feature article

Failed Merger: Failed Corporate Governance?

Patrick A. Gaughan

The last wave of mergers also produced some of the greatest merger failures of all time. How many were due to failed corporate governance?

© 2005 Wiley Periodicals, Inc.

As we begin a new year, we have the opportunity to look back on some very large recent mergers and acquisitions (M&As) that can be considered failures and try to identify the causes of those failures. The fifth merger wave in the second half of the 1990s provides a fertile ground for such critical examination. In that period, we saw not only some of the largest mergers and acquisitions of all time, but also some of the greatest failures. While not all these mega-failures can be attributed to the same cause, failed corporate governance clearly played an important role in many of them. In order to examine the role of corporate governance, we will briefly discuss how companies are governed and managed. In doing so, we will seek to establish what the proper corporate governance process is and how it can fail when it comes to deal making. Lastly, we will discuss some of the leading failures of the recent merger period and see to what extent failed governance played a role in their difficulties.

CORPORATE GOVERNANCE

The ultimate owners of corporations are shareholders. Shareholders elect directors to represent their interests. Directors, in turn, select managers to run the company on a day-to-day basis. The typical board has, on average, ten directors, and of this group, approximately three are insiders, while the remainder are outside directors. Outside directors are those who are unaffiliated with the company, while insiders are members of management. Some directors are what are called "grey directors," as they have some affiliation with the company, such as a consulting contract, but are not employees. In many cases, the CEO sits on the board and may even be the board's chairman. It is usually believed that boards work better when insiders have less influence and when the board is not dominated by the CEO. The market tends to prefer such independent boards. This has been confirmed by research studies that show, for example, positive stock price reactions to appointments of outside directors. Such research also implies that smaller boards may be more effective at disciplining management than larger boards. Other studies have shown that for companies that have been performing poorly and have become the target of tender offers, board sizes tend to shrink after failed tender offers. This implies that when poorly performing companies "dodge a bullet," they sometimes try to "get their act together," and this often includes getting the board down to a size that is more effective at governance. The fact that smaller boards do corporate governance better than large ones is an intuitive result, as it may be easier for a CEO to dominate a larger board, where each board member may have less overall influence and clearly has lower voting control when there are more board votes. Smaller boards, on the

Published online in Wiley InterScience (www.interscience.wiley.com). DOI 10.1002/jcaf.20081

other hand, allow each board member to potentially have greater influence.

Increasingly, large U.S. companies are owned by institutional shareholders, which include mutual funds, pension funds, and insurance companies. It is typical that the majority of shareholders in any given large, publicly held company are institutions. These institutions have become somewhat more activist over the last 10–15 years. The California Public Employees' Retirement System (CALPERS), for example, is a major institutional investor that has become more activist and occasionally has taken strong positions opposing management proposals when they see they are not in the best interest of shareholders. However, while such actions tend to draw attention in the media, they do so partly due to the fact that they are not that common an occurrence. More typically, institutional investors are not very active in monitoring any one firm, as each company in their portfolio may be a relatively small percentage of their total holdings and may not warrant close attention. When institutional investors are dissatisfied by the performance of a company in their portfolio, it usually is easier to sell the holding than to try to influence management. Only when they have a large holding and/or are reluctant to sell for a loss will they consider other options.

While corporate governance has gotten more attention in recent years, the role that such governance plays in merger and acquisition strategy has not attracted such attention. Much of the recent public attention on corporate governance has been focused on corporate accounting scandals and their prevention. Legal remedies such as Sarbanes-Oxley and better industry self-policing have gotten the most attention. Corporate governance and merger strategy, however, has not been the focus. One of the reasons why this is the case is that it is difficult to police poor merger strategy. CEOs have been pursuing many bad mergers and acquisitions, which have cost shareholders many billions of dollars, yet there has been little call for changes to remedy the problem. When a CEO or CFO engages in accounting fraud and other manipulations, it is easy to see that this is wrong and require remedies and punishment. It is much less clear when a merger turns sour and shareholders lose value in their investment that we need to alter the corporate governance process so that such errors are prevented in the future. In the section that follows, we will discuss some leading merger blunders that have cost shareholders billions of dollars and for which the corporate governance movement has put forward no solutions.

Much of the recent public attention on corporate governance has been focused on corporate accounting scandals and their prevention.

CLASSIC FAILED MERGERS

One classic case of a merger strategy gone wrong was WorldCom. This was a company built by growth-oriented CEO Bernie Ebbers, who took it from a small Mississippi-based telecommunications reseller to one of the leading telecommunications companies in the world. It was built through a series of mergers and acquisitions that culminated with the 1998 $40 billion merger with MCI. Not content to stand still, Ebbers then tried to merge with Sprint, but his merger plan ran into resistance from the Justice Department, which opposed it on antitrust grounds. Ebbers was great at building a company through mergers and acquisitions. However, his strength was in doing deals, not managing companies. Reports of his micromanagement tendencies, which ranged from counting coffee bags and filters to monitoring smoker breaks of workers, have provided some amusement for the business media. WorldCom's board let him stay in place even as the days for growth through mergers should have come to an end.

WorldCom had reached an efficient size, if not grown beyond that, and it was time for the board to ask him to step aside and bring in a better manager. Unfortunately, this was not done until the company was headed to bankruptcy.

The case of Daimler Chrysler is different yet, in some ways, is similar. Both WorldCom and Daimler were run by strong CEOs who seemed to dominate the board. Daimler had a less successful M&A track record, as the company had done many deals that it was forced to undo. For example, it had pursed a diversification program that it was forced to unwind. Many of its investments, such as a large holding in Japanese automaker Mitsubishi, proved to be ill-conceived drains on the company. However, Daimler CEO Jurgen Schrempp's biggest mistake was his merger with Chrysler. The deal was called a merger of equals, but many consider it simply an acquisition of the third largest American company by the German luxury automaker. Schrempp dreamed of building an international auto company that was to be unparalleled. He was not content to run the leading luxury car manufacturer in the world. Schrempp's hubris-filled merger strategy generated large losses for shareholders and, as of the end of 2004, showed few signs of turning around. Once again, where was the board when Schrempp proposed his grandiose takeover scheme? Why did they not question it in light of Daimler's prior M&A mishaps?

The second largest deal of all time, and perhaps the biggest merger flop of them all, was the January 2002 AOL and Time Warner merger. This deal, which was valued at $166 billion, was supposed to be a synergy-filled marriage of content (Time Warner) and distribution (AOL). Instead of realizing synergies, however, the merger caused Time Warner shareholders to incur great losses with their merger with AOL, which used its overvalued shares to gain at Time Warner shareholders' expense. One of the most fundamental flaws of this deal was that its strategy and goals were poorly defined. Years after the transaction has been completed, it is difficult to see any synergies. It never was clear how Time Warner would gain from its association with AOL. Admittedly, Time Warner tried to pursue Internet-based activities and lost hundreds of millions of dollars. Gerald Levin, Time Warner's CEO, thought the Internet was key to Time Warner's future and forced his shareholders to pay a heavy price for his failed gamble. Time Warner board members will have a difficult time providing reasons why they approved this deal. One of the lessons of this disaster is that if you have trouble seeing how the synergies will manifest themselves, it is likely that they never will. Synergies are hard enough to realize when their path has been clearly defined. When it is difficult to see how they will occur, odds are pretty good that they never will. This seems to be more of a case of a board rubber-stamping a deal proposed by the CEO without raising enough questions. When the CEO becomes too strong, he or she tends to overpower the board. Strong CEOs need to be opposed by strong boards. In fact, the stronger the CEO, the stronger the board has to be. One common theme that we see in many failed deals is that we have a deal-making, strong-willed CEO and a compliant board that rubber-stamps the CEO's grandiose empire-building schemes.

One of the hallmarks of AT&T's merger history is that the company is undaunted by prior billion-dollar merger failures.

KING OF THE MEGA-MERGER FLOPS

Perhaps the company with the worst merger and acquisition track record is AT&T. This company has a knack for doing mega-merger flops, and few can compete with it. One of the hallmarks of AT&T's merger history is that the company is undaunted by prior billion-dollar merger failures. New CEOs come and go and do not seem to learn from the mega-failures of their predecessors. After giving up the "boring" regional phone companies for the right to enter the highly competitive computer industry, AT&T found that it could not succeed in that business. Rather than cut its losses, the company engaged in a hostile takeover of NCR, which it hoped would solve its computer industry woes. AT&T paid a high price for NCR, which resisted the telecom giant's overtures. The deal was a money-losing flop, and the market put such pressure on AT&T's stock that it had to restructure the entire company and separate the equipment and computer businesses while surviving as a smaller, but more focused, long-distance telecommunications company. However, AT&T was continually losing market share to more aggressive rivals. Rather than focus on being better at the core business, AT&T CEO Michael Armstrong decided to enter the cable and wireless telephone business. AT&T paid $52 billion to acquire TCI in 1998 and then $43 billion to acquire Media One less than a year later. Its poorly conceived strategy of acquiring cable companies so as to allow it to offer telephone service over cable lines directly to customers was flawed. It was also a pretty humorous strategy, as AT&T was already well established in that market when it owned the regional telephone companies—but AT&T did not see the value in these businesses and pursued more exciting pastures in the risky computer field. This adventure brought them nothing but red ink. Now it was pursuing another even bigger gamble, and this one would be equally as bad. The cable lines it acquired could not handle the telecom needs of AT&T and needed major investments to upgrade them. Rivals continued to attack the company in every market it was in. The stock market greatly questioned the company's strategy, and pressure mounted for the company to restructure once again.

AT&T is a company that has made merger blunders on such a scale that it should be barred from ever doing a deal again. Where was AT&T's board when its CEO proposed his $100 billion acquisition program? Why did they allow him to move so quickly to complete his deals without requiring him to do his homework? Why was the market slow to register its concerns about the company's acquisition strategy? Clearly, AT&T's board did not do its job, and shareholders lost as a result.

Still another case of failed corporate governance as it relates to a merger and acquisition strategy was Vivendi Universal's acquisition strategy. The company's board allowed its flamboyant CEO, Jean-Marie Messier, to transform it from a French water utility into an international entertainment company. For Messier, movies and music were obviously much more exciting than a boring water utility business. Apparently the board did not have a problem with acquisitions across the globe that were in fields far removed from the company's core focus. They allowed him to pile up debt while doing deals he found exciting. They did not question his strategy seriously until the company faced severe debt-service pressures and had become a company with a very confused assemblage of companies in highly diverse fields and with little in common with each other. As with so many of the other merger failures we have considered, the board was slow to act and passively stood by while the CEO wasted shareholders' capital.

The cases of a board standing up to a CEO's empire-building plans are few and far between. However, one prominent example occurred in November 2001 when Coca-Cola's board rejected a $15.75 billion takeover proposal for Quaker Oats. In this case, the CEO was new and lacked the leverage of some of the other CEOs whose deals we have discussed. In some ways, the synergies of the deal Coke's board rejected were clearer than in some of the other deals we have questioned. Quaker Oats had various products, such as the popular Gatorade line, that matched well with Coke's other soft drink products. Gatorade commanded over 80 percent of the sports drink market, whereas Coke's own Powerade brand accounted for just over 10 percent of the market. However, the board took issue with the dilutive effects the deal would have on its shareholders and it put their interest ahead of the CEO's feelings and ambitious plans. The board wanted to keep Coca-Cola focused on its main soft drinks business, and worried about straying too far into areas in which it did not believe the company had strong comparative advantages. In this instance, the board wanted to see the CEO follow its strategy, rather than change to fit a new CEO's ambitious plans.

The cases of a board standing up to a CEO's empire-building plans are few and far between.

TAKEOVERS AND CORPORATE GOVERNANCE

When the board is not sufficiently diligent and does not keep an acquisitive-minded CEO in check, the market sometimes steps in to correct the errors in the corporate governance process. The way this sometimes occurs is that the market registers its concern about a failed merger strategy by lowering the stock price. This can make a company vulnerable to a hostile takeover, as the companies that may have been acquired in error may be easily resold and their value may not fully be incorporated into the acquired company's market value. The more such acquisitions a company does, the more vulnerable to a takeover it becomes. When these bad acquirers are taken over, the prior failed acquisitions can be sold off and the company can pursue a more focused strategy. Companies that eventually realize the vulnerable position they may be in may head off the takeover process by selling off the prior acquisitions themselves. When they do this, the market tends to quickly register its approval, and shareholders typically gain as a result. This is an after-the-fact solution to a problem, however, that can easily be prevented by better corporate governance.

FAILED MERGER, FAILED GOVERNANCE

When we consider several of the major merger failures of recent years, we see that a common theme they share is poor corporate governance. In each instance, the board failed to stand up to its CEO when he proposed a deal that was not in the shareholders' interest. They rubber-stamped the CEO's grand plans, and shareholders ended up paying for their passiveness. As we focus on better corporate governance as it applies to accounting fraud and financial reporting, we need to be mindful that corporate governance needs to also be vigilant in monitoring management strategy and merger and acquisition plans. Boards need to independently evaluate CEO-proposed deals and not merely rubber-stamp them. Boards that are largely independent and generally smaller are often better positioned to accomplish this. If boards can focus on this task, they may be able to prevent future merger failures. Now that we have gone a long way to achieving greater accuracy in financial reporting, perhaps the next area where we can sharpen the corporate governance focus is on strategy, especially merger and acquisition strategy.

Patrick A. Gaughan, PhD, is president of Economatrix Research Associates, Inc., which is an economic and financial consulting firm specializing in analysis of economic damages in litigation and valuation of businesses, with offices in Newark, New Jersey, and New York City. He is also a tenured full professor at the graduate level in the College of Business at Fairleigh Dickinson University. Dr. Gaughan has authored two of the three textbooks in the field of mergers and acquisitions, including the award-winning *Mergers, Acquisitions, & Corporate Restructuring* (Wiley, 1999, 2nd ed.). He has also authored numerous other books and journal articles.