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CULTURAL DUE DILIGENCE

The high failure rate of mergers and acquisitions is due largely to 'culture clash.' Why does this still catch companies by surprise? Sooner or later, stockholders are going to make somebody pay.

Illustration by Kyrsten Brooker

Somewhere ahead, just over the horizon, a new kind of lawsuit is waiting to descend upon the board of directors of some hapless corporation. It will be a doozy.

Amid great hoopla and much chatter about the wonders of "synergy," one company—call it Geewhiz Inc.—will pay a great deal of money to acquire another. But the promised synergies will fail to materialize, and a year or two later Geewhiz's stock will have plummeted. Blame will fall on "unanticipated difficulties" with the acquisition. Geewhiz, it will be said, cannot seem to "digest" its new partner. The two firms suffer from a case of "culture clash."

At that point, a group of stockholders, their investment gone sour, will file suit against Geewhiz's board, charging negligence and failure to exercise proper due diligence at the time of the acquisition.

The fiduciary responsibility of officers and directors of publicly traded companies requires that they perform appropriate "due diligence" when making major decisions that can have an impact on the overall value or worth of the company. To fail to engage in due diligence is committing negligence. But this lawsuit won't speak of due diligence in the usual financial sense; the disgruntled stockholders won't be charging that the board failed to send in some capable accountants to pour over the books of the target firm. Instead, they will claim that the board was negligent in that its due diligence process should have taken into account not just the finances but also the *cultures* of the two companies.

Instead of being among the last to know about an acquisition, tomorrow's HR specialists will go in with the shock troops, right behind the Marines from legal and finance.

Mind you, the suit will not hinge on the culture clash itself nor on the fact that it proved more troublesome than anticipated. Rather, the claim will be that the board was negligent because, in the course of approving the acquisition, it did practically nothing that would have allowed Geewhiz to anticipate a culture clash at all and to develop some plan to deal with the situation.

While there may be no direct precedent for the claim that the board was honor-bound to conduct a "cultural due diligence" audit, the plaintiff's lawyer will argue, there is no longer any excuse for failing to do so.

While mergers, acquisitions and alliances can indeed be an avenue to growth and increased competitive advantage, the attorney will point out, relatively few actually yield the results so eagerly anticipated. Numerous studies indicate that between 55 percent and 77 percent fail in their intended purpose. These studies have been widely reported in the business press.

In 1995, for instance, *Business Week* reviewed studies covering 30 years of mergers and acquisitions, and concluded that a negative correlation exists between merger activity and profitability. *Business Week*'s own analysis revealed that stock prices of acquiring companies fell an average of 4 percent.

Also widely reported have been studies and anecdotal evidence suggesting that so-called cultural clashes are the single most common reason for failed mergers and acquisitions. In a 1992 study by Coopers & Lybrand of 100 companies with failed or troubled mergers, 85 percent of the executives polled said that differences in management style and practices were the major problem. In 1996 the British Institute of Management surveyed executives involved in a number of acquisitions and concluded that "the major factor in failure was the underestimation of difficulties of merging two cultures."

There is solid evidence that culture ties directly to profits and to business success in general. In their 1992 book *Corporate Culture and Performance*, John Kotter and James Heskett reported phenomenal differences in the long-term results of companies that "managed" their cultures well as opposed to those that didn't: revenue increases of 682 percent vs. 166 percent; stock price increases of 901 percent vs. 74 percent; net income increases of 756 percent vs. 1 percent.

A 1990 ruling by the Delaware Supreme Court in *Paramount Communications Inc. vs. Time Inc.* established a precedent for the claim that culture is, at least, a viable consideration in merger decisions. (Paramount and two Time shareholder groups brought suit against Time's directors for turning down Paramount's bid for the company in favor of a merger that created Time-Warner. The court ruled that it was proper for Time's directors to attempt to preserve the "Time culture" by merging with Warner, even though Paramount's offer would have meant more short-term profit for Time shareholders.)

Picture our crusading lawyer quoting this passage from the *Ernst & Young Management Guide to Mergers and Acquisitions*: "The due diligence period is a time of intensive searching for facts, thorough analysis, and constant reevaluation. A number of questions need to be asked and answered. Does the company really fit? Is it really as attractive as it appeared to be? Can we manage the company successfully and achieve the benefits we identified? Will the company's managers support our objectives?"

Those last two questions, in particular, go directly to the issue of corporate culture. But how can one answer them without considerable knowledge of the manner and nature of the entire management group, and not just the views or impressions of the senior team? These merged firms are going to have to execute some business plan, and in the execution phase the real task of "working together" will fall upon middle managers and front-line supervisors.

It's no secret that in larger organizations, a yawning gap often exists between the opinions and operating styles of the senior team and those of lower-level managers. But in Geewhiz's case, as with most mergers and acquisitions, the question of whether the two firms' "styles" would mesh was asked and answered only in discussions between the executive groups. In financial and legal due diligence, no such "act of faith" is acceptable; to avoid being negligent you have to investigate the issues directly, not merely assume that what you were told is correct.

Will the angry stockholders win a judgment against Geewhiz's board? I don't know. But I believe we'll see this lawsuit within the next few years. And either because of it or in fear of it, companies are going to change their approach to the due diligence process. For people in training and human resource functions, the change will be particularly startling—because instead of being among the last to know about or become involved in mergers and acquisitions, tomorrow's HR specialists will go in with the shock troops, right behind the Marines from legal and finance.

WHEN CULTURES COLLIDE

"Organizational culture," as defined by organizational theorists Warner Burke and George Litwin, is "the way we do things around here." A company's culture influences the way people treat and react to each other. It shapes the way people feel about the company and the work they do; the way they interpret and perceive the actions taken by others; the expectations they have regarding changes in their work or in the business; and how they view those changes.

Understanding corporate culture is critical to an organization's ability to make its business strategy work. Yet many executives seem to profoundly misunderstand the creation and management of corporate cultures. One CEO who had read a book on the subject told me he wanted to improve corporate performance by "putting in" a good culture. He explained that his company did not presently have a culture, as he and his managers had not yet gotten around to developing one.

Culture exists, of course, for good or ill, regardless of what management does. "Culture clash" is what happens when two groups have different beliefs about what is really important, what should be measured, how best to make decisions, how to organize resources, how to supervise people, how to pass on information and so forth.

In mergers, acquisitions and alliances, vast quantities of time and money are poured into analyzing physical resources, markets and the logic of a proposed union. Little or no thought is generally given to the nature, demeanor and beliefs of the people who will have to make the business plan work. If the cultures of the two groups clash, the collision can lead to arguments, confusion and even disaster.

One of the most notorious culture-related failures was the ill-fated 1994 acquisition of WordPerfect Corp. by Novell Inc. Novell was well-established in software products and in heavy competition with Microsoft, but it had no viable word processing software. WordPerfect at the time owned a little more than half the market for word processing software. If Novell wanted to give Microsoft a run for its money in software dominance, this looked like a match made in heaven.

Everything about the deal seemed to make eminent sense, yet the acquisition was a calamity. WordPerfect gave way to Microsoft Word as the No. 1 provider of word processing software. And when Novell sold WordPerfect to Corel Corp. in 1996, it was for approximately $1 billion less than Novell had paid two years earlier.

The business press was plainspoken in attributing the catastrophe to cultural clash. The two companies had fundamentally different views about basic issues such as customer service: What is "good" service, how do you measure it, and what level of service do you intend to provide? Prior to the acquisition, WordPerfect was famous for its outstanding customer "help line"; WordPerfect's people (not to mention its customers) deeply resented service cutbacks by Novell.

Another cultural difference involved the way decisions were made at the two firms—and the way people *expected* them to be made. At WordPerfect, people at lower levels had a considerable degree of autonomy, while Novell was more highly structured, with a more formal review process for many kinds of decisions. Arguments broke out about product updates and software-integration issues: How would these decisions be made? Who should be involved?

What it boiled down to was that the managers of the two corporations could not get along, and the focus became internal at a time when all parties needed to be concentrating on the market and the moves of Microsoft. While the newly merged corporation was sidetracked with internal arguments and discord, both companies slipped.

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Might there be some noncultural explanation for the failed merger? Something involving market forces or WordPerfect's product? It doesn't appear so: Within about a year after being acquired from Novell by Corel, WordPerfect regained its position as the market leader in word processing software.

DILIGENCE

Would a "cultural due diligence" audit have persuaded Novell not to acquire WordPerfect? *Should* it have? Not necessarily. Cultures can be changed, clashes can be managed, and problems often can be worked out. While the results of a cultural audit might sometimes be scary enough to squelch a merger outright, the real point of such an audit is to discover likely trouble spots in the beginning and to plan how (or whether) you intend to deal with them.

The alternative? Once the merger is done, things start to go sour for reasons nobody quite understands. After much head-scratching, it takes management a year or so to begin to figure out the nature of the problem. By that time, an awful lot of money has gone down the drain—along with the firm's competitive advantage.

To the best of my knowledge, nobody has ever done a full-scale cultural due diligence audit in preparation for an acquisition. How, then, might we HR types go about conducting one? When we study an organization's culture, what potential pitfalls should we keep an eye out for?

While the prospect of an "audit" may be new, we do have years of experience and research at our command pertaining to the study of corporate culture. A recent literature search turned up more than 300 books, articles and papers on the subject, including several master's and doctoral theses. Among the many "models" of corporate culture that exist, we found no fewer than 22 in which the creators had actually measured or quantified the elements of a culture.

My own consulting firm, in its work with corporate clients, uses a model that divides the notion of culture into 12 domains. If I were put in charge of conducting a cultural due diligence audit, I would gather operational and behavioral data on each of those 12 domains in both organizations—the one acquiring, and the one to be acquired. Then I would compare and contrast the data, looking for areas of potential conflict or misunderstanding.

Here is a brief outline of the 12 domains. These are the kinds of things we need to look at when we study a corporation's culture—or when we're seeking warnings of potential culture clash.

1 Intended Direction and Results.

Ascertain what a company intends to accomplish. What is its business plan about? What is the intent and purpose of the organization? What results are expected from its business activities? And, importantly, how are these things talked about, described and communicated? To get the full answers to these questions, you'll need to talk to line managers and supervisors, not just top execs.

In the airline industry, both United and American consider "customer service" and "customer satisfaction" as two distinct phenomenon, each critical to gaining a competitive edge. But at United, "customer satisfaction" is discussed in terms of physical materials and facilities (new planes, better meals, putting computers into the lounges for Red Carpet Club members); at American, talk of "satisfaction" centers on service improvements (planes leave on time, employees make passengers "feel good" about the experience of flying with American). As for customer service, at United the term refers to things employees do in addition to their regular jobs. At American, "customer service" *is* the regular job of all customer-contact people (as opposed to, say, pilots and mechanics), though they have additional duties to perform as well.

2 Key Measures.

What does a company measure and why? The key measures say a lot about what drives the organization, its executives and its staff. Even without the complication of a merger, companies trip over their own key measures all the time.

When a national convenience store chain with a high rate of staff turnover investigated why its initiative to enhance customer service and employee retention was not providing any results, a big part of the answer was found in this domain. It turned out that store managers' performance reviews focused narrowly on inventory control, paperwork and dollar volume; their superiors looked at these areas alone to measure success or failure. A store manager who improved customer service or employee retention rates might hear only, "Nice job—but what about those sales figures?"

Translated into the terms of an acquisition, the point, again, is not that Company A shouldn't acquire Company B if the former values service and retention while the latter cares only about dollar volume. Key measures can be changed. But first you have to recognize that a performance problem is indeed related to a measurement problem. And it's better to anticipate this *before* the acquisition than to figure out what's wrong a year or so down the road.

3 Key Business Drivers.

What are the primary issues driving a firm's business strategy? Is the focus on sharpening its competitive edge? If so, how is that defined—price differentiation? quality? market share? service? reliability? If one company defines success in terms of total market share while another defines it as net profit margin, there is considerable room for disagreement about what actions to take to correct "unacceptable" results, how to evaluate possible new product offerings and so on.

4 Infrastructure.

How is the company organized? What's the nature of the reporting relationships? How do the staff units interrelate with the line units? How do all of the various groups interrelate with one another? For instance, are people expected to "go directly to whomever you need to talk to," or do they need to check with a line officer first?

5 Organizational Practices.

What formal systems are in place and what part do they play in daily life at the company? How much flexibility is allowed at what levels in which systems?

For example, how are budgets developed and managed? (When Westinghouse bought CBS, considerable disagreement arose over what constituted "reasonable" expenses, particularly when it came to entertainment budgets.) Also, what are the procedures by which people tap into the services of such company departments as human resources, legal services, public relations and purchasing?

6 Leadership/Management Practices.

Are managers valued and rewarded more for "leadership" skills (inspiring, coaching, etc.) or for the classic plan-organize-control "management" skills? What basic value systems about employees are in place? How are people treated and why? How does the business plan get implemented through the management system? How are decisions made? Who is involved in what kinds of decisions, and when?

In 1990, the surliness of British Airways personnel working at London's Gatwick Airport became so marked and notorious that travel agents were refusing to book passengers on BA flights out of Gatwick. Bags weren't being loaded. Passengers weren't being processed. What was the problem? In the late 1980s, BA had acquired another airline, British Caledonian. Friction developed at Gatwick over the purpose and style of management meetings held by various functions in various locations around the airport. As far as the BA people were concerned, the purpose of the meetings was to go over the numbers and to identify specific failures of all sorts. To the BC people, meetings were supposed to be occasions to talk about the "spirit" of the organization, to praise people for making a good attempt and so on.

"Of course you never looked at your numbers," the BA people sneered. "They were so bad, you were about to go under."

"You're just a typical, big British company, nobody caring about how anybody feels," the BCers shot back.

The internecine warfare practically brought the Gatwick operation to its knees before the two sides finally were pulled into rooms to talk to each other about the situation. As is often the case with culture-clash problems, once confronted directly, this one wasn't particularly hard to solve.

7 Supervisory Practices.

Supervisory practices have a major impact on employees' feelings about a company and the work they do. What dynamics are at play in the immediate oversight of work performance? The nature of the interaction between the employee and the immediate supervisor is one of the primary tonesetters for the culture of the company.

For instance, I know a company at which supervisors are expected to be gruff and aggressive about important issues—to a point that another organization might consider rude or even abusive. Yet in this firm, a supervisor who speaks softly is signaling that the topic can safely be ignored or treated as a low priority.

8 Work Practices.

How is the actual work performed? Is the emphasis on individual responsibility or group responsibility? What degree of control does the individual worker have on the work flow, quality, rate, tools used and supplies needed?

A classic example here is in manufacturing. Two companies make the same products, but one allows workers to "stop the line" at any time they deem necessary—it thinks the individual worker is best able to recognize a defective product. The other company does not allow unauthorized line stoppages; only the manager, who has knowledge of overall production needs, can assess whether a stoppage is worth the lost production. Both methods can work; companies can be successful using either one. But imagine the difficulties that may arise if one of these firms acquires the other.

9 Technology Use.

This domain applies both to the way an organization views technology internally and to the way it uses technology to reach its customers. How current is the technology being used? What are people accustomed to in the way of technological support and resources?

If a firm that relies heavily on e-mail and "groupware" for communication merges with a company where standalone PCs are the norm and people speak face to face, you can predict tension, misunderstandings, confusion and jealousy.

10 Physical Environment.

How does a workplace look and feel? Observe the buildings, the furniture, the grounds. Open work spaces vs. private offices? High security vs. open access? All of these things have a bearing on how people feel about work and the company. Changes in these areas, particularly if they are perceived as arbitrary, can create bad feelings for years.

Consider two contradictory approaches to the workplace, both based on valuing people and increasing productivity. Company One says, "We value people and we know that an open office increases interactions and camaraderie, making for happier and more productive workers." Company Two says, "We value people and we know that private work spaces give people the room they need to think, contributing to greater focus and increasing productivity."

11 Perceptions and Expectations.

What do workers think is important? How does this compare with what they believe management thinks is important? In general, do they expect management to help them do their jobs better, or, in their view, do bosses just get in the way?

A custom foundry in Alabama was in jeopardy of being closed, yet a union/management schism ran so deep that the two sides couldn't begin to negotiate a plan to save jobs. The union ranks were convinced that management was a revolving door occupied by short-timers who didn't care about the plant or the community. Management was equally convinced that the employees and unions didn't care about the products, the competition, or the plant's profitability. Both beliefs were completely untrue, yet the parties were so sure of their perceptions that they never even discussed them with people on the other side. Once the two sides were persuaded to talk about these beliefs, they began to work together to solve the plant's real problem.

12 Cultural Indicators and Artifacts.

How do people dress and address each other? What is the match between formal work hours and actual hours spent working? What sorts of activities do companies sponsor and what are they like?

From an executive at one midwestern health insurance company, I heard, "Company picnics and social clubs are major tools for pulling people together and building a family atmosphere."

From an executive at a second midwestern health-insurance company, I heard, "Company picnics and social clubs impose on employees' personal and family time, generating friction and resentment." Same area, same industry—very different cultures.

LET THEM TALK

These 12 domains cover the terrain of corporate culture; this is the stuff from which "culture clash" can arise. As the examples attempt to show, companies can take very different approaches within each domain, and there is not necessarily any right or wrong way to deal with the issues involved. The point of cultural due diligence is not to discourage mergers between companies whose cultures happen to differ—most culture-clash problems can be (and have been) handled successfully. Rather, the point is to have a plan to manage these differences, just as companies do with divergent financial procedures or information systems.

It may seem that two subjects commonly found in discussions of corporate culture have been left off this list. One is "values and beliefs," the other is "myths, legends and heroes." In fact, those things are embedded within the 12 domains. Or rather, when you dig into the domains, you will uncover core values and beliefs, and you will hear many tales incorporating heroes and legends.

But you will hear those stories only if you *talk* to people, which means you must use qualitative data-gathering techniques such as interviews and focus groups. Generic, off-the-shelf culture instruments are appealing, given their simplicity and low cost, but questionnaires generate no ready anecdotes or examples from the real world to help you understand what has to change and why. In my own experience doing "culture change" work with organizations, I have found the data from generic instruments interesting and usually accurate. But that data has never been really helpful to the actual change process.

Regardless of what models we choose or what methodology we employ, cultural due diligence is coming, and soon. It won't be accountants or lawyers who conduct the audits; it will be HR people. The question is, Will we be ready?

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