RICH BORGE

The **people problem** in mergers

Ira T. Kay and Mike Shelton

If key employees don't feel that they have been kept in the loop after a merger, they will probably start honing their resumes.

The announcement of a merger sends a strong message to the market: you are trying to move the business forward; you are looking for expansion and rationalization opportunities; you are responding to the increasing pressures of globalization and technological change. Unfortunately, such an announcement also sends just as strong a message to your competitors and to the recruiting firms that serve them: your employees are ripe for the picking.

Competitors understand that your employees don't know whether they have a job or, if they do, where it will be located, where they fit into the new company's structure, how much pay they will receive, or how their performance will be measured. Key employees usually receive inquiries within five days of a merger announcement—precisely when uncertainty is at its highest. And no organizational level is exempt.

Plenty of attention is paid to the legal, financial, and operational elements of mergers and acquisitions. But executives who have been through the merger

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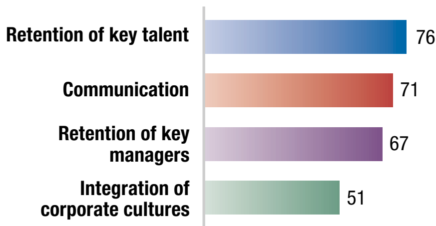
process now recognize that in today's economy, the management of the human side of change is the real key to maximizing the value of a deal. Indeed, a recent survey determined that more than three-quarters of top executives at 190 companies in Brazil, China, Hong Kong, the Philippines, Singapore, South Korea, and the United States believe that retaining key talent is a "critical" ingredient of M&A integration (Exhibit 1).

EXHIBIT 1

People are the key

Percent of respondents who believe activity is "critical"



Source: 1998–99 Watson Wyatt survey of top executives from 190 companies in Brazil, China, Hong Kong, the Philippines, Singapore, South Korea, and the United States

Thus, people problems are a major cause of failed mergers, and you must ensure that most if not all of the people you want are still in place at the end of the integration period. This is best achieved by carrying out an employee selection process whose pace and substance match the kind of merger involved. In M&A, there are basically four choices: operational independence, a takeover of one company by another, a merger of equals, and what might be called a transformational approach, in which the two merging companies change into something much stronger than either of them had been before.

When companies decide on operational independence, there are few choices to make. Since most people will stay in place, the imperative is to clarify the roles of only the most senior executives.

The takeover approach usually proceeds on the assumption that the acquirer's management will remain, though exceptions may be made when the acquired company's employees are clearly superior. One Fortune 500 chemical company, for example, merged with another chemical company that had a weaker management team. This was clearly a takeover, but the acquirer recognized that in a few areas, the other company was better managed. So the acquirer quickly identified the acquiree's key people, told them that they were well regarded, and offered incentives sufficiently generous to keep them. For the most part, however, stabilizing the acquired company takes priority over a protracted and exhaustive evaluation of every employee.

It is the third and fourth organizational approaches that represent the real challenge. A merger of equals requires a "best of both" solution, in which employees of the two organizations are evaluated for each executive position. That is true as well in the transformational approach, which calls for what might be described as the "best of both plus." (*See* sidebar, "An interview with Jon Boscia," on the next spread.)

These kinds of processes cannot be worked through overnight, and that leaves many important employees vulnerable to outside offers during the period of uncertainty—employees you may not even have time to identify! To keep good people, the evaluation and selection process must proceed as quickly as possible. Our experience suggests that six to eight weeks will generally suffice to staff each level of the organization. By getting a jump on the selection process and by communicating clearly throughout, organizations can keep unwanted turnover to a minimum and improve their chances of making mergers successful.

If the purpose of a merger is growth rather than efficiency, integration should be **postponed**

If, however, the purpose of the merger is growth rather than greater efficiency, integration activity should be postponed for a lengthy period. Cisco Systems is probably the benchmark company in this area. During the first three months of a growth acquisition, Cisco filters out all integration activity that doesn't promote revenue growth.

Whatever form a merger takes, it is tempting to move the process along as rapidly as possible to reassure the market and employees. But doing so could divert managers from working simultaneously to improve the business at a time when it is highly susceptible to change. In any merger, the strongest opportunities for capturing value must drive integration activities.

Four selection options

Say that you have decided to seek a best-of-both solution, either because yours is a merger of equals or because you hope to transform the two companies into a new and different organization that is stronger than the best parts of either. You must then determine how you will make each of the many necessary decisions. You have four options, although the fourth is exercised only rarely. The main choice is between what might be called "new leader" and "two in a box." In the new-leader procedure, a single leader is appointed for each line and functional area, and he or she selects the unit's team from the overall pool. The advantage of this arrangement is that it is in the leader's own interest to pick the strongest people, since he or she will soon be depending on them, and the process is quick. In reality, the leader will know little about the other company's managers, so this procedure invites cronyism. The leader should be obliged to develop firsthand knowledge of the other company's candidates, perhaps with the assistance of independent management appraisers.

In the two-in-a-box procedure, both companies provide a leader for each business area, and the two work together to construct a team. Here, the pros

An interview with Jon Boscia

In 1997, Lincoln Life Insurance acquired CIGNA's individual life insurance and annuity business as part of a process of transforming this multiline insurer into a focused financial-services company. In 1998, Lincoln purchased Aetna's life business. The integration task was complicated because Lincoln was dealing with an acquisition involving three different parties. Both efforts are considered a success in the analyst community, as Lincoln exceeded its targets in both cost reduction and revenue enhancement. In the interview below, Jon Boscia, Lincoln's chief executive officer, and Mike Walker, its chief integration officer for this and a subsequent acquisition, talk with McKinsey's Andrew Appel about the challenges the mergers posed.

Jon Boscia: I'd say our biggest challenges were twofold. The first was getting support and enthusiasm from the distribution channels and employee base. We had purchased an organization that was very different from the distribution [channel] we already had, and we believed that a key challenge we were going to face would be maintaining this company as a highly productive part of that distribution [channel]—a highly productive part of a new company. We were concerned that the new distribution [channel] might look upon us as people who shouldn't be buying an upscale distribution channel because we did not know enough about that type of organization.

A related issue was [CIGNA's] employees. The employees who were coming into the [Lincoln] organization had felt pretty good working for CIGNA and working for Aetna. When, all of a sudden, you're with a new organization, people ask, "Are they going to value me here?" "Who are these people?" "Can I trust these people?" And that's a real opportune time for all of your competitors to pounce on the very best people in your organization. We also knew that we were going to have difficulty communicating to our existing life insurance employees in Fort Wayne that they're good, talented people but that we're going to focus our life operations in Hartford [where CIGNA had its headquarters]. You want to make the new people feel good about their skills without alienating the existing people.

Interviewer: Which of the steps you took were particularly helpful?

Jon Boscia: We immediately got in front of the newly acquired employees and told them what we were as a company and who we were as individuals. We stayed in front of them as long as they wanted us to stay, with no ducking of any questions about our intent and how we would be dealing with this process. We were very candid, up-front, and open, and we were there the day it was announced. When you're there within 24 hours, that's about as good as it can get. We named an integration officer right up front and had Mike [Walker] involved on site right from the very beginning.

The second thing we did was to get in front of our Fort Wayne–based employees, where most of Lincoln's life team was headquartered. We had to deal with the following issues: "Well, we're the acquirer, not the acquired, so why are we losing our jobs?" "How are people going to be treated?" "How is the process going to work?"

We also made a lot of decisions even before the announcement of the transaction, and therefore we were able to come to the table immediately. And that, I think, served to reassure the people affected by this [acquisition] that it was a well-thought-out and well-planned one and not just an opportunistic activity that we now had to figure out.

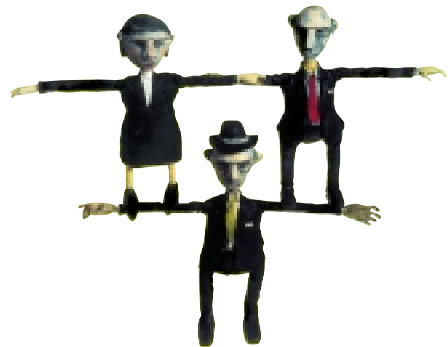
Mike Walker: I don't think many companies would have done what we did the day of the announcement. We had a master list of the key people. We met that day with the key people on site, and then we had a senior team on the phone with key distribution people two hours after the announcement saying, "This is Jon Boscia on the phone, and I want you to know that we're really excited about this acquisition and you're a key part of it." And then we said, "We're going to have a meeting and it's going to be in Chicago and it's in three days. We want you there because we want to tell you why Lincoln made this acquisition and how important you are."

Interviewer: What was the impact of all this communication?

Jon Boscia: One hundred percent retention. I'd say that paid off pretty well. Getting the key employee list from acquisitions is extraordinarily important because in the business we're in, the value of the business is in the people. You can pay a lot of money and still go down the tubes if you don't get the people you need. It's very hard to figure out who the key people are when you are doing a carve-out rather than buying a whole company. You just don't know who is who, and they might not be on the organizational charts, as many of the key people are in shared service organizations outside of the dedicated unit. So you really have to dig in.

Mike Walker: At our initial meeting with CIGNA, at the Four Seasons, here in Philadelphia, we went through the organizational chart line by line and said, "Who are the key players we need to make sure we keep?"

Jon Boscia: You've got to identify the talent very early on, even when it's at the lower levels of the organization and people have to jump up one job or two job levels. Having talent leading the effort will make all the difference in the world. It may create social tensions, but you had better deal with this. Once again, you have to be in front of people very fast, communicate extensively, and tell people what you know long before they hear the rumors, though some things can't be disclosed at certain times. And tell them what you don't know, and assure them that when you do know it, you'll tell it to them. If you are straight with people and they understand what the objectives are—what the end game is—and they get continual reinforcement and updating, you are a long way toward success.



and cons are essentially reversed. The two leaders will between them know the entire candidate pool, but there may be tension between the leaders, since to keep the stronger of the two it will be necessary to designate him or her as the ultimate winner at the outset. Unfortunately, the runner-up may in consequence lose the motivation to make the best choices. Two in a box counteracts the tendency of a new leader to choose automatically from his or her own company but risks causing disruptions.

The two other choices are "independent management appraisal" and "post and invite." In the first, a neutral outside organization—typically, a recruiting firm—appraises candidates in interviews and 360-degree feedback sessions and then makes recommendations to each decision maker. This approach can claim to offer objectivity and the ability to benchmark choices against the marketplace, but it can be time-consuming. Even so, it has been used to advantage in several very large recent mergers. In some of them, it was used broadly, in others only for key positions for which there was no obvious candidate.

If performed well, an independent management appraisal can both **minimize fears of favoritism** and speed up decision making

Done well, an independent management appraisal can minimize fears of favoritism, speed up decision making, and serve as a conduit for feedback from management to the very top of the organization. But employees may be upset at the sudden appearance of nosy outsiders who, they might well think, are not in as good a position as their bosses to assess their true worth.

In the fourth option, post and invite, all available positions are posted internally so that current employees may apply for them. This method may well bring to light qualified managers who would otherwise be overlooked. However, companies committed to developing talent sometimes prefer to install managers in jobs that they will have to grow into, and this kind of employee development is difficult to engineer in a post-and-invite environment. Another drawback of post and invite is that it takes a lot of time to sift through piles of applicants. And because this method announces to the entire organization that jobs will be lost, it encourages a stampede for the exits if good jobs are plentiful elsewhere.

The employee selection process

Typically, an organization begins by elaborating a new structure and then staffing it, beginning with the first level below the CEO and then moving down through the rest of the enterprise. A best-of-both approach goes three

levels down and takes a total of 18 to 24 weeks. Staffing the rest of the organization should take an additional 8 to 16 weeks. (A straightforward takeover can be completed in a month or two; a complex, transformational merger can take several months longer.) Adhering to that schedule, however, doesn't preclude the possibility of attrition and upheaval.

Embrace key employees

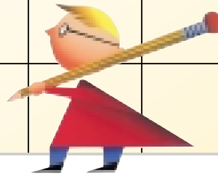
Your first challenge results from the fact that before even the most efficient process is complete, employees will become anxious, some intensely so. Therefore, it is best if key employees learn about their prospects well before the process ends—ideally, before the deal is announced.

The first step should be a "top-to-top" meeting at which a few of the most senior officers from both companies quickly develop a list of 50 to 100 employees indispensable to the new organization, recognizing that the need for haste means that some choices will be based on limited insight. One person should then be charged with managing the business of keeping key employees on board; otherwise, this essential activity usually falls victim to the overwhelming task of integration. At the same time, line managers close to the level in question should make the actual selections.

A simple matrix can help identify all key employees (Exhibit 2). You can keep track of what would motivate them not to jump ship, what actions you will take to keep them (and when), and who should be directly responsible for assuring that they stay. We call this a "re-recruiting matrix" because if you put as much energy into keeping people as you had earlier put into recruiting them, you will succeed.[1]

EXHIBIT 2

Re-recruit your employees

	Impact of loss	Message to deliver (financial and nonfinancial)	Date message delivered	Person responsible	Follow-up required
Key individuals					
Key groups					

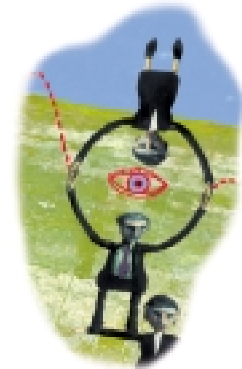
Establish guiding principles

An employee selection process should include the framing of a statement of guiding principles and policies. Such a statement helps ensure consistent

[1] *See* Timothy J. Galpin and Mark Herndon, *The Complete Guide to Mergers and Acquisitions*, San Francisco: Jossey-Bass, 1999, pp.107–8.

standards for staffing the whole organization and powerfully communicates, at the outset, its new goals and values. The statement must be tailored to each deal, of course, but a set of best-of-both guiding principles might look something like this:

- We seek to capitalize on the strengths of both organizations in the selection process.
- Selection will be strictly meritocratic, depending solely on how well the competencies, qualifications, development goals, and experience of the candidates suit them for the positions in question.
- Neither seniority nor political favoritism will play a role in hiring decisions.
- A committee consisting of the CEO, the head of human resources, and other senior executives will review disputed decisions.
- The two companies will not contribute managers to the new entity in a fixed ratio. However, if either company should contribute more than 65 percent of the new entity's managers, the committee referred to above must review the selections.
- External recruiting will commence only after it is determined that the right person for a position can't be found internally.[2]
- People not chosen to perform their present duties in the new entity will not be considered for positions one level down.[3]



In a situation where neither merging company's best practice is acceptable, the new organization must aspire to something more powerful: a genuine transformation. In this case, a completely different kind of guiding principle is called for: for instance, that the span of control (the total number of direct reports) in the new company must be 20 percent greater than that of the larger of the two companies and no less than 6:1. Or, perhaps, that at least

[2]Hiring an outsider takes time, and in the interim the group looking for a leader continues to make decisions. We recommend the appointment of a temporary leader who will do what is necessary to retain people and continue the business's momentum despite knowing that his or her permanent successor will have the authority to redesign the organization.

[3]Enforcing this policy, though it may seem uncharitable to high-level employees who have "plateaued," keeps career paths open for young, highly talented staff who would otherwise leave for greener pastures.

one person must be promoted from each level that is going through the selection process.

These principles force real changes in the way a company operates.

Money matters

Of course, attractive incentives can maintain performance and retain key staff; the trick is to pay neither too much nor too little. Generally, retention incentives add 5 to 10 percent to the total cost of a deal—enough to wreck it—and it is therefore vital to anticipate them.

> It is vital to anticipate the cost of retention incentives, which could add up to 10 percent of the cost of the deal—**enough to wreck it**

The most important factor to consider when you are trying to retain and motivate people is how much "walk-away" money they receive from the merger. For employees without stock, and therefore without the wherewithal to walk away easily, amounts equal to 50 percent of three, six, or nine months of salary (depending upon how valuable they are) should be sufficient. Sometimes staggered payments at those intervals can provide the best solution.

More senior employees with stock may need 100 percent of salary, plus a bonus. Top executives who have done very well in the merger may require 100 percent of direct compensation—that is, salary and bonus—plus the value of their stock option grant for that year. In the case of senior employees with a great deal of walk-away money, it helps to provide half of their bonus in cash and half in stock options, so that they are motivated to stay and help make the integration effort successful.

Incentives can be staggered over time. When one health care supply firm acquired another, creating a $20 billion (revenue) organization, the acquired company was facing bankruptcy. The deal was completed in one month. All senior managers of the acquired company were fired on the first day except for two people with important knowledge. These two were given incentive packages that expired after 18 months, along with their employment.

The total package for each of them amounted to between $3 million and $4 million. The payouts were staged and required the two executives to meet a series of targets involving the reduction of costs and head counts, the retention of key employees, and the quality of customer service. Even so, half of the money was held back until the last payment. By that point, the

measures taken had reduced costs by 80 percent without making much of a dent in revenues.

Another company gave managers of a retail acquisition, also in bankruptcy, bonuses of 20 to 50 percent of their base salary, accruing monthly over six months to a year, depending on their level. In a second retail merger, integration teams received bonuses drawn from a pool that emptied as targets were met.

Generous severance plans are expensive, but they do have a **strongly positive influence** on the remaining employees' morale

Long integration periods, for which regulatory scrutiny is typically responsible, make retaining key staff especially difficult. In these situations, either particular individuals or some portion of a particular target group may require added incentives, along with explicit assurances of their future roles and job security over a certain period. During such efforts, it is particularly important to keep the entire staff fully updated—not least, parent-company employees whose positions overlap those of people in the acquired company.

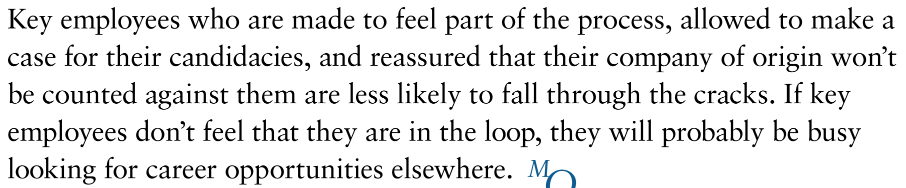
Once everything has been done to promote the retention of key employees, attention must shift to the way terminations are handled. The best long-term strategy is a very generous severance plan: the cost is high, but good plans have a strongly positive influence on the morale of the remaining employees.

In a merger between two regional utilities, for example, only some of the now-unwanted executives of the acquired company had golden parachutes triggered by a change of control. To encourage many more to jump, the acquiring company gave them severance packages, while those executives who were asked to stay received generous cash and stock bonuses. Thanks to this policy, the remaining employees and executives felt they would be treated fairly in the future.

Talk the talk

Executives often feel uncomfortable communicating with key employees after a merger because so many of their questions can't be answered. But not meeting with key employees can be fatal. During a recent global pharmaceutical merger, we were asked to talk with a key employee who had just been offered an attractive post in the new organization. During the interview, she confessed that before the offer came, she had been interviewing for a job with another company. The merger was the most important event on her employer's agenda, but she had not been involved, nor had anyone brought

her up-to-date. Ignorant of where she stood in the new organization, she did not assume that something worthwhile would come along. It was sheer luck that she had not yet accepted another job.



Key employees who are made to feel part of the process, allowed to make a case for their candidacies, and reassured that their company of origin won't be counted against them are less likely to fall through the cracks. If key employees don't feel that they are in the loop, they will probably be busy looking for career opportunities elsewhere.