

Chapter Six: Respect for Human Rights in Merger, Acquisition and Disposal Relationships

Overview

Brief overview of merger, acquisition and disposal relationships

An acquisition and disposal contract is a single agreement, or series of agreements, that governs the acquisition by one party, and the disposal by another, of part or all of a business or entity. Though contracts can vary in scope and form, acquisition contracts generally take the form of an entity purchase contract or an asset purchase contract. Under an entity purchase contract, the buyer purchases a majority (or greater part) of the target entity's stock. The new owner then steps into the shoes of the previous owners, often buying the other entity's liabilities. Under an asset purchase contract, the buyer purchases all the target entity's tangible and intangible assets, but can limit its liability for past actions of the entity. Companies typically conduct substantial due diligence before acquiring a target company and, particularly under entity purchase contracts, seek to value and track liabilities alongside assets. The contract allocates risk between the parties and indicates the buyer's remedies. A buyer will often apply its policies and procedures to the purchased entity or assets and may absorb the entity entirely into its corporate identity. In such circumstances, it will frequently establish a rigorous process of monitoring to chart progress in bringing the acquired entity up to its standards.

A disposal contract is an agreement governing the sale of a business's assets or the entirety of a business. In some cases, a buyer may be interested in only part of a business, leaving the seller with some obligations and liabilities. In other cases, the entire business is sold, including its liabilities. It is usual for a buyer to do due diligence on the seller, in order to understand what liabilities it will inherit. In some instances, a seller conducts due diligence on the acquiring company, for legacy reasons.

Human rights and mergers, acquisitions and disposals

Businesses may consider human rights impacts for a number of reasons when they undertake mergers, acquisitions and disposals. For example:

- A company may expose itself to involvement in adverse human rights impacts and their consequences if it does not understand the human rights-related risks it may assume through a merger or acquisition, or the entity with which it is effecting a disposal. The target company's products, services or operations may result in adverse human rights impacts or the target company may be contributing or directly linked to adverse impacts through its own business relationships. Moreover, commercially insignificant elements of a target company, or elements that are irrelevant to the motive for a merger or acquisition, may generate significant risks. The target company would typically provide information on these potential risks. If a target company is not aware of its human rights responsibilities, or its impacts this may be a red flag for the acquiring company, signalling that more detailed due diligence is necessary to identify potential human rights problems, both in the target company and in its business relationships.

- Failure by a target company to identify and manage human rights risks in its operations and business relationships may have consequences for the long-term sustainability of an acquisition or merger or at least the difficulty of successfully absorbing the target company (because the target company's values and standards do not align with the acquiring company's values, for example, or because the target company is not capable of meeting the company's standards).
- An acquiring company also assumes the stakeholder relationships of the company it purchases. Those individuals and communities may have long standing grievances. Identifying and addressing any legacy of human rights grievances may be an important part of a company's initial due diligence. This issue is relevant to disposals as well as mergers and acquisitions.
- Disposals relieve a company of businesses that no longer fit its commercial objectives and strategy. However, companies may find that disposal does not always end their association with an asset they have sold. If an acquiring company causes or fails to address human rights abuses, or acts disreputably, this may have reputational consequences for the former owner.

Orienting and Embedding – Internal Company Management of Merger, Acquisition and Disposal Relationships

M&A teams may need guidance on when, how and why to consider human rights. Respondents affirmed that mergers, acquisitions and disposals are typically led by the business development department (or its equivalent), supported by other relevant departments (finance, legal, human resources, and operations). Human rights experts in sustainability (or related) teams may be involved, but are often not systematically involved. By the nature of their work, business development teams will generally focus on commercial growth, and especially on valuing assets and liabilities. They may not immediately see the relevance of social issues including human rights as part of that valuation exercise. Several respondents emphasised that it is important to work within this reality, and to help business development teams to see human rights and related experts as enablers, not obstacles.

To do this, and to achieve outcomes that match the company's human rights policy objectives, all departments need to be more aware of each other's interests and drivers. Some companies indicated they are addressing this issue by including human rights and related experts in the cross-functional teams that support mergers and acquisitions, and business development teams in cross-functional human rights working groups or steering committees. The aim is to encourage all sides to be better aligned. In some cases, external advisers, including law firms, were asked to help identify links between human rights and other risks that need to be addressed in the course of mergers, acquisitions and disposals.

Several respondents cautioned against business development teams liaising solely with the legal team in relation to human rights risk where the legal team is focused only on legal compliance. To explain why, suppose that a company wishes to acquire a business

that has a contract with a government allowing it to use local water suppliers. The arrangements are legal under national law, and raise no red flags with the legal team, which is assessing legal liabilities against national law requirements. However, if the target company's operations reduce the access to water of local small-holder farmers and as a result it does not respect the right to water and sanitation, and may have impacted negatively on other rights, it creates potential reputational and financial liabilities for the acquiring company. Recognising that this is an issue, some of the companies are working with their legal teams to make them more aware of the Guiding Principles and corporate responsibility to respect human rights, and so to think beyond legal compliance with national law, to international human rights standards.

The Business Relationship Cycle

Selecting and Starting the Relationship

Setting expectations and communicating them to business partners

Initial due diligence processes and interactions can uncover what is required for alignment and provide a framework for dialogue with a target company.

The Guiding Principles explicitly recognise that human rights risks may be inherited through mergers or acquisitions, and that due diligence procedures should include human rights from an early stage. Respondents commented that due diligence processes (carried out before a potential merger or acquisition to review potential assets and liabilities) can assist an acquiring company to understand what needs to be done to bring a target company into alignment with its own values, standards and practices. Such initial assessments are considered vital to understanding who the acquiring company is dealing with and whether other stakeholders (including government and relevant communities) will support the deal in the long run. Respondents also recognised that initial due diligence enables a company to discuss responsible business conduct, including its policies and practices on human rights, with enterprises it wants to acquire.

Understanding the issues – Assessing human rights impacts in merger, acquisition and disposal relationships

The extent of human rights inquiries during initial assessments may depend on the importance of the deal.

Since mergers, acquisitions and disposals come in all shapes and sizes, respondents emphasised that companies need to decide how to meet their responsibility to respect based on the deal at hand. They said they tended to prioritise a potential target company's human rights performance in more detail when a deal was of strategic importance or involved higher risks. Examples of high risk might include the acquisition of an enterprise that was based in a country in which human rights abuses were common, that was a party to a human rights-related legal proceeding, or that had been accused of association with gross or serious human rights abuses. Companies seemed to take the same approach to disposals.

Existing M&A checklists are unlikely to expressly reference human rights, but checklists are evolving.

Most respondents reported that their existing checklists for M&A due diligence do not explicitly mention human rights or use human rights language, though they commonly cover certain human rights issues, especially occupational health and safety and other labour conditions. Some companies are amending their lists to include human rights references more directly. For example, some companies ask potential target companies to describe the extent to which they have implemented the Guiding Principles or respect human rights. Other companies have not changed their checklists but advise relevant teams on how they can use them to make human rights inquiries. As noted earlier in Chapter 4, while there are evident benefits in clearly defined guidance, there is a risk that overly prescriptive checklists for practitioners not well versed in human rights issues (particularly where these are not accompanied by training on human rights issues) may mean they miss human rights issues that are not immediately recognisable or take a new form.

Information gathering, including with stakeholders, may be constrained by the need to maintain commercial confidentiality.

Respondents noted that M&As and disposals are often confidential, and that it is not always easy to follow up desktop questionnaires or reviews with site visits or other more robust assessments of human rights performance, particularly with external stakeholders. Respondents recognised the value of understanding community, government and other stakeholder concerns about a potential target company or buyer; but they agreed that the range and content of site visits, including discussions with employees and other stakeholders, were inevitably conditioned by the need to protect the confidentiality of deals and respect insider trading regulations.

Several respondents noted that information on social issues is more likely to be in the public realm, and in theory is easier to obtain than proprietary information (like geological data). However, many said the lack of *reliable* information on social issues, including human rights, hampers them from conducting the kinds of comparative analysis they regularly do on financial viability.

Country risk analysis is important to understanding broader human rights risks. Processes to take account of sanctions seem to be in place.

Several respondents are starting to incorporate country-related human rights risk inquiries into their initial assessments. For example, a desired acquisition may be based in a country that lacks a land registration system; its government may have breached regulations when it provided the acquisition with permits; or the government may have engaged in forced resettlement, contrary to international standards, to facilitate the acquisition's operations. If, as a result, the target company has been involved with adverse human rights impacts, the acquiring company will need to explore the potential costs of resolving these impacts.

All the companies involved in the research have rules in place to avoid mergers, acquisitions or disposals in countries subject to sanctions. Some avoid deals in countries with high levels of political risk; human rights are considered to be a factor in such decisions, but are not the only determinant.

When companies obtain human rights information on a target company, they tend to rely on self-disclosure. They increasingly request information on financing conditions and their participation in MSIs.

The respondents reported that they do internal and external desk-based research on the human rights records of potential target companies, but also rely heavily on self-disclosure via questionnaires. If they are concerned by a response, or lack of response, some companies invite external experts to conduct further inquiries. However, questionnaires tend to focus on occupational health and safety, anti-corruption, and discrimination in the context of labour rights, rather than on human rights more broadly. Companies whose projects have a large physical footprint are the exception to this: they tend to research the target company's record on land and resettlement issues, and notably their relations with indigenous peoples.

Several respondents indicated that they are starting to ask target companies whether they belong to or support relevant voluntary initiatives or have signed on to certain international standards. Examples include the UN Global Compact, the OECD Guidelines on Multinational Enterprises, and the Voluntary Principles on Security and Human Rights. One company asks target companies about their public commitment to human rights and other social performance standards, and the management systems they have put in place to implement, monitor and audit these commitments.

Some acquiring companies inquire about the conditions related to environmental and social issues, including human rights, which have been imposed on target companies by financial institutions such as the those adhering to the IFC Performance Standards or Equator Principles. One company has widened the range of documents that need to be requested and screened during its M&A process to include information on environmental, social and human rights conditions in financing agreements, loans and related documents.

Companies are starting to scrutinise the business relationships of potential target companies.

Respondents indicated that, when they scrutinise the human rights performance of a potential M&A target, companies are beginning to consider its business relationships. Several companies ask potential target companies to provide information on their suppliers and contractors, and say what they do to encourage their partners to behave responsibly. One asks potential target companies which codes of conduct they have applied to suppliers, and the extent to which adherence with codes has been incorporated in contracts. Such inquiries rarely mention "human rights" specifically; they do tend to ask about occupational health and safety, and other labour issues including child and forced labour.

It can be difficult to price reputational and other liabilities related to human rights impacts. A company may find it easier to estimate the cost of bringing M&A targets into compliance with its standards.

As they do for other areas of commercial risk, business development teams may want a clear financial estimate of what human rights risks may cost the company before or after a target company is acquired, as part of valuing and tracking assets and liabilities associated with the deal. Respondents noted that it is often very difficult to monetise reputational or operational risk linked to human rights impacts. It may be easier to cost legal risks, based on previous claims. Some of the companies surveyed reported that, instead, they estimate how much it will cost their company to align a target company with the company's human rights policies and practices.

Several respondents said that, if searches revealed that a potential acquisition would cause human rights risks and costs, they would generally always prefer to proceed and to mitigate risks and cost by capacity building and other measures, rather than cancel. This was especially true if the target company's human rights shortcomings could be rectified. They would be more reserved if specific allegations had been made against the M&A target (claims of forced or improperly conducted resettlement, for example) which might require immediate and expensive mitigation and remediation, or if the target company continued to breach legal norms. Respondents felt that weaknesses of company culture could usually be fixed; known problems have known solutions, especially when the target company and the acquiring company operate in the same industry. Some noted, nevertheless, that it may be hard to change the culture of a direct competitor, because of staff resentment, or because staff cuts may leave fewer people to implement the change process.

Human rights issues alone are unlikely to delay a merger, acquisition or disposal unless they are accompanied by other serious (reputational, legal, operational) risks. Companies may have good reasons to become more selective.

Several respondents acknowledged that it is difficult to persuade relevant staff to review the merits of a merger, acquisition or disposal on human rights grounds alone. The risks most likely to command attention are liabilities from (actual or potential) legal claims, reputational damage, or (some forms of) operational delays. The fact that certain forms of liability may not even be taken into account (see above: *M&A teams may need guidance on when, how and why to consider human rights*) makes it harder still to argue that human rights-related risks should be addressed.

Nevertheless, several respondents suggested that it would be in the interest of companies to be more selective in their acquisitions, mergers and disposals. This is not simply because companies will thereby avoid reputational, legal, operational and other risks. A more selective approach may also be positively received by investors, governments, civil society (including communities), customers and potential business partners. In the long term, companies will benefit if they are perceived to be discerning business partners that consistently act responsibly.

Inquiries on human rights are more common during mergers and acquisitions than disposals.

Nearly all companies involved in the research said they look at human rights performance more actively when considering mergers and acquisitions than when they consider disposals. Some respondents felt this is because the risks that a company triggers when it sells assets to another company (that might harm or might have harmed human rights) are less clear than those that arise when it acquires human rights-related liabilities. It may also have less leverage in the case of disposals.

Formalising the Relationship

In acquisitions, leverage should not be an issue in theory but in practice may be more difficult to exercise.

In theory, it should not be difficult for a company that acquires control to apply leverage. This is less evident in practice, however. Firstly, a company may need to develop targeted internal action programmes to bring acquired assets up to company standards. Secondly, in many cases, such action programmes may not have been effectively costed into the deal, leaving the company with insufficient resources (people and money) to raise standards to the desired level. Thirdly, if the company has less than 50% ownership, it can usually do no more than encourage the acquired company to comply with company policies, and cannot require it to do so.

Companies tend not to include explicit references to human rights in contracts relating to mergers, acquisitions and disposals.

According to respondents, companies are unlikely to make explicit references to human rights in contracts (except for some labour rights), and generally refer to a target company's obligation to comply with company codes of business conduct, which may include some commitments to human rights. In some cases, companies require an acquisition to make warranties and representations with respect to liabilities, potentially including human rights-related legal risks; but respondents recognised that this was unlikely to protect an acquiring company against exposure to reputational and operational risks that emerge at a later date.

Closing conditions may incorporate human rights elements even if they are not included in the contract.

Several respondents noted that human rights-related closing conditions may be applied in the deal, even if they are not in the contract. For instance, a company may make it clear to a potential acquisition that it needs to divest parts of the business that operate in countries subject to sanction, or may ask the target company to show that it has sufficient funds to deal with any outstanding human rights-related legal claims. As noted below, a company may also require a target company to complete an action plan before the deal is closed, that will raise its standards to those of the acquiring company. According to respondents, such plans are not likely to focus explicitly on human rights, but they are increasingly likely to contain human rights elements.

On disposals, the situation is complex. Several respondents underlined that it is extremely difficult to enforce social or environmental performance clauses in a disposal contract, including those related to human rights. If such clauses appear meaningless, they are unlikely to be retained in contracts.

Managing the Relationship

If human rights issues are addressed, they are generally integrated in broader action plans that raise the target enterprise's practices to the company's standards. Few companies have stand-alone human rights action plans.

Several respondents noted that human rights are increasingly integrated in broad action plans designed to bring target companies up to the company's social performance standards. One respondent commented that a stand-alone human rights action plan is not just unusual; it may be counter-productive if it is not supported by staff, who may be unused to human rights concepts and language.

Several respondents said that their companies prefer to entrust the task of monitoring compliance with action plans on social performance, including human rights, to a representative of the acquiring company (rather than the target company). Doing so helps to make sure that the acquisition aligns fully with the company's standards. It may also help to strengthen relationships.

Target companies may need continued guidance on raising standards.

While respondents emphasised that expectations with respect to social policies, including performance on human rights, are generally made clear to a target company before a deal is completed, raising standards is often a slow process, particularly with less sophisticated target companies. The pace of integration may be slowed further if the acquisition is asked to adopt and comply with a large number of policies and processes.

Cultural change may also take time. According to one respondent, target companies may have policies or codes that resemble those of the acquiring company, but their implementation and practice may be worlds apart. For instance, employees in an acquired company that have never had access to a complaints procedure (but reported complaints to other forums including senior management) may need in-depth training on how to use a grievance procedure efficiently, to avoid flooding the system.

Ending or Renewing the Relationship

Assets can remain associated with a company after disposal.

Some companies undertake a specific review when they dispose of assets, and will not sell assets to a company that plans to run its project in a very different manner, or to a company with a disreputable history, because of concern for the company's reputation. One respondent noted that it is difficult to monitor compliance with company standards when disposals occur. In one case, the company set up a community foundation to ensure that, under the new buyer, the disposed company would continue the same standard of community relations. However, being difficult to monitor over time, such an arrangement was likely to require the assistance of other stakeholders such as the government, local civil society and community leaders.

Disinvestment due to human rights challenges can pose difficult dilemmas.

Some respondents pointed out the dilemmas that can arise when companies disinvest from countries where the human rights situation had worsened, noting at the same time that human rights campaigns often call for disinvestment from such countries. They observed that disinvestment decisions require companies to balance carefully their commitments to local staff, the impact of disposal on local communities, and broader economic considerations. A company needs to know who will replace its services or activities, and how these will be managed and delivered after the company departs.