

On Human Capital Integration in Mergers and Acquisitions: The Retention of Key Employees

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Abstract: In recent years, China's economic development has entered a new stage; industries have been undergoing a process of renewal, resources across industries have been integrated, and merger and acquisition cases have emerged one after another. The emergence of merger and acquisition cases in clusters has, on the one hand, provided lawyers with new business and, on the other, imposed new demands on the professional competence of lawyers. As merger and acquisition practice touches upon every aspect of an enterprise, the legal profession has begun to analyze the legal issues of mergers and acquisitions from multiple perspectives, and human capital is one of the important components thereof. Although the importance of human capital varies from enterprise to enterprise, it is undeniable that human capital is one of the core resources of an enterprise, and its distinctive character is of growing importance in mergers and acquisitions. This paper examines the retention or departure of key employees in the course of human capital integration in mergers and acquisitions, in an attempt to arrive at a reasonably sound and appropriate plan for the disposition of key employees.

Keywords: enterprise merger and acquisition; corporate control; disposition of key employees; human capital integration

Introduction

Merger and acquisition is the collective designation of merger and acquisition; it refers to a legal event in which a dominant enterprise, by certain means, absorbs one or more independent enterprises. Under Chinese law, merger mainly takes two forms: merger by absorption and merger by new establishment. Acquisition, by contrast, is the obtaining of control over assets by way of the acquisition of equity interests or of assets. The principal difference between acquisition and merger lies in whether the original legal entity of the target company ceases to exist. Merger and acquisition is an important means by which an enterprise integrates external resources and enhances its competitiveness; in actual practice, however, the failure rate is high, and the failure of human capital integration is an important and hidden cause of merger and acquisition failure. Owing to differences in team composition, corporate culture, and

development philosophy, employees are lost in large numbers, with the result that one plus one not only fails to achieve an effect greater than two, but often also drags down the pre-existing dominant enterprise. Key employees, in turn, are the most critical element in human capital integration.

1. The Concept and Classification of Key Employees

1.1 Concept

The key employees referred to in this paper are the administrative management personnel, key technical personnel, key business personnel, financial management personnel, and other employees in the target enterprise who play an important role in its operation and management. An enterprise is a form of social organization; in essence, it is an economic organization constituted by an aggregation of persons, and persons are one of the core resources of an enterprise. In merger and acquisition, the mode of control over assets may be made clear in legal form; but to hold the actual controlling power of an enterprise, one must begin with the control of persons, or else there will be the form without the substance. If human resources are not brought under control, the consequences may be that the acquirer cannot exercise in-depth control over the target company, or that the target company suffers a large loss of personnel and even thereby loses its business capacity, or even that it falls into protracted internal conflict; whichever of these problems arises, it will frustrate the expectations of the merger and acquisition.

1.2 Principal Categories

1.2.1 Key Administrative Management Personnel

Administrative management personnel are responsible for the day-to-day operation of an enterprise. They are familiar with the staffing, organizational structure, and business capabilities of each department, and even with the personality traits and family circumstances of employees, and they constitute the information hub of the enterprise. Retaining key administrative management personnel helps the acquirer to understand the current state of the enterprise promptly at the time of the merger and acquisition, raises the efficiency and accuracy of the transaction, and may exert a significant influence on the course of the merger and acquisition. Key administrative personnel, however, are generally close to the shareholders and to the actual controller of the period before the transaction, and are strongly personal in character. If the former shareholders and the actual controller do not remain, the likelihood of their staying on is small. Once key administrative personnel leave, not only will the acquirer find it difficult to take control of the enterprise, but because these persons are highly familiar with employees of every department, departures are apt to spread from one point to the whole.

1.2.2 Key Technical Personnel

This category refers to employees who hold key technical positions, play an important role in the principal technology of the enterprise, and possess key technical information. The work of technical personnel is relatively undiversified; unlike administrative personnel, who deal with every department, they are chiefly responsible for work concerning things, and are the group least likely to be affected by a merger or acquisition. Yet in any enterprise that has a dedicated technical department, that department is generally the mainstay of the enterprise's core competitiveness; in other words, the enterprise exists by virtue of its technology, and where the technical department is, there the core competitiveness is. Viewed from another angle, the purpose for which an acquirer acquires an enterprise is, apart from

those fixed assets and registered patents, often the technical team. A team, however, unlike fixed assets and patents, cannot be fixed in an explicit legal form, for it is composed of persons; under the current Labor Law of the People's Republic of China (the Labor Law), the possibility that an enterprise may attempt to bind its employees by legal means is considerable. A question naturally arises: once the former owner sells the enterprise and then takes the technical team away, how should this be dealt with?

1.2.3 Key Business Personnel

This category refers to employees within the enterprise who are devoted to business development, the taking on of business, and the sale of products or services, and who are the main force by which the enterprise realizes revenue. In essence they are the same as technical personnel, in that both are professionals within the enterprise; although their work is work concerning people, it is chiefly directed at external clients. They hold the revenue channels and client resources of the enterprise and are its source of revenue. Key business personnel usually possess sound development capabilities, ample social resources, and strong communication and coordination skills, and thereby sustain the level of business performance. They are of great significance for restoring revenue within a short period after the merger and acquisition.

1.2.4 Financial Management Personnel

The importance of finance to an enterprise is self-evident; it is the center of the enterprise's data, where its income and expenditure are recorded and processed. Therefore, apart from senior management, it is the finance department that is able to understand the overall operating condition of the enterprise; moreover, financial personnel in practice understand enterprise information in greater detail and more comprehensively than senior management does.

The foregoing are the four principal categories of key employees identified in this paper. Emphasis may vary according to the type of enterprise, and the employees concerned may even be of an entirely different type; this must be analyzed in each case in light of the actual circumstances of the enterprise.

2. Determination of the List of Key Employees

2.1 Determining the Priorities for Retained Employees According to the Type of Enterprise

Key departments of enterprises share common features, and those common features are relatively easy to determine. The finance department, for example, is a core department of any enterprise, and in any merger and acquisition the personnel of the finance department, or at least some of its key employees, should be retained; otherwise, it will be very difficult for the acquirer to clarify the financial condition of the enterprise within a short period after taking it over. It is impossible to take control of an enterprise without first clarifying its financial condition.

Enterprises differ in the fields and specializations in which they engage, and apart from the departments they have in common, their core departments and key employees generally differ and display individual characteristics. Consider an engineering consulting enterprise whose principal business is project budgeting and costing together with settlement auditing: its key employees are the engineers engaged in project budgeting and settlement, whose experience and capabilities

determine the enterprise's core competitiveness; at the same time, engineers with rich project experience are usually in contact with numerous enterprises and are therefore the source of the enterprise's business. Consider a garment manufacturing enterprise whose principal business is the production and sale of garments: its key employees are its designers, patternmakers, skilled workers, and the business personnel who control the sales channels. Consider an Internet enterprise engaged in APP operation: its key technical personnel and operations management personnel are all crucial.

Through an analysis of the type of enterprise, the screening priorities for core departments and key employees may be established on a preliminary basis. For the target enterprise, a merger and acquisition is undoubtedly an earthquake and a transformation; in carrying it out the acquirer cannot satisfy all employees, nor is there any need to do so, and the departure of some employees is therefore inevitable. What is to be done is to make the transition of the enterprise as smooth as possible and to steer it in the direction designed by the acquirer. Accordingly, once the core departments of the target enterprise have been identified and account has been taken of the acquirer's development direction, the priorities for retained employees can to a certain extent be determined.

2.2 Conducting Due Diligence on Employees According to the Confirmed Core Departments and Fields

Due diligence is an important element of merger and acquisition. In past merger and acquisition practice, attention was generally paid to the investigation of the assets and liabilities of the target enterprise while the investigation of the "soft" personnel was neglected, which ultimately led to the failure of the merger and acquisition. Such failures may be roughly divided into two categories:

The first category is that, during the course of the merger and acquisition, some employees of the enterprise make their influence felt: unease, resistance, and the like arise among the employees, and because the acquirer fails to respond by reasonable means, such sentiments develop into opposition to the merger and acquisition and become an obstructive factor. This obstructive factor is not merely superficial resistance; it manifests itself further in a refusal to cooperate with the acquirer's due diligence and other work, as a result of which the acquirer is unable to gain a comparatively clear understanding of the enterprise and unable to make a judgment, thereby foreclosing the possibility of the transaction.

The second category is that, after completion of the merger and acquisition in the legal sense, a large number of key employees leave while the acquirer is taking control of and absorbing the target company, so that the transition cannot proceed smoothly, the business is seriously affected, and the purpose of the merger and acquisition is ultimately not achieved.

Accordingly, it is necessary to establish the following understandings:

First, employees are one of the core assets of an enterprise. Although an individual employee is to a certain degree substitutable, employees as a team are, within a certain period, irreplaceable.

Second, employees, as enterprise assets, are not readily controllable. Fixed assets, intellectual property rights, and even goodwill can all be made explicit in the form of legal documents and can, within a specific period, be locked in by certain means.

Employees, however, are natural persons; they are protected by the Labor Law, enjoy the freedom to choose employment, and their retention or departure ultimately depends on the judgment of the individual employee. The acquirer may guide such judgment but cannot ultimately determine it, nor can it effect a complete lock-in.

Third, employees are susceptible to external influence and are also apt to develop contagious sentiments. As noted in the classification of key employees above, a large proportion of key employees are closely connected with the senior management of the enterprise, and where the senior management leaves, this group of employees is likely to be affected. If, on the other hand, the senior management remains and this group of employees remains along with it, this will inevitably have an adverse effect on the acquirer's control of the enterprise — a dilemma. The acquirer is, in the final analysis, an outside force, and it will find it difficult to break up the informal cliques among employees within a short period; absent appropriate measures of disposition, adverse sentiments are apt to spread and cause a large number of departures, and the enterprise will then be like a human body losing blood: even if it pulls through, it will inevitably have suffered heavy losses.

It is therefore entirely necessary for those leading the merger and acquisition to make due diligence on key employees an important element of merger and acquisition due diligence, so that the merger and acquisition may be completed smoothly and, after its completion in the legal sense, the acquirer is assured of taking control of the enterprise promptly, so that the enterprise can restore its operations well within a short period.

2.3 Determination of the List

On the basis of the foregoing analysis and due diligence, the key employees are first ranked by importance in reliance on such factors as the enterprise's business data and financial data, and a comprehensive assessment is then made in the light of the purpose of the merger and acquisition, the retention or departure of the senior management, welfares and benefits, corporate culture, and other factors, so as to finalize the list of employees to be retained.

3. Principles for Determining the Retention or Departure of key employees

3.1 Being Guided by the Purpose of the Merger and Acquisition

In reality, the acquirer undertakes a merger and acquisition for a specific purpose, and the purpose of the merger and acquisition may therefore serve as the guide.

Merger and acquisition within the same industry is undertaken in order for the leading enterprise to secure a dominant influence within a particular industry, or a dominant share of the market. In such a merger and acquisition the acquirer is usually familiar with the operating rules and market conditions of the industry, and may even have a considerable understanding of the target company itself. The retention of management personnel is not particularly pressing; on the contrary, the retention of business personnel and technical personnel becomes the priority.

Upstream and downstream extension merger and acquisition is, for example, the acquisition of a tire manufacturer by an automobile manufacturer, the purpose being to reduce the operating costs of the principal business and to enhance market competitiveness. In such a case the acquirer has a certain degree of exposure to the

particular industry, but there are differences in technical characteristics and management methods. Since the merger and acquisition is itself intended to resolve the problem of the acquirer's supply of raw materials or of the sale of its products, the target company will become one link in the acquirer's industrial chain, and the importance of purely sales personnel declines accordingly.

Cross-industry merger and acquisition refers to the situation in which the acquirer is brought by the transaction into a new field. Such a transaction is generally not advocated, its failure rate being relatively high. The acquirer is faced with a comprehensive unfamiliarity with the market, with management, and with technology.

3.2 The Principle of Stability During the Merger and Acquisition and in the Initial Period After Taking Over the Enterprise

A merger and acquisition is a transformation of the enterprise: on the surface, its owners, its controlling party, its actual controller, and the like have changed, and for every person within the enterprise it is a great shock. That shock will inevitably give rise to turbulence. Whether that turbulence will ultimately allow the enterprise to be reborn from the ashes, shatter it to pieces, or bring about a slow death is, however, unknown. What is certain is that, if a major change of personnel is brought about during the merger and acquisition or in the initial period after taking over the enterprise, it will inevitably impede the acquirer's progress in taking control of the enterprise. This stage should therefore be governed by the principle of stability.

3.3 Where the Target Company Still Has Affiliated Enterprises, Retaining Financial and Management Personnel with Prudence After the End of the Transition Period

Compared with technical and business personnel, financial and management personnel are more strongly personal in character and are closely connected with the former senior management of the target company. Moreover, once data integration has been completed and management has been familiarized, financial and management personnel are relatively substitutable.

3.4 Decisively Removing Personnel Whose Orientation Is Inconsistent with the Future Development Direction of the Enterprise

It has been discussed above that a merger and acquisition itself carries a special purpose, and that under that purpose the acquirer's plans for the development of the enterprise differ. Some acquirers seek merely to complete the industrial chain, so that it suffices for the target company to maintain its original operating condition, and personnel should then be dealt with principally on the principle of stability. Other acquirers pursue the purpose of giving the fullest play to the potential of the target company, and even of thoroughly remolding it into a new growth point for the business; a new enterprise of that kind necessarily requires an enterprising corporate culture that presses forward with vigor. Personnel in the original enterprise who are incompatible with such a culture must be dismissed, lest they affect the other personnel.

4. Paths to the Effective Retention of Key Employees

4.1 Announcing a Clear Development Plan and Objectives for the Enterprise

It has been discussed above that the failure of a merger and acquisition is to a large extent attributable to a large loss of employees, and that an important cause of such loss is that an unclear prospect gives rise to fluctuating morale and an absence of a

sense of security. As key employees of the enterprise, have achieved a great deal in a given field, and possess a stronger capacity for choosing employment and enjoy greater freedom to choose employment than ordinary employees. Once their morale becomes unstable, they find it easier to leave and to find new employment. The acquirer should therefore make clear to the employees of the enterprise the development plan for the enterprise after the merger and acquisition, as well as the objectives of its long-term development, so as to stabilize the morale of employees and strengthen their confidence in the future of the enterprise.

4.2 Designating Personnel for Direct Contact and Strengthening Direct Communication with Employees

Besides the announcement of the relevant development plan discussed in the first item above, a dedicated body or dedicated personnel should be designated during the merger and acquisition and throughout the transition period to be responsible for direct contact with employees, so as to convey timely, accurate, and effective information to them and to prevent the spread of misinformation and rumors. It is all the more necessary to prevent certain persons within the enterprise from, out of self-interest and taking advantage of the instability of the merger and acquisition, inciting employees by false information to leave and break away to set up a rival enterprise, thereby causing losses to the enterprise. The advantage of designating dedicated personnel lies in direct communication, which dispenses with the distortion of information caused by intermediate links.

4.3 Setting Reasonable Salary and Benefits, with a Modest Increase

Salary is the basis on which any employee survives and develops in society, and its importance is self-evident. If salaries decline rather than rise after the merger and acquisition, this, combined with the unstable morale of employees, will inevitably lead to departures on a broad scale. Yet at the present stage of China's economic development, persistently high labor costs are a reality, and a general increase of considerable magnitude would cause a substantial rise in the enterprise's labor costs; moreover, it is characteristic of salary that an increase pleases everyone, whereas a reduction necessitated by difficulties in the business is very hard to effect. A substantial increase may, in addition, prevent the acquirer from judging whether the employees who remain identify with the development direction of the enterprise; in truth it has both advantages and disadvantages.

4.4 Preserving the Necessary Positions and Giving Employees Room for Advancement

Key employees are employees who have already achieved a certain degree of success, and such employees usually have particular strengths and abilities in different fields. They therefore have a stronger sense of development than ordinary employees and, apart from basic conditions such as salary, pay greater attention to their own room for advancement. In merger and acquisition practice in the past, many acquirers, in order to take control of the enterprise quickly, assigned large numbers of their own employees to key positions in the enterprise, and even treated assignment to a position in the target company as a form of reward for their own employees, which is highly inappropriate.

It is true that, for the purpose of controlling the enterprise, it is entirely normal for the acquirer to dispatch its own personnel into the enterprise; yet however many personnel are dispatched, they remain a minority. The stable development of the target company still requires that the initiative of its original employees be mobilized. It is therefore entirely necessary to preserve room for advancement for the employees of the original enterprise.

4.5 Establishing a Sound Philosophy of Personnel Appointment and Guiding the Positive Elimination of Employees

Even outside the course of a merger and acquisition, personnel mobility is normal in the day-to-day operation of an enterprise, and healthy personnel mobility can promote the development of the enterprise. A merger and acquisition is a major transformation, and personnel mobility is a wholly normal phenomenon; what is most critical is that positive elimination should be effected, that is, employees who are lazy in their work, low in efficiency, and negative in attitude should be eliminated, while employees who are active in their work, full of enterprise, and cooperative with colleagues should be retained. In this way staff reduction is achieved at the same time as the merger and acquisition, which is not only conducive to the development of the enterprise but also instills sound professional values in its employees.

5. Conclusion

In summary, the integration of human resources is one of the key factors determining the success of a merger and acquisition, and key employees are the most critical element of all. First, the principal orientation for retaining employees should be formulated in accordance with the characteristics of the target company, and a targeted investigation should then be conducted so as to produce the list of key employees. Second, the list so produced should be comprehensively assessed in the light of the purpose of the merger and acquisition, the direction of development, the characteristics of the employees, and other factors, so as ultimately to determine the persons to be retained. Third, information should be announced in a timely manner, an effective two-way flow of information should be realized, reasonable systems should be established, and salary and benefits should be raised. Through the foregoing measures the question of retaining key employees is systematized, so as to ensure the stable transition and sound development of the enterprise.