The Role of Corporate Culture in Mergers & Acquisitions

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ABSTRACT:

Corporate mergers are an important driver of growth, and yet many mergers fail to produce value for the shareholders of the acquiring firms. Survey and anecdotal evidence suggests that corporate culture is central to the success of mergers and acquisitions (M&A), and that cultural differences are an important causal factor in merger failures. However, there is little either by way of theory or by way of large-sample empirical evidence in Finance and Economics on the importance of culture for M&A performance, although there appears to be growing interest in this area. There is a fairly substantial literature in Organizational Behavior, however, on this subject.

To provide a perspective on the role of culture in mergers and outline an agenda for future research that can be built around the key questions whose exploration promises to extend the frontiers of knowledge in this important area, this chapter critically reviews the Organizational Behavior and Economics literatures on corporate culture. Some survey and anecdotal evidence on the effect of culture on M&A is discussed as motivation and also to surface questions that could be more systematically addressed through research. The goal of the chapter is to both acquaint the reader with the research that has already been done in this somewhat nascent area and to facilitate the development of an agenda for future research.

The Role of Corporate Culture in Mergers & Acquisitions

1. Introduction

Corporate mergers are an important driver of corporate and economic growth. Nonetheless, a large fraction of mergers fail to produce value for the shareholders of the acquiring firms.[1] Anecdotal and survey evidence suggests that cultural incompatibility between acquirers and targets is an important reason for merger failures. High-profile deals that supposedly failed due to corporate culture clashes include Daimler-Chrysler and Sprint-Nextel, transactions that ended up destroying billions of dollars in shareholder value. These anecdotes suggest that a deeper comprehension of how corporate culture affects M&A would be of value, both from an academic research perspective and to practitioners.

Despite the apparent importance of corporate culture, there is surprisingly little research on this topic in Economics and Finance. More work has been done in Organizational Behavior: various models of corporate culture have been developed, but few have applied them in an M&A context.

This raises two questions. First, what has been done by way of theoretical and empirical research on the role of corporate culture in mergers? Second, what might be a fruitful research agenda to address the questions still looming as unanswered by the existing literature? The purpose of this chapter is to address these two questions. To address the first question, I review the existing Organizational Behavior, Economics, and Finance literatures on corporate culture in an M&A context and summarize the key findings, as well as unanswered questions.

[1] Bruner (2002) provides an overview of a large number of studies that document this.

To address the second question, I tease out interesting issues that have either been incompletely addressed or not at all in the existing literature and put them forth as issues to be scrutinized in future research.

The rest of this chapter is organized as follows. Section 2 discusses the different definitions of corporate culture that have been proposed in the Organizational Behavior and Economics literatures. Section 3 presents recent survey evidence on the effect of culture on M&A, and discusses several high-profile deals that allegedly did not work out (in part) because of culture mismatches. Section 4 reviews the existing theories and empirical evidence on corporate culture and M&A in Economics and Finance. Section 5 discusses issues to be addressed in theories and empirical work on this topic. Section 6 summarizes and concludes.

2. What is Corporate Culture?

Different definitions of corporate culture have been proposed in the Organizational Behavior and Economics literatures. This section reviews these definitions and draws out similarities and differences.

2.1. Corporate Culture in Organizational Behavior

The Organizational Behavior literature started to pay attention to corporate culture in the early 1980s when several books discussed a link between corporate culture and firm behavior and performance (e.g., Peters and Waterman, 1982; and Deal and Kennedy, 1982). The topic has received a lot of attention since. Cameron and Quinn (1999) argue that (virtually) every highly successful company has a distinctive, readily identifiable corporate culture. Corporate culture is

the organization's personality: its shared beliefs, values, and behaviors. It describes "the way we do things here", and hence represents both explicit and implicit rules of organizational conduct. While culture is typically created by the firm's founder (e.g., Disney), it generally evolves in ways that are intended to facilitate the achievement of specific organizational performance goals (e.g., G.E.).

The Organizational Behavior literature has produced a variety of ways to classify corporate cultures. Below, I discuss two of these classifications that have recently been used in the finance literature to study the effects of corporate culture on M&A performance.[2] Details on the empirical implementation are provided in Section 5.2.

Cartwright and Cooper (1993) build on Harrison (1972) and distinguish between four culture orientations: $\frac{role}{power}\left|\frac{task\ /\ achievement}{person\ /\ support}\right.$. A *role-oriented culture* is highly centralized, bureaucratic, and focuses on job description and specialization. Work is controlled by rules and procedures. People are treated as interchangeable instead of as individual human beings. A *task/achievement-oriented culture* emphasizes team work, values flexibility and worker autonomy. It is very task-oriented, creative, and offers customers tailored products. A *power-oriented culture* is highly centralized, rule oriented, and focuses on respect of authority. Those in control tend to use implicit rules, seek to maintain absolute power, and may practice nepotism and favoritism. Individuals are motivated to act by a sense of loyalty to the boss or fear of punishment. A *person/support-oriented culture* emphasizes egalitarianism, nurtures personal growth and development of its members. This culture tends to be found in cooperatives and communities instead of in for-profit organizations.

[2] Other frameworks include those proposed by Handy (1976), Deal and Kennedy (1982), Denison (1990), and O'Reilly, Chatman, and Caldwell (1991).

Cartwright and Cooper argue that, depending on how much integration and culture change is needed, mergers will fall into one of three types: extension mergers ("open marriages" in which differences in culture between merger partners are accepted and viewed as rather unimportant), collaborative mergers (success depends upon the ability to fully integrate both cultures and create a "best of both worlds" culture and thus create a win/win scenario), or redesign mergers ("traditional marriages", the most typical merger scenario in which the acquirer is the dominant partner that intends to replace the culture of the smaller and/or less successful target, thus creating a win/lose situation). Key insights include the following. First, mergers often fail because one merger partners does not recognize or agree to the other's perception of the marriage terms. Second, in a collaborative merger, culture changes that are perceived to impose more control on employees are resisted more than those perceived to increase employee autonomy, so an acquirer with a Role culture will be more easily accepted by a target with a Power culture than by a target with a Task culture. Third, in a redesign merger, the greater the degree of dissimilarity in cultures, the harder the integration and the longer the integration process will last.

Cameron, DeGraff, Quinn, and Thakor (2006) rely on the previous Organizational Behavior literature to describe the "Competing Values Framework". The framework has four quadrants, each of which stands for a particular type of corporate culture: $\frac{collaborate}{control}\Big|\frac{create}{compete}$. A *collaborate-oriented culture* focuses on building skills, developing people, building cohesion via consensus, and strengthening satisfaction through involvement ("human development, human empowerment, human commitment"). Considerable attention is given to teamwork, decentralized decision-making, and training and development. A *create-oriented culture*

focuses on product, process and service innovation ("create, innovate, and envision the future"). Emphasis is put on coming up with innovative product line extensions, radical new process breakthroughs, developing new technologies, etc. A *control-oriented culture* focuses on improving efficiency by implementing better processes ("better, cheaper, surer"). A great deal of emphasis is put on cost and productivity enhancements, decreases in manufacturing cycle time, efficiency improvement measures, risk abatement, etc. A *compete-oriented culture* pursues competitiveness to the fullest ("compete hard, move fast, and play to win"). The focus of attention is external competitiveness that is measured by customer satisfaction, market share, sales, shareholder value, and so on.

This framework yields important insights. First, while aspects of all four quadrants are typically present in any organization, one or two aspects typically dominate. For example, while one firm may be strong in the Control quadrant (e.g., Emerson Electric), another may excel in the Create quadrant (e.g., Ideo). Second, tensions or "competing values" exist between diagonally-opposite quadrants: Control tends to clash with Create, and Compete tends to clash with Collaborate. This occurs because opposite quadrants emphasize opposite forms of value creation. Since these tensions exist in each firm to a greater or lesser extent, they could also help predict which types of mergers succeed. For instance, if a firm whose culture is largely Create merges with a firm whose culture is largely Compete, the "rules of conduct" may differ so dramatically across the two organizations that it may be difficult to reconcile them, resulting in employee attrition in one of the two groups, with a consequent decline in post-merger performance.

To summarize, the Organizational Behavior literature tends to define culture in terms of the descriptive categorizations of behavior associated with specific cultures, so that culture can be viewed from the lens of what people believe will create value and how they behave. Thus, culture becomes a variable that influences individual and group behavior, and this behavioral influence is over and above the effect of explicit contracts.

2.2. Corporate Culture in Economics

The Economics literature started to address corporate culture a decade after the Organizational Behavior literature. In a seminal paper, Kreps (1990) defines corporate culture in two ways: corporate culture acts as a coordination mechanism in situations with multiple equilibria, and it is also a way to deal with unforeseen contingencies. Kreps' model focuses on situations in which cooperation among different parties is crucial. One way to induce cooperation is via contracts. However, there are many situations in which formal contracts are costly (because of costs associated with bargaining, monitoring, and enforcement) or infeasible (because states or actions may not be verifiable or difficult to specify in advance). Another way to induce cooperation is via repeated interaction. Repeated play can be superior to formal contracts because it may be cheaper and may support desirable outcomes when contracts are infeasible. A potential problem, however, occurs when repeated games have multiple equilibria. For example, suppose that when players 1 and 2 both play A, their payoffs are (6,4); if both play B, their payoffs are (4,6); and if 1 plays A while 2 plays B or vice versa, their payoffs are (0,0). In this game, there are two pure-strategy Nash equilibria: both play A or both play B. The problem is that game theory does not predict which of these two equilibria will be played. Corporate

culture, however, is able to do so. If player 1 is senior and player 2 is junior, the cultural norm may be that both play A, which is the better outcome for the senior.[3] Clearly, this outcome could also have been achieved via contracts, so it may not be obvious why culture has to be introduced.

Kreps points out that the usefulness of corporate culture becomes apparent when the players are faced with unforeseen contingencies.[4] For example, in the game above, it may not be known ex ante what A and B will be, nor what the exact payoffs from playing these two strategies will be. In such an environment, formal contracting is hard, while a cultural norm that everyone plays what is best for the senior ensures an efficient outcome. Another example involves a game with more complex payoffs in which the two players are a boss and an employee. The boss can treat an employee fairly or exploit him, while the employee can trust her boss or not. Suppose that exploiting is the boss's dominant strategy while the employee's best response in that case is to not trust her boss. In a one-shot game, the equilibrium would then involve the boss exploiting the employee and the employee not trusting the boss. If the likelihood of another period is high enough, however, it may be optimal for the boss to treat the employee fairly and for the employee to trust her boss, knowing that the boss has an incentive to protect her reputation. This will be optimal if both parties have an ex ante understanding of what "fair" means. Interestingly, the boss and the employee do not have to be infinitely-lived. It is important, however, that the boss cares about the future (which can be achieved by, for example, linking her pay to the value of the firm), and that future transaction

[3] If the game is played only once, this outcome may not be attained, but if the game is played repeatedly, it can be attained.

[4] Unforeseen contingencies are not the same as difficult-to-specify-in-advance contingencies. Unforeseen contingencies are contingencies the players do not even foresee.

partners can observe the treatment the employee receives.[5] Thus, corporate culture can sustain desirable outcomes in a world with unforeseen contingencies.

Cremer (1993) defines corporate culture as the knowledge shared by (a sizeable part of the) members of an organization, but not by the general population. He argues that a culture is stronger the more shared knowledge exists in the organization. He assumes that individuals are trustworthy but are limited in their ability to process, receive and transmit information. The key benefit of culture is that it acts as a substitute for explicit communication. It does so by providing three things: a common language or coding (companies have their own vocabulary and can signal via actions, such as allocating a bigger office to signal someone's higher status, etc.), a shared knowledge of relevant facts (obtained via training programs, newsletters, etc.), and a shared knowledge of key behavioral rules (whether or not to share information with colleagues, how fast to respond to customer requests, etc.). Corporate culture can be a source of efficiency since it allows individuals faced with time constraints to use simplified decision-making rules. The main cost of culture is that the members of the organization need to invest to acquire this knowledge. Viewed this way, culture is an upfront investment to reduce subsequent communication costs.

Cremer also points out that corporate culture may explain why there are decreasing returns to scale to firm size. Different subgroups in a conglomerate may have different cultures and there may be a lack of synergy between the cultures of the subgroups.

Lazear (1995) views corporate culture as shared beliefs or preferences that arise from an evolutionary process. Specifically, his model assumes that individuals in a firm have

[5] Viewed this way, corporate culture is essentially the same as organizational reputation.

preferences ("genetic endowment"), and that when two individuals meet ("mate"), each individual produces an offspring with preferences that are a mix of the two mates. Top management can ensure that certain preferences are more likely to survive, i.e., it can foster a particular culture. In practice, it can do so in two ways: selection and internalization. To see this, suppose that individuals have preferences A or B and that management favors A. When an A meets a B, the A may complain to top management about the B, and the B may end up being fired and replaced with an A. In this case, selection takes place since management actively replaces "bad"-preference individuals with "good"-preference individuals. Alternatively, management can actively advocate (via training, speeches, etc.) that it favors A. When an A meets a B, the payoff of their interaction may be low, and the B may recall ("internalize") that he is working in an A organization and switch to playing A.

Hermalin (2001) uses an industrial organization (IO) approach to studying corporate culture, which he assumes to be a technology that affects costs. He distinguishes between firms with strong corporate cultures – cultures that are strategically appropriate and widely accepted within the firm – and firms with weak or non-existent cultures ("uncultured"). He starts with the premise that firms with strong cultures have lower marginal costs than uncultured firms (because having a culture economizes on communication costs) and higher fixed costs (because individuals have to learn about the culture). Using a well-known result from the IO literature that, in a competitive industry, only firms with the lower minimum average cost survive, he derives several interesting results. First, if the proportional decrease in marginal costs from having a culture exceeds the proportional increase in fixed costs from having a culture, then only "cultured" firms survive in the long run. Second, keeping everything

else constant, each firm produces more in a “cultured”-firm equilibrium than in an “uncultured”-firm equilibrium. This implies that a competitive industry with cultured firms should have fewer but larger firms than a competitive industry with “uncultured” firms.[6]

Hermalin also uses insights from IO to examine intra-industry heterogeneity in corporate culture. He assumes an industry has two Cournot competitors. He shows that if the cost of adopting a culture is low, then both firms adopt a strong culture; if the cost is intermediate, then one invests in a strong culture while the other remains uncultured; and if the cost is high then both firms remain uncultured. He notes that alternative models can also generate heterogeneous equilibria. For example, if there is uncertainty about future operating environments, then it is possible that one firm invests in a strong culture while the other does not, even when there are no costs associated with adopting a culture. An important insight of his analyses is that while the costs of a strong corporate culture can be gauged by focusing on the firm itself, the benefits depend greatly on the competitive environment in which the firm operates.

Akerlof and Kranton (2005) examine how an employee’s identity may lead him to behave more or less in line with the firm’s goals. While not a paper on corporate culture per se, the extent to which employees identify with the firm and adopt its goals can be interpreted as such. In a standard principal-agent model, an employee’s utility only depends on income and effort. In Akerlof and Kranton, it also depends on the employee’s identity. Specifically, they assume that an employee can have two identities. If he is an insider, the norm is to act in the

[6] Interestingly, this seems to go against Lazear (1995) who predicts that corporate culture is easier to instill in smaller firms, and that as a result, smaller firms tend to have stronger cultures. Hermalin points out, however, that Lazear only focuses on how the costs (not the benefits) of having a corporate culture relate to firm size.

interest of the firm and to put in high effort. If he is an outsider, the norm is to put in the least amount of effort. In both cases, the employee loses utility if he diverges from the ideal effort level for employees with similar identity. They show that if the employee identifies as an insider, the presence of identity utility reduces the wage differential necessary to induce high effort, while for an employee with the identity of an outsider, it increases it. Firms are even willing to invest to change an employee's identity if the reduction in wages exceeds the investment. The authors predict that firms are more likely to use identity-based incentive schemes if it is cheap to instill identity, if effort is hard to observe, and if high effort is crucial for the firm's output.

Akerlof and Kranton also discuss what happens when employees are allowed to identify with their workgroup rather than with the firm as a whole. To do this, they introduce a supervisor who can be strict (the supervisor informs the principal about the employee's actions) or lax (the supervisor does not report). If supervision is strict, the employee views the supervisor as part of management and regards himself as an outsider. If supervision is lax, the employee regards the supervisor as part of the workgroup. In this setup, the firm faces a tradeoff: while strict supervision may lead to higher effort, wage costs go up because the firm needs to compensate the employee for his loss-in-identity utility. Thus, the firm may optimally decide to implement lax supervision.

Van den Steen (2010a) examines the origins of corporate culture, defined as a sense of shared beliefs and values. He starts with the observation that people may have different prior beliefs (as, e.g., in Kreps, 1990; Harris and Raviv, 1993; and Boot, Gopalan, and Thakor, 2006, 2008). In other words, they may disagree on optimal actions even after sharing all relevant

information. He shows that firms that operate in such a world tend to develop homogeneous beliefs. That is, they develop their own corporate cultures and do so through three mechanisms: screening in the hiring process (if outcomes depend on correct decisions instead of effort, employees want to work with others who share beliefs that are identical to their own), self-sorting (since an employee's utility depends on the actions of his boss and co-workers, he may prefer to work / not to work in certain firms), and joint learning (the employees experience the firm's behavior and performance together and learn from it). The model predicts that corporate culture is stronger in older firms (since their employees will have more shared experiences), in smaller firms (since small size makes it easier to observe and communicate experiences), in more successful firms (since very high payoffs make it highly likely that employees agree on the right course of action), in firms where employees make more important decisions (so homogeneity will be greater in consulting firms than in an assembly plant), and in firms where the manager has stronger beliefs about the right course of action.

Benabou and Tirole (2011), while not a paper on corporate culture per se, develops a model of identity in which individuals care about their own reputation. They assume that people have imperfect memory, and therefore make identity investments as self-signals. When contemplating alternative actions, they consider the kind of person each action would make them and how desirable those self-views are. One of the model's predictions is that people resist assimilation: when placed in a new culture, an individual's identity is threatened and this stimulates additional identity investments. Being asked or required to adopt the new culture is viewed as a betrayal of the old culture and may therefore elicit opposition.

We can compare the Economics view of culture with the view developed in Organizational Behavior. While Organizational Behavior views culture as a mediating variable that affects individual and group behavior, the focus in Economics has been on attempting to provide the micro-foundations of why culture matters for economic outcomes. One can make a number of observations about the Economics view of corporate culture. First, different papers in Economics use different notions of culture. While Kreps (1990) defines culture as a particular selected equilibrium out of multiple equilibria, Cremer (1993), Lazear (1995), and Van den Steen (2010a) view corporate culture as shared beliefs and values and thus link culture to shared characteristics of individuals, a view that has much in common with the Organizational Behavior literature. Second, economists have different perspectives on the issue of corporate culture strength. Cremer (1993) argues that culture is stronger when more shared knowledge exists. Van den Steen (2010a) agrees – he predicts that culture is stronger in older firm for the same reason – but also argues that it is stronger in other situations (e.g., in smaller, and more successful firms) for a variety of reasons. In contrast, Lazear (1995) predicts that culture is stronger in small firms since culture is easier to instill in such firms. Hermalin's (2001) IO perspective assumes that strong cultures have lower marginal costs and higher fixed costs. Third, while most of the models assume that the firm has a single culture, some papers have recognized the possibility of sub-cultures within organizations (see Cremer, 1993; and Akerlof and Kranton, 2005).

3. Survey and Anecdotal Evidence on the Importance of Culture for Merger Success

There is survey evidence on how much culture matters for merger performance. Moreover, there has been quite a bit of anecdotal evidence on the importance of cultural alignment for merger success. In this section, I discuss the survey evidence and then discuss several high-profile deals that allegedly did not succeed (in part) because of culture mismatches.

3.1. Survey Evidence on M&A and Culture

A variety of surveys have shown over the years that corporate culture matters for M&A performance. Here, I focus on a recent study by Aon Hewitt (2011). This report presents the results of a survey of 123 firms around the world from a variety of industries. Half of the respondents indicated that their M&A deals failed to meet expectations. When asked about factors leading to deal failure, 33% of the respondents mentioned cultural integration issues, making it the second most important direct driver. However, as highlighted in the report, cultural integration is also an indirect driver to various other immediate causes of deal failure. For example, 60% of the respondents indicated that unsuccessful cultural integration led to delayed deal integration and implementation, which was the most common direct factor cited for deal failure.

Interestingly, while firms understand that cultural integration is vital to deal success, 58% of them responded that they do not have a specific approach to assessing and integrating culture in a deal. The ones that did not have a specific approach for culture reported a higher-than-normal loss of critical employees during a transaction. Moreover, none of the firms (0%) reported that their cultural integration practices were effective. The top three reasons cited for

unsuccessful cultural integration included: a lack of top management agreement on the desired culture (48%), culture risks not recognized during the due diligence phase (48%), and a lack of top management support (44%). Firms with good records in terms of exceeding their own targets in past deals reportedly focus on culture earlier on, spend more time on changing their cultures, and manage those changes more actively than firms with bad track records.

3.2. High-Profile M&A Deals and Culture

Cultural differences have allegedly contributed to the failure of many high-profile M&A deals. By way of illustration, I discuss four of those: Daimler-Chrysler, Sprint-Nextel, Citicorp-Travelers, and HP-Compaq.

In 1998, German-based Daimler-Benz and U.S.-based Chrysler Corporation, two leading global carmakers, decided to combine forces in a merger of equals. The $37 billion stock-swap deal was the biggest ever among car manufacturers and was to result in a combined firm with a market capitalization of $95 billion that ranked third in the world in terms of revenues and fifth in terms of the number of vehicles sold. Analysts initially applauded the deal, arguing that the merger made sense strategically. It would combine Mercedes' engineering prowess with Chrysler's design and marketing savvy. It would give Daimler-Benz easy access to the U.S. market where it enjoyed a less than 1% market share, and would enable Chrysler to sell its cars in Europe. By sharing parts and development costs, it would be highly competitive. By all accounts, this was a marriage made in heaven, with a cornucopia of product development and market synergies. Nonetheless, roughly 15 months after the so-called merger of equals, the new company, Daimler-Chrysler Corporation, was trading at about $30 billion less than the

combined pre-merger market values of the two firms. It appears that stark differences in the corporate cultures of the two companies resulted in an inability to realize most of the projected synergies. Chrysler encouraged creativity, adaptability, efficiency, and decentralized decision-making. In contrast, Daimler-Benz valued hierarchy, detailed planning, and centralized decision-making. From the very beginning, the two management teams resisted working together, were wary of change, and unable to decide which parts image-conscious Mercedes-Benz would share with mass-marketer Chrysler. In 2007, less than ten years after the merger, Daimler-Benz sold Chrysler to private equity firm Cerberus Capital Management for a mere pittance.[7]

In 2005, Sprint bought Nextel for $35 billion in a deal that was classified as a merger of equals. The CEOs of the two companies believed that their respective strengths complemented each other. Sprint was a leader in wireless data communications and had consumers as its primary customer base. Nextel had been a pioneer in the walkie-talkie service and had a stronger presence in the business segment. The deal was expected to create a $70 billion firm with a stronger customer base and generate cost savings with a present value of $12 billion. However, the benefits failed to materialize largely due to a culture clash. Nextel had an informal, aggressive, entrepreneurial, customer-centric culture that valued flexibility and the ability to respond quickly to market changes. In contrast, Sprint had a formal, bureaucratic, top-down, number-driven culture. These sharply different cultures led to mistrust and clashes in everything from cellphone technologies to advertising strategy. When the combined entity decided to use Sprint's number-driven approach, service quality dropped dramatically, and

[7] It effectively paid Cerberus $650 million to take over Chrysler including its ongoing losses and liability for future health care costs. Thus, Daimler-Benz ended up losing more than the purchase price paid for Chrysler in 1998.

many subscribers fled out of frustration about customer service quality. By 2008, Sprint had written down 80% of Nextel's value. In late 2010, Sprint announced it would totally shut down the Nextel network by mid-2013.

In 1998, Citibank Corp (Citicorp), one of the largest commercial banks in the world, and Travelers Group, an insurance company with a major investment banking subsidiary (Salomon Smith Barney), announced they would merge to form Citigroup. The merger was historic for two reasons. First, it was the largest combination ever, with a combined market capitalization of around $140 billion. Second, it was in direct violation of the Glass-Steagall Act, which forbade banks to merge with insurance underwriters, and was thus based on the belief that Glass-Steagall would be repealed in the near future. The passing of the Gramm-Leach-Bliley in 1999 vindicated this view. The rationale behind the merger was to create a financial one-stop supermarket: it would enable Citicorp to provide banking products to Travelers customers and Travelers to sell mutual funds and insurance to Citicorp customers through its branch network. Nonetheless, it is hard to see how this merger was a success. Not only did the combined entity divest some of its insurance business, but Citi was in deep financial distress during the subprime financial crisis, and it took a substantial infusion of equity by the government (in exchange for the government acquiring an ownership claim) to save the bank. Why did the bank get into so much trouble after the merger? While one can find various reasons, there are many who suggest that stark cultural differences between the two partners played a prominent role. Citicorp's culture was conservative and relationship-banking focused. In contrast, Travelers had a fast, aggressive, transaction-focused culture. Their compensation policies reflected these differences too. Cross-selling banking and insurance products proved harder than expected,

possibly in part because of differences in culture. Citigroup decided to spin off Travelers insurance underwriting business in two separate deals in 2002 and 2005.

In 2001, HP and Compaq signed a merger agreement to create a global technology leader with sales of $87 billion. The merger announcement stated that the deal would bring clear strategic benefits by combining highly complementary organizations and product families, which would create substantial shareholder value through cost cutting and access to new growth opportunities. However, this view was not widely shared: there was a lot of disagreement on whether this was a good deal for HP. The stock market reacted negatively. Walter Hewlett, son of the HP co-founder, openly announced his opposition and started a proxy fight. The David and Lucile Packard Foundation, HP's largest shareholder, announced its intent to oppose the deal as well. Analysts also wondered whether there would be culture clashes since the two cultures were vastly different. HP was very much focused on innovation and high-margin products. In contrast, Compaq had a commodity-based, low-margin, high-volume culture. While HP's culture was based on consensus, Compaq's focused on rapid decision-making. Looking back, while the merger was not a total disaster, the expected synergies did not fully materialize.

In light of the Organizational Behavior literature on culture that was discussed earlier, it is easy to understand why these deals failed. For example, the Daimler culture was Control-focused and Chrysler's culture was Create-focused, in the context of the Competing Values Framework (CVF). The CVF predicts that this culture clash is potentially irreconcilable and that the culture that ends up being dominant after the merger will tend to drive away those who are

predisposed to favor the diagonally-opposite culture. This happened to a certain extent in the Daimler-Chrysler case, as many senior Chrysler executives quit soon after the merger.

4. Theories and Empirical Evidence on Corporate Culture and M&A

The anecdotal evidence presented above highlights the importance of corporate culture in M&A. It is therefore surprising that there is a paucity of research on the subject in Economics and Finance.

There is very little by way of theories on the effect of culture on mergers. Van den Steen (2010b) is an exception. He first defines corporate culture and explains its benefits. To do so, he uses a model in which a firm has to decide on a course of action, but its employees have differing priors, i.e., they may disagree on the best approach. In this setup, corporate culture is the extent to which they share beliefs. The key benefit of shared beliefs, i.e., culture, is that it aligns the objectives of the principal and the agent, and hence reduces agency problems. As a result, shared beliefs lead to increased delegation, utility, and effort; reduced information collection, experimentation, and influence activities; and less biased communication. Culture clashes arise when two internally homogeneous groups, with beliefs and preferences that differ across the two groups, decide to merge. He predicts that after the merger, the degree to which employees share beliefs is lower than that in their respective pre-merger firms. Thus, after the merger, agency problems are higher and the above-mentioned benefits of shared beliefs are reduced. Van den Steen's analysis points out how cultural incongruences can dissipate other benefits of mergers, such as product synergies.

The empirical Finance literature on how culture affects mergers is also scant.[8] Recently, this issue has started to receive attention.

Cronqvist, Low, and Nilsson (2009) examine firms that engage in the opposite of M&A, namely spinoffs. They document that spinoffs inherit their parents' behaviors. That is, a broad range of spinoffs' financing and investment policies appear to be more similar to the policies of their parents than to those of similar-sized industry peers. Furthermore, this similarity is persistent. They argue that their main findings are consistent with a culture-based explanation. First, the policy similarities are greater among spinoffs that were grown internally and those that split from older parents, i.e., in cases in which the spinoff and parent are more likely to have stronger shared beliefs. Second, the policy similarities are also observed when the spinoffs are run by outside CEOs, consistent with the idea that firms select employees with beliefs that are similar to theirs.

Bargeron, Smith, and Lehn (2012) examine the relationship between corporate culture and M&A activity. They focus on five aspects in particular: acquisition frequency, acquisition size, acquirer–target similarity (in terms of industry, key financial ratios, and location), bidder announcement returns, and culture changes. The predictions in every case hinge on whether culture is an asset that can be transferred to the target or whether M&A disrupts the acquirer's valuable culture. The results are mixed at best. First, they find that culture does not affect acquisition frequency, possibly because both forces are at work. Second, firms with strong

[8] There are papers on this topic in the Management literature. These studies are largely survey-based and focus on one or more senior executives at the acquirer and/or target. For example, Datta (1991) surveys 173 senior executives (one per firm) at acquiring firms in manufacturing and mining. Krishnan, Miller and Judge (1997) examine 147 acquisitions and survey top management team members at both the acquirers and targets. The emphasis in these studies is on (dis-)similarities in management styles and top management backgrounds. Chatterjee, Lubatkin, Schweiger, and Weber (1992) survey 1-5 senior executives at 30 acquirers. They focus on a broader range of cultural aspects.

cultures acquire smaller firms, consistent with the perspective that M&A may be disruptive and smaller deals are easier to absorb. Third, firms with strong cultures are not more likely to acquire firms that are similar to them, consistent with the view that culture is a transferable asset. Fourth, firms with strong cultures show announcement returns that are similar to those of industry-matched acquirers without strong cultures, but those returns are significantly lower when the sample is restricted to larger deals (at least 5% of the acquirer's assets), consistent with the view that M&A disrupts a valuable culture. Fifth, strong-culture firms that make large acquisitions are more likely to lose their strong culture than strong-culture firms that refrain from such deals, again consistent with the perspective that M&A is disruptive.

Fiordelisi and Martelli (2011) examine how corporate culture affects M&A success in banking. They analyze large M&A deals (over E100 million) by listed banks in both the U.S. (125 deals) and the European Union (63 deals). They focus on one industry – banking – to avoid the difficulty of controlling for differences across industries, thus making it easier to isolate the effect of culture.[9] M&A success is measured based on announcement returns. A key finding of the paper is that cultural homogeneity (the acquirer and target have similar cultures) is not significantly related to merger success. Rather, certain types of cultural heterogeneity between the acquirer and target help predict success. For example, the likelihood of merger success is greater when the acquirer's culture is more focused on efficiency improvements and quality enhancements than the target, and when the target's culture is more focused on being competitive than the acquirer. These findings suggest that while cultural alignment reduces

[9] This benefit is arguably reduced by the fact that they include banks from different countries, and concepts of culture may differ across countries.

conflicts after the merger, it does not imply synergies. In contrast, some cultural differences do imply the existence of such potential synergies.

5. Unresolved Issues that Future Research on Corporate Culture and M&A Should Address

The discussions above raise some key questions. A challenge for the theory is to rigorously address the question: How does combining two corporate cultures affect post-merger performance? A key empirical challenge is: How should we measure corporate culture? While some progress has been made on these questions, our formal theoretical understanding of the mechanisms by which culture impacts post-merger performance has only scratched the surface of this rich area, and the existing empirical measures vary considerably, making it difficult to settle on a parsimonious set of measures that have broad appeal and endorsement. This section provides further elaboration on both questions.

5.1. Theory: How Does Combining Two Corporate Cultures Affect Performance?

Theories on corporate culture need to be able to answer questions such as: How does the coming together of two cultures affect performance? Is cultural heterogeneity within a firm good or bad? While the existing literature has offered glimmers of insight on these questions, much remains to be done before we have satisfactory answers. More on this is discussed below.

Cremer (1993) emphasizes that corporate culture needs to be stable and should not be changed too often for two reasons. First, culture is a stock of accumulated information and this stock is costly to acquire. Thus, culture changes are costly. Second, coding and rules of action

need to be consistent within the entire organization. If there are two modes of organization for marketing and manufacturing (e.g., dynamic versus efficient), it is critical that both departments choose the same mode. A dynamic marketing department works well with a dynamic manufacturing department, not with an efficient manufacturing department. Such integration challenges make it difficult to determine how to change the culture, because all departments need to change at the same time, but change may not be desirable for all the departments. In other words, in contrast to first-blush intuition, cultural homogeneity within the firm may not always be optimal.

When applying these insights to an M&A setting, it is not a priori clear what type of merger will exhibit better performance – a merger between two firms with similar cultures or one between firms with different cultures?. At one level, when two companies with different strengths are brought together, there is more potential for synergies. For example, if company A is strong in activity X and company B is strong in activity Y, the combined entity has the potential to be strong in both activities X and Y. However, if both companies have very different corporate cultures, the combined entity may destroy the strengths in both activities X and Y. It is also possible that heterogeneity in some dimensions is good (e.g., if the acquirer has a reputation for cost cutting while the target does not, synergies may be achieved), while heterogeneity in other dimensions is bad (e.g., if the acquirer focuses on control while the target is very creative, the target's creativity may be stifled after the merger).

5.2. Empirics: How to Measure Corporate Culture?

In order to assess how culture affects merger performance, it is critical to find good proxies for corporate culture. Here, I describe and comment on proxies used in the empirical papers discussed above.

Cronqvist, Low, and Nilsson (2009) use two approaches to measuring corporate culture at spinoffs and their parents. In their first and main approach, firm fixed effects act as a proxy for culture.

While intriguing, this approach raises an important question: Is culture truly a fixed effect? If it is a fixed effect, then culture does not change over time. However, this is unlikely to be true for most firms. The theoretical literatures in both organization behavior and in economics suggest that culture is dynamic and evolves as the firm changes in size and focus. Culture may also change after major mergers. To the extent that culture is treated as a fixed effect, firm fixed effects are likely to also capture other aspects that are persistent, such as corporate governance.

Cronqvist, Low, and Nilsson's second approach tries to measure culture more directly and builds on Schein's (1985) view that employee relations are the most explicit expressions of a firm's culture. Specifically, they create two culture indices using detailed data on several dimensions of a firm's human resource policies and organizational practices. Data provider KLD Research & Analytics gives each dimension a rating of zero or one, and the authors add up the scores. The employee relations index captures five dimensions, including union relationships, the presence of profit sharing programs, employee involvement in decision making or employee stock / option ownership, health and safety strength, and retirement benefits

packages. The diversity index has seven dimensions, including female or minority CEO, progress in the promotion of women and minorities to top management positions, female and minority representation on the board, reputation as employer of the disabled, work / life benefits packages, and a commitment to diversity.

While the attempt to directly measure culture is laudable, it is not clear that all of the dimensions included in the indices truly capture key aspects of culture. Furthermore, some aspects that seem important to capture culture are missing.

Bargeron, Smith, and Lehn (2012) focus on the strength of corporate culture. They view firms that appeared at least once on the annual list of the 100 Best Companies to Work For in America, compiled by the Great Place to Work Institute (GPWI), during 1998 – 2011 as having a strong culture.

Note that Bargeron, Smith, and Lehn do not have a continuous measure of strength: firms either have a strong culture or they do not. While consistent with the theories discussed above, in practice, the strength of culture is likely to lie in a continuum. They also do not distinguish between different types of cultures. That is, some firms that are classified to have strong cultures may have cultures that are similar in various dimensions, but the authors abstract from this. Moreover, there is a potential selection bias since companies have to apply to be evaluated by GPWI. Furthermore, this methodology focuses on larger, more established firms: firms need to be at least five years old and have at least 1,000 employees in the U.S. to that appear on the 100 Best Companies to Work For in America list. Maybe as a result of this, they do not examine what happens when two strong-culture companies merge, and whether the results are different from when firms that do not have a strong culture merge.

Fiordelisi and Martelli (2011) use an Organizational Behavior approach to measuring corporate culture. Specifically, they focus on the four dimensions of culture identified by Cameron, DeGraff, Quinn, and Thakor (2006), and use Cartwright and Cooper's (1993) approach in a robustness check. They use text analysis: for each culture dimension, they identify on average 100 synonyms using the Harvard-IV-4 Psycho-Social Dictionary. The frequency with which these words appear in a firm's annual report (normalized by the total number of words in the annual report) is viewed as a proxy for the importance the organization attaches to that quadrant. Using this approach, they create a corporate culture homogeneity dummy that equals 1 if the acquirer and target have the same dominant cultural orientation, and several culture gap variables which measure the difference in the frequency with which words associated with a particular quadrant appear in the acquirer's and target's annual reports.

This approach seems promising in that it tries to measure different aspects of culture, instead of using firm fixed effects or focusing exclusively on human resources-related variables . It seems defendable to view the firm's vocabulary as the outcome of its culture. One key challenge is to select proper words for each quadrant, and more work needs to be done in this area. Another important issue to be addressed is the appropriateness of using text analysis on the entire annual report. Topics such as cost efficiency and the firm's competitive position are likely discussed in every annual report regardless of the firm's corporate culture.

Clearly, the nascent empirical literature has chosen very different approaches to measuring corporate culture: firm fixed effects, human-resources-related indices, a strong-culture dummy, and OB-related text-analysis-based variables. As discussed above, the chosen proxies have their own weaknesses and strengths. To better understand the effects of culture

on merger performance and to assess ex-ante acquirer – target compatibility, approaches that try to capture several aspects of culture seem to be particularly promising

6. Conclusion

Few would argue that corporate culture does not matter for merger success. But even widely-accepted "truths" are sometimes shockingly lacking in substantial theoretical foundation and persuasive empirical support. Such is the case with the role of corporate culture. This chapter has reviewed the Organizational Behavior, Economics, and Finance literatures on the role of corporate culture in the success of mergers. The overarching conclusion is that there are numerous ways to characterize and measure culture, but a common thread running through all of these seemingly disparate ways is that corporate culture can significantly influence individual and group behavior, and thus affect post-merger performance.

The impact of culture on merger performance may be quite long-lasting. Consider the recent empirical evidence provided by Xu (2012), which suggests that the well-known diversification discount (diversified firms trade at a discount relative to portfolios of pure-play firms) does not exist among diversified firms that grew organically. Rather, it is concentrated in firms that became diversified via acquisitions, suggesting that the diversification discount is at least in part an acquisition discount. To the extent that the underperformance of acquiring firms is driven by cultural misalignment between the acquirer and the target, the diversification discount could very well, at least in part, be a "cultural mismatch" discount. Among other issues, this is a promising question to explore rigorously in future research.

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