



## ERM Insights

### The view from above

The critical role of Board oversight for HSE in post-merger integration

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#### Why HSE issues often get neglected

Despite the best intentions, boards often wind up overlooking HSE issues in the heat of merger planning. Quite simply, the importance of HSE issues in post-merger integration can be deceiving. The direct synergies gained from HSE during the merger are small relative to those in other divisions such as finance and operations. What's more, HSE concerns typically are not seen as having a significant impact on revenue or the price of the deal. Rarely are closings delayed because of HSE issues.

At most companies, HSE managers report through the operations or legal departments, which means they often do not have a seat at the table when the merger integration is planned. Few board members have extensive HSE background and may be unaware of the potential consequences of overlooking HSE concerns in merger integration. In addition, some HSE professionals may not come from a business background and they may be less experienced articulating HSE priorities amid the litany of issues that demand attention. While other divisions such as sales often see a merger as a way to capture more resources or even transform their function, HSE professionals rarely do.

As a result, board members often have a limited view of the key HSE issues in merger planning. They may be led to believe that due diligence investigations of potential environmental liabilities clear all the HSE hurdles and costs that can be addressed through environmental reserves.

#### Unintended Consequences

Boards that don't adequately address HSE concerns during the due diligence process may be leaving the combined company open to unintended consequences once the merger is completed. One of the biggest concerns, of course, is that by missing key HSE issues, the combined company will fail to meet either the legal or corporate standards for safety and compliance to which it aspires.

Directors with the appropriate experience recognize that evaluating and understanding HSE issues in a merger is a broader, more complex process than it may first appear. The potential consequences of missing these broader issues can manifest themselves months or even years after the merger is completed.

For example, many board members will recognize the need to address obvious compliance problems with a target company, such as the lack of a fire suppression system or a manufacturing plant that is out of code. They may be less able to appreciate more subtle, longer-term issues, such

as safety and maintenance programs that if improperly funded can lead to accidents and other liabilities.

#### *Increased risk for noncompliance and incidents*

If the adequacy of compliance programs has not been assessed before the merger is consummated, directors and managers will likely not appreciate the full extent of potential risks and liabilities, and they may find their companies out of compliance and without adequate funds to address the problem.

One major energy company, for example, discovered after a merger closed that the target company was significantly out of compliance on environmental regulations and safety protocols. The acquirer then had to spend eight times its estimated costs to bring the target into compliance because due diligence had not identified all the pertinent HSE issues prior to closing. In simple terms, overlooking HSE issues in a merger is like buying a house without inspecting the furnace. You may have to replace it in two years or it could burn the house down because it's unsafe. If you knew at the time of the purchase that the furnace would need replacement or repair, you could incorporate those costs into the purchase price, avoiding greater expense later.

#### *Missed cost synergies*

If companies don't address HSE operational issues in their merger planning they are likely to miss large potential savings in their post-merger integration. At most companies, HSE budgets, for example, are relatively small, yet what they spend on energy, water, waste and safety is many times greater.

HSE issues can also be the critical enabler to significant savings in operations. The critical path to expanding or combining facilities could well be obtaining the appropriate air permit. If these issues aren't addressed in the merger plan, companies are missing a big potential for synergies and cost savings.

#### *Lingering consequences*

Capturing synergies are integral to every acquisition or merger. Yet directors should also appreciate that misdirected cost reductions can have lingering effects on operational issues such as safety long after a merger is completed.

Two high-profile process safety failures in the past decade illustrate this point. Post-merger cost cutting that reduced safety, training and maintenance budgets contributed to the explosion that killed 15 people at BP's Texas City refinery in 2005, according to a report by the U.S. Chemical Safety Board. Similarly, the Presidential commission that investigated the 2010 Deepwater Horizon disaster, which killed 11 men, noted that the rig's owner, Transocean, was the product of a series of large mergers. Transocean's share of incidents on deep-water drilling projects escalated after its \$18 billion merger with GlobalSantaFe in 2007, according to a Wall Street Journal investigation.<sup>1</sup> The cost reduction programs, reorganizations, new systems and supervisors can also lead to a distracted, confused or demoralized work force that increase the risks of a merger. Pre-emptively addressing these issues can mitigate the risks that come with every integration.

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<sup>1</sup> <http://www.wsj.com/articles/SB10001424052748704307804575234471807539054>

### *Missed growth opportunities*

Every HSE team will address, to some degree, the compliance, liabilities and organizational issues during integration. But few management teams look to HSE to support growth synergies. There are several areas where HSE can play a critical role to enable or accelerate growth.

When one company acquires another it often inherits a portfolio of capital projects targeted to expand production capacity or efficiencies. HSE issues such as permitting, compliance or stakeholder issues may well be the critical path to completing the projects on schedule or at expected production volumes.

The same is true for product compliance. Consider a global chemical company that buys a specialty chemical manufacturer. The buyer intends to leverage synergies of a merger by expanding the distribution of the specialty chemicals across its global network. Only after a merger is completed does it realize it lacks the registrations (e.g. TSCA or REACH) to distribute those particular chemicals in the countries where it operates. As a result, the planned product expansion and merger savings are delayed. However, if these permitting issues had been properly vetted and planned for before the merger was completed, the company could have recognized the benefits of synergies more quickly.

### *Missed opportunity to secure integration resources*

The information technology (IT) and management systems required to run global company are highly complex. HSE often winds up at the back of the line for IT resources in a merger. Understandably, financial, customer and operational systems often get priority. But without a proactive plan and proper resources to address HSE systems, the merged entity can be left with confusing and contradictory programs and, consequently, higher risks.

### *Missed opportunities to transform HSE performance*

The unintended consequences of placing a low priority on HSE issues, however, aren't limited to future costs or undisclosed liabilities. Every merger represents a chance for transformation, an opportunity to set and build capabilities for higher performance standard. For organizations that have fallen short of external or internal expectations, the merger represents a unique and limited window to reset standards and put in programs that will lead to new performance.

## **The board's HSE opportunity**

Many boards now have an HSE sub-committee with responsibility for overseeing the risks and performance on these issues.

It is important that this committee appreciate that any significant transaction offers them a unique opportunity – and limited window - to reset, realign or expand HSE capabilities to support the new company. Decisions that are made (or not made) in the planning period and shortly after close will have implications – positive and negative – for years to come.

Once a transaction has been announced, we recommend the Board HSE committee take three actions:

- 1) Ensure HSE leaders are actively involved in the merger integration planning process as soon as it begins. It is rare to find that the HSE executive has a “seat at the table” when integration planning begins.

- 2) Request a comprehensive integration plan from the HSE team.  
Before a merger or acquisition is closed, Directors and managers should have a comprehensive understanding of how HSE issues will affect the future success of the transaction. The plan should include not only the risks and compliance issues, but also the HSE enablers to key operational synergies and growth opportunities. A comprehensive integration plan from HSE should address five key areas:
- **Liability and Risk Management** –How will liabilities be estimated, reserved and managed in the combined company? What are the critical risks that will come with the new combined company? How will they be mitigated?
  - **Compliance** – How will the cost of compliance be estimated? Have sufficient funds been allocated to bring the new company to expected standards? Will the integrated audit and assurance processes be sufficient for the combined company and new risk profile?
  - **Operational opportunities** – What are the HSE enablers to critical operational synergies? How will HSE-related costs in operations such as energy, water, waste management and safety be reviewed for potential savings?
  - **Growth Opportunities** – How will HSE capabilities enable critical growth synergies such as capital projects and product stewardship?
  - **EHS Functional integration** – Are the HSE performance standards for the new company clear? How will the organization, IT systems and management systems be integrated and adapted to meet the new standards?
- 3) Ensure that the HSE team have secured a portion of the integration budget to fund the compliance requirements, synergy opportunities and organization and IT integration costs.

### **Recognizing the benefits, avoiding the pitfalls**

Of all the challenges that arise in post-merger integration, HSE issues can be the most vexing for directors. Their consequences stretch over a longer timeframe yet they are less obvious when a company is sorting through its pre-merger decisions.

Board members must realize the importance of encouraging transparency and proactively working with HSE staff to understand the full scope of the issues their company faces in an acquisition.

By appreciating how HSE factors into the overall merger integration, companies can not only avoid unexpected costs and missed opportunities, they can actually use HSE to enhance growth and improve operating efficiencies.

### **References**

<sup>1</sup> <http://www.wsj.com/articles/SB10001424052748704307804575234471807539054>