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Forging the Strongest Steel: How Boards Can Make Better Decisions About Deals

BY DONALD S. COLLAT

Among the most difficult and important questions facing companies today is the decision whether to proceed with a proposed large acquisition. In many cases, the process of deal approvals seems to have lacked adequate scrutiny. Donald Collat argues in this article that what is needed at the Board level is a deeper inquiry into the merits and demerits of the deal - an inquiry that entails an active debate.

Throughout the millennia, debates have been viewed as the most effective means of shedding light on difficult decisions. The great orators of ancient Greece and Rome engaged in debates that were central to the deliberations of the

assemblies and the Senate. More recently, debates have played a pivotal role in the election of US Presidents and have become the mainstay of discourse in the parliaments of Europe.

A good case in point is Prime Minister's Question Time in the UK parliament. For an hour every week, the opposition questions the government's actions closely and demands responses from the PM. What results is a sharp exchange of unscripted argument – sometimes raucous and entertaining, often illuminating. The ultimate purpose of the exercise: better decision-making. To paraphrase author Tom Clancy: "A lively discussion is usually helpful, as the hottest fire makes the strongest steel."[1]

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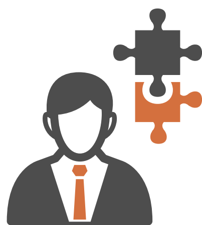
Among the most difficult – and important – questions facing companies today is the decision whether to proceed with a proposed large acquisition. The record of these deals has been mixed, marked by some noteworthy debacles. In many cases, the process of deal approvals seems to have lacked adequate scrutiny. I will argue in this article that what is needed at the Board level is a deeper inquiry into the merits and demerits of the deal - an inquiry that entails an active debate.

THE PROBLEM AND ITS ROOTS

The jury is still out on whether acquisitions have been a winner's game for buyers overall.[2] The evidence shows divergent outcomes, positive and negative, in the performance of deals. What is clear is that a number of large acquisitions, often purporting to be transformative, have failed miserably. The transaction landscape is littered with the debris of deals gone bad.

We think immediately of AOL's purchase of Time Warner in 2000 for $165 billion. The value of the combination was about $350 billion at the time of announcement, but within months almost $200 billion had been lost. Two years later, the combined entity reported a loss of $98.7 billion, then in 2009 split up. In mid-2015, the remnants of AOL were sold to Verizon for the dramatically lower sum of about $4.4 billion.[3]



Other striking failures come to mind. In 2007 the Royal Bank of Scotland led a consortium that acquired ABN Amro for about €71 billion. RBS suffered huge losses in the years immediately afterwards and was saved only through a UK government bailout of more than £45 billion. In 1998 Daimler-Benz acquired Chrysler for $37 billion in a combination so flawed that by 2007 it sold 80% of the US auto manufacturer for just $7 billion. And in 2005 Sprint merged with Nextel for $35 billion, only to shut down its merger partner in June 2013.[4]

What is remarkable about some of these failed acquisitions is that they seem ill-advised not only in retrospect, but also at the time of their conception. Why do companies embark on these unsuccessful adventures? A key to the answer can be found in the decision-making dynamics of organisations.

In many companies, a specific large deal is subjected to the scrutiny of a team usually led by the Corporate Development Officer, or CDO. This officer, who often reports to the CFO or sometimes directly to the CEO, creates the deal valuation model. Needless to say, the model is critical to the decision of whether to present the acquisition to the Board for its approval. As a result, the CDO, or an officer with equivalent responsibilities, is usually the focal point of the preparations leading to the approval decision of senior management.

Deal ideas may spring from any number of sources, including the CEO, the heads of business units or segments, the corporate strategy officer, the CDO, or outside advisors. Suppose that it is the CEO, sitting at the pinnacle of senior leadership, who puts forward a large acquisition. The deal may have been conceived by the CEO alone or in conjunction with the CEO's counterpart at the target. It may have originated with the head of a business unit or segment and have been adopted quickly by the CEO. Either way the transaction will have the sponsorship of the CEO.

To what level of scrutiny will the evaluation team subject the proposed acquisition? Under some circumstances, the CEO will be willing to let the normal process run its course without interference, either overt or covert, as the CDO assembles a model that is as accurate as possible. But consider the case in which the CEO believes strongly in the merits of the deal, feels passionate about its beneficial impact on the enterprise, or stakes his reputation on an agreement penciled with the target's CEO. The CDO, even backed by the CFO, would have to muster quite a lot of courage to question the validity of the deal and

to express that doubt in the valuation model. Nor is the CDO likely to make the career-limiting move of highlighting every possible risk in the deal report. In all probability, the senior leadership team will seek to move forward with the deal.

Who then remains to evaluate the acquisition dispassionately and disapprove it if it is not warranted? Only the Board.

The Board has the difficult, critical charge of assuring that the interests of stakeholders, especially shareholders, are well represented in major corporate decisions.[5] Large acquisitions, often fraught with weighty strategic implications for the company, clearly fall within this decision category. When any large acquisition is brought for approval, the Board should be aware of the questions that should be asked, the concerns that should be raised, the risks that should be weighed. It should make a sober assessment of the benefits of the deal, assuring itself that they have not been exaggerated.

Yet, in the face of a CEO advocating strongly for the deal – his or her subordinates effectively muted – the Board will find it difficult, on its own, to discover all the relevant risks attendant on the deal, evaluate their severity, and consider the magnitude of the deal's benefits. Such an undertaking is a tall order even for directors knowledgeable about the businesses of the enterprise, taller still if the target's business is outside the company's current orbit. It is no accident that many of the most flagrant cases of ill-conceived deals occur when CEOs press strongly to acquire targets well outside the boundaries of their businesses.[6]

This problem may occur even if those reporting to the CEO wholeheartedly support the deal themselves. The organisation may share assumptions that have not been fully examined, and it may be subject to confirmation bias, which is the human tendency to construe new information as confirming one's predispositions and to reject contradictory data. An acquisition proposal based on such assumptions or biases may be flawed. Once again, it might be difficult even for a dispassionate Board to uncover these shortcomings – all the more difficult if the Board itself, as part of the organisation, shares in them.

A PROPOSED REMEDY

What is to be done? At a minimum, sound decision-making requires ample, reliable information and the assembly of that information into a coherent argument, including due consideration of valid counter-arguments. Yet, in this case, the Board may fail to receive all the requisite information or hear all the counter-arguments to the underlying deal rationale or both.

If the Board genuinely wants to make an independent decision but has difficulty obtaining these two components on its own, then one solution is for it to hire outside dispassionate advisors whose task is to supply the missing pieces – to pose the probing questions that should be asked, to find additional reliable information about costs and benefits, and to assemble it deliberately into a counter-argument. This contrary view may, in addition, offer an alternative interpretation of the data or another perspective on the proper weighting of relevant decision factors; it may question existing assumptions; and it may reveal, to a greater extent, the critical unknowns.

The outside advisors then present their counter-argument to the Board at the same time that the senior leadership team gives its report on the contemplated acquisition. What results is a discussion purposely structured as a classic debate between the affirmative advocating for the deal and the negative opposing it. The Board sits as arbiter making its determination not on the basis of superior style, but on the relative merits of the positions themselves. The Board's decision will be all the wiser.

Such a process has at least one collateral benefit. The debate may illuminate risks in the deal that might not otherwise be highlighted. Advocates of the deal

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may then be prompted to consider actions that mitigate those risks – for example, improving the deal structure before the signing of a definitive agreement or creating additional contingency plans that will go into effect after the closing. These changes may enable the Board to approve the deal with greater confidence and, at the same time, increase its value to the company.

The idea of holding a debate is meant to apply to large deals, but not solely to large companies. It will make sense for any company if the cost of the process is outweighed by its benefit – i.e. the impact of avoiding a value-destroying deal or of significantly improving a deal worth pursuing. Not only large companies but also small to mid-size companies may well find the process worthwhile on this basis, when they are considering a large deal.

PRECEDENT: RED TEAMS

Putting a proposed course of action to the test of an independent review is not a new idea. For decades, the US military has used so-called 'red teams' for this purpose,[7] and more recently such diverse organisations as IBM, the UK's Ministry of Defense, the CIA, US Defense Intelligence, and the Israeli Defense Forces have embraced their use.[8] Typically, an independently constituted red team offers a devil's advocate perspective in opposition to the plan of the proponent (the blue team) and thereby reveals its weaknesses.[9]

Organisations say they establish red teams to: combat confirmation bias, question assumptions, reveal flaws in logic, challenge "consensus by building the best possible case" for another view, identify better measures of performance, and improve contingency planning – benefits useful to a Board considering a big deal. Experience suggests that these goals are more likely to be achieved if the red team consists primarily of outsiders because they are less subject to the biases of the organisation.[10]

THE CRUX: MOTIVATIONS OF THE BOARD

Longtime observers of Boards may view the proposed remedy of a debate with some skepticism. They might point out that many Boards, in making major decisions, do pose questions to the CEO but do not engage in the kind of truly rigorous questioning contemplated by the proposal, as outlined above.

They would argue that the incentives for such an inquiry are not in place: many Board members see their prospects for continued service on the Board as deriving primarily from their allegiance to the CEO. Although Board members often receive company stock options as partial compensation and would suffer some financial loss from a wrong-headed decision, the benefits of remaining on the Board for several additional years are usually of far greater importance in their motivational calculus. The result is that many Boards approve the recommendations of the CEO without extended critical debate.

What countervailing factors might lead Boards to take a more rigorous, independent approach to the decision? Certain activist groups, especially hedge funds led by investors like Nelson Peltz, Carl Icahn, Daniel Loeb, Ralph Whitworth, and Bill Ackman, have become increasingly vocal in pressing Boards to take particular actions they believe will increase shareholder value – e.g., returning capital to shareholders through share repurchases or dividend increases, or splitting up the company via spin-offs, split-offs or outright sales of corporate businesses.[11] These activists take significant positions in their target companies and use their ownership stakes to press their case, often through proxy battles for Board seats and public letters. Because of the hedge funds' substantial resources, no company – regardless of how large – is immune from their pursuits; for example, Apple, DuPont, Microsoft, Sony, and UBS have been recent targets. To gain additional leverage, the hedge funds have

even allied themselves with public pension funds. Their successes have been mounting.[12]

Faced with the prospect of an onslaught from an activist group, the Board of a company considering a major acquisition in today's world may well be motivated to delve deeply into the approval decision. The Board need not be presented with an imminent threat from such a group: the mere possibility of an attack may suffice.

And why would the remedy proposed here be appealing to a Board under these challenging circumstances? There are at least three reasons. The first is that the odds of making the right decision increase significantly. The process of debate, as we have seen, leads to a better-considered conclusion about whether to proceed or not. Second, even if the decision is the same – to go ahead – the comprehensive presentation of counter-arguments may lead to the uncovering of weaknesses in the senior leadership team's case, weaknesses that may be largely attenuated by timely contingency plans or improvements in the deal structure. As we have seen, the approved deal may consequently bring greater value to the company. Third, and perhaps most important, the Board and the senior leadership team will be better prepared to respond to an attack: having thoroughly considered the arguments and the proper responses to the counter-arguments, they will be well-armed to debate their activist critics in the press and thereby prevail in crucial shareholder forums.

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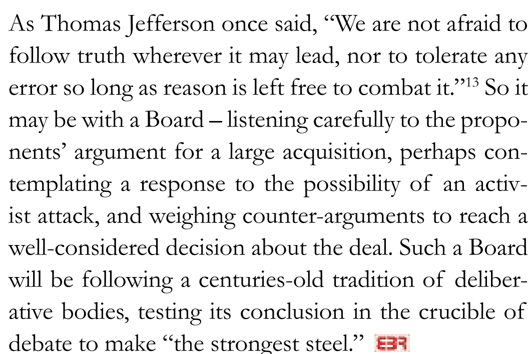
CONCLUSION



As Thomas Jefferson once said, "We are not afraid to follow truth wherever it may lead, nor to tolerate any error so long as reason is left free to combat it."[13] So it may be with a Board – listening carefully to the proponents' argument for a large acquisition, perhaps contemplating a response to the possibility of an activist attack, and weighing counter-arguments to reach a well-considered decision about the deal. Such a Board will be following a centuries-old tradition of deliberative bodies, testing its conclusion in the crucible of debate to make "the strongest steel." EBR

About the Author

Donald S. Collat, formerly a professor of finance at Harvard Business School, worked as an investment banker at Salomon Smith Barney (where he was a Managing Director), Bankers Trust, and Lehman Brothers, and was a partner/principal of Ernst & Young, where he provided strategic advice about mergers and acquisitions to large global companies. He is currently a consultant on M&A and corporate governance. A Rhodes Scholar, he received a D.Phil. (doctorate) in economics from Oxford University, a J.D. from Yale Law School (where he was editor of the Yale Law Journal), and an A.B., summa cum laude in economics, from Princeton University.

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