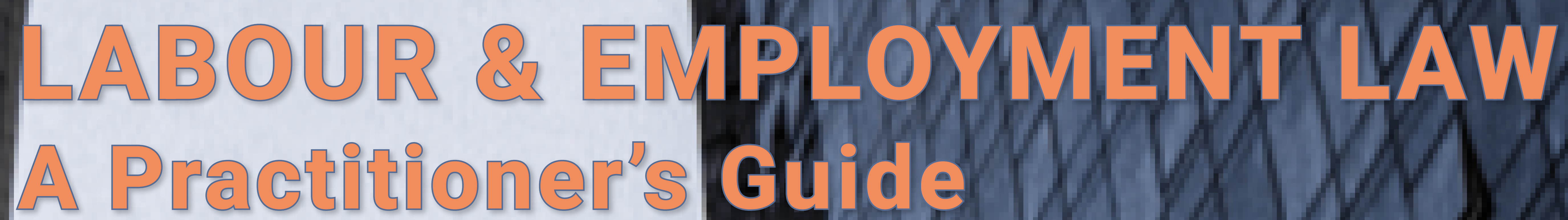

HUMAN RESOURCES DUE DILIGENCE

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TODAY

HUMAN RESOURCES DUE DILIGENCE IN MERGERS, ACQUISITIONS, AND TAKEOVERS

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INTRODUCTION

Due diligence generally refers to a process whereby a company or organization seeks sufficient information about a business entity to enable it reach an informed judgement as to its true value for a specific purpose. It is a procedure commonly used to study, investigate and evaluate a business opportunity. It is designed to answer the important questions, and ensure with reasonable assurance that the seller's claims about the business are fair, accurate and legitimate. Due diligence is an invaluable tool for negotiating the price of a deal.

THE DUE DILIGENCE TEAM

Due diligence takes different forms including legal due diligence, tax due diligence, financial due diligence, intellectual property due diligence, property due diligence and lastly, but not the least, human resources due diligence.

Because of the complexity and the multidisciplinary nature of due diligence, a due diligence team may comprise of corporate solicitors, employment attorneys, tax advisors, financial consultants, estate valuers, human resources experts and a host of other professionals depending on the character and assets of the target company.

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THE DEVIL IS IN THE DETAIL: IMPERATIVES OF HR DUE DILIGENCE IN MERGERS, ACQUISITIONS AND TAKEOVERS

Human Resources due diligence involves a comprehensive audit, investigation, assessment and evaluation of the human capital related issues, risks and exposures in a deal. A thorough HR due diligence is crucial to a successful acquisition, especially in an environment like ours in Nigeria, and the exercise can be quite informative and revealing of the people-issues and risks inherent in an otherwise very seemingly attractive deal or target company.

Regrettably, experience has shown that some merger and takeover deals fail largely due to neglect of some important people-issues during the pre-deal due diligence and negotiations. While some failure can be explained by financial and market factors, a good number can be traced to neglected people issues. The temptation is always there for the acquiring company to beam its due diligence search light on the target company's books, finances, operations and core legal enquiries while people issues often take the back seat. This neglect often results to buying over some latent but very costly human resource related liabilities, and sometimes avoidable employment litigations and industrial relations frictions. There have been cases where the acquiring entities are still bogged down by employees' class actions in courts years after the conclusion of the merger or takeover deal, and with attendant distractions, costs and reputational damage.

EFFECTS OF MERGERS AND ACQUISITIONS ON EMPLOYEES' CONTRACT OF EMPLOYMENT

Under the common law, contracts of employment are personal. The contract of employment ceases to exist where there is a change in ownership of the employing company due to merger, acquisition, takeover or other forms of corporate restructuring[1]. This common law rule has been incorporated into Section 10 of the Nigerian Labour Act[2] which provides that no employee may be transferred to another employer except with his or her consent.

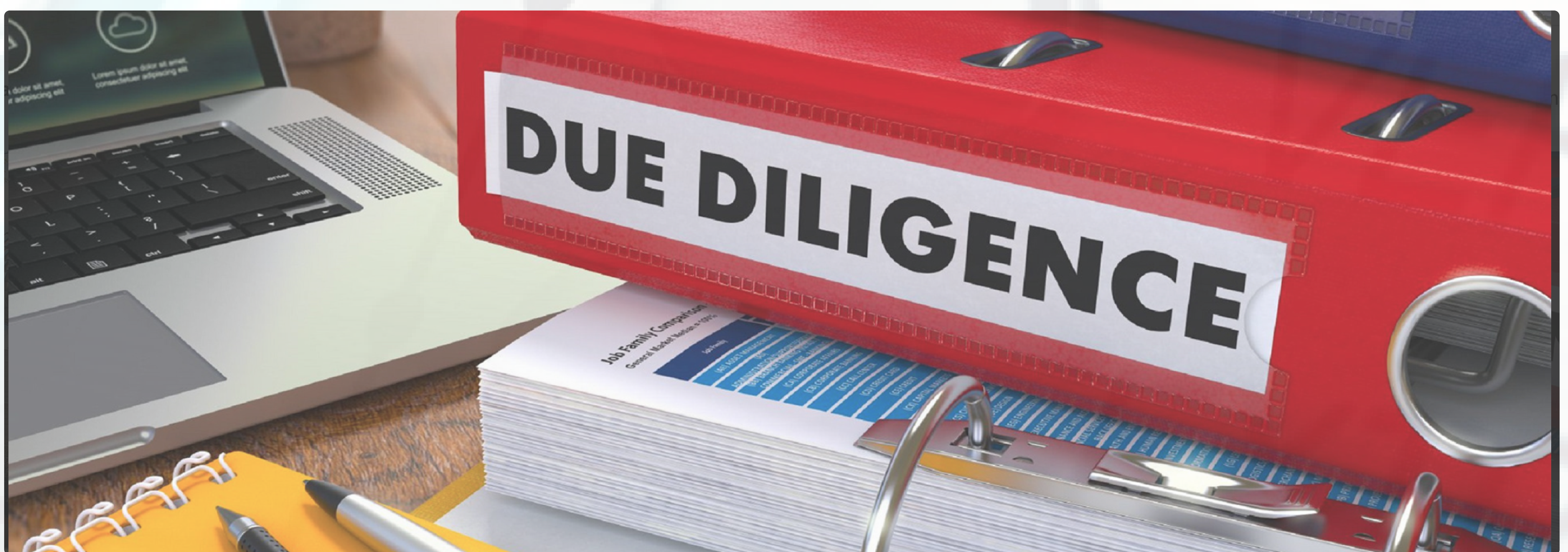
Thus, in the absence of an express consent of the employees freely given individually or through their trade unions, the employees do not automatically become the employees of the acquiring company. However, whether the employees are taken over or not, and unless otherwise agreed by the parties[3], the acquiring company acquires both the assets and liabilities of the acquired entity including human capital related costs and liabilities. This implies that the acquiring entity inherits all the accrued but outstanding labour costs including terminal benefits and redundancy pay, if any.

HR DUE DILIGENCE

- **Important Audits and Review**

The HR due diligence should pay emphasis on existing human capital liabilities including potential risks and exposures. The due diligence team must study and evaluate the target company's HR processes and it's implications on the deal.

There may be a variety of people issues, real and potential liabilities lurking just below the surface which may never be discovered unless the right enquiries are



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[1] See Nokes v Doncaster amalgamated collieries (1940) ac 1930.
[2] CAP LFN 2004.
[3] Even where the merger document does not vest or transfer employee issues and liabilities to the acquiring company, it is in the interest of the acquiring company to ensure that the target company fully discharges its contractual and statutory obligations to its employees and settle all people issues prior to final closure.

made. A thorough HR due diligence requires an understanding of knowing where to look, the right questions to ask, and who to ask including how to verify the responses. The due diligence team must courteously, but firmly demand for support and cooperation from the target company. The team must insist on being treated as welcomed guests, not people on espionage.

AREAS OF FOCUS

The HR due diligence team must beam its search light on, and pay special attention to the following:

- **Review of Contracts of Employment and Employee Handbook**

This is the traditional part of the due diligence that requires a comprehensive audit of the HR processes, policies and related documentation. The starting point is the review of contracts of employment, employee handbook, manuals and other important HR policies of the company.

Where the target company is small, it may be possible to ask for, and review all the employees' contracts of employment. However, in medium and large target companies, especially the labour intensive ones, it is not practicable to imagine that the due diligence team would wade through employment contracts of over a thousand employees. In such cases, a random sampling of contracts of employment of different cadres or grades of employees will be sufficient although more attention should be paid to the contracts of employment of the managing director, executive directors, general managers and other senior managers. This is for the simple reason that most times, contracts of these categories of staff do have special benefits including bonuses, directors equities and profit sharing schemes.

A contract of employment contains the basic terms and conditions of emloyment. The due diligence team should pay attention to those terms and conditions that may impact on the deal including but not limited to terminal benefits, redundancy pay and other termination costs.

The Employee Handbook, HR Manuals and other HR policies of the target company should be carefully audited for provisions that may impact on the deal. Particular attention should be paid to provisions or policies relating to compensation and benefits, bonuses, gratuities, pension, redundancy and redundancy pay, profit sharing, employees' shareholdings, etc. The financial costs and impacts of these provisions and policies on the deal should be carefully analyzed, and taken into consideration in the pricing of the deal. Where the company has a gratuity scheme, it is important to confirm if the scheme is funded or not.

- **Review of Collective Bargaining Agreements**

Where the target company is unionized, special care and due diligence is key to the success of the deal. There have been some cases of failure of mergers and takeover deals largely on account of trade unions and industrial relations issues. It is important that the acquiring company ensures that the target company carries the relevant trade unions along before the conclusion of the deal. Not carrying the trade unions along is one sure way to kill the deal, or at best a recipe for post deal industrial relations crisis. Trade unions have been known to be a major challenge in closing merger or takeover deals, and as such it is important that they are given adequate consideration during the merger talks. Trade unions are always keen on protecting their members (employees of the target company) during merger and takeover talks, and to secure them the best deal possible in the event of layoffs resulting from the merger or takeover. The acquiring company should insist on knowing the deal with the trade unions regarding employees and ensure that the target company follows through.

- **MERGERS AND TAKEOVERS: The Right Of Employees To Be Informed**

Employees' rights and claims are akin to property rights in the enterprise, and these rights may be activated upon the occurence of a particular event such as redundancies or business transfer or similar corporate resructuring which puts these rights at risk. These property rights underscore the need for employees and their trade unions to be informed of any proposed mergers and takeovers, and be carried along in the process. Section 123 (2) of the Investments and Securities Acts provides that in cases of an intermediate or a large merger, the acquiring company and target company shall inform the employees and their respective trade unions. It is also not uncommon for the target company to declare redundancy preparatory to a merger or takeover deal. Section 20 of the Labour Act also mandates employers of labour to inform the employees or their trade unions of any redundancy plan.

The due diligence team must also ask for copies of the Collective Bargaining Agreement[4] (CBA) in force between the target company and the relevant trade union(s). Particular attention must be paid to provisions under the CBA relating to terminal benefits including gratuities, long service awards, ex gratia and other similar provisions that may impact on the deal.

The cost impacts of these provisions must be carefully analyzed and taken into consideration in deal valuation and negotiations. This is also important because most CBAs have provisions committing the companies' successors in title and assigns to the CBA.

- **Audit of Staff Strength and Personnel Records**

The due diligence team must also audit the staff strength of the target company including its payroll costs; particular attention must be paid to the age and sex composition of the staff, their qualifications and performance appraisals.

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[4] *Collective Bargaining Agreement refers to agreements concluded between employer and employees union relating to terms and conditions of employment.*

- **Audit of Pension, NSITF, ITF, HMO, Personal Income Tax, and other relevant statutory obligations**

One of the most costly mistakes for the HR due diligence team is not to uncover outstanding employee related costs such as outstanding pension liabilities, NSITF and ITF contributions, indebtedness to HMOs, unremitted personal income taxes and similar human capital related statutory obligations and costs. There have been cases where target companies have unremitted staff pensions running into hundreds of millions of naira, outstanding but unpaid contributions to NSITF and ITF, including unremitted personal income taxes. These are important considerations in ascribing value to the deal. It also offers useful insights on how people matters are handled in particular, and how the company is run generally. It reveals whether or not the company is a compliant one, or an entity that "cuts corners" or one with very weak governance culture.

Where there are outstanding statutory obligations or cases of unremitted contributions, the accrued interests and applicable penalties should be taken into account as well.

- **Contingent Staff**

The world of work has witnessed tremendous changes in the last decade, including the increasing dominance of non-standard work arrangements one of which is labour outsourcing. Labour outsourcing is a business model where an enterprise retains another to provide its manpower needs in consideration for a fee. It is a triangular employment relationship where a labour contractor recruits and deploys personnel to user companies on need basis. Where the target company uses such arrangement for its personnel needs, the due diigence team must carefully audit the manpower outsourcing arrangement. A poorly structured and managed labour outsourcing arrangement may turn out to be a significant cost to the acquiring entity. The Service Level Arrangement (SLA) entered into bewteen the target company and the labour contractors must be painstakingly audited and reviewed to address concerns of co-employership. The labour outsourcing arrangement might have been mismanaged to give rise to co-employership status and with attendant cost implications for the deal.

Where evidence of co-employership is found, provisions must be made for the treatment of these contingent staff. Where the acquiring company has no need for them, the target entity must be made to terminate the Service Labour Agreement (SLA) with the labour contractors. But more importantly, the due diligence team must ensure that any cost or liability associated with this termination is borne and settled by the target entity. Where the acquiring company intends to inherit the outsourced staff, considerations must be given to the costs of retaining these contractors including the termination costs if it chooses to terminate the Service Labour Agreement. There have been cases where the outsourced staff file class actions at the National Industrial Court against the user companies and claim terminal benefits and redundancy pay.

- **Employee Litigations and Potential Litigations**

The due diligence team must also audit the employee litigations pending against the target company at the various courts in Nigeria, especially at the National Industrial Court. Particular attention must be paid to the nature of the reliefs sought, and the potential bandwagon effects on the company if the claims succeed. Threats of litigations by former employees should also not be ignored.

- **Staff Culture Check**

Culture check is an important, yet often neglected component of HR due diligence. It is important for the due diligence team to be conscious of cultural differences between the merging companies. Culture check is very crucial to the success of post-deal employee integration. The merging entities must investigate whether they have compatible cultures, and in the event of cultural differences, how best to align these differences. Cultural differences can manifest in different ways including how workers dress, communicate, relate and so on.

The marketing or sales team of the target company may be perceived to be complacent while that of the acquiring company may see themselves as exceptional and aggressive. There have also been cases where the merging entities have diametrically opposed management styles including reward systems.

CONCLUSION

The people side of due diligence is critical to a successful merger and takeover. Just like the traditional legal, financial and operational due diligence, HR due diligence is as important, not only to ensure that the deal is fairly valued, but also to ensure a smooth post deal employees' integration. A carefully planned and executed HR due diligence may expose serious people issues which may impact not only on the pricing of the target company but on the overall success of the deal.