other stakeholder groups; and (2) it emphasises control rather than value creation.

At its core, corporate governance should be at least as much about value creation as about value protection. Sometimes these are two competing ends, no more so than during an acquisition. But directors are not paid to preside over companies stagnating even if they have done an excellent job of value protection; since arguably any company standing still is losing its shareholders' money – at least during a growing market. Of course, during a downturn, and more particularly during the Global Financial Crisis commencing in 2007, any board of directors that through its diligence and prudence managed to preserve the *status quo* would be a standout example of performance.

Hilmer and Tricker (Tricker 2006) have constructed a framework that goes to the core of the "value protection versus value creation" trade-off, as summarised in Figure 8.

Figure 8: A framework for balancing board activities: past and present focus, internal and external



Source: Adapted from Hilmer and Tricker (1991)

Managing the balance and trade-offs between 'inward looking' and 'outward looking', 'past / present' and 'future' perspectives, is of course not easy. The emphasis may vary depending on a company's lifecycle stage and current set of performance issues and strategic priorities. During the recent Global Financial Crisis, for example, the focus for many boards may well have turned inward to the 'here and now', in an effort to improve internal efficiencies, drive cost reduction or cost containment initiatives and manage working capital and balance sheet effectiveness. Arguably, however, a board would not be serving its shareholder constituency well by remaining introspective and short-term focused.

Put differently, boards have to manage the balance between 'performance' and 'conformance' (see Figure 9 below). In Australia, the Hilmer report (Hilmer 1993) argued that the primary role of the board is "to ensure that corporate management is continuously and effectively striving for above-average performance, taking account of risk", with shareholder value protection as a subsidiary role. In other words, the focus should be on adding value through driving up performance. Of course, as in all things, a balance must be struck on the weightings given to these two key focal roles; and inevitably for most boards the relative balance will ebb and flow depending on circumstances.

In the *Australian Financial Review* (AFR) on 6 July 2009, Ewen Crouch, the chairman of Allens Arthur Robinson, wrote as follows:

"Corporate compliance risks are overtaking corporate strategy as the priority for many boards, and not by choice. Under the cover of accountability, government, regulators and some shareholders are weighing down directors with a growing number of boxes to tick. In doing so, they are forcing boards to assume a more hands-on role in day-to-day management, lest they open themselves up to some future liability."

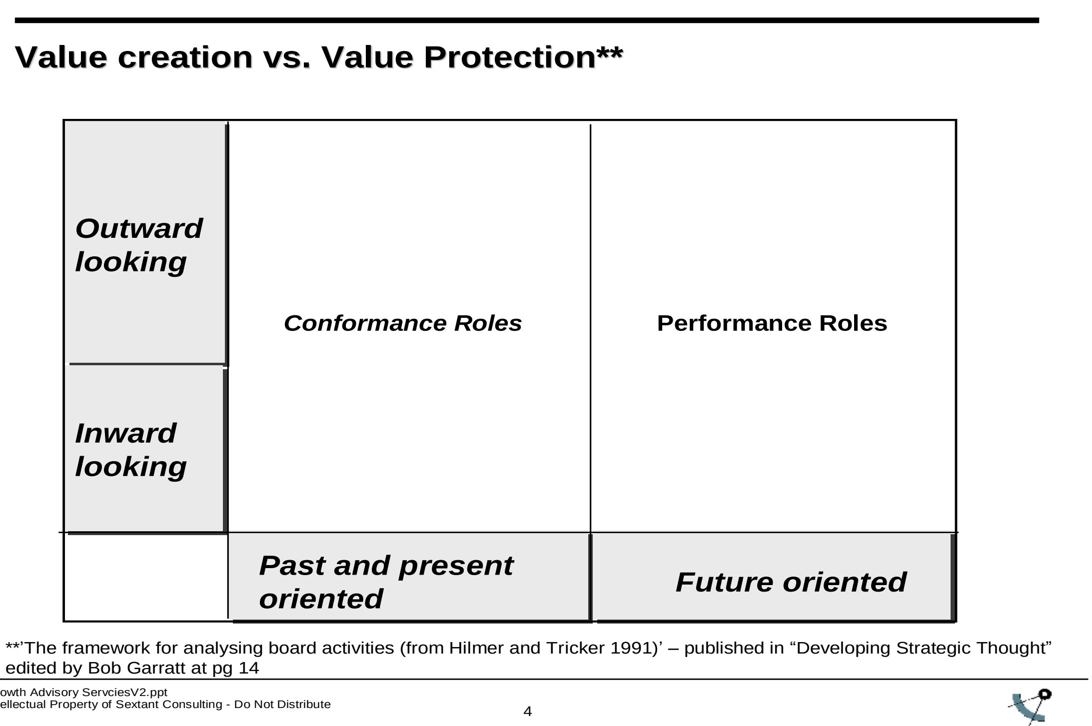
In the same article Crouch went on to say:

"A board agenda should fall essentially into two areas:

- There is the strategic side or 'creating the future'. This is the place where the board should focus most of its attention. That requires members to look forward and to exercise their business judgment in good faith in the best interests of their company.
- There is the oversight function, which should essentially be high-level review and pertinent questioning on progress against budget and previously approved strategic plans and effectiveness of risk management systems."

This approach accords with that espoused by Fred Hilmer and Bob Tricker, as summarised in Figure 9.

Figure 9: Performance versus conformance



Source: Adapted from Hilmer and Tricker (1991)

Ewen Crouch continued:

> "…there needs to be a debate and clarification of a director's role.
>
> Statutory law says 'management' is vested in directors and that they have the power to delegate. Case law suggests directors need to 'guide and monitor' management. This blurring between management and boards serves no one well. However, if you were to ask many senior business people about their expectations of the role of directors, it would be that their role is not one of manager but should encompass the following attributes:
>
> - Sound commercial judgment and an ability to make decisions;
> - A responsibility to increase the value of a company over the medium term, benefiting both shareholders and staff;
> - To have a strong awareness of governance and community expectations;
> - An ability to stand back critically from day-to-day issues and have a vision for the future;
> - To act as the custodians of 'values' of an organisation and therefore unlock the energy and talent within the organisation;
> - The ability to bring perspectives from contemporaneous experience with several entities".

Crouch's views go to the heart of the accountability versus delegation issue for boards. It is not always clear where **accountability** for overall corporate performance lies: is the board accountable and management is responsible or vice versa? Generally speaking, **responsibility** for delivery of agreed strategies and priorities ought to be delegated to management. A good governance system within an enterprise should make it relatively clear where that demarcation line is drawn for decision-making rights and authority levels. Demarcation of accountabilities between board and management is, however, not an exact science and there are many shades of grey. Whilst there are likely to be common views, the delineation between directors and management for one enterprise may not be appropriate for another.

The question also needs to be asked: does this blurring of roles also occur in the case of M&A activities? Mergers are not standard operational, business-as-usual activities; nor are they a straightforward investment assessment – unless we are talking of minor bolt-on acquisitions.

Generally speaking, sizeable transactions are irregular, sometimes occasional occurrences for most companies and usually represent a step change in terms of: corporate size and scale; significantly increased complexity in terms of strategic and operational management; and usually with significant balance sheet and capital management ramifications. The board clearly needs to be involved in such decisions; but the corollary questions then arise: What does being 'involved' mean? How much involvement? And when or how often?

Because mergers or acquisitions are generally irregular or occasional occurrences, often management and boards need to make it up as they go, in so far as determining where and how each party contributes separately and jointly.

Again, there is no standard recipe for answering these questions and none of the governance literature available appears to provide clarity about levels and forms of involvement with regards M&A. For example, executives and the board would both typically regard themselves as being involved in governance of the transaction, but the nature and form of that governance will be different. As mentioned in the preceding review on commercial literature (Section 3.3), there is a dearth of guidance – research-based or otherwise – on how to determine what each accountable body (management vs board) typically needs to do during transactions, where the boundaries for accountability and decision-making may overlap (and the parties work in in an integrated way) and where they are different.

What has the debate about conformance versus performance to do with M&A? To grow faster than their organic rates of growth and those of their industry peer group, most companies sooner or later – depending on needs, maturity and capability – will probably give some serious consideration to M&A as a growth option. Maintaining the *status quo* is usually not an option.

Thus, where there is a growth mandate from the board to management, there is an orientation toward what Hilmer and Picker called the performance role. That said, once an M&A process commences i.e. a merger or acquisition is under serious consideration, in order to succeed, any merger needs a balance of 'value protection' and 'value creation'. Thus even when in 'performance' mode (or maybe, particularly when in performance circumstances), boards still need to manage the conformance aspects of the transaction i.e. maintain a balance between value creation and value protection. Sustainable shareholder value creation requires that both elements be present.

Are there a set of guidelines or rules of thumb that directors can draw on for how boards can achieve this balance during a transaction? As far as conformance is concerned, although there are extensive risk management guidelines available to directors that address matters such as risk management sub-committees and risk governance, there are no guiding principles targeting risk management in acquisitions or how best to manage trade-offs between value creation versus value protection.

The emphasis on value creation for directors goes to the heart of the theory of the company construct and the role of directors as agents. Agency theory is one of several constructs that aim to explain governance by executive directors and is explored next.

Agency theory and conflicts of interest

Agency theory provides a construct for understanding the dynamic tensions that exist between directors as representatives of the owners and management who may have different motivations.

Jensen quotes Adam Smith:

> "The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail,

> more or less, in the management of the affairs of such a company." [Adam Smith. The Wealth of Nations, 1776, Cannan Edition" (Modern Library, New York, 1937) p. 700. (Jensen 1976)]

The issue of governance by the board goes to the heart of the principal-agent mechanism – with the management team being agents and the board being the elected representatives of the shareholders as principals:

> "….it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint. In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (non-pecuniary as well as pecuniary), and in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal." (Jensen 1976)

As Jensen describes the issues of agency theory:

> "The firm is a 'black box' operated so as to meet the relevant marginal conditions with respect to inputs and outputs, thereby maximizing profits, or more accurately, present value. Except for a few recent and tentative steps, however, we have no theory which explains how the conflicting objectives of the individual participants are brought into equilibrium so as to yield this result." (Jensen 1976)
>
> "Berle and Means (1932) were among the first to recognize the conflicts of interest that arise between principal (owner) and agent (management) in the corporate setting. Incentive alignment and monitoring are two ways by which the agency problem can be mitigated. Monitoring by the board of directors and aligning the interests of owners and managers form part of corporate governance and the primary means by which shareholders exercise control of top management (John and Senbet, 1998). Two corporate governance factors, board composition and leadership structure, may reduce agency problems by enhancing corporate boards' monitoring capabilities." (Jensen & Meckling 1976)

Agency theory is a pivotal construct that points to the challenge that company owners and investors wrestle with, namely how to have confidence that the company's interests, management's interests and directors' interests and behaviours are all in alignment?

> "Agency theory deals with the cooperative relationship which develops when one individual in an economic exchange (the principal) grants authority to another (the agent) to act on his or her behalf, and the welfare of the principal becomes affected by the decisions of the agent (Arrow 1985; Barney & Ouchi, 1986; Jensen & Meckling, 1976)." (Peter Wrighta 2001)

The essence of the theory is that principals and agents are driven by different outcomes and that value may not be maximised because the principal and the agent tend to have different objectives and predispositions toward. "Specifically, principals are considered risk neutral in their preferences for individual firm actions since principals can diversify their shareholdings across multiple firms (Wiseman & Gomez-Mejia, 1998). In contrast, agents are assumed to be risk averse since agent employment security and income are inextricably tied to a single firm (Donaldson, 1961; Williamson, 1963). In essence, agents are assumed to be risk averse in decisions regarding the firm in order to lower risk to personal wealth. Thus, the focus of agency theory is on a contract that minimizes costs associated with an agency relationship." (Peter Wrighta 2001)

"Agency theory identifies the board of directors as the primary internal control mechanism enabling firm principals to monitor management behaviour. According to the theory, one of the main tasks of the board is to specifically carry out the monitoring function on behalf of the firm's owners, acting to remove managers who misuse firm assets and participating in the formulation of strategic decisions which have a considerable impact on shareholder investments" (Gomez & Russell, 2005)[58].

The authors maintain that if board members, particularly NEDs, are there to monitor management on behalf of shareholders (principals), the board themselves are also acting as agents of the shareholders.

The questions therefore to be explored are what aligns NEDs with the principals' interests and whether Agency theory helps to explain why, where and how M&A results are impacted by boards.

Agency theory fails to explain why non-executives, as the representatives of the principal, often advocate for M&A – or why boards support executives (as agents) in these endeavours.

Gomez and Russell comment on the murkiness surrounding what motivates NEDs themselves – a discussion which considers the paucity of Agency Theory to address NED motivations, plus a consideration as to whether the Stewardship Theory and the Resource Based View more adequately explain the dynamic of what motivates NEDS. They conclude that there is a need for an integrative model or theory which also draws on Social Cognitive Theory (which "...sees motivation as a function of common human needs, which can be identified, such as the need for achievement, the need to fit in, and the need for power."). They hope that such a theory will address NED motivation, which they see as a weak link in governance research.

It is also worth understanding whether a structural response to managing the tensions between managements' and shareholders' interests is likely to assist in performance i.e. whether combining CEO and chairman roles (i.e. when an individual occupies dual roles) or ensuring arms' length separation is on balance likely to produce better outcomes for shareholders.

> "According to Fama and Jensen (1983), the separation of decision management (CEO) and decision control (chairperson) functions within a firm reduces agency costs and enhances firm performance… If Fama and Jensen (1983) are correct, firms that separate the roles of CEO and chairperson should experience an improvement in performance subsequent to the change in leadership structure. However, evidence taken from short-run performance studies suggests the US market is indifferent to changes in a firm's duality status, with no significant cumulative average excess return around the announcement day (Baliga et al., 1996). In contrast, in the UK, where CG codes advise firms to split the roles of CEO and

[58] "Boards of Directors in an Era of Corporate Scandal: An Examination of the Question of Motivation of Non-Executive Directors" (Pierre-Yves Gomez and David Russell) http://www.ifge-online.org/docftp/director_motivations.pdf

> chairperson, the decision to split (combine) them is greeted with a positive (negative) abnormal return. The abnormal return is strongly related to various measures of agency costs (Carapeto et al., 2005)." (Brown 2011)

Another dimension is the extent to which directors, as the appointed representatives of the shareholders, are able to access sufficient and reliable information to keep shareholders effectively informed i.e. whether directors can establish an effective line of sight into the actions and operations of management.

> "Agency theory is concerned with resolving two problems that can occur in agency relationships. The first is the *agency problem* that arises when (a) the desires or goals of the principal and agent conflict and (b) it is difficult *or* expensive for the principal to verify what the agent is actually doing. The problem here is that the principal cannot verify that the agent has behaved appropriately. The second is the *problem of risk sharing* that arises when the principal and agent have different attitudes toward risk." (Eisenhardt 1989)

The consideration is therefore whether different types of contracts with management e.g. behaviour based (such as via salaries, hierarchical governance) or outcome based mechanisms (such as stock options, commissions) produce better results.

Eisenhardt argues that:

> "Two propositions capture the governance mechanisms which are identified in the positivist stream. One proposition is that out- come-based contracts are effective in curbing agent opportunism. The argument is that such contracts co-align the preferences of agents with those of the principal because the rewards for both depend on the same actions, and, therefore, the conflicts of self-interest between principal and agent are reduced. For example, Jensen and Meckling (1976) described how increasing the firm ownership of the managers decreases managerial opportunism. In formal terms:
>
> *Proposition I: When the contract between the principal and agent is* outcome based, the agent is more *likely to behave in the interests of the principal*." (Eisenhardt 1989)

It would appear in fact that an alignment of incentive systems does produce an alignment of results, although whether these tend to benefit shareholder is not indicated by evidence:

> "…Argawal and Mandelker (1987) examined whether executive holdings of firm securities reduced agency problems between stockholders and management. Specifically, they studied the relationship between stock and stock option holdings of executives and whether acquisition and financing decisions were made consistent with the interests of stockholders. In general, managers prefer lower risk acquisitions and lower debt financing (see Argawal & Mandelker, 1987, for a review). Their sample included 209 firms that participated in acquisitions and divestitures between 1974 and 1982. Consistent with agency ideas (e.g., Jensen & Meckling, 1976), executive security holdings (outcome-based contract) were related to acquisition and financing decisions that were consistent with stockholder interest. That is, executive stock holdings appeared to co-align managerial preferences with those of stockholders." (Eisenhardt 1989)

The incentives under which CEOs act in pursuing M&A have knowingly been approved by boards. Unless there has been wide-spread lack of foresight and naivety by boards it is hard to argue that none of them have realised that incentivising CEOs for growth – organic or inorganic – would result in increased risk.

Eisenhardt also postulates that:

> “The second proposition is that information systems also curb agent opportunism. The argument here is that, since information systems inform the principal about what the agent is actually doing, they are likely to curb agent opportunism because the agent will realize that he or she cannot deceive the principal.”

The difficulty boards have in monitoring management’s actions during M&A points directly to the issue of asymmetry of information – and asymmetry of time and focus, which leads to:

> “Proposition 2: *When the principal has information to verify agent behavior, the agent* is more *likely to behave in the interests of the principal*.” (Eisenhardt 1989)
>
> “The first case, a simple case of complete information, is when the principal knows what the agent has done. Given that the principal is buying the agent's behavior, then a contract that is based on behavior is most efficient. An outcome-based contract would needlessly transfer risk to the agent, who is assumed to be more risk averse than the principal.
>
> The second case is when the principal does not know exactly what the agent has done. Given the self-interest of the agent, the agent may or may not have behaved as agreed. The agency problem arises because (a) the principal and the agent have different goals and (b) the principal cannot determine if the agent has behaved appropriately. In the formal literature, two aspects of the agency problem are cited. *Moral hazard* refers to lack of effort on the part of the agent. The argument here is that the agent may simply not put forth the agreed-upon effort. That is, the agent is shirking.” (Eisenhardt 1989)
>
> “Information asymmetry is linked to the power of lower order participants (e.g., Pettigrew, 1973)… In agency theory they are resolved through the co-alignment of incentives – the price mechanism of economics.” (Eisenhardt 1989)

Again, despite the relative paucity of time and attention that non-executive directors can pay to the information related to transactions, Agency theory doesn’t adequately explain their limited use of external governance support; for example employing independent outsiders or special advisers to sanity check managements’ assertions. Agency theory fails to explain the extent of risk taking or lack of effective risk management by management and boards alike. If the risks attendant upon M&A are generally well-known and widely documented, why do events appear to point to inadequate risk management and due diligence?

If one accepts the argument there is asymmetric information between management and boards – which is not hard to accept when one considers the simple weight of information that boards are expected to process with part-time availability – and given that M&A loss making is such a recurrent theme, one would expect that boards would be hyper vigilant around certain topics and insistent on receiving satisfactory answers form management. Applying a learning effect to M&A non-executive directors would be presumably not easily fobbed off by superficial answers. Agency theory does not adequately explain this.

If Agency theory and the supremacy of shareholders does not adequately explain value destruction, what of other theories?

There are a number of alternative and supplementary theories that could be mentioned *inter alia*: Stakeholder theory, Stewardship theory and the Value Maximisation theory.

All three constructs, however, whatever their relative merits, are generalised and do not shed light on boards' roles in transactions and specifically on what they are doing or not doing that undermines value creation. Knowing that boards may act with a bias to one or other constituency – shareholders, stakeholders, or as stewards of the company's assets – consciously or sub-consciously, may be interesting with regards mindset and focus, but does not help to codify right governance in terms of recommended actions or activities.

For example, if managers and boards were driven by the interests of a far wider constituency, how does a stakeholder theory explain why they would undertake acquisitions that result in rationalisation of suppliers (their own or those of the target), staff (on both sides of the fence) or potentially closure of assets to the detriment of local communities?

Alternatively, Stewardship theory argues that managers and directors are motivated by a greater good than their own selfish interests as agents and are driven by a collective motivation, and a focus on higher order needs such as opportunities for growth, achievement, affiliation and self-actualisation. "Stewardship theory takes exception to agency theory's depiction of individuals as individualistic, opportunistic, and self-serving….". (Gomez, 2005). But this theory does not explain how well-meaning and potentially more altruistic managers presumably still get it wrong with regards acquisitions – or why, where and how those boards too have failed to play effective roles in balancing a stewardship mindset with the necessary focus on value delivery or value maximisation.

We next consider Australian Stock Exchange guidelines to directors that are of a generic nature but that could or should influence their conduct during transactions.

Providing transparency into the adoption of good governance practices

Part of the response by investors and regulators to headline-grabbing instances of catastrophic mismanagement and failures of governance (read Enron, WorldCom, Lehmann Brothers and the like), has been an emphasis on compliance. In effect, boards have been pressured to report on their governance regimes and to adopt processes and structures that respond to 'codes of best practice' e.g. via a separation of CEO and chairmen's roles, a majority of non-executive, independent directors etc.

In Australia we have the Australian Securities Exchange (ASX) Principles of Good Corporate Governance[59] – introduced in 2003 and updated most recently in March 2014[60]. Under ASX Listing Rule 4.10, "Companies are required to provide a statement in their annual report disclosing the extent to which they have followed these best practice recommendations in the reporting period. Where companies have not followed all of the ten chief recommendations, they must identify the recommendations that have not been followed and give reasons for not following them."

This is known as the 'if not, why not?' disclosure approach. The preface to the ASX Principles clearly acknowledges that there is no 'one size fits all' approach to governance and that each company's circumstances should dictate what is most appropriate for it.

Listed enterprises in Australia in their published annual financial statements are thus obligated to provide detail and some evidence as to how they are responding to the ASX Principles.

In terms of the identifying which of the 10 ASX principles may be directly applicable to the M&A lifecycle, there are four in particular that have indirect or tangential applicability to acquisition activities:

"Principle 1: Lay solid foundations for management and oversight"

"A listed entity should establish and disclose the respective roles and responsibilities of its board and management and how their performance is monitored and evaluated.

Recommendation 1.1
A listed entity should disclose:

(a) the respective roles and responsibilities of its board and management; and

(b) those matters expressly reserved to the board and those delegated to management." (ASX Corporate Governance Council 2014)

The commentary under the points of guidance states that "Clearly articulating the division of responsibilities between the board and management will help manage expectations and avoid misunderstandings about their respective roles and accountabilities."

There are specific pointers provided according to the guidelines that touch on aspects critical to M&A effectiveness:

"Usually the board of a listed entity will be responsible for (*inter alia)*:

- overseeing management's implementation of the entity's strategic objectives and its performance generally;

[59] http://www.shareholder.com/shared/dynamicdoc/ASX/364/ASXRecommendations.pdf

[60] http://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf

- approving operating budgets and major capital expenditure;
- overseeing the entity's process for making timely and balanced disclosure of all material information concerning the entity that a reasonable person would expect to have a material effect on the price or value of the entity's securities;
- ensuring that the entity has in place an appropriate risk management framework and setting the risk appetite within which the board expects management to operate;
- approving the entity's remuneration framework; and
- monitoring the effectiveness of the entity's governance practices." (pg. 8) (ASX Corporate Governance Council 2014)

The previous 2003 version of the ASX guidelines (at pg. 19) included under board responsibilities:

- "monitoring senior management's performance and implementation of strategy, and ensuring appropriate resources are available
- approving and monitoring the progress of major capital expenditure, capital management, and acquisitions and divestitures." (ASX Principles 2003)

"Principle 5: Make timely and balanced disclosure"
"A listed entity should make timely and balanced disclosure of all matters concerning it that a reasonable person would expect to have a material effect on the price or value of its securities." (page 26) (ASX Corporate Governance Council 2014)

"Recommendation 5.1

A listed entity should:

(a) have a written policy for complying with its continuous disclosure obligations under the Listing Rules; and

(b) disclose that policy or a summary of it."

"The disclosure policy should include vetting and authorisation processes designed to ensure that announcements by the entity are factual, complete, balanced and expressed in a clear and objective manner that allows investors to assess the impact of the information when making investment decisions.

In this context, "balanced" means disclosing both positive and negative information.

The disclosure policy should address:

- the roles and responsibilities of directors, officers and employees in complying with the entity's disclosure obligations;
- safeguarding confidentiality of corporate information to avoid premature disclosure;

- media contact and comment;
- external communications such as analyst briefings and responses to security holder questions; and
- measures for responding to or avoiding the emergence of a false market in the entity's securities." (ASX Corporate Governance Council 2014)

This recommendation aims to promote timely and balanced disclosure of all material matters concerning the company. This means that the company should have the necessary written policy for disclosure and must have in place mechanisms designed to ensure compliance with the ASX Listing Rule requirements such that:

- "all investors have equal and timely access to material information concerning the company – including its financial situation, performance, ownership and governance
- company announcements are factual and presented in a clear and balanced way.

"Balance" requires disclosure of both positive and negative information." (2003 ASX guidelines, pg. 38). (ASX Principles 2003)

"Principle 6: Respect the rights of security holders"

"A listed entity should respect the rights of its security holders by providing them with appropriate information and facilities to allow them to exercise those rights effectively.

Commentary

A fundamental underpinning of the corporate governance framework for listed entities is that security holders should be able to hold the board and, through the board, management to account for the entity's performance. For this to occur, a listed entity needs to engage with its security holders and provide them with appropriate information and facilities to allow them to exercise their rights as security holders effectively. This includes:

- giving them ready access to information about the entity and its governance;
- communicating openly and honestly with them; and
- encouraging and facilitating their participation in meetings of security holders." (pg. 27) (ASX Corporate Governance Council 2014)

"Principle 7: Recognise and manage risk"

"A listed entity should establish a sound risk management framework and periodically review the effectiveness of that framework.

"Recommendation 7.1

The board of a listed entity should:

(a) have a committee or committees to oversee risk……

(b) if it does not have a risk committee or committees that satisfy (a) above, disclose that fact and the processes it employs for overseeing the entity's risk management framework."

"Recommendation 7.2
The board or a committee of the board should:

(a) review the entity's risk management framework at least annually to satisfy itself that it continues to be sound; and

(b) disclose, in relation to each reporting period, whether such a review has taken place." (Council 2014)

"Recommendation 7.3
A listed entity should disclose:

(a) if it has an internal audit function, how the function is structured and what role it performs; or

(b) if it does not have an internal audit function, that fact and the processes it employs for evaluating and continually improving the effectiveness of its risk management and internal control processes." (ASX Corporate Governance Council 2014)

"Recommendation 7.4
A listed entity should disclose whether it has any material exposure to economic, environmental and social sustainability risks and, if it does, how it manages or intends to manage those risks." (ASX Corporate Governance Council 2014)

These ASX principles are important guides on **what** boards ought to do, generally speaking, to discharge their governance duties. They are designed, in effect, to provide guidance to directors on their overarching roles and duties, and to ensure enhanced transparency to the market on those aspects of governance that could be structural, procedural or activity based.

Generally speaking, however, they do not provide guidance on the **how** of governance, and specifically are silent on stewardship over M&A activities. That said, it is perhaps unrealistic to expect these principles to address directly board behaviour and actions during mergers and acquisitions, relative to all the other monitoring, strategic and other oversight tasks a board ought to cover.

In terms of the ASX's required disclosure process, unfortunately the practical translation of disclosure and voluntary compliance has meant that boards and governance practitioners alike have tended to use checklists and 'tick the box' exercises to assess the state of adherence in many organisations, often as a way to be able to benchmark practices across enterprises and to aid in compliance checking.

These approaches generally ignore or are not designed to address the reality that good board structures and processes do not overcome poor judgment or weak debate or lack of skills. This has resulted in what could be described as a 'triumph of form over substance'. As a far more eminent source, Justice Neville Owen was quoted as saying: "For me, the key to good governance lies in substance, not form. It is about the way the directors of a company create and develop a model to fit the circumstances of the company and then test it periodically for its practical effectiveness. It is about the directors taking control of a regime they have established and for which they are responsible."[61]

This issue is very much a current one and affects boards large and small (being arguably disproportionally impactful on smaller listed enterprises). Boards are increasingly compliance oriented – partly as result of the Sarbanes-Oxley requirements; partly owing to ASIC governance declarations and statements; and partly owing to a self-imposed effort to be transparent with regards other factors such as the management of risk (resultant from the Global Financial Crisis), sustainability and environmental pressures.

For governance to be working effectively and more importantly, to be seen to be working properly, greater transparency inside the boardroom would be desirable. Would this be practical, however, and what would this mean for M&A? Are there any lessons on how to improve M&A governance, based on general corporate governance codes and disclosure principles?

If one were to follow the same path that ASX governance requirements or codes of good practice generally have followed, and apply those approaches and tenets specifically to M&A practice, there are three options that arise:

1) Adopting a process and structural response, just as many boards have sought to do to improve governance performance. What will the benefits be for a board that adopts M&A processes or structures such as by putting in place a 'M&A review sub-committee' or tasking its Audit sub-committee or Strategy sub-committee with this task?
2) Adopting a voluntary Code of Practice or Board Charter that also specifically addresses M&A conduct. Would the adoption and disclosure of "M&A Governance Principles and Practices" potentially aid board performance and shareholder confidence?
3) Adopting an improved transparency and disclosure regime. Would better disclosure of the steps the board was taking to assure or secure M&A value, give investors justified grounds for confidence, or conversely concern?

These options and questions are worthy of consideration and taken together potentially could make a difference. How much weight the investing public ascribes to disclosure statements of this kind is debatable – but astute investors are unlikely to be satisfied simply by what could be termed as window-dressing. The value of these mechanisms would need to be explored as a separate study that goes beyond current recognised M&A governance practices.

As instruments or matters of 'form', however, these options would need to be juxtaposed to options of substance, such as the appointment of 'deal-savvy' executive and non-executive directors and by encouraging critical debate of deals. Can the efficacy of these options, taken solely or in combination, be proven? No literature has pointed to the relative effectiveness of these governance mechanisms. Whether useful, directional views surface from research interviews conducted with non-executive directors will be discovered later.

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[61] Report of the HIH Royal Commission, *The Failure of HIH Insurance* (2003), xxxii, available at http://www.hihroyalcom.gov.au/finalreport/index.htm (last visited 4 December 2012).

In summary, the net position based on governance codes is that there are no direct or clear requirements for non-executive directors on how to conduct themselves in the case of M&A.

Having considered transparency via disclosure requirements, we next consider the structural aspects of governance, primarily the role of the chairman, the question of independence, and the 'separation of powers' between executive and non-executive directors. The elements have been covered in a range of codes of best practice, which are considered first.

The role of the chairman and independent non-executive directors

The Cadbury Report (1992) titled *The Financial Aspects of Corporate Governance*[62] and its associated Code of Best Practice was one of several such reports that emphasised the importance of non-executive directors (NEDs), and particularly <u>independent</u> NEDS.

Independent NEDs are viewed as critical to help to support more objective, impartial debate in boardrooms; to counteract the power of executive directors; and to aid in enhanced transparency. In the Cadbury report and in a range of others like it, considerable effort went into defining (a) what is an independent director, and (b) what proportion should they represent on boards and their various sub-committees.

The Institute of Company Directors in the UK provides the following definition:

> "Independent' directors, are defined in the Cadbury Report as persons who "apart from directors' fees and shareholdings [are] independent of the management and free from any business or other relationships which could materially interfere with the exercise of the independent judgement."[63]

Cadbury was followed by other similar reports each emphasising the importance of independent NEDs: The Greenbury Report in the UK in 1995 focused more on directors' remuneration and the need for remuneration committees to be comprised of independents only; the Hempel Review also in the UK, initiated by the Financial Reporting Council (in 1995 and reported out in 1998), examined the benefits being achieved by the Cadbury Code and by Greenbury.

In the US, the Treadway Commission in 1987 had also emphasised the role and importance of independents – suggesting audit committees by made up solely of independents.

Impact of having sufficient independent numbers

"Board composition is "independent" if the majority of the members are outside directors and "non-independent" if the majority of the board is composed of inside directors. Leadership structure is defined as "split" when the CEO is not also the chairman of the board and "combined" if the same person serves in both positions." (Schooley, Renner et al. 2010)

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[62] http://www.jbs.cam.ac.uk/cadbury/report/index.html
[63] http://www.iod.com/MainWebSite/Resources/Document/roleofnxds_1006.pdf

Having outside directors appears to matter and to make a difference, although proven correlations are weak.

> "Indeed, research provides inconsistent results in evaluating the effects of board composition on performance. Two meta-analyses (John and Senbet, 1998; Dalton et al., 1998) report no correlation between board composition and financial performance or market performance. Bhagat and Black (1999) also find little correlation between board composition and financial performance, except that boards with a supermajority of outside directors demonstrate worse performance. The authors speculate that these boards contain too few inside directors who typically have valuable knowledge about the company necessary to make good decisions. Indeed, Fama and Jensen (1983) state that the board should be composed of decision experts, including insiders. Finally, Yermack (1996) and Schnake and Williams (2008) find that smaller boards are associated with higher market value and better financial performance than larger boards. Rosenstein and Wyatt (1990) discover that firms replacing inside directors with outside ones experience an increase in stock price, and boards dominated by outsiders are more likely to use performance-based pay for executives. More recently, Fields and Keys (2003) find that firms with poorer performance are likely to replace inside directors with outside ones." (Schooley, Renner et al. 2010).

The focus on independents, whilst laudable, is not a panacea and there is no compelling evidence that with more independent directors present, better decisions will be made. More independent directors on to a board does not of itself guarantee more penetrating debate or better decision-making around major capital commitment or transactions, unless these individuals bring the requisite skills, experience and tenacity with them. Nonetheless, improving the balance of independent numbers and adding diversity of experience is at least a start. Some quantum of improvement in governance should result, unless the company indulges in window dressing or the new independent appointees are out of their depth or not adequately authoritative relative to the executive directors. The presence of strong NEDs, on the balance of probability, is not likely to harm M&A results, provided they bring 'deal nous' to the table.

The role of the chair in delineating boundaries

Australia's governance requirements for the presence of NEDs and the separation of powers between a CEO and a chairman closely mirror those of the UK. Nada K Kakabadse (Northampton Business School) and Andrew P Kakabadse (Cranfield School of Management), have compared and summarised Australia's governance regime to that of the UK and USA as follows in their paper "Chairman of the board: demographics effects on role pursuit". (Kakabadse 2007). Table 2 summarises national variations in governance mechanisms.

Table 2: National variations in governance mechanisms as developed by Kakabadse and Kakabadse 2007

Context	UK	USA	Australia
Governance practice	Self-regulatory ('comply or explain' approach)	Legislation driven	Self-regulation but strictly conforming to national regulatory authorities (Australian Securities and Investments Commission)
Legal responsibility	'Collective responsibility' – 'no difference' between executive and non-executive directors (shared liability)	Chairman/CEO and CFO (chief financial officer) carry legal responsibilities– certification of financial reports under Sarbanes-Oxley (2002)	Chairman has ultimate accountability
Role separation	Clear preference for separation (92 per cent of UK's 1702 listed companies)	Role duality. Only approximately 20 per cent of US's 6,703 listed companies have split chair/CEO roles	Clear preference for separation (90 per cent of 1,774 Australian listed companies)
Independent directors	At least one half of the board (Higgs, 2003)	Substantial majority of the board (both independent and grey) – often all, with exception of CEO (NYSE Conference Board, New York Stock Exchange, 2003)	Substantial majority of the board – often all, with exception of CEO

According to Kakabadse and Kakabadse, chairmen in the UK and in Australia tend play a more direct role in setting the tone for how the board goes about its business. The Higgs (2003) report emphasised the chairman's crucial role:

> "…in crafting the conditions for director and board effectiveness. Higgs (2003) recommended that the chairman should be responsible for:
>
> - the leading of the board, ensuring its effectiveness and for setting its agenda;
> - ensuring the provision of accurate, timely and clear information to directors;
> - ensuring for transparent and relevant communication to shareholders;

- arranging for the regular evaluation of the performance of the board, its committees and individual directors;
- enhancing the contribution of non-executive directors; and
- ensuring for constructive relations between executive and non-executive directors."[64]

The extent to which a chairman can surround himself or herself with suitably skilled and competent directors, and then coach and lead them to be a highly effective team, ought to be a determinant of company performance, logically speaking. The reality is that there are no compelling empirical studies that prove causality between company performance and the adoption of good governance practices and/or a highly skilled, competent and well-led board.

The converse is also true i.e. there are no well-established links between poorly performing companies and their lack of adoption of good governance standards or the poor quality of their boards.

Ultimate accountability for board actions and those of executive management resides with the chairman in Australian and UK enterprises. Australian company law draws no distinction between the responsibilities of executive and non-executive directors.

Governance ultimately is how the board goes about its business of stewardship i.e. how it carries out its roles and responsibilities. Understanding the responsibilities of chairmen and how their roles are defined is thus important. Kakabadse and Kakabadse conducted series of interviews with chairmen of major enterprises in the UK, US and Australia, covering 33 ASX Top 50 companies (and 35 each from the UK FTSE 150 and the S&P 500 in the USA) in 2005/06. A number of important findings emerged indicating the unique aspects of governance in Australia.

Table 3: Roles of chairmen as developed by Kakabadse and Kakabadse 2007

Demographics	UK	USA	Australia
Role boundary	Chairman runs board; CEO leads the enterprise	CEO/chair leads the enterprise and the board	Chairman role delineation jointly determined with CEO/MD
Status: executive or non-executive	Little difference in practice	Executive dominant	Extensive difference
Accountability	Chairman accountable for board performance	CEO / chairman accountable for board and business performance	Chairman accountable for board and business performance

64 Nada K. Kakabadse (Northampton Business School, The University of Northampton) and Andrew P. Kakabadse (Cranfield School of Management, Cranfield, UK) – *Journal of Management Development* Vol. 26 No. 2, 2007 at page 174. extract from http://www.som.cranfield.ac.uk/som/dinamic-content/media/documents/192a.pdf

Demographics	UK	USA	Australia
Vision ownership	Chairman: vision passive	CEO / chairman: vision active – if role split, then passive	Chairman: vision active
Recruitment	International	National	National
Domicile	Not relevant	Not relevant if role is split, otherwise CEO / chairman resides in the same city as headquarters	Chair resides in same city as headquarters
Counter balancing role	Senior independent director (SID)	Lead independent director (LID)	Deputy chairman (little need for the counter balance)
Tenure	More effective longer in role (12 to 15 years)	More effective longer in role (eight to ten years)	More effective longer in role (12 to 15 years)
Governance application	Voluntary: increasingly compliant	Legislative: compliant	Voluntary: compliant

Regarding the role boundary dimension, Kakabadse and Kakabadse describe the establishment of role boundaries as an "idiosyncratic process". "The role of chairman was reported as 'uniquely' enacted by each incumbent and adapted to each boardroom context. Board context was reported as influenced by:

- the board's history and culture
- the norms of conduct within the enterprise
- the pattern of selection to the job
- the nature of socialisation with board colleagues
- the degree to which each board member's expectations of their role was realised (or not)
- the quality of dialogue on the board
- the nature of board power based relations
- external conditions such as the influence of regulators, legislation, codes of practice, stock exchange conditions and the demands of institutional investors.

Thus, the chairman's contribution was described as individually and idiosyncratically enacted from board to board and from country to country …"[65]

The authors conclude that "Australian chairmen emerged as more dominant than their UK counterparts with the majority reporting that they, together with their CEO or in many cases the managing director (MD), jointly determined the nature of role delineation." (at pg. 12).

In the US, of course, the situation is far more complicated as there is usually no separation of power between the CEO / president / chairman.

Knowing where the boundaries are for the chairman's power *vis a vis* that of the CEO, means *ipso facto* knowing what the board is accountable for relative to management. In the context of major board decision-making, the clarity of these boundary issues could have a significant impact.

Boundary setting is a crucial activity that chairmen and CEOs ought to attend to; and has been flagged as one of the six key disciplines of highly effective chairman (Kakabadse 2008). In an interview[66], one of the book's lead authors stated:

> "…we went to over 900 boards, and it was four surveys over seven years – we could not, for a long time, find out trends. So every board we went to, every chairman we went to, it was different.
>
> "….a good board is one that positions itself to have advantage for the business by asking questions like: What is our competitive advantage? How different are we? So these are very much business questions that the top team would ask and the smart chairman is the one who says the purpose of the board today in this place is … and sets a boundary and then says the management contribution is … and sets another boundary.
>
> And then they set a very interesting boundary between the role of chairman and CEO, and we have found direct competitors who would have a chairman in one place, having the role and contribution of a CEO, and a CEO in the other place having the role and contribution of the chairman, so it looked as if the two roles were completely out of balance. What was so great about them, because these were two very good companies, was that the chairman and CEO had sat down together and said 'What's our job here, how do we really add value?' And they came up with a boundary between them, and a role and contribution between them that made business sense."

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[65] "*Chairman of the board: demographics effects on role pursuit*", Nada K. Kakabadse, (Northampton Business School, The University of Northampton, Northampton, UK), and Andrew P. Kakabadse (Cranfield School of Management, Cranfield, UK) – *Journal of Management Development* Vol. 26 No. 2, 2007 at page 180. Extract from http://www.som.cranfield.ac.uk/som/dinamic-content/media/documents/192a.pdf at page 11

[66] Professor Andrew Kakabadse: http://www.som.cranfield.ac.uk/som/dinamic-content/media/documents/leading%20the%20board.pdf

Knowing what these boundaries are and where they are drawn is a key exercise for every company. Knowing for example, at headline level, that the board needs to approve and monitor M&A activities, is not particularly instructive in knowing *where* the board needs to be active and hands-on (for example, co-crafting the M&A strategy?) or passive i.e. reviewing and approving management's proposals and plans (for example, the due diligence reports or merger plans and timetables?). Even if this is an idiosyncratic activity, how do individual board members know which activities they should generally be focusing on and what the rules of thumb are for where the boundary lines are drawn? This clarity on how to delineate roles is not at all apparent from the governance literature, even at a generic level, as was also found to be deficient in the commercial literature explored in the preceding section.

The crucial ways that effective chairmen contribute to success

The chairman's role in enabling effective governance, as previously indicated, is crucial. In a separate study titled *Chairman and the Board: A Study of the Role, Contribution and Performance of UK Board Directors* (Kakabadse 2008), by Professors Andrew Kakabadse and Nada Kakabadse and two others, a number of potential de-railers of board effectiveness were identified.

> "Given the differences in perceptions reported by board directors, a number of issues that could negatively impact Board performance – particularly with regard to the chairman – have been identified.
>
> - The roles of chairman and CEO are not always clearly delineated.
> - Chairmen believe they make greater contributions to strategic decision-making than other board members believe they do.
> - Other board members report that chairmen do not encourage feedback.
> - Chairmen need to do more in managing board performance.
> - Chairmen lack clear mechanisms for their own succession and scrutiny.
> - The core role and contribution of senior independent directors is not clearly understood." (Kakabadse 2008)

Research evidence points to the pivotal role of the chairman:

> "…despite nationally determined practices, despite role delineation (or not) and sound governance application (or not), the values, qualities and behaviour of the leader(s) emerge as a key ingredient to determining firm success." (Kakabadse 2006)

Having explored the pivotal role of the chair, and the 'boundary delineations' between executive and non-executive directors, we briefly consider some seminal governance cases arising in the US and how these have shaped consciousness about board malfeasance and/or incompetence.

The role of the chair and board in helping to set direction and select strategy

A 2008 study of UK directors for example, undertaken under the aegis of the Cranfield University School of Management[67] suggested that an "... area of possible contention concerns strategic decisions. The results indicate that chairmen believe that they strongly drive the company vision; determine the organisation's strategy; and enable understanding of organisation strategy."

Later in the same report, the authors indicated that "Chairmen believe they drive the vision and determine the organisational strategy, whereas CEOs believe that they determine the vision and drive the strategy." (at pg. 11).

Whilst delineation of ownership may vary from board to board, and perceptions may also vary as to who is accountable for what, the UK research indicates a consistency of conclusions with this thesis, namely that chairmen and board members regard their involvement in strategy as crucial.

In another report the same authors say that:

> "In terms of identifying and promoting a vision for the future of the firm, British chairmen reported their role as positioning the board to debate, challenge and 'sign off' on the vision of the CEO and his or her management team. The 'more passive' UK chairman was contrasted by the 'more proactive' Australian chairman who reported distinct involvement in, and for some outright determination of, the vision of the company. The majority of Australian chairmen reported themselves as the 'stewards' of the vision of the enterprise."[68]

As Jay Lorsch and Robert Clark, writing in the April 2008 *Harvard Business Review* at pg. 108 state:

> "In assuming leadership of their companies' long-term destiny, boards first need to be clear with themselves and with management about the complementary roles each side must play. Each group must be realistic about what it has the time and knowledge to do on its own. Different boards and management teams will define their roles differently, of course, according to company circumstances. In general, however, the setup will look familiar – but with an emphasis on the long term: Management will develop and propose

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[67] "Chairman and the Board: A Study of the Role, Contribution and Performance of UK Board Directors" Summary Report by Professor Andrew P. Kakabadse, Cranfield University, School of Management; Professor Nada K. Kakabadse, Northampton Business School, The University of Northampton; Dr. Andrew J. Myers, AJM Associates, Cranfield University, School of Management, April 2008; page 9

[68] *Chairman of the board: demographics effects on role pursuit*, Nada K. Kakabadse, (Northampton Business School, The University of Northampton, Northampton, UK), and Andrew P. Kakabadse (Cranfield School of Management, Cranfield, UK) – Journal of Management Development Vol. 26 No. 2, 2007 at page 182. Extract from http://www.som.cranfield.ac.uk/som/dinamic-content/media/documents/192a.pdf

long-range plans, and the board will react to these proposals and debate among itself (and with management) their validity and wisdom." (Lorsch and Clark 2008)

Successive US corporate failures have changed the liability landscape

The corporate failures of Enron, Tyco, and WorldCom happened in quick succession in 2001/2002 and the aftermath rocked boards around the world. Three key patterns were identified that led to director liability: lack of vigilance or tight controls over internal audits; lack of stewardship and scrutiny over major transactions; and lack of control over new capital raisings.

These three factors were summarised by Alan Hevesi, Comptroller of the State of New York and the sole trustee of the NY State and Police Pension Fund. He played a key role in the plaintiffs' decision to insist on personal director liability in the WorldCom case:

> "WorldCom is the largest fraud in history. Its $11 billion in false filings, $40 billion in damages, $76 billion in restatements… Their audit committees spent between three and six hours a year overseeing the auditing and financing. They failed to supervise their internal audit department. They approved major acquisitions with little or no deliberation and no paperwork, a $2 billion acquisition of Skytel Communications in a fifteen-minute meeting and a $6 billion acquisition of Intermedia in a thirty-five-minute meeting. No paper, no nothing – they just signed off on it and this – Intermedia – was a disaster for the company and for the shareholders. They allowed debt to spiral in the company to $36 billion without engaging in any debt planning. Their debt plan was to authorize Bernie Ebbers and Scott Sullivan to borrow at their own initiative without anybody else's approval as long as each individual transaction did not exceed $15 billion. …I mean, it's a disastrous failure on the part of the board." (Bebchuk, Bachelder et al. 2006)

Bebchuk goes on to say:

> "The terms of the settlements were unusual. They involved the directors of the companies making some payments out of their own pockets. Richard Breeden, former SEC chair, called these settlements a 'watershed development' that will send a shudder through boardrooms across America and could change the rules of the game." (Bebchuk, Bachelder et al. 2006)

Lack of control over new capital raisings

John Olson, Senior Partner; Gibson, Dunn & Crutcher LLP; Washington, DC summed up the due diligence requirement and the directors' defence:

> "In both the Enron and WorldCom cases, the primary legal issue was whether or not there was liability under section 11 of the 1933 Act[69] in connection with the issuance of securities… section 11 basically says that if there's a material misstatement or omission relied on by investors in a document that goes out when you offer securities – and both of these companies offered billions of dollars of debt and equity securities – the company

[69] Securities Act of 1933: http://www.sec.gov/about/laws.shtml

> itself is absolutely liable. The underwriters are absolutely liable. And the directors and officers are also absolutely liable to give you your money back – to the extent that there's a material misstatement or omission in that offering document. The company has no defense. But in the case of the officers and directors and underwriters, they can establish that, after the exercise of due diligence, they did not know and should not have known of the misstatement or omission. The problem legally, as limned out in the preliminary rulings ….in WorldCom, is that …people had already come in …and made findings that these directors had not done what they should be. According to the Breeden report, not only had they slept while the train went by the switch, they'd been sleeping on the switch. So, they were going to have a very, very difficult time establishing a section 11 'due diligence' defense." (Bebchuk, Bachelder et al. 2006)

Stewardship and scrutiny over major transactions

These cases have caused directors to focus not only on the process surrounding their decisions but also on the content of their decisions. John Olson, Senior Partner, Gibson, Dunn & Crutcher LLP, Washington, DC:

> "What all of these cases have done is cause directors to focus a lot more on process. I don't think that's all bad. Process is not the whole story but it's what we can best measure. So, now you have boards getting independent advice, taking more time, spending hours on a proposed acquisition instead of twenty minutes, getting fairness opinions, asking hard questions, and having people like me to tell them what questions to ask." (Bebchuk, Bachelder et al. 2006)

Events such as these have provided some guidance to directors as to the do's and don'ts during acquisitions. Based on these learnings, one would expect that directors have become far more assertive in asking management for information and assuring themselves of the facts. Of course this does not necessarily mean that independent non-executive directors will find it any easier to 'swim against the tide' or separate themselves from a board dynamic where the hard questions are not being asked of management or themselves as directors. What options are therefore open to minority directors in asserting their independence and protecting their positions?

What options are open to the dissenting director who doesn't agree with the process or the outcome?

The options to a dissenting director are relatively clear-cut: acquiescence without protest; acquiescence under protest; minority dissenting vote; abstention or resignation.

Bob Monks, a specialist governance advisor, explains the dynamic well:

> "As a director of Tyco, I became very concerned in the late eighties and early nineties with the way in which the board was conducting its business. What do you do if you're a board member and you don't think they're running their business well? It's a hard question, I think because there are lots of sort of club rules about boards. And one of them, at least in boards that I've been on, and other people may have encountered a different phenomenon – is you do not talk about company business outside of the board room with anybody. You don't have directors who meet outside of the board room, because that

> would be a cabal. So what I did, what every nice, you know, well-intended graduate of the Harvard Law School does, I sat down and wrote a letter to the chairman of the board. And I collected those, and if you have a masochistic instinct, you can go and buy 'Corporate Governance III' by Monks and Minow, for $80.00, and read the collection of letters that I sent to the board over about eight or nine years. …So, I finally, I had my final magic wand to pull out and I said "All right, I think this board's dysfunctional. We've got to have an evaluation." You know, we have never done anything like that before, so we had an evaluation and guess what? Guess what they concluded? I was a pain in the ass. So, there by the grace of God, in 1995 I'm kicked off the Tyco board, and I sit and I read in the newspaper five years later that a couple of my colleagues are now residents of one of the more unpleasant institutions in Alan's state. I have no idea what will be the ultimate juridical denouement of my former board colleagues." (Bebchuk, Bachelder et al. 2006)

The ability or persistence of an individual director to hold the line in the face of unsatisfactory answers or poor decision-making – whether related to major investments or to other board matters – is not something that can be easily predicted or enshrined as right practice; but what should be addressed is the ability of a chair to create a climate or board dynamic that is conducive to dissent being respected.

What role do board behaviours and dynamics play?

Independent directors are of little value if they cannot bring an independent frame of mind to the boardroom, with the courage to tackle hard topics. This is, of course, easier said than done.

In an interview with the McKinsey Quarterly (Lovallo 2010), Anne Mulcahy, chairman and former CEO of Xerox said:

> "You need internal critics – people who have the courage to give you feedback. This requires a certain comfort with confrontation, so it's a skill that has to be developed. The decisions that come out of allowing people to have different views are often harder to implement than what comes out of consensus decision making, but they're also better."

In the preceding review on commercial literature, reference was made to the impacts of behaviours and mindsets of the board members, individually and collectively.

To explore the effects of personality and group dynamics requires a switch in disciplines from governance to behavioural psychology – that is beyond the remit of a specific study on right practices by executive and non-executive board members on M&A transactions.

Usually it falls upon the shoulders of a chairman to allow, indeed encourage, what could be termed 'fierce conversations'[70] – i.e. open, challenging but respectful engagement on critical issues within the board ranks. Additionally, it is also the chairman's role – although perhaps not all would see it in these terms – to strike a healthy balance between the board (a) acting in a collegial and cohesive way to support management; and (b) directly challenging and controlling management where

[70] *Fierce Conversations* by Susan Scott http://www.fierceinc.com/

necessary. Again, a study of the chairman's role in board dynamics and in managerial relations, goes beyond the scope of this thesis.

Creating the right dynamic

One construct that is perhaps useful in helping to understand the duality of board interactions, comes out of social science theory: in what is or was known as the 'order versus conflict' debate[71]. Essentially, the **order** approaches concentrate on explaining the nature of social order and equilibrium; and the **change** school is more concerned about problems of change and conflict.

Again, it is not a focus of this thesis to explore complex theories of social dynamics or board culture, but it is worth reflecting briefly on the 'order versus conflict' debate. In short, the key elements of the two theories are as shown in Table 4.

Table 4: Comparison of 'order' versus 'conflict' views of society

The 'order' or 'integrationist' view of society emphasises:	The 'conflict' or 'coercion' view of society emphasises:
Stability	Change
Integration	Conflict
Functional co-ordination	Disintegration
Consensus	Coercion

Source: Gibson Burrell and Gareth Morgan, 1979, *Sociological Paradigms and Organisational Analysis*, at pg. 13

Certain academics argue, however, that these are not mutually exclusive, separate states, but are in fact two sides of the same coin. Rather, it is not a case of one versus the other – it is generally now perceived as more of a spectrum or continuum than polar opposites.

Applying this to M&A transactions, one can quite easily recognise that if one wants vigorous debate and scrutiny of a deal to take place, a board that is solely in 'order' mode is unlikely to apply the blowtorch effectively when evaluating the business case for the deal to proceed. This should not mean that a board needs to become confrontational to conduct an assessment of the acquisition business case; merely that it is able to provide critical challenge and is willing to assert itself to have its questions answered to its satisfaction. It requires careful management of board dynamics in moving from collegial questioning of executives to a more robust challenge.

How to accomplish these shifts in board dynamics will depend upon a combination of several critical variables, *inter alia*: the skill of the chairman; his or her relationship with the CEO; the ethos of the board in making the hard decisions, not necessarily the popular ones; its ease in

[71] Gibson Burrell and Gareth Morgan, *Sociological Paradigms and Organisational Analysis,* 1979 at pg. 10

dealing with constructive confrontation; its preparedness to deal with divergent thinking rather than (or in addition to) convergent conversations; the board's flexibility in moving from challenge to collaboration; the make-up of the board and its composition of 'contrarian' thinkers who are not easily cowed into acquiescence; and finally how the chair accommodates and indeed leverages the personality types of the individual members.

Challenge versus convergence

As Alfred P Sloan, Chairman of General Motors during its heyday, said:

> "Gentleman, I take it we are all in complete agreement on the decision here... then I propose we postpone further discussion on this matter until our next meeting to give ourselves time to develop disagreements and perhaps gain some understanding of what the decision is all about." (Crainer 2008)

Board dynamics and culture are generally not covered in the conventional literature regarding governance, but they are vital ingredients to the effective functioning of boards and their ability to be constructive whilst still being challenging; and to be cohesive and collaborative when the debate is over.

It has been asserted that boards need the ability to shift smoothly and easily between the two modes of interaction – challenge and convergence – as circumstances require it, without creating permanent schisms or becoming dysfunctional. One could term this as 'achieving semi-schizophrenic behaviour' (the author's own words). The chairman would need to be the chief catalyst and guardian of this duality. This, however, is subject best explored in more targeted research.

As the conflict school of thought is also about coercion, there is a broader theme to governance about the extent to which a board ultimately needs to assert its will over that of management. Certainly, as the legitimate representatives of the shareholders and the appointer of executive management, it should be relatively clear that the board owes its primary accountability to those who have elected it. The question of the primacy of the board, however, in enforcing sensible controls over management, could also be the subject of a separate thesis.

Understanding how a board functions requires context – each enterprise's culture and context are unique. Whilst governance literature does not explore contextual determinants of how a board defines its roles and duties, systems' thinking does give us a useful framework for understanding internal and external drivers of board actions.

Seeing the board as part of an open system

Companies do not operate in isolation from their external environments – competitive, regulatory, technological, economic, social, environmental and community based factors all play a part in shaping direction and performance. As has been described in an earlier section (Section 3.2), there is a range of external and internal factors that could determine how well an acquisition or merger performs and specifically how well a business tackles its M&A opportunities.

All businesses are open systems – unless inconceivably they have no suppliers or no customers. So too, the performance of a board of directors forms part of an open management system: the board cannot (or rather should not) insulate itself from the business or from the external environment. In fact one could argue that the best boards are those most in tune with what is happening around them, beyond the boardroom table – and have well-developed sensing capabilities. This of course does not mean that some boards may exhibit more of the characteristics of closed systems than open systems.

Burrell and Morgan write that open systems are:

> "characterised by an exchange with their environment. They engage in transactions with their environment, 'importing' and 'exporting' and changing themselves in the process….Whilst a closed system *must* eventually obtain an equilibrium state, an open system will not. Given certain conditions, an open system *may* achieve a steady state, homeostasis, in which the system remains constant as a whole and in its phases. However, such a steady state is *not* a necessary condition of open systems." (Burrell and Morgan 1979)

Burrell and Morgan emphasise that "An open system can take a wide variety of forms. There are no general laws which dictate that it must achieve a steady state, be goal directed, evolve, regress or disintegrate. In theory, anything can happen".[72]

There are a range of general principles that are applied to the study of open systems, summarised by Burrell and Morgan (at pg. 63), namely that:

1) There is some kind of boundary which demarcates the system from its environment.
2) The system is characterised by a 'processual' (process based) nature, which involves an input, throughput and output based process along with feedback loops.
3) The system is comprised of mutually inter-dependant sub-systems that support the broader system's needs / performance.
4) The behaviours of the sub components of the system are a guide to the performance of the overall system.
5) The system has needs (akin to the system being a living organism) that need to be satisfied and are directed to the survival of the system.
6) What Burrell and Morgan call *boundary transactions*, externally and internally between sub-systems, are crucial activities.

Whilst systems' models tend to fall into two broad camps – mechanistic and organismic (based on biological organisms) – other variations have surfaced, such as the cybernetic model. As Burrell and Morgan explain (at pg. 66), cybernetics is "…the study of phenomena which behave as if they had goals. More specifically, it is concerned with the theory of complex interlocking 'chains of causation' from which goal-seeking and self-controlling forms of behaviour emerge." In essence these are self-regulating systems.

[72] Burrell and Morgan ibid at pg. 59

Systems' theory is an entirely appropriate way to better understand how boards interact with their companies, stakeholders and environments, for example, via the management of 'soft systems' in the form of interactions between the chairmen, board members and CEO.

Pressures for increased transparency and understanding

What appears to matter to the investing community is increased transparency about board structure (separation of powers) and processes. How do major institutional investors, who usually have good access to CEOs and investor relations' teams, know whether the board as a whole is on top of things and having the necessary fierce conversations? How does one know from the outside in?

Independence of directors is useful but no guarantee

> "By increasing a board's independence from management, corporate leaders can enhance legitimacy in the financial community by increasing congruence between visible attributes of the board and widely shared investor beliefs about good governance (Dowling & Pfeffer, 1975; Pfeffer, 1981; Suchman, 1995).
>
> Increased board independence should influence each of the three forms of legitimacy identified by Suchman (1995). It should enhance a firm's 'pragmatic legitimacy', derived from appealing to the self-interest of constituents, because greater independence is taken to indicate stronger board control exerted on behalf of shareholder interests (Suchman, 1995: 578). Then, given that increasing board independence is a central normative prescription or 'injunctive norm' of the agency logic (Bansal & Clelland, 2004; Cialdini & Goldstein, 2004: 597; Strang & Sine, 2002), it should also enhance the firm's normative legitimacy.
>
> Further, as a reform that is integral to a prevailing institutional logic, increased formal independence makes enterprise governance more comprehensible to members of the financial community, conferring 'cognitive legitimacy' (Clemens & Cook, 1999; Suchman, 1995: 582).
>
> When organisations enhance the legitimacy of corporate governance practices, they also enhance the legitimacy of their strategies. Increasing board independence from management creates the impression that corporate leaders can be trusted to pursue shareholder interests rather than their own preferences. By adopting normative reforms such as greater board independence, moreover, corporate leaders may also bolster confidence or competence based trust in their leadership (Elsbach & Elofson 2000).
>
> Thus, given some uncertainty about the specific content or consequences of corporate strategies, analysts and other financial stakeholders are likely to respond more positively to strategies following the adoption of board reforms that increase independence from management." (Westphal & Graebner 2010).

In a wide-ranging research project into "Taking stock of what we know about mergers and acquisitions: a review and research agenda" (Haleblian, Devers et al. 2009) the summary point was made:

> "Finally, our review shows that an understanding of how acquisitions affect the membership, compensation, and behavior of the board of directors is underdeveloped. Several possible questions arise in this area: Do acquisitions allow firms to attract different, and possibly more prestigious or capable, board members? How do acquisitions that result in combined boards influence the communication patterns, interpersonal dynamics, and information content shared within boards? Do board members receive higher and, possibly, less performance-sensitive compensation packages after acquisitions, as top managers of the firm have experienced? In short, we see important unanswered questions regarding how acquisitions influence the functioning of boards as well as the effectiveness of these boards in representing shareholders." (at pg. 492).

Conclusions on governance literature

Form versus substance

Governance can be viewed from the perspective of both form and substance. Trying to understand governance solely in terms of form i.e. in its more formulaic sense in terms of roles and structures, processes and procedures, is a one-dimensional exercise. Most literature on governance practice is skewed towards the tangible aspects of form, structure, function and process. There is, however, a body of credible research dealing with the roles of chairmen, role delineation (as a general concept rather than specific responsibilities versus those of management), and broadly with board effectiveness.

Approaching governance and board efficacy without a thorough consideration of substantive activities, particularly the impact of board skills, mindsets and behaviours, is likely to lead to an imbalanced and flawed assessment of a board's ability to exercise stewardship over major transactions.

The governance literature review has surfaced three key gaps in relation to boards' impacts on the determinants of M&A success. Firstly, there is limited explicit coverage of M&A involvements by boards. Secondly, there is no direct guidance or direction regarding board accountabilities and involvement particularly when it comes to participating in, or having oversight of, the M&A lifecycle. Thirdly, whilst there is growing interest and research into executive decision-making, there is a dearth of evidence-based research or investigation into the role that board dynamics – in particular the role that behaviours and mindsets – play in the successful prosecution of merger or acquisition transactions.

These appear to be potentially significant omissions worthy of further exploration. It would seem to be self-evident that, when it comes to managing a major transaction, there would be considerable virtue in having clarity on 'who does what and when?' and where the primary accountabilities should lie. Similarly, it would seem obvious that there is benefit in having a board that is able to move beyond governance 'form' and has the substance to provide effective stewardship of a company's capital commitments (and particularly oversight and control of transactions).

Delineating accountabilities of the board versus responsibilities of management

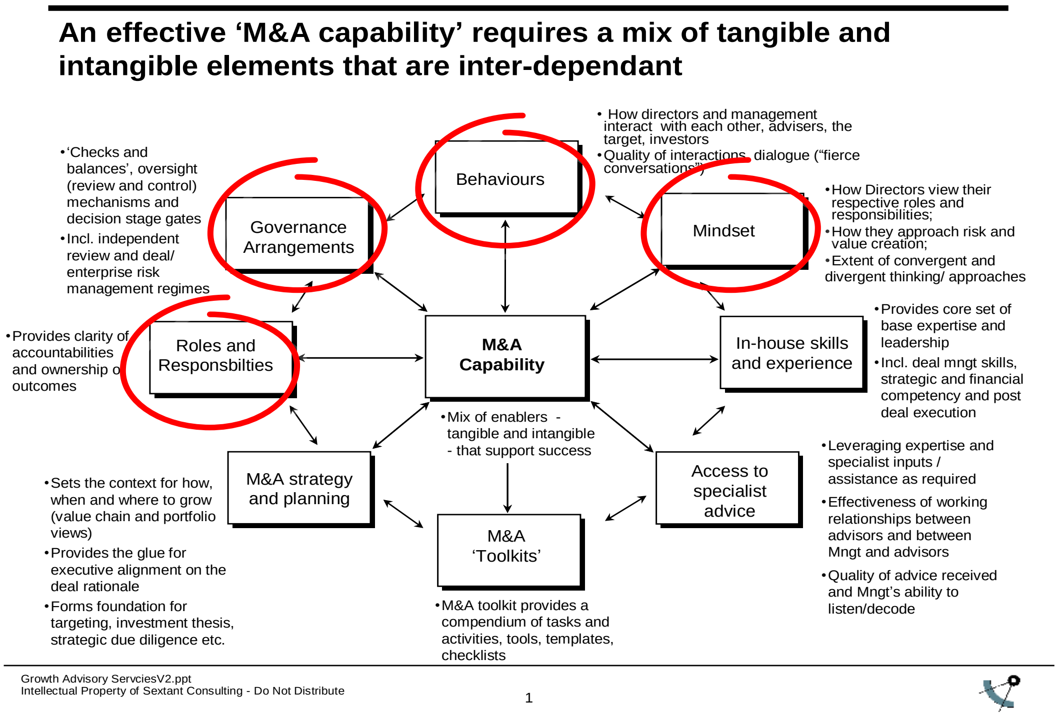
The literature review on governance also points to the paucity of specific guidance to chairman and non-executive directors (NEDs) on their roles and responsibilities in exercising stewardship over a management team that is prosecuting a M&A strategy. If NEDs wanted to access formal 'right' governance practice, in order to know what specific questions to ask and what to do (and not do) at key points in the M&A lifecycle, and how to behave, they would be left somewhat stranded.

There are no specific governance guidelines for boards as to the specific accountabilities or practices that will assist them in creating and/or protecting shareholder value during acquisitions. One would expect that clarity of responsibilities and roles *vis a vis* management and the board would also be important when it comes to managing major transactions; but the extant literature does not provide specific guidance or rules of thumb to boards on how to delineate board accountabilities, decision-making rights and forms and levels of involvement in mergers.

Soft systems gaps relating to mindset and behaviours

Sufficient literature points to the merits, albeit unproven, of 'mindset and behaviours' in affecting board performance; and therefore should be added as further dimensions of a M&A capability set, alongside governance and roles and responsibilities (see circled additional capabilities in Figure 10). Again, these further elements, for the reasons described above, would appear to hold interest and potential value as topics to be further explored in the thesis that follows. The evidence thus far is that these are inadequately addressed in the literature and consequently directors would not be easily able to source guidance on managing these elements when exercising stewardship over major investments or transactions.

Figure 10: Understanding the various factors comprising an M&A capability set

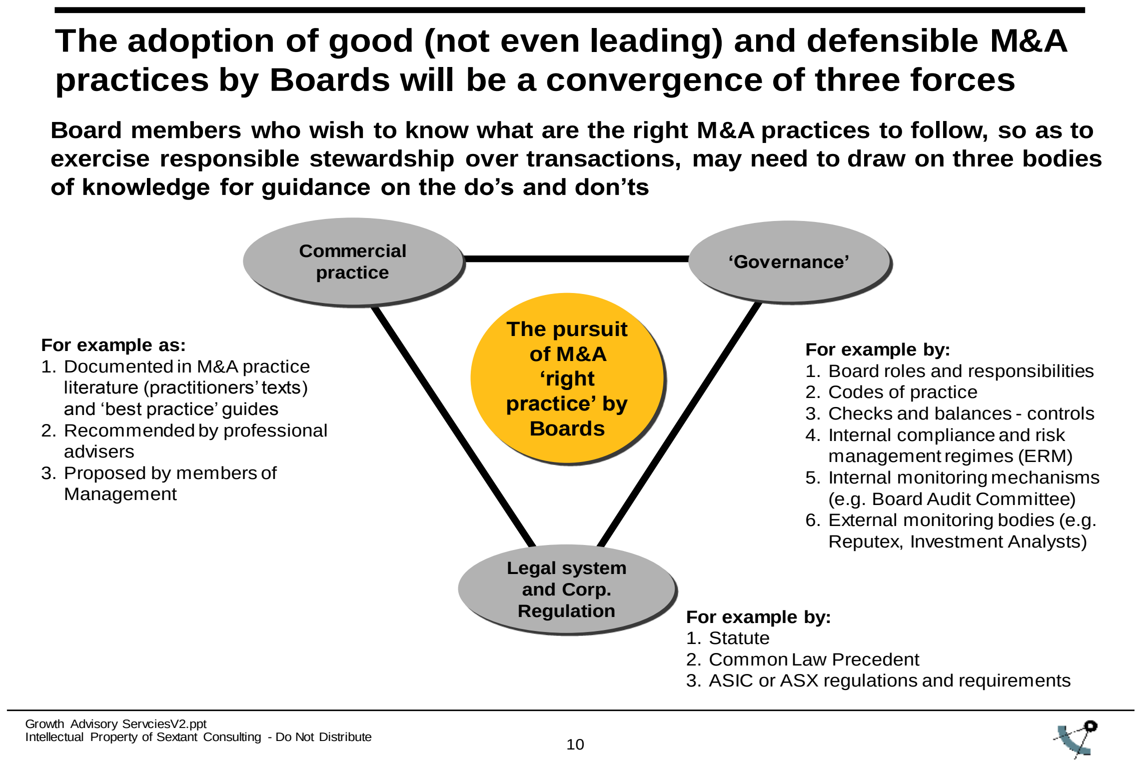


Source: Dean Blomson (thesis author)

This therefore completes the second corner of the M&A guidance triangle, namely governance literature and practice. Figure 11 illustrates the triangulation of factors influencing clarity of directors' duties during M&A.

To summarise, up to this point from the literature on commercial practice, non-executive directors involved in transactions would at best be able to extrapolate some tangential guidance regarding processes and activities that they should follow; and from the governance literature just covered would be able to glean 'directional' guidance to support stewardship of transactions, including from ASX regulations and the various generic codes of best practice. The absence of research-backed guidance and learnings on the topic for board members is noteworthy. Will the legal literature provide an interested non-executive director with the necessary clarity and the missing elements on what the do's and don'ts are for 'M&A governance right practice'?

Figure 11: Triangulation of factors influencing clarity of directors' duties during M&A



Source: Dean Blomson (thesis author)

The focus therefore shifts to the third and final corner of the triangle that could hopefully provide missing clarity on board responsibilities and required actions during transactions. The following section examines legal literature – and more correctly, legal precedents rather than research writings – regarding the legal responsibilities of directors. The focus is on exploring whether clear and unequivocal direction is available to assist directors in understanding what they should and should not do during transactions relative to carrying out their duties, and how they ought to behave to demonstrate the necessary diligence, skill and care.

Introduction to legal literature review

The discussion that follows aims to distil what legal guidance there is for the board of directors of a bidder involved in a M&A if they wanted to develop an informed appreciation of the do's and don'ts that would represent responsible stewardship over a transaction.

The acid test to be applied is whether clear and unequivocal direction is readily available to assist such directors in understanding how they ought to behave, in order to apply the necessary diligence, skill and care, in the context of transactions. The acid test is three-fold:

1) Is it clear what a non-executive director's accountabilities during transactions are, as far as the law is concerned?

2) Is there clear guidance on what to do to avoid liability i.e. what would typically be deemed in or out of bounds?
3) Is it clear therefore when such a recalcitrant director would be culpable?

Unlike the preceding two sections, the literature referenced in this section is not in the form of commercial and scholarly writings, but rather is sourced from the direction provided by the Australian Parliament and Australia's courts and regulatory agencies.

3.4 Literature dealing with legal responsibilities and duties of directors

The intent of this section is not to undertake a deep examination of statutory and common law with regards to directors' duties, or to provide a critique of case history in this area. Rather the aim is to target specific topics, in order to distil the critical duties of directors and specifically where and how these may be applicable to M&A activity. Therefore the intent is not primarily to describe what the pertinent laws are – although that is important – but rather to evaluate the clarity of the law in relation to the 'M&A governance' question at hand.

Research into the legal aspects of this thesis primarily focuses on questions of care, diligence and skill – as these duties form the foundation for chronicling what a diligent director should observe in the course of an M&A transaction. Questions relating to directors failing to act for a proper purpose, acting out of self-interest or fraudulently, are not explored here.

As has been indicated, more often than not 'law' is a result of developments in the other two legs of the stool, in that the legal response is driven by or reactive to:

1) a recognition of what M&A practitioners, management and directors are **already commonly doing** or advocating
2) a response to what institutional investors and representative bodies such as the Institute of Company Directors, Australian Securities and Investment Commission ('ASIC') or the Australian Stock Exchange ('ASX') **believe directors should be doing** from a M&A stewardship perspective
3) agitation by the investing public in response to events, on how they 'justifiably' expect directors to be held accountable.

This first section lays out some broad foundations such as the fiduciary duties of directors and describes the elements of law underlying those duties.

Fiduciary duties

Directors have a unique influence over companies' performance – particularly through their involvement in the corporate decision-making process. They are considered from a legal perspective to stand in a fiduciary relationship with the shareholders of 'their' company, and are subject to specific duties stemming from that relationship.

What is a 'fiduciary'?

> "Fiduciaries are under a strict duty to act in the best interests of the person to whom the duty is owed, to the exclusion of their own interests, and are required to avoid circumstances in which there is the possibility of those interests conflicting."[73]
>
> "Directors' fiduciary duties are owed to the company and all its shareholders equally and as a whole. It is not a duty typically owed to individual shareholders, creditors, employees or the community, although, in certain circumstances, directors' fiduciary duties may extend to these stakeholders. Directors' duties can be summarised as duties to avoid conflicts of interest, not misappropriate the company's property or funds for personal or third party benefit, not misuse their position for personal or third party benefit and not divert any profit making opportunity for personal or third party benefit. These duties have the potential to overlap extensively with one another. It is important to note, however, that not all directors' duties arise from their situation as fiduciaries. For example, the duty to exercise reasonable care may arise in negligence, contract (in the case of an executive director) or in equity, but it is not a fiduciary obligation.
>
> Directors owe a fiduciary duty to all shareholders in <u>all transactions</u> – whether it is the sale of inventory in the ordinary course of business or the sale of the whole business, and anything in between. Creditors' superior position to shareholders in insolvency is based in statute and law apart from the issue of fiduciary duties owed by directors."[74]

In examining the subject, recognition needs to be given to the three different interpretive lenses and sources of guidance that courts may turn to when considering directors' duties:

- statutory
- common law
- equitable principles.

<u>Statutory law</u> results from the need for the state to provide specific legal sanctions, where commercial, economic, political or social events have, in the view of a majority of the legislature, rendered civil remedies and penalties ineffective or uncertain in their ability to respond adequately.

Statutory law will always override conflicting common law.

In <u>common law</u>, cases are decided upon principles of precedent developed and shaped in preceding cases and legal analysis. Precedents become a key determinant of successive future decisions.

<u>Equity principles</u> is the "… body of law that addresses concerns that fall outside the jurisdiction of common law."[75] It emerged from a different dynamic to, and to some extent, as a counter to the 'rough edges' of the common law. Equity can be described but not defined. It is the body of law

[73] http://www.mallesons.com/publications/marketAlerts/2006/Documents/8711870w.htm
[74] http://www.stephens.com.au/view/22/47
[75] http://legal-dictionary.thefreedictionary.com/equity

developed by the Court of Chancery in England before 1893, which was a Royal Court presided over by a Chancellor. Unlike Common Law which was independent of the Crown and applied strict interpretation of state and common law based on precedent, Equity decisions were made without reliance on the common law to correct, supplement and amend its inadequacies. It softened and modified many of the perceived injustices in common law, and provided remedies where, at law, they were either inadequate or non-existent.

In developing an understanding of the position of directors in relation to their legal responsibilities, we consider what directional guidance is available under each of these three interpretational regimes.

How does literature address the responsibilities and duties of directors to act responsibly in generating or protecting shareholder wealth?

Statutory duties

Statutory duties of directors are primarily enshrined in the *Corporations Act 2001*, section 180.

"Care and diligence" – civil obligation only

Care and diligence – directors and other officers

1) A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

   a) were a director or officer of a corporation in the corporation's circumstances; and

   b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer."[76]

This sub-section is a civil penalty provision[77] and therefore there is no criminal sanction for breach of section 180(1).

Courts have held that the content of the statutory duty of care is essentially the same as that of the common law duty of care.

ASIC has acted as the guardian of directors' standards of behaviour

ASIC has endeavoured to carry its role as the watchdog for enforcing standards of conduct expected of directors in a number of landmark cases.

Please note that for interpretative purposes all sections and references are to those sections of the *Corporation's Act 2001* unless expressly stated otherwise.

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[76] Section 180(1), *Corporations Act 2001* (Cth)
[77] Section 1317DA, *Corporations Act 2001*, as applied to section 1371E(1)(a), *Corporations Act 2001* (Cth)

In describing reasonableness

In *ASIC v Adler (2002) 41 ACSR 72*, Santow J adopted a mixture of principles from *Daniels v Anderson* and *PBS v Wheeler*, namely that:

- the statutory duty of care enshrined in section 180(1), arises in common law and equity, but is not a fiduciary duty;
- The test is to ask what a reasonable person, with the knowledge and experience of the defendant might be expected to have done in the circumstances if acting on their own behalf;
- It is an implied term in the contracts of employment of all executive directors; and
- The basic principles in *Daniels* still apply and that a director appointed due to his or her special expertise in a particular area is not relieved of the duty to pay attention to the company's affairs even outside that area of expertise.

The modern duty of care recognises that the requisite standard of care applicable to a given director will vary according to factors such as type and size of company, distribution of functions within the company, and responsibilities of the particular director or officer, but will always be subject to a minimum standard.

In *ASIC v Maxwell*[78], the court examined a range of factors that bore on the scope and constituent elements of directors' liability, being:

a) the type of company
b) the provisions of its constitution
c) the size and nature of the company's business
d) the composition of the board
e) the director's position and responsibilities within the company
f) the particular function the director is performing
g) the experience or skills of the particular director
h) the terms on which he or she has undertaken to act as a director
i) the manner in which responsibility for the business of the company is distributed between its directors and its employees
j) the circumstances of the specified case.

In partial support of these principles it is worth noting that annual directors' reports of public companies must include details of directors' qualifications, experience and special responsibilities; and how many directors' meetings each director attended[79].

[78] (2006) 59 ACSR 373
[79] Section 300(10), *Corporations Act 2001* (Cth)

In firming up disclosure duties of company officers of target companies

In *Vines v ASIC*[80], ASIC alleged contraventions of statutory duties by three senior executives of GIO Insurance Limited, one of whom, Mr Vines, was the Chief Financial Officer ('CFO') when it was the subject of a hostile takeover by AMP in 1998.

Aside from having broad responsibility for GIO's financial reporting and tax affairs, Vines assumed a central position in the takeover response process. Vines served on the due diligence committee ('DDC') established by the board to prepare GIO's Part B Statement, along with five non-executive directors and representatives from GIO's solicitors and financial advisers, and was given special responsibility by the board for ensuring the integrity of financial information in the Part B Statement (including the stated profit forecast).

During the bid period, a Caribbean hurricane caused major damage, which resulted in significantly higher than expected liability exposure to GIO under its reinsurance contracts.

The Part B Statement contained a profit forecast for the GIO Group for the year 1998–99 of AU$250 million, including a forecast profit of AU$80 million for GIO Re, GIO's reinsurance division. ASIC claimed that the appellant knew or ought to have known that it was highly unlikely that GIO would achieve the forecast stated in the Part B Statement, as a result of such intervening events.

> "The central issue in the case was whether Mr Vines had adequately discharged his duties in keeping the DDC and, through it, the board informed of the impact of Hurricane Georges on the profit forecast disclosed in the Target's statement."[81]

ASIC, the respondent, sought a civil penalty under section 232(4) which provided that:

> "In the exercise of his or her powers and the discharge of his or her duties, an officer of the corporation must exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances."[82]
>
> "A majority of the New South Wales Court of Appeal upheld three of Austin J's earlier findings, namely that Mr Vines had contravened his statutory duty of care and diligence. The key areas where Mr Vines was negligent with regards the takeover process, were as follows:
>
> - Mr Vines gave his management sign-off to the DDC, without qualification regarding the potential impact of Hurricane Georges on the profit forecast for the company's reinsurance business. The court held that it did not matter:

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[80] (2007) 25 ACLC 408

[81] http://www.mallesons.com/publications/marketAlerts/2007/Documents/9165288w.htm – 01 November 2007 *Executive director liability – lessons from Vines*

[82] Section 232 of the Corporations Act was, with effect from 13 March 2000, replaced by section 180. Further, the definition of "*executive officer*" was repealed, and the new definition of "*officer*" encompasses people in the position of executive officers.

- o that he may have formed the view that the overall profit forecast could be maintained for other reasons, or
  - o strikingly, that other members of the DDC or the board may have had other sources of information which indicated that it was improbable that the profit forecast would be achieved.

- Mr Vines failed to:

  o ensure that the impact of Hurricane Georges on the forecast was being monitored, and

  o put in place a system to update the published forecasts if necessary."[83]

The Court's finding hinged on a number of contraventions including the failure to disclose material information, failure of the due diligence process and failure to ensure proper monitoring arrangements.

> "There are a number of lessons that can be drawn from the Court of Appeal's decision. Whilst the judgment concerned a CFO's role in a takeover, the findings also have application where a company is issuing a prospectus, product disclosure statement, or even an announcement required by the continuous disclosure regime.
>
> - In giving the unqualified management sign-off, the executive takes personal responsibility for the matters stated in it. The sign-off is a representation that the signatory has taken appropriate steps, through inquiry, to ensure the accuracy of the matters certified.
> - In reporting to the board, a CFO's role is to be the "arms and legs" of the non-executive directors, and the CFO must keep them fully informed of key financial information and profit forecasts. The directors are likely to rely on the weight of the CFO's authority and are entitled to expect a properly formed judgment. A company's non-executive directors cannot discharge their responsibilities unless senior executives of the company, having responsibility to do so, lay before them all material information.
> - Where a company has published profit forecasts, there is an ongoing duty on the responsible executives to monitor whether new circumstances will impact on whether the forecasts will be materially affected. In part, Mr Vines was held responsible for the failures of subordinates charged with monitoring the situation to report to him.
> - Where the board delegates particular responsibility for preparation of a document to an individual, that individual may be held liable, even where a number of others are involved as members of a committee which approves the document."[84]

[83] http://www.mallesons.com/publications/marketAlerts/2007/Documents/9165288w.htm- 01 November 2007 *Executive director liability – lessons from Vines*

[84] http://www.mallesons.com/publications/marketAlerts/2007/Documents/9165288w.htm – 01 November 2007 *Executive director liability – lessons from Vines*

In the first judgment of *ASIC v Vines*[85] Austin J found that the executives had breached their duties of care and diligence under section 232(4) (the predecessor to section 180(1)) of the Corporations Act by failing to ensure that GIO, the DDC and its auditors were properly informed and that GIO's statement was accurate.

> "ASIC applied for declarations that the executives had contravened a civil penalty provision in section 1317EA of the Corporations Act (now section 1317E(1)). Based on Austin J's findings in the Honesty judgment, the full bench of the Supreme Court was under a statutory obligation to make the declarations. This then lead that Court to consider whether it should make a disqualification order or a pecuniary penalty order against each executive."[86]

In the second judgment of *ASIC v Vines*[87], the Appellant's appeal for relief from liability under sections 1317JA or 1318 of the Corporations Act[88] was denied.[89]

In the third judgment of *ASIC v Vines*[90], the court made declarations that the executives had breached civil penalty provisions, and disqualified all three executives from managing corporations, imposed fines against all three, and made an order for compensation against one of them.

Whilst the various judgments in *ASIC v Vines* deal with statutory duties in relation to a Part B statement, the Court consistently applied a broad interpretation to the terms of section 232(4) (the predecessor to section 180(1)), when considering the requirements on directors to act with the necessary care and diligence. Directors of the bidder arguably will be similarly obliged when issuing a bidder's statement, a disclosure document in relation to capital raising or any other public document that investors and potential investors can reasonably rely upon.

What are the potential implications of *Vines* for an acquirer?

In terms of *Vines*, a director serving on a due diligence committee is expected to make the necessary enquiries of management; and for their part the management or executives providing information to a due diligence committee – or to the broader board in furtherance of M&A activities – would have to disclose all material information, whether they qualified or unqualified.

Therefore, as a hypothetical extrapolation, if the CFO of the bidder was not to present a 'full and frank' disclosure to the members of his or her board of the matters emerging from the financial or commercial due diligence of the target, the CFO would be guilty of negligence or even fraud, depending on the particular circumstances.

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[85] *[2005] NSWSC 1349*, known as the Contraventions Judgment

[86] http://www.mallesons.com/publications/marketAlerts/2006/Documents/8663533w.htm

[87] *[2005] NSWSC 1349* , known as the Honesty Judgment

[88] Now sections 1317S and 1318 of the Corporations Act. These sections give the court power to excuse contraventions if the party has acted honestly and ought fairly to be excused in the circumstances.

[89] For further details on the first and second judgments refer Mallesons Corporate Governance Update – March 2006: http://www.mallesons.com/publications/2006/Mar/8326986W.htm

[90] *[2006] NSWSC 760*, known as the Penalty Judgment.

What if the due diligence committee had failed to ask the necessary questions or to probe adequately? What would be their liability? And what guidance is there to a non-executive director on how far he or she should go to make the necessary enquiries?

The answers to these questions follow.

Common law duties

Historically, the common law test for the duty of care and skill has been largely applied on an objective basis, by Courts asking "What would the reasonable person expect from a director in this role?"

More recent decisions, however, for example the AWA case, per Rogers J (see same section below) have started to use a more subjective approach i.e. "How much care (and skill) ought to be shown by someone with this particular director's level of experience and knowledge?" Over time, a body of common law decisions has developed which provides guidance on the key elements of the duty of care. For example, a key focus on the duty of care has been on what is the acceptable level of attendance at, and participation in, board meetings.

In *Marquis of Bute*[91], the Court set the bar relatively low, for the determination of a duty of care where the bank president attended one board meeting in 38 years and was (predictably) unaware of various irregularities. Nevertheless, he was found not to be liable for neglect of his duties as he was not expected to take a very active part in the management of the bank or to attend every board meeting. This is a good illustration of where the law on this area may have 'started' but it is obviously out of date now. In *Re City Equitable Fire Insurance Co Ltd*[92], the court held a director must take 'reasonable care', which was to be measured by the "care an ordinary man might be expected to take in the circumstances on his own behalf". In contrast, the director:

- need not exhibit more skill than may reasonably be expected from a person of his knowledge and experience
- is not bound to give continuous attention to the company's affairs
- in the absence of grounds for suspicion, may trust an official to perform duties honestly.

This line of logic continued for many years with some modification periodically. In *AWA Ltd v Daniels*[93], the court importantly differentiated between executive versus non-executive directors: "It is something of an anachronism to expect non-executive directors, meeting once a month, to contribute anything much more than decisions on questions of policy and, in the case of really large corporations, only major policy." Greater responsibility was, however, unsurprisingly, placed upon the chairperson and chief executive officer.

The *AWA* case arose from significant exchange rate losses arising in connection with contracts for imported goods. Losses were incurred owing to the inappropriate use of treasury products,

[91] [1892] 2 Ch 100
[92] [1925] Ch 407
[93] (1992) 7 ACSR 759

exacerbated by poor monitoring and reporting procedures. The AWA Board did not properly appreciate the risks nor did it seek regular reporting on the risks. Poor policy making, lack of reporting procedures and inadequate training and communication, all combined to create a climate where the risk of incurring loss was unnecessarily increased.

In neither of the two independent audits of AWA, however, were the foreign exchange consequences of the forward purchasing activities fully disclosed to the AWA Board, although the auditor had noted the defects in the company's system of internal control. AWA's failure to establish adequate internal controls and record and account keeping, had allowed the losses to be concealed.

AWA sued the auditor for negligence for failing to draw attention to these deficiencies and for not qualifying the audit reports. The auditor denied any breach of duty to AWA and cross-claimed against it and, inter alia, the non-executive directors for contributory negligence. It is the claim against the non-executive directors that is of immediate interest[94].

The court also held that:

> "A director is justified in trusting officers of the corporation to perform all duties that, having regard to the exigencies of business, the intelligent devolution of labour and the articles of association, may properly be left to such officers... A director is entitled to rely without verification on the judgment, information and advice of the officers so entrusted. A director is also entitled to rely on management to go carefully through relevant financial and other information of the corporation and draw to the board's attention any matter requiring the board's consideration. The business of a corporation could not go on if directors could not trust those who are put into a position of trust for the express purpose of attending to details of management... Reliance would only be unreasonable where the director was aware of circumstances of such a character, so plain, so manifest and so simple of appreciation that no person, with any degree of prudence, acting on his own behalf, would have relied on the particular judgment information and advice of the officers... A non-executive director does not have to turn himself or herself into an auditor, managing director, chairman or other officer to find out whether management is deceiving him or her."[95]

How would precedent from AWA potentially apply to a merger or acquisition?

Extrapolating AWA to M&A involvements, the position today is that directors overseeing a merger would not be expected to demonstrate more skill than they themselves possess i.e. based on a subjective test.

Non-executive board members would also be excused, up to a point, for having part-time involvement in and potentially a less deep intimacy with deal detail and progress. Where that point is, or where the line would be drawn by the courts in Australia, is not easily identifiable.

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[94] 'Non-Executive Directors' General Law Duty of Care and Delegation of Duty: But do we need a Common Law Duty of Care?' Geoffrey Flint, *Bond Law Review*, Volume 9, Issue 2 1997 Article 5
[95] *AWA Ltd v Daniels* (1992) 7 ACSR 759 at 868 per Rogers CJ

There was also the recognition in the first *AWA* decision that the board should meet as often as it deems necessary to carry out its functions properly; and that directors' duties will vary according to the size and nature of the business of the particular company and the experience and skills that the directors held themselves ought to have. Thus the board or due diligence committee overseeing management's handling of the transaction would be expected to invest the necessary amount of time to be across the key details and findings. Again, where the line will be drawn by our courts is not immediately apparent – at best it is a question of judgment by each board. The question of judgment will be examined in detail below.

The duty of care has also been translated in different ways for executive versus non-executive directors. Rogers in AWA[96] said the following of non-executive directors:

> "In contrast to the duties imposed on a managing director, non-executive directors are not bound to give continuous attention to the affairs of the corporation. Their duties are of an intermittent nature to be performed at periodic board meetings, and at meetings of any committee of the board….Notwithstanding a small number of professional directors there is no objective standard of the reasonably competent company director to which they aspire."

Additionally, unless they have obvious ('manifest') grounds to be suspicious, non-executive directors should be able to take at face value the information being presented to them by management.

Should this be established as precedent, such an interpretation would not be reassuring to investors.

Further movement towards an objective test in the Centro case

On appeal, however, the Supreme Court's decision in *AWA v Daniels*[97] put a little distance between the preceding decision in *AWA*. In *Daniels v Anderson* (1995) 16 ACSR 506 and *AWA* on appeal,), a less clear distinction was made between executive and non-executive directors. The Court of Appeal in *AWA* decided that there was no substantive difference between the duty of care owed by non-executive and executive directors. The Court also suggested that there should be an objective minimum standard of care applicable to all directors, each of whom are required to place themselves in a position to guide and monitor the management of the company.

This decision means that directors must:

- obtain or possess a basic understanding of the business of the company
- keep themselves informed about and monitor the activities of the company
- maintain familiarity with the financial status of the company by a regular review of financial statements
- inquire into matters revealed by the financial statements that call for inquiry

[96] (1992) 10 ACLC 933 at p. 1014
[97] 1995 13 ACLC 614

- be allowed to make business judgments and decisions in a spirit of commerciality, unrestrained by the concerns of a conservative investment trustee.

A further tightening of the common law position on directors' duties occurred in *Permanent Building Society v Wheeler*[98]. The Court held that:

- The duty of care and skill is not fiduciary – it is an equitable as well as legal duty.
- Directors need to balance a reasonable risk of harm against potential benefits that could reasonably have been expected to accrue from the conduct.
- An objective test ought to be applied, namely what an ordinary person with the knowledge and experience of the defendant would have done if acting on his own behalf.
- In the circumstances there was a heavy duty on the directors to scrutinise the proposed transaction.

A more recent pronouncement on the common law duty of care relates to the role and responsibilities of directors in relation to statutory financial reporting. *ASIC v Healey & Ors*[99] dealt with civil penalty proceedings against eight directors (the chief executive officer and seven non-executive directors) and the Chief Financial Officer of various entities within the Centro Group.

The financial statements of various Centro entities for the financial year ended 30 June 2007 were alleged to have failed to make adequate disclosure about the extent of maturing short-term debt. The extent of interest bearing liabilities disclosed as current, significantly understated the true debt position (AU$2.6 billion for Centro Property Group as opposed to AU$1.1 billion initially disclosed in the accounts). Approximately AU$1.5 billion of short-term liabilities had been classified as non-current liabilities and c. AU$500 million of the short-term liabilities of Centro Retail Group (CER) had been classified as non-current.

The annual statements had also failed to disclose, as post-balance date events, certain guarantees given by the Centro Property Group, entered into after the 30 June 2007 balance date, of short-term liabilities of about US$1.7 billion.

Middleton J in the Federal Court of Australia delivered judgment in favour of ASIC, finding that each director:

- knew or should have known of the current interest bearing liabilities and of the guarantees
- was aware of, or should have been aware of, the relevant accounting principles which would have alerted each director to the apparent error in the proposed financial statements
- could or should have then made relevant enquiries in order to take all reasonable steps required of them.

The decision in *Centro* hinged on the specific requirements of:

[98] (1994) 11 WAR 187
[99] [2011] FCA 717

- section 344 of the *Corporations Act 2001*, which requires a director to take all reasonable steps to comply with, or to secure compliance with, the financial reporting obligations contained in Part 2M.3 of the Act; and
- sections 180(1) and 601FD(1)(b) of the *Corporations Act 2001*. These sections impose a duty to act with care and diligence on directors of companies and officers of responsible entities of registered schemes, such as the managed investment scheme which was housed within the Centro Retail Group.

The startling admission by all directors was that they had not read the accounts. Despite this Middleton J indicated that there was no question that the directors were not conscientious people; and no suggestion that any director had not honestly carry out their responsibilities; but he "….found, in the specific circumstances …that the directors failed to take all reasonable steps required of them, and acted in the performance of their duties as directors without exercising the degree of care and diligence the law requires of them".

Middleton J summarised the applicable duty of care and diligence in these terms:

> "In my view, the objective duty of competence requires that the directors have the ability to read and understand the financial statements, including the understanding that financial statements classify assets and liabilities as current and non-current, and what those concepts mean. This classification is relevant to the assessment of solvency and liquidity. Equally, a director should have an understanding of the need to disclose certain events post balance sheet date."

According to Middleton J, the "financial statements must be read, understood and focused upon"[100] by each director before approving them in order to ensure as far as reasonably possible, that the information included in them is accurate. This scrutiny should be undertaken with the knowledge that each director has or should have by virtue of his or her position as a director. The decision highlights that "…where directors are required to give an opinion under the Corporations Act, the formation of that opinion cannot be delegated."[101]

Implications of Centro for M&A

The application of an objective test is noteworthy; and the implication is that, whether in a M&A context or otherwise, a director will not be relieved of a duty to understand and act upon complex financial statements, arrangements or instruments that the company is intending to enter into, or at least to seek expert advice that will explain the meaning of such a proposed arrangement. The decision should not therefore be seen as pivotal for M&A practices – rather as being an important reminder of the responsibility of directors in approving financial statements.

Mindful of the specifics of this case, there are elements that can be extrapolated that would provide two pivotal implications for M&A activity – namely that directors:

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[100] http://www.blakedawson.com/Templates/Publications/x_publication_content_page.aspx?id=62871
[101] http://www.blakedawson.com/Templates/Publications/x_publication_content_page.aspx?id=62871

- must be familiar with the fundamentals of the business and have the financial literacy to understand basic accounting treatments – failure to do so may of itself amount to a breach of the duty of care and diligence
- may rely on others, including management and external advisers, to prepare financial statements and advise on accounting protocols. But "Directors cannot substitute reliance upon the advice of management for their own attention and examination of an important matter that falls specifically within the Board's responsibilities"[102] This includes the duty to approve financial statements – and "to express an *opinion* as to their compliance with accounting standards and that they give a true and fair view – rests with the directors and is not capable of delegation."[103]

The latter point means that directors cannot uncritically rely upon the advice of management or third parties or substitute that for their own attention and examination of any important matter that falls specifically within the board's responsibilities. Therefore non-executive directors should also be able to understand and should seek to clarify as required, for example the impact that a pending acquisition may have on their own financials and any associated projections have been developed by management and specialist advisers.

Middleton J observed, however, that directors are entitled to rely on specialist advice. Such reliance, however, depends on the circumstances, and whether a director has taken all reasonable steps to be informed and to apply his or her mind, having regard to various factors, including the complexity of the enterprise, its business and internal management controls and reporting procedures.

Importantly for the assertions of this thesis, Middleton J noted that "…a director is not relieved of the duty to pay attention to the company's affairs which might reasonably be expected to attract inquiry, even outside the area of the director's expertise."

Interestingly, and somewhat surprisingly from a public policy perspective, when it came to penalty judgment, no disqualification or pecuniary penalty orders were made against the non-executive directors, despite submissions from ASIC.

Based on Centro, it would therefore appear to non-executive directors that 'uncritical reliance' on management or external advisers is not an excuse. Just when and how much critiquing, probing and challenging should be applied, again is a matter of judgement. The Centro case continues to build on the trend of the last quarter century, where the minimum standards expected of directors have continued to evolve.

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102 http://www.claytonutz.com/publications/news/201106/29/what_does_the_centro_case_mean_for_directors.page

103 http://www.blakedawson.com/Templates/Publications/x_publication_content_page.aspx?id=62871

Can shareholders rely on advice from directors that they will be generating or protecting shareholder wealth?

One of the more pointed requirements of the *Corporations Act 2001* is encapsulated in section 670A which deals with mis-statements in, or omissions from, takeover, compulsory acquisition and buy-out documents.[104]

This principles relating to accuracy and adequacy of disclosure (completeness of material information) is also enshrined in other takeover provisions of the *Corporations Act 2001*, such as section 636(1)(m), in regard to the necessary content of a bidder's statement and Division 3 of Part 6.5 that sets out the necessary level of disclosure in a target's statement.

Bidders' statements – as opposed to targets' statements – are required to provide shareholders in the target entity with sufficient information to enable the target shareholders to make an informed decision as to whether, in all the relevant circumstances, they should agree to sell their respective target shares to the bidder, on the terms being offered. Depending on whether cash, securities or a combination of the two is or are offered in the bidder's offer, the disclosure requirements will necessarily be materially affected.[105,106]

The Corporations Act and accompanying ASIC Regulatory Guidelines govern – as they do for prospectuses for IPOs and other capital raisings – the content of:

- an investment memorandum (IM) typically issued in connection with the proposed sale of an enterprise

- an explanatory memorandum and scheme booklet (collectively 'EM and Booklet') that are published in anticipation of the convening of members' meetings where the acquisition is intended to be effected by a court approved members' scheme of arrangement[107]

- a bidder's statement and target's statement issued in connection with a takeover offer,

as to the completeness and accuracy of representations made therein[108].

Section 670A covers misleading and deceptive statements, and material omissions – applying strict liability under section 6.1 of the Criminal Code[109.] Section 670A(2) states that:

> "A person is taken to make a misleading statement about a future matter (including the doing of, or refusing to do, an act) if they do not have reasonable grounds for making the

[104] http://www.austlii.edu.au/cgi-bin/sinodisp/au/legis/cth/consol_act/ca2001172/s670a.html?stem=0&synonyms=0&query=S670A
[105] http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s636.html; see also section 636(1)
[106] See section 636, especially section 636(1)(m)
[107] See section 411(4)
[108] See section 670A(1)
[109] See section 670C(4)

> statement. This subsection does not limit the meaning of a reference to a misleading statement or a statement that is misleading in a material particular."[110]

In the context of a takeover offer, the bidder's statement *inter alia* needs to provide an outline of the bidder's intentions with respect to the target – such as what changes are envisaged to the ongoing operation/s, continuity of employment, fixed assets and the source/s of any cash or securities to be used for completing the proposed acquisition.[111] The intended target audience for bidder's statements interestingly is usually the target's shareholders, not the bidder's, although the latter have access to the same contents via published sources. Notably such a requirement reinforces the assertion that disclosure duties of the acquirer's board to its own shareholders are generally voluntary and far less prescribed.

As an interesting corollary, the question is: If it is sufficiently material for the target shareholders to receive deal-related information within a bidder's statement, then why should the bidder's shareholders also not have a chance to be officially advised of these matters too?

Generally speaking, courts have not wanted to hamstring directors by requiring pre-deal disclosure to their own shareholders. The directors have been appointed to represent the bidder and have been elected (and tacitly authorised) *inter alia*, to make bids that they feel are in the best interests of the bidder and its members. Occasionally, the consent of the bidder's shareholders is required such as in consensual takeovers under SEC 611, item 7 or under listing rules when the bidder is proposing to issue shares as bid consideration that exceeds the available limit under listing rules 7.1 and 7.1A.

Extent of reliance

What is the position where directors make unfounded or groundless claims, even if done in good faith i.e. not for fraudulent purposes?

These claims could encompass <u>quantitative matters</u> such as management and the board's estimates of the value of the target company or the likely value or benefit it offers one or other set of shareholders; or qualitative, more subjective matters as their intentions with the merged entity; or their ability to make a success of the venture

In reality, almost all bidders' statements use qualifying language to ensure that the directors of the bidder can subsequently defend their statements. For example: "as far as we are aware…", or "based on information about the target currently available to the bidder …" etc.

Two interesting questions thus arise.

- Firstly, in the absence of disclosure as to how they have made enquiries or applied their minds, shareholders – whether of the acquirer or the target – have no way to assess the grounds for the directors' assertions.

[110] http://www.austlii.edu.au/cgi-bin/sinodisp/au/legis/cth/consol_act/ca2001172/s670a.html?stem=0&synonyms=0&query=S670A
[111] See section 636(1)(c)

- Secondly, whether those qualifying phrases will be sufficient to defend miscreant directors who allow the bidder's statement to include mis-statements or material omissions and what if any defences they could effectively apply.

Reliance on expert advice provided to shareholders

The nature of the offer, i.e. cash and/or shares, also has a bearing on directors' duties of disclosure.

Where the bid consideration is cash-only, the bidder's statement must be accompanied by a directors' resolution[112]. If, however, the bid consideration is a combination of cash and equity, or exclusively the bidder's equity:

- the bidder's statement must be accompanied by a directors' resolution passed unanimously[113]

- an expert opinion must accompany the bidder's statement outlining "whether, in the expert's opinion, the value stated is fair and reasonable and gives the reasons for forming that opinion".[114]

The term 'expert' is defined[115] in section 9 as "a person whose profession or reputation gives authority to a statement made by him or her in relation to that matter". Further considerations in connection with such an expert and the content of any report prepared by such person, are contained in ASIC Regulatory Guidelines 111 and 112.

The definition of 'expert' is relevant to section 648A of the Corporations Act, which requires a statement issued *by a target company* to be accompanied by an expert's report prepared by a person who is not an associate of the offeror or the target company[116].

Section 640 requires that an expert report be given *by a target company* in circumstances where the bidder has 30 per cent or more of the voting shares in a target company at the time of making the takeover offer or where the bidder is a director of the target company or there is a common director between the bidder and the target.[117]

It is usually the directors of the bidder who appoint and commission the expert. Having found the expert, directors have to be alert to interpretational issues of the valuation i.e. that neither the expert nor the board misrepresent past, current or future matters. Forecasts of future prospects are particularly challenging and could leave directors open to civil claims for loss.

[112] See section 637(1)(a)(i)
[113] See section 637(1)(a)(ii)
[114] http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s636.html
[115] http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#expert
[116] http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s648a.html
[117] http://www.austlii.edu.au/cgi-bin/sinodisp/au/legis/cth/consol_act/ca2001172/s640.html?stem=0&synonyms=0&query=s640

Reliance and remedies where based on capital raising documentation

When a bidder offers equity as some or all of the bid consideration, the extent and nature of the bidder's disclosure has to be of the same standard as in a prospectus used in a capital raising, because that is what will effectively be happening under the bid – see section 636(1)(G).

Where the acquisition requires a capital raising, this needs to take place under a 'disclosure document' for example under sections 728 and 729. By definition these documents do ***not*** relate to or effect takeover documentation. These requirements are, however, worth considering as they place additional demands on directors of the acquirer to apply their minds and to make the necessary disclosures.

The analogous sections in takeovers are found in sections 636 and DIV 3 of Part 6.5 as noted above.

Section 729 allows a person who suffers loss or damage because an offer of securities under a disclosure document contravenes section 728(1) (which deals with misleading or deceptive statements in, or omissions from, a disclosure document) to recover loss against a person in contravention of the relevant section. Section 729 has the effect that civil action may be brought against an expert, if a disclosure document includes a misleading or deceptive statement (including any material omission/s) or doesn't reflect new circumstances that may have arisen (under section 728(1)). In effect any groundless, ill-considered claims conveyed to shareholders via these lodged documents opens directors up to liability and criminal sanction under section 729.

Under section 729, "Right to compensation":

> "A person who suffers loss or damage because an offer of securities under a disclosure document contravenes subsection 728(1) may recover the amount of the loss or damage from a person referred to …table if the loss or damage is one that the table makes the person liable for. This is so even if the person did not commit, and was not involved in, the contravention."[118]

Interestingly, section 729 of the Corporations Law (now repealed) does not expressly differentiate between those who took up the new securities from the seller's side (through their reliance on the disclosures made) or those who from the buyers side held on to their existing shares – although the section was designed with the former, not the latter, in mind.

In summary, a degree of schizophrenia is required by non-executive directors preparing to issue a bidder's statement in that it should be clear that they need to act in the best interests of their shareholders in prosecuting the transaction; but in directing their opinions to the target's shoulders, they ought to believe what they claim and have defensible grounds for the representations made.

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[118] http://www.austlii.edu.au/cgi-bin/sinodisp/au/legis/cth/consol_act/ca2001172/s729.html?stem=0&synonyms=0&query=S729

The James Hardie decisions

One of the most recent and interesting guidance for directors regarding the scope and nature of their duties has emerged from a trilogy of *James Hardie* cases.

A. *ASIC v Macdonald* [2009] NSWSC 287

In this case, the court held that the former directors of James Hardie Industries Limited ('JHI') had breached their duty of care and diligence under section 180 of the Corporations Act.

The Board had approved a draft ASX announcement containing statements that the special foundation established by JHI to meet current and future asbestos claims, would have sufficient funds to meet all legitimate claims ('JH Foundation'). As a result of a corporate restructure, the asbestos liabilities of two JHI subsidiaries had been transferred to the JH Foundation and the JHI Board knew, or ought to have known, that the JH Foundation did not have the financial resources to satisfy the actuarially derived amount of expected claims.

The case hinged on a draft ASX announcement considered by the JHI Board in February 2001, stating the JH Foundation was "fully funded" to meet all future legitimate claims ('ASX Announcement'). It also stated that the JH Foundation had been established with "expert advice" from well-known firms of actuaries and international accountants (Trowbridge, Access Economics and PwC). In fact, the mandates for Access Economics and PwC did not cover the validation of assumptions in the cash flow model presented to the board.

The decision in *ASIC v Macdonald* was a decision of a single judge of the Supreme Court of New South Wales and was subsequently appealed. Nonetheless, it provides important lessons for directors on several fronts, namely delegation of duties, following of internal procedures, management of board meetings and the responsibility of executives to the board.

Firstly, delegation and reliance:

> "The extent to which directors can delegate their powers and rely on information or advice provided by others is one of the most complex aspects of the duty of care. Statutory provisions dealing with these issues provide only limited guidance to directors, in that they place the onus on directors to ensure that they make 'proper inquiries' in relation to matters that they have delegated, and an 'independent assessment' of information or advice they receive from others."[119]

The court held that the JHI directors, in the specific circumstances of this case, could not delegate their duty to a co-director. Nor could they rely on the advice of management or external advisers. It was each board member's duty, individually, to exercise the necessary diligence in order to ensure that the ASX Announcement was not misleading.

[119] http://www.blakedawson.com/Templates/Publications/x_article_content_page.aspx?id=55219

The issue for the court was that the directors had been advised previously that the actuarial calculations were not definitive or certain and the board therefore should have been more guarded in its wording regarding the guarantees around adequacy of funding.

Additionally, since there had been such adverse public reaction to the establishment of the JHI Foundation, the court believed that public statements about asbestos claims fell within the board's oversight responsibility, and was not a management responsibility.

Secondly, failure to follow internal procedures: none of the key players involved – the JHI Board members, management or the external legal advisers – had seen the draft ASX Announcement prior to the board meeting. This omission ran directly counter to JHI's standard operating procedures that ASX announcements (of a non-financial nature) were to be drafted by its Corporate Affairs department and approved by the CEO, CFO, general counsel and the company's external legal advisers before being submitted to the JHI Board for its consideration. The court felt that failure to follow this procedure meant that the JHI directors ought to have been far more diligent in their consideration of the wording of the draft ASX Announcement.

Thirdly, management of meetings: Two directors had dialled in to join the meeting from overseas and in materially differing time zones. The court could not find any evidence that the draft communiqué had been faxed or emailed to the two dial-in participants or that the content of the draft ASX Announcement had been read out to them for their consideration (those directors physically present only received the draft ASX Announcement when they attended the meeting). There was no record of the two dial-in directors formally abstaining or calling for copies of the draft or otherwise noting their dissent. Accordingly, the court regarded those directors as having participated in the approval of the ASX Announcement. Despite the fact that the minute taking at the JHI Board meeting was effected outside the prescribed one month period as required by section 251A, the judge held that those minutes noting approval of the ASX Announcement were generally accurate.

Fourthly, responsibility of executives to the board: The flip side of the coin in relation to delegation and reliance by the board, is the duty of executives to bring certain material matters to the attention of the directors. In this case, the court noted three failures in review and advisory mechanisms:

a) The CEO had failed to advise his co-directors that the draft ASX Announcement was too emphatically worded or that PwC and Access Economics had not been asked to check the assumptions contained in the cash flow model.
b) The company secretary and general counsel had similarly failed to raise those same two issues as part of a key duty to protect the board from potential liability for false or misleading statements in relation to trading in securities.
c) The CFO failed to advise the board about the dangers of placing too much reliance on the adviser's reviews given that the assumptions had not been validated or stress tested by them.

As Blake Waldron (now Ashurst) have suggested, "The case therefore illustrates that multiple officers may be under an obligation to disclose the same information to the board."

All three individuals were held that to be 'officers' within the definition in section 9 of the Corporations Act "because they participated in decisions that affected the whole or a substantial part of the business."

Further developments

Subsequent to the first case, two other judgments followed.

A. **Morley v ASIC [2010] NSWCA 331** (commonly known as 'the directors and officers judgment')

In this case, the Court of Appeal of the Supreme Court of New South Wales:

- "allowed the appeals of the former non-executive directors of JHI against the findings of contravention that had been made against them, overturning the finding of the trial judge (Gzell J) that the directors had approved a misleading draft ASX announcement;
- partially allowed the appeal brought by the former secretary / general counsel of JHIL (Mr Shafron) and partially allowed ASIC's related cross-appeal, making an additional declaration of contravention; and
- dismissed the appeal by Mr Morley and dismissed ASIC's related cross-appeal."[120]

(Morley was the former CFO).

B. ***JHINV v ASIC*** **[2010] NSWCA 332** – ('the JHINV judgment')[121],

In this case, the Court of Appeal dismissed:

- JHINV's appeal against the finding that it had engaged in misleading conduct;
- JHINV's appeal against the finding that it had breached its continuous disclosure obligations;
- JHINV's appeal against the finding on penalty; and
- ASIC's related cross-appeals."[122]

Finally, and on appeal:

> "On Friday, 6 May 2011 the New South Wales Court of Appeal (Spiegelman CJ, Beazley and Giles JJA) handed down a joint judgement in appeals against refusal to grant relief from liability, disqualification and pecuniary penalty orders by a former company

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120 http://www.mallesons.com/publications/marketAlerts/2010/NSWCourtofAppealdeliversjudgmentsinJamesHardieappeals/Pages/default.aspx

121 James Hardie Industries NV (JHINV – based in the Netherlands)

122 Ibid above

> secretary and general counsel and the former CFO of James Hardie Industries Limited (JHIL) (Morley v ASIC (No 2); Shafron v ASIC (No 2) [2011] NSWCA 110)."[123]

Following an appeal, Mr Shafron, the then company secretary and general counsel, was found to have breached a duty of care and diligence as he failed to advise that the deed of covenant and indemnity[124] should be disclosed to ASX and he failed to advise the board on the limitations of a 'best estimate' of exposure to asbestos claims. Mr Morley, the former CFO, was found to have breached a duty of care and diligence as he had failed to advise the board of the limited nature of reviews of a cash flow analysis by certain experts.

In this most recent decision, the Court of Appeal dismissed an application by Mr Morley for relief against liability. Although the Court found that Mr Morley was acting honestly while failing to disclose important expert information to the board, the Court refused to exercise its discretion to grant relief. The Court stated:

> "Proper corporate governance and business activity depend on business leaders adhering to standards not only of honesty but also of care and diligence, and a failure of the nature and seriousness of that of Mr Morley is not in our view one which can properly be excused."[125]

Greg Medcraft, ASIC Chairman, has said that the decision has reinforced the importance of companies providing correct and accurate information to the market: 'Directors must engage with the most important announcements.'[126]

What lessons therefore do recent judgments hold for boards driving transactions?

It is interesting to speculate on what the outcomes would have been if the decisions in the James Hardie trilogy, as they currently stand, were to be applied to a hypothetical M&A transaction.

Blake Waldron note that:

> "From the perspective of directors, this judgment indicates the high level of scrutiny that is required of major transactions, and the potential limitations on the ability of directors to delegate to or rely on others… For executives, it illustrates the need for particular care

123 http://www.mallesons.com/publications/marketAlerts/2011/NSW_Court_of_Appeal_delivers_decision_on_appeal_of_penalties_in_James_Hardie_case/Pages/default.aspx

124 James Hardie Industries Limited ('JHIL") agreed to pay annual sums under a Deed of Covenant and Indemnity ("DOCI") to its subsidiaries as funding to meet the asbestos claims against the subsidiaries

125 http://www.mallesons.com/publications/marketAlerts/2011/NSW_Court_of_Appeal_delivers_decision_on_appeal_of_penalties_in_James_Hardie_case/Pages/default.aspx

126 http://www.asic.gov.au/asic/asic.nsf/byheadline/12-275MR+Decision+in+James+Hardie+penalty+proceedings?openDocumenthttp://www.asic.gov.au/asic/asic.nsf/byheadline/12-275MR+Decision+in+James+Hardie+penalty+proceedings?openDocument

when briefing the board about significant public announcements to ensure that they provide all the information that the board needs."[127]

Mallesons point out that:

"The Court of Appeal confirmed the seriousness of knowingly or negligently withholding relevant information from the board and the market. Non-director executives should therefore carefully consider advice to the board to ensure that all relevant matters are accurately explained and that a misleading impression is not conveyed (including by omission)."[128]

Table 5 applies the key features of the Hardie cases to a hypothetical set of circumstances to see how the case could potentially influence M&A specific activities.

Table 5: Applying key features of *James Hardie* cases to a M&A hypothetical

Hypothetical action	Nature of representation or misrepresentation	Liability
1. If directors of the acquirer approved or made certain unqualified or unfounded public assertions during a transaction including under their duties of continuous disclosure	That the company had adequate capital or reserves to fund an acquisition without financial distress	Directors could be held liable (departure from the care and diligence required by section 180(1) of the Corporations Act) depending on how much information they were provided by executive management. Nonetheless directors are expected to apply their own minds/expertise to the arguments / facts presented to them by executive management (note: this was also the position pre James Hardie)
2. If directors of the acquirer omitted to interrogate adequately the basis of certain future cash flow projections by third party advisers where these cash flow projections were either quite limited or were heavily conditional	Third party adviser projections that future cash were adequate	Directors and officers may <u>not</u> be relieved from liability even if they acted honestly but in a mistaken belief. They would be held to their duty of reasonable care and diligence and the Court could impose disqualification orders and/or financial penalties Such an outcome would also depend on the seriousness of the representation/omission
3. Executives (CFO, Company Secretary) declare that	May omit to disclose full list of assumptions and/or caveats	Directors could be held liable if fraudulent – and maybe even if only

[127] http://www.blakedawson.com/Templates/Publications/x_article_content_page.aspx?id=55219

[128] http://www.mallesons.com/publications/marketAlerts/2011/NSW_Court_of_Appeal_delivers_decision_on_appeal_of_penalties_in_James_Hardie_case/Pages/default.aspx

Hypothetical action	Nature of representation or misrepresentation	Liability
professional opinions have been received regarding adequacy of funding	qualifications of the third party opinion / study	negligent – in (non) disclosure. They could be barred from holding similar office in companies and be subject to financial penalties. May be exonerated from civil liability under section 1317S and section 1318 if that person has acted honestly and the departure from section 180 was not flagrant (and having regard to all of the circumstances of the case)
4. The merger sub-committee reviewed the third party report on their own company's financial adequacy	The main board members did not adequately probe what the sub-committee had considered or failed to consider in their deliberations or did not ask to see the cash forecast document	Directors could still be held liable (departure from the care and diligence required by section 180(1)) depending on how much information they were provided by executive management or fellow board members.

Non-executive directors do therefore have access to some current guidelines but should treat these with caution

James Hardie decisions, but also the *GIO* related cases, provide a set of directional guidelines and implications for directors involved in M&A transactions. The implication is that all board members and senior executives involved in a transaction – even indirectly – have to demonstrate the utmost vigilance, ask the right questions of each other, not take any provided opinions at face value, have well-substantiated grounds for any of their public assertions and cannot 'sugar coat' or 'dress up' material advice they have received or may in turn be providing.

The foregoing examples of recent case history are directional but ASIC's lack of track-record in prosecuting errant directors for negligence arising from M&A – or from cases that are analogous to major transactions – has meant that there has not been adequate clarification on where the line is always likely to be drawn. The fact is that by its nature, and for good policy reasons, neither parliament nor the Courts want to have 'the line' too clear or definitive. It needs to be kept vague in order to provide flexibility to accommodate the myriad of circumstances and the infinite number of degrees of bad conduct / culpability that could arise.

Therefore, if a non-executive director was looking to legal precedent to determine his or her responsibilities, he or she should be able to distil a set of 'litmus test' legal duty questions they ought to ask themselves, and their advisers, which should include:

- Have I/we asked for and received all the necessary information I/we require for this decision? Do I have confidence in the sources and the quality of what I have received?

- Do I really agree with the interpretations of colleagues? Why?
- Do I really believe in what I am advocating? Are my grounds defendable? Can I describe the key gaps in knowledge that I have? Am I comfortable that the risks associated with these gaps are either immaterial or that management has provided plausible risk management strategies around these risks?
- In sharing these views with our shareholders, have we provided all salient details? Have we tempered our views according to the information we have available or does some of our advice fall into the realm of unsubstantiated or overly optimistic (or pessimistic) opinion? In other words, is this an 'evidence based' opinion?

The inescapable conclusion for directors from the interpretation of their statutory requirements is that there is not a set of objectively ascertainable criteria that can be described for the 'right M&A practice' by the hypothetical reasonable director. Ultimately it comes down to an imperfect set of criteria and judicial tests, simplistically put: 'Try your level best, ask probing questions and don't act with impure motives'. At best it could be said, therefore, that the law is non-prescriptive or permissive. This is intentional and probably wise, as the courts do not wish to control what goes on in a boardroom or to legislate for every eventuality; but it does not unfortunately provide any succour to a non-executive director who is looking for guidance.

It is somewhat surprising that so little attention has emerged from legal and commercial literature about what the 'acquiring' directors ought to do, or ought not to do, during mergers or acquisitions, so as to act with the necessary care.

A significant part of this lack of clarity can be traced to policy which has tended to focus on the role that directors' discretion and judgment play and what the impacts would be on economic activity if that judgement were to be unnecessarily fettered. Clearly, management and directors need to be free to evaluate and take a certain amount of risk when executing investment options for the business.

The challenge for the Law is to accurately locate the tipping point at which it should intercede in protecting the interests of shareholders, creditors and other interested parties, as opposed to allowing directors to carry out their duties in ways that they reasonably believe are right and in the best interests of the abovementioned parties. The topic of exercising business judgment is explored in Section 3.4.9.

Having explored statutory requirements on directors, and distilled some implications for non-executives, albeit with imperfect clarity, attention should now turn to the common law.

Encapsulating common law precedent as it presently stands

The common law legal position has evolved, for the most part, in a fairly logical way given the role of precedent, despite a few diversionary steps. The evolving position with regards common law precedent on roles and duties of non-executive directors can be succinctly summarised as shown in Table 6.

Table 6: Summary of changes over time relating to roles and duties of non-executive directors

Year	Direction	Great onus or lesser demands
1925	Directors owe a fiduciary duty to the company and are expected to use a level of reasonable care, skill and diligence in discharging those duties that an ordinary man (which is not the same as the 'reasonable director') might be expected to take in similar circumstances; but are not liable for genuine errors of judgment[129];	Greater
1988	A director is not responsible for company debts if the director was not involved in the day to day running of the business[130], and had nothing to do with the debt being incurred[131];	Lesser
1989	Directors are responsible if they make a decision, even if they do not have all the necessary information[132] – in the *North Sydney Brick and Tile Company* case the directors made a decision regarding a takeover without all the information;	Greater
1990	Directors are liable for a company's debts even if the director/s had no input at all into the running of the business[133];	Greater
1990	Directors are liable for a company's debts, unless the debts were incurred without their express or implied permission or where they were not reasonably aware that the company could not repay the debts[134] (in which case, the directors are not liable);	Unchanged
1991	Directors are liable as they should question management on the state of the company[135];	Greater
1992	Independent directors are not liable, if they do not have awareness of a particular issue and there was no dereliction of duty in not being aware of that particular information[136], as they are not expected to give constant attention to a company's affairs;	Lesser

[129] Re City Equitable Fire Insurance Co Ltd [1925] Ch 407
[130] Metal Manufacturers v Lewis (1988) 6 ACLC 725
[131] Under the current provisions of the Corporations Act, non-involvement, non-participation or ignorance are no longer defences unless the director can uphold a defence under Section 588H)
[132] North Sydney Brick and Tile Company v Darvall (1989) 15 ACLC 230
[133] Statewide Tobacco Services v Morley (1990) 8 ACLC 827
[134] Group Four Industries v Brosnan and Anor (1990) ACLC 137
[135] Commonwealth Bank of Australia v Friedrich and Ors (1991) 9 ACLC 946
[136] AWA Ltd v Daniels (1992) 10 ACLC 933

Year	Direction	Great onus or lesser demands
1993	Independent directors are not liable as they should limit their duties to board meetings and special committees[137];	Lesser
1994	Independent directors are liable if they do not disclose all their information to the board[138];	Greater
1995	Independent directors are liable as there are no differences in the obligations of executive directors and independent directors[139];	Greater
1998	Independent directors are liable as they should exercise the degree of care and skill which could reasonably be expected[140];	Greater
2002	Independent directors are liable as they are expected to act with reasonable care and skill[141];	Greater
2007 and **2009**	Company officers' have a statutory responsibility to exercise care when making profit forecasts[142] or when providing information to the marketplace about the state of a company's financials.[143]	Greater
2011	Non-director executives should carefully consider advice to the board to ensure that all relevant matters are accurately explained and that a misleading impression is not conveyed (including by omission).[144]	Greater

Source: *The Role of the Independent Non-Executive Director In Australia*, Trevor Lipman, Macquarie University, Feb. 2008, at pg. 38

To apply these common law precedents to a hypothetical M&A acquisition liability situation where significant loss was incurred by the acquirer, *'ceteris paribus'* independent directors will be equally liable to the executive directors if as a result of the M&A of that acquisition occurring, the company incurred debts or liabilities, regardless of whether they approved of the debts or the independent directors attended all the board meetings, unless they questioned management on these matters and were somehow led astray.

The above summation gives a reasonably clear exposition of when (in broad terms) directors will be held accountable and culpable. Again for common law, as was the case for Statute, it does not,

[137] Vrisakis v ASC (1993) 11 ACLC 63
[138] Permanent Building Society v Wheeler (1994) 11 WAR 109
[139] Daniels v Anderson (1995) 13 ACLC 614
[140] Circle Petroleum (Queensland) Pty Ltd v Greenslade (1998) 16 ACLC 1577
[141] ASIC v Adler (2002) 41 ACSR 72
[142] Vines v ASIC (2007) 25 ACLC 408
[143] ASIC v Macdonald [2009] NSWSC 287
[144] James Hardie Industries Limited (JHIL) (Morley v ASIC (No 2); Shafron v ASIC (No 2) [2011] NSWCA 110)

provide guidance on the specifics of what directors should do or not do to avoid such culpability. This is understandable, however, as it is ‘impossible to legislate for common sense’ or to prescribe business judgment.

How does the Business Judgment Rule operate?

The Corporations Act has a ‘safe harbour’ test (or less charitably, a ‘get out of jail’ clause) in the form of the Business Judgment Rule (‘BJR’). Under section 180(2), the BJR is intended to protect those directors who:

- make business judgments in good faith and for a proper purpose
- have acted on an informed basis to the extent they reasonably believe to be appropriate
- do not have a material personal interest
- have a rational belief that the decision is in the best interests of the corporation.

The BJR will not provide any assistance unless all these requirements are satisfied. When the BJR applies, the director is deemed not to have breached his or her common law duty of care and diligence.

As regards the first prerequisite, there must be a decision – that is, whether to act or not act. As obvious as it sounds, the BJR does not operate where no decision is made or where the directors ‘*abdicate their responsibilities and fail to exercise any judgment'*.[145] ASIC suggests that a director cannot be properly satisfied that a decision is truly in the best interests of the company where he or she has simply ‘rubber-stamped’ the decision.[146] There must be an exercise of judgment in reaching the conclusion, even if it results in doing nothing i.e. an act of omission, or involves action that ultimately causes the company loss.

Therefore, in practical terms, if a director simply goes along with the rest of the board in accepting a takeover recommendation without personally having scrutinised the detail of that recommendation, he or she cannot benefit from the BJR. Similarly, the BJR does not offer exemption from liability where an individual director rubber-stamps an independent expert’s report, or does not apply his or her mind to the challenges or potential risks of a particular takeover recommendation.

Thus a director cannot simply rely on other directors on the board considered to be experts on the subject matter under decision – they must make independent inquiry themselves. A consequence of the third prerequisite, however, is that it leaves the door open for culpable directors to slip through, given that they have only to inform themselves to the extent they think is appropriate (which is a largely subjective test).

As regards the fourth component of the test, the director’s or officer’s belief that the judgment is in the best interests of the corporation must be a rational belief, unless it is one that no reasonable

[145] Resolution Trust Corp v Acton, 844 F Supp 300, 306 9 ND Tex (1994).
[146] ASIC Info Sheet ‘The Company Director Survival Kit’ July 1998.

person in their position (and implicitly, with their experience) would hold. In other words, it is an objective test.

The BJR only provides protection regarding the duty of care and diligence in section 180(1) and the equivalent duties at common law or in equity (including the duty of care that arises under common law principles governing liability for negligence). It does not have universal application to any other duty under the Corporations Act. This limitation is expressed in the endnote of section 180(2).

For the BJR rule to apply:

- There must be a business judgment.
- It must be made by a director or officer.
- The director or officer owes a duty of care and diligence.

If all three criteria are met, the merits of the BJR will not be subject to further review by the courts and the duty of care under section 180(1) is also deemed to have been met.

Professor Annette Greenhow quoting from the American Law Institute Corporate Governance Project[147] said that the business judgment rule developed because of a "desire to protect honest directors and officers from the risks inherent in hindsight review of their unsuccessful decisions, and ... a desire to refrain from stifling innovation and venturesome business activity".

To be effective, a corporate governance system must allow management and the board the freedom to drive their company forward without undue impediment, otherwise shareholder returns may be unnecessarily retarded. If directors lived in fear of retribution from taking commercial risks, corporate performance and shareholder value creation would be likely to suffer.

What role does skill play?

Even if due care by directors is shown, this might not equate to skill. For example, whilst section 180 imposes standards on directors relating to care and diligence, it makes no reference to the necessary level of skill – an omission some might find surprising.

What, if anything, is the required level of skill? Is this the same for all directors? What if directors are 'well skilled' in all other aspects or requirements of governance when it comes to the 'normal' activities of the entity, but are out of their depth when it comes to M&A activities?

Again, the literature appears silent on this question. There is no clear view about the remedies available to shareholders where there has been a failure of skill. These are largely unchartered waters.

As skill, however, is not part of the duty of care and diligence, there is no examination by objective standards whether the director was adequately skilled and experienced in the first place.

[147] Branson DM, *Corporate Governance 1997 Cumulative Supplement*, Michie Law Publishers (1997) Para 7.01-7.20

In other words the test is simply: 'Would another director in the same position and circumstances, with the same level of skill, have had a similar rational belief?' This is a palpable deficiency but there is no evident recent precedent that directly determines culpability based on a deficit in skills If M&A in particular is a key feature of a company's agenda and strategy, it ought to be incumbent on boards regularly to evaluate whether, as part of board renewal, they have the necessary skills directly represented on the board and amongst the executive leadership cadre. If not, it should be part of their responsibilities to ensure that they at least have arm's length access to the required skills.

Conclusions on Legal literature and its guidance for directors during transactions

As things currently stand, under statutory law, post the *James Hardie* decisions, directors and officers failing to make a full disclosure and/or not adequately questioning the details placed in front of them by management or expert advisers, will be liable if that conduct is a significant departure from the standard of care one would expect under section 180 in applying an objective test for directors' duties. Directors and managers may be barred from holding office and/or be subject to financial penalties if the omission or representation is material.

Nonetheless, whilst progress has been made in cases prosecuted by ASIC it is still not crystal clear where the line is likely to be drawn regarding culpability for poor disclosure and for decision-making with regards disclosure. In many ways common law does a reasonable job of defining where (or in which broad circumstances) non-executive directors' accountabilities lie and when they may be culpable. Knowing what they ought to do, how and when is still an open question.

Given the entrenched position of the BJR and the challenges of retrospectively questioning how directors applied their minds, common law has not as yet tested the boundaries as to what levels of care, diligence and skills need to be demonstrated with regards investment decisions (including M&A decision-making) i.e. in deciding whether or not to proceed with a takeover bid. At best it can be said that non-executive directors will be protected by doing everything realistically possible to form an independent and informed view of what management is presenting to them (despite what can best be described as asymmetrical information available to them). The fact that a director has a 'part time role' will quite probably be of no weight in regard to the potential liability that may attach to the performance of his / her role as a director.

3.5 Overall conclusions from literature review – triangulating the three intersecting elements

Commercial literature is rich with sound, practical, M&A advice for management, but not for directors.

The commercial body of knowledge is mostly based on practical research, case studies and anecdotal evidence; for the most part this does not have a strong empirical or academic research backing.

The commercial literature generally looks to observable and directly manageable issues and mechanisms relevant for management to attend to and proposes practical and relevant ways to address these problems, in the form of effective M&A approaches, tools and practices.

Commercial literature focuses on 'hard factors'

The commercial literature moreover tends to focus on the more overt activities and mechanisms of what management should do – that is, what could be termed 'hard' factors. The 'softer factors' such as underlying behavioural tendencies and competencies crucial for deal success (and the 'pathologies' that tend to drive poor M&A performance) receive little discussion at all. There is, however, a growing body of literature that explores decision-making processes by executives – that is, rational and instinctive decision-making – but it is not directed specifically at boards and not to M&A transactions.

Commercial literature does not explore in a detailed manner the relative impacts and materiality of specific actions relating transactions, other than perhaps citing factors rated by executives as most important to deal success or failure – but these are not ranked relative to each other.

Empirical evidence on the critical actions or drivers of value is missing

Additionally, causality and correlations between activities (or transaction critical success factors) are unexplored, which is understandable as no two deals are identical and there are multiple factors, internal and external, that may be highly variable. It would require complex multivariate analysis and a whole range of conditional assumptions (for example, assuming 'all other factors are held constant' i.e. '*ceteris paribus*'), to isolate deal factors and impacts – particularly in complex open systems with non-linear co-relations between variables.

Toolkits and practice guides abound for management but not for boards

It could therefore be said that the practice of M&A lifecycle management, the procedures, processes, mechanisms, including tools and enablers, are well described. The framework for what management and executive directors ought to do or attend to, is in broad terms clear and consistent. There can be no regimented approach, as specifics will of course vary from transaction to transaction and will require directors to apply their minds to their circumstances. 'Practice guides', 'toolkits', or 'M&A playbooks' for this target audience are readily available from legal, audit and consulting firms but do not really address what non-executive directors ought to do.

The commercial M&A literature is, however, silent on what value-adding or value-protecting activities the board of directors specifically (as opposed to management) ought to focus on. This is a sizeable omission, given that too many boards preside over M&A transactions that underperform. There appears to be limited commercial or scholarly analysis or learning about what boards could do or ought to have done to have prevented these mishaps.

It appears what 'happens in the boardroom stays in the boardroom' by and large; or to misquote Winston Churchill: "It is a riddle, wrapped in a mystery, inside an enigma; but perhaps there is a key. That key is (self) interest."[148]

Looking next to **Governance literature**, the various codes of practice place a heavy emphasis on the importance of independent non-executive directors. The underlying rationale for this is that

[148] http://www.phrases.org.uk/meanings/31000.html

there needs to be sufficient independent opinion and impartiality to act as a countervailing force to challenge the insider knowledge and expertise of executive directors and management and to exercise the necessary checks and balances.

Skills do not receive much 'airplay'

Directors' skills and experience are assumed to be a critical factor in transactions but causality is not proven; although like global warming – and the usefulness or otherwise of carbon credits and emissions caps – having M&A savvy directors on a board can do little harm. Chairmen and Nomination Committees should be making an informed and objective assessment of what external experience and skills are really required for board success and renewal, given each company's specific strategies and cultural nuances.

'Soft systems' are largely overlooked

Similarly, there is a dearth of guidance about how to engender the right balance of critical thinking and debating skills on each board. Ultimately this is a matter best determined by each chairman but there would be considerable value in having some practical guidance available on ways to achieve critical challenge – and the kinds of questions to be asked and explored especially with regards major investment decisions.

Governance practice tends to focuses on 'hard factors' or 'tangibles' that have little to do with M&A

Perhaps owing to the challenges of providing reliable research into these softer factors, especially during or after transactions, the focus of governance literature tends to be oriented to dealing with observable, directly manageable manifestations of good governance practice – much like the commercial literature around M&A.

The emphasis in the governance codes of practice therefore tends to be on the more tangible factors, namely board composition, structures and processes. The focus generally is not on how best to engender critical debate within a collegial environment or balance constructive criticism and challenge of management but within a collaborative atmosphere.

Perhaps this omission is understandable – this is not the sort of activity or behavioural material that lends itself to a checklist or formulaic approach. Most skilled chairmen should know how to create this kind of environment and constructive engagement. Whether most chairmen do so, is an interesting point but is not for exploration here.

Similarly there are no specific 'play books' or practice guides or advice to directors on how boards ought to participate in an M&A transaction such as:

- what their specific roles and responsibilities are
- where these boundaries start and finish
- where the delineation is between their direct input and involvement versus that of management

- what mechanisms best provide non-executive directors with the necessary controls and oversight arrangements.

Whilst determining these answers may be context- or situation-specific, there is no real guidance on how to go about addressing these matters – or what the typical answers may look like at either extreme (i.e. highly permissive) or highly controlled,

The focus of governance guidelines, especially codes of practice, tends to be on form and function – such as on committee structures, board processes, voting procedures, access to information, compliance type activities, etc., rather than on substance and workings.

Putting aside the tenor and direction taken by various codes of governance practice, the commercial literature is clear that the two critical roles for the board are conformance and performance.

Conformance requirements do not extend to M&A assurance guidance

Boards have to strike a healthy balance between conformance and performance and inward and outward focus. In carrying out the conformance role, internally focused monitoring of management is a critical function. In carrying out the performance role, boards have to provide strategy formulation and policy making.

Whilst the literature does not extrapolate these roles further into the context of M&A transactions, the direction and implications are relatively clear, namely that a board that does not:

- effectively monitor management in conducting an M&A transaction, would be failing in its governance
- provide input or direction to, or does not adequately review and test the M&A strategy or the policies surrounding the proposed M&A transaction, would also be failing in its stewardship.

Looking lastly to the **Legal literature**, common law and statute have tended to converge around a set of criteria for the duty of care and diligence: that it is circumstance- and board-specific and relative to the experience of that specific director.

Some parameters are clear but still hard to know the objective standard of care and skill

There is no easily assessable, objective standard of care or of skill – and certainly little that is directly 'on topic' for M&A.

Whilst there is no definitive formula that specifies the necessary standard of care or skill, many cases have sought to place certain 'stakes in the ground' regarding acceptable or unacceptable levels of conduct that is expected of directors, even though many may be regarded as fact specific. The law also now appears to have converged in recognising that:

- non-executive directors cannot be an "all-seeing, all-knowing, omnipresent" force
- by corollary, executive directors generally have a higher level of accountability and need to be informed to a far greater degree than non-executives

- directors are entitled to delegate and to place reliance on the professionalism, skills and bona fides of management.

Guidance on culpability for acts or omissions specifically during transactions is lacking

Whilst available literature explores question regarding directors' duties and legal liability for negligence in reasonable detail, there is no direct precedent regarding a failure by directors to demonstrate the requisite level of care, diligence and skill in conducting a transaction – or where they have been taken to task either by shareholders or the regulator for that reason. In other words, there is a dearth of coverage in the available literature that explores the potential culpability of directors generally, and specifically those of the acquirer, for transactions that have failed or materially under-performed.

Boundary delineation – accountability of directors versus management for M&A activities

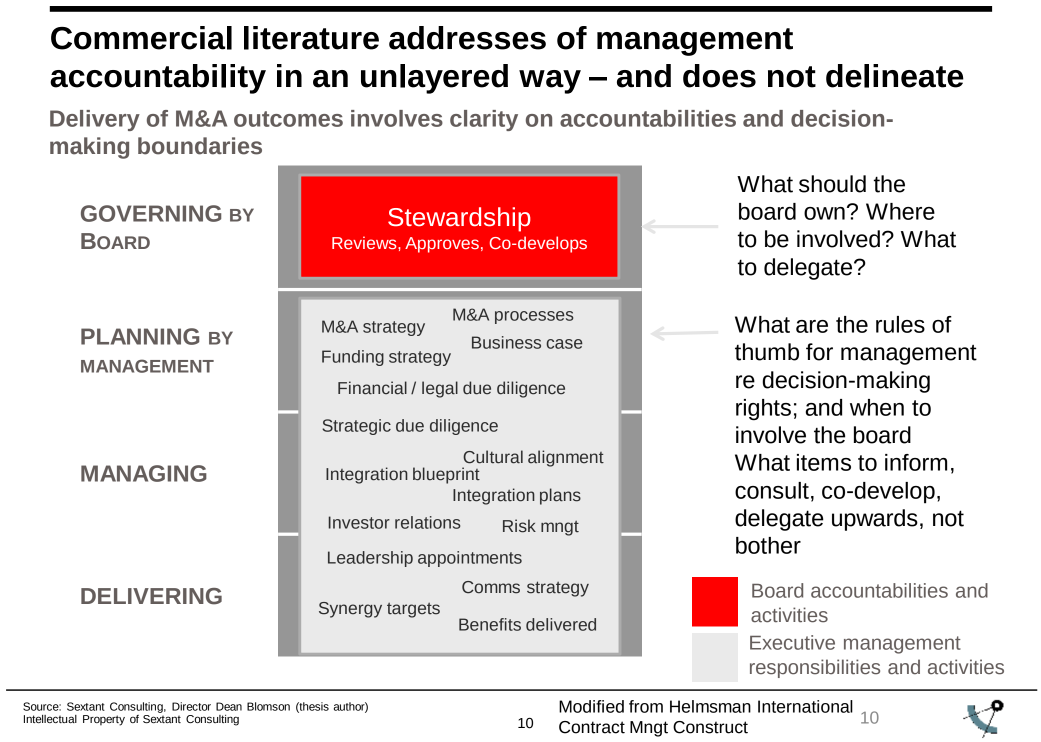
There is no clear set of guidelines for boundary definitions to discern where management's responsibilities for M&A activities and outcomes end and those of the board start. This is a theme that starts to become apparent in the commercial literature, continues in governance writings and remains largely unanswered in the legal body of knowledge. Whilst commercial literature addresses strategy involvement by boards – in so much as this relates to M&A planning – the ownership or stewardship of a range of other tasks that relate to managing the transaction and its execution once the deal goes live are not separately addressed.

The governance layer for M&A remains largely unexplored or clarified except in the most general of terms. If is not apparent where the boundary may be drawn between the board and management and how the interface of accountabilities and actions are decided or managed at and across the boundary.

Whilst this is an idiosyncratic process determined by each company and board's unique context and culture, the rules of thumb about what activities the board should be involved in, and their relative level of involvements, ownership and accountability, is not easy to determine. The challenge lies in determining: On which items or activities are there reserved powers for the board? Where is there co-ownership? Where should the board review, test and approve? Where should it be consulted? Where does it simply need to be informed? And on which items should it have no involvement and potentially no need for information?

Delineating by whether an item is strategic, operational or tactical is helpful but not instructive. As one example, if integration or synergy initiatives are under-resourced that is an operational matter for management to address, but that could easily cause slippage in integration performance. Board members would or ought to have a keen interest in knowing that an integration program is under threat owing to inadequate resourcing. In general, commercial literature does not delineate types of M&A activities specifically requiring board purview. Figure 12 highlights the issues involved in delineating the boundaries.

Figure 12: Delineating the boundaries in delivery of M&A outcomes



Source: Sextant Consulting, Director Dean Blomson (thesis author)

The Business Judgment Rule looms large

There is, however, a considerable amount of cases that have decided that a director will not be held liable for a bad business decision, as long as the requisite levels of care and skill were applied in connection with making that decision. It is accepted that it is extremely unlikely that there will ever be case law or statute (or any corresponding legal literature) that suggests that simply because a business decision was bad, *ipso facto* the directors who ultimately took that decision should to some degree be regarded as personally and legally 'culpable'.

The prevalence of the business judgment defence does not help curious directors to know what precedent (if any) there is for culpability for not 'interrogating' management about whether, for example, they have an integration plan; or whether they have adequately assessed cultural alignment; or how they plan to deliver synergies, etc.

Thus, whilst recent decisions have taken significant strides in tightening up the interpretations of care and diligence, legal literature and court decisions in Australia have provided no direct, transaction-specific guidance in relation to the duty of care that could answer the following types of questions that interested non-executive directors are likely to be curious about:

a) What is reasonable behaviour in evaluating deals? That is, what would constitute acceptable levels of effort in trying to ascertain deal value, evaluate and mitigate deal risks?

b) What should the board reasonably be expected to do to ensure that management is prepare for delivering synergies and what oversight mechanisms should it apply to monitor how much value is delivered by management after the deal?

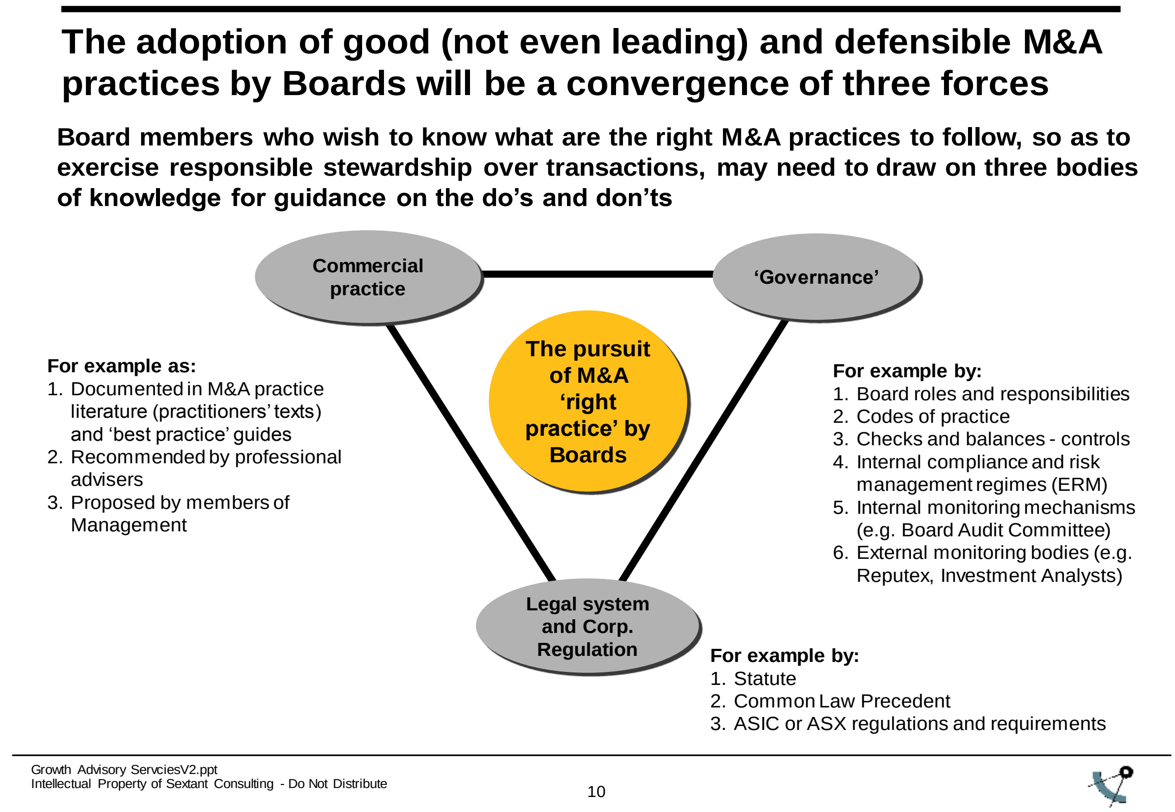
c) What standard of conduct would I be judged by? What is the set of 'right practices' that if I were to adopt and implement, in most circumstances I would be seen as having behaved responsibly?

d) Conversely, at what point does a failure to take reasonable steps in regard to (a) and (b) above constitute negligence (perhaps even gross negligence)?

3.6 Addressing the knowledge gap in the triangulation between accepted M&A business practices, governance and legal interpretation

Up to now, although closely inter-twined, the three strands of commercial, governance and legal literature have been separately explored and generally found wanting in terms of direct guidance targeted towards non-executive directors involved in transactions. Moreover, in that process of discovery, there is no one authoritative source that has emerged that has tried to bring the three prongs of the literature together around the focal point of M&A transactions. There is significant literature that explores the potential culpability of directors generally, but a dearth of guidance that relates to duties of non-executive directors specifically those of the acquirer, for failed or materially under-performing transactions.

Figure 13: Triangulating the extant bodies of knowledge



Source: Dean Blomson (thesis author)

Tackling this as a holistic, integrated topic from the target shareholders' perspective – far less from that of the bidder shareholders' – appears to be a novel approach. Individually, for each of the three areas of literature, there are also significant gaps. Each of the three legs of the 'board M&A right practices' stool (or corners of the triangle) taken alone, has its deficiencies when it comes to providing a clear articulation of what directors ought to do and how they ought to behave, in order to deliver or protect shareholder value before, during and after an M&A acquisition.

On the face of it, the extensive body of knowledge on commercial practices does an effective job of describing what management and executives ought to attend to in M&A transactions. But it does not provide clear guidance to directors and specifically non-executive directors, as a special category.

Generally there is a considerable amount of research and commercial knowledge about pre- and post-merger activities and good practice, when compared with the dearth of directly relevant governance literature and legal precedent in connection with such transaction-related activities.

Of the other two legs of the stool – governance and legal literature – both are deficient in providing specific guidance in relation to acquirers' duties. A lack of specific and direct commentary around directors' actions during M&A transactions appears to be a consistent 'blind spot' for all three legs – leaving exposed a director who wishes to turn to a credible source of targeted advice on good M&A practices by boards.

If higher levels of thinking and interrogation are to be achieved, one of the most fundamental cornerstones of directors' defences, the BJR, will ultimately need to be addressed. The BJR looms large as a potential obstacle to driving more responsible behaviour. Proper debate needs to take place about constructive, practical ways to address the issue of directors' accountability for poor skills and behaviours, rather than judgment. Until that time, value destruction without accountability will probably continue at enormous cost. The BJR, however, is not the focus of this thesis.

Having undertaken the literature review, the 'white space' for further research has started to crystallise. The emergent knowledge gap appears to reside in the absence of knowledge and research into 'right M&A governance' – that is, from the perspective of codifying what directors ought to do to in exercising stewardship in the interests of the shareholders of the acquiring company.

Clearly a 'cookie-cutter' approach is neither possible nor desirable as each board needs to strike its own balance between (a) protecting shareholder capital from undue risk (however that may be construed by each specific board) and (b) growing wealth, in whatever way/s that may be defined (e.g. in terms of capital appreciation, dividend streams, total shareholder returns) and against whatever benchmarks may be set.

The gaps surfaced through the literature review have led to a conclusion about the need to explore and identify 'right practice' with a view to:

1) evaluating what should comprise good practice (not necessarily 'best practice') by the acquiring directors primarily in pre- and post-deal activities
2) understanding whether such activities, *ceteris paribus,* are perceived as improving value protection and creation.

By undertaking this exploration, it may become apparent as to which practical steps can be taken by boards to 'lift the bar', so as to protect their shareholders from value loss and themselves from embarrassment and more particularly from potential legal liability. It may also provide some ideas on which compliance and/or legal mechanisms, if any, should be considered to encourage the 'right' kinds of behaviours by boards.

As has been previously pointed out, this thesis is not intended to be a legal treatise – rather an exploration (using the legal framework as a backdrop or context) from a **commercial and governance perspective** to describe what is required to be done practically and sensibly by executive and non-executive directors to protect and deliver shareholder value from M&A transactions.

As can be gauged from the foregoing discussion, a set of focal points have emerged from the literature review pointing to a dearth of authoritative and accessible 'right practice' regarding M&A governance.

A sizeable knowledge gap is discernible in the white space between literature sources

This chapter has described the journey of discovery undertaken into understanding where the 'white space' lies in board governance of M&A – by attempting to determine directors' responsibilities in the intersection point between commercial, governance and legal literature,

The literature review has shown an important gap in knowledge, and a dearth of information, relating to board activities specifically when carrying out M&A – whether in the form of practices, governance or legal duties.

This is a significant knowledge and practice gap in our commercial and governance literature and a potentially exploitable hole in our law. This potential lack of clarity imperils the effective performance of boards and management, the confident and sustainable performance of our stock markets and the rights and confidence of our shareholders. There is no one clear and reputable source that has tried to bind these three legs of the 'right practice' stool together. Tackling this as a holistic, integrated topic from the perspective of the acquirers' shareholders appears to be a novel approach. This literary exploration has thus surfaced a potentially valuable research topic.

The scene is thus set for a more thorough exploration of this white space by drawing on, and attempting to chronicle, the experiences and learnings of board members as to what they believe they ought to do; and to examine how well this aligns with what was uncovered in the Literature Review.

Having outlined the conclusions drawn from the literature review undertaken, the next chapter (Chapter 4) will describe the focusing questions that have been framed to guide research into directors' views. These focusing questions are a direct consequence of, and response to, the gap in knowledge exposed. Once the questions are described, the next following chapter, Chapter 5, will examine research approach alternatives and then narrow down the choice of methodology to describe a preferred option for conducting this PhD research to provide some missing clarity to 'right practice' in M&A stewardship.

4. Research question and objectives

"If I had read as much as other men, I should know no more than they."

[Source – Thomas Hobbes, reported in *Brief Lives*, by John Aubrey (1626–97)]

"Concepts which have proved useful for ordering things easily assume so great an authority over us, that we forget their terrestrial origin and accept them as unalterable facts. They then become labelled as 'conceptual necessities,' 'a priori solutions,' etc. The road of scientific progress is frequently blocked for long periods by such errors. It is therefore not just an idle game to exercise our ability to analyze familiar concepts, and to demonstrate the conditions on which this justification of their usefulness depends."

[Source – Albert Einstein (1879–1955)]

Key points

1) A focusing question for the research has been identified that is at the intersection point of commercial, governance and legal practices, regarding directors' actions or omissions during mergers and acquisitions.
2) The parameters for the research question have been defined and the scope will centre on evaluating:
   a) what it is that non-executive directors and chairmen believe that they should do that makes a sizeable difference to value delivery for the acquirer's shareholders
   b) how they (i.e. interviewed directors) believe they ought to carry out their roles in protecting and securing enterprise value most effectively, and thus
   c) how their espoused views align with, diverge from, or supplement what may be missing, in the literature;
3) Given the importance of M&A activity to the economy, and its generally patchy track record, this thesis aims to break new ground in an area that needs focused examination, fresh approaches and clearer answers to assist non-executive directors.
4) The evidence from the literature examined is that the current commercial and governance focus leans strongly towards tangible tasks and activities that management ought to undertake, and that existing literature:
   a) is not directive or overt on what directors specifically ought to do to improve M&A outcomes
   b) does not address the intangible dimensions of directors' contributions and roles i.e. the impacts of their behaviours and mindsets.
5) Given the paucity of chronicled 'right practice' for M&A governance, this research has been approached with no specific operating hypotheses about what directors, especially non-executive directors, ought to do during an M&A lifecycle. Rather, a 'grounded theory' research process was chosen to be followed in interviews and data analysis to enable unfettered thinking about how directors describe their key accountabilities and 'value adding' actions and activities during transactions.

4.1 Introduction and recap of literature review

Chapter 3 has explored in considerable detail the extant literature in discovering what can be learned about directors' required M&A governance practices and requirements. This has been undertaken by attempting to triangulate commercial, governance and legal writings – so as to distil or discern the body of knowledge dealing with M&A guidance, directors' general duties and legal liabilities for negligence. The weight of commercial writing leans towards pre- and post-merger activities and 'best practice' by management supported by some scholarly research but more 'practitioner based' research and knowledge emerging from management consultancies. Non-executive directors have no access to directly targeted, usable and explicit guidance on M&A.

Based on Chapter 3, the following conclusions were arrived at, namely that:

1) Given the breadth and availability of the existing 'chronicled' body of commercial knowledge about M&A – and via the market for expert advice – it ought to be reasonably clear to executive management what to do and how to go about transaction management.
2) However, a director or board about to commence M&A activity would have far less direct or specific commercial practice guidance as to what they should do or how they should act, generally speaking, in exercising stewardship over the M&A process from start to finish – in essence each board or board member would have to distil a set of learnings for themselves from available commercial literature.
3) Additionally governance literature is more generalised on board practices and structural matters, leaving another gap in specific M&A guidance and knowledge.
4) Legal guidance, however, does better in describing directors' duties and recent precedent points to a tightening set of analogous duties such as evaluation of expert opinions and guidance to shareholders.
5) Taken together, however, all three sources still fall short and this leaves exposed such non-executive directors who are in search of advice and directly applicable learning; and as a result their management teams, companies and shareholders are potentially vulnerable to mistakes or omissions occurring.
6) By implication, these omissions also mean there is quite possibly no consistent set of duties that most boards would be able to define.

The scene is thus set for a more thorough exploration of this white space by drawing on, and attempting to chronicle, the experiences and learnings of board members as to what they believe they ought to do.

In Chapter 4, the research question that emerges from the literature review is articulated and 'unpacked'; and some of the likely challenges from research are then described. This then sets the scene for a deeper consideration in Chapter 5 of the research methodology selected – why it was chosen, what it involves, etc.

4.2 Setting the scene for the research question

Chapter 3 identified a number of significant gaps in the body of knowledge that is available to provide guidance to boards of acquirers – including the theory and practice of M&A stewardship.

At best, in many cases an inquiring or inquisitive director would struggle to find a reliable source of advice and would need to interpolate from what commercial literature indicates that management ought to do – as the focus is predominantly on management not directors. This gap in the body of knowledge and guidance is a significant void in our knowledge and represents a 'white space' in the convergence of the three disciplines of:

1) commercial transaction management and practice
2) corporate governance practices broadly around directors' functions and actions when it comes to value creation and protection generally and more especially around transactions
3) legal duties and liability issues when it comes to M&A specifically, for non-executive directors but no less so, for directors as a category.

One obvious way to attempt to close the knowledge gap would be by doing some 'depth soundings' with a sample of highly experienced directors to gather their views in relation to their responsibilities. In effect this would mean 'taking the temperature' of directors' stated views about their responsibilities and what constitutes 'right practice' in M&A stewardship. This is essentially a qualitative research task and is a necessary starting point given the gaps evident in the prognostications of the literature examined. The research technique to be followed is Grounded Theory which will use inductive approaches and coding to then deduce and formulate an emergent theory of right practice.

Having analysed and distilled views from a research sample of directors interviewed, these would hopefully form a baseline set of advocated or espoused practices and could be compared and contrasted to the perspectives contained in the extant literature.

Therefore the second logical step would lie in comparing what the research sample of directors themselves say they actually do or believe they ought to do in practice with what literature designates or indicates. The intent would be to surface differences or similarities in views expressed and to identify any patterns that cause concern or are worthy of further investigation.

In effect the targeted interviews would establish a baseline or a reference point for accepted activities and behaviours by finding out what directors interviewed believe ought to be done**.** This could then be juxtaposed to whatever the literature indicates is necessary for board members (or failing that, for executive management as the closest possible proxy for non-executive directors) to do.

A number of outcomes could potentially result from the comparison of perspectives:

- Areas of overlap and convergence – in so far as the imputed or implicit views of theory about what directors ought to do could be reinforced by the interviewed directors – allow one to treat this as a working hypothesis of 'right practice'.
- Areas of divergence or contradiction could arise from the two bodies of knowledge – a gap analysis could flag a set of philosophical or practical issues (activities, behaviours, etc.) that may need to be explored by later research.

- It may be that the directors' views of what they ought to do during M&A in fact directly address gaps ('white space') evident in the literature and thus their articulation could begin to provide a new source of guidance to directors, for further examination and testing.

4.3 Overall focusing question for thesis

The focusing question relates to directors' actions and accountabilities.

Based on the preceding thinking, an over-arching focusing question for the thesis research (and a number of sub questions), has started to emerge, namely:

> *Is it possible to describe 'right M&A governance'? If so, what is it?*
>
> *More particularly, is there convergence, divergence or white space resulting between: how a sample of experienced non-executive directors see their accountabilities and believe their necessary actions and behaviours should be, based on personal experience; and what theory indicates the directors of the acquiring entity ought to do to improve the success rates of mergers and acquisitions?*

As a natural corollary to the above question, there is a further question, the 'so what?' question, relating to gaps which might exist (for example, areas evident from the interviews but not within the published literature). The sub-questions here would be:

> *What are the consequences of these gaps for the existing literature and of course for practice?* And
>
> *What can be done to close any significant gaps or to achieve better alignment of those practices?*

4.4 Scope of research

Based on the emergent focusing question described above, the scope or boundaries of what the research will and will not cover have become apparent. The focus is primarily on commercial practices and governance.

A number of matters are outlined below that are within or outside of the thesis scope. From the words used in the focusing question above, the following research scope matters should be apparent:

1) The focus is on board members (particularly non-executive directors), not management, although certain executive directors like CEOs and CFOs will have a critical role to play in interfacing with the board but with a different level of involvement to other board members.
2) The focus will be on board members of the acquiring entity.
3) The study will examine what directors ought to be doing to aid value creation and/or reduce value destruction. The focus will be on developing a new Emergent Theory that addresses the areas of convergence between what scholarly and commercial literature indicates are critical accountabilities and activities (the theoretical *ought* of what directors ought to do); and what

directors believe their critical contribution should be (the directors' espoused *ought*). The two perspectives may overlap or converge in some regards but may diverge in others.

4) What the literature review would appear to advocate and what the directors themselves believe is important could be a mix of tangible and intangible elements:

   - 'Hard factors' or tangible elements in the form of process type activities and mechanisms – such as for example by instituting and adopting formal M&A processes, undertaking risk assessments; establishing a formally approved M&A strategy.
   - 'Softer factors' or intangible elements such as the attitudes and mindsets they bring to bear on the deal, general M&A skills and experiences.

5) The study is concerned primarily about commercial practice and governance practices. Legal accountabilities will be considered only in passing, not because they are irrelevant but because the two other aspects will or should help to provide the necessary norms for the legal system to respond to (if a legal response to M&A 'malfeasance' is believed to be an appropriate option).

6) As has been indicated earlier, mergers and acquisitions have a lifecycle commencing at Targeting stage, then going through the Transaction stage, then the post deal stage comprising a Transition period and finally ongoing management and Transformation. The research will not be structured deliberately around these four stages but in terms of scope the M&A lifecycle starts at Targeting and ends with value realisation activities during Transformation. Given these four stages, however, it may be worth looking for evidence in a more targeted way:

   - At the transaction or deal-making stage, what is reasonable behaviour in evaluating and executing deals? In other words, what would constitute acceptable levels of effort in trying to ascertain and secure deal value, evaluate and mitigate deal risks?
   - During and after the transaction, what should the board of directors reasonably be expected to do to prepare for, monitor and manage value capture?

It may be that directors' duties and involvements are different at various points in the M&A lifecycle.

The central line of investigation to be examined in the thesis is:

1) Can a sample of experienced directors articulate a set of practical, activities, steps and mechanisms that they believe should be followed by the boards of acquiring companies (although not empirically proven)?

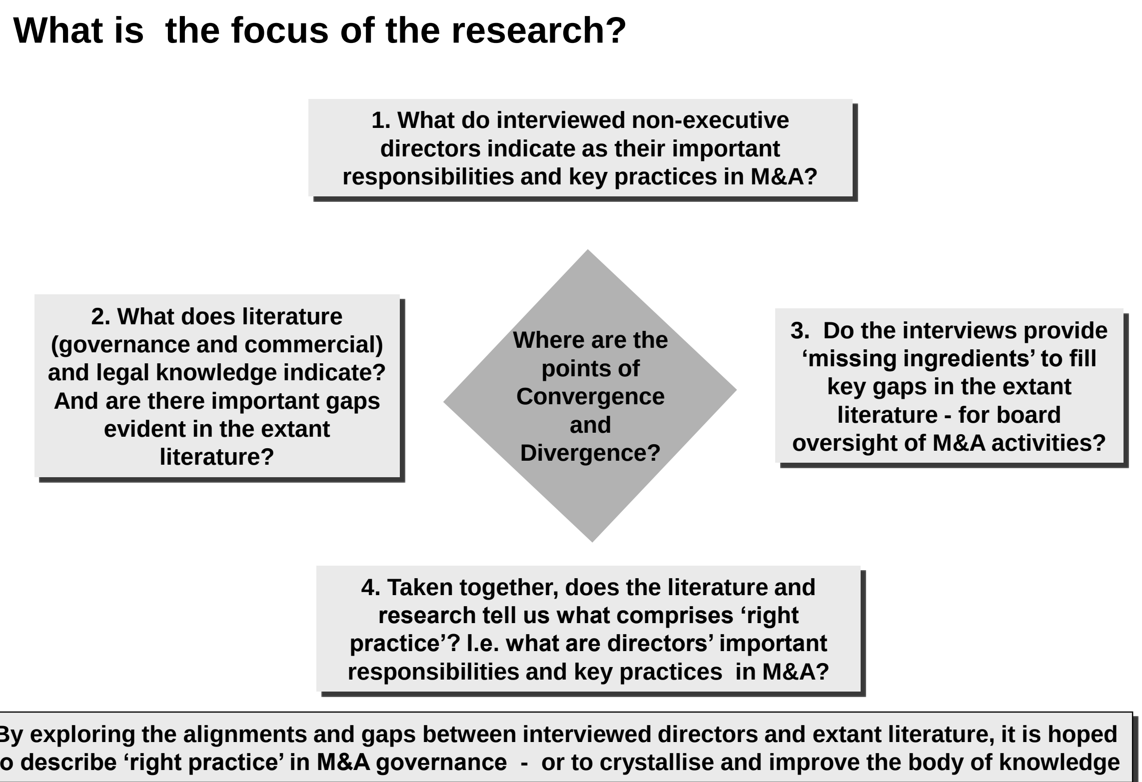
2) How different or similar are the directors' views to what literature proves or anecdotally defends as being the practices for directors that are likely to reduce the probability of ill-advised and/or poorly-executed corporate M&A activities? Is it clear what practices the research advocates should be adopted by non-executives and boards?

3) Do these two worlds converge into a cohesive set of practical, 'common sense' commercial and governance activities (or 'right practices'), behaviours and mechanisms that should protect shareholders' interests more effectively than they presently are?

In the event that a provisional 'code of right M&A governance practice' can be pulled together and articulated, this may form the foundation for further research and analysis. Only once that has been undertaken would there be justifiable grounds to codify this, formally or informally, as right practice, so that it forms an integral part of what directors ought to do. The bigger question at that point will be whether and how boards should be encouraged by a variety of possible mechanisms, voluntary or imposed (compliance driven) to 'lift their game' or face the consequences. Without being definitive, some of these potential mechanisms could be regulatory or legal requirements and sanctions; codes of M&A practice based on 'comply or explain' criteria (with 'name and shame' embarrassment for non-adoption or non-compliance); or greater transparency on deal management (perhaps in the form of a bidder's statement to its own shareholders for example).

Having outlined the high-level elements and logical structure for the research question, Figure 14 depicts the focus of this research.

<u>Figure 14: Thesis research focus overview</u>



Source: Dean Blomson (thesis author)

In essence, the research can be considered to represent a consolidation of experience: of existing documented knowledge and the articulation of new wisdom from experienced directors – and an acknowledgment of where gaps still appear to be.

Given the foregoing logic structure, the thesis focuses on three main activities:

1) Desktop research of existing commercial practices and literature, governance and legal literature relevant to the topic, in order to develop an informed understanding as to where the gaps and deficiencies were in the current body of published literature.
2) Face-to-face interviews with a cross-section of board members i.e. non-executive chairmen and non-executive directors and the completion of a short survey.
3) Analysis of observations arising from those interactions and coding of results, resulting in the development of findings and conclusions.

In doing so, it identifies and distils critical M&A commercial and governance practices by board members (especially non-executives) when undertaking acquisitions.

4.5 Potential research issues and challenges that needed to be addressed

There are three key issues to consider and address.

The foremost challenge is to **achieve objective, insightful feedback** from company directors – whether they were involved in deals that were seen 'after the fact' as having been successful versus neutral or marginal versus value destroying. Every interviewee inevitably will have brought some degree of their own bias to bear. This thesis is, however, not a search for the guilty or the incompetent but rather an exploration of the understanding by directors of what they ought to do or believe boards ought to do in most common M&A circumstances.

The consideration of what directors 'ought to do' may, however, may be confused or wrapped up in some circumstances by recollections on what the board actually did do or what the Director observed to be happening in practice. To avoid confusion, each interview focused on the idealised set of activities that directors advocate or believe 'ought' to be followed, in order to mitigate the risk that directors will defend a particular position in a specific M&A or sub-consciously talk up their M&A skills and commercial nous. The intent is not to undertake a case-by-case transaction autopsy.

This is a problem with almost any research, that there is very little indeed that is 'objective'. The question of subjectivity and bias is addressed further in Section 5.4, 'Addressing the challenge of bias in a qualitative study'. As the French writer Anais Nin said, "We don't see things as they are, we see them as we are."

The challenge therefore lies in evaluating opinion without direct evidence. The best protection resides in setting up ways of asking questions that search for evidence to counter directors' expectations and beliefs. That is the essence of the scientific method. Such questions have included an exploration of what learnings, positive and negative, have emerged from conclusions commonly found in the literature and personal experience on which M&A practices work or do not work and why. These questions will help to neutralise bias or to surface it.

The second and closely related challenge arises from what could perhaps be called the **homogeneity of corporate board directors**. Many board members come from successful careers in large corporations or from having worked as senior specialist advisers to corporate clients.

Since the M&A track record of enterprises is generally patchy, it could be speculated whether these non-executive directors bring to boards the same conceptions and practices as they had in their corporate careers. It is challenging to find board members who bring fresh perspectives to bear and are willing to question orthodoxy or conventional managerial wisdom.

This second challenge reinforced the value of carefully setting up the conceptual or analytical framework for the study, guided by the literature review only for context (not for the specifics or elements of any hypothesis), before exploring the topic via semi-structured interviewing. See Section 5.6 for further details on the interview approach used and Section 5.8 on the purposive sampling process followed.

The third challenge is one of **fear of added controls and sanctions**. Directors being interviewed may see this research as a stick with which to beat them, by making them more accountable in a punitive sense. Or they may see it as a way to limit their discretion and to undermine the business judgment rule by demanding that, wherever a sizeable portion (however defined) of shareholder capital has been destroyed during M&A activities, a higher duty of trust and care is required in carrying out the board's stewardship.

Regarding potential controls that could be placed upon boards, this is not a topic where directors' views have been canvassed during interviews or explored via desktop research. Interviews have touched on board control mechanisms of transactions and have explored the checks and balances that board members ought to apply to executive management, rather than exploring in fundamental ways what controls can be imposed on boards themselves by shareholders or regulators. Asking board members to opine on more externally imposed compliance and regulatory intervention would be like asking 'turkeys to vote for Thanksgiving'. Governance commentators have argued that policing generally is a blunt, costly and relatively ineffectual stick; therefore the best protections for shareholders tend to lie in having well-led boards which focus on skill, experience and competency development and hold themselves to the highest standards.

Having described the thought process behind articulating the focusing question for the research, and some of its dimensions and boundaries, and then having outlined some specific key challenges to the research, the next chapter will outline the selection of the research methodology.

5. Methodology selected and research design

"All truth passes through three stages. First, it is ridiculed. Second, it is violently opposed. Third, it is accepted as being self-evident."

[Source – Arthur Schopenhauer (1788–1860)]

"There are two ways of constructing a software design; one way is to make it so simple that there are obviously no deficiencies, and the other way is to make it so complicated that there are no obvious deficiencies. The first method is far more difficult."

[Source –AR Charles Hoare, Turing Award Lecture (1980)]

Key points

1) Given the gaps exposed in the extant literature, the emphasis is on describing how Boards can better assure the chances of successful M&A transactions for their shareholders.
2) This is a qualitative study, not one focused on an empirical, scientific truth, as commercial and governance practices are not exact, hard sciences.
3) To accomplish insights into how directors approach or ought to approach their value creation and protection responsibilities, non-executive directors' will be interviewed to elicit their experiences and views on what actions and behaviours by Board members tends to improve the chances of a successful transaction outcome.
4) The researcher has adopted key elements of Grounded Theory as the research method offering the best prospects of surfacing the views of directors – such that these can emerge in a unconstrained, inductive way; and the resulting pattern/s can then form the basis of a set of emerging themes or a new theory.
5) Grounded Theory is a branch of phenomenology, which studies conscious experience as personally experienced from the perspective of the interviewee. The emerging conclusions are said to be grounded in the data arising from the interview.
6) Qualitative interviewing of directors via semi-structured interviewing was felt to offer the best balance between:
   a) a focused gathering of directors' views in a consistent way
   b) a flexible exploration of what they see as important dimensions of their roles and contributions when it comes to stewardship over the M&A lifecycle.
7) Qualitative interviewing is not without its challenges primarily that of subjectivity, selective recall and bias; but:
   a) the research is into directors' experiences of what they believe works best, which in reality is a subjective / perceptual assessment by them

b) the coding / grouping of answers should help to link consistent patterns across/between directors/interviewees.

8) To avoid the constraints of a structured approach, a semi-structured interviewing process has been followed to increase the chances of surfacing further thoughts and practices; all interviews were conducted face-to-face with conversations taped and then transcribed.

9) Additionally, at the conclusion of each interview a structured questionnaire-checklist of key M&A activities was evaluated by each director for relevance.

10) After data analysis, participating directors were contacted and face-to-face debriefing sessions held to ensure that feedback and conclusions (collective not individual) were reflective of views provided; additionally interim conclusions were sanity-tested with two senior venture capital companies and with a forum of NEDs.

11) Twelve directors were interviewed representing a total of 22 public company boards with an average turnover of A$3.12 billion and average NPAT of A$434 million (for 26 Australian listed and non-listed entities, as sourced from BRW Top 2000 Companies 2008).

5.1 Introductory comments and re-cap

The literature review contained in Chapter 3 has indicated two main focal points where a knowledge gap appears to exist specifically with regards the M&A lifecycle, in describing or aiding understanding as to what activities and duties directors should be particularly mindful of. These relate to:

1) their p**erformance monitoring and management roles** i.e. the need to monitor and control past and present performance, which has both an inward and outward looking dimension
2) their **conformance roles** i.e. the need to provide strategic context/direction and policy, focused towards the future, again with an inward and outward orientation.

As previously indicated, these roles are likely to be multi-faceted – that is, a blend of actions and activities, responsibilities, skills, processes, attitudes and behaviours. Depending on each set of circumstances and the dynamics of the board and management, the mix of these elements required for success, could vary.

There is no one management discipline or scientific method required to carry out successfully the performance and conformance roles; but a blend or amalgam of disciplines: economic, financial, strategic, managerial, behavioural, social, psycho-dynamic, etc. Isolating one 'active ingredient' or mix of ingredients for a standard 'recipe for success' is fraught with risks and challenges.

As indicated in Chapter 3, this research is aimed at clarifying commercial practice and governance practices as two legs of the stool upon which sits the board's involvement in value delivery from mergers and acquisitions. Ideally all three legs of the stool need to be aligned or harmonious otherwise the legal leg of directors' responsibilities would be somewhat disconnected from commercial and governance realities.

Directors' views of legal duties, have therefore been accorded a secondary focus for the interview-based research, given that either:

- 'it is what it is' in terms of current precedent or interpretation and asking directors for their views of it would be speculative and may not be particularly effective; or
- the Statutory regime will respond in due course to better match the demands of commercial and governance practice or societal / commercial mores, if the legal component is out of kilter with the other two legs.

As has been explored in some depth in the preceding chapter, the bodies of existing commercial knowledge, governance literature and practices and legal precedent between them are unable to address satisfactorily the key focusing questions for the thesis research, namely:

Is it possible to describe 'M&A governance right practice'? If so, what is it?

> *More particularly, is there convergence, divergence or white space resulting between: how a sample of experienced non-executive directors see their accountabilities and believe their necessary actions and behaviours should be, based on personal experience; and what theory indicates the directors of the acquiring entity ought to do to improve the success rates of mergers and acquisitions*?

Focusing questions relate to directors' actions and accountabilities. As previously described, the focus is on:

1) commercial practice and governance dimensions particularly, that are believed to make a difference to M&A success
2) non-executive directors sitting on boards of listed public companies
3) practices i.e. processes, procedures and activities, actions, behaviours and interactions
4) understanding how a sample of directors see their duties and responsibilities during M&A and whether this converges with, diverges from or supplements identified gaps in published practices.

This chapter will work through the decisions made in the choice of research methodology. In doing so, it will encapsulate and reiterate the conclusions from Chapter 3 on the gaps in the extant literature that are worthy of exploration; then reaffirm the nature of the research question and focus, and in doing so argue that this necessitates a qualitative study at this stage, rather than a normative or predictive one. Thereafter, the focus will shift to considering some of the challenges of a qualitative study and how these will be addressed; and finally will work through the methodology selected (Grounded Theory) and the basis of selection of the sample of directors and how data coding was undertaken to progressively distil common elements.

Having reaffirmed the nature of the research question and focus, the nature of the study type required to explore the research task, is examined next.

5.2 Adopting a qualitative approach

As has been indicated in Chapter 2, in dealing with the literature on commercial practices, M&A is not an exact science; there is no as yet proven direct causality between action *x* and outcome *y*. M&A activities are more probabilistic than deterministic. One cannot categorically and simplistically say that a set of inputs, for example 'due diligence' or 'independent valuation report' will lead to an output of 'shareholder value delivery'. These are also not likely to be linear activities (where continuous increases in inputs, such as management time, will lead to direct and continued improvements in value created); nor can the impacts of these be measured or evaluated as discrete activities.

There is of course quite extensive anecdotal evidence that some actions by executive directors tend to make a significant difference, usually when taken in combination, but single factor causality and relevance is unproven, let alone multiple cause and effect relationships. Moving beyond single factor causality to multiple factors acting in combination and their correlations, is unchartered territory. Attempting to develop a scientifically provable predictive theory with proven causal correlations between single activities, let alone multiple M&A actions (or lack of them) and shareholder value results, is well beyond the scope of this study.

In the above circumstance, if it were the objective of this study, hard empirical evidence would be required to prove causality. Such data would doubtless be hard to come by and not likely to be entirely persuasive anyway.

How can one say with certainty that the conducting of a due diligence exercise, or obtaining an expert valuation for example led to value improvement, even across several cases, unless you can filter out a whole range of other internal and extraneous variables? Many of these are irreducible variables i.e. not subject to being provable, owing to their being non-discrete components in a broader overall system.

There are a plethora of external deal-impacting variables and internal deal elements that could vary widely:

1) size of the deal
2) broader stock movements in the sector operating at the same time
3) market noise and activities such as by hedge funds, impacting share prices
4) takeover mechanism selected (e.g. scheme of arrangement versus traditional Chapter 6 takeover bid)
5) takeover defences raised; friendly versus hostile
6) nature of the acquisition e.g. vertical integration, horizontal diversification, industry consolidation/roll-up
7) concentration of economic power and regulator's responses
8) mix of funding and investment vehicle selected
9) customers' and competitors' responses during and after the transactions etc.

Critically there is also the product-service makeup, business model and value driver differences that are unique to each business to consider. Comparing like with like businesses is fraught with complexity, as it would be to compare like with like transactions.

Given the range of almost endless combinations and permutations, it would be a near impossible modelling task isolating these multiple effects or arriving at a consistent, like-with-like comparison to support empirically proven causality. There are far too many variables to arrive at an empirically sound, predictive theory. Qualitative research will help to establish an effective normative theory.

Given the above complexity of undertaking a comparative study backed by empirical research, the aim of this research is therefore more modest – although nonetheless it would still represent unchartered waters – namely to postulate a set of conclusions as to the mix or bundle of activities, actions or behaviours that (a) based on directors' experiences represents desirable practice; and (b) may be congruent to or divergent from current literature; and therefore should be tested further.

For all of the preceding reasons therefore this thesis is a <u>qualitative study</u> – that is, it will describe what could be an emergent set of pointers to 'right practice' in M&A stewardship and any disconnects and gaps between directors' views and theory.

What works or has worked best in specific circumstances is a question of informed judgment and is event- and context-specific. Understanding how experienced non-executive directors see their roles, responsibilities and ideal activities in M&A – and what could be done to enhance board performance, is a task that does not lend itself to a formulaic approach.

Given the qualitative nature of the study, by implication it will not be normative or predictive. For example, by attempting to prove that IF we want to achieve better outcomes for shareholders, THEN the following: (a) norms or behaviours, (b) actions and (c) mechanisms/frameworks, *should be considered as options* that on the balance of probabilities will produce a positive difference for shareholders. Attempting to go down this path would require a different research methodology and an entirely different analytical process to that of a qualitative study.

The most sensible way to get directors to download their experiences, observations and beliefs regarding the key board activities/actions during M&A is via interview; which also provides an effective mechanism to start to identify gaps or discontinuities in the published body of knowledge.

The intended way to generate an articulation of right practice, or to flush out differences of view between practitioners and theoreticians as to what ought to be done by directors, is to explore and postulate a new construct. Here, the writing of W Graham Astley in *Administrative Science as Socially Constructed Truth* (Astley 1985) offers food for thought. Astley argues that empirical research is of little use when testing theoretical constructs. Empirical research is useful when a hypothesis can be drawn and the evidence is observable objectively. Administrative science however – much in the same way as social contracts and the law – is a socially constructed product.

Astley continues that since:

> "empirical observations are inevitably mediated by theoretical preconceptions, our knowledge of organisations is fundamentally shaped by the subjective world views through which we perceive data." Truth tends to be "defined in terms of the theoretical constructs and conceptual vocabulary that guide research and mediate access to organisational phenomena. The chief product of research is, consequently, theoretical language, rather than objective data."

Astley goes on to argue in effect that administrative science is a product of social definition not something that is built from objective truths. Thus, trying to instil research into administrative science with 'scientific authenticity' is a misguided notion.

Having argued therefore that the focusing question requires a qualitative study at this stage, rather than a normative or predictive one, the focus now shifts to considering the nature of the research approach to be adopted.

5.3 Considerations of Espoused Theory as a 'baseline for comparing practice to theory'

Espoused Theory versus Theory in Action may be intellectually interesting but is not relevant or practical for this study.

Examining the potential gap or difference between directors' views on required practices, and between commercial and governance literature (theory), is likely to highlight where the literature is either at odds with commercial practice and boardroom realities; or where the literature falls short of explaining what really occurs during M&A.

Comparing the 'literature view' of what ought to be done, to the directors' view of 'ought', is in effect a comparison of research-backed theory with practice.

Consideration has been given to whether there is merit in exploring Espoused Theory versus Theory in Use. This is, however, not a simple juxta-position between what people say and what they do – that is, between theory and action or practice. It is more complex than that, as it explores whether in fact there are two different theories of action i.e. how people (in this case directors) believe or think they act (which could be different to the theory of how they should act) and what they actually do in practice.

"An Espoused theory is the world view and values people believe their behaviour is based on" and "Theory-in-use is the world view and values implied by their behaviour, or the maps they use to take action"(Anderson 1994)

Espoused Theory versus Theory in Action (or use) draws heavily on Argyris and Schon's work, which examined conscious and unconscious reasoning processes. In essence, Argyris and Schon argued that "people hold maps in their heads about how to plan, implement and review their actions" although they are often not aware of the belief and governing systems that manage their behaviour. In other words, these maps may be different to the theories that people espouse or say they follow.

Argyris and Schon further argue that: "Few people are aware that the maps they use to take action are not the theories they explicitly espouse." In other words, few people are aware of the maps or theories they do use and are unaware that their theories-in-use are often not the same as their espoused theories, and that people are often unaware of their theories-in-use. There is a 'double-disconnect' in that sense.

Proceeding down the Espoused Theory versus Theory in Action path would add considerable complexity to this PhD study, with no likely increase in clarity, reliability or value. This would require a three-dimensional view of individual directors' thoughts and actions during M&A:

1) in using as a baseline point of reference how the literature believes directors ought to act
2) in trying to distil how each non-executive director believes they *ought to operate* (and what lies behind that) and comparing that back to the theory – gap #1, then
3) to determine how they think they *do operate* in practice and then comparing that to how they think they *ought to operate* – gap #2, and then
4) to compare gap 1 and gap 2 to how they *actually do operate* – gap 3.

This thesis is not a study into how to help *individual* directors to comprehend their actions and mental paradigms; nor is it targeted at getting *individual* directors to manage their behaviour more effectively; rather this research is an attempt to describe the activities and behaviours that 'ceteris paribus' appear to represent 'right practice' in M&A stewardship and where and how board members should be effective in carrying out their duties.

Nor is this intended to be a study at the individual director level into how each of director interviewed reacts and why (and whether that is consistent with their individual articulated or unarticulated sets of rules); but rather it is an examination of how they see their responsibilities and what they believe they ought to be doing. This does recognise that their views on 'ought' would be likely to be based of course on some insights gained experiential learnings – that is, as a result of what they or other co-directors did or didn't do in previous circumstances.

This study thus requires a particular kind of focus that an Argyris and Schon construct will not be suitable for and which would take the thesis down a different path.

These and other elements of subjectivity are explored next.

5.4 Addressing the challenge of bias in a qualitative study

Achieving objective, insightful feedback from those company officers and directors who have carried out previous deals is not a straightforward exercise. The foremost challenge is to achieve balanced, ideally objective and insightful feedback from non-executive company directors. The second and closely related challenge arises from what could perhaps be called the homogeneity of corporate board directors. The third challenge is potentially one of fear on the part of those being interviewed that: either their responses could prove embarrassing; or the fear that the research could possibly catalyse more stringent constraints on directors.

It is worth again exploring primarily the first issue, namely that of the subjectivity of interviewees. Distilling reliable insights from interviewing non-executive directors is not without its challenges.

Subjectivity by directors could occur in different ways. For example, for those who may have been acting for the acquirer in transactions that were value destroying or simply under-performed, there would be a risk of subjectivity if one were appraising their views on:

a) how those boards and management had performed their takeover activities
b) where they failed to properly protect value or deliver value
c) what the underlying pathologies were of deals that had gone bad or had merely under-delivered.

For different reasons, those directors who were involved in successful deals, or deals that they believe were successful (again more likely a subjective assessment rather than relative to a set of quantifiable and unquantifiable criteria), could also inadvertently colour their responses to emphasise their perspectives or contributions as to what worked.

These risks of subjectivity by the interviewees have been largely mitigated by an interview process that has deliberately not focused on the specific actions undertaken in particular circumstances or on the *minutiae* of any specific deal; but rather by following an open-ended exploration of views by directors as to what actions they tend to adopt or place value on, generally speaking.

The interview process sought to mitigate subjectivity in a number of ways, namely through: a generalisation of experiences; avoiding a 'post-mortem' on specific transactions; iterative coding; and a continuous reference to the need to focus on observations and learnings.

The intention was to avoid exploring specific transactions where directors may need to justify their decisions or actions; and rather to get them to talk in more generic terms about what board activities they perceive as really making a difference.

<u>A focus on the generalisation of experiences</u> and views is particularly important if the aim is to avoid (a) placing too heavy a weighting on certain 'situation specific' actions that were required to be undertaken in unique transactional circumstances; and (b) being caught up in directors' personal beliefs, recollections and experiences of specific transactions and events.

The focus throughout has been more broadly on (a) what set of actions, deliberations and interactions typically represent 'right stewardship' by directors and boards in significant transactions , and (b) what are the views of chairmen and directors on how a board should conduct itself to make an effective contribution.

<u>To depersonalise each conversation</u>, the emphasis was on collective actions rather than individual or director specific activities; and on major transactions in general rather than being 'down in the weeds' of any specific transaction.

<u>The coding process itself is an important risk mitigant</u> for interviewee bias. The grouping and coding of key words and phrases has meant that critical recurring themes and views could be

flushed out and distilled from the process. It is improbable although not impossible that there would be a consistent mirroring of bias across the directors, and everyone interviewed would raise precisely the same issues – that is, that there would be a tight and recurring clustering. The clustering associated with the analytical technique selected aimed to surface as many different views as possible, rather than to hope for a convergence of opinion on one or two items.

Regarding the fear of self-incrimination or embarrassment, in each interview it was emphasised that the study was not a post-mortem or autopsy into specific past transactions or even a post project review; nor is it a search for the guilty or the negligent. The interview process has emphasised a focus on positive learnings, reflections and wisdom about activities and interactions that are believed to make a positive difference (or the converse).

The key way to counter this concern has been to re-emphasise in each interview that the focus is on what boards can do to demonstrate leadership, responsibility and results to their shareholders, rather than exploring specifically negative activities i.e. by focusing questions in effect on 'managing the assets side of the M&A balance sheet' not the liabilities' side. Thus interview questions have tended to focus on positive practices and learnings rather than on documenting negative pathologies in deals that have gone wrong when boards are involved, or not involved, in transactions.

An additional risk relates to the impacts of time and distance that may either dull or distort perspectives and recollections. In all prefacing comments prior to each interview it was emphasised that names, dates and specifics were not of concern – that the respondent could be as general or as specific in providing detail as he or she wished, but that the interviewer was focusing on general practices and activities.

Paradoxically, in many ways, distance and time could in fact aid in bringing some clarity and objectivity to what at the time may have been obscured in the swirl of the deal. In fact, on a number of occasions, those interviewed acknowledged that they had not had a chance to sit back and reflect on certain M&A learnings until that moment.

The second key issue and potential constraint on the reliability of a qualitative study resides in the potential homogeneity of directors i.e. the fact that by and large directors' ranks in large enterprises are stocked with ex-corporate executives. The majority of these are white, Anglo-Saxon, middle aged (or beyond) males. Whilst each enterprise and board will have its own unique culture, as a generalisation, corporate directors are not young and inexperienced, overt risk-takers, entrepreneurial, or with a great deal of culture diversity.

Subjectivity and some homogeneity is inevitable but the focus of the study mitigates these risks in exploring what does happen in practice.

The risk of homogeneity of opinions would only be properly mitigated by a much larger sample of directors cutting across many different enterprises. That alone would not have been adequate. Additionally, the directors would have to be carefully selected: (a) for their behavioural and attitudinal differences, (b) for variations in their skills and experiences; and (c) in relation to the boardroom dynamics under which they typically operate (e.g. if they tended to gravitate towards companies with particular cultures of governance) and (d) to include other poorly represented minorities including females. This is, however, a practical impossibility for a study of this scope, but could be carried out in subsequent studies, to further test and evaluate findings and options (for example, if the Australian Institute of Company Directors chose to canvass further views from its members).

It is worthwhile emphasising, however, that the intent with the field research was to speak with seasoned directors who had dealt with a variety of mergers or acquisitions, of significant magnitude, across sectors. Experience and exposure to the 'big end of town' i.e. ASX top 100 board members, were the driving factors in selection. In that sense the use of purposive sampling (expanded on in Section 5.5.1 below) is accordant with the Grounded Theory approach that was selected for use. To do this, all prior experience and judgments have been suspended to allow the data to speak for itself.

The well-recognised phenomenon of the 'old boys' network' (particularly as far as female directors are concerned, and aspirant younger directors) is also a potential factor in bias. Directors as a genre are well-networked and many board appointments originate from word-of-mouth recommendations from ex-colleagues and trusted business partners. Homogeneity in attitudes and behaviours is more likely to operate than heterogeneity. That does not mean of course that there is automatically homogeneity in terms of thinking or responses; or consistency across directors as to how they see their roles, how they approach problem solving or how they deal with each other and with management.

There is virtually no practical way to eliminate the homogeneity factor if directors are the target for research and the focus for action. The best protection lies, however, in the fact that this study is not about describing the make-up of the ideal director or the perfect board. Rather it is practical exploration and description of what boards can and ought to do that should make a difference to successful M&A activities.

Participating directors, whatever their individual strengths, experiences, deficiencies or blind spots, are quite capable of describing what they do during transactions and what they tend to focus on and how they see the board and managerial interactions *in practice*.

If the research had intended to ascertain the ideal makeup and characteristics of a chairman or non-executive director most likely to make the strongest positive contribution to M&A activities, then a different, more stratified form of sampling from a cross-section of directors and non-directors would become important.

Despite their commonalties in the ASX Top 100 pedigree of the interviewed directors, they represented a variety of professional and corporate backgrounds with different functional expertise and skills. The task was not to understand their personal DNAs or effectiveness as individual directors but rather to work through their views on what they believe that directors as a collective on the board ought to do across the M&A lifecycle to make a difference to performance. The key ingredient was their involvement in M&A. To that end, every director had been involved in transaction activity not in one or two cases but in some cases, many different transactions: whether as advisers, as part of executive management, as board members or a combination of these.

The interviews were aimed to distil what chairmen and non-executive directors do or believe they ought to do, to describe effective practices that may improve positive outcomes for shareholders. It is not *per se* about what other M&A practitioners or advisers think directors ought to do. That may be interesting and even relevant, but is unlikely to constitute persuasive grounds for directors to act differently.

The best risk mitigation for bias has been to adopt a sampling approach that has brought into the interview process a mix of directors who bring with them (a) a breadth, depth and richness of corporate experience, and (b) ‘deal nous’, from both sides of the fence i.e. whilst all of the interviewees were currently non-executive directors, they came from a range of executive (CEO, CFO) roles, deal advisory and professional director backgrounds and understood both sides of the accountability equation.

Whilst it is a challenging activity to elicit e semi-objective learnings of what worked and what did not, after the event, there is a great deal of relevant literature on interview and survey techniques that help a researcher to mitigate these various risks. Ultimately an interview approach was designed and piloted through ‘safe testing’, to focus in on the factors that most directors nominate as making a positive difference to shareholder value creation and/or protection.

The preceding argument has been that understanding what drives M&A success is not a formulaic or empirically provable science, of ‘If this, Then that results’ type logic. Rather, an approach that is inductive first, then deductive has been followed: (a) to identify whether a pattern of experiences and observations arises from the interviews; and then (b) to establish elements of data convergence to indicate whether there is a discernible pattern of actions or a ‘stewardship recipe’ that could be emerging.

Section 5.5 expands on the research methodology that has been used – adopting an interpretivist approach that draws heavily on Grounded Theory to sort, categorise and analyse the data that will be collected through the interview process.

5.5 Utilising Grounded Theory

Using Grounded Theory approaches, a theory will emerge from experiences, views and observations.

Grounded Theory is general research method that is not owned by any one school or discipline.

> “Grounded Theory is an inductive methodology. Although many call Grounded Theory a qualitative method, it is not. It is a general research method. It is the systematic generation of theory from systematic research. It is a set of rigorous research procedures leading to the emergence of conceptual categories. These concepts/categories are related to each other as a theoretical explanation of the action(s) that continually resolves the main concern of the participants in a substantive area. Grounded Theory can be used with either qualitative or quantitative data.” (Grounded Theory Institute)[149]

Grounded Theory is considered to be one of the most effective and widely used methodologies in qualitative research, where the aim is to generate new theory (Strauss 1997).

[149] http://www.groundedtheory.com/what-is-gt.aspx

Grounded Theory is an interpretivist methodology based on the philosophy of phenomenology.

An interpretivist approach to research derives from the notion that "The actions of people, individually and collectively, are based on their constructions of the nature of the world in which they operate." (Burrell & Morgan 1979 pg. 28)

The Interpretive school of social science:

"…is informed by a concern to understand the world as it is, to understand the fundamental nature of the social world at the level of subjective experience. It seeks explanation within the realm of individual consciousness and subjectivity, within the frame of reference of the participant as opposed to the observer of the action." (Burrell & Morgan 1979, pg. 28)

Grounded Theory has its roots in phenomenology. As defined by the *Stanford Encyclopaedia of Philosophy* [150],

> "Literally, phenomenology is the study of 'phenomena': appearances of things, or things as they appear in our experience, or the ways we experience things, thus the meanings things have in our experience. Phenomenology studies conscious experience as experienced from the subjective or first person point of view. This field of philosophy is then to be distinguished from, and related to, the other main fields of philosophy: ontology (the study of being or what is), epistemology (the study of knowledge), logic (the study of valid reasoning), ethics (the study of right and wrong action), etc."

In basic terms, phenomenology studies conscious experience as personally experienced i.e. from the first-person perspective, along with relevant conditions of experience, as the experience applies directly or intentionally toward a certain object.

With qualitative analytical research methods, there is no firm recipe or formula as to how conclusions are arrived at. The hypothesis or theory emerges from: (a) the coding and sorting process that comes with using key elements of a Grounded approach; and (b) continuous iteration and checking and revisiting the field to gather further data – what John Cresswell describes as the 'zigzag' approach (Creswell 1998).

In the case of this thesis topic, given the lack of a codified set of practices and evident gaps in the literature, the key activity is to describe what is or ought to be cohesive set of right practices. The emerging theory should then represent a distillation or amalgamation of the literature surveyed and the interview content (plus any other observations arising from the interview processes). Such a set of practices, if capable of being expressed, may then serve as a foundation for further testing and subsequent modifications.

How is Grounded Theory applied?

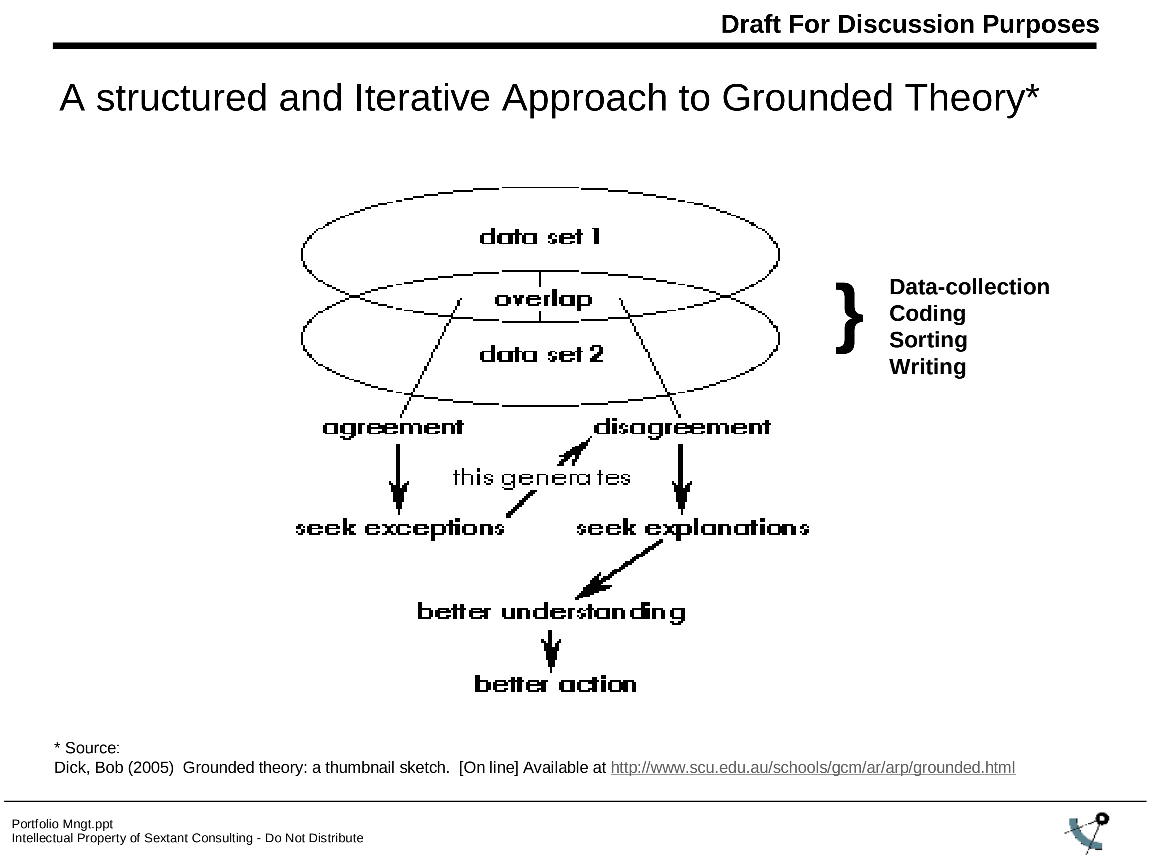
With a Grounded Theory approach, the researcher does not establish or test a pre-formed 'going in' hypothesis (although there may be a set of early stage ideas to guide the formulation of

[150] http://plato.stanford.edu/entries/phenomenology/

questions). Rather, the researcher explores a particular topic in an open-minded way, gathers data via a set of interviews and observation of the interviewees, and analyses the emerging data and findings via a process of coding, grouping and analysing of the data. This enables him or her to then formulate a theory or understanding based on the research. In effect, the data determines the emergent theory and for that reason the theory is said to be grounded in the data that emerges.

Use of Grounded Theory is appropriate for the focusing question posed above, as it is not possible to predict with any degree of certainty how non-executive directors will see their specific responsibilities or their value-adding actions or where they believe their responsibilities start and end as part of a broader management system.

<u>Figure 15: The iterative nature of Grounded Theory</u>



Source: Dick, Bob (2005) – Grounded theory: a thumbnail sketch

In Grounded Theory, data analysis is crucial and follows a set of procedures for classifying and grouping the data. Using multi-levels of codes to support a categorisation and codification process:

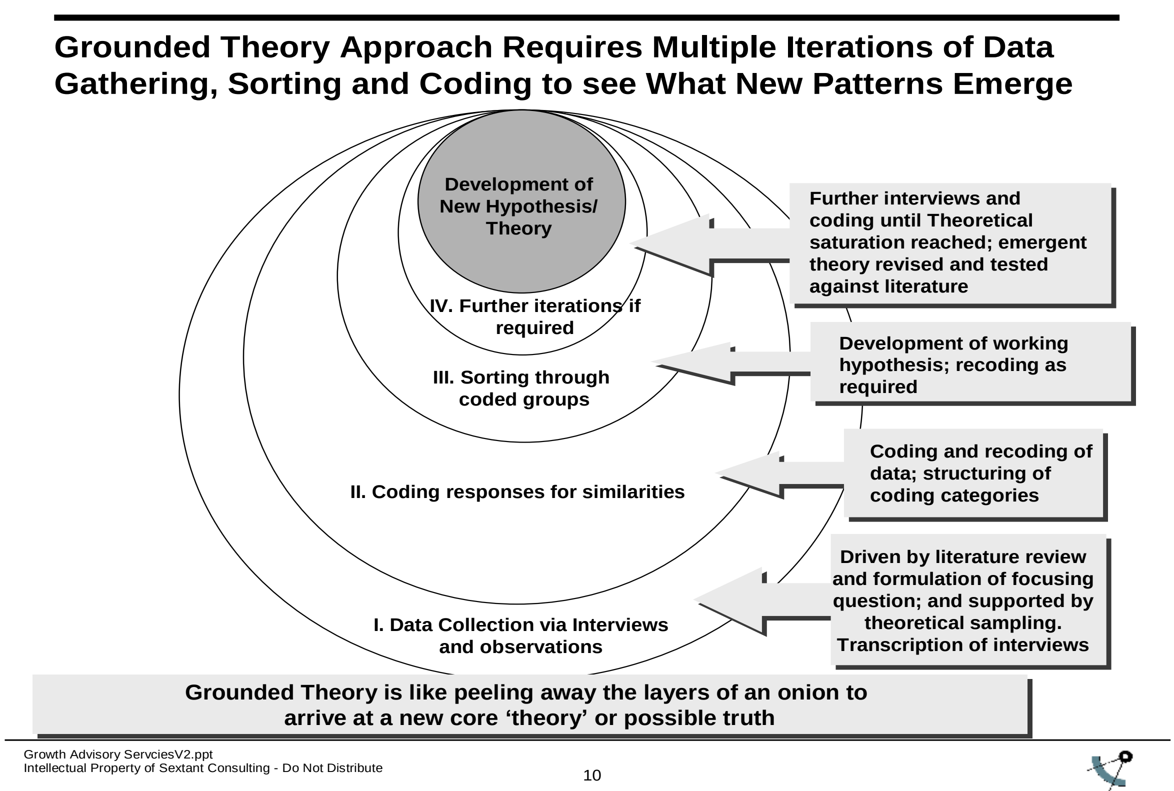
1) requires an interactive process to grouping and categorising the data derived from the interview process

2) is critical to organising and making sense of extensive data and this provides structure and order
3) allows initial codes to be modified and revised as the researcher explores new emerging patterns or combinations
4) provides a balance between being systematic and orderly and being able to explore new emerging relationships
5) enables the researcher to link themes and concepts as he or she develops the new, emergent theory.

The important element to remember about a Grounded Theory approach is that the theory is constructed but not tested.

The Grounded Theory approach, upon which this research draws, has not been followed in a purist sense but essential elements have been adopted by following the four key steps indicated in Figure 16 below. Essentially, the approach is like peeling away the layers of an onion and seeing what is left at the core, as shown.

Figure 16: Peeling away the layers of meaning to arrive at the core of new theory



Source: Adapted by Dean Blomson (thesis author)

In the case of this thesis therefore, an emergent theory should serve as the working hypothesis for further testing as to whether:

1) the composite set of M&A practices articulated by board members is sufficiently aligned to the distillation of research literature-based practices to appear to have a valid foundation as a set of performance drivers
2) there appears to be any other significant ‘right M&A’ governance procedures and behaviours that may be equally or more relevant as a compendium of ‘right practices’.

5.6 Data collection approach used

There are a number of standard data collection options available for a qualitative research study: diaries; critical incident techniques; focus groups; questionnaires and surveys; interviews; observations. Each option has its place: individually and in combination and in the right circumstances, can offer up value results.

The formal questionnaire route (such as by using emailed or web based questionnaires to a far larger sample of directors) was considered but ruled out, owing to the challenges of:

1) not wanting to prescribe answers on the one hand (through yes/no or menu driven answers)
2) the response rate being likely to be lower
3) the attendant risk that the task of responding could be delegated to a more junior staff member, or
4) being undertaken with undue haste or limited thought.

This project has been based primarily on the use of semi-structured interviews, as these would be more likely to give the interviewer the best mix of consistency and structure, plus flexibility to drill down or go wider where circumstances required it. The preferred methodology is via qualitative interviews, face to face with non-executive directors.

The semi-structured interviews were, however, supplemented by a structured, short questionnaire at the conclusion of each interview. The purpose and content of this questionnaire is expanded on in Section 5.12 below.

The interviews were conducted with chairmen and non-executives across a variety of major institutions and enterprises (listed and unlisted). Individual interviews were selected as the preferred method primarily to elicit, distil and analyse personal observations.

Whilst a focus discussion group **may** have achieved similar ends, it was not pursued for three important reasons:

1) the logistics of assembling several high-powered and busy board non-executives
2) the risk that there could be group thinking that emerges without sufficient critical debate (especially as it may be socially awkward publically to challenge peers)
3) there is likely to be considerable reticence and self-censorship to speak openly about poor performance or embarrassing activities observed whilst on or working with other boards, even if Chatham House rules were applied.

There were other reasons aside from availability, privacy and confidentiality, why the personal one-on-one interviewing method was preferred, namely:

1) the ability to follow a similar set of questions and to exercise some degree of control over the process
2) responses were less likely to be curtailed by limited ‘airtime’ which would be a factor if everyone in a group needed to have a fair chance to speak
3) playing to the audience was less likely to be a factor with no peers present
4) interesting answers could be more easily explored in further detail.

That is not to say that group discussions are not without their value; or that one-on-one interviews are a panacea in all circumstances. On balance, however, face-to-face, one-on-one interviews offered the best way to explore and discover untapped views, given the experiential subject matter and chosen focus for this thesis.

5.7 Semi-structured interviews

The key assumption underpinning semi-structured interviews is the expectation that interviewees are more likely to express their viewpoints in a relatively open interview situation than in a more rigid interview or questionnaire. As Uwe Flick (2005) puts it, such standardised approaches “…which restrict when, in which sequence and how topics should be dealt with, obscure rather than illuminate the subject’s viewpoint”.[151]

One of the key attributes and benefits of qualitative interviewing (versus quantitative interviewing) is that in the former the focus is primarily on the *interviewee’s* point of view; in the latter, the interview reflects the *interviewer’s* concerns and priorities. Since qualitative interviewing allows the interviewee periodically to go off on a tangential exploration, this increases the chances of the researcher gaining a unique perspective into what the interviewee sees as important and relevant, and thus may lead to new, unanticipated insights.

There are three characteristics of semi-structured interviews:

1) The interviewer and respondents engage in a formal but flexible interview.
2) The interviewer develops and uses an interview guide i.e. a list of topics and questions that need to be covered, usually in a particular order.
3) The interviewer follows the guide, but is able to indulge in and allow topical diversions, that may stray from the interview guide.

Semi-structured interviews are best used when the interviewer will not get more than one chance to interview someone and/or when several interviewers could be sent out into the field to collect data.[152]

[151] Uwe Flick, “An Introduction to Qualitative Research”, 2005, pg. 92
[152] According to Bernard (1988) and cited in http://www.qualres.org/HomeSemi-3629.html

Therefore, whilst structured interviews have much to offer in terms of consistency of results, comparability of data etc., the overriding need was to not constrain interviewees' responses, or to in some way narrow or limit their flow of thoughts and ideas. In other words, the journey of serendipitous discovery was an overriding factor in opting for the semi-structured approach.

The interview guide was designed and implemented to facilitate a tight-loose approach i.e. to guide interviewees closely and consistently wherever possible in order to achieve reliable, comparable qualitative data – but with the necessary recognition and flexibility for each interviewee to be given latitude to explore and address those aspects of each question that are most relevant to them. Therein lays the value of the semi-structured interview: that a looser, less rigid exploration of a topic may yield some unanticipated nuggets.

Thus in semi-structured interviewing, by and large, all interviews are asked the same questions using similar words – but each interviewee is given latitude in how to reply; and in that process, new questions may be added specific to that conversation for deeper exploration. Semi-structured interviews were felt to offer a healthy balance between consistency and flexibility, particularly since:

1) **Interviewers** need freedom to explore important emerging issues (which cannot always be anticipated) or to resolve apparent contradictions in what the interviewee is saying.
2) **Interviewees** need to be given a degree of freedom to express their thoughts in their words and to expand on areas of specific interest or concern to them.

Semi-structured interviews are often accompanied by observation to allow the researchers to develop a richer understanding of the interviewees' responses to the topic being explored – especially as a key reason for using semi-structured interviews is to identify new ways of seeing and understanding the topic at hand.

Since semi-structured interviews often contain open-ended questions – and the conversation may diverge from the interview guide. It is therefore generally best to tape-record interviews and later transcribe these recordings for analysis.

While it is possible to try to take notes to capture respondents' answers, it is difficult to build rapport between interviewer and interviewee whilst concurrently taking notes. Quality of dialogue is essential in semi-structured interviews.

There are several other key benefits of using semi-structured interviews:

1) Questions can be prepared ahead of time, allowing the interviewer to be more in control and better able to control and structure the interview thus achieving a good degree of consistency.
2) The medium/form allows interviewees latitude to express their views in their own terms and words with less prompting.
3) Semi-structured interviews can provide reliable, comparable qualitative data.
4) It enables the interviewer to explore specific issues arising in a particular interview without being caught in a procedural straitjacket.

Uwe Flick (2005) says that semi-structured or semi-standardised interviews are a way of reconstructing the subjective theories of interviewees.

> "The term 'subjective theory' refers to the fact that the interviewee has a complex stock of knowledge about the topic under study. The knowledge includes assumptions which are explicit and immediate and which he or she can express spontaneously in answering an open question. These are complemented by implicit assumptions. In order to articulate these, the interviewee must be supported by methodological aids, which is why different types of questions…are applied here."(pg. 80)

Flick goes on to explore different kinds of semi-structured interviews. For this PhD field research, what Flick calls 'the expert interview' approach was adopted, based on the work of Meuser and Nagel (1991). Flick says that

> "…here the interviewee is of less interest as a (whole) person than in his or her capacity of being an expert in a certain field of activity… The range of potentially relevant information provided by the interviewee is restricted much more than in other interviews. Therefore, the interview guide has a much stronger directive function with regard to excluding unproductive topics." (pg. 89)

Such style of interviewees are not without their challenges: the interviewee may not have the subject matter expertise originally expected or hoped for; the interviewee gives a lecture or diatribe on his or her pet subject/s and tends to ignore the question posed; or tries to draw the interviewer into a debate or exploration about his or her own views on the subject. Focusing on the topics of relevance to the interviewer and guiding the conversation back to those points is an essential activity.

5.8 Selecting directors for interviews – the interview sample

Twelve non-executive directors were interviewed, representing between them active directorships on:

- publically listed companies in Australia
- an offshore global company
- private companies
- 'not for profit' enterprises
- federal policy making boards
- national sports bodies
- major education bodies.

Two directors were on the same board of one listed company.

Further detail on the directors' profiles – sanitised to preserve confidentiality – is provided in Section 5.8.3.

The interviews were conducted in three phases.

- Phase 0 was a trial period to fine-tune the interview questions through pilot interviews with three current executives; then to revise / tighten the questions, adjust the questionnaire activity list and revise the approach with the thesis supervisor. This approach is effectively ignored for the purposes of data / response analysis and irrelevant to the thesis, having served its purpose to hone preparation before going live. The data arising from those interviews was not transcribed or coded but the learnings about what questions worked, which didn't, and how to adjust the interview structure and style were valuable.
- Phase 1 comprised nine interviews; and once the transcripts had been reviewed and coded these were review by a peer who had been a senior lecturer, doctoral student and frequent thesis reviewer.
- Based on interim conclusions derived, another three interviews were then conducted as part of Phase 2.

Ideally, in endeavouring to achieve a robust, representative result, one would want to conduct interviews with as wide a range of directors as possible. First prize, if it were feasible, would be to interview all chairmen and NEDs of all public companies listed on the ASX.

This is of course entirely unpractical – in terms of time, money, availability, accessibility and of course interest. The sampling methodology selected follows below.

Sampling methodology

To select a sample to be interviewed, two options existed: (1) handpick a selected sample that is representative of the overall population; or (2) follow a non-probability sampling approach.

For the first method to work effectively, the entire population needs to be assessed and defined, so that its profiles can be understood before a representative sample can be chosen. This is known as probability sampling. Probability sampling is not suitable for qualitative research.

> "In probability sampling members of the research population are chosen at random and have a known probability of selection. Groups are represented in the sample in their true proportions; or, where unequal probabilities are used the data are reweighted back to the true proportions. The aim is to produce a statistically representative sample, suitable for hypothesis testing."[153]

Additionally, given the impracticalities of defining the overall population of directors in Australia in meaningful and reliable terms, the first option was discarded.

This study follows the second option, what is termed **non-probability** or **purposive sampling**.

[153] "Designing sampling strategies for qualitative social research: with particular reference to the Office for National Statistics' Qualitative Respondent Register" by Amanda Wilmot www.ons.gov.uk/about/.../designing-sampling-strategies-.pdf

Non-probability sampling is appropriate for qualitative research because it does not aim to draw statistical inferences based on a statistically representative sample.

> "Indeed, a phenomenon need only appear once in the sample. Purposive sampling is one technique often employed in qualitative investigation. With a purposive non-random sample the number of people interviewed is less important than the criteria used to select them. The characteristics of individuals are used as the basis of selection, most often chosen to reflect the diversity and breadth of the sample population."[154]

One variant of purposive sampling is **theoretical sampling**, which was developed from the Grounded Theory approach (Glasser & Strauss 1967).

With purposive, theoretical sampling, the characteristics / criteria for selecting interviewees need to be clear.

The selection criteria for this thesis were clear and relatively self-evident. The common elements were non-executive directors of ASX Top 100 listed entities who have a track record of directorships on more than one board; have had an exposure to M&A from board roles and/or from executive or professional advisory roles where M&A was involved before becoming directors. It is important that the NEDs interviewed should have seen M&A from both sides of the fence.

The selection criteria were based solely on these demographic factors. Looking to a sample based on psychographic criteria (attitude, behaviours, and values) would be virtually impossible to construct.

There appeared to be no significant upside in looking beyond the above criteria, to a wider or more diversified sample, in that:

- Interviewing executive directors (CEOs, CFOs) would be interesting but not necessarily instructive to what the board needs to do.
- Moving beyond Australia and the ASX to other offshore listed enterprises was impractical.
- Interviewing academics would be likely to offer up little more than the literature which was deficient anyway.
- Going to investment bankers, consultants, lawyers and the like would be unlikely to solve the dilemma in the directors' heads about where they should focus and what they should do. Plus many of these individuals would be equally if not more conflicted in their views.

As indicated earlier, with a Grounded Theory approach, sample size is not critical:

[154] Ibid, Amanda Wilmot

> "A feature of qualitative sampling is this fact that the number of cases sampled is often small. This is because… a phenomenon only need appear once to be of value. There is no need for scale as there is no need for estimates of statistical significance."[155]

Purposive sampling – respondent recruitment

At an early stage in this research, when the possibilities of a survey-based approach was being explored, approaches were made to ASIC (Australian Securities and Investments Commission) and AICD (Australian Institute of Company Directors).

The ASIC senior executive contacted was initially lukewarm (but not entirely averse) to providing some form of access to its database of directors, although internal clearances and procedures would need to be addressed; but the ASIC director did not return calls after an initial meeting.

The AICD was amendable to the idea of tacit support for a survey although it would not officially endorse it. The senior executive involved was, however, gracious enough to offer to indicate on the AICD's monthly newsletter to members that the survey was being undertaken and to provide an 'opt in' web link option for those members who were interested.

The survey option ultimately was discarded for a number of reasons:

- difficulties in accessing respondents through a semi-involved and partly-committed intermediary
- uncertainty as to whether the sample would represent the right mix of quality and experience
- lack of visibility or control as to who was actually completing the questionnaire (the task may be delegated)
- the level of focus and thought given to each question before answering (risk of instinctive or cursory responses.
- most significantly, the challenge in posing questions via a survey that would adequately surface and crystallise learnings, insights and value-adding observations (a structured web-based survey or questionnaire would be comprehensive and would allow comparisons and benchmarking across respondents, but ran the risk that it would not allow a fertile exploration of themes and issues and would in effect be hypothesis driven).

For these reasons it was concluded that face-to-face interviews with a targeted sample of experienced non-executive directors offered the best option for effective data collection.

Knowing that the AICD was not going to be receptive to an approach which directly canvassed its members to participate in interviews, it was decided not to table a revised proposal for face-to-face interviewing. Additionally, the AICD, despite its willingness to help on a survey option, was

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[155] Designing sampling strategies for qualitative social research: with particular reference to the Office for National Statistics' Qualitative Respondent Register" by Amanda Wilmotwww.ons.gov.uk/about/.../designing-sampling-strategies-.pdf

already significantly stretched in terms of its own research work with heavy demands on its staff and members.

Therefore the decision was made rather to look to other sources and channels where support would be easier to achieve without pre-conditions.

Once it was decided to go down the face-to-face interview route, and a sampling frame of criteria was constructed, an approach was made to a global search company that had a significant profile in board selection, placement and performance evaluation. Despite positive noises from the lead recruitment partner for NEDs about supporting the thesis and providing entre to NEDs to participate, the interest did not emerge and the firm did not respond to follow up contacts.

The researcher therefore approached a few board members of his own network for advice: ex-clients, colleagues who were executives of listed entities and a professional director. The latter, an ex CEO of an investment bank, graciously offered to approach other independent directors who shared 'chambers' together – a loose network of professional directors. This is a common arrangement and several well-known clusters of directors operate in Sydney and Melbourne in different shared-premises' arrangements. Such a networked arrangement could have introduced some aspects of like-mindedness, or common points of view relating to M&A, and this needs to be acknowledged as a possible limitation in the sampling. The directors' backgrounds reflected a cross-section of function expertise as a differentiator: ex CEO's vs. ex CFOs vs legal advisers vs investment advisory. Whether their varied functional and sectoral backgrounds would have reduced sampling bias is not known.

An initial email was prepared providing some brief background to the research purpose, which the professional director then kindly circulated amongst his network of associates.

This email brought a good response and provided access to a strong sample of non-executive directors who met the sampling criteria. This group was supplemented by a few other directors – one who was a member of another directors' chambers arrangement and a few that were 'freelance'.

The value in having had a personal introduction cannot be over-emphasised. The directors interviewed have a range of other priorities and all were high-powered businessmen and women. It is extremely unlikely that better access would have gained to a sample of directors with equivalent calibre and experience – real applicable experience as well as reputational cachet – had he gone down the track of an unsolicited mail-out to a directors' association membership base.

Most of those interviewed had presided in executive roles over companies with a powerful brand presence in Australia; and/or were currently or had recently been chairmen or NEDs of such enterprises. The range of enterprises represented was oriented towards, but not limited to, the Top 100 on the ASX. The interviewer accessed non-executive directors of lesser-known listed entities that may have faced different growth, resourcing and financial challenges when it comes to M&A.

All communications, diary and meeting arrangements etc. were directly coordinated and conducted solely by the researcher.

One director was based in Perth; another was based in Brisbane but both were interviewed during visits to Sydney. One interview was conducted face-to-face in Melbourne. The remainder were all Sydney based directors and interviews.

Profiles of directors and their affiliated companies involved in the interviews

Whilst these twelve non-executive directors and their corporations need to remain nameless, between them they represented a depth of current board experience++, as shown in Table 7.

Table 7: Profiles of directors and their affiliated companies

ASX and offshore public company boards represented (2 cases of double memberships) 8 were in the ASX Top 100 by revenue in 2010	18 + 4
Non listed public company boards represented incl. Federal Govt. boards (2 cases of double memberships)	11
National sports, cultural bodies	4
Health, Social and Community well-being bodies and Academic Institutions (1 case of double membership)	6 + 4

++ Non-executive directors also had extensive previous records on boards: as ex CEOs, CFOs and as past NEDs and chairmen. None of those currently in the chairman's role were executive chairs.

Table 8 reviews the size of the enterprises.

Table 8: Sizes of affiliated companies

Average turnovers represented as at last published FY end** (26 Aus. entities only)	AU$3.12bn
Average NPAT as at last published FY end**	AU$434M
Average Shareholders' Funds as at last published FY end**	AU$3.35bn

**Source: BRW Top 2000 Companies 2008

Interviewees represented current board memberships across a range of national and global industry players:

- Commercial airlines – two of the world's largest
- Logistics – one of Australia's largest
- Retailers – one of the world's largest
- Financial institutions – one of the world's largest banks
- Commercial developers and operators – one of the world's largest and two of Australia's largest

- Beverages companies – one of Australia's largest
- Diversified services'/facilities' management company – one of Australia's largest
- Universities – one of Australia's largest and most reputable
- Professional services – one of the world's largest, and two of Australia's largest, professional engineering firms
- Foremost Federal Government monetary authority.

Listed entities in the Mining and Minerals, Investment Banking and Insurance, and Retail/Grocery industry sectors were also represented.

Most had come out CEO or CFO or professional services' partners' roles previously before commencing their boardroom careers as professional 'full time' directors. None of the interviewees were in executive roles any more – and none was an executive chairman. Their career paths to the ranks of NEDs was varied: for some, having attained seniority in the executive ranks and having done their time already as executives and being ready for semi-retirement; or having come up via the ranks of professionals and not sought executive roles; and having made a conscious decisions to embark on non-executive careers.

In terms of demographics, two of the interviewees were females. All interviewees were estimated to be over 50 years of age. Given their ages, board profiles and previous roles, the sample was certainly not a 'newly minted' set of non-executive directors or well-meaning theoreticians. Most had been on boards for a number of years prior to the interviews (estimated to be 10 years each on average), giving them collectively 120 years of big board experience. Adding to this their previous corporate executive or leadership roles, and general exposure to transactions, collectively they would have had approximately 120 years of additional management governance experience.

By way of some highly sanitised examples of the stature and pedigree of those interviewed:

Director 1: Currently chairman of a major insurance group; board member of a major retail property group; deputy chair of a major sports body; previously ex CEO of an international bank; ex CEO of a major audit and professional services' group and ex board member of a major logistics company.

By way of example from one of his boards:

- The logistics company made three acquisitions during 2009 and 2010 – one of which exceeded US$1.2bn.

Director 2: Currently non-executive director of a major insurer; director and chair of the audit committee of a major health products company; board member of a major Oil and Gas business that has led multi-billion dollar gas developments; and a member of its audit and environmental, health and safety committees; director of a major financial services intermediary and regulatory body; previously vice president at two major investment banks.

Director 3: Currently chair of a major international transport business; director of a global construction and project management business; senior adviser to a global private equity firm; previously ex CEO and ex chair of global minerals group.

By way of example from one of his boards:

- The global PE firm he is an adviser to has completed investments in over 160 companies since 1977, completing at least one investment in every year except in 1982 and in 1990.[1]

Director 4: Currently chair of a major financial services entity; chair of a major consumer products' company; director of a research institute; advisory committee member of a major telco; previously chairman of a banking group, an insurance group, retail property group; and several federal bodies.

By way of limited example from two of his boards:

- The bank he is presently chair of in 2009 acquired control of a European bank in Australia that it previously had been a junior partner in; and in 2010 it acquired the Asian banking operations being sold by another global banking group (a post GFC sale) for $750 million. This latter acquisition involved significant integration activities.
- The retail group has grown organically and by acquisition of property companies and through land development to the point it now has total assets worth more than A$50 billion, owning over 100 properties across four countries.

All four directors hold additional current and past positions to those mentioned, which have been purged from the above synopses, as these may provide too many clues as to their identities. The other eight non executives interviewed were of equal calibre and experience.

The public companies in which they hold present and past directorships would be generally regarded as growth oriented and acquisitive; and have a track record of growth that attests to their leading market positions.

Having access to this level of accumulated experience and wisdom provided an invaluable richness of input and observations.

5.9 Interview process management

Achieving alignment and consistency

To conduct the interview, the same prefacing remarks were made by the interviewer as a structured and consistent 'scene set', in order to align each interviewee to the purpose of the session. These scene-setting comments included explaining: (1) the focus of the thesis; (2) scope and definitional boundaries; (3) the structure of the interview being conducted; and (4) confidentiality and recording.

As regards the first point, the researcher indicated that the focus was on understanding what boards of directors can or ought to do that, *ceteris paribus, is likely to* improve the chances of M&A

success. This was to be based on personal perspectives/beliefs and on individual experience and learning. No clues were given as to what answers were being expected or what particular dimensions of outcome were being hoped for, other than to be able possibly to chronicle these practices or observations.

Secondly, as regards the scope and definitional matters, several key points were consistently made at the commencement of each interview:

1) The focus was on the board of the acquiring company (not the target).
2) The focus was on public company boards, not those of private companies.
3) The focus was on transactions across the full M&A lifecycle i.e. the end-to-end M&A process, not just the deal stage.
4) The interviewee should consider the demands of larger transactions (relative to the asset base of the acquirer) ideally but smaller or simpler bolt-ons only if there were key learnings from these.
5) The interviewee should answer with any examples from the vantage point of their experience – but the preferred locus for comment was on the board's actions / behaviours, more so than those of executive management. Therefore ideally the interviewee should mentally try to wear a 'board member hat' or perspective when reflecting on actions or duties – even if some of their experience/observations were gained when they were an adviser working with a board/s or an executive member of management. In those circumstances what mattered was how he or she observed the board as operating.

As regards the third point, the interview structure, each interviewee was advised that there were five relatively broad questions which would take approximately 50 minutes to complete; followed by one short task to evaluate a set of M&A activities on a checklist – all to be completed within the space of an hour.

The above upfront scene-setting comments were strictly adhered to, to alleviate any potential concerns and to ensure the right frame of mind and reference for each interviewee.

Part of the preparatory task of the interviewer was rapport building, to set the interviewee at ease and break the ice; but the conversation around *ad hoc*, situational topics was kept short. In one case, it was an exploration of one of the not-for-profit companies the interviewee was chairman of and clearly was highly enthusiastic of their work and role; in other cases the ice-breaker may have been around something topical in the financial press that day.

As a final housekeeping task, before the commencement of each interview, each interviewee was asked to confirm or update his or her biographical details. The interviewer generally had sourced biographical profiling data on each interviewee from publically available sources such as via Google or company reports. This aim of the profiling data was to enumerate current directorships held by company, past directorships and executive roles.

Once the interview commenced, in order to ensure consistency, the same five open-ended interview questions were asked in the same sequence and in the same way with limited variability of wording.

There were some necessary exceptions to this process being followed too rigidly. On a few occasions, the question wording was modified in part or expanded on when the interviewees were unable or unwilling to answer the first question adequately; or asked for a question to be clarified; or wandered off topic and the interviewer's task was to guide them gently back the question at hand. Several of these tangential answers were, however, highly beneficial.

In the case of the first issue, which happened twice when the interviewee could not nominate a specific transaction or transactions that had been of a seminal effluence, the interviewer moved to the second question but effectively achieved what he sought via subsequent responses and explanations provided to later questions.

Lastly, as regards point confidentiality and recording, it was again emphasised upfront in each interview that the interviews were being conducted in accordance with the stringent ethical standards of Macquarie University which includes *inter alia* the disclosure of the confidentiality regime upfront with each interview. This meant in effect that:

1) Whilst the interviews were being recorded and would be transcribed, all references to the interviewee's name and any references to any specific transactions or company names or details would be expunged from the final report.
2) The interviewer would sanitise or redact their identities and personal details.
3) No 'quotable quotes' would be attributed to them.

Thus the interviewees were encouraged to be as specific as they wanted to be; or they could be more general in their comments if they felt uncomfortable, as the focus was not on conducting a detailed autopsy of any specific transactions.

The researcher also indicated that he and his supervisor would be the only persons knowing who was interviewed, other than possibly any director who may have facilitated the introduction to another director to participate in the interviews.

Importantly, there were no objections raised in any of the interviews to the management of privacy or confidentiality or the recording of the interviews.

At the conclusion of the interview, the assurance of strict confidentiality was again flagged and that the interviewees could call for a copy of their transcripts to review at any time should they so choose.

Interview method

The interviewer used a mix of techniques as part of the semi-structured interviewing approach, including close observation and note taking.

To get the best out of each interview, structured and unstructured (spontaneous) questions periodically were used.

Almost all questions were open-ended i.e. not closed. A variety of probing questions and follow-up questions were used depending on the circumstances, which varied based on each director's orientation and style of addressing the question.

As previously discussed, semi-structured interviewing provides consistency, balanced with flexibility.

Most of the questions posed to the interviewees were aimed to elicit what they believed ought to be done – so as to see whether this aligned with what was evident in the literature: or conversely whether responses were providing new board activities that were not evident in the literature and by doing so were potentially adding to the body of knowledge by addressing gaps.

As a secondary purpose, however, there was value in also assessing espoused versus actual / enacted practice i.e. gaps between what directors said they believed important and what they actually did in practice (do directors 'walk the talk'?); or to identify activities that they did not undertake in practice. The paramount focus thus was on what directors believed is necessary and important regardless of whether they follow their own advice. This was cornerstone of the interview purpose, which is expanded on in Section 5.9.3.

Interview aims

The explicit aim of the interviews was to understand what directors believe they ought to do to improve the chances of M&A success. That was conveyed consistently to each interviewee.

The other aims, as reflected in the interview questions, but not explicitly stated in case they prompted the interviewees to mention or discuss tasks the board ought potentially to be attending to, were to:

1) Capture their observations and views as to what they believe they ought to do in terms of commercial actions – the directors' views of 'ought'.
2) Then compare and contrast what directors indicated they believe in doing in practice – with what the desktop research into commercial practice indicates are key actions for executive management generally (the theoretical ought), to detect if there were any discernible differences.
3) Then capture their views on their governance responsibilities and activities and codify how they (board members) saw their roles and duties in exercising stewardship during transactions; and specifically to understand where they see their responsibilities as starting and those of management as ending (or where there are any overlaps).
4) Again, to the extent possible compare their views on responsible governance to the literature to assess gaps or commonalties.
5) Finally, chronicle the key actions and behaviours required by board members and governance mechanisms necessary to improve deal success.

Interview structure

The interview-based phase of the research was focused on:

1) Exploring the mindset and priorities of directors in evaluating and pursuing transactions and what factors or actions by the board they placed the heaviest importance or emphasis on, in trying to produce good M&A outcomes
2) Determining the behaviours, actions and the management controls that interviewees generally believed made the biggest contribution to positive outcomes, regardless of the specific characteristics of a transaction (the directors' views of ought)
3) Identifying whether there was any convergence of these views and factors with the literature or 'theoretical view' of what ought to be done.

Semi-structured question sets

The interviews were organised and conducted in five segments, described below.

Part 1 of each interview involved identifying and discussing the interviewees' perspectives on a transaction or transactions that had a significant formative impact on their approach to the M&A process.

a. Question: Could you please think about a significant transaction or transactions, positive or negative, which stands out as having most influenced the way you approach transactions today? (Depending on their responses follow up questions could be: What were the key lessons/learnings? Was this a positive experience overall? What would you do differently?)

Part 2 of the interview probed what a director has foremost in his or her mind as he/she approaches a major transaction. This goes to their mindsets and mental checklists of what they believe they ought to examine or monitor or control or direct.

b. Question: What is the set of considerations you have in mind as you approach a major new transaction?

Part 3 explored the board member's theoretical constructs and analytical frameworks to M&A management from a commercial and/or governance perspective. This is a check on the director's views of the 'theoretical-ought' dimension.

c. Question: Is there anything in the literature that stands out as being really important when it comes to managing transactions? Why?

Part 4 explored what happens in reality in the swirl of a deal. This is an exploration of reality i.e. what happens in practice, as opposed to the idealised view of what is the 'directors ought'.

d. Question: When the pressure is on and you are making a decision, or driving the process, what really goes on around the boardroom table?

Part 5 was a general exploration of their thoughts regarding future challenges for boards and how they will or should carry out their duties.

e. Question: What are your reflections on the future as regards directors' involvements and duties especially when it comes to delivering shareholder value from M&A?

Although not counted as a formal question, after the fifth major question above had been answered, the interviewee was usually asked whether there was anything else he or she wished to add.

These five interview segments were followed up by a paper-based rating and selection exercise.

Structured questionnaire

All interviewees were also requested to complete a short page and a half questionnaire that asked for: firstly their simple rating score on the importance of board involvement in various typical M&A activities; and secondly their delineation between board and management responsibilities / involvements at different stages of the M&A lifecycle for the same set of M&A activities.

This last dimension was explored via a simple checklist of typical tasks along an M&A lifecycle and was aimed to assess for each specified task:

a) how they saw the importance for board involvement
b) where the duties of Executive management ended and those of the board members started; and
c) where there were shared, overlapping responsibilities for each activity.

Refer to Appendix A for the task sheet.

The purpose of this short questionnaire was to ensure that for completeness' sake, the views of interviewees could be gathered and compared in relation to:

1) how highly they rated the importance of and need for board inputs to most key M&A tasks; and
2) how they perceived their accountabilities *vis a vis* those of management for the same M&A tasks.

The questionnaire provided a consistent, structured yardstick for comparison that a semi-structured interview would not achieve.

This exercise was deliberately conducted at the end of each interview, to further avoid prompting the interviewees to mention or discuss tasks the board ought potentially to be attending to during the course of their live interviews.

5.10 Data collection method

Based on research literature and discussions with other doctoral scholars, it was believed that a three-pronged approach would work best:

1) digital recording, careful transcribing and quality checking

2) note taking
3) monitoring body language and observing non-verbal responses.

To the first point, digital recording: the interviews were all conducted using digital recording equipment with the added back-up of an analogue, hand-held dictaphone as a safety precaution.

In the first interview, the digital recording malfunctioned and the back-up handheld mini-cassette recorder proved its worth as a safety net.

The digital recording software was replaced after the first interview and there were no further malfunctions.

The use of recording equipment may be distracting or uncomfortable for certain interviewees, although that was not evident at any stage in this specific process. In fact none of the interviewees questioned the use of recording equipment – all had already been assured of the process for managing confidential information.

The first interview was typed up by a freelance typist who found she could not cope with the interview-based typing. Thereafter a professional outsourced transcription service was used that had been recommended by another doctoral scholar and recordings were efficiently uploaded and managed on a secure website.

Secondly, as regards careful transcribing and quality checking: Once the transcript was uploaded after typing, the recording was again listened to in detail, so as to check / quality control the typing and to address any gaps (words the transcribers could not decode/decipher properly) or inaccuracies that may have occurred. This was a careful, word-by-word check to match the typed transcription to the original interview recording.

Although obviously time-consuming to undertake, the process of recording and transcribing interviews has several key benefits:

1) It prevents/overcomes the natural limitations of our fallible memories and deficiencies in note taking.
2) It removes interpretative bias on what we believe people are saying or have said and protects the researcher from any claims of bias.
3) It gives the researcher the latitude to keep going back to re-analyse what was said.
4) It is a formal, verifiable record of the interview should anyone wish to examine or review what was said.
5) It allows the data to be reused for subsequent research.

Once checked for correctness and accuracy, the typed interview transcripts could be easily coded and analysed.

Thirdly, as regards note taking: Reasonably comprehensive notes were taken, which served as a useful prompt when it came to data analysis and interview checking.

Lastly, observing of non-verbal responses: Given his training in interviewing from his years as a management consultant, the interviewer was able to take notes without unduly impacting eye contact or not observing body language and gestures. Generally the interviewees were relaxed, engaged, reflective and focused. Very little defensive posturing or dis-engaged body language was observed – and on the one or two occasions it occurred, it was only brief. Observations regarding body language were noted; and compared to answers given. On extremely rare occasion, follow-up questions were asked to test whether the view was complete or backed up by other opinions or views.

The use of a digital recording device proved invaluable in practice: it enabled the checking and re-checking of transcripts for accuracy afterwards; it freed up the interviewer to build rapport with interviewees; it enabled the interviewer to maintain almost uninterrupted eye contact, other than periodic reference to questions or occasional note taking; and allowed the interviewer to observe the respondents closely for non-verbal responses.

All interviews were conducted in private meeting rooms (and in two cases in private studies) without any interruption or intrusive background noise.

Having selected and interviewed a sample of directors, and having assessed questionnaire answers as a separate follow-up task, the data coding process was undertaken. Section 5.11 describes the process for coding and analysing data of interview outputs to ensure that it was diligently undertaken in a disciplined way, but that both art and science were applied to discerning interesting patterns.

5.11 Data analysis – the data coding process

All interviews were recorded and transcribed. Analysis of data was conducted using QDA (Qualitative Data Analysis, by 'Provalis') software for coding of transcriptions and qualitative analysis of all findings.

As previously described in Figure 16, using a Grounded Theory based approach is akin to peeling away the layers of an onion Thus the data analysis activity followed three key steps that are iterative: (1) open coding; (2) modifications to coding; and (3) further refinement of core categories; before conducting any further required iterations.

The first step of open coding commenced after the first four (4) interview transcripts had been received and reviewed. The purpose of the open coding was to tag and flag the data so that concepts could be identified and then logically grouped into related categories. This process of tagging and flagging was reapplied several times to the first transcripts, as part of a continuous improvement process. Inevitably the first few passes lead to a plethora of codes, which were gradually reworded and adjusted.

The first coding exercise followed an ‘open coding’ process, so called because the coding is used to open up the data so that concepts can be identified. (Morse 2002)

In effect the first insertion of codes followed a line-by-line review of interview data, which resulted in a relatively a*d hoc* code allocation process. As key words and phrases occurred, these were identified and flagged with codes. No hierarchy of codes was followed initially. After the first four transcripts were read and re-read end-to-end, the coding was revisited to: (a) ensure that no significant gaps had occurred with key phrases potentially being omitted; and therefore (b) confirm that the coding set was likely to be suitable for use in the further texts.

The review also attempted to ensure that whilst phraseology around similar subject matter may have varied from director to director, where there were overlapping ideas / expressions, concepts or convergent wording/data, these could be consistently coded.

The key focus in this initial activity was to avoid duplication of similar concepts and to aid in clarity of thinking. The selection of codes is more art than science and is driven by the author's own subject matter expertise in recognising key words and patterns (Hussey 1997) or is determined in part by the words or data of the interviewees themselves (*in vivo* coding).

The categories themselves typically expand and then contract as patterns emerge, various codes are shuffled around to more logical category homes and the categories themselves over time are reworded, reshaped and synthesised as the case may be.

No code count was undertaken after the first four interviews were coded; and no immediate groupings of codes took place. The initial coding took place 'down in the detail' for example: 'Too much formality inhibiting entrepreneurship'; or 'Meeting offline with management'; or 'Conversation/openness/frankness'. These codes could also represent verbatim sound bites such as 'Non contentious directors – old boys' network' or 'Ego / self-interest'.

At this early stage typically it is hard to know whether one is dealing with an emerging trend or a recurring theme. It is possible, however, to start to see some initial groupings or clustering, although the natural tendency is to start to organise codes; this should be resisted to allow a degree of randomness to take place so as to see what would emerge as the interview process proceeds.

The next step of modifications to coding occurred via additions and relatively minor changes to the codes themselves as the remaining interview transcripts (five through to twelve) were coded.

Although different permutations in the coding selection were examined, and several examinations of various alternatives were conducted, the coding was retained through the remaining interviews. The primary reason for this was to have the flexibility of moving from a fairly granular or precise level of coding of data to understand the bigger position i.e. having coded at a micro level, it is important to be able to zoom out to a more macro view of alternative themes and coding groups as part of the experimentation and testing process. It was readily apparent, however, that the range of alternative codes was too large and unmanageable, especially as there were some clear overlaps emerging.

Before the end of the process of coding all twelve transcripts, the codes were saturated and no additional codes were necessary to accommodate new information or data. Further details on the permutations tested, is provided in Chapter 6 in Section 6.2.

The more significant focus in this second stage was not the focus on the codes but the effort given to the categorisation of codes.

A critical part of the process is to apply groupings to clusters of related codes. Categorisation of codes is necessary to arrive at a classification that is felt to be explanatory and predictive and therefore will facilitate analysis.

This involves the identification of provisional categories to provide a relevant grouping to associated codes or phenomena observed. The intention is to be able to study associated phenomena with similar properties, to see whether specific patterns can be observed.

This grouping process is both art and science and continues iteratively. Even observations or properties that are not entirely congruent with the main category can be useful and should be accommodated, as long as these concepts can be accommodated with thin comfortable limits. (Strauss 1997)

By the end of the second step, from the fifth interview until the final twelfth interview, a relatively settled set of codes was followed, structured pen ultimately into 21 categories and 76 codes within the categories. These are discussed in depth in the next chapter.

Regular assessments of code occurrences were undertaken using the analysis and reporting capabilities of a research-specific software product called ‘QDA Miner’ to assess patterns, gaps, overlaps. The codes were allowed to emerge without undue interference or intervention and were kept relatively consistent for the coding of interviews five through twelve; nonetheless this semi-structured approach had led to an unwieldy number of categories. The codes and categorisation were therefore ready for a heavy review.

The third and final step of ‘Further refinement of core categories’ took place on completion of the coding of the twelfth interview.

During the third step in particular the point was reached when a range of coding options needed to be considered, so as to restructure the categories in a more elegant, consistent and helpful way.

In particular the codes were considered by topic or issue, to explore whether a different pattern would emerge; or whether there were evident holes in the coding structure.

The semi-structured interviews were followed by the use of a structured questionnaire.

5.12 Structured questionnaire on board M&A activities

As indicated earlier in Section 5.7, at the conclusion of each interview the researcher asked the participant to complete a short questionnaire that covered 29 typical M&A related activities that a board **may** have some involvement with.

The purpose of the short questionnaire was to ensure that for completeness’ sake, the views of interviewees could be gathered and compared in relation firstly to how highly they rated the importance of board inputs to a variety of typical M&A tasks; and secondly, how they perceived their accountabilities *vis a vis* those of management for the identified 29 M&A tasks. In other words, their views were gathered first regarding the perceived importance of board involvement in certain 'transaction support and stewardship' activities; and then secondly for their views on the delineation of accountability between management and board for these same activities.

These two dimensions were explored sequentially.

As indicated, each of the semi-structured interviews was followed by completion of the questionnaire (not preceded by it), which was critical if directors' views in the unstructured interview that took place first were to be unclouded by suggestion or prompting.

The terminology used in the structured questionnaire had common business meanings, for example: 'mergers', 'acquisitions', 'takeovers', 'corporate strategy', 'due diligence' – these are all words that have a commonly understood core meaning, even if some interpretations may vary 'at the boundary'.

Nonetheless, some may argue that it is a deficiency to ask directors to nominate the importance of board involvement in a particular activity without asking for example what they mean by 'involvement'. For some directors 'involvement' may mean their having an awareness of an activity or subject matter or recommendation, as a result of communications with or from management. For others 'involvement' may mean that they have actively scrutinised, tested and checked off a particular item of M&A activity.

The first counter-argument to such a challenge is that the nature of the research has been ontological rather epistemological as indicated in Section 4.3. This research is not underpinned by an epistemological approach to ascertain particular interpretations of actions or activities.

The second counter-argument is that the activities on the short questionnaire generally are part of common management and business parlance, and whilst there may be some slight interpretational differences at the periphery, the essence of understanding would most likely be similar across most executives.

Once the structured questionnaire was administered, it was not followed by a discussion as to why any particular activity was scored in a particular way; nor was there any interrogation of each interviewee's interpretation. The constraints of a one-hour interview with time-poor non-executives precluded such an exploration, and a deep dive into interpretation and meaning would have alienated them rather than added further insights to a result.

The analysis activity was straightforward: gathering of all results and 'slicing and dicing' these for each dimension. The results of these question sets are provided in Chapter 6.

5.13 In conclusion

This chapter has focused on what research option is best suited to addressing the focusing question first developed in Chapter 4.

In doing so it is argued that the question is essentially one that requires a qualitative study, at this stage anyway, rather than a normative or predictive one.

Having developed this line of thinking, the focus shifted to considering and selecting the most suitable research option available, by considering the nature of Espoused Theory and Phenomenological studies, before selecting a Grounded Theory methodology.

For the reasons explained above, the approach has followed semi-structured interviewing techniques with a sample of experienced non-executive directors, based on non-probability (purposive) sampling.

The basis of selection of the sample of directors was then described and a detailed explanation provided of the sequential steps undertaken for data coding. In so doing, the intent is to ensure that the way in which patterns of common data elements were progressively distilled is logical, robust and defendable.

A coding process has been diligently followed as described in Section 5.11. The data inputs to the coding process were generated via careful transcription of interview contents. By following an iterative process, the coding categories were progressively narrowed down until a set of categories emerged that appeared to address all of the issues and topics that had been processed on a 'mutually exclusive and collectively exhaustive' basis.

Having described the research methodology and how data was iteratively 'cut' and analysed, the scene is set for the following chapter, Chapter 6, which describes in detail the emergent themes resulting from the coding exercise of the interview transcripts, plus other findings and observations arising from directors' oral comments and their written responses to a structured survey questionnaire that was also applied at the end of each interview.

6. Results and analysis

"Rule No.1: Never lose money. Rule No.2: Never forget rule No.1."

[Source: Warren Buffett]

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

[Source: Warren Buffett]

"The opposite of a correct statement is a false statement. The opposite of a profound truth may well be another profound truth."

[Source – Niels Bohr (1885–1962)]

"We all agree that your theory is crazy, but is it crazy enough?"

[Source – Niels Bohr (1885–1962)]

Key points

1) Six key themes emerged from coding of "advocated" activities:
   a) clear strategy upfront
   b) early preparation and planning
   c) proper understanding of culture
   d) rigorous testing of the investment business case and funding strategy in order to be confident in its rigour and to know how to fund it without putting the company at risk of financial duress
   e) regular control points post transaction
   f) well-chaired board with constructive challenge.

Key points to note with regards these six points in turn:

2) ***Regarding the upfront M&A or growth strategy***, most interviewees agreed that there must be direct board involvement and sign-off. The board then becomes the primary guardian or 'keeper' of the strategy that management has committed itself to implement
3) ***Regarding early preparation***, directors emphasised the critical need for the Board to:
   a) provide input well before the first transaction lands

b) be clear as to where the boundaries or bookends of the business are, as well as the growth parameters and preferences for areas of growth

c) not be too permissive i.e. not be too open to varying interpretation.

4) Directors emphasised that preparation and pre-planning are crucial; such pre-planning includes having M&A processes and capabilities in place

5) ***Culture*** is a critical issue and front of mind (for directors); however the level of attention and rigour accorded to ascertaining culture appears variable. Some directors believed a culture assessment needs to be ‘deep, detailed and disciplined’; others seemed to rely on their instincts and judgment based on interactions with executives and non-executives of the target entity, ex-employees, etc.

6) ***Capital capacity and adequacy*** was a front-of-mind issue: ‘Can we afford this? What impact does it have on the balance sheet?”

7) Board involvement in ***post-merger integration*** appears to be patchy e.g. critically reviewing synergy costs and the design of the future state (merged entity) operating model

8) Similarly, the emphasis on ***post transaction benefits' tracking and reporting*** is also not what it ought to be, although the importance (as a directors’ view of right practice) was clearly recognised

9) Interviewees identified the critical role of the chairman to:

a) Manage board interactions, and to provide early advice to a CEO considering the pursuit of a M&A transaction

b) Facilitate and encourage discussion, critical debate, engagement, and commitment

c) Ensure that the board and the CEO are fully committed to the deal

d) Avoid deal fever and a premature rush to convergence from “should we support this?” to how do we make it happen?

10) Lastly, via a short survey covering a range of common M&A tasks, directors provided clear guidance on

a) importance of boards’ involvement and participation

b) delineation of accountabilities *vis a vis* management.

6.1 Introduction

The data collected and analysed in this section is the product of 12 interviews conducted face-to-face and the same number of questionnaires completed by the interviewees.

Chapter 4 provided a high level outline of the process whereby interview data was rigorously coded and progressively re-cut in order to arrive at a set of seven, and then six coding groups, representing the key themes emergent from the interview transcripts.

Chapter 5 expands on this outlined process by explaining in greater detail how the resulting coding groups were identified through exploration of various coding options, over several iterations of coding, and were tested to provide a balanced and ‘MECE’ (mutually exclusively and collectively exhaustive) categorisation of themes.

As will be explained, these six codes relate to ‘advocated’ behaviours, activities, actions and enablers that the participating directors believed that boards ought to do. This chapter focuses on understanding the elements of each theme and more particularly where and how it (a) aligns with, or (b) diverges from or (c) add to (i.e. addresses gaps in) the existing body of published literature and knowledge. The focus of this chapter is therefore to begin to articulate a consolidated view of what directors believe ought to be done, and what researchers point as a set of practices and behaviours, by the acquiring board to assure and secure M&A value.

The contents of Chapter 6 follow the following sequence:

1) Discusses the results of the structured questionnaires used at the conclusion of each interview.
2) Explains the coding options that emerged and how these were evaluated to assist with a set of MECE codes and related categories.
3) Explores the six key categories (constructed as major themes) emerging from the data codification as the emergent collective wisdom of non-executive directors along with quotable quotes from the interviewees illustrating their points.
4) Considers the extent of alignment or conversely gaps between the directors’ wisdom and the literature (documented practice) from Chapter 3.
5) Analyses the results of the survey questionnaires completed by all interviewees and considers the implications arising from their responses.
6) Describes the key elements that interviewees described as the key actions or activities that boards generally ought to attend to as part of each of the six major themes from the coding.

The interview findings have also been enhanced by the results of the short, structured survey that each interview participant completed. The questionnaire results have not been coded, owing to the survey forms being structured and potentially prompting interviewees to rate factors that they might not otherwise have considered or raised. Therefore the questionnaire analysis has been kept quite separate so as to not pollute the interview results – but have been analysed in detail and referenced so as to add further colour and potentially a different set of dimensions that will amplify or explain some of the coding themes emerging from the interviews.

Before commencing with detailed examination and juxta-positioning of the interview coding themes with literature, the short survey results are considered first.

Data emerging from the structured questionnaire on board M&A activities

As indicated in Section 5.7, at the conclusion of each interview the researcher asked the participant to complete a short questionnaire that covered 29 typical M&A related activities that a board may have some involvement with.

The first required activity was to rate the importance of various activities (and governance related practices) – on a simple scale of high, medium or low importance – that could require board involvement in order to support value creation and/or value protection by the board.

The second activity required the scoring of the same set of questions / activities relating to who should have primacy in directing the activity -– management or the board -– which is another way of determining the level of involvement. Put differently, the answers to these questions should delineate boundaries and decision-making rights.

For example, if an activity is scored as one that the 'Board Directs, Management Supports', it is likely to have significant board ownership and involvement. If it is one nominated as 'Equal Ownership of activity' the board involvement would be similarly significant if not greater.

This does not mean that the board necessarily invests as much time as management in preparing for or undertaking the activity in question, as management will have resources and 'bandwidth' at its disposal well beyond what the board typically has. It is, however, a clear indicator of the seriousness with which the participating directors believe that boards should approach their input and intellectual ownership of the contents or outcomes of a particular activity.

The reason for exploring the questionnaire results, before those of the coding from interviews, is that the survey questionnaires address a number of contextual issues necessary to understand the potential frames of reference of the interviewees. The context is framed firstly by which M&A activities board members see as representing their M&A duties *vis a vis* those of management; and secondly where they believe they need to have primacy for key activities. How Directors perceive their involvements and which activities they believe ought to be board-led or directed, should be a key contextual determinant for their interview comments on M&A governance generally.

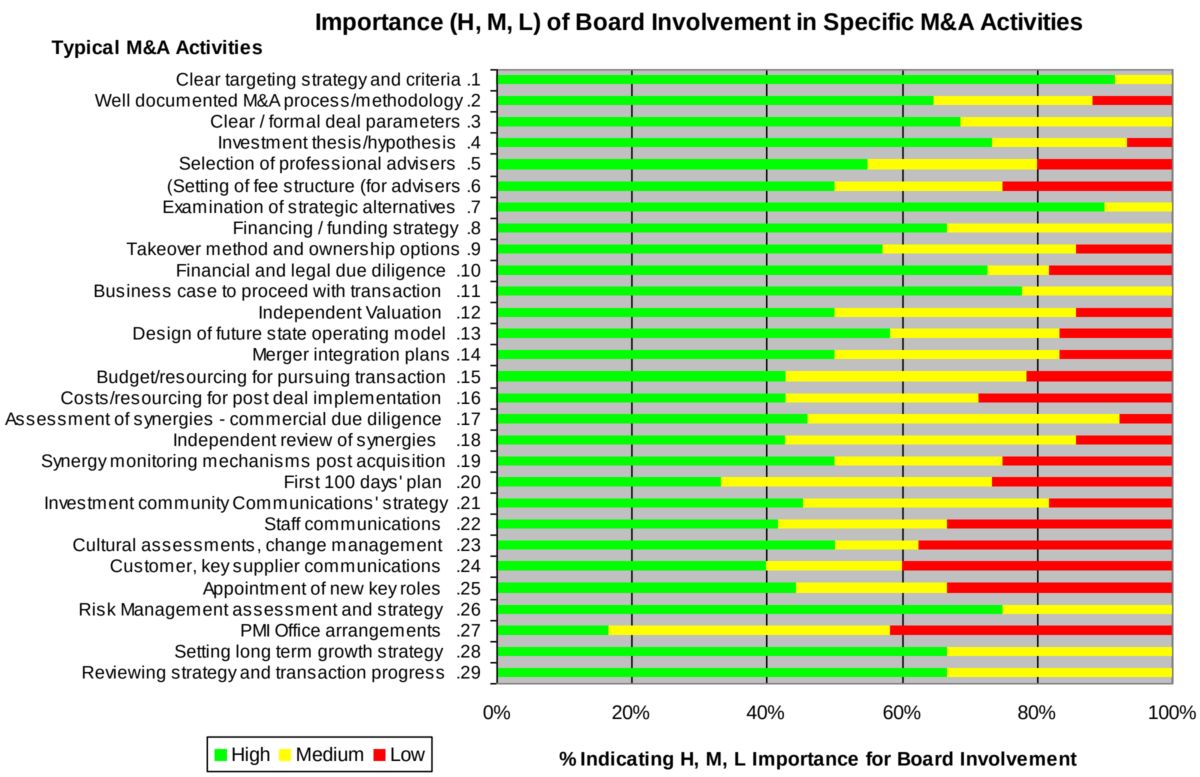
The structured survey questionnaire provided a consistent, structured yardstick for comparison that a semi-structured interview would not achieve. For further detail on the questionnaire, refer to Appendix A: Structured questionnaire to interview participants.

The results of the survey questionnaire for each of the nominated 29 activities are outlined in the diagrams below, covering the two dimensions of the question set: firstly the level of importance attributed to board involvement in the key activities; and secondly, where the boundary for involvement and ownership by the board should exist i.e. how they saw the delineation of accountability for conducting that activity. 'Level of importance' is examined first.

Findings on importance of board involvement in M&A activities

Figure 17 outlines the first part of the survey results that explores the level of importance the interviewees ascribed to board involvement in the 29 M&A activities tabled for evaluation.

Figure 17: Importance of board involvement in a range of M&A activities – questionnaire responses



What is clear from the findings outlined in Figure 17 is that the survey indicates a high level of importance for board involvement in *Strategy* (1, 4, 7, 28 and 29) and *Risk Management* (26).

Additionally, several other activities scored high levels of importance: *Funding Strategy* (8), *Takeover method and Options* (9), *Financial and Legal Due Diligence* (10) and *Business Case* (11).

There are a number of unexpected ratings that emerged, relatively speaking, via the survey questionnaire relating to synergies and monitoring of post transaction results. Three notably interesting aspects emerging were: business case involvement / scrutiny by the board; synergies; and monitoring activities.

Firstly, *the business case signoff*, activity #11, can be viewed as the final investment decision to proceed i.e. it is a critical step to proceed with a transaction and thus is or should be a significant focal point for board attention. In effect, as it is the final go / no go decision from the board (assuming the business case contains the details of the offer and conditions), the business case should be the tangible culmination of the board's involvement in the transaction phase of the takeover. The set of activities 8-11 are closely inter-related: activities 8, 9 and 10 typically are critical inputs into a business case. These activities are of a predominantly financial nature. The final investment decision goes to the heart of most boards' fiduciary duties in relation to capital protection and ensuring adequate liquefy in the business. Hence its relative importance is unexpected.

In addition to activities 8, 9 and 10, there is a range of other related 'feeder' activities for board review that are key components typically into the business case: costs and resourcing for post deal implementation (16); and assessment of synergies, arising from the strategic or commercial due diligence (17).

Secondly, *synergy-related* activities, (activities 16 and 17), interestingly do not score as highly as one might have been predicted from the literature. Synergies of course do not play a significant role in every transaction and there is general recognition by M&A practitioners that revenue-type synergies (whether tangible or more 'blue sky') are less easy to assure or secure than cost-based synergies and thus need to be heavily discounted relative to the latter.

Nonetheless the reliability of synergy estimates usually hinges on the accuracy and quality of the strategic or commercial due diligence (unless this has been a hostile transaction) and one would expect that the board takes a strong interest in the scope and reliability of the due diligence. Further in those transactions where revenue or cost or asset based synergies are available, the business case reliability / rigour will be determined at least in part by the accuracy of synergy flows. Thus synergy flows are critical to many transactions unless they involve 'standalone' acquisitions which are not likely to provide synergistic opportunities; or deals where there is no immediate integration planned or likely e.g. a new market / country entry or will be run as an autonomous entity.

Given the importance of synergies to many transactions, it is quite noteworthy therefore, that the interviewees did not place a heavy emphasis on board involvement in the *Assessment of synergies* (17) or the *Independent review of synergies* (18), although for some directors these activities may be encompassed by activity #11, *'Business case to proceed'*.

Thirdly and lastly, one might expect that boards would see their ***monitoring role*** as being significant – which should be a key role for boards as identified for example in the work of Hilmer and Tricker (see Section 3.3.1).

In the case of M&A, monitoring translates to the tracking of integration progress and synergy realisation. '*Synergy monitoring mechanisms post-acquisition*' (activity 19), however, did not score particularly highly; nor do the associated 'feeder activities' relating to integration or post transaction management such as *Design of future state operating model* (13), *Costs/resourcing for post deal implementation* (16), *Merger integration plans* (14) or *First 100 days' plan* (20).

Activity 29 '*Reviewing strategy and transaction progress*' does score a high importance rating – but this is not about post-merger benefits' tracking *per se*, but rather about overall transaction progress.

One possible interpretation for these scores is that these activities are seen as primarily management's activities, which is not to say that the board members interviewed would believe that their input or interest is unimportant *per se*; but possibly that they believe that management has to take the lead. This observation is explored further in Section 6.9.2 below in relation to post-transaction benefits' tracking.

The transaction phase of a takeover is 'the end of the beginning'; what follows post-deal in the transition phase is of crucial importance to value delivery, and is where one might expect a greater weighting being placed on post-merger plans and activities.

The second dimension of the structured survey questionnaire related to 'boundary management' or views on the delineation of accountabilities between board members and the executive.

6.1.1 Findings on delineation of responsibilities between board and executives

Figure 18 indicates findings based on the respondents' views about who has primacy for the various 29 activities.

Figure 18: Delineation of responsibilities / involvement in a range of M&A activities – questionnaire responses

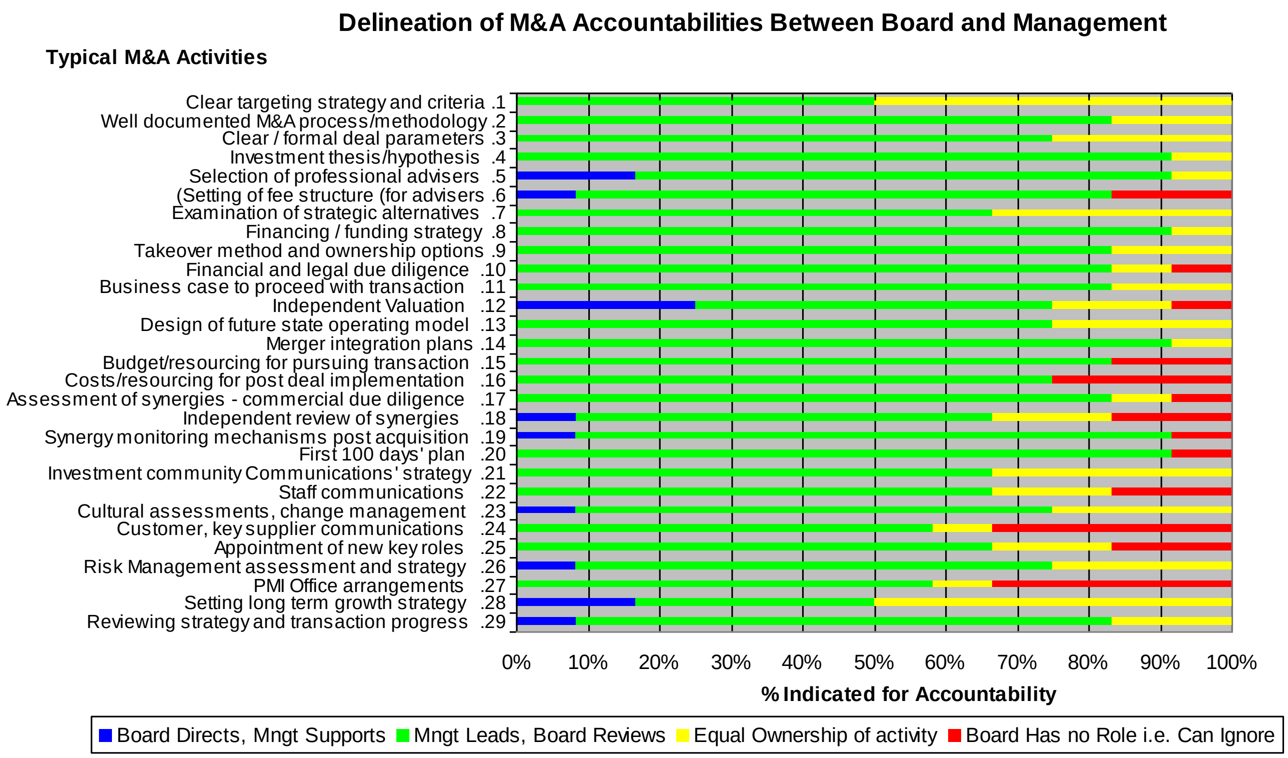


Figure 18 indicates a number of activities where the board members interviewed saw a strong level of board participation, to the extent of co-ownership of a number of activities.

Primary amongst those activities perceived to be key responsibilities, are: Clear targeting strategy and criteria (1); Investment community communications' strategy (21); Cultural assessments, change management (23); Risk management assessment and strategy (26); and Setting long-term growth strategy (28).

Activities 1 and 28 scored identically in terms of 'Equal Ownership of activity' but in the case of the latter, a few directors went so far as to indicate this to be an activity that 'Board Directs, Management Supports'.

There were few activities where there was a strong presence of 'Board Has no Role i.e. Can Ignore' nominations, perhaps the one standout being '*Costs/resourcing for post deal implementation*' (#16).

These views of course represent the opinions of a sample of directors. Whilst this study breaks new ground in attempting to explore directors' views on their M&A priorities and responsibilities, their views need to be regarded as directional rather than categorical.

It was well beyond the scope of the study to compare their opinions with those of other non-executive directors and executive directors on the same boards; but it may be quite instructive to investigate whether there is a constancy of views on the same boards as to the importance of specific activities and whether there were convergent or divergent views on the delineation of responsibilities during transactions.

For example, in a study of UK directors, undertaken under the aegis of the Cranfield University School of Management[156], quite sharp discrepancies emerged in how chairmen rated their involvements and contributions versus how Executive Directors saw them.

In similar vein, in 'A Study of the Role, Contribution and Performance of Australian Board Directors[157], "The survey shows that chairmen rate themselves higher with respect to strategic decision making, governance, risk, style, qualities and performance. Other members of the board rate them lower in these areas." (At pg. 9).

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[156] Professor Andrew P. Kakabadse, Cranfield University, School of Management; Professor Nada K. Kakabadse, Northampton Business School, The University of Northampton; Dr. Andrew J. Myers, AJM Associates; "Chairman and the Board – A Study of the Role, Contribution and Performance of UK Board Directors" Summary Report, April 2008; page 5

[157] Professor Andrew P. Kakabadse, Cranfield University, School of Management; Professor Nada K. Kakabadse, Northampton Business School, The University of Northampton; Mr. David Pumphrey, Heidrick & Struggles Australia, Dr. Andrew J. Myers, AJM Associates; "Chairman and the Board – A Study of the Role, Contribution and Performance of Australian Board Directors" Summary Report, April 2008

That comparison of perspectives, however, is not the point of this exercise, which is to develop a view as to what M&A activities non-executive directors emphasise and believe they need to have an active involvement in (in some shape or form).

The delineation of responsibilities and decision-making rights is determined between executive management and the board either through (a) following a structured, sometimes negotiated process which may be formally documented; or (b) being developed and modified on a case by case basis – or what Andrew P. Kakabadse (Cranfield School of Management) and Nada K Kakabadse (Northampton Business School) describe as an 'idiosyncratic process'. Refer to Section 3.3.3.

The implications of the data emerging from the structured survey instrument will be revisited in the context of the six key themes that emerged from the coding of interview responses. Various activities explored in the survey should provide an additional set of lenses through which to consider the six key emerging themes arising from the face-to-face interviews.

We now turn our focus to the six overarching themes emerging from the semi-structured interviews.

6.2 Results flowing from semi-structured interviews

As indicated in the Chapter 5, by the end of the second step, i.e. from the coding of the fifth interview until the final, twelfth interview, a relatively settled set of codes was followed, structured pen ultimately into <u>21 categories and 76 codes within the categories</u>.

The 21 categories provisionally used at the end of the second stage were:

1) *Process* which *inter alia* included M&A Process, Business Portfolio Management and Programme Management.
2) *Strategy* which included Strategic Fit, M&A Strategy, Board's Involvement in Strategy and other 'key no-no's' like No strategic clarity, Stick to the knitting.
3) *Communication* which included CEO Communication with Board, Early discussions, Regular updates, Investment Community, etc.
4) *Culture* which included Understanding Culture, Cultural Fit, Retaining key talent.
5) *Challenge* which included Critical challenge, Saying No, Decisiveness, Business Judgement, Conversation/openness/frankness, etc.
6) *Due Diligence* which included Financial DD, Strategic/Commercial DD, Legal DD, etc.
7) *Preparation and Planning* which included Pre-deal preparation, Planning Process.
8) *Relationships* which included CEO and Chair relationship, Collaboration with Management, Board cohesion and collegiality, Confidence in CEO/Management Team etc.
9) *Risk Management.*
10) *Capabilities* which included M&A capabilities/experience, Project Management.
11) *Capital Funding* which included Funding strategy, Capital stress, Opportunity Costs, etc.

12) *Post Deal Value Delivery* which included Post merger Integration, Integration Planning, Future State Design.

13) *Advisers* – Independence, Expertise.

14) *Business Case* – Sensitivities and Scenarios, Financial Returns.

15) *Controls* – Benefits' Tracking, Financial Management Controls.

16) *Convergence* incl. Deal Fever, Management Disciplines.

17) *Learning* – Post Acquisition debriefs, Preferred Approaches.

18) *Principles* – Deal Parameters, Guiding Principles.

19) *Board Meetings,* which included NEDs offline/informally, Dedicated meeting focus, Dedicated DD roles, Meeting offline with Management, Creating agenda time.

20) *Board Structures,* which included Two tier boards, Advisory Boards, Unitary Board, Non contentious directors – old boys network, Attitude of ownership, Governance and ethics.

21) *Accountability* – Management Accountability, Board Accountability.

A full listing of codes is detailed in Appendix B.

This set of categories included the recognition of emerging themes around ‘convergence’ of boards, and ‘critical challenge’ as two prime examples of new codes introduced.

The codes were allowed to emerge without undue interference or intervention and were kept relatively consistent for the coding of interviews five through twelve; nonetheless this semi-structured approach had led to an unwieldy number of categories. The codes and categorisation were therefore ready for a heavy review which was undertaken in ***the third and final step of “Further refinement of core categories”*** upon completion of the coding of the twelfth interview.

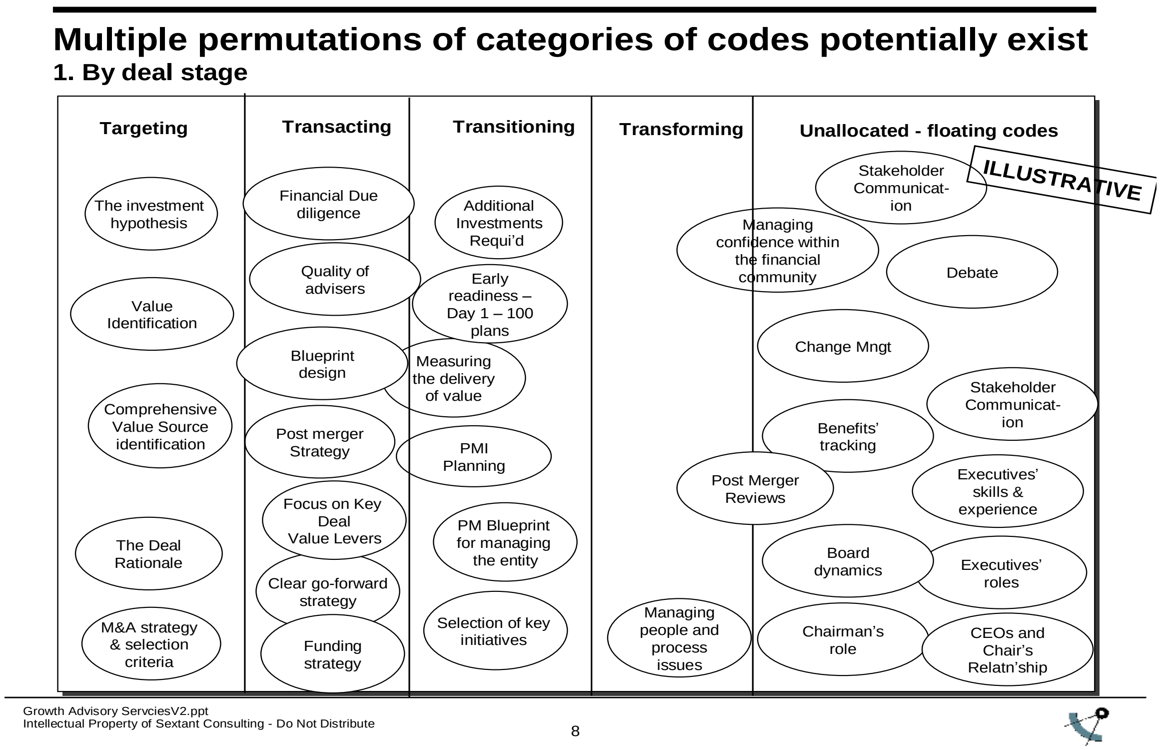
Four main alternatives were considered and then discarded.

The <u>first grouping process</u> that was considered was <u>a simple arrangement</u> which would have explored categories within the three factors around which the literature review was structured i.e. Legal versus Governance versus Commercial practice. On reflection this construct was felt to not be helpful or insightful, primarily as directors duties’ may reflect in Legal outcomes but directors don’t undertake ‘legal duties’ *per se*. This is not what appears to be their core focus in approaching transactions. Tellingly, not one director specifically mentioned their actions or activities being driven by their legal obligations. Further, as the legal literature review indicated, directors’ duties with regards M&A are not explicit.

Putting aside the Legal category, the Governance and Commercial categories may be useful as a super categorisation but these are not specific enough to pick up the important next level of categories. Additionally these categories would not lend themselves to effectively managing codes relating to inter-personal dynamics, thinking styles, etc.

Having considered and rejected this simple high-level categorisation, three other main permutations were considered and explored: specifically by M&A stage, by process, and by M&A skills and competencies. The suitability of each of these options is considered in turn below.

Figure 19: Grouping by M&A stage

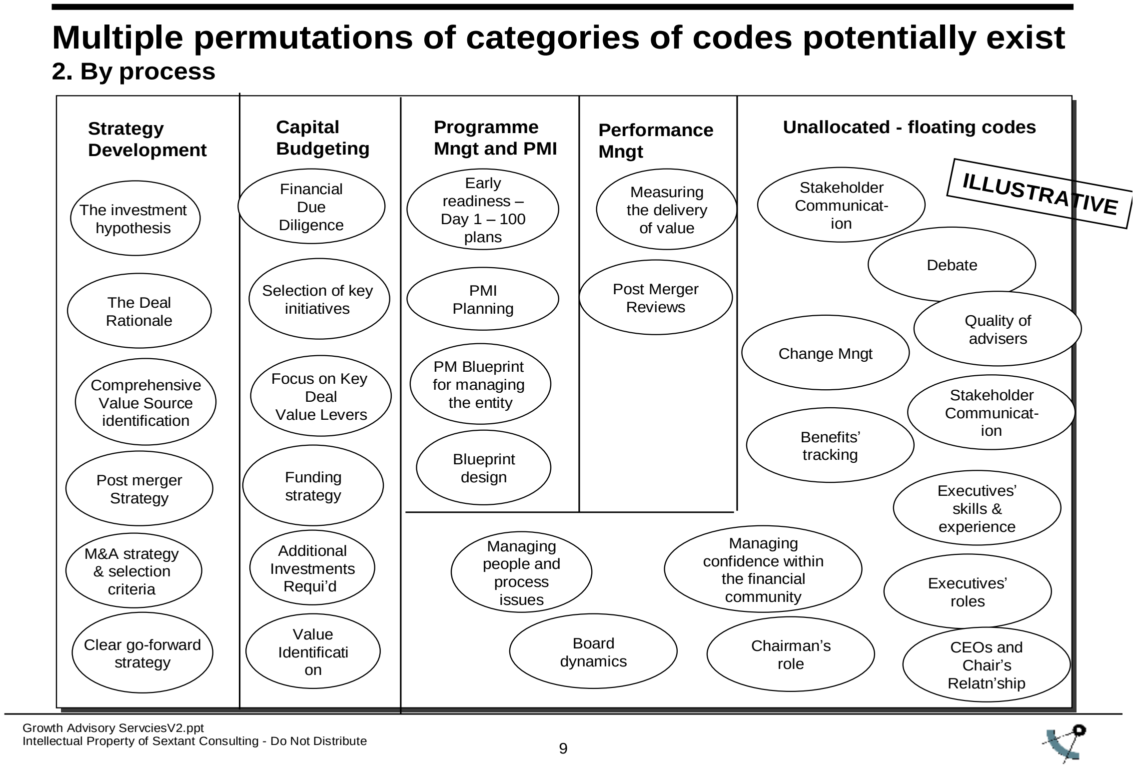


Source: Dean Blomson (thesis author)

Whilst the second option of filtering codes through a lens of 'M&A stage' may be useful in organising some of the comments, it left a large amount of potentially important topics or codes unallocated. As the PhD topic looks to what it is that boards ought to do, whilst some of their activities may vary by stage, not everything will. Having 'constructive debate' for example is a 'transversal' activity or factor which may cut across more than one M&A phase; so too are 'strategy' or 'planning' or having the necessary skills and experience (which is not an activity at all but more of a requirement or key attribute).

The third option considered whether the adoption of a process-based approach to categorisation would be beneficial, since processes form a core component of Governance and Commercial practice.

Figure 20: Grouping by process



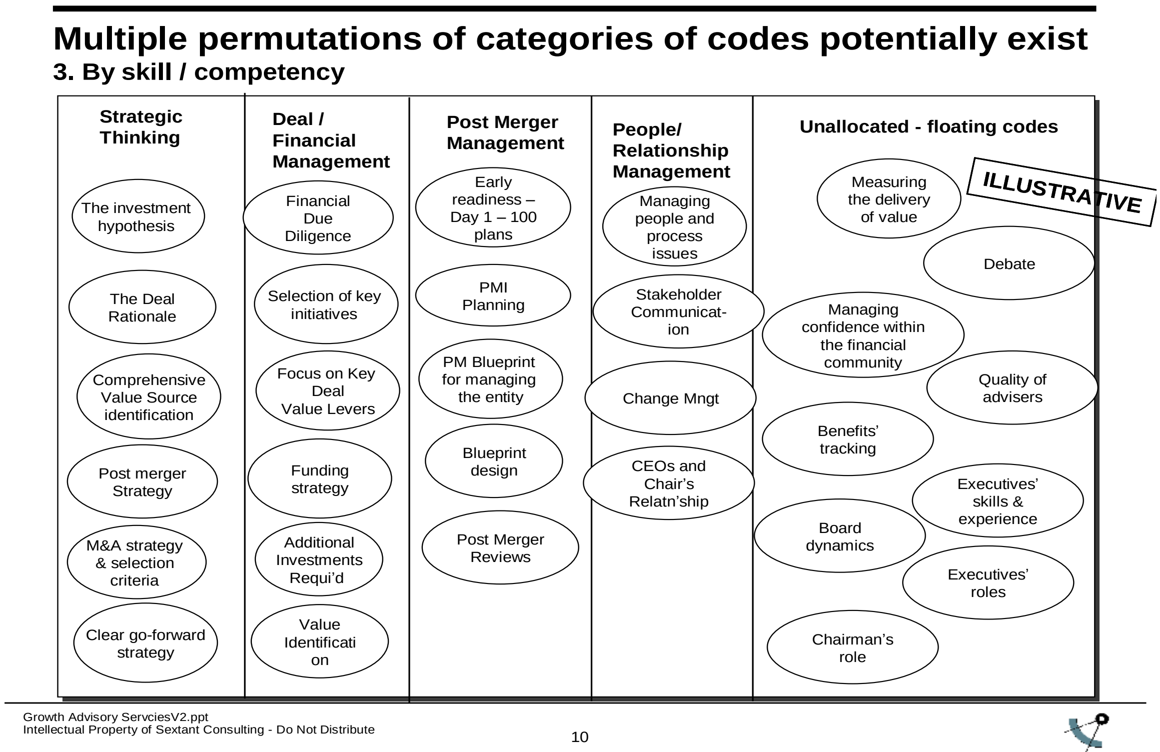
Source: Dean Blomson (thesis author)

A process-based categorisation does provide some insights and logic as to where the key issues may be occurring, but again there are a considerable number of floating issues left over, such as those dealing with inter-personal and stylistic matters (including behaviours), skills and experience.

Some of the 'left over' codes could be gathered under further process banners such as 'the communication and change management process' or the 'benefits realisation process'; but other codes could only be addressed by adding further process sub-categories such as 'Director appointment processes' (which may to a degree address matters of skills or style). This lead to another challenge to the organising construct: even if sub-processes were called out and used, how then should non-process elements such as depth and quality of board debate be addressed? Putting such elements or codes under a further process title such as 'Board Meeting Management Process' could be taking the construct and discipline of process analysis to a level that is not necessarily beneficial to understanding the ingredients for M&A success, as this is not simply about how tasks and activities get conducted during meetings.

The <u>fourth categorisation option</u> considered was via <u>skills or competency sets.</u>

Figure 21: Grouping by skills and competency sets



Source: Dean Blomson (thesis author)

This categorisation of codes would have helped to address some of the deficiencies of the preceding two options by looking at what core competencies directors need to bring to the table to improve deal success. The categorisation, however, does not directly address behavioural dimensions such as boardroom debate or the desirability potentially for having an independent mindset and attitude or the need for courage to stand up to a runaway board. These were all personal attributes that were raised in various interviews and were coded in the data. Additionally, certain process based codes like performance management cannot be easily accommodated under a skills' based categorisation.

Having considered and discounted all four main options, it was decided to revert to the code analysis and the code topics that had been explored in the earlier categorisation.

A solution needed to be constructed to accommodate a variety of related but separate themes: relating to strategy; management of culture; concern for affordability, economic returns and financial adequacy; reliance by the board on management to be properly prepared; and concern for post-merger value delivery. There was also a range of recurring 'behavioural' themes that needed to be accommodated, relating to the board culture and climate and how the chairman engenders the appropriate levels of debate and challenge and ultimately alignment. With such a selection of related but mutually exclusive themes, a more holistic categorisation approach was required.

At this point, the codes were re-sorted into a more elegant, streamlined structure that was concordant with the above key thematic messages that were becoming evident from the interview process. A series of analytical tasks were carried out at this point, examining differing alternatives around these themes, to see in which ways the data clustered most strongly. Twenty-one codes were settled upon as representing the strongest set of alternatives around the coded statements.

These codes related to seven major themes each with three filters or options – what the interviewees mentioned they did; what they advocated ought to be done; and what they noted as activities that were generally not done or done well.

The key rationale for selecting these categories was that seven themes represented recurring issues cutting across the preceding coding permutations that were considered. Additionally, since the thesis focus is on understanding what activities and actions directors believe to be important, it was crucial to see what practices they espoused or 'advocated'. When the data was cut using the 'advocated' element in particular, the emergent clustering into seven themes was clear.

By code occurrence five of the key clusterings or themes were around strategy, culture, 'preparatory' activities, financial aspects, benefits' monitoring – all of these being key activities by Directors; and then two key categories relating to behavioural dimensions, namely the role of the Chair and Board Culture, necessary to foster robust challenge and debate and effective communication and alignment.

The final set of codes that were settled upon therefore was:

1) Strategy
   - Emergent Themes Strategy Enacted
   - Emergent Themes Strategy Advocated
   - Emergent Themes Strategy not applied
2) Culture
   - Emergent Themes Culture Enacted
   - Emergent Themes Culture Advocated
   - Emergent Themes Culture not applied
3) Process, Preparation, Planning, Philosophy
   - Emergent Themes Process, Preparation, Planning, Philosophy Enacted
   - Emergent Themes Process, Preparation, Planning, Philosophy Advocated
   - Emergent Themes Process, Preparation, Planning, Philosophy not applied
4) Business Case Review DD[158] and Risk Assessment
   - Emergent Themes Business Case Review DD and Risk Assessment Enacted

[158] Due diligence

- Emergent Themes   Business Case Review DD Risk Assessment Advocated
- Emergent Themes   Business Case Review DD Risk Assessment not applied

5) Benefits tracking
   - Emergent Themes   Benefits tracking Enacted
   - Emergent Themes   Benefits tracking Advocated
   - Emergent Themes   Benefits tracking not applied

6) Challenge and Chairmanship
   - Emergent Themes   Challenge and Chairmanship Enacted
   - Emergent Themes   Challenge and Chairmanship Advocated
   - Emergent Themes   Challenge and Chairmanship not applied

7) Communication and Chemistry
   - Emergent Themes   Communication and Chemistry Enacted
   - Emergent Themes   Communication Chemistry Advocated
   - Emergent Themes   Communication and Chemistry not applied.

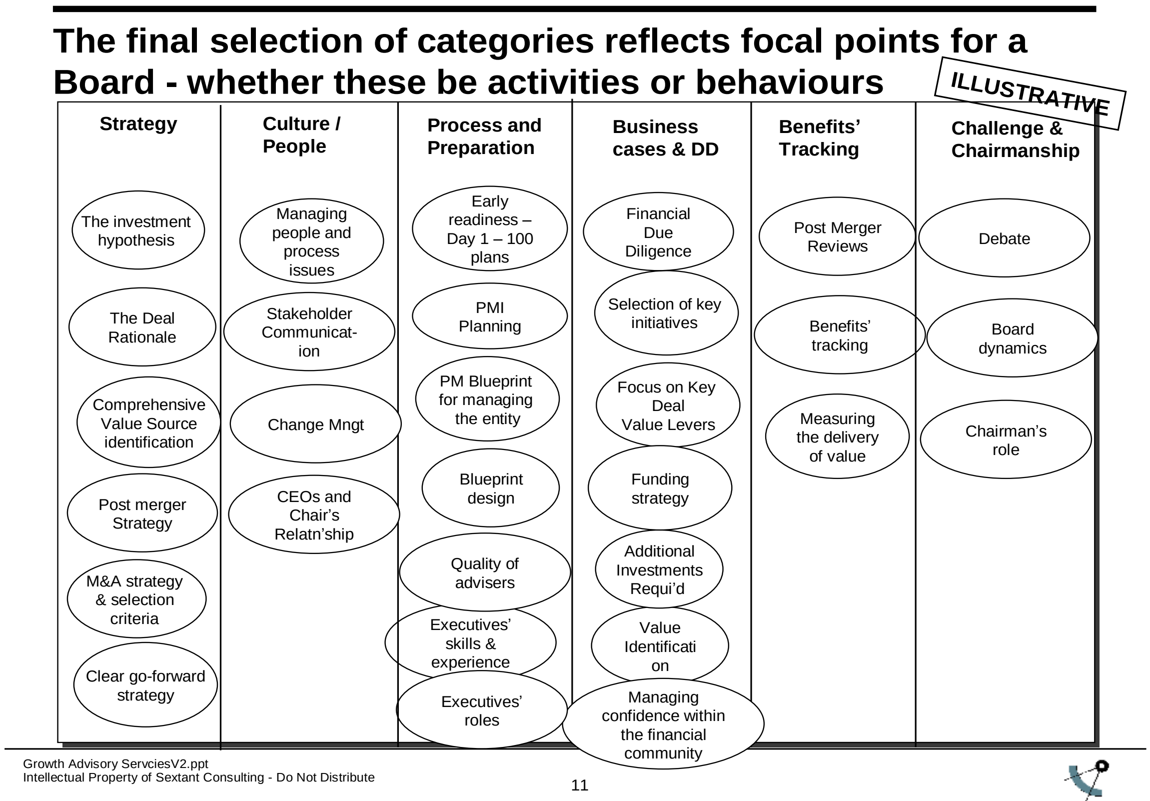
A final step then took place: the sixth and seventh coding groups were ultimately combined as they were so closely intertwined. It was recognised that category 6 and category 7 in the coding structure described above were in effect flip sides of the same coin i.e. the way a board is chaired is a key determinant of the extent to which (a) dialogue and challenge is encouraged and (b) quality of communication and chemistry is created. Coding these as independent categories did not provide any noticeable incremental benefits.

After rigorous testing, these codes were felt to offer the best categorisation of themes and constituted a balanced and complete set of defendable options that met the requirements of the MECE principle i.e. 'mutually exclusive and collectively exhaustive' in relation to the full set of data points. Collectively the codes appeared to represent a range of key factors that the literature had been flagging, namely the need for the board to have satisfied itself that:

- Management was putting forward the right acquisition strategy.
- Management was following 'due process' and was properly prepared.
- Business cases were sufficiently robust and that adequate funding was in place.
- Benefits' tracking was taking place to maintain momentum and to keep the board reliably informed.

The last factor, namely 'Challenge and Chairmanship', was not something that related specifically to M&A but had been flagged in the literature as an ingredient for successful, high performing boards.

Figure 22: Final categorisation by key focal points (actions and behaviours)



Source: Dean Blomson (thesis author)

In particular, it was the 'advocated' dimensions of each theme that was most relevant to understanding what Directors believed were most important and that boards ought to attend to.

6.3 High level themes emerging from interviews

From the coding of emergent themes indicated above, six key findings have emerged which in combination could be the essence of what directors ought to be focusing on to assure to more successful M&A results:

1) **Clear strategy upfront:** The board has to be centre stage with management in intellectually owning the strategic direction and specific conclusions about where and how to grow the business – without that clarity, evaluating **strategic fit** becomes problematic;
2) **Early preparation and planning:** the board needs to know that management has established the M&A processes, policies and planning upfront. It also saves confusion and distraction if the board and management are well-aligned on their M&A philosophy before the opportunity hits; whereas trying to develop a shared perspective in the swirl of the transaction adds additional risk;

3) **Proper understanding of culture:** this is always important but in some transactions it is critical. The board should ideally know **before** the deal is done that management has conducted an assessment of the target company's cultural compatibility (incl. attitudes, values, behaviours, leadership style, performance and reward systems, decision making processes and rights) ;

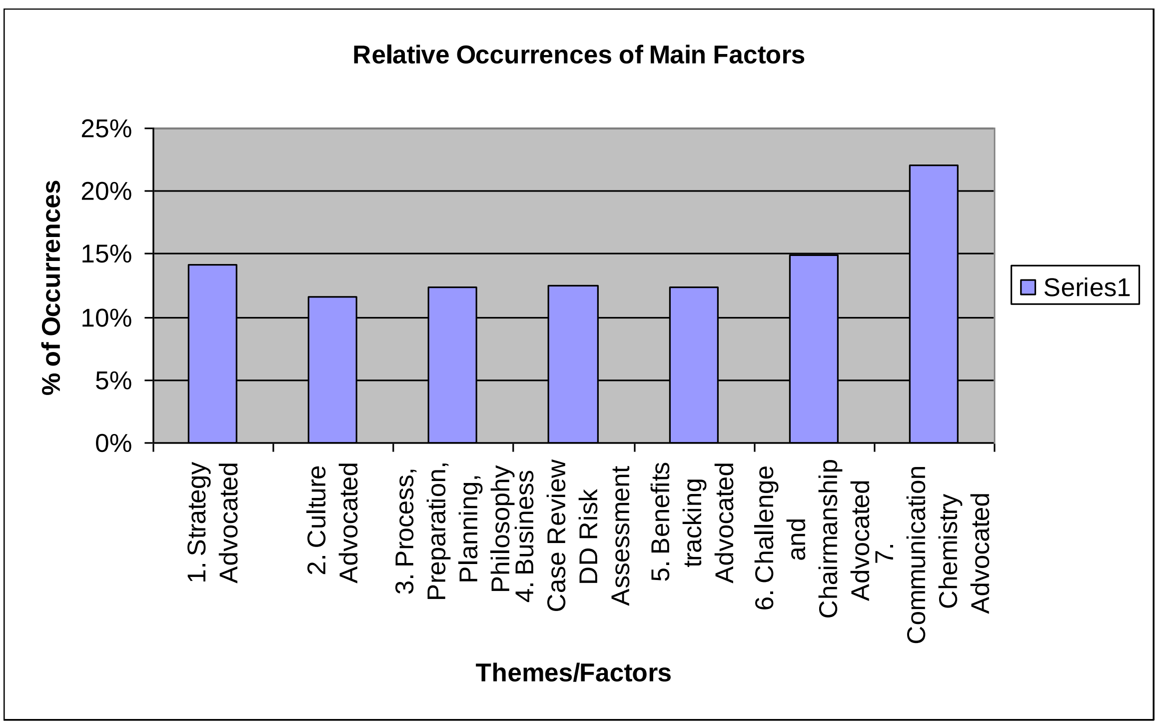
4) **Rigorous testing of the investment business case and funding strategy** (a) to be confident in its reliability and (b) to know how to fund it without putting the company at risk of financial duress;

5) **Regular control points post transaction**: having a clear point of view on the quantum and realism of synergies and what it will take to achieve the synergistic outcomes – resources, skills, management time, funding, operating model impacts – and then keeping the spotlight on benefits' tracking;

6) **Well-chaired board with constructive challenge:** this is perhaps the best guarantor of M&A value delivery – and protection for shareholders – where (a) the chair encourages healthy scepticism and insightful debate; and (b) board members have strong enough relationships to constructively challenge each other and management.

These themes arose directly from the coding of remarks captured in the interview transcripts and are depicted in Figure 23 below.

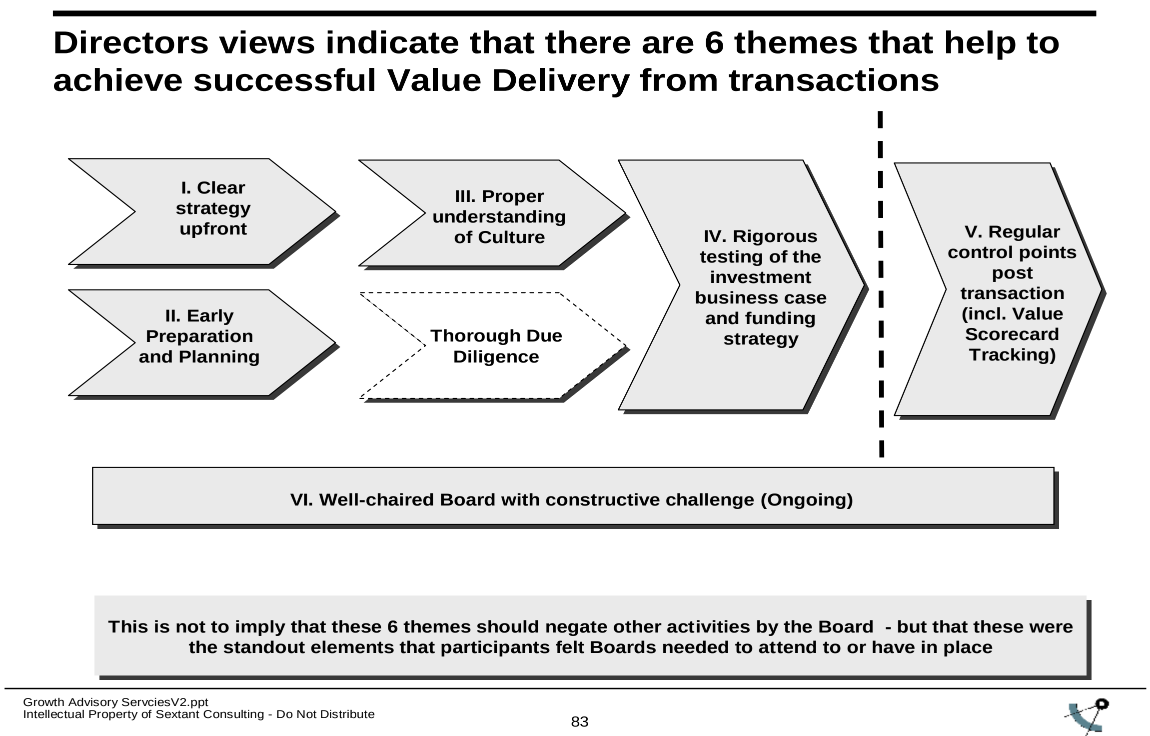
Figure 23: Coding of emergent themes



Note: As indicated above, category 6 and category 7, in the coding structure outlined in the diagram above, have been combined, as these two factors are flip sides of the same coin.

The occurrences of references, coded from interview transcripts, to these themes are more or less the same, barring theme 7, which is a standout factor. The analysis of findings that follows, evaluates each of these six themes across five different dimensions, which are expanded on in Section 6.4 below. The themes are explored in the sequence in which they are mentioned above. This is not to infer that one factor is more important than another. Rather these themes follow a logical, sequenced process or a set of focal points for directors' activities and behaviours. These are depicted in Figure 24.

Figure 24: Assessment of six emergent themes



Source: Dean Blomson (thesis author)

One additional activity has been added namely 'Thorough Due Diligence'. This is an important item flagged in the literature as primarily the domain of executive management i.e. not a board activity per se. Nonetheless it has been represented in the diagram above as a 'ghost activity' for the board to have some oversight of but not a direct involvement in.

The reason for this addition also results from the strong endorsement of activity 12, '*Independent Valuation*', which should be carried out at the board's behest. An independent review is a key safeguard that non-executive directors have the right to request or commission, aside from their thorough questioning of management on their views of the value to be extracted from the transaction and testing the basis for their conclusions on the attractiveness of the target.

Lastly, as will be discussed further on, ‘a well-chaired board’ is a transversal, ongoing activity that overarches all other themes.

6.4 Detailed findings and conclusions on each of the six major themes

As described in Section 6.3, six major themes emerged from the codification of the transcribed interview content.

The analysis of findings that follows, evaluates each of these six emergent themes across five different questions or dimensions in turn, namely by addressing the following questions:

1) Do directors regard this activity or focus area as an important potential driver of deal success?
2) How important do they believe it is to have board involvement in the activity? (which draws on survey / questionnaire results)
3) Who takes the logical lead for this activity i.e. the board or management and how is that accountability delineated? (which also draws on survey results)
4) How does this factor, nominated as important by directors (as ‘right governance’ practice), relate back to the literature or theory i.e. does it align with, or diverge from or potentially plug gaps in the extant theory? (the ‘theoretical ought’ distilled from the literature review).

Each of the six themes has been considered as described above on a standalone basis – and where applicable in combination with other related factors, before considering the last question:

5) How does the theme link back to the overarching focusing question namely:

Does this aspect of directors’ or board activity or behaviour appear to form part of an emergent theory that points to how directors see ‘right M&A practice’? Does it provide guidance on how they believe they ought to operate, and is that likely to provide a clearer guide as to how to improve the outcomes from M&A?

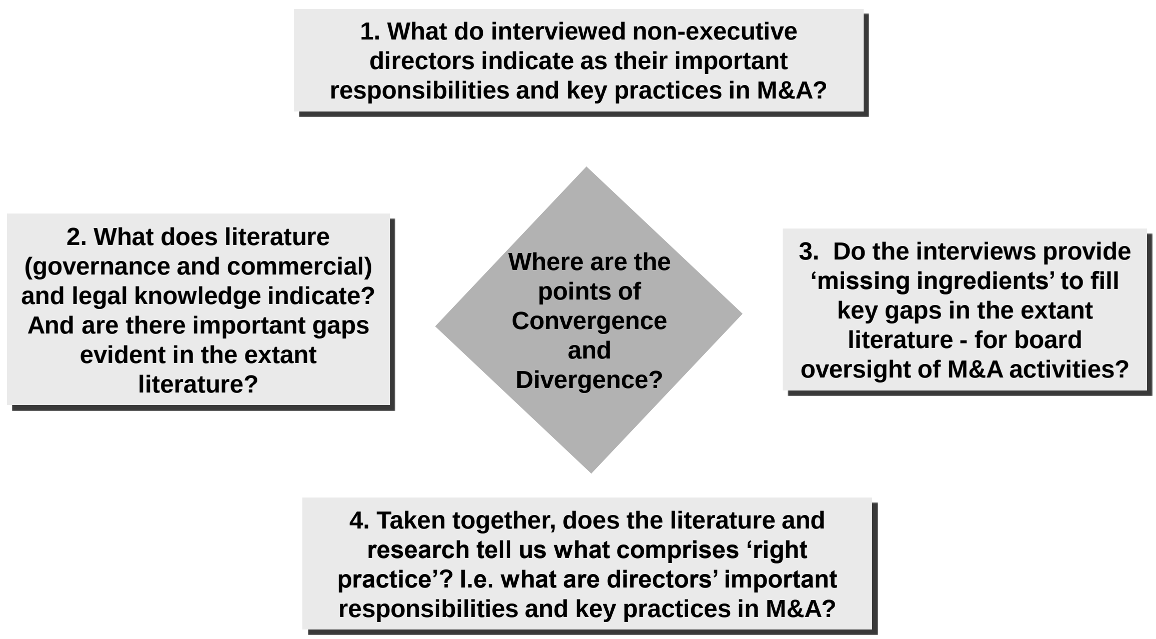
As indicated schematically below in Figure 25, against the construct first offered in Section 3.2 **Scope of research,** questions 1, 2 and 3 above relate directly to the first step below.

Question 4 above addresses steps 2 and 3 below by indicating whether there is a convergence or divergence occurring.

By exploring the alignments and gaps between interviewed directors and extant literature, it is hoped to describe ‘right practice’ in M&A governance – or to crystallise and improve the body of knowledge.

Thus Question 5 above should provide the answers for step 4 below.

Figure 25: A gaps' model to assess the extent of theoretical and interviewee alignment



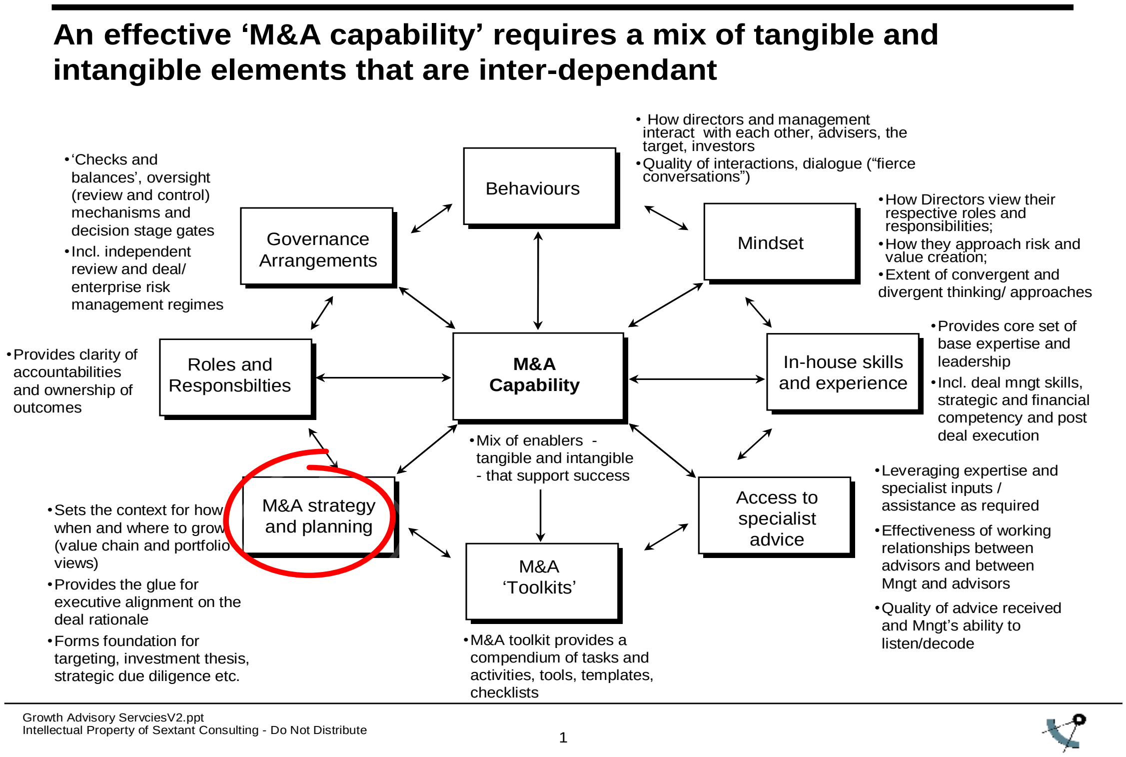
Source: Dean Blomson (thesis author)

Each of the six emergent themes briefly described in Section 6.3 will be explored below on a detailed basis against the five dimensions outlined directly above. The first of the six themes to be considered is **Strategy.**

6.5 Clarity of Strategy as a factor that could improve the success rates of M&A for the acquiring company

M&A strategy is addressed first, as one of several factors important to M&A capability (as depicted in Figure 26 overleaf), and is the logical starting point nominated by directors for embarking upon a transaction process. Firstly therefore, why is an M&A strategy seen by directors' as being important?

Figure 26: Understanding the various factors comprising an M&A capability set



Source: Dean Blomson (thesis author)

Perceived importance of strategy as a driver of deal success (or as a focal area for directors)

M&A activity can typically commence in one of two ways: (a) as a deliberate decision to grow, often with clear specifics on where and how and sometimes with whom; or (b) as a largely unplanned reaction when an unsolicited approach is made or a target of opportunity 'pops up on the radar'. Of course there is a range of alternatives in between, where management and the board have thought through the corporate growth strategy with varying degrees of rigour and detail.

Board interviewees certainly recognised the possibility of the unplanned M&A event i.e. that a company has not thought through where and how it intends to grow and a deal presents itself unanticipated 'from left field' – and that 'temptation' may then become the catalyst for an acquisition or merger to take place.

As one board member and ex corporate executive said in his interview:

> *"So if you don't have that (a strategy) then …you can end up stumbling from one deal to another. And maybe some companies are lucky, they just stumble across a deal and that determines their strategy but it's not the way to do it."*

This is not to say that such a start necessarily dooms the transaction to failure; rather the view is that the consideration of the merits of a transaction should be undertaken in an unhurried and properly reflective way.

Strategy – in the sense of having a clear view that articulates the company's growth intentions – should be the logical starting point of the M&A process. This thesis does not seek to prove empirically that companies with a clear M&A strategy are more likely to make a success than those without, but the interviewees were clear in their views: having no M&A strategy is risky; and developing such a strategy on the fly, in the swirl of a deal, is best avoided.

Strategy was certainly noted as a key factor by directors in interviews, and similarly it does receive special mention in the commercial M&A literature, unsurprisingly. Harding and Rovit for example, two directors of Bain and Co., say[159] that:

> "…deal making is an extension of a company's business policy, or strategy. Before a company can form a valid opinion of a potential deal, it needs to assess whether an acquisition will further its growth strategy. The decision to acquire must demonstrate that it will strengthen the firm's overall business portfolio… Making mergers work is inseparable from strategy. You need to have an investment thesis in order to make a strong acquisition."

Harding and Rovit go on to say that the best performers have a very clear view of what their core business is (or their business definition and core competencies) and what their business formula or business model is for making money. (Harding and Rovit 2004, at pg. 38/39).

This understanding is a critical ingredient for working out where to grow (without straying away from one's core focus and competencies) and how to potentially make money from a specific target. These and other authors do not expressly say: "Before you do anything else, invest the time and effort in a deep analysis and detailed conversations between management and the board about your M&A strategy." Possibly this is so self-evident to professional strategy practitioners that it doesn't need to be stated, but it comes through as a pivotal activity in the opinion of those directors interviewed as something that the directors and the executive team ought to (a) invest the time upfront on; and (b) ensure that they are on the same page.

Strategy, in the holistic sense – rather than a more narrowly defined M&A strategy – is recognised as a critical activity for board involvement in some of the literature. Jay Lorsch and Robert Clark, writing in the April 2008 *Harvard Business Review* at page 108, state:

> "The obsession with quarterly earnings impedes boards' ability to plan for the long term. Some business leaders argue that all their companies need are short-term goals and results. After all, the long term is made up of a series of short-term accomplishments, they point out. We strongly disagree. We've been on boards where directors and management were so absorbed with quarterly earnings…that they were slow to recognize trends that ultimately created problems for their organizations…. If companies are to succeed in the

[159] Bain & Co., *Mastering the Merger*, 2004, by David Harding and Sam Rovit at pg. 9

> global economy, their directors and top executives need to have a clear view of where they want their organizations to be in five or 10 years.
>
> Most directors will say they squeeze some time into their meetings to discuss what they call 'strategic matters.' In most cases, however, they're actually talking tactics: They're answering questions like 'How did we do last quarter?' and 'What do we need to do differently in the next three months?' The metrics considered are almost always financial, because that is a language that directors with different backgrounds share and can converse in knowledgeably. Strategic capabilities such as technology or marketing often get only limited attention. When the company's ultimate destination is always just 90 days away, neither the board nor the senior managers will have the time or incentive to draft explicit and well-articulated long-term organizational goals." (Lorsch and Clark 2008)

Conversations on strategic direction and intent are seen as critical activities for board input not just in the literature but by the interviewees themselves:

As one interviewee put it:

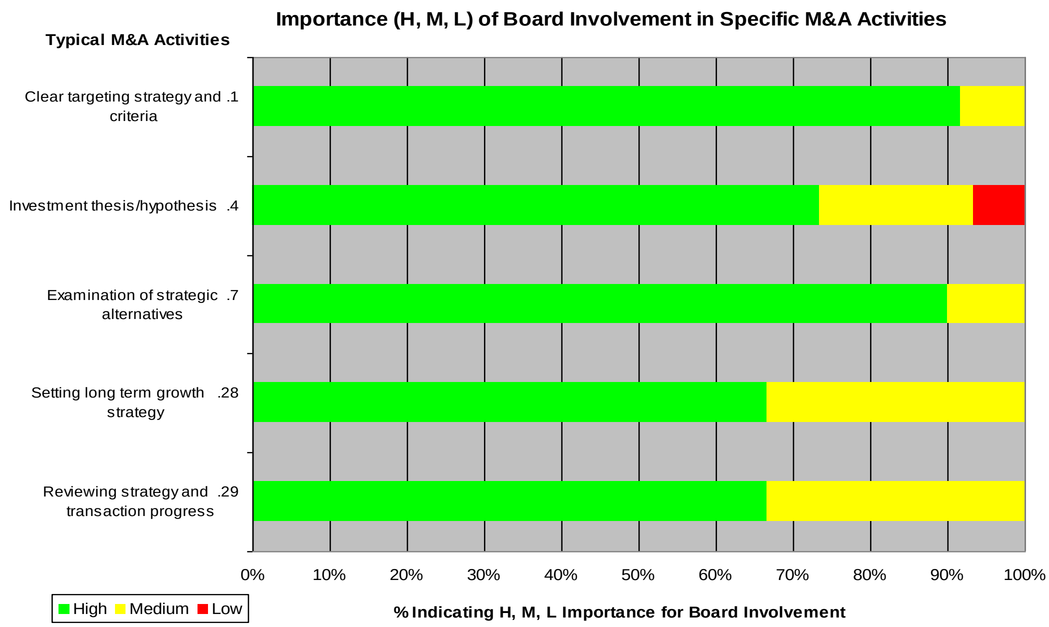
> *"So the custodians of the strategic clarity I think is the board. The three functions of the board in my mind are the overall governance of the organisation, the strategy, and making sure we've got the best CEO that's possible for the business….but …the board can't walk away from saying 'well the CEO saw an opportunity, it was cheap so we thought we'd buy it, but …it makes no strategic sense whatsoever'"*.

Having considered the role of strategy, how important is it for directors to become involved in selecting or approving it?

How do directors view the importance of their participation in M&A Strategy?

The short survey provided valuable input to the importance directors attributed to key M&A activities. As indicated in Figure 28 below, directors were near to unanimous in the importance of having board input into the *M&A targeting strategy* (#1), the *consideration of strategic alternatives* (#7), *setting growth strategy* (#28) and *reviewing strategy and transaction progress* (#29).

Figure 28: Importance of Strategy involvement by the board



Source: Dean Blomson (thesis author)

Involvement in the Investment Thesis (either in co-developing it or reviewing it) was never mentioned or nominated specifically in the (unprompted) interviews but came through strongly in the questionnaire (of prompted) responses. Interestingly too, no directors made the express link between the importance of having an investment thesis and using it as a focal point in undertaking a commercial or *strategic due diligence* (activity #17), although clearly they regarded having some input to the investment thesis as important.

As one interviewee put it, the foremost question is:

> *"Well the main thing is does it align with strategy? I mean hopefully you don't just fall into a transaction, ...I know transactions are opportunistic and they do come up quickly, but the planning process should be starting two to three years prior in terms of where the company wants to go, particularly if the transaction is in something that's new. You know, a new area of either geographically or of core capability; then… it really has to align with strategy; there's nothing worse for a board than management walking into a room with 'this is a great opportunity' and that's it. It looks cheap but how does it fit in, what can we add to it, ...does it suit us culturally, hundreds of questions."*

Despite having developed a clear M&A strategy, some transactions may and often do present themselves as targets of opportunity. In many cases boards receive unsolicited approaches from investment bankers with pitch books on specific targets. Sometimes these opportunities can be evaluated in the context of a well-researched and clearly described targeting strategy developed by the business; in other cases, such approaches bring added risk where there is absence of a M&A strategy. The message from directors is clear: "Do the analytical groundwork first and if or when those companies on the target list come into play, then you can move fast and with confidence" (author's own wording).

As one very seasoned chairman explained it:

> *"I think that there are a number of very important indicators for what would really be a successful transaction. The first is that the board is not surprised by it. Undoubtedly the best transactions I've seen and the best boards in this regard and the most contributive that boards can be is where basically it's a learning curve that they start to see the sun coming up on the deal years maybe before it occurs. That they watch it, that they nurture it… then they spring and then they do it. …there is a PhD in a thesis of those who were opportunistic and quickly dived in versus those who have watched over time and I would lay almost pounds to peanuts that the ones who do it over time are the better deals."*

The same interviewee went on to say:

> *"…not every company can be perfect …but if we're dreaming of a perfect thing, (at) some time, let's say at year zero, somebody starts to develop the whole series of (thoughts about) where the company should go and what acquisitions could take it. They test with the board their knowledge of each of the companies. They work through where each of those company acquisitions will take the company both in direction, in its viability with its debt, with its equity position, all aspects, and they keep testing where these companies are going…. Management is concentrating, working through, and then either comes the event that allows one to spring, or a time thing where you say I'm ready to go. That is the best. .... I don't know that I've ever seen ....a great transaction which has been done overnight in an area that the company hasn't been contemplating, ...generally those deals have .... spelled the end of a company."*

These were not isolated views. Directors generally recognised that without clear and early engagement with management on a growth strategy – that provides clear guidelines for M&A activity – the risks of a successful takeover would diminish and the board would essentially be failing in its stewardship.

As one interviewee put it:

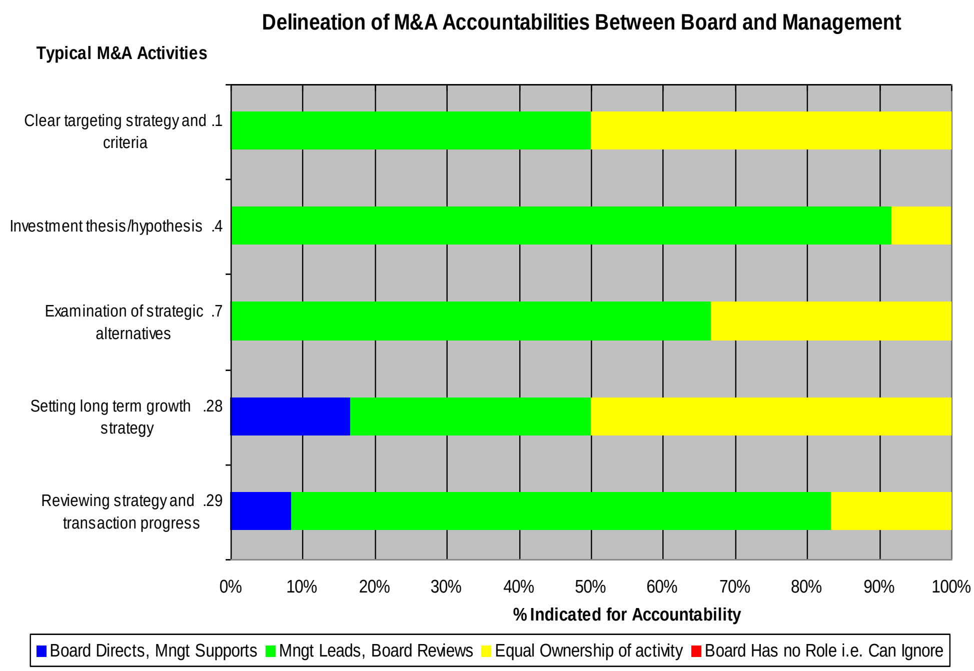
> *"…to me, the board can't walk away from saying "well the CEO saw an opportunity, it was cheap so we thought we'd buy it, but you know, it makes no strategic sense whatsoever".*

The delineation of accountability for this activity

The survey questionnaire also provided important guidance as to how directors saw accountabilities being delineated for a range of M&A activities.

As indicated in the figure below, the delineation of responsibilities for managing the corporate strategy is split between 'Management Leads' and the board having 'Equal Ownership'. This is a clear indicator of the high level of importance that these directors place on their involvement in the growth/M&A strategy.

Figure 29: Delineation of accountability for strategy



Source: Dean Blomson (thesis author)

To see the emphasis directors placed on different aspects of strategy involvement outlined above, relative to all the other factors, refer to Figure 29 above.

From Figure 29, it is clear there are strong views about the board having an involvement in key aspects of strategy. This begs two questions: 'How broad is the Strategy *process*'? And 'What is meant by *Involvement*'?

As to the first, the typical strategic management process followed in organisations could range across a set of key strategy sub-processes or activities: scenario development (future opportunity scanning); formulation of strategic intent and direction setting; detailed strategy development; budgeting and planning; performance measurement and monitoring. 'Strategy' is a process (and an outcome) that covers quite a broad spectrum of activities or sub-processes.

Interviews with directors were not focused on their views about their involvement in what could be called the strategic management process. How directors involve themselves in this process, end to end, and how their involvements vary by sub-process as described above, could be fertile ground for another PhD study.

Rather, strategy involvement for the purposes of this study should be interpreted broadly, as the board's involvement particularly in those aspects of strategy that deal with growth through M&A or transactions (as a corporate strategy could include many other dimensions including organic growth).

Regarding the second question, namely what is meant by involvement, views ranged from board members being active participants in strategy formulation with management, to vetting the strategy, to monitoring its execution.

It would be fair to say that whilst there was a spectrum of views about how good or otherwise their boards were at these various activities, without exception directors advocated being 'active and involved' rather than being 'passive and monitoring'. The interviewees described a set of critical strategy related activities that they variously believed boards should attend to:

1) Taking a long term view

> *"I see the board's role as actually helping management, when management are in the boardroom, helping management actually think long term because it's very easy to get caught up in the day to day."*

2) Keeping to a strategy driven agenda

> *"I think that every board meeting should have a strategic element to it…. and if you think about it really early then bringing in these transactions is easier because everyone's got a part of their mind on the next five years not just the next two years."*

3) Ensuring strategic clarity

> *"So the custodians of the strategic clarity I think is the board. …the three functions of the board in my mind are the overall governance of the organisation, the strategy, and making sure we've got the best CEO that's possible for the business, …and that person then sets the tone of the organisation..."*

4) Testing and co-developing strategy, not instigating it

> *"…I believe firstly a board is to be very involved in strategy… The question is, what is a board to do in strategy? I'm not totally convinced that a board should be an instigator. …a board to me makes the determination of the CEO and they should look to the CEO to instigate strategy. The board's job is to test that strategy, to develop that strategy and then to determine what comes from that strategy. I think it's quite dangerous to allow the board to instigate strategy. They are not in the market place generally. My perception …of a board… is that they are not the experts on what*

they're doing and shouldn't be…It always reminds me of the guy who's about to serve the ball. We are there to make sure that his feet are in the right place, that the ball toss is right, that the racket is facing the right way and that it is correct for him to send that ball at this time."

5) Signing off the strategy well before any deal making takes place

> *"I think management should own the strategy and plan and obviously the board should sign off on it and support management in a certain directions. But ultimately management should bring the targets to the table... So suddenly there was a succession of deals that came before the board….. The board, again, lacking a strategic framework, just sort of said, "yeah go ahead management" and then put in… reasonably robust processes around it. So it seems to me it's fundamental that the strategy is absolutely signed off on by the board of management and then the management is free to actually execute. And here we had a company without a clear strategy, with a desire to do something big, on which the board and management were aligned and potentially I think it could have been quite damaging had they moved forward."*

6) Acting as a sanity-checker and advisor

> *"So you are ….not running the company, you are not setting strategy. The board guides, the board tries to query and open the eyes and highlight the risks and ensure that things are in line with the strategy that has already been set. But the board does not set the strategy and doesn't run the company, so if management is hell-bent on doing it there is not really very much the board can do."*

7) Acting as the 'keeper of the faith' and active monitor of strategy

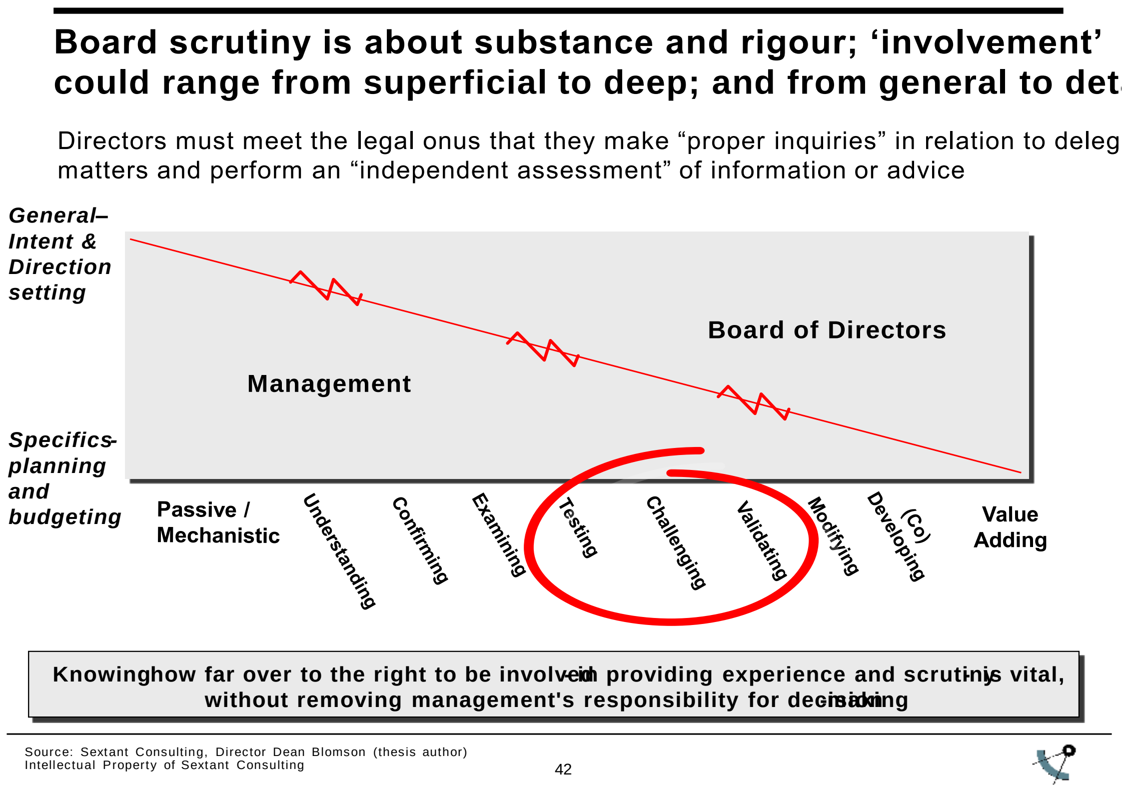
> *"…when I said before that the board doesn't set strategies, the board is charged with the role of keeping management aligned and accountable to strategy, so if it's starting to go off pace then that's where the board really needs to be tough and I think that's a hard thing to do because management are all really excited and you are going to really piss them off. But that's where the board has to be strong and not over pay and not continue with something that's actually maybe when we got a bit closer is not as good as we thought. But that's the hardest thing to do. It's really hard to pull back on something once its down past a certain (point), you may have spent two or three million dollars and to pull back is a hard thing to do."*

The above opinions therefore point to a spectrum of views on what should constitute board involvement in strategy**:** from critical review and approval of strategy; to testing and sanity checking; to participating in development; to co-owning the strategy; to the board being the ultimate custodian.

Diagrammatically, as indicated in Figure 30 below, a board's involvement in strategy (that drives growth and/or M&A), could range across a spectrum of participation. Technically any board could consider itself involved at various stages of the continuum, but arguably the level of ownership, commitment and accountability increases from left to right.

Whilst there is no ‘one right answer’ about the degree of involvement, the weight of interviewee opinion is that ‘right’ practice should place a board somewhere in the middle – not just understanding or confirming – and not going to the extent of co-developing – but rather with a significant focus on testing and challenging.

Figure 30: Spectrum of value-adding involvement in strategy



Source: Sextant Consulting, Director Dean Blomson (thesis author)

Typically a board is able to provide an important contribution to management in testing M&A strategy in that they have the benefit of perspective through not being involved in the day to day running of the company. As a council of ‘informed sceptics’ it is their responsibility to really scrutinise the relevance, rigour and risk associated with a M&A strategy and decide whether they can honestly claim that this is likely to be in the long-term benefit of shareholders.

Whilst involvement in the strategy detail may ebb and flow across boards and across the various stages of the strategic management process, interviewees were clear on the importance of their involvement.

As indicated in Figure 29 above, there is a strong representation of views shared almost equally between those who said “Management Leads, Board Reviews” and those who indicated there is “Equal Ownership” for the various strategy related activities. The convergence of opinion around direct and active board involvement in strategic issues is noteworthy and perhaps not surprising.

The scoring indicates in essence a view that effective stewardship starts with the setting of strategic direction that the board has been actively engaged in – either as co-author or reviewer.

How does this compare to literature studies? As covered in Section 3.3.11 "The role of the chair and board in helping to set direction and select strategy", research indicates a consistency of conclusions with this thesis, namely that chairmen and board members regard their involvement in strategy as crucial, although the same dichotomy of views is represented in literature as to the extent to which the board should shape or co-develop management's strategic agenda. Regardless of quite where the boundary may be drawn for each board, recognition of their complimentary roles, however, is vital.

The implications for board accountability are inescapable. The responses indicated in Figure 30 above and from the interviews conducted, indicate in effect a strong sense of ownership by and accountability of the board for the M&A strategy.

Implicitly these results are indicating that the board members believe that if they sign off to a strategy that is materially deficient – where for example it takes the company into geographies or markets or parts of a value chain where it ought not to go, or they target a company that ought not to have been targeted – they are fully complicit in that decision.

Responses to the questionnaire and to the interviews indicate that as far as growth strategy generally and M&A strategy specifically are concerned:

- There is a critical requirement for board input and sign-off.
- The strategic thinking should be done well before the first transaction commences.
- The strategy must be clear as to intentions and preferences e.g. regarding targeted markets, segments, which part/s of the value chain.

Explicitly most participants recognised that the strategy is a key foundation and context-provider for M&A activity – not simply a 'nice to have' or a window dressing:

> *"…it is essential that ahead of time as I've said, you've worked out the end product of what you want to do. Your strategy is clear. Should you be going worldwide? Should you be just local? Are you looking to stay in one particular industry or move into another? That has to be abundantly clear. It has to be agreed upon because if you don't agree upon it you better debate it out… I think the better thing is to have clear direction, clear understanding of the market and be opportunistic within what you're aiming to do….And you can buy…. expertise on how to get an M&A. You can buy expertise on how to do the funding on M&A. You can buy expertise on how to do the due diligence on M&A. What you can't do is to buy …the actual strategy and also the understanding of your industry. Your CEO generally…. understand the market better than any adviser and if they don't I've got the wrong CEO."*

Several directors indicated that if the growth strategy was too permissive i.e. open to wide or varying interpretation, it was likely to lead to potential misadventures. Clarity is critical. As another director put it, in relation to a less than successful venture offshore where the strategy was possibly too permissive:

> *"So I think that whilst we stayed broadly within the parameters of a stated and agreed strategy, it was quite broad the strategy and I think it was used to suit the circumstances…"*

For those boards that may think a generally worded / stated intention of growth that is endorsed by the board is adequate, here is what one director said:

> *"I mean every organisation I've been involved with, you have your strategic direction that you want to follow, from where you are today and where you'd like to get to. And that may or may not involve M & A activity. If it does, it's very, very specific, and very, very targeted. If it doesn't, it doesn't mean you don't extend the vision of management to consider it, if you could do it."*

Alignment of board practice and involvement in strategy setting to literature

The views espoused by interviewed directors relating to strategy are surprisingly given a relatively light touch in the literature which focuses on a more abstract (rather than practical) consideration of strategy activities by management. As flagged in Section 3.3.1, however, there is clear recognition of the importance of a targeting strategy and specifically an investment thesis about where and how the acquirer believes it will produce (superior) value from a potential target.

The commercial M&A literature and practitioners' guides generally expect that the acquirer, before reaching the point of engaging with a target, will have diligently worked through **whether** and **why** it needs to grow by acquisition, that is:

1) **Why** the business needs to grow via M&A relative to organic growth options
2) **Whether** M&A is the preferred alternative relative to JV or alliance options
3) **What** acquisitive growth will mean for the capitalisation and funding structure of the business (its profit trajectories, cash flows and dividend polices)
4) **What** impacts a (major) acquisition (or set of minor acquisitions) will have on other initiatives than the business needs to undertake
5) **What** level of scale is envisaged via M&A: a few minor bolt-on acquisitions or a momentum changing transaction
6) **Where** it needs to grow i.e. which markets, segments and parts of the value chain
7) **How fast** i.e. with what speed can the business accomplish the growth targets
8) **Whether** 'on paper' a particular shortlist of target companies represents the best option/s.

These may seem to be fairly obvious questions – although it should not be taken as a given that these are asked and answered in clear and rigorous ways in all larger company boardrooms.

Perhaps it is a fair assumption for commercial practitioners to make, that these questions have been asked and answered rigorously and that informed debates will have happened **before** any targets are approached. Whilst several participants clearly indicated the need for these conversations to take place early on, before any direct activity commenced, we should not assume that this is entrenched practice in most boards. We know that oftentimes boards receive unsolicited overtures from investment bankers bearing ‘pitch books’ of potential targets – and for some boards this becomes the catalyst for these kinds of discussions to occur.

Of course what really matters is the quality and rigour of the analysis and debate about growth through M&A: the “why, where, when, who, how?” type conversations, as stated above. So whilst the consensus view of interviewees is that M&A strategy is crucial for directors to engage on, the corollary questions about quality and frequency of these conversations were not explored specifically.

The directors’ view of what ought to be done, flowing from interviews, is clear and unequivocal. Those NEDs interviewed were unanimous in saying that the M&A strategy is a critical matter for board input; and there was significant convergence that this is an activity that board and management both ‘own’ or share. For activity #1, “Clear targeting strategy and criteria”, 6 out of 12 indicated they believed there was co-ownership and 6 said that “Management Leads, Board Reviews”. For activity #28, “Setting long term growth strategy”, the views supporting board involvement and responsibility were even more pronounced.

This view comes out clearly in the Figure 29 above.

If there is one possible criticism to be raised about directors’ views on the importance of a clear strategy upfront, it is that the interviewees did not explicitly make the link between the M&A strategy, the targeting criteria, the investment thesis and the strategic due diligence. It is fair to say, however, that these links are often not explicitly made in the literature either, but there needs to be a nexus or thread of logic connecting these activities. If the strategy is deficient (ill-defined or illogical), the context for subsequent activities (such as due diligence or the type and style of integration undertaken) becomes less clearly defined. Whether this linkage was readily apparent to those interviewed is hard to say.

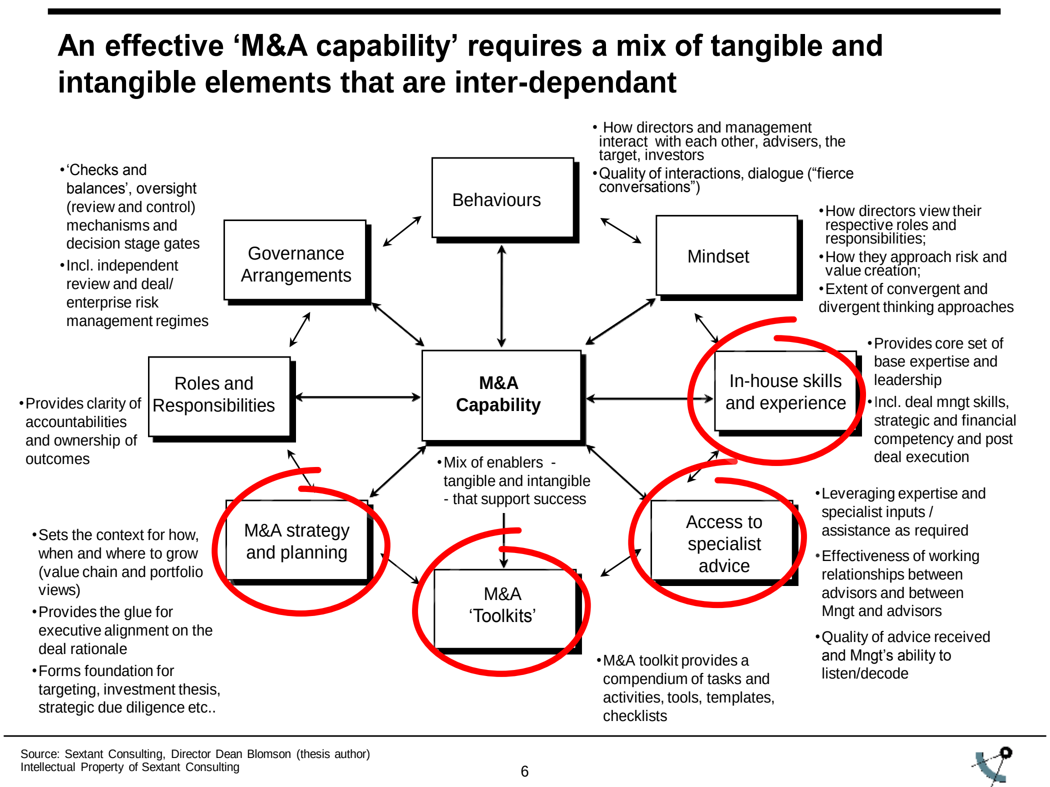
Having explored at some length the need for board involvement in M&A strategy, attention should turn to the second key theme arising from the coding of interview opinions namely to directors’ involvement in early preparation and planning. This relates to the board members needing to know that management has established the M&A processes, policies and planning upfront. It also saves confusion and distraction if the board and management are well-aligned on their M&A philosophy before the opportunity hits – trying to do so in the swirl of the transaction adds additional risk.

6.6 Perceived importance of early planning and preparation as factors that could improve the success rates of M&A for the acquiring company

This theme explores the importance of planning and preparation, which came through in the interviews as being of considerable importance.

In the literature review, the role of having the necessary ‘M&A tooling’ was raised as part of a broader conversation about having M&A as a core capability in the business. A ‘toolkit’ is shorthand for a range of foundation elements supporting the smooth running of a transaction: processes, templates, policies, guiding principles. It implies there is a 'tool box' which the M&A team can access to support the smooth operating of a transaction. This is part of building a repeatable, industrialised M&A capability so the M&A team can swing into action at relatively short notice and not be inhibited by a lack of pre-considered policy, procedures or processes to follow.

Figure 31: Understanding the various factors comprising an M&A capability set



Source: Dean Blomson (thesis author)

How do directors view the importance of planning and preparation?

The importance of developing the M&A strategy in advance of any transaction has already been highlighted in Section 3.3.1. The view of participants is that M&A activity should not be left to happenstance or become driven by the relatively random arrival of new opportunities – but that consideration of the merits of any transaction must be undertaken in an unhurried and properly reflective way rather than in the swirl of a deal. Similarly, the early planning and preparation that goes with thinking about M&A prospects was also highlighted.

Directors stressed this point in a variety of ways:

> *"I mean hopefully you don't just fall into a transaction…. I know transactions are opportunistic and they do come up quickly, but the planning process should be*

starting two to three years prior in terms of where the company wants to go, particularly if the transaction is in something that's new… then… it really has to align with strategy…"

"So therein lies one of the points that I think is really important for a board is the pre-planning and strategically making a decision about well 'we want to expand our business in that particular direction' and then patience and persistence."

"I don't think there's any question that the macro learnings are about proper preparation, about understanding the fit, about incredibly good due diligence and not necessarily financial due diligence and ticking boxes."

As a theme therefore, M&A planning and preparation was nominated in interviews as being important, but delving into what that may mean, and how directors participate in and/or exercise stewardship over such planning by directors, should be explored next.

Boards' involvement in ensuring there is proper planning and preparation

As indicated in Figure 17 (the Importance of Board Involvement in a range of M&A Activities – Questionnaire Responses), Activity #2 "Well documented M&A process / methodology" is ascribed a fairly high level of importance.

In interview transcripts, however, it came through more strongly as a significant factor. This is but one aspect of preparation. Activity #1 "Clear targeting strategy and criteria", Activity #3 "Clear / formal deal parameters", and Activity #5, "Selection of professional advisers" should also be regarded as preparatory activities.

The board was seen to have a critical role in (a) ensuring that planning is appropriate and is done upfront; and (b) maintaining its perspective, so as to provide effective guidance to management.

"So having …invested in the relationship building and having the forum where those sorts of conversations can be had and have to be had, is a very important part of the pre-planning of the thing like this. Because once you're in the eye of the storm….it can go anywhere and therefore maintaining that sort of, on the dance floor or on the balcony, and you've got to doing both. But having said that …I think you…. have to keep coming back to, 'am I comfortable that the principals that we are using to make our decisions on all sorts of different areas are right, and is the process right?' And that could be 'have we got the right people, is the process being done sufficiently rigorously enough, in the right sequence?'"

The question then arises: is it the board's role to lay the groundwork and to undertake the necessary preparation or is that the responsibility of management?

The delineation of accountability for this activity

As indicated in Figure 18 above (Delineation of Responsibilities / Involvement in a range of M&A Activities – Questionnaire Responses), Activity #2 "Well documented M&A_process /

methodology" is clearly marked as one that "Management Leads, Board Reviews", although a few directors did ascribe parity of ownership to it.

The view appears to be that management is primarily <u>responsible</u> for carrying out this activity, but the board is <u>accountable</u> for ensuring that is it is done satisfactorily.

The importance of preparation and groundwork came through clearly in the interviews and the views of participants can be summed up around a few key activities that were seen as important to success:

1) By undertaking the analysis of a target/s, competitive intelligence and monitoring on an ongoing basis upfront:

> *"…they run files on potential acquisitions and all of them, and they just keep calling them, the file. So you'd dust off the file, update the information, which goes to discipline and persistence and preparation and those sorts of things which, from my general experience in other places, I would suggest that not often is done. It is more opportunistic."*

2) By ensuring there is an effective end–to-end transaction management process in place

> *"...good process is an essential part of maintaining the discipline and to me the project management, that's what it is. You set an expectation, you keep monitoring it….And …to me an M&A is no different than an IT project... or a building that you're building, you've got to have the project management skills to enable that to happen. So to me a primary function of the board is to make sure that that process and people are in place."*

3) By having the necessary project management skills

> *"So I think one of the great skills that is needed in the whole M&A agenda is project management…..I grew up in a project management school in [Co. X], I passionately believe it….. So I've put my bias on the table. But if you just think about the ….the merger with* [Co. Y]*…., one of the senior team ….was the full time integration manager. We had 54 different projects, separate projects underway and this is in the next phase of the integration of, once you've done the deal and somebody's signed the cheque, then …that's only just the start."*

4) By developing with management a set of guiding principles, philosophies about integration and parameters for the deal

> *"And they came back with what we called our principles diagram. And …the number of times ….when the going got tough in the integration, we kept putting the principles on the table and saying, what we agree is a principle was this….. Merging two businesses like financial services businesses, in reality, you know, you have a blue one and I have a green one. So most people then say we'll have best of breed, which I think is a grossly overused phrase. We adopted a principle that it's A or B not C.*

Because, you think of the commercial realities of that, you can't say to the investors of the blue one and the green one, well bugger off because we don't do that anymore. So you are forced to keep them both going. If you then compromise and don't make the hard decisions, you also create the best of breed which is now a pale blue one, and your cost synergies go out the door...."

"So…just thinking through those set of principles that ….I've used it always in terms of well before we start getting into the detail what are the guiding principles were we going to adopt in whatever we need."

"So that just at the cool light of day go back to your principles. Why are we doing this? What are the parameters that we set in terms of our expectations and returns, etcetera, etcetera?"

5) By ensuring suitable professional service providers are in place

"…one of the things in terms of the pre-planning phase from a board's perspective is understanding where the capability resides for the things that you might want to do. Now ….which investment bank are we going to use? Which law firm are we going to use (for) due diligence? Which cultural assessment function are we going to use to assess, well what are we actually buying here? You don't want to be doing that in the heat of the moment in the transaction to say "Well, you know, let's get six management consultants and have a beauty parade".

"I think that …if your strategy is M&A you've got to have a whole series of capabilities either internally or externally, and the board should be sort of saying…'where is the relationship building that's going on in the cool of the day rather than in the heat of the transaction?', which sometimes, in my experience in other places, doesn't happen."

6) By making sure that a realistic level of pre-planning and checking has taken place

"So …it's 'plan for the worst and hope for the best'."

"…I guess the thing I would say is tick as many of the boxes as you can, and answer as many of the questions as you can before the inevitable deal frenzy takes over. Cause with the best will in the world, it will occur. Cause people actually want to do transactions."

7) By checking that the pre-thinking and preparatory analysis has been done satisfactorily

"In a perfect world when I press the button to start to move towards mergers and acquisitions I know a lot about that company. I know where it fits in ours, I know what we would like to achieve. I know that the CEO is keen. I know my board are keen. It's made that a lot easier. Seldom is it as good when somebody bowls into the room and says I've met a merchant banker in a drunken soiree the night before. He's put to me this idea, never thought of it before but it looks great. That's a much more

difficult one. So assuming I'm in the position where I know it, these are the things that would come to mind. First, ...I know what it does for the company. Second I should say, if it is in our industry I know the industry…, if you're on a board for three or four years, as a non-executive director, you tend to know the industry."

8) Most importantly perhaps, the board needs to satisfy itself the various internal capabilities have been thought through and that capability gaps have been addressed

> *"I think you really .... need to understand very early on management's ability. I think if you look at a company like QBE you just see a great example of a company that understands acquisitions. And I think that a lot of companies think they do but don't, so I think ability to actually bed down and identify and then work through all the issues on them are fundamental to (M&A)."*
>
> [Q: Are they battle hardened?]
>
> *"Exactly and if they're not, which is possible and yet they still need to do them, then how do you surround them and the company with the appropriate skills. And that's not so easy because quite honestly I think most investment banks are right, and they're all smart. ....But you know today it's insurance companies and tomorrow it's a plant manufacturer…. .*
>
> *So I would think that any transaction you are going to do you need to get in-house some of those really deep, deep skills to be able to understand the macro issues as much as anything."*

And:

> *"I think the capacity and the ability of the existing management to do it is fundamental to any transaction."*

In M& A literature, all of the above elements are essentially treated as management tasks: preparation, planning, proposed deal parameters, processes, project management skills and the selection and appointment of professional advisers. The view of participants appears to be that these are activities that "Management Leads" but the board must be able to satisfy itself that management has taken care of these preparatory activities to an adequate standard.

This goes to heart of the difference between stewardship and hands-on involvement: the board is ultimately accountable but often delegates responsibility for implementation to management; in order words, the board is accountable but management is responsible. The difference between accountability and responsibility is not simply one of semantics: it goes to the heart of agency.

In similar vein, the board ought to know that management has established the M&A policies, processes, and planning upfront. It also saves confusion and distraction if the board and management are well-aligned on their M&A philosophy before the opportunity hits – trying to do so in the swirl of the transaction adds additional risk and distraction.

The importance of a set of guiding principles or a 'deal philosophy' to aid in decision making has been clearly indicated above. Implicit in this view is that it is an activity that the board itself should take ownership for – to help it maintain its perspective when the going gets tough. The board also needs to independently exercise its mind as to management's capabilities i.e. are they up to the task?

Putting oneself in the shoes of a group of aggrieved shareholders for a minute, in a hypothetical transaction that has resulted in material loss, the litmus test for culpability from a societal perspective could be: "Did the board satisfy itself with adequate justification that the planning, preparation and competencies (in-house and external) were adequate for the task?" This is a notional test postulated from the shareholders' perspective, not the formal legal test; but from a public policy perspective this does not sound like an unreasonable 'reasonable directors' test.

Taken together, the eight elements in Figure 31 above comprise key components of what could be termed an M&A capability i.e. the ability to carry out transactions on a regular basis with a high level of consistency and skill:

> *"Well QBE have it in their DNA I think, although whether it's just Frank O'Halloran or whether it is the company, will be interesting to see when Frank retires. You know Westfield have it in their DNA in a different way because a lot of their transactions are centres rather than entities... I mean they just know how to do it, they know every question along the way and they know every pitfall and they know where to go and what questions to ask and they know how to get around it, so they then build it into their contracts ways of circumventing the problems."*
>
> *"It goes down to management and their ability to do transactions, understand deals and then to implement them as I think QBE can deal... But it's a machine, they have a methodology and they just seem to apply (it) time after time after time."*
>
> *"There are a lot of (investment) banks around ...who will do all those things for you, not run it after you've acquired it. ...But I think what's important is that the executives know what they can and can't do and that's where you have confidence that they know their own limitations."*
>
> *"...it does require having a team thinking about it, focusing on it, building up that skill internally."*
>
> *"And I would have to say that experience counts for so much in this. You know, if I look at M&A transactions and investment banks will tell you X, Y and Z but when you have been there, you have made sufficient mistakes to have hopefully not repeated them for the next time."*

Alignment between directors' views and literature on board practice and involvement in ensuring preparation and planning

The 2002 Bain & Co research indicated the top two reasons for success cited by executives as being:

- "cultural integration addressed early on and actively (eighty three per cent of executives cited this factor as important or very important); and
- Best people selected to lead the combined entity, irrespective of which company they come from."[160] (81 per cent cited it).

In close descending order behind these top two factors, Bain's research also identified: 'integration focused on value'; 'leaders communicated extensively'; 'measures of success established and tracked'; 'plan in place before deal closed'; 'approach tailored to the deal's strategic rationale'; 'new management team chosen before deal announced'; 'majority of employees focused on base business'; and 'speed valued above perfection'.

The Bain research explored actions like having a 'plan in place before deal closed' and 'new management team chosen before deal announced', which corresponds with the views of the PhD interview participants. Their research also indirectly points to the importance of good planning and preparation. But the available practitioner research generally does not describe the theoretical ought in any more detail. Nor do any of the opinions or anecdotal evidence address specifically the board's role or tasks in the pre deal phase strategy, or in planning, preparation and monitoring before, during or after the transaction.

The PwC 2014 report into M&A Integration found that 'Performing integration planning early in the deal process improves deal result'. With regards to the point at which integration teams should get involved in the deal process, 44 per cent of participating executives in the study indicated that it should be during due diligence (whereas 26 per cent said it should be as early as deal screening; 23 per cent said it should be post the letter of intent; 7 per cent between signing (deal announcement) and close; and 0 per cent said after the deal closed). (PwC 2014)

Fortunately the views of the PhD interview participants have provided a rich vein of advice and practice around what directors ought to do. The sample of seasoned directors interviewed emphasised that the board must ensure that the preparatory work and planning is done early and properly by management.

Those boards and management teams for which M&A is a critical part of their strategies ought to go a step further and approach M&A as a capability building task. They need to look at how to build up their M&A capabilities and to industrialise or institutionalise these, so that they are repeatable, dependable processes.

As regards the benefits of building an M&A capability, there is reasonable convergence between the theoretical views of what ought to be done and the directors' views conveyed in interviews. The literature, however, is more explicit than the interview participants were in commending the benefits of a gradual build-up of a core competency in M&A through regular (but smaller) transaction activity and continuous improvement. Participants alluded to M&A capability building and commented on one or two well-known serial acquirers, but did not directly drive home the point about 'practice makes perfect'.

[160] Bain & Co, *Mastering the Merger*, 2004, by David Harding and Sam Rovit at pg. 96

Section 3.2.1 cited a research paper[161] in which BCG explored the stock market performance and financial results of listed companies in the US, over a ten-year period ending in 2002. There was strong evidence that highly active acquirers were actually enjoying on average better total shareholder returns than less active acquirers or companies that relied more on organic growth.

BCG used the phrase “practice makes perfect” to describe this developed M&A skill in a subsequent study.[162] This study did not, however, enumerate what mix of planning, process, people, project management etc. is proven (or even believed) to make the difference.

It was concluded that the literature view of what directors ought to do with regards proper planning and preparation suffers from significant gaps; and as a consequence needs to be supplemented by interview and questionnaire findings. It is apparent that directors’ firmly believe in the importance of planning; but the accountability for key activities – such as Activity #2 “Well documented M&A_process/methodology” – is largely regarded as one that “Management Leads, Board Reviews”.

Therefore, in addressing the knowledge gap in ‘right practice’ regarding the theme of preparation, the distilled implication from the director’s interviews is that directors’ ought to test and validate that management has assembled the necessary capabilities (incl. M&A tools and methodologies), plans and contingency plans in advance of a transaction. How deep they probe the levels of readiness could be the subject of targeted research, but the research evidence is clear that companies who have diligently built and improved their M&A capabilities and prepared properly tend to be the better performers. Directors cannot therefore leave this task to management without some oversight, by satisfying themselves to some degree that the preparation has been done.

Having explored the first two themes, namely the importance of strategy upfront and proper preparation and planning, we now examine the third major theme that emerged from the interviews. **Proper understanding of culture** is always important but in some transactions it is critical. This theme is explored next.

6.7 Importance of culture fit as a driver of deal success (or as focal area for directors)

Cultural fit and more particularly cultural misalignments come up frequently in the literature as one of the key challenges and pitfalls for many acquisitions. As indicated in Section 3.2, several management consulting studies have highlighted the need to focus on culture early on and in a proactive manner. The board needs to know **before** the deal is done that management has conducted an accurate assessment of their compatibility with the culture (attitudes, values, behaviours, leadership style, reward systems, decision making processes and ‘rights’) of the target company. Two examples are worthy of reference although there will be many others.

[161] BCG research paper “Growing Through Acquisitions – The Successful Value Creation Record of Acquisitive Growth Strategies”, May 2004
http://www.bcg.com/impact_expertise/publications/files/Growing_Through_Acquisitions_rpt.pdf
[162] *BCG* May 2008, “Return of The Strategist” at pg. 19

In a 2002 survey of 250 global executives[163] involved in M&A, Bain & Co. indicated that one of the top two reasons for success cited by executives was “cultural integration addressed early on and actively” (83 per cent of executives cited this factor as important or very important).

In the previously quoted 1999 global research study by KPMG International[164], interviews with executives identified a combination of six ‘keys’ – three hard keys and three soft keys – that were necessary for a deal to succeed. In terms of “soft keys” (the people issues), companies that placed priority on:

- Management team selection, in order to reduce organisational uncertainty, were 26 per cent more likely to improve value to shareholders.
- Addressing cultural issues was 26 per cent more likely to succeed in adding value for shareholders. Those that handled these issues early in the pre-deal process had a better success rate than those who left cultural issues until the post-deal period.
- Communications were 13 per cent more likely to enhance shareholder value. Poor communications with employees posed a greater risk to a deal, relative to poor communications with shareholders, suppliers or customers.

Cultural alignment and managing change are prominently identified in the literature as critical focuses for management. Logically one would expect that proactive and vigilant boards would be alert to cultural compatibility as an acquisition / integration challenge; but it is not flagged directly and explicitly in the literature as a focal point for board scrutiny (although the same could be said of several other significant transactional activities).

Clearly, however, issues of culture were front of mind for many of the interviewees. So whilst assessment of ‘culture’ is not a specific board activity when it comes to M&A in the literature, it ought to feature prominently on the M&A activity list for boards.

The key questions to answer therefore are: how important is it for boards to give attention and proper examination to the question of cultural compatibility? And the corollary, how do the board members know that management has done its homework?

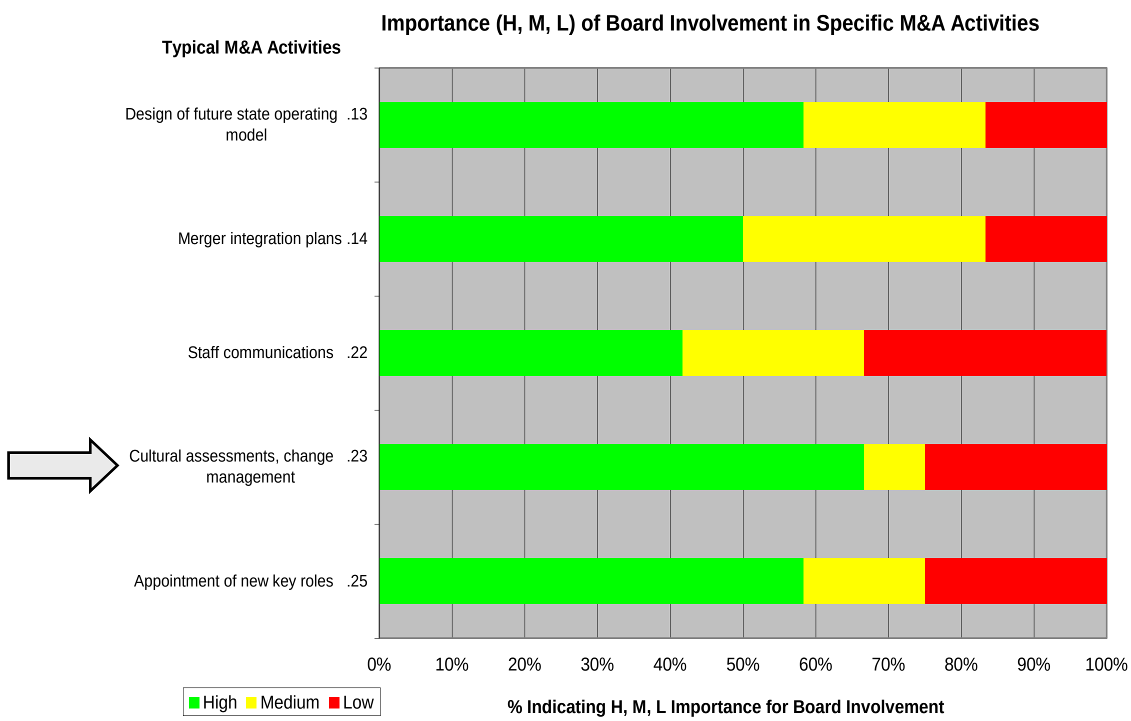
How do directors view the importance of assessing the target company’s culture?

As the data in Figure 32 below indicates, most directors did see an assessment of the target company’s culture and the development of change management strategies as an important activity for board input. Somewhat surprising, however, was that a sizable percentage (35 per cent) of participants rated activity #23 as a low or medium activity for board involvement.

[163] Bain & Co, *Mastering the Merger*, 2004, by David Harding and Sam Rovit at pg. 96
[164] Unlocking Shareholder Value: The Keys to Success”, *KPMG M&A Global Research Report*, Nov. 1999; cited also in http://www.riskworld.com/PressRel/1999/PR99a214.htm

Most felt management should drive this process, which is understandable given that in general directors would view the development and management of an effective corporate culture to be a specific CEO accountability.

Figure 32: Importance of board involvement in cultural and other staff and structural matters



Source: Dean Blomson (thesis author)

Chairmen were aware of the cultural issues and prepared to play their parts.

> *"It does take a lot of time and I think a chairman has to be prepared to be involved…. I mean the situation that I'm looking at the moment I've found that… I needed to meet the other chairman and so it's like a one on one. Then it's a case of meeting with CEOs, whether it's a case of really pushing your own people about the sort of the rationale and sometimes you got to keep circling back. …it's another way of saying that things like culture and values which are often taken for granted; they are in fact also things that will destroy you if there's incompatibility."*

Similarly, other directors were firm on being proactive on managing cultural issues in a decisive way as integration proceeds and not focusing only on (financial) performance metrics:

> *"….you really do have to put in a hell of a lot of effort to get it right and I think that at that front end and on these sort of cultural… values sort of compatibility type issues that there's not near enough weight given to that, it goes much more to the head stuff rather than, if you like, the heart stuff. ...I don't want to reduce it to a bunch of metrics."*

And:

> *"…if you feel as a consequence of what's happening that there are elements in there really who are going to fight you tooth and nail, culturally and value wise, because they are just on a different agenda, then you got to be pretty tough line with it. ... you've got to basically get them out of there, and you'd do that, I think with kindness, and ….with generosity, because I think that also sends a message to the rest of the organisation. And it helps you in the way you build new."*

Some directors believed the culture assessment needs to be detailed and disciplined "*very deep, very deep"*; other participants, however, seemed to rely on their instincts and judgment based on interactions with executives and non-executives of the target entity, as well as ex-employees, suppliers, key customers, market intelligence, etc. Forming a view of a target's culture based on the interactions and views of potentially conflicted parties may be helpful but not particularly reliable.

In the case of hostile acquisitions and competitive acquisitions where the potential suitors are driven against a tight bidding timetable, one has to use whatever data sources are available to one. This further reinforces the need for early planning and data gathering on potential targets well in advance of any possible acquisition events. In a friendly acquisition or merger, however, the due diligence team should be able to draw on a broader set of more reliable data points.

What was explicitly stated is that the acquiring company's executives often know their competitors and their people – which at a certain level is probably true and useful but only to a degree:

> *"…you've spent a lot of time thinking about who's in that space and who are the good guys and who are the bad guys, so more often than not you should know a fair bit about your target, and that includes knowing and understanding how good they are, how good the people are and whether they complement what you've got."*

Is that knowledge likely to be sufficiently adequate and accurate? Would a shareholder be satisfied that adequate cultural due diligence has taken place based on this approach? These were not questions directly canvassed during the interviews but they go to the heart of adequacy of involvement: i.e. what is the appropriate level of scrutiny by management and the board?

As regards boards' involvement in ensuring that cultural dimensions have been adequately analysed and planned for, it is sometimes a case of too little too late:

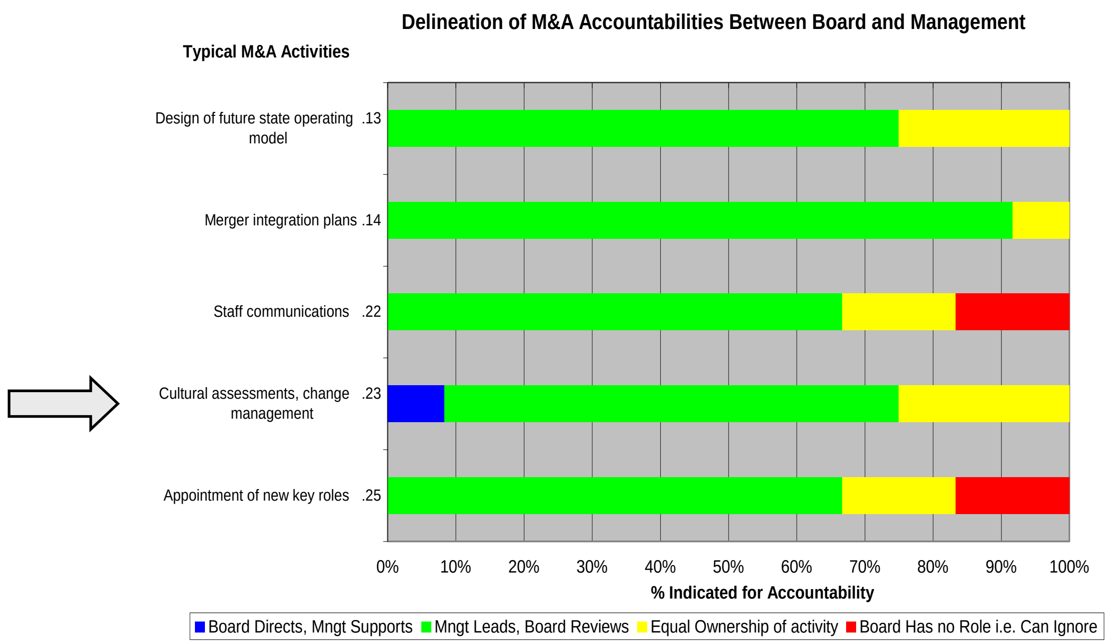
> *"….most of us say 'oh, we'll deal with that afterwards'. Most people cannot face that ahead of the thing. It's hard to ask to go, because you don't know the culture until you go out yourself to visit it and I think that it's a hard thing for a board to ask to do.*

Because, it might be something that's confidential and if the whole board suddenly appears you are blowing your cover. ....I think you have really got to try and push down those culture questions with management and make sure that they understand what the culture is. It's funny because people ...don't really take you seriously when you ask about culture and yet everyone blames it when things go wrong, always. You read all the reports that have come out of analysis of acquisitions gone wrong, every single one of them starts with culture."

The delineation of accountability for evaluating culture

Accepting strong recognition of the board's need to be involved, the key questions that arise are: who has primacy for this activity and where does the board's accountability lie? Figure 33 points to the views on this topic.

Figure 33: Accountability for cultural and other staff and structural matters



Source: Dean Blomson (thesis author)

The majority of views indicated that Activity #23 is one that "Management Leads, the Board Reviews". Indicative of the importance that some directors ascribed to corporate culture alignment matters, a number of the participants flagged this either as an activity that that "Board Directs, Management Supports" or one where there is equal ownership.

Given the general recognition of culture as a critical issue, the corollary question is: how active and assertive does this review need to be? A diversity of views emerged.

To quote one board member, when it comes to understanding culture, the board has to ensure that management has been *"Deep, detailed and disciplined"*.

At the other end of the spectrum, as one chairman put it:

> *"Reading all the guff that goes out on the culture in my experience often doesn't help. I think that culture is a sort of more ethereal thing and as a board member you have to be alive to it and you just have to think it through."*

Board inquiries into corporate cultural matters therefore could range across a spectrum (as with their involvement in reviewing strategy) from simply asking whether management has assessed the target's culture and has a plan to address any alignment issues (at the cursory or more superficial end of the inquiry spectrum); through to a deeper inquiry into what conclusions management has formed, on what basis, and specifically where and why they are either confident or concerned about managing successful integration.

Forming a view about the target's culture and implications and challenges for a successful post deal process, requires a certain level of scrutiny by the board.

Is a cursory examination adequate to flush out issues on how management have formed their assessments of culture? The answer would be 'probably not'. And a light touch by the board is not easy to justify unless non-executives have a high and well-founded level of confidence in management being attuned to cultural alignment.

What would the hypothetical position be in terms of legal liability if an acquisition caused material shareholder loss, directly as a result of cultural incompatibility? Probably the theoretical answers would hinge on: (a) whether management took the necessary steps to examine and satisfy themselves with cultural compatibility; and if yes, (b) as a result, whether the cultural issues were known and foreseen by management.

If the answer to (b) was yes, and they either overlooked or downplayed these risks; the next line of questioning presumably would be whether management either failed to inform the board or the board failed to make reasonable inquiries of management regarding their conclusions. This does not mean that the non-executive board members necessarily had to test those conclusions rigorously. In this hypothetical case, one would expect culpability by management and the board – for one party (management) being liable for gross negligence (bordering on fraud) and for the other party (the board) being guilty of negligence.

Whilst the intent here is not to postulate on the legal interpretation of the duty of care, it is likely that 'right practice' would be seen by the interviewed directors' to exist if the board tested management on whether they had carried out any thorough investigation and if so, what their conclusions were and how they to planned to attenuate and manage any attendant cultural risks.

Certainly there would be little harm of 'crossing the boundary line' (and only upside, from a risk management perspective) in a board making sure that a CEO is properly challenged about key elements of cultural fit, by asking questions such as:

1) How have you assessed the target company's culture? How have you defined it?
2) What makes you confident that you have an accurate fix on their culture and its alignment with ours?
3) How reliable and broad-ranging is your data set?
4) How significant are the gaps? How can these be remedied? Will it be worthwhile and what are the key risks?
5) What will cultural change/realignment require? How long and with what sort of financial and non-financial impacts?

The directors interviews conducted did not explore whether their interrogations of management typically match or exceed the above questions – or the quality of boardroom conversations around culture prior to the transactions; nor is this a focus of this research.

Certainly the non-executives interviewed were alert to the challenge of cultural alignment and some had suffered personal disappointments and reputational bruising as a result of poor integrations.

Culture is a notoriously amorphous topic for line management and executives to assess and manage. Similarly it appears that board members also struggle to get to grips with it.

As one interviewee put it:

> *"So I don't know how you get some language around that and other ways of asking to get a feel for culture without using the word culture because management ...bat that one back, they don't really take that seriously."*

In theory, culture appears to be high on board members' radar but in practice (and speaking generally) do they (management and the board) have the capabilities and tenacity to be rigorous and sophisticated in the assessment of cultural fit?

Whilst there are often sizeable gaps between words and deeds, the ostensible emphasis placed by interview participants on culture – and the need to ensure this is properly addressed – provides a clear message that they see this as an important responsibility. Whether rhetoric and actions match up effectively, is another issue.

What was noticeable as an omission, however, is that no one explicitly commented on the need to benchmark in a scientific, rigorous and objective way, how the two organisations would fit together, in a behavioural sense. Rather there was a sense that simply by chairmen and CEOs talking to their opposite numbers or to the target's ex staff now on their own payrolls, they've been able to understand their target's culture and somehow de-decoded its DNA.

> *"...I've found that, you know, I needed to meet the other chairman and so it's like a one on one. Then it's a case of meeting with CEOs, whether it's a case of really pushing your own people about the sort of the rationale and sometimes you got to keep circling back."*

Of course there is no 'one size fits all' approach to assessing culture. The organisational development landscape contains a wide range of diagnostic instruments, theory and approaches – and whilst management teams talk about values and culture there are widely differing approaches and interactions as to how culture is actively managed, harnessed and monitored.

Additionally, whilst culture is always important to transactions, in some deals it is less critical than in others. Some transactions will be largely asset plays where culture matters less; or are relatively straight-forward and minor bolt-ons. In other acquisitions, the acquirer has no intention of integrating and plans to run the acquired entity at arm's length – sometimes for geographic practicalities or for market or brand driven reasons. In other cases, however, the converse occurs and there is a recognition that culture and current performance are inextricably linked and that tampering with the culture could erode value dramatically (e.g. if the target entity has a unique way of doing things). In those cases, the wise acquirer looks (or should look) for mechanisms to protect or reinforce the existing *modus operandi*.

In either event, of extensive or limited integration, board and management ought to have a shared point of view about what level of cultural assessment is sufficient and wise. This is circumstance dependant, but requires considerable time and effort to do it well. This is especially the case in a hostile takeover or an auction process. With a friendly acquisition or merger it is generally easier to form and test a view on cultural alignment but that does not mean that it is necessarily done well by management.

Another director said the following:

> *"....you need to put in the work before doing the transaction because otherwise you can ...make a real* faux pas *as we did in one instance."*

Interviewer:

> *"So you were saying it's got to be deliberate and it's got to be disciplined?"*

Director:

> *"And very deep, very deep. I think that you really need to spend the time, and you can't rely on consultants for that stuff, because consultants don't understand your culture so there's no point in sending a consultant to come up with the cultural fit when they don't understand your culture."*

The challenge for boards thus appears to be two-fold:

- One, to be proactive and to ensure well before the event i.e. before the deal is pursued, that management is truly alert to the challenges that culture may present, so that they can deploy sufficient resources and apply proper rigour to evaluating cultural alignment.
- Two, to be convinced before signing off on the transaction and integration plans that management truly has done its homework and has understood the target's culture in an informed and suitably objective way.

Alignment of directors' views regarding board practice and involvement in culture assessment / management to that of literature

As indicated above, the general commercial literature on M&A does not give much air-time to what directors' ought to do to ascertain culture in a reliable way – aside from clearly noting that it is a major potential eroder of value if not managed well, deliberately and started early.

The interviews conducted show the board members are alert to these matters and do consider and debate them, although anecdotally the rigour with which they assess cultural alignment appears to vary.

The interviewed directors' view of what ought to be right practice appears to be only somewhat aligned with the theoretical ought, given that the degree of rigour and sophistication probably vary quite widely by boardroom; and what some directors would consider to be adequate practice by themselves and management would not align well with what organisational development practitioners would advocate.

There is much practitioner and academic material on the importance of understanding culture and the crucial role that executive leadership plays in integration management – but there is not much direct advice for boards per se. In other words the theoretical 'ought' is deficient.

The directors' views are somewhat ambiguous: all directors recognised the importance of culture but when it comes to practice, some directors felt that reasonable inquiries and instinct were adequate to get one through; others felt that it requires rigour and diligence to get to accurate answers. Why directors should be reticent to insist on hard, objective, factual assessment by management (supported by their personal judgment) when it comes to culture, is not clear.

Perhaps the following view best sums up the dilemma of directors:

> *"There's transactional risk, there's people risk, there's country risk. As I said before, there's the risk if it's not exactly in your core capability there's risk of the skills you are acquiring walking out the door. How do you keep them, how do you meld them in with your existing business. How does that fit, and the culture piece is a big part of that as well. You know all the banks in the eighties when they were buying brokers didn't understand the culture of a broker, none of them worked. They all sold them, now I notice they are all starting to buy back into them but you know the culture is a really big thing and it's not ….focused on enough because it's something that is very hard to write down and measure, and to present to a board. This is the culture of that company versus ours, its quite a hard thing to have tangible evidence around yet when deals go bad, the first thing that's blamed is the culture."*

The position therefore remains unsettled: literature clearly sees cultural alignment issues as potential deal breakers and value destroyers, but doesn't articulate what directors ought to do. The directors interviewed saw culture management as an important management responsibility, but the boards' level of stewardship over cultural alignment matters remains mixed. Directors were clearly alert to the inherent issue but the unresolved question is how structured their validation of management's assessment should be. Views range from: chairmen and directors making the necessary informal inquires and relying on instinct from personal exposure to the other party; to wanting management to apply more science and rigour to the process. There is clearly a vacuum both in the literature and in directors' views as to what right practice is and where the bar should be set for what is acceptable stewardship of this issue.

Having explored the dimensions of the third theme, relating to cultural assessment and enquiries by the board, we now turn to the fourth major theme that emerged namely **rigorous testing of the investment business case and funding strategy.** This was felt to be a critical activity for the board (a) to be confident in the quality (relevance, reliability and robustness) of the business case; and (b) to know how to fund it without putting the company at risk of financial duress. This theme is explored next.

6.8 Rigorous testing of the investment business case and funding strategy as factors that could improve the success rates of M&A for the acquiring company

How do directors view the importance of the investment business case and funding strategy?

The business case is in many ways the final checkpoint before the transaction can receive a green light. It is also the source document that, if completed thoroughly and comprehensively, contains all the thinking about the transaction: its strategic rationale and relevance and its financial viability i.e. potential value, impacts, risks and requirements, etc. All of this content should be expressed in hard quantitative (dollar) terms and in qualitative thinking, supported by the necessary factual arguments.

It is thus not entirely surprising that rigorous testing of the business case emerged as the fourth theme after strategy, preparation and planning and culture.

Financial strategy and funding requirements to support a transaction is of course a logical focus for a board. How much emphasis do directors place on it? The answer is probably "much more today than perhaps would have been the case prior to the Global Financial Crisis".

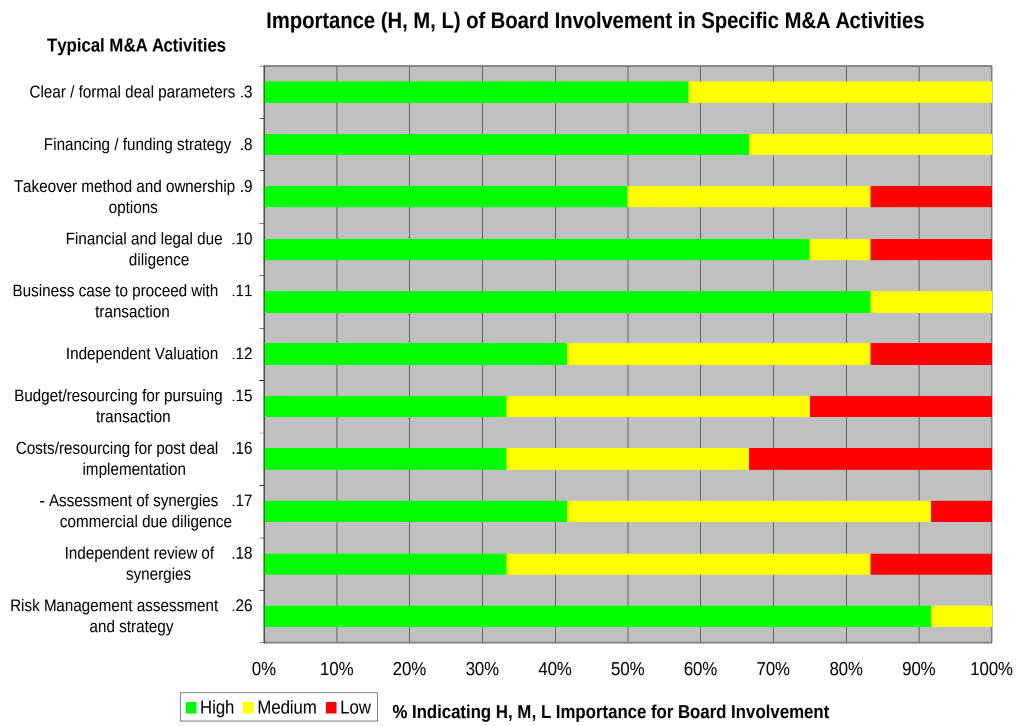
Boards' involvement in ensuring the appropriateness of the investment business case and funding strategy

As indicated in Figure 34, two activities stand out as having particularly high levels of importance:

- business case to proceed with transaction (Activity #11)
- risk management assessment and strategy (Activity # 26).

Figure 34 contains a subset of the 29 activities from the structured questionnaire that relate to financial aspects of the deal, broadly speaking. Many of the activities are what could be termed the input or feeder activities that should ultimately become part of a well-rounded business case (i.e. activity #11).

<u>Figure 34: Importance of board involvement in business case and related financial aspects</u>



Source: Dean Blomson (thesis author)

What is perhaps somewhat surprising is the lower level of importance attributed to activities 16, 17 and 18 i.e.:

1) costs/resourcing for post deal implementation (#16)
2) assessment of synergies – commercial due diligence (#17)
3) independent review of synergies (#18).

In interviews, however, the opinions were far more positive about the need to understand the deal's value drivers, the future state design, to focus on synergies and to test these:

> *"Well I would be expecting them to identify with some precision what will be the drivers for building the….new entity. Where is it going to come from? And to what extent will it be…. as a consequence of the two together and therefore kind of organic, or whether they are going to need to be new add ons to go with that. So I'd be looking for a fair amount of clarity ... and I think that the ability to paint it and the ability to show it will…largely*

determine your ability to get people buying into it. And forgetting about …all of the egos I've got and will he get my job and all of this. Now …the head bit will also look at cost lines and synergies and, when I think you've got to be very honest about that, and you've got to name that upfront and deal with it.…"

The previously cited 2002 research conducted by Bain & Co., covering 250 global executives involved in M&A", examined the reasons why deals break down. The study found that "…with the benefit of hindsight, two thirds of executives realized they had overestimated the synergies available from the deal. Half discovered the target had been dressed up for sale. Half believed that their due diligence process had failed to highlight critical issues in the deal[165]" Two thirds (67 per cent) similarly had ignored integration or implementation challenges. (Harding and Rovit 2004, at pg. 62).

It is thus somewhat surprising that directors did not give more weight to those activities.

In interviews fortunately, a number of directors emphasised the importance of their reviews of the business case and synergies:

"…I've spent 80 per cent of my time really getting critical of what assumptions am I making, and what are the critical ones? …..vacancy rates, …. growth in rents, or whatever it's going to be, and really making sure that I tested…. up down…and middle scenario. And quite often you get lost in all that. So…. just asking the very simple questions of 'what are we assuming in synergies for revenue versus costs?' Because I think my experience would be most of these things always overestimate the revenue synergy, and always underestimate potentially the damage that some of the cost synergies will create. So you go in and so you just decimate the team, because ….. we don't need their head office. Well… if all the corporate memory…. is in that group of people, you've just lost a large part of the intellectual property that you bought."

A key sub theme which emerged from the interviews was the importance that directors ascribed to the funding strategy. The following quote typifies the views of several of the interviewees:

"I think today, more so than in the past, funding now becomes even more critical, whereas maybe 5 years ago funding would have been a given, funding is no longer a given. And…, it's both capital and net funding and structure of the company…. Arguably funding would be number one on many lists today…"

This significant focus on funding strategy was perhaps not as clearly borne out in the questionnaire responses as it was in the interviews (refer activity #8 in the diagram directly above). As can be seen in Figure 35 further below, the overwhelming view is that this is an activity where "Management Leads, Board Reviews." And certainly one can quite readily accept the validity of conventional wisdom that the CFO has primary responsibility for developing capital budgets and finance strategy – and for ensuring capital adequacy.

Board members recognise, however, that today they have to be sure that the capital buffer is adequate, even more so than before. Increasingly a front of mind question for directors is: "Can we afford this? What impact does it have on the balance sheet?"

The delineation of accountability for this activity

A significant importance was ascribed to activities 11 and 26 in Figure 34 above. When it comes to a delineation of accountabilities for these two activities, the clear view is that these are activities that "Management Leads, Board Reviews." This does not mean that the board does not go about its review process in a less than rigorous way or that the board members spend less time on these two crucial activities than on others.

What the thesis has not and cannot assess is the quality of interrogation and conversation that takes place around a final go/no go decision – or what weighting is accorded to financial versus non-financial factors, subjective versus objective arguments (emotion versus fact), risk versus return, etc**.**

The views expressed by directors during interviews do, however, provide considerable assurance that they approach the business case and financial reviews with considerable rigour, by focusing on a few critical roles:

1) Stress-testing under different scenarios

> *"To me that sort of stress testing, you know, getting into the detail, it's a given. And you have to really sort of look at close test under those assumptions say it's a mining thing, well you can make a small adjustment to say currencies or the price of the commodity and whether it be, you know, your discount rate or something…"*

And:

> *"…I think what you do have is a responsibility as a board to constantly keep testing the scenarios against your hypothesis. Whether the hypothesis is our current business model or the hypothesis is this M&A transaction, you've got to be realistic and, you know, and the black swan, that book."*

[A reference to book by the same name, "The Black Swan: The Impact of the Highly Improbable", by Nassim Nicholas Taleb, published May 2007]

2) Providing discipline and a sanity-check around synergies

> *"…if it's in your own backyard the issues are more about having the appropriate disciplines around it, you know, are you betting the company, have we got it funded, I mean are our assumptions about synergies right? Because they often prove harder to get…, and synergies… important though they are, aren't permanent benefits…. they're once off benefits. So it's really putting the discipline around it and …what I think is the right thing to do and it's very hard to achieve, is actually within management and/or the board, getting the right mix of enthusiasm to do it and*

diligence. If the MD's very keen on it, it's very hard to get any people in management to question any of the assumptions. Certainly if you got the MD and the CFO on board…it's hard to stop the train. And it's that balance between… not wanting to slow down something that… hopefully… is a valuable and exciting opportunity, but putting the discipline around it."

3) Ensuring capital adequacy

> *"I think today, more so than in the past, funding now becomes even more critical….funding is no longer a given. …it's both capital and net funding and structure of the company that needs to be (examined). Arguably funding would be number one on many lists today…"*

4) Maintaining perspective on target rates of return and being alert to gaming of the numbers

> *"I'm a bit critical of those who say internal rates of return have to be 15 per cent of my money. To be honest I regard that as pretty flimsy because in my experience what happens is that people either pump up the numbers to get to that or have the eternal J curve that it will get to that and beyond, so it's an irrelevancy. What I think you've got to do is work through ….what you're aiming to return to your shareholders in your business and then prove backwards what this does for you."*

5) Adding experience and business judgment

> *"I think what you've got to do is drill down into those assumptions and then from your own experience say 'well look, last time we did one of these it finished up to be 1.75 because...Now prove to me why that won't be the case here'."*

And

> *"Or …you've underestimated (that) …., to fund all that business you're going to need… so much more working capita …..Or what does a (change in)…what variations and assumptions, whether they be interest rates, currency….would do to do to the model."*

6) Testing whether the business has the resource bandwidth (financial and top management capacity) to cope with integrating the acquisition

> *"I think that the board member has to also understand the capacity of the company and as I said it's both its financial resources and its people resources because as you've seen, if you get either those wrong or both as some people do, well you go out the back door."*

7) Maintaining impartiality and clear evaluation criteria when examining a business case and being prepared to draw a line in the sand

"…..well if I give you the money what are the criteria? You know, is it an accretive acquisition, etcetera, etcetera. The other thing I think the board has to be responsible for, is what the opportunity cost of actually investing in this. What can't we do if we do this?"

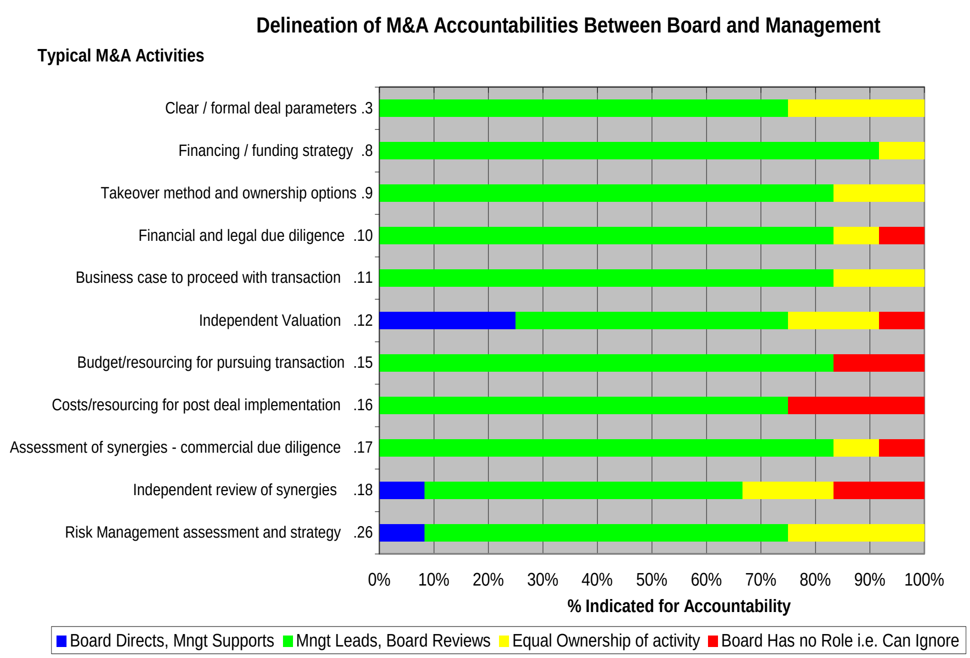
"…some very clear hurdle rates had been set and some very clean lines in the sand had been drawn and I was interested to note that the management had set those and the board supported management in not bidding or not try to outbid the successful company in the end."

"…I think in these sorts of endeavours it's very easy to get seduced into the... acquisition. I mean what worries the life out of me when I hear people say 'This is a strategic transformational acquisition'."

8) Remembering that it is the board's right and duty to decide not to proceed if the justification is not compelling enough or if the risks are too great

"Ultimately you've got to be able ….to say no."

Figure 35: Accountability for business case and related financial aspects



Source: Dean Blomson (thesis author)

In Section 6.5.3 the point was made that in relation to boards' involvement with strategy, that 'being involved' covers a potentially wide spectrum of participation: from simply understanding and noting management's assessment, intentions or views; through to stress testing, then validating, then modifying, ultimately to co-creating strategy. So too is the case with boards' involvement in business cases and financial aspects of the deal.

Ultimately directors must conduct thorough pre investment reviews not simply to understand management's recommendations, but to make 'proper inquiries' in relation to delegated matters and perform an 'independent assessment' of information or advice (this is the minimum legal onus that they must meet). Scepticism helps – and the greater the degree of challenge and critical scrutiny the business case receives, the greater the likely security for shareholders. A number of directors indicated that they saw that playing devil's advocate was one of the key roles of non-executive directors in this process.

Alignment of directors' views on board practice and involvement in business case and funding matters to views from literature'

The theory and practice is well documented regarding what management specifically needs to do in relation to synergy assessments, funding strategies (in multiple corporate finance texts), financial and strategic due diligence etc. For directors, however, the *theoretical ought* is not well described.

The Business case to proceed with the transaction (Activity #11), the Financial and legal due diligence (Activity #10) and Assessment of synergies – commercial due diligence (Activity #17), all tend to receive a considerable amount of focus in the commercial M&A literature – but again, only in relation to what management or executive directors ought to be aware of. Board members' involvements are far more implicit than explicit. So whilst the literature and theory is strong for practitioners and management, the theoretical ought of governance practice for directors is relatively weak.

The literature and documented best practice around funding strategy and risk management is plentiful.

Financing strategy is a specific topic addressed typically in specialised corporate finance texts – so M&A handbooks tend to assume it has been adequately addressed as part of the necessary pre-deal house-keeping.

Risk management perhaps also tends to be taken as a specialist subject and is not well-covered as a specific discipline in M&A texts – one assumes that it is seen as part of the necessary deal house-keeping. While indeed the interviewees may concur with this view, they are clearly keen to ensure that Risk management / mitigation strategies are in place and of the necessary quality.

As outlined in Section 3.3.2, under the ASX 'Principles of Good Corporate Governance'[166] Listing Rule 4.10, "Companies are required to provide a statement in their annual report disclosing the extent to which they have followed these best practice recommendations in the reporting period".

[166] http://www.shareholder.com/shared/dynamicdoc/ASX/364/ASXRecommendations.pdf

Principle 7 deals with recognising and managing risk and it would be a foolhardy public company board that does not establish a reliable system of risk oversight, management and internal controls.

The extent to which this system is extended to transactions or how Risk sub-committees of boards get involved in transactions would vary on a company-by-company and case-by-case basis. One would also expect that as part of this process, boards evaluate and describe their risk appetites prior to commencing transactions (what will they tolerate and what will they not entertain), although there is no way to assess the extent or quality of this practice via the current study.

The one issue that perhaps stands apart from others in M&A practice guides – and that boards need to be particularly alert to – is the issue of estimating synergies and the associated costs and resources to deliver these.

As one director put it:

> *"The other thing I think the board has to be responsible for, is what the opportunity cost of actually investing in this. What can't we do if we do this, and that's broader than just the capital dimension, it is, if this absorbs the whole intellectual property of the business, and takes us out of focus because we were integrating this huge beast, what does it do to the rest of the business, and ....that usually gets forgotten about.... ...That impact on business as usual is huge. Because of the time and energy that goes into actually that the transaction itself, bedding down the integration, the opportunity cost of that time is something that ....has got to be weighed up as an asset allocation. I can invest my effort there or I can do it there. Just because it ticks the return is not necessarily the only decision you've got to make."*

Whatever the deficiencies are of the literature regarding direction of right practice by directors , the views from participants have provided a good deal of clarity on what they thought the key focus of directors' activities should be. Three activities come through particularly strongly from the interviewed group as critical areas of focus:

- Funding/Financing Strategy (Activity #8)
- Business Case to Proceed (Activity #11) – with a range of sub activities that board members need to be particularly attentive to
- Risk Management Assessment/Strategy (Activity #26).

The board ultimately has accountability for growing <u>and</u> protecting shareholders' funds. In this regard, as keepers of the purse, the board has to stand back from the deal and really challenge management:

> *"...but it seems to me, and we're getting to the board's role, once management fall in love with the deal they fall in love with the deal, ...and obviously the earlier the board recognises that the easier it is for the board to have an impact on perhaps the direction that it takes, or indeed whether it goes anywhere. And ...if there haven't been 3 or 4 interactions along the way, then you come with investment bankers who are dead keen on the deal and they've got a reason to be. You've got management who generally have got a*

good reason to be, and you've got all the advisors who have done a lot of work, some will get paid and some won't, if the deal goes ahead, who have an interest should I say. So ….the board needs to make sure it is checking that it is really challenging management as to being able to stand back and look at this things from 100 foot rather than from within, and saying "does it really make sense?"

Today, financial prudency is front of mind for directors:

"Today after the GFC, …. I would say the first thing I would ask is can I afford it? ….What will it do to my debt covenants? How much equity would I have to raise? Am I in a position to raise that equity? What will it do to my share price? What will it do to the return on shareholder's funds for looking out at the share price going forward? I'm very conscious of that. There would not be an assumption today that the acquisition per se would be good, whereas in boom time that is the presumption. So that's a big different factor? Having determined that I can afford it then I will look at a few other things, which I'll come to. If I determine I can't afford it then I have to very carefully look at what I'd have to do to afford it and in today's market I'd probably not go further. People just won't take the risk, whereas a few years ago debt was cheap, equity was plentiful…."

As Jay Lorsch and Robert Clark, writing in the April 2008, *Harvard Business Review* at pg. 110 state:

"…management in most instances will actually draft the financial goals and the means for achieving them. But boards must help determine whether the senior team is creating the right capital structure. The important point here is that directors should spend less time on quarterly earnings and more time on financial infrastructure – delving into questions about, say, the cost of capital or the debt-to-equity balance that the company is wrestling with." (Lorsch and Clark 2008)

Perhaps the X-factor that no text book or checklist can help boards with, is the question of experience and business judgment. Applying the blowtorch to a business case and drilling into the detail is a critical board activity. That may get you 80 per cent or 90 per cent of the way to a decision, positive or negative. Thereafter, business judgment comes into play and directors recognise this as a crucial factor – and one that cannot be codified.

"…I like to approach it in the initial instance in a very high level way. …why do we want to do it? What do we think the benefits are? How much is it going to cost? How are we going to fund it? And then from that, if it passes that high level test, …with a board input...., you then start to delve into the detail (but) delving into the detail can end up costing you a hell of a lot of money and time. So you don't want to do that unless you pass the original test of 'is it in our sector? If it isn't, are we taking too big a risk going outside of it?'; and they're all pretty common sense sort of things, then you work downwards until your due diligence efforts start usually external to the target you're involved with so you're making a lot of assumptions. Then if it gets serious you finally get the chance to… look at it internally, and it's just verification, verification, verification with a strong financial discipline, a strong accountability of who's going to do it, and who's put their knock on the line for that degree of improvement, and driving it as hard as you can once you do press the button to do it. ….at the end of the day it is gut feel to a degree. ….you say 'shit' …'I

think it's right, but I'm not too sure'. …at the end of the day you're really backing your management team and if that's not right you shouldn't be doing the transaction."

There can be no guidebook on 'common sense' and business judgment – so in that sense it is not practical to codify directors' views on what. Given too the prognostications of our courts and the upholding of the Business Judgment Rule, whilst some financial due diligence tasks can be specified, commercial acumen and judgment cannot be.

Under the theme of business case and funding, the literature is deficient in many regards as it does not generally advise non-executive directors on the level of scrutiny to apply to the financial estimates presented to them. Recent legal precedent, such as that explored in Chapter 3 may, however, be a richer source of guidance. Directors' views of right practice, whilst not unanimous, did provide some guidelines on key activities such as: stress-testing the financial impacts of the business case under different scenarios; providing discipline and a sanity-check around synergies; ensuring capital adequacy; maintaining perspective on target rates of return and being alert to gaming of the numbers

In summary, interviewed directors would appear to have provided missing clarity by supplementing or expanding on the far less clear-cut guidance targeted at directors available in commercial literature.

We have now explored in some depth the views of directors, which have also been cross-referenced to some of the literature, with regards the first four themes outlined in Section 6.3, namely:

1) clear strategy upfront
2) early preparation and planning
3) proper understanding of culture
4) rigorous testing of the investment business case and funding strategy.

These themes relate to planning and board conduct up to the point of deal closure. The preceding argument has established that both in the literature (the theoretical ought) and in the minds and actions of the directors interviewed (the directors' ought) the above four are crucial activities that lead to establishing a solid foundation for most transactions.

The 'clear strategy upfront' element means going after the 'right' transactions and targets for the right reasons; 'early preparation and planning' means focusing on the right things to ensure that potential deal value is established, evaluated and the foundation for value delivery is established; 'proper understanding of culture' means that directors and management look beyond tangible assets, the P&L and balance sheet to the 'people assets' of the business to make sure there is a good degree of understanding of values and style fit, and therefore of likely compatibility; and 'rigorous testing of the investment business case and funding strategy' means that proper scrutiny is given by the board to the affordability and payoff questions.

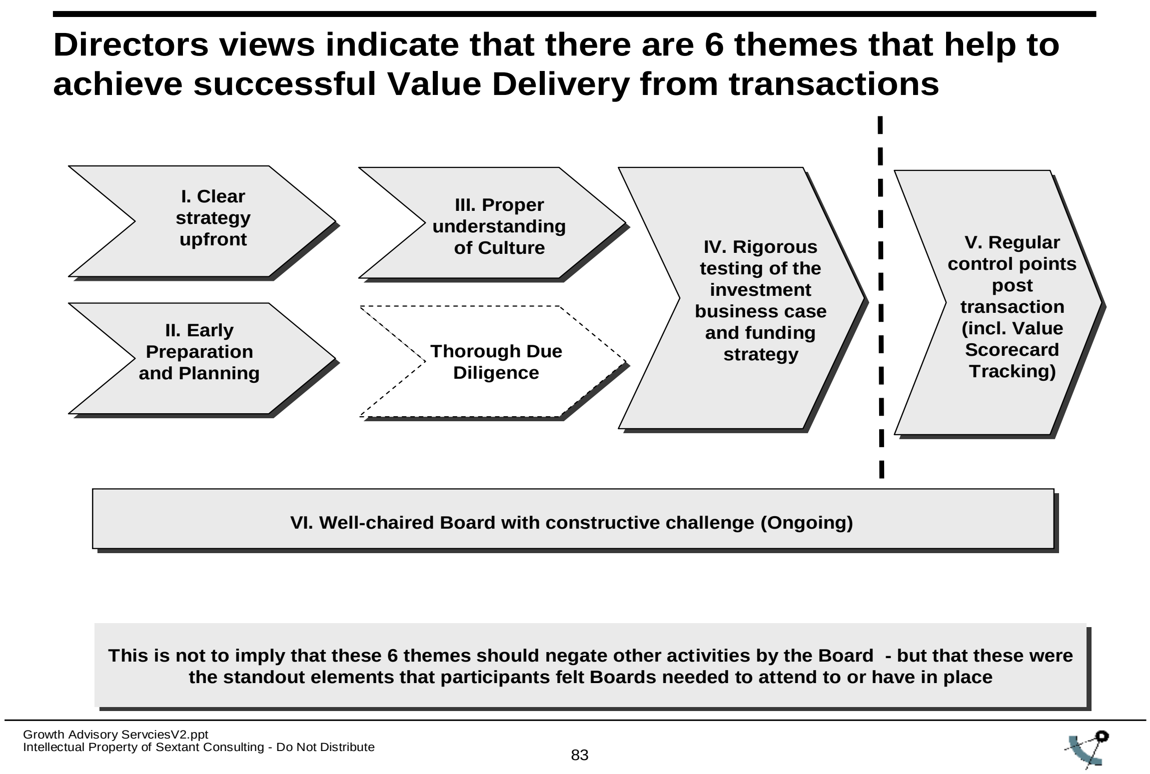
Put differently, the board should be answering four related questions:

1) **Why** should we really be interested in the target entity, if at all?
2) **What** do we need to do to acquire and absorb it?
3) **How** compatible as businesses are we really (and how will our people work with their people)?
4) **What** can we really afford to pay for this and how do we justify it in terms of probable returns and other options?

These seem to be self-evident questions that the literature emphasises and that the directors interviewed were highly cognisant of.

If the answers to each of the preceding four questions can be answered in the affirmative in compelling terms, then usually there are good grounds to proceed; which then leads to the next and fifth focusing theme for directors.

Figure 36: Assessment of six emergent themes



Source: Dean Blomson (thesis author)

The fifth key theme emerging from interviews and coding is the need for **regular control points post transaction**: having a clear view on the quantum and realism of synergies and what it will take to achieve these – resources, skills, funding, management time and resources, operating model impacts – and then keeping the spotlight on benefits' tracking. All four preceding themes provide a foundation and set of critical inputs to the fifth theme.

6.9 Regular control points: exercising control post transaction

How do directors view the importance of post-transaction monitoring?

Directors' views were fairly clear and consistent on post transaction monitoring in three regards: it is a critical activity; it requires discipline to stick to it; it is generally not done well or consistently.

Directors' views can be summed up in these two different quotes:

One, that post-deal monitoring is just another part of good housekeeping:

> *"So now we've done a deal as you say, how do we monitor it? Well I think we monitor it like we monitor anything else. We own it, we own existing businesses too. We have all the financials, we're very interested in the integration. I think that we basically talk, watch, I think we should have an arrangement with the CEO and others that we're there to assist, because even if we're against the deal, once it's done, as non-executive directors we must help them make it happen."*

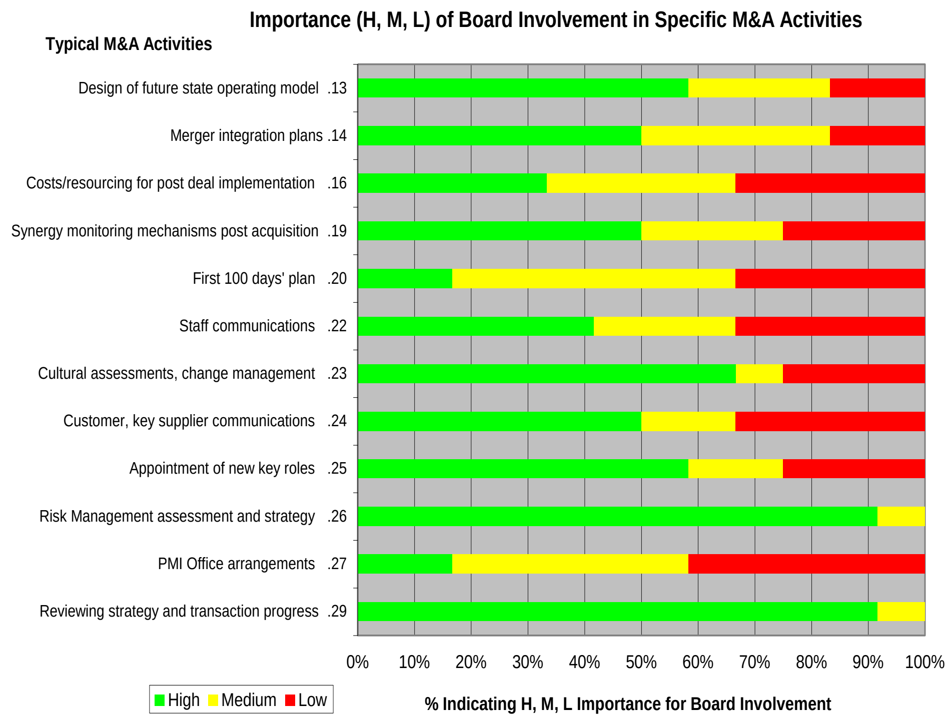
Two, that some boards find this monitoring and control activity hard to do:

> *[Interviewer:* What about, let's say the deal has now gone through, how's the board's involvement after that*?]*
>
> *Interviewee:* **"***That's the critical area, that's usually where everyone just forgets about it. But the critical area …where boards I think don't do this, and should......is keep all the original documentation and then six months later ask them about something and they hate that.*
>
> *And it never turns out (as one expected). And you don't do it that way, you say 'oh well when we first went into this we were expecting this and how is it looking now'. You do it in a constructive way. But I don't think there is enough formal reporting back. Other companies ….may do it better of course but I haven't seen it in the companies of the boards that I sit on that that sort of accountability….. You don't see that feedback and those milestones. The milestones you have to reach in order to generate the value that we said it would by year one and it seems to have just come in, gulp, and it's part of the business…. I know things get blurred but I still think if management tried they could feed back and it would probably be a good learning tool for management too."*

Boards' involvement in post transaction monitoring

The activities outlined in Figure 37 relate to a range of post-transaction, post-deal mechanisms and actions. It is evident from the data that there is a degree of variability around the importance ascribed to board involvement in these activities.

<u>Figure 37: Importance of board involvement in post transaction monitoring</u>



Source: Dean Blomson (thesis author)

The above questionnaire responses show a mixed and 'weak' set of views regarding the criticality of the various M&A activities as matters for the board involvement. It is somewhat surprising that a relatively low emphasis is placed on activities that the literature would generally emphasise as important: *merger integration plans* (#14), *costs and resources for post transaction implementation* (#16), *synergy monitoring mechanisms* ((#19), *first 100 days' plans* (#20) and *PMI arrangements* (#27).

These questionnaire responses, however, need to be contrasted with the interview contents, which fortunately provided a strong set of views about the importance of post transaction management.

With regards to post transaction benefits' tracking per se as a theme, there is no one particular activity above that focuses solely on this dimension, as it is in many ways an outcome of a range of supporting or 'feeder' activities that, when aggregated, support benefits' tracking. (Note that Activity 29 is about general strategy and transaction monitoring not post transaction benefits' tracking specifically). Therefore it is unwise to speculate too widely as to why the individual activity scores in the questionnaire do not appear to match the emphasis given to benefits' tracking as a subject in the literature and in the interviews.

Whilst this is a small sample study, these results seem to be somewhat at odds with much of the commercial literature that points to the need to ensure that anticipated transaction benefits are delivered. These relatively low scores may point to a different factor. Behind the questionnaire responses is perhaps a belief that preparing for, and then managing the integrated entity (post transaction) is management's responsibility primarily and that benefits' realisation becomes an operational matter for management. This could be one possible reason for the relatively low scores. This is borne out in the interview responses captured below in Figure 38 below that deals with the delineation of accountabilities for post-transaction monitoring.

This needs to be counter-balanced, however, against the old adage that 'what is measured gets managed' (or 'what is <u>inspected</u> gets <u>expected</u>') i.e. if the board expects to be kept updated on benefits' delivery then management is more likely to be diligent about benefits' tracking and synergy delivery. Put differently, it is the actions, behaviours and mindset of the board that really matters when it comes to focusing on benefits and that will set the tone from the top that will influence management to undertake 'proper' performance monitoring. Although general corporate and business unit performance reporting by management is a standard activity, the extent to which management teams will voluntarily expose their post-merger performance to scrutiny through detailed reporting is harder to gauge. Therefore the expectation of the board to be able to interrogate the delivery of results, post-merger, is likely to be critical to targeted reporting.

Fortunately there are boards which have instilled the discipline of benefits' tracking around value delivery and see it as an intrinsic part of their governance responsibilities:

> *"…we have a board agenda item which is merger integration updates and a six monthly, 12 months, 18 months… Now we keep dragging out well 'what we said when we bought this thing was this was going to happen, what are the lessons learnt. ….where did we get it right? Where did we get it wrong?' And that's been a very valuable tool in actually preparing us for doing bigger mergers."*

This particular board member believed that value tracking is important and also that post-transaction reviews assist in learning:

> Question: *"And so would you expect that there's a running scorecard kept of how the synergies are tracking and all of that? Would that be part of your agenda items going forward?"*
>
> Answer: *"Absolutely. And by the way I believe in post-acquisition audits."*

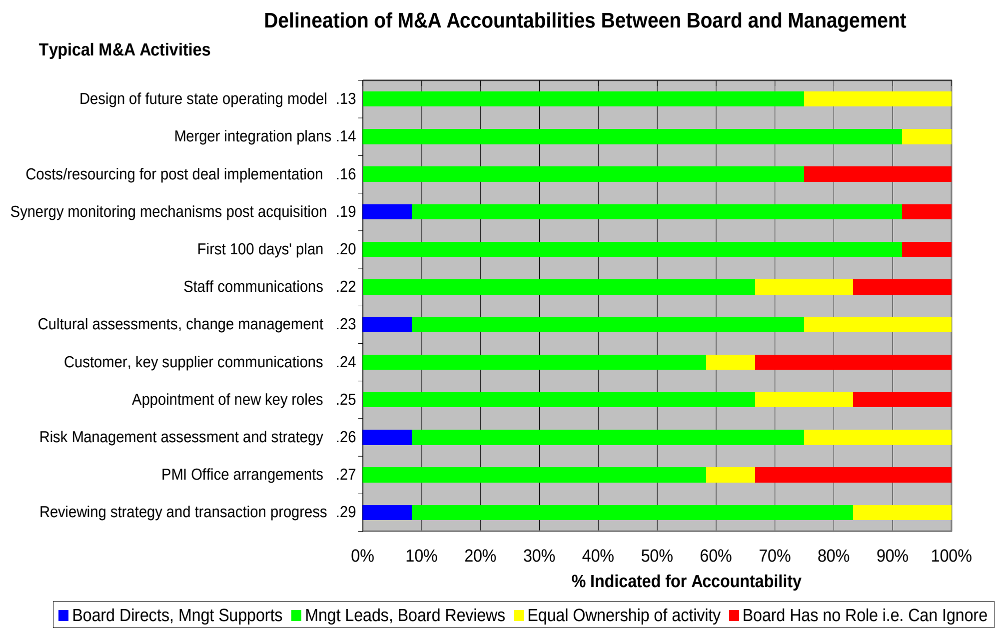
And:

> *"So I think, I haven't really reflected on it in these terms, it might well be that eventually management almost got a bit frantic that they weren't going to be able to do a deal. Clearly they hadn't been able to do one in Asia. This is a deal that didn't work ...so that's why I suppose you learn more I think from deals that don't work, though that's not (always) true we learnt from [transaction xx] here, it worked a treat."*

The delineation of accountability for this activity

Ensuring that proper 'synergy monitoring mechanisms' (Activity #19 below) are in place is a crucial activity for board involvement – and an important signal to management from the board in making its desires clear with regards the need for proper tracking and reporting. Without this board interest, it is less likely that management will voluntarily report on progress in detail. After all, why would most management teams want to subject themselves to added pressure and scrutiny?

<u>Figure 38: Accountability for post-transaction monitoring</u>



Source: Dean Blomson (thesis author)

From the interviews it appears there could be several different reasons why boards do not push harder to get detailed post-transaction reporting:

1) It is a natural human tendency not to want to hear bad news

   "And it goes past the deal because, you know, once you put your name on doing it, you're then hoping like hell it's going to work, and in fact you don't want to hear bad news, and perhaps you don't interrogate as harshly or with the same vigour that you probably should. 'Cause you actually should be looking harder. I mean (it's) your own business you know...."

2) Discovering that you have overlooked something significant is embarrassing and potentially exposing – and boards do not necessarily want the extra scrutiny externally

> *"Well ….no one's gone into it looking for it not to work. But perhaps you're not as diligent after you've done it because, you know, you don't want to turn up something that you might have found beforehand."*

And:

> *"….having made the investment, the board should set up as part of its process and due governance an asset and investment review at regular intervals and of course people are a lot more enthusiastic about buying things than they are about reviewing their purchases."*

3) Management itself could either be disinclined to provide the post-merger performance data (in a transparent and traceable way) or does not have the time or systems to provide separate and detailed reporting

> *"…we didn't get separate reporting on the one third of the … business which was the original transaction which was the faulty one….And it's…the old sort of Allan Bond method, isn't it? You know, you never present the same balance sheet two years in a row, and no one can ever draw comparisons…"*

Whatever the causes, which can be speculated on, the theory and practice of benefits' tracking is clear: establish a clear baseline for benefits' realisation, set targets, ensure the benefits' 'run rate' is clear, put robust tracking mechanisms in place and request regular updates. More sophisticated M&A practitioners advocate the use of a 'value scorecard' i.e. a specific set of metrics to track and report on benefits' realisation post transaction. A board that makes its intentions clear to management in these regards is far more likely to get greater visibility and transparency of outcomes, good and bad. Such an activity goes to the essence of a board's duty to monitor performance and to keep the market informed.

Alignment of boards' view of post-transaction practices to literature

The views of interviewed directors are clear on the role and importance of post-merger integration and the need to have a clear vision, plan and future state design (although these are implicitly assumed to be management responsibilities). Similarly there was clear recognition in interviews of the importance of having a post-transaction monitoring activity. The data coming from the questionnaires regarding delineation of responsibilities for managing post-merger tasks indicates clearly that "Management Leads, Board Reviews" i.e. the participants believe that this is primarily a management activity.

The challenge, however, is that in some cases the board either neglects to ask management to conduct a formal review of progress; or management is *laissez- faire* about doing so or neglects (possibly intentionally so) to provide regular updates. In either event, this fails to be a structured, disciplined and regular process of performance monitoring.

The real danger is that boards run the risk of being blindsided by management not wanting to deliver bad news. Where material write-downs relating to a transaction (or any other strategic or operational events) are imminent, the market needs to be advised of this; and for a board to be taken by surprise is disastrous – in terms of ongoing reporting requirements to the ASX and for corporate reputation. Material write-downs could come as a result of poor benefits' delivery: from over-estimating synergies (their size and/or speed of delivery) or from under-estimating synergy realisation costs.

It is readily apparent from the data on delineation of M&A responsibilities in Figure 38 above, that in the views of a few directors there should be a low level of board stewardship over a range of post-merger integration (PMI) activities i.e. indicated as ‘Board has no role’.

There is an apparent contradiction between Activity 19 – having a synergy tracking mechanism (value scorecard) in place; and Activity 29 – regular monitoring of strategy and transaction progress against agreed milestones. There is strong advocacy for the latter but support for the former is divided. It is the former, however, that goes to the heart of benefits’ extraction, and is a prerequisite and enabler for the latter. It should be noted, however, that Activity 29 is worded somewhat more broadly and has application to strategy and transaction progress i.e. it does not explicitly target the delivery of value post-transaction.

There are some warning signs as to why board members may tend to loosen their vigilance over post-deal value delivery and achievement. A real discipline and focus on post-merger value delivery would be predicated, generally speaking, upon a foundation of supporting activities. The directors’ responses to the questionnaire indicate differences of perspective about these foundational, ‘feeder’ activities that collectively perhaps point to the potential cause of boardroom lapses around value tracking. Respondents did not indicate a high level of priority for board inputs into:

- The future state operating model (Activity #13)
- Merger integration plans (Activity #14)
- Costs of post deal integration / implementation (Activity #16)
- The synergy assessments (Activities #17 and 18)
- PMI arrangements (activity #27).

This raises the question as to whether the seeds for deficiencies in post-deal benefits’ tracking are in fact planted in how the board behaves <u>before the deal</u>: i.e. in how much scrutiny it gives to the future state operating model for the business; the potential synergy flows; the first 100 days’ plans etc. <u>at the time of the transaction.</u> These concerns were highlighted in Section 6.9.2 regarding the surprisingly low level of importance attributed to Activities 16, 17 and 18 i.e.:

- Costs / resourcing for post deal implementation (Activity #16)
- Assessment of synergies – commercial due diligence (Activity #17)
- Independent review of synergies (Activity #18).

Why participants indicated that it is less important for them to have input into the above three activities is unclear. There were no direct reasons offered in the interviews. If one were to speculate, there could be a variety of factors causing poor discipline in benefits’ tracking. Potentially a board could believe that:

- After the deal is done delivery of benefits' becomes management's problem.
- Post-merger plans are management's responsibility as too is an assessment of synergies pre-deal.
- Post-transaction performance monitoring is primarily a management (operational) task and reporting can be accomplished as part of standard business updates.
- There are more important and relevant matters for them as board members to focus on. Or ,
- They do not need to deal with these items at the time of the transaction but will still be able to assert post-merger control and monitoring after the event.

Speculating on the underlying causes is interesting but not instructive. The real question that should be asked is whether the questionnaire data means that board members do not see a need for them to monitor? The answer is 'No' firstly because the majority of responses to the questionnaire indicated that these were seen as tasks requiring stewardship ('Management Leads, Board Reviews'); and secondly because it was clear from interview data that most of the board members interviewed did see benefits' tracking as a key governance and control activity. Most interviewees believed that it is an important function of boards to review progress, post-transaction; although there was some recognition that the way they tend to do it is not particularly disciplined.

The views that directors provided in the interviews would seem to indicate that they do not see monitoring as unimportant or something they should not be involved or participating in. The responses to the questionnaire about the importance of certain activities (and the delineation of responsibility for these) provide some potential but important clues as to where directors' espoused responsibilities are breaking down.

The value of learning via post-transaction reviews was also well accepted:

> *"Formal wash ups. And you know, you don't get through the process, you got a six month one, 12 month, 18 months, and then you move into business as usual, unless you get called back through a project review. If the project manager or integration manager, in an operational review, says 'Well this isn't going well' then it comes back to the board. But that's very illuminating because, you know, you can see where we've overestimated the revenue synergies, you know, we've acquired your business and you want to bring all these clients and well no you didn't. .... so that's a very valuable part of the follow up process from the board's perspective…"*

And the same interviewee:

> *"….we've done 50 mergers in the last ten years, so ….by the time you (meet) say three times for every one of the 50, it can easily be one or two in each board meeting, but it is a standard agenda item."* (author's addition in parentheses)

The literature is clear: measurement matters. Research supports the old adage: if it doesn't get measured, it won't get managed. The PwC 2014 report into M&A Integration found that "Survey respondents with the highest performing deals reported applying more deal performance indicators than those reporting less success. Higher performers also reported that more of those measures were of greater importance to them."

In summary therefore practice (via directors' views) and theory (via the literature) are quite aligned and clear, namely: (a) that post-merger tracking and monitoring is an important action; and (b) that directors recognise this is a vital activity but the level of adherence and involvement varies (i.e. it is generally it is not an engrained discipline).

If there is a gap or discrepancy between theory and practice it lies in some of the responses to the questionnaire which indicate that the antecedent or foundational activities necessary to entrench effective post-merger benefits' tracking perhaps do not get the required level of emphasis by directors that they perhaps should (refer to Figures 37 and 38 above).

The sixth and final key theme relates to **well-chaired board with constructive challenge.**

As indicated in Figure 36 above, this theme represents an ongoing "transversal" activity that overarches and influences the other five themes. What this means and why this is so important will be demonstrated in the section that follows.

6.10 Well-chaired board with constructive challenge

Before this important theme is addressed, it is worth reiterating that significant transactions usually bring with them greater complexity and larger attendant risks; and therefore demand potentially special requirements and vigilance, as opposed to 'business as usual' type governance arrangements. How extensively boards are involved in larger transactions, how they act and behave, what aspects of the deal they are more likely to scrutinise, is likely to be determined by a combination of four factors:

1) the board's prevailing governance arrangements particularly checks and balances on management
2) the directors' views of their roles and decision-making rights versus those of management
3) their mindsets, particularly the extent to which they bring independence of mind and reason to the boardroom table
4) their behaviours, namely their ability to provide scrutiny of information presented to them and their willingness to debate matters critically but in a collegial manner.

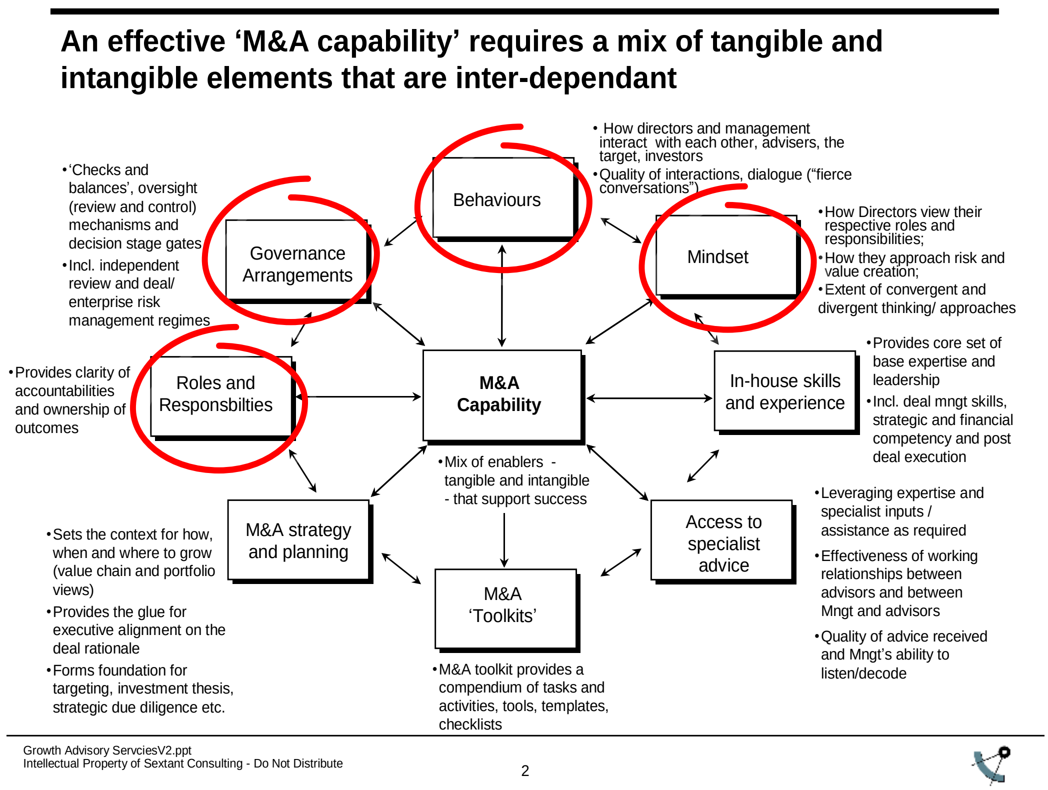
These four elements go to the heart of stewardship.

The discussion that follows on a "well-chaired board with constructive challenge" therefore touches on these four aspects namely: (1) governance arrangements, (2) roles and responsibilities, (3) mindsets and (4) behaviours. As indicated in Figure 39 below, these four elements form part of an enterprise's M&A capability set and represent generally the soft systems relating to a board's role and effectiveness.

As will be explored below, having an effective chair influences all four components – at least from an M&A perspective.

Governance arrangements were explored earlier in the literature review – and it was concluded that none of the traditional sources of governance literature adequately explore how a board needs to conduct itself specifically in relation to a merger or acquisition.

Figure 39: Understanding the various factors comprising an M&A capability set



Source: Dean Blomson (thesis author)

The structured questionnaires shared with interview participants did not explore the four circled elements *per se* – rather, it elicited their views on role delineations and responsibilities for particular M&A activities.

Key elements of ***Governance arrangements*** (in the form of checks and balances) and ***roles and responsibilities*** (how interviewees see these as being delineated), have been explored in the preceding five themes: strategy (in Section 6.5), planning and preparation (Section 6.6), culture (Section 6.7), business case testing and funding (Section 6.8) and monitoring of benefits' delivery, post-transaction (Section 6.9).

Certainly how the board sees its role *vis a vis* that of management has been identified as a key determinant in what they claim to focus on and what level of direct involvement they tend to seek to have in various activities. Boundary setting is a crucial activity that chairmen and CEOs ought to attend to; and has already been flagged as one of the six key disciplines of highly effective chairmen in ‘Leading the Board – The Six Disciplines of World-class Chairmen’. (Kakabadse, 2008)

Specifically in Section 3.3.8, dealing with the role of the chairman and independent non-executive directors, the case was made that effective chairmen tend to be those that sit down with their CEOs and explore where and how they could best add value and then delineate the boundary between them (in terms of decision-making rights), and agree their respective roles and contributions that make most business sense.

Mindsets and ***Behaviours*** have been touched on in several earlier sections but have not been directly explored as a theme.

Section 6.11 pulls together these four seemingly disconnected topics and explores them under the banner of the role of the chairman. The section considers the key traits of the chairman in so far as these may impact on successful deals; and then examines the ‘climate’ the chair creates in the boardroom that allows the ‘right’ kinds of constructive behaviours to take place when dealing with transactions.

6.11 How do directors view the importance of effective chairmanship?

There were a number of views that came through quite explicitly in the interviews, as to the crucial role an effective chairman needs to play in the transaction process:

1) Providing early and honest feedback

> *“The first thing I would say to you it is vital that the chairman and the CEO have had a private debate about it. If they haven't, it's very dangerous…. It doesn't mean that they have to come out of that debate agreeing. In fact sometimes it's better they don't, but the thing is I think that the chairman has to a) help with what information goes to the board and if he hasn't entertained the discussion already, he won't know what information should go to the board. That's number one.”*
>
> And
>
> *“... that if there isn't an honesty between the chairman and the CEO outside the board meeting, because I think it's very difficult for a chairman to take on the CEO in a board meeting, particularly if half the rest of the board are supporting the proposition and the chairman's sitting there saying “I don't think we should do this”. It's a very different and difficult dynamic to manage.”*

2) Acting as a conduit of views from the board to the CEO and Executive team (and vice versa) in doing some early depth soundings

> *“Number two, I think that the chairman can help the board to know the enthusiasm or otherwise of the CEO. And I think it's terribly important that the chairman is not there to humiliate the CEO nor to do his bidding and that's why I've got to be honest. I do it and I know a lot of others do but I've already debated it and if we've both in agreement I think*

we usually say so, but then it's on for young and old. But if I find as chair that if I've said a lot of my points privately to the CEO, I can organise the meeting better so that everybody gets a say. "

3) Maintaining objectivity and perspective

"So bringing that external perspective and not being seduced into the deal fever I think is the hardest thing because once again you don't want to be, you know, my initial response is always no, particularly as the chairman. The chairman I think has a much more difficult role to play in all that, because the chairman in some ways has got to crystallise the views of the board and then also be, you know, testing the process and the principles of the CEO…."

4) Ensuring a free and unfettered exchange of views

"(the chair)… can't be sort of always on the other side saying to the CEO "Well I don't think we should do this because this and this" because that I think then drives a very big wedge between (them) if the CEO's saying "I think this is strategically where we've got to go" and the chairman says "No"."

5) Keeping the M&A process disciplined

"….what I think is the right thing to do and it's very hard to achieve, is actually within management and/or the board, getting the right mix of enthusiasm to do it and diligence. If the MD's very keen on it, it's very hard to get any people in management to question any of the assumptions. Certainly if you got the MD and the CFO on board, you know, it's hard to stop the train. And it's that balance between….not wanting to slow down something that…hopefully…is a valuable and exciting opportunity, but putting the discipline around it."

6) Driving to an outcome

Ultimately a board is a decision-making body – depending on where and how it has delineated its authority – and an effective chair needs to move the board members to a decision, one way or another. Interestingly, no chairmen or non-executive directors in their interviews spoke directly of their chairman's influencing skills: whether they took this as a given, or possibly were reticent to discuss it possibly in case it sounded like self-aggrandisement or manipulation, is unclear.

Influencing skills have been flagged as one of the six key disciplines of highly effective chairman (Kakabadse et al 2008). In a recent interview (Kakabadse), one of the book's lead authors, Professor Andrew Kakabadse said:

> "…it is a paradox here because on the one hand you are trying to get all your board directors to contribute and so you want a really open debate and dialogue, and yet you still have to guide it and this is the paradox – I want it to be open, yet I want it to go my way. And it was those chairmen that could handle that paradox well and provided a sort of nudging to the board members who may be managers as well as non-executive directors,

> because on British boards you could even have a balance of executive directors and non-executive directors, who would very cleverly influence the process of discussion and debate to an outcome which makes sense to everybody."

This is a view that the thesis interview participants also alluded to, less directly:

> *"So board disagreement, I don't have a problem with, unless it starts to fester as true disagreement as against opinion disagreement on observational terms, you know. If it gets down to the situation where we're spending more and more money on due diligence …and you get this mix of… some directors that have a different risk threshold to others. How do you manage that as you go along? And my personal view is you never take it on to the stage where you know damn well you can't win the battle. But at times you got to have the gumption to lead it far enough along the path such that you know that if you did put it to a vote you'd have the decision, even though somebody might disagree."*

Governance literature and codes of practice recognise the pivotal role of the chairman. As indicated previously in Section 3.3.8, the role of the chairman and independent non-executive directors, the chairman in UK and Australian Boards in particular plays a pivotal role in setting the tone for how the board goes about its business. The Higgs (2003) report emphasised the chairman's crucial role "in crafting the conditions for director and board effectiveness". Higgs (2003) recommended that the chairman should be responsible for: leading the board, setting its agenda and ensuring its effectiveness; ensuring the provision of accurate, timely and clear information to fellow directors; ensuring transparent and relevant communication to shareholders; arranging the regular evaluation of board and board member performance; and enhancing the contribution of non-executive directors; and ensuring constructive relations between executive and non-executive directors.[167]

The last two points in particular lay the foundation for what could be called 'constructive challenge' i.e. ensuring that board members, executive and non-executive, are able to contribute effectively and to challenge and debate all key aspects of the transaction.

Based on the roles emerging from the interviews, the critical role of the chairman is to: provide early advice to a CEO considering the pursuit of a M&A transaction; manage board interactions and keep to a disciplined process; facilitate / encourage discussion, critical debate, engagement, and commitment; know when to move from debate to decision. These views align with the literature including in particular the last two points, which relate to the culture or climate on the board.

One of the key challenges that no interview participants addressed directly was how a chair can indicate his or her views at some point in the debate, without inadvertently signalling to fellow non-executive directors that their own views will be discounted. One director said the following:

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[167] Nada K. Kakabadse (Northampton Business School, The University of Northampton) and Andrew P. Kakabadse (Cranfield School of Management, Cranfield, UK) - Journal of Management Development Vol. 26 No. 2, 2007 at page 174. Extract from http://www.som.cranfield.ac.uk/som/dinamic-content/media/documents/192a.pdf

"The first thing I would say to you it is vital that the chairman and the CEO have had a private debate about it. If they haven't, it's very dangerous. That doesn't mean they have to agree….In fact sometimes it's better they don't, but ….I think that the chairman can help the board to know the enthusiasm or otherwise of the CEO. And I think it's terribly important that the chairman is not there to humiliate the CEO nor to do his bidding… but I've already debated it and if we've both in agreement I think we usually say so, but then it's on for young and old. But if I find as chair that if I've said a lot of my points privately to the CEO, I can organise the meeting better so that everybody gets a say."

The question that needs to be asked is: if a chairman does signal his views and he and the CEO are united, how encouraging and productive is it for the other NEDS to challenge them?

Undoubtedly this comes down to each chair's sense of judgment and his or her sense of self-awareness i.e. how aware he is of the impact his voiced opinions will have on the board; and therefore the timing for when he (or she plays) his cards.

6.12 How do directors view the importance of behaviours and mindset on deal success?

This is an area where the conventional commercial literature was found to be weakest, as the content matter that may have relevance to board behaviours tends to reside in industrial and behavioural psychology. *Behaviours and Mindset* have surfaced in the coding of interviews as two factors in the opinion of directors that could make a significant difference to the manner in which boards prepare for and undertake transactions. The inclusion of these factors alongside the 'doing' and more standard checklist type activities that are more commonly associated in the governance literature with board effectiveness, adds a different perspective to the factors that could make a sizeable difference to transaction success.

As indicated in Section 3.2.4, *Behaviours* and *Mindset* are the two critical elements of M&A performance that the conventional commercial literature does not explore.

Four particular aspects of behaviours and mindset were explored via the coding of interview transcripts namely: constructive challenge and critical debate; handling deal fever; applying Business Judgment; and saying no.

These four elements came up regularly in the interviews and have been grouped under the category of *Behaviour and Mindset* for the following reasons:

a) Constructive challenge and critical debate, as discussed by directors, goes to the heart of individual and collective board interactions in not simply 'going with the flow' and unquestionably accepting data presented and others' viewpoints.

b) Handling Deal Fever, as also covered in extensively in the commercial literature, refers to a board's ability not to succumb to fatigue or impatience.

c) Applying Business Judgement – a cornerstone of legal precedent – is all about demonstrating commercial savvy and being able to justify why the Business Judgment Rule should give exemption coverage to the board's decision making.

d) Saying No represents the mental toughness required of the board not to act as a rubber stamp to management's recommendations.

These four coding subcategories will now be dimensioned and explored.

Firstly, as regards Critical Challenge by board members of each other and of management; this was an area of board practice and capability that interviewees generally did not explicitly label. Many of the participants did, however, raise points about the interactions with the executive directors and management that were directly related to the effectiveness with which they were able to challenge each other's thinking and debate issues in a constructive way. Hence the 'Critical Challenge' coding was applied to like references.

From the interviews a number of key elements were surfaced that pointed directly to the need to support better decision-making via constructive challenge.

1) Constructive debate starts with having the right mix of skills and experience around the boardroom table and when directors know they will be held accountable:

> *"So I think you have got to be comfortable that you have got the right people in place and by asking fairly smart questions you can send signals, the sort of thing you'll be looking at and you'll be holding them accountable for, but if you are really .... dead against it and you think you're betting the company on it then you have to resign. if it gets to that point."*

2) Directors emphasised the need to have honest and open communication and avoid management and the board taking fixed or closed positions (to negate a win-lose perspective):

> *"Well I'm a great believer in the value of conversation, internal conversation as much as external conversation, and that if you've got residual (concerns) then I think that you're mad to not express them, and you're mad not to carry on the conversation. Now I think that.....if there are .....fundamental difference of views between boards and management, well, to where you don't trust the CEO or whatever, well you've got to do something about it.... . But on the basis though that you just ....have concerns ...I think you've just got to just engage with conversations...., which can mean that things take a while, take longer, but I think you get a better result."*

3) There was recognition that holding a line on a critical issue takes courage and an independent frame of mind:

> *"... the best you can do is speak out. Having said that, it wasn't a transaction but it was a major decision on the board recently, and every member on the board agreed except one, and the one had really firm views. ...he really believed strongly that his decision was right and the chairman wouldn't allow there to be a split vote. So we just didn't go home, it went on until 9, 10pm at night and we were debating this issue and trying to get that view. And there were times when he almost turned it the other way, and at the end we actually found a way to get him information that would prove that his view was wrong, and it was. It is very hard, and what he did, and I said to him afterwards ... 'you're a hero to have persisted for that long'...,. So you can say 'I don't agree', and we all I think can do that*

today quite comfortably, ...but there comes a time when .... I suppose pragmatism has to also take over and think, oh shit maybe I'm wrong if 20 other people don't agree with me.... But I think your challenge is the very least to be heard. It happens ....very occasionally."

4) Critical debate is crucial to a stress testing a decision:

"...I remember...when I was involved in a rectification of a document ...it was one sided rectification. We went to the judge and said "here it is, it's wrong, got to change it, do this." The judge said there and said, "that's very nice. I want to hear someone that's arguing against it. So go away, go and find someone to argue against it, and make sure it's a strong argument." And that's, I think, one of the problems that boards don't do because there's not an incentive to do it. In fact, there's a disincentive to do it."

And:

"...you want the board to be questioning. You know, chief executives and executives teams get pretty exuberant and there is a lot of precision about numbers, but there is not necessarily a lot of accuracy because there is a lot of assumptions. So you are wanting the board to ask difficult questions, you know, you are wanting that to be a stress test both in a questioning way and in a you know, in an evaluation way."

5) Having one or two board members who present the counter-argument effectively often leads to a better outcome:

"So ...the approach that I try to take is more of the devil's advocate, ...to put an opposing view, and to then be comforted by the fact that the proponent has considered all the opposing views and still comes to the same conclusion."

6) Crucially the CEO and chairman need to be big enough to debate their respective points of view:

"I do not want you to go to the view that the two have to come in holding hands. These best meetings are where the board is secure enough ... and both chairman and CEO put the contra views in the thing and then ultimately it's a matter of debate. And then maybe the CEO can say well what if we did this? And the chairman says yeah, we mentioned that in our private discussion. What do you think? Everybody agrees. Suddenly you've got alignment."

7) A healthy, properly functioning board is one that encourages debate and accepts disagreement:

"The most important meetings of any board I've been to is where the chairman and the CEO disagree and the best meetings in that regard are where it's healthy discussion. A healthy board....from time to time my (CEO) and I, we know each other well, disagree and we both put our points of view and we debate it, and I don't really care, neither does the (CEO), who wins. We try and win of course because..., but we don't leave that room hating (x) because he voted for that one. That's a healthy board. An unhealthy board,

which you can say is more natural, is a factional board. A board… where basically people side with each other. I've been on those, they're terrible and they'll make bad decisions."

8) Trust must be built to facilitate constructive debate and to help the board navigate through the intensive pressure that usually comes with a major transaction:

"…we used to meet …in what we call the doughnut room because it happened to be a big round table, and …often in that room there were four of us, as directors and there might have been 20 advisors. But little by little we, I think, came to recognise each other's sort of strength and weaknesses and how we could work together and dealing with all of these issues …and we developed a really strong collaborative working relationship. It was amazing. And it was no coincidence that everybody sat in a circle. ….and ….at the time it really was fairly heavy weather,…humour punctuated the thing, often at the most extraordinary times in a way that helped everybody. And eventually I think the quality of the decision making around those particular issues was sound."

And:

"So having once again, invested in the relationship building and having the forum where those sorts of conversations can be had and have to be had, is a very important part of the pre-planning of the thing like this. Because once you're in the eye of the storm, you know, that it can go anywhere…"

It is important to note that the above views were raised in the context of board debate around M&A - but arguably these attributes go to the heart of board decision-making on any significant issue.

In a Cranfield Business School report titled *Chairman and the Board: A Study of the Role, Contribution and Performance of Australian Board Directors* (Kakabadse et al. 2008) the authors note that ASX survey respondents (207 respondents in total) rated Boards highly in a few key areas, namely their:

a) "shared understanding and cohesion – not being divided

b) attentiveness to corporate reputation

c) diligence in governance application." (at pg. 12).

Additionally, the Australian survey respondents scored their boards highly in attentiveness to risk management and being "well balanced in terms of member skill/experience". (Kakabadse et al. 2008)

The survey also asked respondents to rate their chairmen on their ability to: encourage consensus, work with the CEO/MD, handle tensions and sensitivities, and utilise the skills and experience of board members well.

The survey findings circle around, but do not directly address the requirement that an effective chair is able to strike the right balance between constructive challenge (or critical debate) and alignment and consensus.

Andrew Kakabadse summed up the special qualities of an effective chairman with regards to constructive challenge:

> "It is incisiveness. It is robustness and it has a great deal to do with courage because the argument that needs to be interrogated is the project and proposal that is put forward by management, and the board now has to go into depth to see whether through their interrogation this proposal is either going to bankrupt the company, it's going to enable the company. Have management thought through (it) sufficiently?" (Kakabadse, Cranfield University interview 2008[168])

Secondly, as regards dealing with Deal Fever, this is a key aspect of the board's mindset and behaviours that can cause them to lose control and perspective, thus leading to either rash or ill-conceived decision making.

Deal fever is consistently identified in literature and in discussion with many M&A practitioners as a pathology that often occurs in transactions. It refers to the point in the transaction process at which logic and discipline are over-ridden and the desire to do something, to 'land the target', becomes the driving force, individually and often collectively.

> *"I think one of the hard things too is that if you get halfway down the track with the transaction and something goes wrong I think it's very... hard for management to walk away….and I've even seen transactions set up in such a way that the company was set up because they were unsure that it was something that they wanted to do, that they took a 20 per cent stake first and realised that it was not a good thing and still went ahead. They set up all the right signals and strategies around 'this is a really high risk transaction' and then got all the negative signals and still did it! Because you just get into this mindset of deal fever and I think that happens to everyone.…"*

What can chairmen do to counteract this tendency? According to interviewees:

1) Savvy chairmen and board members are alert to this phenomenon and work hard to counteract it:

> *"…that's where the board really has to play that independent part and the board has to be able to say "this is not in line with the initial report you gave us supporting that transaction. Too many things are outside the parameters, whether it be the price has gone up, or the synergies aren't going to be the same as we thought or there's some onerous contracts or other onerous things involved…", and …the board is charged with the role of keeping management aligned and accountable to strategy, so if it's starting to go off pace then that's where the board really needs to be tough and I think that's a hard thing to do*

[168] http://www.som.cranfield.ac.uk/som/dinamic-content/media/knowledgeinterchange/booksummaries/192/Transcript.pdf

because management are all really excited and you are going to really piss them off. But that's where the board has to be strong and not over pay and not continue with something that's actually maybe when we got a bit closer is not as good as we thought. ...It's really hard to pull back on something once its down, past a certain (point), you may have spent two or three million dollars and to pull back is a hard thing to do."

2) The chairman needs to hold the line but without causing a schism especially between executive directors and NEDs. This requires diplomacy and sensitivity and people management skill on the part of the chairman (unless of course he or she is the instigator of a contentious deal, in which case he or she could struggle to be seen as an honest broker). Ultimately, however, having 'free and frank' conversations comes down to trust in and respect for each other:

> *"A good chemistry around the board table should not be the CEO versus the board. The CEO's job is to put up opportunities. His job is also to tell you whether he's in favour of it. It's up to the board whether they do it. Now if the board says no we move on to the next thing. No recriminations. Obviously if the board says no to everything he does that's a different thing but that's not what you're talking about. It's an opportunity, the board is scared, the board is there as the elders to think. They must be allowed to say no…"*

3) The chair and board members themselves need to be particularly alert to the early warning signs of deal fever in behaviour:

> "*I think you watch everybody. I think that's not… just management but actually the other board members as well. .... of course there's no question that quite early on you begin to understand that everybody has an agenda but has a view. And I think that the challenge is to make sure that that view either doesn't dominate the discussion to the extent that the other views are allowed to come through, or that it doesn't turn a deal off for the wrong reason."*

> *"The changes in behaviour. And we all have our particular style. You know, some are listeners, processors then contribute. Others talk and sort of contribute as they talk and think as they talk. Just watching when that starts to change and ..... what's the underlying reason for that change."*

4) Maintaining perspective and objectivity is crucial:

> *"*So it seems to me that of all the things that the board needs to make sure it is checking that it is really challenging management as to being able to stand back and look at this thing *from 100 foot rather than from within, and saying 'does it really make sense?'"*

And:

> *"Because once you're in the eye of the storm, you know, that it can go anywhere and therefore maintaining that sort of, on the dance floor or on the balcony sort of, and you've got to doing both."*

5) Checking that the process has not lost its integrity and maintaining discipline is one of the best protections against rushing to a close:

> *"…you have to keep coming back to, 'am I comfortable that the principals that we are using to make our decisions on all sorts of different areas are right, and is the process right?' And that could be 'have we got the right people, is the process being done sufficiently rigorously…, in the right sequence?'"*

And

> *"….not being a process Nazi or a process junkie, but when abnormal things are happening in the process, is you know, we promised a report on the technology because it's a critical dimension and well it's not available.…"*

6) Creating and permitting an environment where alternative views, other than the chair's and the CEO's, are able to be aired:

> *"I think the danger is if you have the chairman and the CEO going full bore at this, it is very difficult for non-executives sometimes to stand up to that; so you want the chairman to be truly eliciting views ….and if the chairman is hot to trot and the CEO is hot to trot, that is okay as long as the chairman genuinely elicits some support. There is no use if the chairman goes in unsupportive but you know, by the same token he has got to make sure that he draws out views and if you know, it's a weak argument and the chairman and the CEO are still absolutely determined, it is not so easy for boards to resist it."*

Thirdly, as regards Business Judgment, this is the ethereal quality that seasoned businessmen and board members should possess. Business Judgment is the ability to apply commercial experience and hard to define 'instinct' or gut feel to the data in front of one. It is the ability to move beyond the data and make sense of what's there and to form a view where information is incomplete or unreliable. No transaction, even a friendly, uncontested one, comes with complete information. Usually there is significant informational disequilibrium (asymmetrical knowledge) between the seller and the buyer; so savvy buyers need to apply business judgment as much to what information is presented to them as to what they're not seeing but sensing.

How do the interviewed directors endeavour to ensure effective judgment is applied?

1) By making sure that the basic and sometimes all-too-obvious questions get asked:

> *"And quite often you get lost in all that. So, you know, just asking the very simple questions of 'what are we assuming in synergies for revenue versus costs?' Because I think my experience would be most of these things always overestimate the revenue synergy, and always underestimate potentially the damage that some of the cost synergies will create. So you go in and …just decimate the team, because you know, we don't need their head office cause we've got one. Well …if all the corporate memory …is in that group of people, you've just lost….a large part of the intellectual property that you bought."*

2) By having directors who have 'been there' before and have an applicable frame of reference, industry knowledge and insights:

> *"...you got a checklist in your own mind of things that you ....think, of comparable transactions. You know, when people come forward and say "Well we think we should pay X" and my first question is why? Is that the market price? Is that the ...premium to get control? Is it based on comparable transactions? Or is it we've seen a jewel in there that no one else has seen, or we think it's an absolute steal? ...And quite often people don't bring those sorts of external reality checks to the table, so when it becomes ....less external reality checks that's when I start to worry because ...external scrutiny.....in reality is what the board is supposed to bring to the table."*

3) By building a thorough understanding first before exercising judgment:

> *"The first thing is what they've been told, you can't make a decision unless you understand and for example I find it incredible that the outgoing world chief of UBS Warburg's made the comment that they dealt in derivatives that were so complex that they didn't understand them themselves. If the board doesn't understand it, it is incapacitated to make a decision on it, so must be able to understand it, and the presentation to the board must be sufficiently structured in a way that the board can understand what they have been told. So if I am a director, I won't approve or disapprove anything I don't understand as a prerequisite. The second thing is the board's job is to test it, and to challenge it, to push back and on the basis of the information they've been provided ...."*

4) Turning to internal or external sources who can provide a reality check:

> *"It is very hard for the board to be a devils' advocate, themselves. What you do need....well in my old career we used to have a business evaluation group which took a sort of third party reviewer (role) of the deal and they weren't always right and I didn't always agree with them, but I tell you what, at least they gave cause for deliberation and I think that is important. You know, "where might this go wrong?" and they do a sensitivity analysis, those sorts of things."*

5) Stepping back and seeing beyond the obvious:

> *"So it seems to me that of all the things that the board needs to make sure it is checking that it is really challenging management as to being able to stand back and look at this things from 100 foot rather than from within, and saying 'does it really make sense?'"*

Like the elusive concept of common sense, commercial nous and business judgment cannot be taught in a management course. When it comes to M&A and major transactions, experience, wisdom and a critical mindset are perhaps the ingredients most needed.

Lastly, as regards saying No, views were mixed, with some participants implicitly saying that the board was caught between a rock and a hard place i.e. if it said no, that would create a schism with executive directors. Other participants felt it was a mark of a mature board and a trusting relationship when non-executive directors could in effect overrule the CEO and it would not be treated as a vote of non-confidence in management's proposal or capabilities.

The first group viewed a ‘no’ decision as a potential slap in the face of management:

> *“Well it is because you can only question so far. You are a non-exec, you are not a part of management and whilst all the literature says call for an independent report, call for this call for that, by doing that you are sending a pretty strong signal to your management i.e. ‘we don't trust you, we don't think you are up to it, we need a second opinion’ and if you are sending that sort of message, you should change your management. So I think the board literature is incorrect in that. You have to, you can quiz up to a certain point and then you've got to back your management and if you can't back your management then you need to sack your management and start again….”*

The second group argued that it is a mark of an effective board where one could agree to disagree without this amounting to a win-lose situation:

> *“I don't agree with that at all and I think that's a pretty sour, and I'd have to say I think that's old fashioned. A good chemistry around the board table should not be the CEO versus the board. The CEO's job is to put up opportunities. His job is also to tell you whether he's in favour of it. It's up to the board whether they do it. Now if the board says no we move on to the next thing. No recriminations…..They must be allowed to say no….”*

If, however, the board does veto a deal, and the CEO is surprised, that in itself could indicate that the communication process has not been well-handled

> *“I think though it really is up to the CEO to manage it better than that. I think the CEO's made a mistake if he arrives at a meeting and gets knocked back and he is surprised. At the very least the CEO should be hesitant and say so.”*

Saying no takes courage and resolve – and is easier when personal relationships do not get in the way of doing the right thing

> *“I look back on my career and the guys that I worked for – the very best understand the role and they are not afraid to say no. I think boards, I have once said, should be friendly, but not friends. You know, I don't think you want your mates on the board…”*

As another director said:

> *“You should be able to disagree without becoming disagreeable.”*

Alignment of directors’ views on ‘well-chaired board with constructive challenge’ (and importance of behaviours and mindset) to literature

As has been flagged in relation to the comments regarding the chairman’s role, the views of participants are well aligned with the literature and the theory. An effective chairman is one who manages the process in a disciplined way, but who also ensures that the exploration of the transaction is thorough and balanced. Without that effective chair and board in place, the investment could be jeopardised.

The extent to which a chairman can surround himself or herself with suitably skilled and competent directors, and then coach and lead them to be a highly effective team, ought to be a determinant of company performance, logically speaking.

Moving beyond the chairman's own contribution and role, as regards mindset and behaviours, here the literature is weaker and less explicit than the views of the interviewees – although the literature does implicitly point in the same direction. Governance literature and codes of practice certainly address directors' skills and the importance of the independent director – but the independence of mind of directors and the need to be sceptical and contrary when necessary, is not well explored as a particular theme.

The views expressed by directors add significant thinking to the gaps prevalent in governance literature. As indicated in Section 3.3.8, dealing with independent directors and various governance reports and codes, independent NEDs are viewed as critical to help to support more objective, impartial debate in boardrooms, to counteract the power of executive directors and to aid in enhanced transparency. Various codes have gone to considerable effort in defining (a) what is an independent director, and (b) what proportion of membership should they represent on boards and their various sub-committees.

As indicated earlier, however, the focus on independents is not a panacea. Bringing more independent directors on to a board does not of itself guarantee more penetrating debate or better decision-making, unless (a) these individuals bring with them the necessary knowledge, experience and courage; and (b) they are managed by a chair who knows how to get the best contribution out of them. Ultimately independence is about a state of mind and action – and more formulaic approaches to board structures and numbers tend to overlook this elusive quality.

This issue of independence, in the form of having free thinkers and critical minds around the boardroom table, is a critical ingredient of the twin factors of mindset and behaviours that has been identified as emerging from the interviews.

As an aside, it has to be noted that probably not every chair would welcome independent thinkers; some no doubt would place a higher premium on having team players with whom it is easier to build consensus.

The two factors, independence versus cohesion, should, however, not be mutually exclusive. One can and should still be able to ensure critical debate without jeopardising chemistry (which is often a euphemism for not rocking the boat).

In an article titled: "Corporate Governance: Hard Facts about Soft Behaviors" (Kocourek et al 2003), Kocourek, Burger, and Birchard state:

> "A culture of constructive questioning requires members to perform a delicate balancing act. The goal is an oxymoron - directors exercising "collegial disagreement" or expressing "reserved advocacy." "The atmosphere that needs to prevail between a CEO and a board is one of mutual confidence, trust, and a sense of them all being in it together," says Michael Miles, a former CEO of Philip Morris Companies Inc. and a member of eight boards. "It must be an open, mutually supportive, two-way street."

> "Although it is the responsibility of both the chief executive and the directors to nurture the right boardroom culture, "the CEO has to set the tempo," says Steve Beering, a former president of Purdue University and a director at five companies, including Eli Lilly and Company and American United Life Insurance Company. "You need a very good CEO who is obviously the orchestra conductor." (Kocourek et al. 2003)

This last comment should probably be qualified as it is stated in a US context where the CEO is usually also the chair of the board.

The views of interviewed directors were clear, namely that boards ought to be able to engage in constructive challenge and critical debate, to really test management's thinking. Without that approach to board engagement, M&A investment proposals and plans are not likely to enjoy the level of scrutiny, testing and validation that they ought to benefit from. Here the directors' views on 'right practice' emerging from the interviews appears to be more explicit than the theoretical ought.

Generally governance literature about good practice has focused more on process and form than the actual dynamics of the board. The closest that governance literature, in the main, comes to the ability of boards to hold constructive debate, is in the views propagated about directors' independence. Independence of thought and judgment is of course a vital component but if the environment is not conducive to debate, even the most independent of thinkers will be starved of oxygen.

As Crainer and Dearlove state in *Boards of Deflectors*,[169] "The boardroom isn't designed to be a comfortable and harmonious place. It isn't – or at least it shouldn't be. Rather, it should be a challenging forum for lively debate and decision-making." (Crainer 2008)

The power of personality and group dynamics should not be underestimated: "in any battle between business and human nature, human nature always wins". (Wagner 2006)

Beyond the need to orchestrate debate and discussions, chairmen need to monitor closely the behaviour of their teams (executives and NEDs) to pre-empt or ameliorate the effects of Deal Fever. Although literature does frequently reference deal fever as a phenomenon and a threat to value, the directors' view of 'ought' comes through more strongly than the theoretical ought.

Participants have flagged the need to apply *business judgment* in order to go beyond the data presented and to sanity check it. This too is not a topic that has been well-explored in the literature specifically as far as boards and M&A are concerned – although there are many texts addressing the art and science of decision making.

In a McKinsey Quarterly article by Lovallo and Sibony (2010) "Taking the bias out of meetings" the authors quote a McKinsey survey of 2207 executives, where:

> "Only 28 per cent said that the quality of strategic decisions in their companies was generally good, 60 per cent thought that bad decisions were about as frequent as good

[169] *Business Strategy Review,* Volume 19 Issue 1, Pages 59–63, 12 Feb. 2008

> ones, and the remaining 12 per cent thought good decisions were altogether infrequent. Our candid conversations with senior executives behind closed doors reveal a similar unease with the quality of decision making and confirm the significant body of research indicating that cognitive biases affect the most important strategic decisions made by the smartest managers in the best companies. Mergers routinely fail to deliver the expected synergies. Strategic plans often ignore competitive responses. And large investment projects are over budget and over time – over and over again." (Lovallo and Sibony 2010)

Lastly, although saying No is always an option, the literature on M&A tends to focus more on what is required to get the transaction to be successful rather than on the discipline of walking away. Thus here too the participants' views tended to crystallise a subject (saying No) that is not well explored in M&A or governance literature. This element of the directors' view of what ought to be done has come through strongly and is unsurprisingly seen as a critical ingredient for board performance in evaluating transactions.

In summary, there appears to be a gap in commercial literature around the impacts of behaviours and mindsets when it comes to M&A.

The 'well-chaired board with constructive challenge' theme represents a transversal theme that underpins all five other preceding themes.

The first five themes represent for the most part things or activities that interviewed directors believe that boards ought to do namely: clear strategy upfront; early preparation and planning; proper understanding of culture; rigorous testing of the investment business case and funding strategy; and regular control points post-transaction.

What the 'well-chaired board' theme indicates is that <u>how</u> you go about doing something is sometimes at least as important as <u>what</u> you do.

The sixth theme emerges as the special ingredient or 'secret sauce' that is perhaps the best guarantor of M&A value delivery – and protection for shareholders – where (a) the chair encourages healthy scepticism and insightful debate; and (b) board members have strong enough relationships to challenge each other and management constructively.

6.13 Summary of conclusions on research findings

This chapter has explored at length the six key thematic findings that have emerged from the codification of interview comments and has compared these to the literature review findings from Chapter 3. Between these two sources i.e. directors and literature – but particularly emerging from interviews – it is possible to decipher six prevailing themes relating to M&A right practice espoused by directors and supported in parts by the extant literature:

1) **Clear strategy upfront,** and how the board needs to actively participate and co-own the corporate strategy, before the event

2) **Early preparation and planning** and the need for the board to ensure that management has established the necessary M&A Processes, Policies and Planning upfront and that a suitably skilled team is in place
3) **Proper understanding of culture**, and the importance of ensuring that management has properly assessed their compatibility with the culture of the target company
4) **Rigorous testing of the investment business case and funding strategy** and sanity checking of key assumptions
5) **Regular control points post-transaction** whereby the board can keep the spotlight on benefits' tracking and absorb key learnings from the transaction
6) **Well-chaired board with constructive challenge:** where the chair plays a vital role in encouraging challenge and debate.

The participants' views have provided important guidance, in many cases where the literature and theory is silent, about what directors ought to do during transactions, in order to improve the likelihood of success. To recap, interviewed directors have articulated what they believe board members ought to do via a set of headline 'right practice' activities and behaviours, which encapsulate a number of sub-elements, so as to clarify the components that may be involved:

1) Helping to achieve a **clear strategy in advance** of the transaction (refer Section 6.5) by:

- Taking a long term view
- Keeping to a strategy driven agenda
- Ensuring strategic clarity
- Testing and co-developing strategy, not instigating it
- Signing off the strategy well before any deal making takes place
- Acting as a sanity-checker and advisor
- Acting as the 'keeper of the faith' and active monitor of strategy

2) **Early preparation and planning** (refer Section 6.6) by:

- Conducting the target analysis, competitive intelligence and monitoring on an ongoing basis upfront
- Ensuring there is an effective process in place
- Having the necessary project management skills
- Developing with management a set of guiding principles, philosophies and parameters for the deal and for integration
- Ensuring suitable professional providers are in place
- Making sure that a realistic level of pre-planning and checking has taken place
- Ensuring that the pre-thinking and preparatory analysis has been done satisfactorily

- Making sure the various required internal capabilities have been thought through and that capability gaps have been addressed.

3) **Assessing / evaluating cultural fit**: Boards' contributions and involvements are not explored well in literature when it comes to transactions specifically. It is fair to say that participants' views were less direct when it comes to what is really required by the board to make the necessary impact. The most direct views would be the need for culture assessment to be:

    - A deliberate, detailed and disciplined activity
    - Conducted with some level of board input and oversight before the deal is concluded (obvious as this may appear to be).

    Whilst culture was recognised as a really important matter to attend to, the sense is that actions do not always match the rhetoric. What causes this disconnect to occur is unclear i.e. whether this is because:

    - There are different interpretations of what culture is; or
    - Culture is an amorphous and elusive concept and it is unclear to some board members as to how to assess it in practical and reliable terms; or
    - Setting and managing culture is seen as the exclusive domain of the CEO in providing leadership.

4) **Rigorous testing of the business case** (refer Section 6.8) by

    - Stress testing the investment proposal under different scenarios
    - Providing discipline and a sanity check around synergies
    - Ensuring capital adequacy
    - Maintaining perspective on target rates of return and being alert to gaming of the numbers
    - Adding experience and business judgment
    - Testing whether the business has the resource bandwidth (financial and top management capacity) to cope with integrating the acquisition
    - Maintaining impartiality when examining a business case and being prepared to draw a line in the sand
    - Remembering that it is the board's right and duty to decide not to proceed if the business case is not compelling enough or if the risks are too great.

5) **Regular monitoring of post-transaction performance** was recognised as a critical activity; that requires discipline to maintain – but is generally not done well or consistently. There are several possible reasons, all speculative but based on clues provided by interviewees, as to why there is inconsistency in post-deal benefits' monitoring:

- Post-transaction integration may be seen as an operational activity to be carried out by management.
- It is politically expedient not to keep resurfacing mistakes (such as that may have occurred during the due diligence through for example over-estimating potential synergies).
- Board oversight of management applies to assessing its ability to hit the targeted numbers for the business overall, not specific performance or targets relating to the transaction (which are often hard to isolate).
- Management is not necessarily keen to be held to account against firm milestones and targets and happier with a *laissez- faire* monitoring regime.
- It is tempting to 'declare victory and run away' i.e. move on to the next deal.

Possibly the seeds for poor post-transaction monitoring lie earlier on in the acquisition lifecycle, where there is an apparent relative lack of emphasis placed on pre-deal scrutiny (i.e. during the transaction stage) of post-merger integration plans, tracking mechanisms, costs for integration and expected synergies etc. (see Figure 31: Importance of board involvement in post-transaction monitoring, based on questionnaire responses). If the board is soft on synergy assessments and post-transaction planning <u>before</u> the deal is concluded, management is more likely to take their cues from that.

6) **Well-chaired board with constructive challenge:** participants provided clear recognition that having an environment conducive to 'critical challenge' is vital to generate rigorous decision making on transactions. The role of the chair has also been unequivocally borne out extensively in governance literature and various codes of best practice. This environment can only operate effectively if three ingredients are present:

- an effective chairman who encourages and facilitates challenge and debate
- a trusting relationship between chairman and CEO
- a board that has confidence in the CEO and management team.

A number of interviewees indicated, although more implicitly than explicitly, that a climate of constructive engagement can only be successful in an environment of trust and honesty. Without that, CEOs will either feel threatened or board members will be seen as critical rather than constructive and there to help. Once the hard conversations are over, the board collectively has to embrace the decisions made and collectively move forward with management.

Certainly the commercial literature does not tackle this behavioural element in an explicit way in general and certainly not with regards M&A.

Most interviewees therefore felt that certain behavioural traits had to be present: constructive challenge and collaboration and commitment.

This sixth and last theme also explores the role of behaviours and mindset i.e. the culture of the board (created by the chair) to allow rigorous questioning; and the inherent mindset of directors to provide critical challenge. The views of the interviewed directors amplify what the governance literature and codes of practice only partly address, namely that M&A processes and checklists are all well and good when it comes to transactions, but the best protections for shareholders lie in directors who are determined to satisfy themselves (one way or another) through a thorough exploration of the merits and likely impacts and implications of the transaction.

Table 9 summarises the combined view of directors' wisdom and academic research and commercial literature for each of the six themes explored above – and compares it to issues identified from commercial literature in section 3.2 – causes of value loss from unsuccessful transactions – to ensure that these have been adequately addressed.

Table 9: Summary of viewpoints on themes, from directors and academic research

Theme	Guidance from literature	Perspectives from interviewees	Key issues identified is S3.2
1. Clear strategy, upfront	Explicit for executives; oblique and implicit for board	Clear and explicitly stated	Flawed merger intent or lack of clarity - addressed
2. Early preparation and planning	Semi-explicit for executives	Clear although largely a management led activity	Lack of adequate preparation and homework - addressed
3. Proper understanding of culture	Explicit for executives; oblique and implicit for board	Clear messages but some mixed practice	Clash of operating models - addressed
4. Rigorous testing of the investment business case and funding strategy	Explicit for executives; implicit for board	Clear and explicitly stated	A 'conspiracy of optimism' regarding synergies. Inadequate focus on commercial or business due diligence - addressed
5. Regular control points post-transaction	Explicit for executives; implicit and directional for board	Clear and explicitly stated	Not identified as a primary cause
6. Well-chaired board with constructive challenge	Semi explicit and indirect	Clear and explicitly stated	Not identified in commercial literature (as it is a board specific matter)

The analysis in Table 9 shows some gaps between the two sources. On the face of it these findings are not overly surprising or news to some observers to corporate governance. The relevance, however, lies in the lack of direct, explicit guidance in literature for non-executive directors. The theoretical ought of right practice is generally targeted at executive management but is largely implicit and tangential in describing non-executive directors' duties during transactions. The non-executive directors interviewed were unequivocal in their views on the kinds of things they believed they ought to do; hence their views tended to confirm what was explicit for executive management but only implicit for non-executives.

If any director – interested in understanding his or her duties regarding M&A – were to attempt to seek enlightenment from a single source of codified 'M&A governance' practice, he or she would likely struggle to get adequate clarity; and even turning to multiple published sources may not provide clear direction. Unlike literature on the subject, interviewed directors were generally clear about the elements comprising effective stewardship of transactions.

Based on detailed analysis of literature and interview findings, the above six themes, drawn from interviews and supported by literature, form the nucleus of a new grounded theory regarding board governance of major transactions. Taken together these elements potentially comprise a 'recipe' that respondents believe are more likely to lead to more successful outcomes. A summary statement of the new theory has been outlined in Section 7.1.5.

Are successful outcomes from implementing these themes guaranteed? The answer is that anecdotally they work and are tried and tested, but without empirical evidence it is too soon to tell without rigorous further testing..

The six themes are the potential ingredients for success but do not form a fail-safe recipe or silver bullet; and they are as yet untested. Given the small sample size and the qualitative nature of this research, these themes need to be treated as directional, potentially not exhaustive or comprehensive and therefore as a working hypothesis.

As has been pointed out, transactions are not standard events and do not lend themselves to formulaic responses. But do the six themes potentially hold the key to right practice and the possibility of improved outcomes? The litmus test will be whether subsequent research and analysis can prove their relevance and validity. As a set of directional markers, the themes emerging from could advance the understanding of what boards need to do to improve the chances of successful transactions.

This question as to the applicability of the six themes is explored further in Chapter 7, which deals with conclusions relating to the emergent theory plus practical implications of this research and indicated areas of further study.

7. Conclusions and emergence of a new theory

"It's a lot easier to act our way into a new way of thinking than to think our way into a new way of acting."

[Source: Richard Pascale's law (1990)]

"We all want big change fast... but in everybody else".

[Source: Michael Black]

"Unless we agree why, we end up doing what everyone accepts but no one really wants."

[Source: Jerry Harvey, Abilene Paradox: The Management of Agreement (1974)]

Key points

1) The literature review has indicated the dearth of knowledge at the intersection point of governance, M&A practice and legal requirements and precedent when it comes to boards' stewardship of M&A.
2) By tapping into directors' views to address the white space around right M&A governance, six key themes have emerged which appear to explain the missing ingredients for effective board stewardship of transactions; and has provided important views as to the key actions, activities and behaviours that ought to make a difference.
3) This PhD has sought to understand what directors can and should do, during transactions, to make a difference. The messages of ***be prepared***, ***be disciplined*** and ***be challenging,*** encapsulate at a behavioural level the six themes emerging from the research.
4) Based on literature and experienced directors' wisdom there is a range of practical activities and interventions that the board can adopt to ensure that they and management are prepared and remain disciplined.
5) The ***be challenging*** dimension in particular goes to the heart of what chairmen and board members ought to do to ensure debate and vigilance. Research sources indicate a broader malaise at board level around debate and challenge.
6) Whilst internal and external assistance – such as by enlisting the involvement of Internal Audit and Compliance functions and external deal advisers – can help a board to be better prepared and more disciplined, only the board itself can attend to the ***be challenging*** dimension.
7) To this end, the role of a non-executive chair is vital in catalysing debate and seeking the active and willing participation of a CEO and non-executives in working with the board in carrying out its stewardship.

8) The literature review has indicated the dearth of knowledge of accepted practice at the intersection point of governance, M&A practice and legal requirements and precedent when it comes to boards' stewardship of M&A.

9) By tapping into directors' views to address the white space around right M&A governance, six key themes have emerged which appear to explain the missing ingredients for effective board stewardship of transactions; and has provided important views as to the key actions, activities and behaviours that ought to make a difference.

10) This PhD has sought to understand what directors can and should do, during transactions, to make a difference. The messages of ***be prepared***, ***be disciplined*** and ***be challenging,*** encapsulate at a behavioural level the six themes emerging from the research.

11) Based on literature and experienced directors' wisdom there is a range of practical activities and interventions that the board can adopt to ensure that they and management are prepared and remain disciplined.

Chapter 6 has explored in depth the six key themes that have emerged from the research. Based on a grounded theory approach, it is proposed that these themes form the nucleus and beginnings of an emergent theory into directors' governance of transactions.

Chapter 7 firstly reiterates and consolidates the findings from Chapter 6 and further defines the elements of the emergent theory. It then considers practical implications of these findings for management, boards and shareholders, by considering for example how directors could respond (in effect addressing the question of 'what does this mean'?). Pen ultimately this chapter calls out potential limitations of this research and constraints of the study and resultant findings; and indicates where and how this study has contributed to original knowledge development (by answering the question as to 'why does this matter'?). It concludes by indicating immediate areas of further study that other academics should consider.

First therefore, the conclusions and articulation of an emergent theory arising from the research are recapped and consolidated below.

7.1 Key research conclusions and the emergence of a new theory

There are several related strands of conclusions emerging from the research. These relate to:

- limited guidance being currently available that is 'on topic' for non-executive directors
- sound M&A oversight practices having been articulated by seasoned campaigners
- M&A right governance practices having been identified through codification
- the assertion that intangible actions matter at least as much as tangible activities.

These points are discussed in turn in the following sections:

7.1.1 Limited M&A stewardship guidance is currently available that is 'on topic' for directors

<u>Firstly, M&A guidance for directors from existing sources of knowledge is limited, disconnected and is targeted at an executive management (or C-level[170]) audience.</u>

The question of what is right governance of M&A by boards – necessary to improve successful outcomes from M&A activities – lies at the intersection point of three bodies of knowledge:

1) M&A literature (usually aimed at practitioners but also well-supported by scholarly research into the performance of transactions)
2) governance guidelines, codes and research into board practices generally
3) legal precedent and statute.

These bodies of knowledge have been harvested as the literary or *theoretical ought* to ascertain just how clear these are in providing literature-based guidance on what directors ought to do.

The inescapable conclusion from Chapter 3, the Literature Review, is that these three existing bodies of knowledge provide only limited and often opaque guidance to board members, especially non-executive directors, as to what they ought to do before, during and after transactions; therefore the *theoretical ought* is deficient in its utility for board members.

There is, however, a rich vein of M&A literature targeted at practitioners, which provides guidance to advisers and corporate executives on requirements for M&A success. Given that its primary audience is not board members and that their duties and activities are sometimes subtly or distinctly different for the executive management team, this practitioner-focused material has only implicit or directional guidance for board members.

Directors would or should know that from a legal liability perspective, the board has a generalised accountability for diligent, critical review (of any investments, including M&A transactions); and that there are particular ASX requirements imposed on the directors of the acquiring and selling companies. Aside from these fairly general requirements, however, there are generally no specific prerequisites spelled out for board members on what to do or not to do when exercising governance during M&As or in prosecuting transactions.

As a consequence of the discovered gap in knowledge, a range of targeted, semi-structured interviews was conducted with chairs and non-executive directors, to elicit their perspectives on right governance.

These interviews with seasoned directors have provided valuable supplementary knowledge – that is focused specifically on directors' views of right practice i.e. what directors themselves believe they ought to do when involved in overseeing transactions (as opposed to conducting them, which is the job of executive management).

[170] 'c' for chief, as in chief executive officer, chief operating officer and chief information officer

7.1.2 Sound practices have been articulated by seasoned campaigners

Interviewed directors were able to point to what they would consider sound practices.

Directors sampled have been able to articulate what they consider to be sound practices. From their interviews, and via multiple iterations of data coding, it has been possible to distil a discreet set of activities and actions by boards that are believed to make a difference to M&A success. Some of these activities are 'hard' or tangible factors i.e. knowable, ascertainable and auditable, such as having a robust business case or knowing that a M&A process is being followed. Other factors are 'soft' or intangible, for example the impact of board members' mindsets, behaviours and knowledge (including business judgment). Some of these activities are input or preparatory activities to the M&A lifecycle (such as planning); others are output activities (such as monitoring).

Arising from the interviews, directors were able to address much of the white space in the extant literature and provide their views on what boards ought to do versus what management ought to do – although the emphasis on specific activities and their delineation (boundary issues) of accountabilities will differ from board to board based on a process of negotiation, power and influence from company to company.

7.1.3 Right M&A governance practices have been identified through codification

From the *directors' views of what they ought to do*, supplemented in parts by the *literary view of 'directors' ought'*, it is possible to describe several key themes and an emerging theory of M&A right governance.

Based on a sample of directors' views of what right practice is or ought to be, it is possible to describe a preliminary or emergent view of right practice, including what M&A activities directors believe they are accountable for and ought to be involved with; and who leads versus who supports each specific activity.

In essence, this articulation of right practice and accountabilities could potentially form the beginnings of a reasonable directors' test for the duty of care.

Before such a test could be reliably framed, however, the validity of these views would need to be validated through an expanded sample set of informed directors, then via thorough testing.

At this juncture, therefore, it appears to be possible and indeed feasible to describe the key activities and actions of the board that are likely to assist in either protecting value for their shareholders and/or in creating value. This is the crux of the research described in the findings in Chapter 6 and is recapped below.

These activities or factors cluster into six main themes; and whilst there is no way of knowing at this point whether one theme is more important than the next, the themes appear to be inter-dependant to some degree; in order to be effective. These elements – some of which are more tangible process-related activities and others are behavioural and attitudinal – need to be present throughout or attended to at key points.

From the interviews and coding there was strong alignment around hard factors or **the what** i.e. key activities that directors ought to do, such as to review the strategy and evaluate the investment business case. There was also a high coding occurrence regarding the soft factors or **the how** i.e. how they go about exercising stewardship over transactions.

7.1.4 Intangible actions matter at least as much as tangible activities

<u>Whilst it is convenient and easy to target tangible activities, intangibles appear to matter at least as much, if not more.</u>

In this regard it is the directors' mindsets and behaviours that could hold the difference between simply carrying out key activities and critically evaluating and monitoring all material aspects of transactions. Interviewed directors acknowledged the importance of this in the feedback on the sixth theme relating to **well-chaired board with constructive challenge;** and literature is increasingly considering the importance of how decisions are made by executives and boards.

Specifically, the vital ingredient appears to be the extent to which directors are able to challenge and test what they are seeing or being told, and then being able critically to apply business judgment (prior experience and knowledge) to this information.

Behaviours such as critical debate and constructive challenge were seen, by those interviewed, as a direct result of the climate in the boardroom and the way the chair facilitates discussion and guides the oversight process. The dynamics between board and executive are directly influenced by the chemistry (originally exposed in theme 7, which was consolidated with theme 6) between the CEO and chair and (a) the degree to which the CEO enjoys the board's trust and confidence and (b) the maturity of the CEO in seeing the board as a group of wise individuals rather than an unwanted interference.

Therefore, obvious as it may seem to some, the quality of board decision-making, especially with regards to one-off matters like investment or transaction decisions, will be influenced by: (a) the individual and collective experience and skills of board members, including their training and education; (b) their personality characteristics, such as their ability to ask perceptive questions and not to be cowed into silence; and (c) their collective desire for and tolerance of constructive debate and critical challenge.

Harnessing a board's ability to provide critical challenge is of course a matter of careful judgment: too much of it could lead to a management team feeling like it is being continuously interrogated and even second-guessed; too little of it could lead to a board and executive team becoming lazy in its thinking and acquiescent in its deliberations.

There is of course a broader question that has not been addressed – the proverbial elephant in the room – as to whether a board's input really matters to value creation in M&A. Whilst this would represent an entirely different line of enquiry, governance theory is predicated on the assumption that a board is there to safeguard shareholders' interests, so even if does not improve deal success it is there to ensure at a minimum that shareholders' interests are protected. Thus it is notionally possible that there may be circumstances where the deal analysis, preparation and execution by management could be faultless and there is limited further value that the board can add; in this unlikely scenario, however, at a minimum the board has carried out its duty of care to shareholders by scrutinising the deal and all its implications.

7.1.5 A new theory has emerged

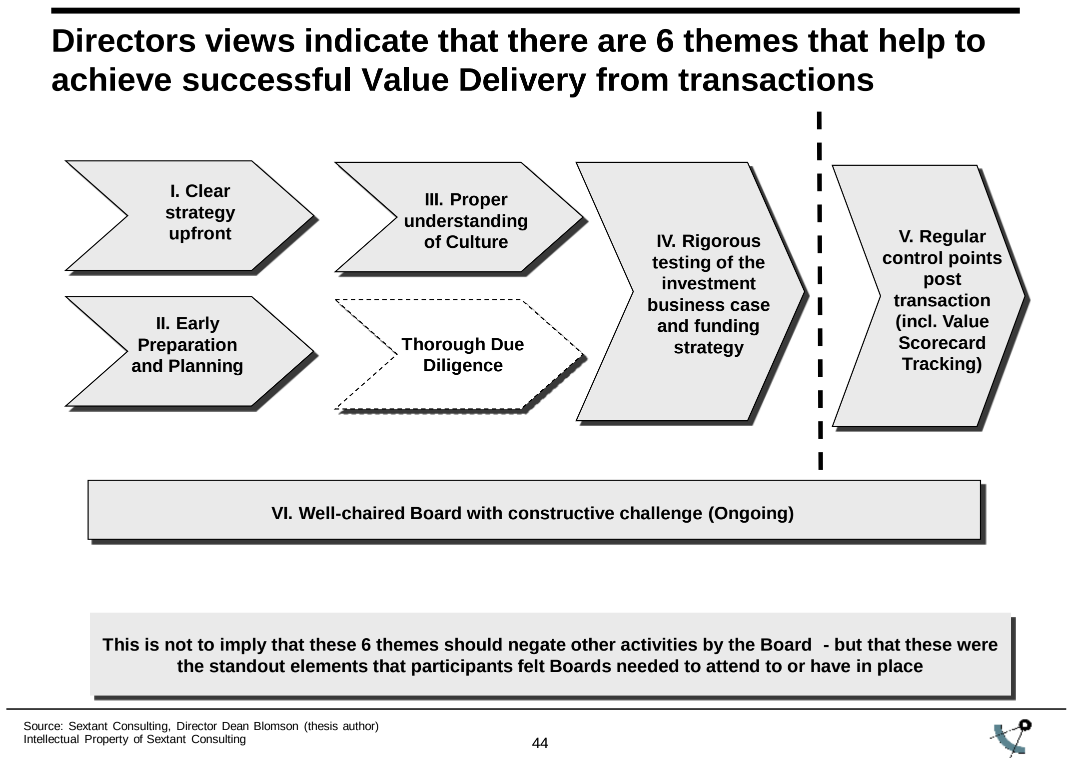
The outcomes of the interviews conducted are supported by existing research, but in many cases go well beyond published material to supplement the deficits evident in the extant literature. From this combined research a new theory of right M&A governance has emerged which is encapsulated in six themes illustrated in Figure 40 below:

- Clear strategy, upfront
- Early preparation and planning
- Proper understanding of culture
- Rigorous testing of the investment business case and funding strategy
- Regular control points post-transaction
- Well-chaired board with constructive challenge.

Coalesced as a statement, the new theory could be articulated as follows:

> To enhance the likelihood of value being delivered from an acquisition, right practice by the board of an acquirer is that the directors should be ensuring that the M&A strategy is properly developed upfront; that the board should be assuring that early preparation and planning by the executive team is taking place and that managers and advisers have conducted a proper due diligence which includes thoroughly assessing the extent of strategic and cultural fit. Based on this, the board must satisfy itself with the rigour of business case and deal funding strategy before proceeding. Subsequent to the deal, the board should monitor value delivery at regular points. Throughout the lifecycle of the deal, board members should be applying constructive challenge to all material aspects guided by a vigilant chairman.

Figure 40: The six key themes that have emerged for boards



Source: Dean Blomson (thesis author)

These six themes summarise the M&A oversight and governance responsibilities of a board in a way that forms a virtuous and sequential set of activities, almost in the typical ‘plan, do, measure and improve’ loop. These thematic activities are: to set direction (theme 1), plan the transaction (theme 2), assess culture (theme 3) as part of checking all key due diligence deal drivers, test all material business case elements (theme 4), review and control progress (theme 5), and manage board dynamics (theme 6) on an ongoing basis.

The last theme in particular underpins the assertion that intangible factors matter considerably in how the board and executive collaborate to assure value for shareholders and to drive to results.

Without the benefit of the next wave of further necessary research, these six themes cannot yet be regarded *ipso facto* as a proven recipe as to what will deliver the attainment of M&A outcomes; but based as they are on many accumulated directors’ years of experience, they are a set of directionally sound, no-regrets activities to be addressed by boards.

7.2 The ingredients of success lie in managing tangible and intangible factors

The six themes explored at length in Chapter 6 represent the nucleus of a new theory but what do the conclusions really mean for boards?

The assertion is that by attending properly to the six emergent themes of right M&A governance, chairmen and board members should be more likely to improve successful results from transactions (or where circumstances warrant it, to make wise decisions not to proceed); and at the same time be able to carry out more diligently their duties and responsibilities to their shareholders.

In terms of implications for boards, what is it that they need to do in support of the six themes explored above to exercise and demonstrate what appears to be right governance? The specifics of what needs to be done will vary depending on the circumstances of each transaction; , however there do appear to be important ingredients arising from the *directors' ought* and the *literary ought* that acquisitive boards ought to focus on as part of 'right practice':

1) Boards need to ensure that <u>a few critical **tangible** activities get adequate and rigorous board attention</u>, direct input and ownership, specifically:

    - strategy (before the transaction)
    - business case and funding (during the transaction)
    - risk management (during and after the transaction)
    - performance monitoring (during and after the transaction).

2) Boards need to <u>deal with the preparatory activities upfront</u> by ensuring that management has certain matters under control, specifically that:

    - Policies and principles, deal parameters, and planning are described and agreed.
    - There is a well-defined process in place to support a disciplined approach.
    - People with the necessary skills are in place i.e. that management has hired and/or developed the requisite internal competency and experience.
    - Management have sourced external expert advice and have agreed remuneration arrangements that are more likely to encourage appropriate behaviours (and to the extent possible, some degree of objectivity).

    These are **tangible factors** that are clearly identifiable and ascertainable activities that the board can inquire into or carry out assurance over; however **intangible factors** also need careful attention.

3) Chairmen and CEOs need to agree – before the transaction is underway – on <u>how to delineate respective accountabilities and decision-making rights</u>, namely:

    - what activities and decisions management are responsible for and what tasks the board 'owns'
    - where and when accountability for these elements is shared, but recognising that there is no 'one size fits all' approach that applies to all boards and in all circumstances.

4) Chairmen, boards and CEOs also need to think carefully beforehand about <u>building M&A capability</u>, specifically to:

    - strengthen the transactional skills and experience of the board

- understand how robust the various elements of their M&A capability really are and improve these to the required levels (get match fit)
- assess how well-prepared management and the board really are, before moving into acquisition mode.

5) Then, when the deal is underway, chairmen in particular also need to pay close attention to board dynamics, namely to:
   - focus carefully on the behaviours and mindset of their board members including crucially the CEO once the deal is happening
   - monitor closely whether their members are able to switch at the right time, from 'Constructive Challenge and Critical Debate' to 'Collaboration and Cohesion' (the 4 C's).

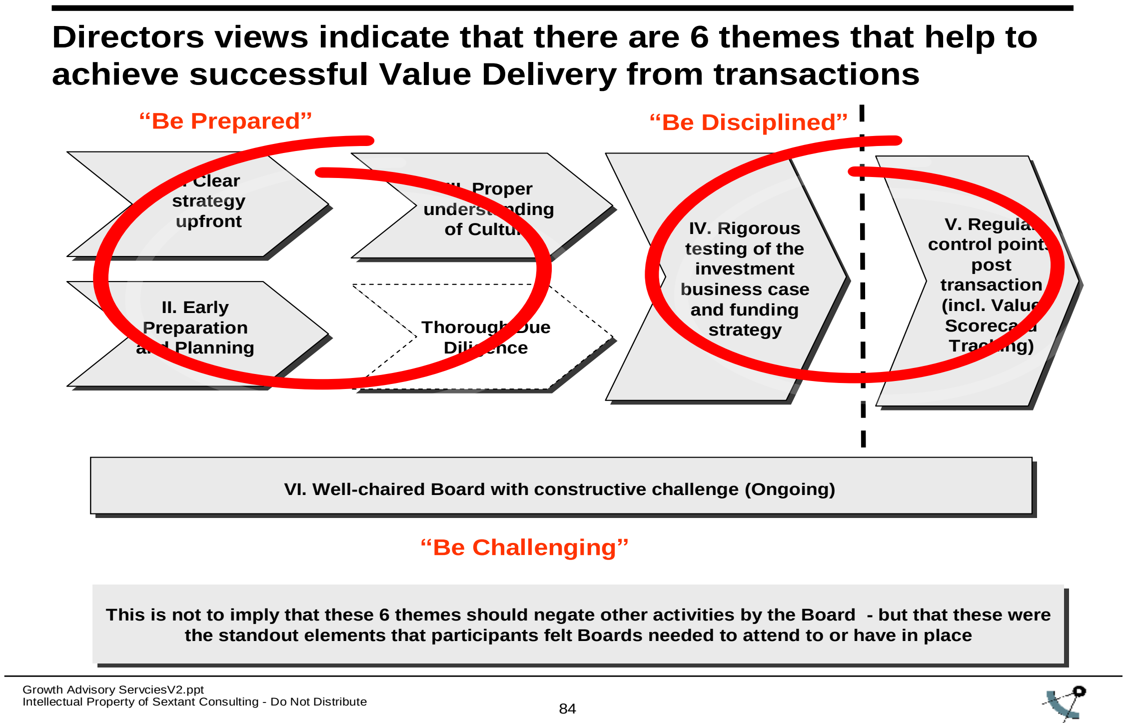
7.3 What does the new theory mean for chairmen and board members?

There are a number of messages and implications arising from the six themes. Taken together the six emergent themes could be consolidated into three higher-order key messages for boards:

- Firstly, that *preparation matters*, such as by having an M&A process, procedures and of course suitably skilled people (internal and external advisers) in place before the event. Preparation also matters in terms of having a well-thought through (properly researched), clear and coherent strategy to drive M&A activity.
- Secondly, that *discipline and rigour matter*, such as by following the due diligence process, by not being rushed into decision making, by having proper checks and balances in place, and being thorough in making proper inquires.
- Thirdly, that *critical challenge matters*, such as by demonstrating the ability to play devil's advocate, asking the hard questions of management and board peers and having the courage to hold a line when required.

The message for boards, therefore, is that in order to exercise effective stewardship over transactions – before, during and after the deal – boards need to: ***be prepared***, ***be disciplined*** and ***be challenging***. This mantra encapsulates at a behavioural level the six themes emerging from the research. These three overarching messages have been depicted in Figure 41 below.

Figure 41: The three key messages that cover the six key themes



Source: Dean Blomson (thesis author)

In considering what the thesis conclusions (and themes) mean in practical terms for boards, it is apparent board (and management) before, during and after transactions should be particularly mindful and vigilant to:

1) ***Be prepared***: executive management and the board should be prepared before the event.
2) ***Be disciplined***: the board should be deliberate in following due process and ensuring rigour in its decision-making.
3) ***Be challenging***: the board should apply critical judgment and be challenging of executive management and each other, in order to stress-test decisions.

The implications and conclusions relating to the three above summary messages are dealt with in turn in the following three sections.

7.3.1 Be prepared

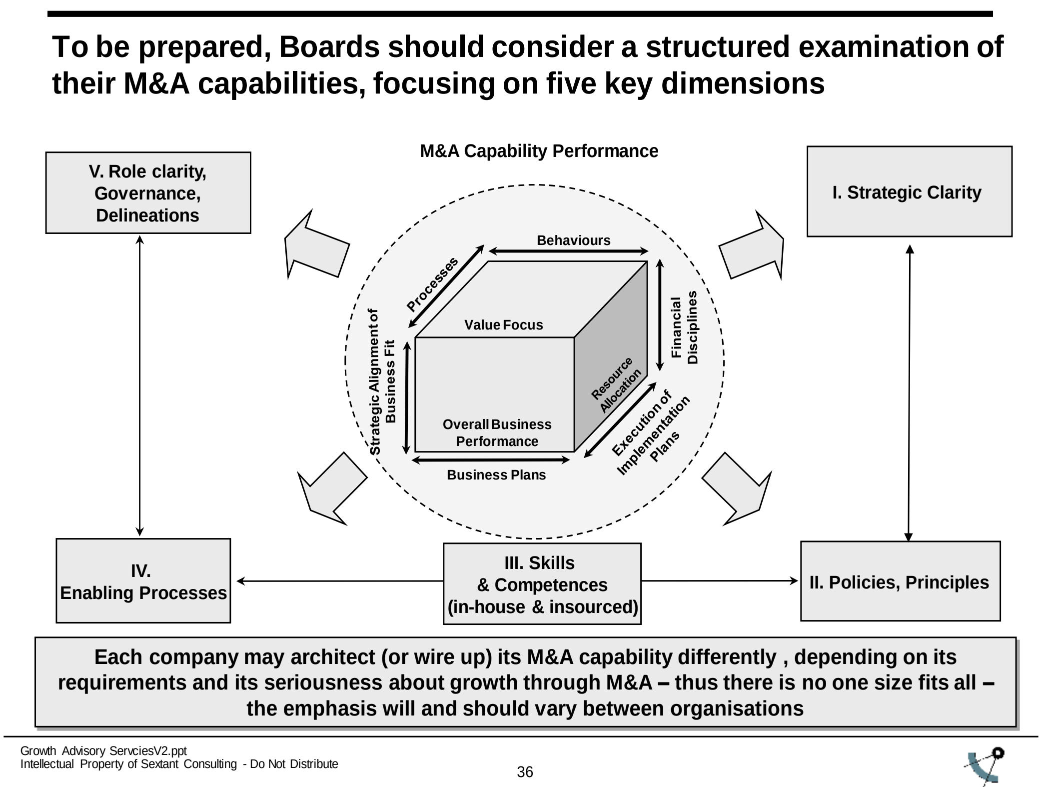
Firstly, preparation is necessary. This comes through clearly in terms of the first and second themes regarding doing the strategy thinking and direction-setting upfront and laying the preparatory groundwork (via policies and principles, processes and planning, deal parameters and people). Management by and large will be tasked with executing these preparatory activities that need to be reviewed by the board.

Implications for management and the board

The extent of preparation can be assessed by the board via enquiry, in a reasonably structured way to assure themselves that this work has been carried out suitably.

The board itself can request a structured assessment – using internal audit and compliance or independent advisers – into various aspects of 'transaction readiness' (as depicted in Figure 42 below) to satisfy themselves that management is as ready as they claim to be, before pushing the start button on acquisition targeting.

<u>Figure 42: What boards should be testing by way of an M&A Readiness Review</u>

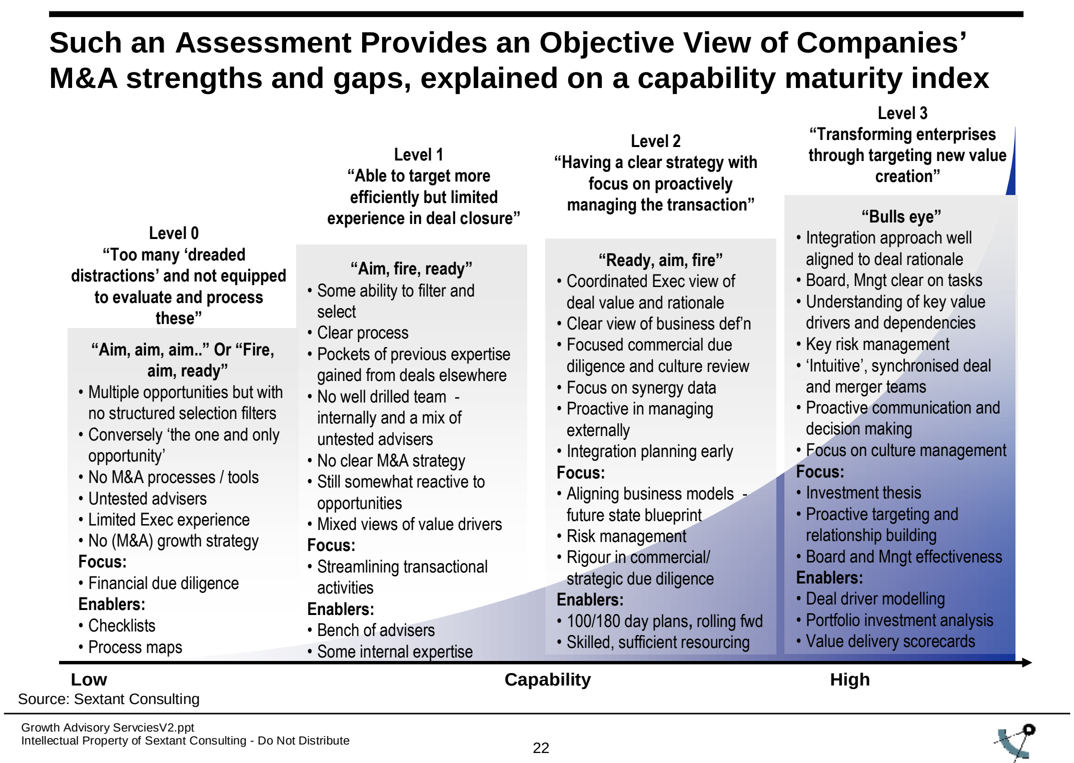


Source: Sextant Consulting, Director Dean Blomson (thesis author)

As part of being prepared, it should be incumbent on the board to understand in an objective and dispassionate way how evolved or mature the management team and their business systems are in relation to executing major transactions, well before the transaction eventuates. Early assessment and response could save an enterprise from significant embarrassment and material loss, rather than by building capability on the fly.

Whilst speculative, it is quite conceivable that investors, if they were aware of internal capability and preparation, would look unfavourably upon a board and management team that had not taken adequate steps either to prepare the enterprise for what lay ahead or to satisfy themselves that its preparation and capabilities were adequate to the task ahead. Practitioner literature in particular advocates an understanding of where the company's M&A capabilities are on a 'capability maturity spectrum' to help to address potentially fatal gaps in capability. One such capability maturity spectrum is illustrated below.

Figure 43: Illustrative capability maturity spectrum



Source: Sextant Consulting, Director Dean Blomson (thesis author)

7.3.2 Be disciplined

The second key message relates to being disciplined in initiating and carrying out transactions.

The theme of discipline and diligence encompasses again soft and hard systems, or intangibles and tangibles.

Tangibles or hard systems include key processes such as due diligence activities, business case reviews, synergy reviews, development of integration blueprints and master plans, Day 1 / Day 180 integration plans etc.

Clearly borne out in the literature and via interviews and questionnaires, is the importance of having a properly structured, clearly described and well-understood M&A process, in providing a foundation for discipline, to assist in keeping management and the board coordinated and on-task.

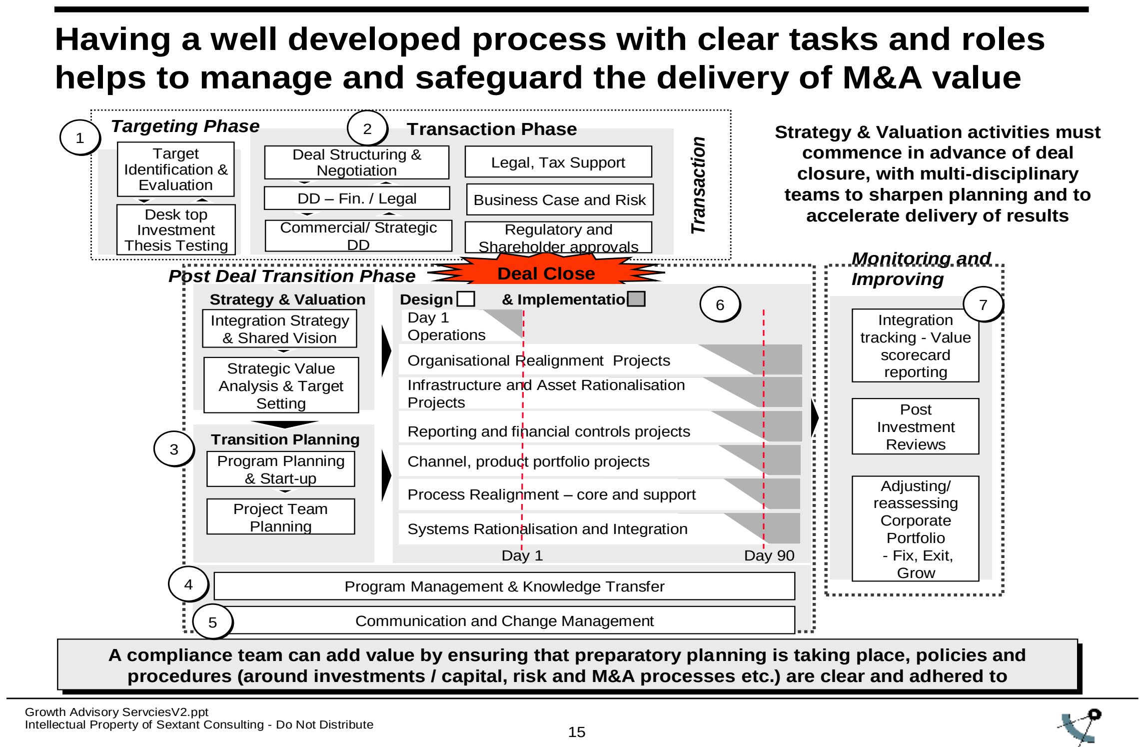
Process helps

Lovallo and Sibony (2010) in "The case for behavioural strategy" "…used regression analysis to calculate how much of the variance in decision outcomes was explained by the quality of the process and how much by the quantity and detail of the analysis. The answer: process mattered more than analysis – by a factor of six. This finding does not mean that analysis is unimportant, as a closer look at the data reveals: almost no decisions in our sample made through a very strong process were backed by very poor analysis. Why? Because one of the things an unbiased decision-making process will do is ferret out poor analysis. The reverse is not true; superb analysis is useless unless the decision process gives it a fair hearing."

> "To get a sense of the value at stake, we also assessed the return on investment (ROI) of decisions characterized by a superior process. The analysis revealed that raising a company's game from the bottom to the top quartile on the decision-making process improved its ROI by 6.9 percentage points. The ROI advantage for top-quartile versus bottom-quartile analytics was 5.3 percentage points, further underscoring the tight relationship between process and analysis. Good process, in short, isn't just good hygiene; it's good business". (Lovallo and Sibony 2010)

As indicated below, a typical M&A process encompasses several key phases, tasks and activities which should guide the actions of a management team. Again, an internal audit team could assess compliance on behalf of the board – and the board itself should have a set of clear actions and control points that guide its participation across all stages of the process. One such M&A process model is illustrated in Figure 44.

Figure 44: Following a generic M&A process could aid discipline and decision-making



Source: Sextant Consulting, Director Dean Blomson (thesis author)

Continuing on the theme of the value of tangibles such as processes and procedures, as Kahneman and Klein discuss in "Strategic decisions: When can you trust your gut?" (Kahneman and Klein 2010):

> "The problem is that people don't really like checklists; there's resistance to them. So you have to turn them into a standard operating procedure – for example, at the stage of due diligence, when board members go through a checklist before they approve a decision. A checklist like that would be about process, not content. I don't think you can have checklists and quality control all over the place, but in a few strategic environments, I think they are worth trying."
>
> **"The McKinsey Quarterly**: What should be on a checklist when an executive is making an important strategic decision?"
>
> "Daniel Kahneman: I would ask about the quality and independence of information. Is it coming from multiple sources or just one source that's being regurgitated in different ways? Is there a possibility of group-think? Does the leader have an opinion that seems to be influencing others? I would ask where every number comes from and would try to postpone the achievement of group consensus. Fragmenting problems and keeping judgments independent helps decorrelate errors of judgment." (Kahneman 2010)

Therefore it is an important protection for shareholders that the board has well-informed confidence that management has followed or will follow due process and approved procedures, is adhering to the prescribed policies, following corporate standards applicable to key functions or disciplines.

Confidence through assurance

Building well-placed confidence comes about in a variety of ways, such as assurance checks at various checkpoints and stage gates of an M&A process, adoption of agreed procedures and deal guidelines, by ensuring that management thoroughly undertakes all key activities and that deal analysis is not an after-thought or rushed through.

Whist directors interviewed did not place significant emphasis on internal and external assurance checks on management activities and estimates, relative to other topics, their concern about proper planning and preparation, disciplined thought and action and prevention of myopia and deal fever were all pointers to the need for sober and impartial deliberations.

Directors interviewed had all experienced the phenomenon known as ‘deal fever’ and were alert to the temptation to short-circuit the process, omit key steps, etc. Following a process does not automatically guarantee that critical thinking will take place, but certain right practice activities were advocated to provide sanity checking of key documents, such as via a critical review of the investment case or a detailed risk assessment or modelling of alternative scenarios affecting cash flows and capital reserves. These could all be prudent risk-reduction mechanisms that *ceteris paribus* could lead to more informed decision-making.

Implications for management and the board

Before deal finalisation, employing stage gates and review mechanisms could be a valuable protection for management and boards tempted to race to the finish. This is not to suggest that the board should be project managing the process – in fact that is not to be desired: directors believe they should stand outside of the process but at key points and stage gates should apply assurance checks on adherence to the agreed policies, standards, process, such as by inquiring:

- Has an independent third party reviewed the synergies and what is management’s view?
- Have we lodged the appropriate documents with the ASX, Australian Competition and Consumer Commission (‘ACCC’), Foreign Investment Review Board (‘FIRB’), etc.?
- Are all material exposures fully understood?
- Is there an actionable risk management strategy for the transaction that has been reviewed? Is being actively adopted? What are the material transaction risks and is management monitoring and managing these?

An internal audit function could assist management and the board in the independent verification of compliance to the endorsed M&A process, procedures and checklists.

After deal closure, ensuring discipline in delivering post-merger initiatives and benefits and monitoring of post implementation milestones, is another way that directors advocate that boards can help to safeguard shareholders' interests, by ensuring that:

- disciplined tracking and reporting takes place of integration costs and synergies achieved, relative to targets and baseline estimates
- regular reporting on integration progress is a standing board agenda item (the 90 day update; the 180, 270 and 360 day updates, etc.)
- PIRs (post investment reviews) are formally conducted and resultant learnings are documented and disseminated.

Disclosing that these post-transaction mechanisms and disciplines are in place and being adhered to, could or should be reassuring to investors.

The Internal Audit and Compliance function could be involved in acting as the eyes and ears of the board in a transaction, for example by:

- undertaking a comprehensive risk management assessment, for the board, of the project and deal risks including the extent to which knowns and unknowns have been modelled and adequate contingency built in for risk mitigation
- assessing the risk management policies, practices and register of risks of the target company and its fit with that of the acquirer, as part of the due diligence (assuming one is dealing with a friendly acquisition).

7.3.3 Be challenging

Challenge and debate in the boardroom is the last of the three key messages and relates to critical thinking.

This is the X-factor of transaction quality i.e. the extent to which suitably skilled directors (executive and non-executive) can really debate and challenge the deal components in a constructive but rigorous way.

There is an important difference between the first two overarching messages and the third, *be challenging,* in terms of what that implies for the board. When it comes to the first two key messages of *be prepared* and *be disciplined*, it could be argued that those boards that might be deficient in experience or rigour could be protected from their lack of experience or wisdom by suitably skilled management teams and/or external advisers.

The chair as X-factor

In the case, however, of ensuring challenge and debate in the boardroom, which came through as an important requirement from interviews, only the board members can provide this. There is no formulaic recipe to achieving vigorous debate – only a willing board under a chair able to catalyse proper inquiry can achieve this. In terms of right governance, most interviewed directors directly recognised that an astute chair is the X-factor and is required to stimulate this process and engender debate. There is little that can be done to remediate a failure of debate from the ‘outside in’ but mechanisms can be developed and agreed upfront that will stimulate challenge.

Implications for management and the board

- Establish internal mechanisms and/or seek external support in ensuring that the necessary sanity-checking of major decisions takes place. Some directors for example advocate a ‘red team business case’ exercise i.e. the counter-factual argument critiquing the deal to be tabled to the board as a sanity-check on the primary business case.
- Advocated M&A practice also includes ensuring that a range of alternative scenarios and sensitivities have been modelled in the business case and being clear on key assumptions that have been documented and tested.
- Lastly, a chairman should encourage the use of other mechanisms such as the ‘pre-mortem technique’ (attributed to Gary Klein) to get the team to consider contrarian, devil’s advocate thinking. This is akin to a medical post-mortem but done up front before a project starts (Kahneman 2010) describes it thus:

> “We should say, “We’re looking in a crystal ball, and this project has failed; it’s a fiasco. Now, everybody, take two minutes and write down all the reasons why you think the project failed.” (Kahneman 2010)

Does this verification or checking process on behalf of the board necessarily mean that better debate will ensue at board level? The answer is ‘ no’; but if a board team insists upon a range of ‘cold eyes’ reviews such as a counter-factual business case being prepared and presented, or an independent assessment of synergies being conducted, or a review of Day 1 readiness being undertaken, then that additional scrutiny ought to provide additional insights or data points to a board. More importantly, it tends to move the debate from emotion and opinion to data and facts.

The above mechanisms tend to represent hard systems such as agreed processes and procedures by the board. Debate and vigilance does not occur within a vacuum; it requires having certain personality traits operating in an environment conducive to enquiry. When it comes to critical debate, the adoption and performance of soft systems by the board are critical.

Managed challenge can be constructive

As Gary Klein stated in an interview (Kahneman and Klein 2010),

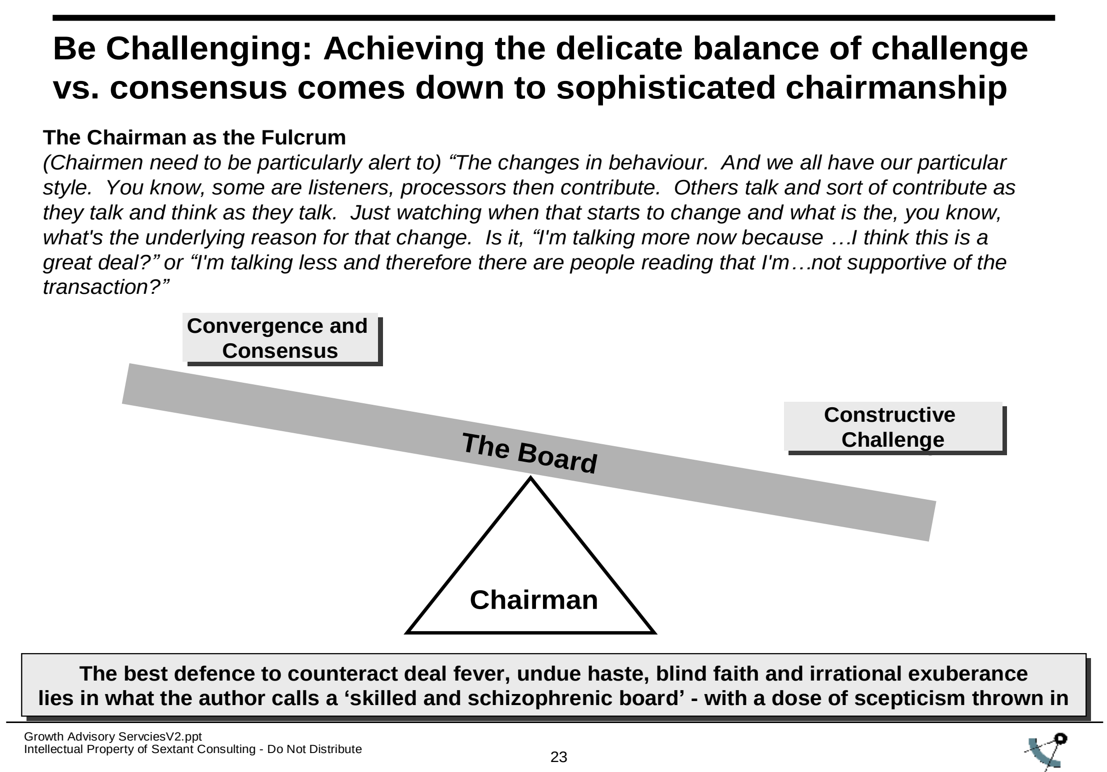
> “What concerns me is the tendency to marginalize people who disagree with you at meetings. There’s too much intolerance for challenge. As a leader, you can say the right things – for instance, everybody should share their opinions. But people are too smart to do that, because it’s risky. So when people raise an idea that doesn’t make sense to you as a leader, rather than ask what’s wrong with them, you should be curious about why they’re taking the position. Curiosity is a counterforce for contempt when people are making unpopular statements.” (Kahneman and Klein 2010)

As Crainer and Dearlove ague in “Boards of deflectors”, “The boardroom isn’t designed to be a comfortable and harmonious place. It isn’t – or at least it shouldn’t be. Rather, it should be a challenging forum for lively debate and decision-making.” (Crainer 2008)

This view is further supported by the research of Professor Randall Peterson of London Business School, carried out among top teams in several industries. Peterson is quoted as follows: “My findings suggest that rather than investing in the platonic ideal of people getting along perfectly, companies should put more attention into how they can better manage conflict.” (Crainer 2008)

These views align with the thesis findings that chairmen have the critical responsibility for balancing critical debate and constructive challenge with convergence and consensus, as indicated in Figure 45.

Figure 45: Effective chairmanship requires a delicate balance



Source: Dean Blomson (thesis author)

Kocourek speaks of the challenge in the following terms:

> “A culture of constructive questioning requires members to perform a delicate balancing act. The goal is an oxymoron – directors exercising ‘collegial disagreement’ or expressing ‘reserved advocacy.’” (Kocourek 2003).

This same phenomenon could be described as the 'delicate balance of a schizophrenic board'.

Kocourek goes on to quote Michael Miles, a former CEO of Philip Morris Companies Inc. and a member of eight boards: "The atmosphere that needs to prevail between a CEO and a board is one of mutual confidence, trust, and a sense of them all being in it together. It must be an open, mutually supportive, two-way street."

He continues:

> "Establishing this collegial yet critical culture is indeed a challenge, especially on boards heavily loaded with current or former CEOs. Each person has to submerge his or her ego to work for the common interests of the company." (Kocourek 2003)

The contribution of critical debate as an ingredient for board effectiveness cannot be under-estimated: whether in relation to its general stewardship or specifically in relation to large investments and transactions.

At the heart of this behaviour lies a deeper issue with regards board composition and appointments. Crainer and Dearlove quote recent research of 760 directors that:

> "found that the route to sitting on numerous boards had more to do with conformity, flattery and favours than with activities on behalf of shareholders. Sarbanes-Oxley has shifted attention onto performance – or at least compliance – at the expense of esprit de corps. Great teams have both." (Crainer 2008)

The authors go on to state that "The fashion is for leaders who don't rock the boat. What's critically needed are more leaders able to generate creative conflict."

They also quote Professor Andrew Kakabadse "There is a worrying lack of vigorous debate in many boardrooms."

As indicated earlier in Section 3.3 of the literature review of governance readings, non-executive directors, particularly those who are independent directors, are of little value if they cannot bring an independent frame of mind to the boardroom, with the courage to tackle hard topics. This is one of the key reasons for emphasising the importance of *behaviours and mindsets* emerging through the research and interview findings.

Usually it falls upon the shoulders of a chairman to allow, indeed encourage, what could be termed 'fierce conversations'[171] i.e. open, challenging but respectful engagement on critical issues within the board ranks. Additionally, it is also the chairman's role – although perhaps not all would see it in these terms – to strike a healthy balance between the board (a) acting in a collegial and cohesive way to support management; and (b) directly challenging and controlling management where necessary. An in-depth study of the chairman's role in board dynamics and in managerial relations is, however, well beyond the scope of this thesis.

[171] "Fierce Conversations" by Susan Scott http://www.fierceinc.com/]

These research observations have led to the conclusion that it is the third message of 'be challenging' that could be paramount. Whilst the two messages of 'be prepared' and 'be disciplined' are undoubtedly important, these messages apply as much to management as they do to the board (if not more so). The 'be challenging' message, however, goes to the core responsibility of the board for checking, verifying and challenging. It is arguable, but not proven, that the verification or assurance activity is the most effective safety-check for shareholders. Without the necessary degree of 'be challenging' behaviour, the board becomes a rubber stamp for management's proposals; or it will lead to the majority of a board imposing its will on an acquiescent minority.

The directors' views emerging from interviews correspond to and reinforce the observations of governance academics.

On the face of it there appears to be a high degree of co-dependency, and indeed a virtuous cycle, between 'be prepared', 'be disciplined' 'be challenging'. The absence or lack of one of these factors cannot be fully mitigated by the presence of the others.

The overarching mantra of 'be prepared', 'be disciplined' 'be challenging' sums up the critical behaviours necessary for the six key themes to be effective. The six themes and mantra of behaviours for directors has to date not been packaged as a consolidated summary of 'right practices' that boards should adopt around major transactions.

The challenge being passed on from this PhD will be for later researchers to test the relevance and voracity of these themes with a broader sample and then to evaluate their efficacy on M&A performance.

7.4 Thoughts on creating greater transparency on board involvement with M&A

Having described the emergent theory regarding 'M&A right governance', it is appropriate to turn back to the opening premise of the thesis, namely that shareholders in acquiring companies are not well-served by the current level of legal requirements and ASX disclosure and compliance checks and balances on the board.

The underlying assertion associated with the emergent theory is that the best protection for shareholders lies in proper preparation and planning, diligence and discipline and in real debates and strategic conversations at board level, supported by effective monitoring of results. The unstated assumption is that the board has the right mix of skills and experience present. But how do shareholders know what level of vigilance and challenge is actually occurring when it comes to larger M&A decisions?

7.4.1 Sunlight may be the best disinfectant

Generally speaking, ASX disclosure and compliance requirements are geared towards capital raising and financial management and statutory reporting matters, plus operational risk management issues. These disclosure regimes in general do not help shareholders of the acquirer develop any dependable understanding of how well-placed the board is to make the right decisions or deliver value-creating outcomes from a transaction.

Current requirements relating to capital preservation and protection of minority shareholder rights do not necessarily assist the acquirer's shareholders to understand what is driving a major transaction and how confident they should feel about a successful outcome.

From this thesis has emerged a set of right practices that reasonable directors should attend to, that ought to provide better safeguards to shareholders. The question that should be asked is whether there would be merit in disclosing whether boards are attending to these factors?

These right practices should guide enlightened self-interest – and not be a big stick with which to beat directors. For example, borrowing on the idea of ASX corporate governance guidelines of the 'comply or explain' nature, it could be asked whether boards should adopt a voluntary disclosure code when it comes to material transactions covering key aspects of the activities nominated as important by directors in Figure 32: Importance of board involvement in sundry M&A activities – questionnaire responses, above.

It could be reassuring to some investors – even if no guarantee of success – for their board to advise them on how well they are attending to stewardship 'housekeeping' factors that support value-creating or value-protecting outcomes. Such a voluntary disclosure statement could potentially include the following elements and assertions:

- "We, the board, have evaluated this target thoroughly against a clear set of decision criteria and against other strategic alternatives"
- "We have conducted a financial due diligence and legal due diligence using qualified third parties."
- "We have undertaken a strategic (commercial) due diligence which includes assessing the cultural alignment of the two entities."
- "We have developed a clear and actionable risk management strategy."
- "Management's estimates of synergies and underlying assumptions have been independently tested and validated."
- "We have reviewed our management team's master plan and programme of works to deliver targeted synergies and necessary integration outcomes; the responsibility for sponsoring this activity has been allocated to an executive general manager who will be supported by suitably skilled programme staff."
- "We will be reporting the delivery of target outcomes every 6 months against a baseline set of estimates and targets."

Will this level of disclosure prevent or resolve inept or hasty decision making? The answer is probably not; but it should give boards "cause to pause" i.e. for directors to stop, check and reflect before issuing such a statement. For their shareholders, whilst no guarantee, at minimum, statements along these lines should give some confidence that basic deal-making housekeeping has been taken care of.

In addition, depending on the board's appetite to provide further details, or the level of scrutiny coming from institutional investors, there may or may not be some further supporting statements about:

- the basis for valuation
- the confidence that the board may have in this transaction meeting target hurdle rates on capital and/or being earnings' accretive within a particular period
- the extent to which the acquisition can be comfortably accommodated within existing targeted levels of balance sheet gearing.

In the light of the James Hardie decisions, most boards would, however, be extremely reluctant to provide any disclosure that contains specific predictions or assertions to the marketplace that for example the transaction will be value accretive by *x* per cent or that the transaction is adequately funded.

The experiences of the directors of James Hardie is not directly pertinent to capital protection activities relating to acquisitions; but its central tenant does apply, in that essentially a board will have to take all reasonable steps to ascertain the veracity of any claims, before making any specific statements relating to capital adequacy and shareholder value performance (otherwise they could potentially be misleading and deceptive).

7.5 A note of caution on balancing the theory of what directors ought to do with practice

It is reasonably easy for a seasoned M&A practitioner to develop a set of starter questions for boards, such as were indicated earlier in Section 6.5.4; and to develop checklists of things boards ought to look at. It is easy, however, to overlook a few key issues:

Firstly, there is no such thing as a standard transaction: company make-up, operating models and market dynamics vary widely; transaction structuring varies; competitive responses and market reaction to bids will differ, etc. In practical terms, therefore, there is no such thing as a one size fits all approach.

Secondly, non-executive directors are not full-time employees, do not have access to all detailed company data or if they do, usually do not have adequate time to process it all, and a transaction comes on top of the usual boardroom agenda. Typically even in the normal course of events, non-executive directors have limited bandwidth in dealing even with the 'business as usual' boardroom agenda.

As a 2008 Cranfield Business School study of Australian Boards indicated, "In terms of the way the board operates:

- over three-quarters (81.6 per cent) work on a board that has between 6 and 11 members. Boards with 12 or more members are rare (2.4 per cent)
- in 74.4 per cent of cases, board meetings are held on a monthly or six weekly basis
- meetings typically last for up to half a day (34.8 per cent) or a full day (50.7 per cent), but rarely longer." (Kakabadse et al 2008)

7.5.1 Carving out adequate time

Warren Bennis is quoted by Crainer and Dearlove:

> "It is even more crucial these days for boards to resemble a great group, more than ever before. That means, among other things, shared goals, a healthy respect for the institutions they are trustees of and full transparency. This isn't easy when the board members do not meet regularly, usually have day jobs elsewhere and where deadlines and decisions are of a different order than those of insiders. That leads to a difficult, hard to achieve, but an absolute imperative goal: transcending the inherent 'role strain' of all board members of public institutions". (Crainer 2008)

Additionally, listed company boards are already labouring under a hefty compliance and disclosure regime, simply to deal with business as usual and operational matters. Arguably these requirements eat into time they should be devoting to strategic debates and decision making.

<u>Lastly, boards need to balance the functions of value protection versus value creation</u> as introduced by Hilmer and Tricker. Both elements are present in transactions but the relative emphasis may vary.

<u>Value protection</u> usually lends itself to a more systemised, structured and checklist oriented approach (without generalising too much). In this regard, risk management and internal audit functions can be useful vehicles for assisting their boards with value protection assessments.

<u>Value creation</u> potential, however, is determined by what is known as the investment thesis i.e. where and how the acquirer is likely to achieve a superior return on capital from the acquisition. Value creation assessment requires a specific case by case evaluation that is highly tailored and targeted to the sources of value. The board needs to ensure that it does its best to get the balance right between both types of inquiry.

In summary therefore, whilst it is important to understand what boards ought to do, one needs to be realistic about what they are able to do. Common sense would suggest that it is desirable to provide some transparency of intention, preparation and due diligence efforts to investors (retail shareholders and institutional investors) and regulators alike – provided it can be done within the bounds of not showing other bidders for the target how a board intends playing its hand.

The reality is that boards operate in different ways with different biases and are not infallible decision-makers. Further, the realities of deal-making are that transactions are often messy and confusing, driven by aggressive timeframes and imperfect information: short on data and objectivity and long on hypothesis and opinion. That said, a greater level of strategic due diligence, process discipline, objectivity and scrutiny is unlikely to go astray.

This preceding section (Section 7.5) has sought to consolidate the findings from Chapter 6 and to further define the elements of the emergent theory.

The next two sections will summarise the potential contributions of this research and acknowledge the limitations and constraints of the study and resultant findings.

7.6 Where and how does this thesis contribute in an original way to expanding the body of existing academic knowledge?

As has been pointed out in Chapter 3, if M&A practice, corporate governance and legal requirements on directors were clear, specifically with regards their management of transactions, there would be no new ground broken by this thesis. It could, however, still be argued in those circumstances that there is still a need for a clear encapsulation and effective chronicling of existing guidance on what directors ought to do, as the realities of poor wealth creation results from M&A indicate that the messages are not getting through to many boards of directors.

The gaps in literature indicate clearly, however, that there is a significant deficit in guidance for boards as to what they ought to do. Therefore, at the most basic level, by trying to accomplish a triangulation of existing M&A practice, corporate governance and legal requirements, this thesis will hopefully have drawn attention to what is a significant gap in guidance, direction and advice for board members. Therefore, it is hoped that a value-adding contribution has been achieved simply by (a) triangulating these three inter-connected dimensions which no one appears to have done before; and then (b) recognising there are significant gaps in the body of knowledge at the intersection point of these three factors.

These gaps have to some extent been addressed by engaging with experienced non-executive directors and asking them to download their personal ‘watch-outs’, good practices and advice for boards and chairmen. In doing so, this thesis has established an operating hypothesis for improving M&A stewardship by boards.

In effect, the research should have accomplished five key outcomes:

One, <u>it has described and chronicled good M&A governance practices for boards and chairmen under six specific themes</u> or activity areas. Simply by assembling, chronicling and clarifying these practices, this could represent a significant step forward and aid for boards that want to do better.

Two, by ‘codifying’ these views on ‘right practices’, <u>this thesis has laid the foundation for an emergent theory</u> of what boards (and especially non-executive directors) ought to do in circumstances of large transactions.

Three, the thesis <u>findings and recommended practices begin to describe what could potentially form a ‘reasonable directors’ for negligence</u>. Shareholders, especially large institutions that are active investors, are unlikely to sit passively by observing significant capital dilution or destruction by under-performing boards. Insisting *ex post facto* that negligent directors resign is unlikely to be an adequate safeguard. Sooner or later shareholders are going to test common law with regards to culpable directors who have not been adequately vigilant or assertive in their stewardship over transactions. Under the protection of the BJR, well-meaning amateur directors may still be able to evade responsibility – but an ill-defined and subjective test for directors’ duties during transactions is unlikely to meet the demands of a more demanding commercial world to deal with matters of gross negligence.

Therefore this thesis has gone beyond laying the foundations for a new theory and has suggested that if governance practices and M&A practices by boards are more clearly established, then ‘in due course' the legal dimension (as the third element of the triangle) will need to follow suit to maintain balance and to recognise a new reality on the ground.

Fourthly, the thesis has also gone beyond simple governance literature, and <u>has explored to a degree the behavioural dimensions of boards</u>, by arguing in effect that following policies, procedures and good practices goes some way to reducing risk, but it is the behavioural and mindset aspects of boards that potentially hold the key to performance.

Lastly, the thesis has suggested that boards themselves can lift the performance bar by offering greater transparency to their own shareholders of their intentions and level of preparation before a transaction and then their commitment and progress towards delivering the post-transaction outcomes and targets.

These are important steps forward towards a commercial environment where board members have a far clearer understanding of what they need to focus on that is likely to make a difference to transaction success; and shareholders concurrently start to insist on having greater transparency and some judicial recourse where the expected level of vigilance and stewardship does not meet reasonable expectations.

This research, whilst representing a significant step forward, needs further exploration and substantiation.

7.7 Recognising the potential limitations of this research

Whilst the emergent theory has been derived from judicious research and coding of interviews, it is nonetheless prudent to flag and summarise potential shortcomings in the research, some of which have been flagged already in preceding sections.

In Section 4.5 several challenges were indicated:

1) The foremost challenge was to achieve balanced, objective, insightful feedback from company directors – every interviewee will inevitably have brought his or her own bias to bear; and of course opinions are oftentimes limited to personal experience and therefore are a personal perspective of what appears to have work for one in the past and in certain unstated context/s.
2) The second challenge lay in the homogeneity of corporate board directors – many if not most board members come from successful careers in large corporations or from having worked as senior specialist advisers to corporate clients.
3) The third challenge was fear of added workload, controls and sanctions. Directors interviewed may have been reluctant to flag activities that would have meant further more onerous actions by them, on top of their existing demands and workloads; or may have seen the other practices as a stick with which to beat them by making them more accountable in a punitive sense. Or they may have viewed some codification of right practice as a way to limit their discretion and to undermine the Business Judgment Rule.

This is speculative of course; we will never know the impact of these factors on the respondents. The research approach followed a proven and defendable methodologically through the adoption of accepted sampling, interviewing and coding techniques, but does have some limitations.

Firstly, the challenges of matching theory with practice: knowing what directors believe they ought to do could not be juxta-positioned (within the constraints of interview scope and time and commercial confidentiality) against what the board actually did do in some circumstances (see Section 5.3 which deals with Espoused Theory versus Theory in Action constraints).

Secondly, scope limitations which create various other challenges to the efficacy of the research which were described in Section 2.5.

Some of these limitations include the possible impacts on the research from:

1) the number and size of deals previously done by each company or its board members (individually or collectively) in recent years
2) the often- repeated reality that no two transactions, boards or companies are the same.

There are other challenges to the research methodology that have been outlined and addressed point by point in Sections 4.5 and 5.4.

Thirdly, the research intent has <u>not</u> been able to access causality or correlation data on – nor has it sought to prove empirically – any of the following:

1) what the key drivers of poor M&A performance are generally
2) specifically the impacts of those drivers of M&A performance that are attributable to director or board influence, acts or omissions; or as a consequence of 1 and 2 above,
3) that by adopting elements of the suggested actions and behaviours arising from the research, positive outcomes are guaranteed to follow.

In this regard, this thesis does not seek to persuade or convert the sceptic that adoption of the key messages and themes will make an empirically provable difference to his or her board. Adopters will be those who believe that either there is scope for improvement (generally speaking) at board stewardship level or that specifically his or her board could potentially do better.

This research has explicitly adopted a more modest and sensible set of objectives: to show that there appear to be certain 'things' that boards ought to do, that in the experience of a sample of directors and from the extant literature do make a difference. The detailed chronicling of these 'right practices' that has been undertaken, based on interview, coding and prior and supplementary research, is the starting point for further testing.

The greatest impediment to adoption of right practices, however, may not be scepticism by lazy or recalcitrant directors' in a lack of hard empirical evidence but the absence of one or other force for change. These forces could consistent of push and pull factors: pull forces by the wider director community to try to overcome hubris, ignorance and inertia; and push forces from the investment community and regulators demanding higher levels of transparency and performance.

Sceptics are, however, unlikely to be satisfied even by further testing. A lack of adoption of right practices for improved board performance is roughly akin to dealing with uncertainties around global warming: some climate sceptics won't act until there is unequivocal scientific proof that

CO_2 emissions are the root cause of global warming, whereas others would ask 'What harm can it do to take sensible steps to reduce noxious gasses and fumes being pumped into the atmosphere?' Similarly, the right M&A governance practices, outlined in the six themes of the emergent theory, could be followed by proactive boards on a 'no regrets basis' i.e. what possible downside could there be by adopting these?

7.8 Areas of further study arising from the emergent theory – pointers to future researchers

It has already been clearly noted that further research is advisable in exploring the outlined six themes. Specifically, further analytical research is required in:

1) considering whether a wider sample of directors would add further practices to the 'recipe' or modify or dispute practices identified in this PhD
2) identifying where these themes and factors operate on a MECE (mutually exclusive, collectively exhaustive) basis or potentially whether there are other actions/behaviours that ought to be added to the mix
3) proving <u>causality</u> i.e. knowing that each of the identified board actions and behaviours are directly linked in a cause and effect relationship to M&A success
4) investigating <u>correlations</u> between preventative actions by boards i.e. proving which elements and interventions are likely to have the greatest efficacy on transaction outcomes and how much they impact upon each other.

Beyond this obvious and immediate further research to test and validate or improve the emergent theory, there are a few other areas potentially warranting further study, have been alluded to at key points. These further topics include *inter alia*:

1) the role of skill and experience in influencing board performance generally and specifically during M&A (and as consequence, whether the Corporations Act should embrace a requirement of skill)
2) the role that directors' behaviours tend to play in determining or undermining deal effectiveness and whether good process can overcome bad behaviours
3) whether a voluntary or compulsory disclosure regime would lead to more vigilant and effective boards and more productive outcomes
4) whether an objective test for directors' reasonableness during M&A could be formulated and what that would comprise; and the corollary i.e.
5) whether the removal of the BJR defence for negligence would lead to beneficial consequences and better protections for shareholders
6) what role behavioural aspects such as constructive challenge play on a board in leading to better decision making.

These are the more significant topics where governance practices may benefit from further research.

7.9 A final word

The emergent theory – via the six themes – describes what directors ought to do to, from a governance perspective, to improve the likelihood of success of transactions. The elements and implications of the six themes have been described in detail. Having explored **what** should be done and broadly the **how** elements of the themes, it is worth reflecting on why these conclusions really matter.

As Carline et al. state:

> "Mergers are among the most economically significant decisions made by corporate managers. It is therefore surprising that, in spite of the intensity of focus on the association between corporate governance and managerial decisions practically no attention has been devoted to how corporate governance directly impacts the operating performance effects of mergers." (Carline, Linn et al. 2009)

The conclusions reached above really matter if boards are to have an effective way of accessing and applying knowledge in an area where the propensity to fail – and the consequences of failure – should be seen by shareholders as too high to tolerate. In an investor driven world the slightest changes in quarterly earnings – via weakening operating margins or profits or earnings before interest and tax ('EBIT') – attracts deep scrutiny and often punishing criticism. Thus the general lack of repercussions from poor control of large amounts of capital spend continues to be somewhat bewildering; but it is a question of time before markets will be far less tolerant of poor management and board decisions and actions.

So perhaps via this research for the first time proper light can be shone into an under-served topic of what boards really ought to do to support effective transaction management – and by so doing, to help directors to access a set of guiding activities that protects their shareholders and themselves.

The distilled wisdom of many numbers of director-years has been captured as a potential code of conduct that will benefit all stakeholders in M&A – and has been translated into a set of key themes for directors which have the weight of substantial research behind them and can set the stage for the future.

In applying these themes, there are a number of lookouts for boards:

Face the challenges of complexity

Most major transactions are usually complex; with many moving parts, variables and unknowns; and large risks usually accompany large returns. With listed entities there is an additional overlay of complexity including stock market movements, ASX regulations, hedging activity, insider trading risks, etc. which could further complicate transaction performance and value creation. The documented commercial literature regarding accepted or recommended practices for M&A transaction management may provide useful guides, prompts and checklists for management, but they only assist up to a point; and non-executive directors are usually not the beneficiaries.

The choice of the term ‘right M&A governance’ is also a recognition that the level governance is not an absolute but should be relative to and relevant for the complexities of each transaction. More complex transactions require more stringent controls to be in place including governance; therefore each transaction’s complexity needs to be well understood. Following *leading practice* at all times may not be appropriate or necessarily more effective; and following *good practice* in some circumstances of high complexity may not be adequate. Hence *right governance practice*.

Be aware of behavioural blind spots

As a complicating factor, there is the human dimension which conventional M&A practice literature does not talk about: greed, haste, ignorance, naivety, complacency, arrogance, etc. These behaviours and attitudes can and probably often do override sensible M&A practices and effective disciplines. Drill beneath the surface of many M&As that have failed and you are likely to find one or more of these factors present; but perhaps because these factors are hidden behind boardroom doors their operation and impact is not well-explored in governance literature.

The fields of study of cognitive and behavioural psychology, if applied to executive decision-making, should help to illuminate these human dimensions that appear to often trip up transactions. The question of how to protect boards and management from their behavioural blind spots lies beyond the scope of this PhD research.

Focus on what really matters to mitigate the imitations on directors’ capacity

Putting aside norms and behavioural factors, the other real constraint to effective decision-making and stewardship by boards is bandwidth – that there are only so many hours in the day. Therefore <u>even if</u> non-executive directors are vigilant, experienced in that industry and commercially astute, some key aspects of a transaction may still receive less than ideal scrutiny. Combine a director’s M&A workload with ongoing ‘business as usual’ compliance requirements and you are likely to find well-meaning and possibly well-performing boards that struggle to provide real scrutiny to transactions, before, during and after the event. The counter argument to this of course is that a board that realises it will not have the capacity to provide effective scrutiny and stewardship over a pending transaction ought to push back on proceeding; or should seek other mechanisms to help overcome its capacity constraints or other limitations.

Recognising that transactions are usually complex and that non-executive directors are time-poor and sometimes distracted, should not, however, suggest that failures in stewardship are excusable, as boards should work in several ways to anticipate and overcome these constraints:

Assemble the necessary skills in the boardroom – ignorance is not an excuse

Firstly, transaction complexity should not imply that M&A is a form of quantum physics. Whilst transactions (even friendly ones) are likely to be complex, the art and science of M&A is fairly well-documented and there is significant expertise readily available in the advisory marketplace to assist boards and management with scrutiny of transactions and planning disciplines.

The assertion is that one cannot legislate for integrity, common sense and disciplined decision-making. If, however, some clear principles and practices are developed and monitored, that may help some boards (a) to think twice before acting in haste and (b) to lift the bar when it comes to significant M&A transactions (or in fact, all larger capital allocation decisions).

Buy the right advice

A well-prepared board that is commercially astute should be able to ensure that they or management have dealt with selecting appropriate external expertise and rewarding advisers for their independence and quality of advice. Management (rather than the board primarily) should be providing rigour in advisor selection and adoption of a 'horses for courses' approach in selecting external advice. This should be underpinned by clear thinking about what the company requires of its advisers that is reflected in appropriate letters of engagement and effective remuneration arrangements. These are all necessary factors that the board should have confidence that management has attended to.

Leverage other internal functions

As indicated earlier, internal, semi-autonomous functions like Internal Audit and Risk or Compliance functions, can play a valuable role in working with the board and removing some pressure from them by:

a) validating whether preparatory activities by management (strategy, planning, people, deal parameters, M&A processes, procedures and guiding principles) have been thoroughly carried out
b) monitoring the adherence to deal processes and disciplines by the executive and the board during and after the event.

Specifically, with a view on a greater level of transparency and disclosure, compliance functions within corporations and beyond in the advisory marketplace could assist boards and management to be prepared for self-imposed compliance requirements that may be suitable for significant transactions.

Pay adequate attention to performance not just conformance

Large scale transactions are usually highly irregular or infrequent events – unless you are a serial acquirer and have developed the appropriate 'M&A DNA' – and bring with them material risks and rewards (although not always in equal measure). The compliance community needs to shift its focus away from steady state, 'business as usual' compliance tasks to helping directors to be prepared, be disciplined and to be challenging. In particular compliance functions can assist with the inward looking assessment and provide the necessary assurance or alerts to board Risk sub-committees.

Boards have to manage the delicate and imperfect balance between 'Conformance' and 'Performance'. As cited in Chapter 3, the Hilmer report (1993) argued that the primary role of the board is "to ensure that corporate management is continuously and effectively striving for above-average performance, taking account of risk." (Hilmer 1993)

As indicated in Section 3.3.1, when a merger or acquisition is underway, a successful approach to the merger needs to strike a balance between 'value protection' and 'value creation'. Thus even when in 'performance' mode – or maybe, particularly when in performance circumstances – boards still need to manage conformance aspects of the transaction i.e. maintain a balance between value creation and value protection. Sustainable shareholder value creation requires both elements be present. Managing the trade-offs between risk (conformance) and return (performance) is a critical aspect of any major transaction.

As has been indicated in Chapter 6, the board members interviewed for this research have in effect indicated a dual focus: on the performance trajectory for growth (in the form of strategy and planning) and on conformance (via process disciplines and policy).

Putting aside the "be prepared" and "be disciplined" messages emerging from the first five themes, the key to effective performance appears to lie in the sixth message i.e. to "be challenging". Here the role of the board chair is pivotal.

Perhaps the closing quote should go again to Crainer and Dearlove:

> "They have to be loyal and affirming board members and simultaneously critical and watchful of the fiduciary and leadership performance of the firm. In short, they cannot be uncritical lovers but have to be loving critics to the institutions which they are paid to serve." (Crainer 2008)

Appendix A: Structured questionnaire to interview participants

Importance and Delineation of Responsibility for Typical Deal Activities

Name:____

Date:__________________

Please rate how important it is for a Board to provide input to each of the indicated M&A lifecycle activities (H, M, L).

Then, please delineate by making an X where:

- Management must take the lead and the Board must provide support; or
- The Board must call the shots and Management must support.

You may make more than one x per row.

Potential M&A Related Activities, assuming a large transaction by a public company	**Importance For Board Input H, M, L**	**Board Directs, Mngt Supports**	**Mngt Leads, Board Reviews**	**Equal Owner-ship of activity**	**Board Has no Role i.e. Can Ignore**
1. Development of a clear acquisition targeting strategy and evaluation criteria					
2. A well-documented M&A process and methodology					
3. Setting clear / formal deal parameters during negotiations i.e. negotiation strategy					
4. Establishing an investment thesis/hypothesis i.e. how and where a specific target should increase value (pre deal activity)					
5. Selection and appointment of professional advisers					
6. Setting of fee structure with bankers / advisers					
7. Examination of other					

Potential M&A Related Activities, assuming a large transaction by a public company	**Importance For Board Input** **H, M, L**	**Board Directs, Mngt Supports**	**Mngt Leads, Board Reviews**	**Equal Owner-ship of activity**	**Board Has no Role i.e. Can Ignore**
strategic growth alternatives					
8. Financing / funding strategy (required to achieve the transaction)					
9. Takeover method and ownership vehicle/options					
10. Financial and legal due diligence					
11. Business case to proceed with acquisition/merger – detailed examination of strategic and financial rationale					
12. Independent Valuation					
13. Design of a future state operating model/blueprint for the (new) enterprise					
14. Formal merger integration plans					
15. Budget and resourcing for pursuing the transaction (not the purchase price)					
16. Costs and resourcing for post deal implementation					
17. Assessment of synergy targets i.e. via commercial / strategic due diligence					
18. (Independent) review of synergies' assessments					
19. Establishing synergy monitoring mechanisms post-acquisition (value tracking scorecard)					
20. First 100 days' plan					
21. Market (investment community) Communications' strategy					
22. Staff communications					
23. Cultural assessments and change management strategies					
24. Customer and key supplier					

Potential M&A Related Activities, assuming a large transaction by a public company	**Importance For Board Input H, M, L**	**Board Directs, Mngt Supports**	**Mngt Leads, Board Reviews**	**Equal Owner-ship of activity**	**Board Has no Role i.e. Can Ignore**
communications					
25. Appointment of new key roles					
26. Risk Management assessment and strategy					
27. Post-merger programme office arrangements					
28. Setting long term growth strategy					
29. Reviewing strategy and transaction progress against agreed milestones					
30. Other factors?					

Appendix B: Coding structure

Once all interviews were transcribed, checked and re-checked, 97 codes were developed, comprising 21 categories and 76 codes within the categories. The initial set of categories follows below:

Process

- M+A Process
- Portfolio Management
- Programme Management
- Too much formality inhibiting entrepreneurship

Strategy

- Strategic Fit
- M+A Strategy
- Board's Involvement in Strategy
- Market growth expectations
- First exclude organic growth
- No strategic clarity
- Stick to the knitting
- Ego/self interest

Communication

- CEO Communication
- NEDs Outside Boardroom
- Early discussions
- Regular updates
- Investment Community
- Information load

Culture

- Understanding Culture
- Managing Culture
- Cultural Fit
- Retaining key talent
- People

Challenge

- Critical challenge
- Saying No
- Decisiveness
- Business Judgement
- Conversation/openness/frankness

Due Diligence

- Financial DD
- Strategic/Commercial DD
- Legal DD
- Board involvement in DD

Preparation and Planning

- Pre deal preparation
- Planning Process

Relationships

- CEO and Chair relationship
- Collaboration with Mngt
- Board cohesion_collegiality
- Confidence in CEO/Mngt Team
- Chairman's role

Risk

- Risk Management

Capabilities

- M+A capabilities/experience
- Core competencies
- Project Management
- Management competencies

Capital Funding

- Funding strategy
- Capital stress
- Opportunity Costs
- Shareholders' Perspective

Post Deal Value Delivery

- Post-merger Integration
- Integration Planning
- Future State Design

Advisers

- Independence
- Expertise

Business Case

- Sensitivities_Scenarios
- Financial returns

Controls

- Benefits' Tracking
- Financial Mngt Controls

Convergence

- Deal Fever
- Management Disciplines

Learning

- Post-Acquisition debriefs
- Preferred Approaches

Principles

- Deal Parameters
- Guiding principles

Board Meetings

- NEDs offline/informally
- Dedicated meeting focus
- Dedicated DD roles
- Meeting offline with management
- Creating time

Board Structures

- Two tier boards
- Advisory Boards
- Unitary Board
- Non contentious directors – old boys network
- Attitude of ownership
- Governance and ethics

Accountability

- Management Accountability
- Board Accountability

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13 August 2009

Mr Dean Blomson
PO Box 144
Rose Bay
NSW 2029

Reference: HE28AUG2008-D00088

Dear Mr Blomson,

FINAL APPROVAL

Title of project: Caveat Emptor: the actions and accountabilities of the acquiring directors necessary to achieve effective value management during mergers and acquisitions

Thank you for your recent correspondence. Your response has addressed the issues raised by the Ethics Review Committee (Human Research) and you may now commence your research.

Please note the following standard requirements of approval:

1. The approval of this project is **conditional** upon your continuing compliance with the *National Statement on Ethical Conduct in Human Research (2007).*

2. Approval will be for a period of five (5 years) subject to the provision of annual reports. **Your first progress report is due on 01 August 2010**

If you complete the work earlier than you had planned you must submit a Final Report as soon as the work is completed. If the project has been discontinued or not commenced for any reason, you are also required to submit a Final Report on the project.

Progress Reports and Final Reports are available at the following website:
http://www.research.mq.edu.au/researchers/ethics/human_ethics/forms

3. If the project has run for more than five (5) years you cannot renew approval for the project. You will need to complete and submit a Final Report and submit a new application for the project. (The five year limit on renewal of approvals allows the Committee to fully re-review research in an environment where legislation, guidelines and requirements are continually changing, for example, new child protection and privacy laws).

4. Please notify the Committee of any amendment to the project.

5. Please notify the Committee immediately in the event of any adverse effects on participants or of any unforeseen events that might affect continued ethical acceptability of the project.

6. At all times you are responsible for the ethical conduct of your research in accordance with the guidelines established by the University. This information is available at: http://www.research.mq.edu.au/policy

If you will be applying for or have applied for internal or external funding for the above project it is your responsibility to provide Macquarie University's Research Grants Officer with a copy of this letter as soon as possible. The Research Grants Officer will not inform external funding agencies that you have final approval for your project and funds will not be released until the Research Grants Officer has received a copy of this final approval letter.

Yours sincerely

Dr Karolyn White
Director of Research Ethics
Chair, Ethics Review Committee (Human Research)

Cc: Professor Guy Ford, Macquarie Graduate School of Management & Professor Tyrone Carlin, Faculty of Economics and Business, The University of Sydney